

Regulatory Accounts 2010





SOUTH WEST WATER

**REGULATORY ACCOUNTS
FOR THE YEAR ENDED
31 MARCH 2010**

This report is published in accordance with the requirements of the
Water Services Regulation Authority

REGISTERED OFFICE: Peninsula House, Rydon Lane, Exeter EX2 7HR
REGISTERED IN ENGLAND NO 2366665

REGULATORY ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2010

CONTENTS

Page No

3	Directors, Registered Office and Auditors
4	Operating & Financial Review
21	Directors' Responsibility Statement
22	Directors' Certificates to the Water Services Regulation Authority
23	Independent Auditors' Report
26	Historical cost financial statements and accompanying notes
65	Reconciliation between Statutory (IFRS) Accounts and Historical Cost Regulatory Accounts
68	Current cost financial statements for the appointed business and accompanying notes
81	Additional information required under Condition F of the Company's licence

DIRECTORS, REGISTERED OFFICE AND AUDITORS

Chairman	K G Harvey
Chief Executive	C Loughlin
Operations Director	S C Bird
Finance Director	S J Davy
Customer Service Director	M S Read
Non-Executive Director	M O J Taylor (Appointed 1 st March 2010)
Secretary	K D Woodier
Registered Office	Peninsula House Rydon Lane Exeter EX2 7HR
Auditors	PricewaterhouseCoopers LLP Chartered Accountants and Statutory Auditors 31 Great George Street Bristol BS1 5QD
Registered Number	2366665

OPERATING AND FINANCIAL REVIEW

South West Water performed strongly this year, improving its customer service, delivering further operational efficiencies and achieving sound financial results. It has now successfully completed the 2005 – 2010 regulatory contract and has a solid platform in place for continued success during the next regulatory period (2010 – 2015).

The company continues to be led by its vision of 'Pure Water, Pure Service and Pure Environment'. Underpinning this vision is the strategy of striking the right balance between investing to improve our services, customer affordability and financeability.

In November 2009 Ofwat announced its Final Determination of the company's business plans and set price limits for the period 2010 - 2015. This confirmed average real price increases of 1.9% over the next five years.

Throughout the Periodic Review process, our focus was on safeguarding our many achievements of the last 20 years through investment where needed whilst delivering stable bills for our customers. Our future plans continue to reflect customer priorities but we have also challenged ourselves to deliver further cost efficiencies beyond those set by Ofwat.

Many of our key operational results and achievements over the last 12 months demonstrate the benefits of our 'Pure Water, Pure Service and Pure Environment' approach.

During 2009/10, the company delivered significant improvements in both operational and customer service performance across a range of key measures, which will provide a springboard for the challenges to come.

BUSINESS AND STRATEGY

South West Water is the licensed water and sewerage service provider for Devon, Cornwall and parts of Dorset and Somerset. The company serves a region of nearly 10,300 square kilometres with over 1.65 million residents. In addition over 39 million visitor nights as recorded by South West Tourism were spent in the region in 2009. On average each day it distributes over 420 Megalitres (Ml) of treated water and disposes of around 235 Ml of waste water each day through an asset base comprising:

Distribution mains	15,058 km
Sewers	9,288 km
Impounding reservoirs	15
Water treatment works	39
Waste water treatment works	634
- including 55 works with ultra violet treatment and three with membrane filtration	
Intermittent discharges	1,668
- including 1,029 combined sewer overflows	

Since privatisation in 1989 the company has successfully delivered the largest capital programme per capita of any of the privatised water and sewerage companies with an initial focus on improving coastal waste water treatment and disposal. The region currently has 144 EU designated bathing waters, almost one third of the total in England and Wales, and 132 of these have been improved over the last 18 years from the company's marine investment programme. Following completion of a complete overhaul of water resources, water treatment and distribution over the same period we are able to demonstrate major improvements in water quality supply and reliability for our customers.

South West Water expects to create value through delivering the regulatory contract agreed with Ofwat. The contract scope is reviewed every five years. As well as determining outputs, Ofwat sets prices to enable efficient companies to earn a reasonable rate of return on their assets.

OPERATING AND FINANCIAL REVIEW (continued)

In the new regulatory period starting in April 2010 Ofwat has assumed that the equity cost of capital for all companies will be 7.1% real after tax with an overall weighted average cost of capital of 4.5% real after tax.

South West Water has a clear 25 year vision 'Pure Water, Pure Service and Pure Environment', which was at the heart of our Strategic Direction Statement published in December 2007. Underpinning the vision is the strategy of striking the right balance between investing to improve our services, financeability and, importantly, customer affordability.

The vision defines the following aspirations for South West Water:

Pure Water – investment in maintaining our assets to give our customers the highest quality drinking water

Pure Service – improving the services that customers experience.

Pure Environment – delivering sustainable sewerage services for the region's benefit.

Focussing on our 'Pure' vision has assisted the company in delivering a strong set of results both and financially and operationally. This has also ensured there is a solid platform in place for future progress to be made. Ofwat's Final Determination for 2010 – 2015 represents a tough challenge for the company but it is one we have accepted and are determined to deliver.

To meet this challenge, we have:

renegotiated our key operational contracts with service partners to create more innovative ways of working and further cost efficiencies, including establishing the new incentivised 'H₂O' Delivery Alliance to deliver the capital programme

invested in a more centralised operating structure employing increased levels of automation continued our organisational restructuring drive to sustain our services through flexible working while securing efficiencies. It is expected that a further £4m will be provided for restructuring costs in 2010/11

successfully reduced our energy consumption through our 'Megawatt Challenge' company wide initiative. Staff-led energy saving projects resulted in overall energy savings of 6.5 GWh, a reduction of around 3,500 tonnes of CO₂ and a cost saving of around £600,000 per annum. Further energy savings will be delivered by our 'PowerDown' programme which is in place to achieve further energy usage and cost reductions between 2010 and 2015.

REGULATORY & COMPETITIVE ENVIRONMENT

COMPETITION

Customers using more than 50Ml of water per year can contract with alternative suppliers for water supply. South West Water has 36 customers in this category, whose aggregate water charges account for approximately 1.5% of its total water and sewerage revenue, or 3.2% of its water revenue. No single customer accounts for more than 1% of revenue.

The Government's independent review of competition and innovation in the water industry led by Professor Martin Cave published its final recommendations in April 2009. Legislation will be required for any further significant extension of competition in the water and sewerage markets. During the year Ofwat consulted on arrangements for extending the current 50Ml criteria for competition under Water Supply Licensing to cover customers using more than 5Ml. This extension to the existing competition regime is expected to apply during 2010/11. Ofwat has published a number of consultation papers concerning the potential for future retail and upstream market reform.

OPERATING AND FINANCIAL REVIEW (continued)

The review into fairer water charges commissioned by Defra, known as the Walker Review, was concluded in 2009. The review noted that, while the regulatory regime in the water industry has served customers well over the last twenty years, improvements can be made to address the twin aspects of affordability and fairness for water customers. The Government has asked Ofwat to advise it on one or more of a number of options to address the issue of water bills in the South West:

- A one-off or other financial adjustment by Government.
- Contributions by other water customers across the country.
- A package of tariff proposals for South West Water customers.

Ofwat and South West Water have established a joint working group to develop and examine the options which could address the issues identified by the Walker Report.

PRICE CAP REGULATION

Ofwat regulates water and waste water charges by determining the maximum increase in charges which a company can impose in any year. The water regulator conducts a Periodic Review and sets price limits every five years. Prices are set by reference to inflation as measured by the Retail Price Index (RPI) plus an adjustment factor known as 'K' which is specific for each company.

The 'K' factors for the period 2005 to 2010 for South West Water were determined by Ofwat in its Final Determination in December 2004 and are:

Year	'K' factor %
2005/06	12.5
2006/07	9.8
2007/08	9.8
2008/09	1.7
2009/10	1.4
Average	6.9

In setting price limits for South West Water, Ofwat assumed the following annual efficiency improvements:

	Operating Costs	Capital Maintenance	Capital Enhancements
Water	2.5%	5.0%	5.0%
Sewerage	2.0%	8.7%	16.4%

The 2004 Final Determination provided for total capital expenditure of £762 million (2002/03 prices on a UK Generally Accepted Accounting Principles basis) over the five year period. All the major outputs were achieved, as set out in the following table:

Activity	2005-2010	Status at 31 March 2010
Adequacy of water resources	Security of Supply Index to be maintained at 100	Security of Supply Index was 100. No water restrictions for 13 th consecutive year
Leakage control based on three year rolling average	Maintain at 84 megalitres per day (Ml/d)	82Ml/d achieved in 2009/10
Asset condition above ground	Maintain stable	Stable
Asset condition below ground	Maintain stable	Stable
Meet Drinking Water Inspectorate milestones for water mains rehabilitation	Complete five milestone packages of improvements	Completed
Continuous discharges dealt with	Complete 95 schemes by 31 March 2010	Completed
Improvements to intermittent sewage overflows	Complete 113 schemes by 31 March 2010	Completed

OPERATING AND FINANCIAL REVIEW (continued)

The 'K' factors for the period 2010 to 2015 for South West Water were determined by Ofwat in its Final Determination in November 2009 and are:

Year	'K' factor %
2010/11	1.1
2011/12	3.4
2012/13	2.5
2013/14	1.3
2014/15	1.1
Average	1.9

The 2009 Final Determination provided for total capital expenditure of £705 million (2007/08 prices on a UK Generally Accepted Accounting Principles basis) over the five-year period 2010-2015.

LEGISLATIVE DRIVERS

The water industry in the UK is subject to substantial national and EU regulation. This places significant statutory obligations on South West Water with regard to, amongst other things, the quantity of water abstracted, and the quality and quantity of waste water discharged. Examples of relevant EU directives include the Drinking Water Directive, the Habitats Directive, the Urban Waste Water Treatment Directive and the updated Bathing Water Directive.

The Water Framework Directive was incorporated into UK law in 2003. It provides a framework for the protection of and improvement in the quality of water resources, together with the promotion of sustainable water consumption. To comply with the Water Framework Directive, EU member states will have to achieve the challenging target of 'good status' for groundwater, rivers, estuarine waters and coastal waters, in three six-year cycles, the first running from 2009 to 2015. The Final River Basin Management Plan, published by the Environment Agency in December 2009, confirmed that the Plan's implications are unlikely to require changes to South West Water's assets at least until 2015, due to the successful delivery of a wide range of river, estuarine and coastal water environmental improvements by the company since 1989.

Further significant legislative developments are expected for the water industry following introduction of the Flood and Water Management Act in April 2010. Many of the legislative changes will implement the recommendations of the Pitt Report which was commissioned after the severe flooding in other parts of the country in summer 2007.

CLIMATE CHANGE

South West Water is working closely with many organisations to assess the implications of climate change for water supply and waste water services. Adaptation and mitigation plans are being developed which will involve innovative approaches and new methods of influencing catchment behaviour upstream of its water supply systems, in sewered areas and downstream of its waste water systems to protect the wider environment.

The company's final Water Resources Plan for the next 25 years was published in the summer of 2009 and was approved by Defra. It includes information relating to rainfall and temperature variations. The plan includes allowances for demand changes associated with climate change. Predictive models are in place to address uncertainty. Infrastructure developments have been identified, the timing of which can be adjusted if the expected rate of climate change alters. Increasingly efficient and careful use of water play a major part in adapting to the expected effects.

OPERATING AND FINANCIAL REVIEW (continued)

KEY PERFORMANCE INDICATORS (KPI's)

Key Performance Indicators (KPIs) – Pure Water

In 2009/10, South West Water abstracted 160,771 Megalitres (MI) of raw water from its 82 licensed abstraction locations which have a total licensed volume of 388,366 MI. The abstraction sources are reservoirs and rivers, accounting for 93% of supplies, with 7% drawn from groundwater aquifers.

Drinking Water Compliance

Tap water quality, as measured by Mean Zonal Compliance, is the Drinking Water Inspectorate's preferred method for water quality assessment. In 2009 we maintained the best ever compliance value of 99.98% (2008: 99.98%).

Key Performance Indicators – Pure Service

Overall Performance Assessment

The Overall Performance Assessment (OPA) index is maintained by Ofwat as a comparative tool to measure companies' performance. The OPA is based on performance in areas such as customer service and complaint handling, billing, debt collection, asset serviceability, environmental compliance and quality of drinking water delivered. In 2008/09 South West Water's performance moved to eighth place amongst the ten water and sewerage companies (seventh in 2007/08) but the number of OPA points for that year increased from 380 to 394. For 2009/10 the number of OPA points increased further to 411 but the relative places of water and sewerage companies have not yet been published.

Ofwat has announced that OPA will be replaced with a new measure of water industry customer performance called the Service Incentive Mechanism. 2010/11 data will be reported on this new basis.

Customer Satisfaction Call Handling

Ofwat measures the overall manner in which a customer call is handled. The measure is obtained by quarterly tracking surveys undertaken by an independent company engaged and managed by Ofwat. The data is averaged for the year to assess a performance trend. For 2009/10 the satisfaction score was 4.53 (2008/09 4.5). The maximum score is 5.0.

Key Performance Indicators – Pure Environment

The Company recognises the importance of its environmental responsibilities, monitors its impact on the environment, and designs and implements policies to reduce any damage that might be caused by its activities. The Company is subject to significant regulation and must comply with the high standards set by the Environment Agency. The Pennon Group has a long established environmental policy, as set out in its annual Corporate Responsibility Report, which does not form part of this Report.

Waste Water Treatment Compliance

The percentage of population equivalent served by sanitary-compliant waste water treatment works in the calendar year 2009 was 99.70% (99.50% in 2008).

This consistently high performance contributes to South West Water's region having the highest percentage length of high quality rivers in England.

OPERATING AND FINANCIAL REVIEW (continued)

Incidents and Prosecutions

There were no Category 1 incidents for the 11th year in succession. Two Category 2 (significant pollution) events and 69 Category 3 events were recorded by the Environment Agency in 2009 which were deemed non-compliant with discharge consents. This compares with three Category 2 incidents and 64 Category 3 incidents in 2008. The total number of wastewater pollution incidents in 2009 was 106 (2008: 92). 41% of the Category 2 and 3 incidents in 2009 were identified by the company and self-reported.

During the year the company was convicted on four occasions for environmental offences and fined a total of £11,500 (2008/09 four convictions and fines of £28,100).

The company always self-reports incidents it becomes aware of and co-operates fully with any investigation undertaken by the relevant regulatory authority. After each pollution incident, including incidents leading to prosecution, the company takes such steps as are necessary to ensure that the incident will not be repeated and also seeks to ensure that lessons learned are widely disseminated throughout the company.

Bathing Water Performance

Compliance with the mandatory EU bathing water standard was 96.5% in the 2009 calendar year, a marked contrast to a decade ago when compliance was only 42.6%. This compares to 93.1% for 2008. In 2009, all but 5 of the region's 144 bathing waters achieved the EU mandatory standard and 73.6% achieved the more stringent EU Guideline standard (72.2% in 2008).

Key Performance Indicators – Financial and Business

Growth in Regulatory Capital Value

Regulatory Capital Value (RCV) is the financial base used by Ofwat to allow a rate of return and set prices at each Periodic Review. The RCV at 31 March 2010 amounted to £2,620.9m. After adjustment for AMP5 log up/down and other Final Determination adjustments the figure is £2,554.9m which represents an increase of 3.8% in the year. From 31 March 2005 to 31 March 2010 the company achieved a 31% growth in RCV, the highest percentage increase of any quoted UK water company.

Net debt decreased by £23.9m to £1,547.2m, with the gearing ratio in relation to adjusted year-end RCV of £2,554.9m moving to 60.6% from 63.8%.

The growth in RCV adds directly to shareholder value as the allowed return is attributed to South West Water's asset base by the water regulator.

Operating Profit

South West Water achieved an operating profit (on a UK GAAP basis before restructuring costs of £5.0m) of £194.0m in 2009/10, up £5.7m from 2008/09.

Key Performance Indicators – Health and Safety Performance

The health, safety and welfare of the company's employees remain paramount in all its activities. The company has a health and safety strategy which focuses on providing strong leadership, engaging with employees, building competence and measuring performance. These principles are promoted by a health and safety steering group comprising a cross section of directors, managers and employee representatives.

OPERATING AND FINANCIAL REVIEW (continued)

Occupational health and safety are key elements of the company's risk management and internal control processes. We continue to pursue initiatives to improve further the welfare of the company's employees through the provision of training on and promotion of good health and practices.

RIDDOR incidents per 1,000 employees totalled 13 in 2009 compared to 21 in 2008 and we welcome this improvement.

CORPORATE RESPONSIBILITY/RELATIONSHIPS

Governance and Internal Control

The Board of Directors generally meets eleven times a year to review both non-financial and financial data. The Group control environment is set out in the annual report of Pennon Group Plc.

Formal risk assessment is undertaken quarterly. As part of Pennon Group Plc, the Company's controls and risk management are subject to assessment by the Pennon Group Plc internal audit functions and reviewed by the Pennon Group Plc Audit Committee.

The Company is aware of its responsibilities for effective reporting of financial and non-financial data. Data is reviewed regularly at Board level and, in addition, special meetings are held with the Executive Management Board and the Reporter and Auditor, and the Board and the Reporter.

As well as the risk management policy of the Company there is an established internal control framework which comprises:

- (a) a clearly defined structure which delegates an appropriate level of authority, responsibility and accountability, including responsibility for internal financial control, to management
- (b) a comprehensive budgeting and reporting function with an annual budget approved by the Board of Directors, which also monitors monthly achieved results and updated forecasts for the year against the budget
- (c) documented financial control procedures. Managers are required to confirm annually that they have adequate financial controls in operation and to report all material areas of financial risk. Compliance with procedures is reviewed by the Company's internal audit function
- (d) an investment appraisal process for evaluating proposals for all major capital expenditure and acquisitions, with defined levels of approval and a system for monitoring the progress of capital projects
- (e) a process of signing off all non-financial information included in returns to Ofwat.

Customer, Community and Employees

Customers

South West Water has consulted with customers about its priorities for 2010-2015 and this feedback has been central to the development of its customer service improvement plans to deliver its Pure Water, Pure Service and Pure Environment strategy.

Providing help and support to customers in need is at the heart of the company's Pure Service strategy and accordingly the company remains an industry leader in the provision of priority services to vulnerable customers. In 2009/10 the company has helped thousands of customers with reading their meter or by providing extra help in an emergency.

OPERATING AND FINANCIAL REVIEW (continued)

'WaterCare', the company's industry-leading scheme to support customers who have difficulty in paying their bills, completed a third successful year. Since the start of the programme over 7,000 customers have been helped with benefit entitlement checks, tariff advice and water-saving measures. The 'WaterCare' programme has been commended by the Government.

Customers are kept informed about our services through 'WaterLevel', our company newspaper, leaflets, the media and our website www.southwestwater.co.uk. Consultation with customers and stakeholders has an influence on the improvements made to our literature and website as we seek to provide information of interest in increasingly accessible ways.

The company meets regularly with the Consumer Council for Water (CCWater), which champions the interests of water customers. It regularly consults with CCWater and other stakeholders such as pensioners' forums and Citizens Advice, prior to introducing major changes or initiatives.

The company continues to promote the efficient use of water with advice and practical support for householders and non-domestic customers.

The company continues to support business customers through water efficiency reviews, waste minimisation projects, providing advice for water management plans and by highlighting opportunities for reduction, re-use or alternative sources of supply. An education programme for schools has also been developed this year to extend the spread and reach of this work. As part of the 'WaterCare' programme and to investigate customers' high water consumption queries 2,831 audits were completed in 2009/10 (2008/09 3,088).

Business customers continue to have access to a secure online system which tracks and displays consumption on their sites. South West Water's 'Business Accounts Online' also offers a water efficiency calculator with a free water audit.

No single customer accounts for more than 1% of revenue.

Community, Corporate Responsibility and Sponsorship

South West Water concentrates its sponsorship on community projects and organisations within its service area which are linked to water, benefit the environment or promote youth participation.

Highlights in 2009/10 included the staging of a series of environmental walks with Cornwall Wildlife Trust around the coastline to mark the completion of a pipe replacement scheme at Looe and the sponsoring of the 'Nipper' youth championships of the Surf Life Saving Association of Great Britain at Falmouth.

Other supported events ranged from the TRAIL environmental art sculpture festival on the South West Coast Path between Dawlish and Shaldon and the opening of Pynes Water Treatment Works, Brokenbury Waste Water Treatment Works and Mary Tavy Hydro for guided public tours during the national Heritage Open Days.

For the third year, the company also co-sponsored South West Tourism's annual awards and funded the sustainable tourism prize. This demonstrates how its 'Clean Sweep' project has helped underpin the renaissance of tourism, the region's number one industry. The company is also proud to continue to support the water industry charity, WaterAid, through sponsorship and many other fund-raising activities such as the publication of a calendar featuring water-themed photographs taken by Group employees.

The company achieved a 'Green Apple' award for transforming a disused sludge lagoon into a pond for wildlife with a number of other habitat improvements around the water treatment works site at Tottiford, near Bovey Tracey. This project was shortlisted as a finalist in the Community Campaign of the Year category of the Water Industry Achievement Awards. This recognises the way the company engaged with adults with learning difficulties for the supply of bat, bird and dormouse boxes now fitted across the site.

OPERATING AND FINANCIAL REVIEW (continued)

Employees

South West Water's people strategy continues to focus on recruiting and developing individuals who can support the delivery of the company's 'Pure' vision, enabling the provision of a high quality service to customers and the achievement of operational efficiencies.

Technical and managerial skills training have underpinned the company's Puros project. A range of other programmes to support the development of customer facing and operational skills continue to form a fundamental part of our strategy.

Employee involvement and participation in all aspects of business and organisational change is encouraged and supported through the company's Staff Council, and craft and industrial consultative forums.

The company holds the 'Investor in People' (IIP) Silver Status, which represents the achievement of a high standard in IIP evidence requirements.

The Company as a 'good employer' has been introducing a number of 'Family Friendly' policies, which exceed statutory requirements. All employees are entitled to participate in a Pennon Group Sharesave Scheme and a Pennon Group Share Incentive Plan, both of which are all-employee plans where performance conditions do not apply.

The Company remains committed to a non-discriminatory employment policy, making every reasonable effort to ensure that no current or future employee is disadvantaged because of age, gender, religion, colour, ethnic origin, marital status, sexual orientation or disability. In particular, the Company welcomes applications for employment from disabled persons and makes special arrangements and adjustments as necessary to ensure that disabled applicants are treated fairly when attending for interview or for pre-employment aptitude tests. Wherever possible, the opportunity is taken to re-train people who become disabled during their employment in order to maintain their employment within the Company.

Key Relationships

Regulators and others

Relationships with regulators, Government and its agencies, customer representative organisations and its customers are central to South West Water's operations. The Company maintains a continuing dialogue with Ofwat, the Environment Agency and the Drinking Water Inspectorate. It contributes to national policy on developing issues through its membership of Water UK, the industry trade body. The company works with the Consumer Council for Water to ensure that customers' issues and concerns are addressed and a full understanding of the company's activities is maintained.

Procurement and Suppliers

South West Water's procurement strategy is focused on partnering and strategic alliances with 60 key suppliers who account for the large majority of expenditure. Regular meetings are held to manage performance, encourage sustainable business activity and to identify and deliver continuous improvement opportunities for reducing costs further whilst improving performance and service levels.

The company has successfully completed a tender programme of strategic contracts in preparation for the K5 (2010 to 2015) period and has established a new 'H₂O Alliance' structure for delivery of its 2010-15 capital programme. This will enable the company to work closely with suppliers, particularly small and medium-sized businesses across the South West, ensuring value-for-money for customers and supporting the regional economy.

OPERATING AND FINANCIAL REVIEW (continued)

No supplier (revenue) accounts for more than 5% of the turnover and South West Water sources all its purchases from competitive markets.

Payments to suppliers

It is the Company's payment policy for the year ending 31 March 2011 to follow the Code of The Better Payment Practice Group on supplier payments. The Company will agree payment terms with individual suppliers in advance and abide by such terms. Information about the Code may be obtained from The Better Payment Practice Group's website at www.payontime.co.uk. Trade creditors at 31 March 2010 represented 26 days of the amount invoiced by suppliers during the year (2009: 29)

PRINCIPAL RISKS AND UNCERTAINTIES

The following are identified as the principal risks and uncertainties facing the Company:

Risk	Mitigation
Tighter price controls over the revenue of the company's regulated business	The current periodic review was completed in November 2009 when Ofwat set water company charges for the years 2010 – 2015. South West Water has met Ofwat's efficiency expectations in the last three Periodic Review periods.
Failure to deliver the capital investment programme	The company has a track record of delivering its capital programme in accordance with regulatory requirements and progress is regularly monitored and reviewed. The K4 capital programme has been delivered and the company has developed plans to deliver the K5 programme.
The company may be unable to raise sufficient funds to finance its functions	Pennon Group and the company have robust treasury policies in place. These include policies that there are always pre-drawn or committed facilities to cover at least one year's estimated cashflow and that no more than 20% of borrowing matures in any one year.
Failure to deliver operating cost savings implicit in the regulatory review	In line with its track record, the company remains confident of delivering the assumed operating cost savings. A major restructuring programme is currently being implemented to contribute towards the additional efficiencies required for the K5 period.
Environmental regulations and quality standards could increase the company's costs	These issues are addressed through the five year regulatory price review mechanism.
Climate change	The company has plans ready and will adapt the way it conducts its business to respond effectively to the hotter, drier summers and wetter winters which are anticipated.

OPERATING AND FINANCIAL REVIEW (continued)

Risk	Mitigation
Contamination to water supplies	The Company has established procedures and controls in place, as well as contingency plans and incident management procedures. It also maintains insurance policies in relation to these risks, although there can be no assurance that all or any of the costs associated with these risks would be covered or that coverage will continue to be available in the future.
Non-recovery of customer debt	In addition to existing strategies, which are kept under review, South West Water continues to implement new initiatives to improve and secure cash collection, including the use of property charging orders. Stretching debt and collection targets – with incentives – have been agreed with our customer service contractor. The accounts of major customers are kept under close review. Provision has been made in the K5 Final Determination for companies to make an application for an Interim Determination in the event of household bad debts being significantly above the amount allowed by the water regulator due to worsening economic circumstances in the company's operating area.
Pension costs may increase due to factors outside the company's control	All defined benefit schemes have been closed to new entrants and replaced by defined contribution arrangements.
Poor investment performance may affect the defined benefit scheme assets and increase the pension scheme deficit	Employee and employer contributions are kept under review and have been increased. Further contributions of £9.9m were made in the year. Pension trustees keep investment policy under review and use professional investment advisers.
Water resource adequacy	The company has a number of schemes in place to maintain water resources (such as pumped storage for certain reservoirs) and promotes conservation measures. In particular, South West Water prepares a new Water Resources Plan every five years and reviews it annually for a range of climate change and demand scenarios. The Water Resources Plan indicates that no new reservoirs are required before the planning horizon of 2035. However, investment is needed to develop the overall trunk main infrastructure, to expand treatment capacity and to enhance certain pumped storage facilities.
Operational failures	The company is able to monitor its significant assets by automated and remote operation and has routine controls and operating procedures in place that are constantly kept under review. Asset management techniques are employed to pre-empt the failure of assets.

OPERATING AND FINANCIAL REVIEW (continued)

Risk	Mitigation
Reduced revenue from falling customer demand for water	The reduced demand experienced in the K4 regulatory period has been taken into account by the regulator in setting a baseline turnover level for the K5 period. A revenue correction mechanism is in place from the start of the K5 period, which allows water companies to recover a shortfall in income for a five year regulatory period in the next period.
Financial loss arising from the insolvency of a major supplier or contractor	The company does not have material exposure to payment before receipt of goods and services. The company uses a third party credit monitoring service for changes to major suppliers' financial status and creditworthiness to supplement an annual risk review of key and strategic suppliers.
Impact of competition in the industry	The company continues to consider and evaluate developments and proposals in relation to development of competition as part of its risk management and business strategic planning processes. Legislation will be required for any further extension of competition in the water and sewerage markets.

The Directors have established a formal framework for the identification and monitoring of both operational and financial risks arising from the Company's activities.

OPERATING AND FINANCIAL REVIEW (continued)

FINANCIAL REVIEW

Financial Results

Turnover

Appointed business turnover for the year increased by 3.3% from £424.7m to £438.6m as a result of tariff increases and new connections, offset by the effects of customers switching. Within this, turnover from main water and sewerage charges, including large user revenues, was £428.3m (2009: £411.4m). Approved tariff increases, including the 1.4% K factor, amounted to £20.9m. 5,000 new customer connections contributed £2.9m of additional turnover in main charges.

The effect of meter option switchers was to reduce turnover by £7.0m, benefiting 17,890 customers (2009: 23,162 customers) by, on average, about £380 each (2009: £372 each). 68% of South West Water's domestic customers are now metered (2009: 66%).

Measured demand was consistent with the prior year after a fall of an average 4.2% in 2008/09. The improved demand compared to 2008/09 was in part reflective of the stronger tourism season in the South West.

Whilst demand improved in 2009/10, turnover continued at levels lower than that assumed in the PR04 Final Determination (FD 04). In 2009/10 the overall shortfall was £15.7m, with the largest elements being £12.1m due to falls in measured demand for both domestic and commercial customers and £7.9m from 16,963 additional meter optants compared to the FD 04 and an average loss per meter optant being over 50% higher than allowed. Other income, including third party sales, was lower than FD 04 by £3.4m, mainly due to the impact of the recession on third party sales, particularly mains diversions.

These turnover shortfalls against FD 04 were partly offset by £7.7m that arose due to the timing difference between the average RPI in 2009/10 of 0.4% used to re-price the FD 04 and the 3.0% tariff year RPI which applied to 2009/10 actual turnover, leading to overall turnover being less than FD 04 by £15.7m (2008/09 £23.4m).

Operating Costs

Total Appointed business historic cost operating costs, including depreciation, rose from £244.1m to £251.1m.

The key increases have been:

- Price increases above average inflation due to the market costs of power and strategic contract where price rises are agreed prior to the start of the financial year.

- Additional costs for new capital schemes and increased health and safety costs.

- Lower net property sales.

Offset by:

- Efficiencies in manpower, hired and contracted services, power usage across the company and saving on EA charges due to the introduction of Operator Self Monitoring (OSM).

- Lower costs associated with third party sales.

OPERATING AND FINANCIAL REVIEW (continued)

Total depreciation charges increased by £2.1m from £70.8m to £72.9m reflecting the impact of the company's capital expenditure programme, with the infrastructure renewals charge increasing from £26.3m to £28.1m.

The company's restructuring programme continued in the year with £5.0m charged to the profit & loss account (2008/09 £5.0m)

The pension cost charged to the profit & loss account continues to be lower than the FD 04 due to the adoption of FRS 17 in the regulatory accounts. The difference was £2.5m in the year. However, this masks the payments made which are recognised through reserves rather than through the profit and loss account, in line with accounting standards. Payments to the pension scheme in 2009/10 (in line with the actuarial update at March 2009) totalled £9.9m, with £8.8m representing further deficit recovery payments and £1.1m relating to the crystallisation of liabilities following the cessation of a joint venture in 2007/08. Over the K4 period, the company has made cash contributions to the pension scheme which have equated to more than double the amount allowed in the price limits in FD 04.

The charge for bad and doubtful debts increased in the year by £0.6m from £12.0m to £12.6m. During the year £5.9m (2008/09 £4.9m) of debts were written off against the provision, of which £0.9m related to the company's Restart programme, a customer affordability initiative.

Despite the downturn in the property market, property disposals in the year contributed £1.0m to profit (2009: £1.7m profit)

The Ofwat target of efficiency cost savings by the end of the K4 period was achieved ahead of schedule. New efficiency projects in 2009/10 have created a platform to enable further improvements to operational and customer service performance.

Efficiencies were broadly achieved in the following areas:

Manpower costs: reduction in staff numbers and overtime levels; increased productivity through mobile working and improved balance of planned to reactive work; absorption of additional work; changes in terms and conditions.

Use of materials and contracted services: examples including rightsourcing reviews; improved chemical management; process rationalisation; proactive asset management philosophy with targeted investment to improve asset reliability.

Other costs: reduced energy usage; more robust flow volume data reducing compliance charges; overhead reductions.

There have been no changes of policy in respect of current cost depreciation and the infrastructure renewals charge. The current cost depreciation charge at £96.5m is higher by £6.5m.

The infrastructure renewals charge is in line with the average of the past 5 years and projections for the next 10 years, as deemed appropriate by the company and in line with regulatory accounting guidelines.

OPERATING AND FINANCIAL REVIEW (continued)

Investment

Capital expenditure in the year was £152.1m (including £23.8m of infrastructure renewals expenditure) compared to £157.8m in 2008/09.

£82.1m was invested in water supply improvements including water mains renovation and water treatment works enhancement. The water mains renovation programme to replace or reline water mains was completed in December 2009 with a further 104 km replaced or refurbished in the year. During the K4 regulatory period a total of 2,280km of mains have either been completed, providing improved compliance with iron standards and reduced incidents of discoloured water for customers. A new trunk main to safeguard South Devon's water supply was completed, as well as a second water main to bolster Cornwall's water supply. Park Lane on Bodmin Moor, the company's fifth biggest reservoir is now operational while work has started on converting nearby Stannon Lake into the company's fourth biggest reservoir.

This has been our 13th consecutive year without water restrictions.

Capital investment in the year for the waste water business totalled £70.0m including progress on the final parts of the 'Clean Sweep' programme such as the treatment works at Boscastle, Bossiney and Tintagel. There has also been investment at a number of sewage treatment works to increase capacity and deliver environmental benefits by treating previously untreated sewage.

Targeted investment in capital maintenance programmes ensured that serviceability was assessed as 'stable' for all the company's areas of service.

Capital expenditure for the year included £9.7m advance expenditure on K5 projects agreed by the Regulator.

Taxation

The overall tax charge for the appointed business for the year decreased by £10.3m from £28.9m to £18.6m.

Within the tax charge the current corporation tax charge increased by £10.3m, from £20.1m to £30.4m, the main reasons for the increase being a higher profit before tax and lower pension deficit payments (which attract relief as payments but are not charged to the profit and loss account).

The charge for deferred tax was reduced by £20.6m from a charge of £8.8m in 2008/09 to a credit of £11.8m in 2009/10. The main reasons are the increase in the discount applied to the provision of £11.9m (discount rates at 31 March 2009 were particularly low, reducing the value of the provision) and movements relating to the increased pension deficit.

Financing

Net interest payable decreased by £5.8m to £64.1m from £69.9m, reflecting generally lower interest rates, including a lower charge for the index-linked bond. Net debt at 31 March 2010 was £1,547.2m compared to £1,571.1 at 31 March 2009, a decrease of £23.9m. This is lower than the increase of £115.9m in 2008/09 due mainly to a higher profit before tax and lower pension fund and dividend payments compared to the prior year when backlog payments for both produced untypically high cash outflows.

At 31 March 2010 loans and finance lease obligations were £1,812.1m and the company held cash and deposits of £264.9m (of which £33.2m was on restricted deposit).

OPERATING AND FINANCIAL REVIEW (continued)

Pennon Group and the company have robust treasury policies in place. These include policies that there are always pre-drawn or committed facilities to cover at least one year's estimated cashflow and that no more than 20% of borrowing matures in any one year. The Treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintain reasonable headroom for contingencies and manage interest rate risk. It operates within policies approved by the Board and does not undertake any speculative trading activity.

Funding facilities are in place to cover both medium and long term requirements, including loans from the European Investment Bank. In addition, short term facilities exist with a range of financial institutions.

Short term facilities in place at 31 March 2010 and not utilised totalled £110.0m (2009: £124.0m). In addition the company has short-term uncommitted bank facilities of £60.0m (2009: £80.0m).

Derivatives, usually interest rate swaps, are used to manage the mix of fixed and floating rate debt. The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and do not, therefore, constitute an exposure for the company.

The balance sheet value of derivatives moved from an overall liability of £18.5m at 31 March 2009 to a liability position of £17.7m at 31 March 2010. The movement is taken to reserves through the Statement of Recognised Income and Expense.

South West Water has approximately 25% of its debt index-linked to 2014-2057.

South West Water has entered into covenants with lenders. Whilst terms vary, these typically provide for limits on gearing (primarily based on Regulatory Capital Value) and interest cover.

Redemption penalties included in the facility documentation can be invoked if debt facilities are redeemed early. The redemption penalties vary in each facility.

The financial covenants included in the company's debt facilities are monitored on a regular basis. The financial covenants accepted by the company include a provision to re-test the covenants applying frozen GAAP accounting standards. This is to protect the company from changes in accounting standards that may have a detrimental impact on the financial covenant testing methodology.

South West Water's debt to Regulatory Capital Value (RCV) was 60.6% at 31 March 2010 (2008/09 63.6%), within Ofwat's 'optimum range' of 55% - 65%. The improvement in the gearing ratio is attributable to the reduced net debt and an increase in year end RCV due to the RPI movement.

The Board regularly monitors the Company's expected financial requirements for the next 12 months. These will be met from existing cash balances, loan facilities and cash flows for the coming year.

The Company has considerable financial resources and operates in a relatively stable, regulated business environment. Consequently the Directors believe that the Company is well positioned to manage its business risks successfully despite the current uncertain economic conditions.

OPERATING AND FINANCIAL REVIEW (continued)

Dividends and reserves

Dividends totalling £54.4m (2009: £103.8m) were paid to the parent undertaking, representing a base dividend for 2009/10 of £53.3m plus an additional £1.1m in respect of the previous two years taking into account actual movements in RPI. (The 2008/09 figure represented a 'catch up' after the share capital reduction during that year created sufficient distributable reserves on a statutory, IFRS basis, to release a backlog). These dividends were calculated with reference to the projections in the Final Determination 09.

The Company has established a dividend policy, which involves the following components:

A sustainable level of base dividend growth, determined by a number of factors including the shareholder's investment and the cost of capital.

A further level of growth funded by efficiency out-performance.

Consistency with the assumptions made by Ofwat in setting prices for the K4 period.

Dividend payments are designed to ensure that key financial ratios are not prejudiced and that the ability of the Appointee to finance its Appointed Business is not impaired.

FUTURE DEVELOPMENTS

The key factor affecting the Company's performance for 2010/11 is the Periodic Review completed in November 2009 when Ofwat set water company charges for the years 2010-2015 giving 'K' price increases of 1.1%, 3.4%, 2.5%, 1.3% and 1.1% for 2010-2015 (an average of 1.9% p.a. over the five years). It also determined the investment outputs to be delivered by the Company over this period.

Key points of the Final Determination 09 are as follows:

A cost of capital of 4.5% (real, post tax basis) applicable to the whole industry

'K' price increases (above RPI inflation) averaging 1.9% per annum over the five years

A capital programme of around £705m at 2007/08 prices

A Capital Incentive Scheme (CIS) score of 105 (water) and 110 (sewerage), in line with the industry average

Operating efficiency improvements of 2.8% per annum, comparable with K4 delivery.

Over the period 2010-2015 average bills decreasing by 1% before inflation

Capital investment priorities, including protection and maintenance of the improvements made over the last 20 years, further improvements to meet EU Directives and their corresponding UK legislation, achievement of operating cost savings and delivery of projects to increase our levels of renewable energy generation and to improve sustainability of the company's activities.

Ofwat's Final Determination 09 represents a tough challenge but it is one the company accepts and is determined to deliver. To meet this challenge, we have:

renegotiated our key operational contracts with service partners to create more innovative ways of working and further cost efficiencies through establishing the new incentivised 'H₂O' Delivery Alliance to deliver the capital programme

invested in a more centralised operating structure employing increased levels of automation continued our organisational restructuring drive to sustain our services through flexible working while securing efficiencies. It is expected that a further £4m will be provided in 2010/11

successfully reduced our energy consumption through our 'Megawatt Challenge' company wide initiative. In addition to reducing our energy costs by 3GW this initiative also reduced our carbon footprint. Further energy savings will be delivered by our 'PowerDown' programme which is in place to achieve further energy usage and cost reductions between 2010 and 2015.

DIRECTORS' RESPONSIBILITY STATEMENT FOR THE REGULATORY ACCOUNTS

Statement of directors' responsibilities for regulatory information

Further to the requirements of company law, the Directors are required to prepare accounting statements which comply with the requirements of Condition F of the Instrument of Appointment of the company as a water and sewerage undertaker under the Water Industry Act 1991 and Regulatory Accounting Guidelines issued by Ofwat.

This additionally requires the directors to:

Confirm that, in their opinion, the company has sufficient financial resources and facilities, management resources and methods of planning and internal control for the next 12 months

Confirm that, in their opinion, the company has sufficient rights and assets which would enable a special administrator to manage the affairs, business and property of the company

Confirm that, in their opinion, the company has contracts with any associate company with the necessary provisions and requirements concerning the standard of service to be supplied to ensure compliance with the company's obligations as a water and sewerage undertaker

Report to Ofwat changes in the company's activities which may be material in relation to the company's ability to finance its regulated activities

Undertake transactions entered into by the appointed business, with or for the benefit of associated companies or other businesses or activities of the appointed business, at arm's length and

Keep proper accounting records which comply with Condition F.

These responsibilities are additional to those already set out in the statutory financial statements.

In the case of each of the persons who are directors at the time when the report is approved under Section 418 of the Companies Act 2006 the following applies:

- a) so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and
- b) he/she has taken all the steps that he/she ought to have taken as a director in order to make himself/herself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

The directors are responsible for the maintenance and integrity of the company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

DIRECTORS' CERTIFICATES TO THE WATER SERVICES REGULATION AUTHORITY

LICENCE OF APPOINTMENT - STATEMENT RELATING TO CONDITION K

At 31 March 2010 the Company had sufficient rights and assets to comply with the requirements of paragraph 3.1 of Condition K of the Licence from the Secretary of State for the Environment.

LICENCE OF APPOINTMENT - STATEMENT RELATING TO CONDITION F

The Board of Directors of South West Water Limited has resolved that a Certificate be issued to the Water Services Regulation Authority confirming:-

- (1) that in the opinion of the Directors, the Company will have available to it sufficient financial resources and facilities to enable it to carry out, for at least the next 12 months, the Regulated Activities (including the investment programme necessary to fulfil the Company's obligations under the Appointment); and
- (2) that in the opinion of the Directors, the Company will, for at least the next 12 months, have available to it management resources which are sufficient to enable it to carry out those functions.

C Loughlin
Chief Executive

25 June 2010

INDEPENDENT AUDITORS' REPORT TO THE WATER SERVICES REGULATION AUTHORITY AND THE DIRECTORS OF SOUTH WEST WATER LIMITED

We have audited the Regulatory Accounts of South West Water Limited ("the Company") on pages 26 to 80 which comprise:

- the regulatory historical cost accounting statements comprising the regulatory historical cost profit and loss account, the regulatory historical cost balance sheet, the regulatory historical cost cashflow, the regulatory historical cost statement of total recognised gains and losses, the historical reconciliation between the statutory financial statements and the Regulatory Accounts and the related notes including the statement of accounting; and
- the regulatory current cost accounting statements for the appointed business comprising the current cost profit and loss account, the current cost balance sheet, the current cost cash flow statement and the related notes including the statement of accounting policies.

This report is made, on terms that have been agreed, solely to the Company and the Water Services Regulation Authority ("the WSRA") in order to meet the requirements of Condition F of the Instrument of Appointment granted by the Secretary of State for the Environment to the Company as a water and sewage undertaker under the Water Industry Act 1991 ("the Regulatory Licence"). Our audit work has been undertaken so that we might state to the Company and the WSRA those matters that we have agreed to state to them in our report, in order (a) to assist the Company to meet its obligation under the Regulatory Licence to procure such a report and (b) to facilitate the carrying out by the WSRA of its regulatory functions, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the WSRA, for our audit work, for this report or for the opinions we have formed.

Basis of preparation

The Regulatory Accounts have been prepared in accordance with Condition F of the Appointment and the Regulatory Accounting Guidelines, the accounting policies set out in the statement of accounting policies and, in the case of the regulatory historical cost accounting statements, under the historical cost convention.

The Regulatory Accounts are separate from the statutory financial statements of the Company. There are differences between United Kingdom Generally Accepted Accounting Principles ("UK GAAP") and the basis of preparation of information provided in the Regulatory Accounts as the Regulatory Accounting Guidelines specify alternative treatment or disclosure in certain respects. Where the Regulatory Accounting Guidelines do not specifically address an accounting issue, then they require UK GAAP to be followed. Financial information other than that prepared wholly on the basis of UK GAAP may not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in financial statements prepared in accordance with the Companies Act 2006.

Respective responsibilities of the WSRA, the Directors and Auditors

The nature, form and content of Regulatory Accounts are determined by the WSRA. It is not appropriate for us to assess whether the nature of the information being reported upon is suitable or appropriate for the WSRA's purposes. Accordingly we make no assessment.

The Directors' responsibilities for preparing the Regulatory Accounts in accordance with Regulatory Accounting Guidelines are set out in the statement of directors' responsibilities for regulatory information on page 21.

INDEPENDENT AUDITORS' REPORT TO THE WATER SERVICES REGULATION AUTHORITY AND THE DIRECTORS OF SOUTH WEST WATER LIMITED (continued)

Our responsibility is to audit the Regulatory Accounts in accordance with International Standards on Auditing issued by the Auditing Practices Board, except as stated in the "Basis of audit opinion", below and having regard to the guidance contained in Audit 05/03 "*Reporting to Regulators of Regulated Entities*" issued by the Institute of Chartered Accountants in England and Wales.

We report to you our opinion as to whether the regulatory historical cost accounting statements present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of the appointee and its appointed business in accordance with the Company's Instrument of Appointment and Regulatory Accounting Guideline 2.03 (Guideline for classification of expenditure), Regulatory Accounting Guideline 3.06 (Guideline for the contents of regulatory accounts) and Regulatory Accounting Guideline 4.03 (Guideline for the analysis of operating costs and assets); and whether the regulatory current cost accounting statements on pages 68 to 80 have been properly prepared in accordance with Regulatory Accounting Guideline 1.04 (Guideline for accounting for current costs and regulatory capital values), Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03. We also report to you if, in our opinion, the Company has not kept proper accounting records as required by paragraph 3 of Condition F and whether the information is in agreement with the appointee's accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03.

We read the other information contained in the Regulatory Accounts, including any supplementary schedules on which we do not express an audit opinion, and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Regulatory Accounts. The other information comprises the Directors, Registered Office and Auditors information, the operating and financial review, the notes on regulatory information, and the additional information required by the Company's Regulatory Licence.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board except as noted below. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Regulatory Accounts. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the Regulatory Accounts, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Regulatory Accounts are free from material misstatement, whether caused by fraud or other irregularity or error. However, as the nature, form and content of Regulatory Accounts are determined by the WSRA, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under International Standards on Auditing (UK and Ireland).

Our opinion on the Regulatory Accounts is separate from our opinion on the statutory financial statements of the Company on which we report, which are prepared for a different purpose. Our audit report in relation to the statutory accounts of the Company (our "Statutory" audit) was made solely to the Company's members, as a body, in accordance with sections 495 and 496 of the Companies Act 2006. Our statutory audit work was undertaken so that we might state to the Company's members those matters we are required to state to them in a statutory auditor's report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume any responsibility to anyone other than the Company and the Company's members as a body, for our Statutory audit work, for our Statutory audit

INDEPENDENT AUDITORS' REPORT TO THE WATER SERVICES REGULATION AUTHORITY AND THE DIRECTORS OF SOUTH WEST WATER LIMITED (continued)

report, or for the opinions we have formed in respect of that Statutory audit.

The regulatory historical cost accounting statements on pages 26 to 64 have been drawn up in accordance with Regulatory Accounting Guideline 3.06 in that infrastructure renewals accounting as applied in previous years should continue to be applied and accordingly that the relevant sections of Financial Reporting Standards 12 and 15 be disapplied. The effect of this departure from Generally Accepted Accounting Principles, and a reconciliation of the balance sheet drawn up on this basis with that drawn up under Companies Act 2006 is given on page 66.

Opinion

In our opinion the Regulatory Accounts of the Company for the year ended 31 March 2010 fairly present in accordance with Condition F of the Instrument of Appointment granted by the Secretary of State for the Environment to the Company as a water and sewerage undertaker under the Water Industry Act 1991, the Regulatory Accounting Guidelines issued by the WSRA and the accounting policies set out on page 31, the state of the Company's affairs at 31 March 2010 on an historical cost and current cost basis, the historical cost and current cost profit for the year and the current cost cash flow for the year and have been properly prepared in accordance with those conditions, guidelines and accounting policies.

In respect of this information we report that in our opinion:

- c) proper accounting records have been kept by the appointee as required by paragraph 3 of Condition F of the instrument;
- d) the information is in agreement with the appointee's accounting records and has been properly prepared in accordance with the requirements of Condition F and, as appropriate, Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA;
- e) the regulatory historical cost accounting statements on pages 26 to 64 present fairly, under the historical cost convention, the revenues and costs, assets and liabilities of the appointee and its appointed business in accordance with the Company's Instrument of Appointment and Regulatory Accounting Guideline 2.03, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA;
- f) the regulatory current cost accounting statements on pages 68 to 80 have been properly prepared in accordance with Regulatory Accounting Guideline 1.04, Regulatory Accounting Guideline 3.06 and Regulatory Accounting Guideline 4.03 issued by the WSRA.

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors

25 June 2010

HISTORICAL COST PROFIT AND LOSS ACCOUNT for the year ended 31 March 2010

	Notes	Total 2010 £m	Total 2009 £m
Turnover	1(b) & 2	446.0	432.4
Operating costs	3	(185.1)	(180.0)
Depreciation	4	(72.9)	(70.8)
Profit on disposal of fixed assets		1.0	1.7
Operating Profit		189.0	183.3
Other income		0.8	0.8
Net interest payable	5	(64.1)	(69.9)
Profit on Ordinary Activities Before Taxation		125.7	114.2
Tax on profit on ordinary activities	6	(18.9)	(29.3)
Profit on Ordinary Activities After Taxation		106.8	84.9
Dividends	7	(54.4)	(103.8)
Retained profit / (loss) for year		52.4	(18.9)

HISTORICAL COST STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES for the year ended 31 March 2010

	Notes	2010 £m	2009 £m
Profit on Ordinary Activities After Taxation		106.8	84.9
Actuarial loss recognised in the pension scheme	22	(32.8)	(50.6)
Movement on deferred tax relating to actuarial loss	25	9.2	14.1
Movement on hedging reserve (net of tax)	25	(1.2)	(19.0)
Total gains recognised since last annual report		82.0	29.4

The notes on pages 31 to 64 form part of these historical cost regulatory accounts.

HISTORICAL COST PROFIT AND LOSS ACCOUNT for the year ended 31 March 2010 (continued)

Analysis of historical cost financial information between appointed and non-appointed business

	Appointed Business £m	Non- appointed £m	2010 Total £m	Appointed Business £m	Non- appointed £m	2009 Total £m
Turnover	438.6	7.4	446.0	424.7	7.7	432.4
Operating costs	(178.8)	(6.3)	(185.1)	(173.7)	(6.3)	(180.0)
Depreciation	(72.3)	(0.6)	(72.9)	(70.4)	(0.4)	(70.8)
Operating income	1.0	-	1.0	1.7	-	1.7
Operating Profit	188.5	0.5	189.0	182.3	1.0	183.3
Other income	0.3	0.5	0.8	0.3	0.5	0.8
Net interest payable	(64.1)	-	(64.1)	(69.9)	-	(69.9)
Profit on Ordinary Activities Before Taxation	124.7	1.0	125.7	112.7	1.5	114.2
Tax on profit on ordinary Activities	(18.6)	(0.3)	(18.9)	(28.9)	(0.4)	(29.3)
Profit on Ordinary Activities After Taxation	106.1	0.7	106.8	83.8	1.1	84.9
Dividends	(54.4)	-	(54.4)	(103.8)	-	(103.8)
Retained profit / (loss) for year	51.7	0.7	52.4	(20.0)	1.1	(18.9)

The "Appointed Business" comprises those activities which are necessary for the Company to fulfil its function and duties as a water and sewerage undertaker.

The notes on pages 31 to 64 form part of these historical cost regulatory accounts.

HISTORICAL COST BALANCE SHEET at 31 March 2010

	Notes	2010 £m	2009 £m
Fixed Assets			
Tangible assets	11	2,401.3	2,352.1
Investments	12	3.4	3.4
		<u>2,404.7</u>	<u>2,355.5</u>
Current Assets			
Financial assets			
Derivative financial instruments	19	-	0.2
Stocks	13	3.5	4.1
Debtors	14	71.0	67.6
Investments	15	264.8	250.6
Cash at bank and in hand		0.1	1.1
Infrastructure renewals prepayment		8.9	13.1
		<u>348.3</u>	<u>336.7</u>
Current Liabilities			
Creditors: amount falling due within one year	16	(280.9)	(148.9)
Derivative financial instruments	19	(17.7)	(18.7)
		<u>49.7</u>	<u>169.1</u>
Net Current Assets			
Total Assets Less Current Liabilities			
		2,454.4	2,524.6
Creditors: amounts falling due after more than one year			
	17	(1,656.8)	(1,767.5)
Provisions for liabilities and charges	20	(84.4)	(93.9)
Deferred income	21	(14.0)	(15.1)
		<u>699.2</u>	<u>648.1</u>
Net Assets Excluding Pension Liability			
Pension Liability	22	(60.0)	(37.1)
Net Assets Including Pension Liability		<u>639.2</u>	<u>611.0</u>
Capital and Reserves			
Called-up share capital	23	150.9	150.9
Reserves	25	488.3	460.1
		<u>639.2</u>	<u>611.0</u>
Capital and Reserves	26		

The notes on pages 31 to 64 form part of these historical cost regulatory accounts.

The historical cost regulatory accounts on pages 26 to 64 were approved by the Board on 25 June 2010 and signed on its behalf by:-

C Loughlin
Chief Executive

S Davy
Finance Director

HISTORICAL COST BALANCE SHEET at 31 March 2010 (continued)

Analysis of historical cost financial information between appointed and non-appointed business

	Appointed Business £m	Non- appointed £m	2010 Total £m	Appointed Business £m	Non- appointed £m	2009 Total £m
Fixed Assets						
Tangible assets	2,401.3	-	2,401.3	2,352.1	-	2,352.1
Investments	3.4	-	3.4	3.4	-	3.4
	2,404.7	0.0	2,404.7	2,355.5	-	2,355.5
Current Assets						
Derivative financial instruments	-	-	0.0	0.2	-	0.2
Stocks	3.5	-	3.5	4.1	-	4.1
Debtors	69.7	1.3	71.0	66.2	1.4	67.6
Investments	264.8	-	264.8	250.6	-	250.6
Cash at bank and in hand	-	5.1	5.1	-	4.5	4.5
Infrastructure renewals prepayment	8.9	-	8.9	13.1	-	13.1
	346.9	6.4	353.3	334.2	5.9	340.1
Current Liabilities						
Creditors: amount falling due within one year	(285.4)	(0.5)	(285.9)	(151.6)	(0.7)	(152.3)
Derivative financial instruments	(17.7)	-	(17.7)	(18.7)	-	(18.7)
	43.8	5.9	49.7	163.9	5.2	169.1
Total Assets Less Current Liabilities	2,448.5	5.9	2,454.4	2,519.4	5.2	2,524.6
Creditors: amount falling due after more than one year	(1,656.8)	-	(1,656.8)	(1,767.5)	-	(1,767.5)
Provisions for liabilities and charges	(84.4)	-	(84.4)	(93.9)	-	(93.9)
Deferred income	(14.0)	-	(14.0)	(15.1)	-	(15.1)
Net Assets Excluding Pension Liability	693.3	5.9	699.2	642.9	5.2	648.1
Pension Liability	(60.0)	-	(60.0)	(37.1)	-	(37.1)
Net Assets Including Pension Liability	633.3	5.9	639.2	605.8	5.2	611.0
Capital and Reserves						
Called-up share capital	150.9	-	150.9	150.9	-	150.9
Profit and loss account	482.4	5.9	488.3	454.9	5.2	460.1
	633.3	5.9	639.2	605.8	5.2	611.0
Capital and Reserves						

HISTORICAL COST CASH FLOW STATEMENT for the year ended 31 March 2010

	Notes	2010 £m	2009 £m
Net Cash Inflow from Operating Activities	28a	284.9	235.6
Returns on Investments and Servicing of Finance	28b	(56.4)	(56.1)
Taxation		(1.3)	(21.8)
Capital Expenditure and Financial Investment	28b	(149.3)	(157.8)
Equity Dividends paid		(54.4)	(103.8)
Cash inflow/(Outflow) Before Use of Liquid Resources and Financing		23.5	(103.9)
Management of Liquid Resources	28b	20.0	(80.0)
Financing	28b	(27.2)	111.5
Increase/(Decrease) in Cash in Year	28c	16.3	(72.4)

The notes on pages 31 to 64 form part of these historical cost regulatory accounts.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

1. Accounting Policies for the year ended 31 March 2010

These financial statements are “regulatory accounts” prepared in accordance with guidance issued by the Water Services Regulation Authority (Ofwat). They have been prepared under the historical cost convention, as modified by the revaluation of certain financial instruments, and in accordance with applicable accounting standards in the UK except for the dis-application of certain parts of FRS 12 and FRS 15 in relation to infrastructure renewals accounting as described below in note 1(c)(i) and, except for the treatment of grants and contributions on infrastructure assets, with the Companies Act 2006. An explanation of this departure from the requirements of the Companies Act 2006 is given in note 1(e) below. A summary of the more important accounting policies is set out below, together with an explanation of where changes have been made to previous policies on the adoption of new accounting standards in the year.

These financial statements were approved by the Board of Directors on 25 June 2010.

Changes in accounting policies

There have been no changes in accounting policy during the year.

(a) Consolidated financial statements

The Company is exempt under the provisions of Section 400 of the Companies Act 2006 from the requirement to produce group financial statements as it is a wholly-owned subsidiary undertaking of Pennon Group Plc which is registered within the European Economic Area and which itself prepares consolidated financial statements. Accordingly consolidated financial statements have not been prepared and the financial information presented is for the Company as an individual undertaking. Group financial statements are included in the Annual Report of Pennon Group Plc which is available from Peninsula House, Rydon Lane, Exeter, EX2 7HR.

(b) Turnover

Turnover comprises charges to customers for water, sewerage and other services excluding value added tax and is derived only from the United Kingdom.

Turnover is not recognised until the service has been provided to the customer.

Turnover relates to charges due in the year, excluding any amounts paid in advance. Turnover for measured charges includes amounts billed plus an estimation of the amounts unbilled at the year end. The accrual for unbilled charges is estimated using a defined methodology reflecting historical consumption, estimated demand trends and current tariffs. Turnover for unmeasured charges is recognised on a time apportioned basis.

New properties are recognised when reported as connected. Unoccupied properties are identified through physical inspection, mailings and customer contacts. These properties are given a void status within the billing system and turnover is not recognised against these properties.

The accounting policy within the statutory accounts recognises infrastructure charges as turnover; however these charges are credited to fixed assets in accordance with the regulatory accounting guidelines.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

1. Accounting Policies (continued)

(c) Tangible fixed assets and depreciation

Tangible fixed assets comprise:-

(i) Infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, pipelines and sea outfalls)

Infrastructure assets comprise a network that, as a whole, is intended to be maintained in perpetuity at a specified level of service by the continuing replacement and refurbishment of its components.

Expenditure on infrastructure assets relating to increases in capacity or enhancements of the network, in accordance with defined standards of service, and to the maintenance of the operating capacity of the network, is treated as capital expenditure on tangible fixed assets and included at cost after deducting grants and contributions.

The infrastructure renewals charge represents the level of annual expenditure required to maintain the operating capacity of the network and is calculated from an independently certified asset management plan. In accordance with Regulatory Accounting Guidelines, the relevant sections of FRS 12 and FRS 15 have been dis-applied in relation to infrastructure renewals accounting, resulting in any cumulative difference between infrastructure renewals charges and actual infrastructure renewals expenditure is held as a prepayment or accrual in the balance sheet.

(ii) other assets (including properties, overground plant and equipment)

Other assets are stated at cost less accumulated depreciation. Freehold land is not depreciated. Other assets are depreciated evenly over their estimated economic lives, which are principally as follows:-

Buildings	30 – 60 years
Operational properties	40 – 80 years
Fixed plant	20 – 40 years
Vehicles, mobile plant and computers	4 – 10 years

Assets in the course of construction are not depreciated until commissioned.

(d) Leased assets

Assets held under finance leases are included in the balance sheet as tangible fixed assets at their equivalent capital value and are depreciated over their estimated economic lives or the finance lease period, whichever is the shorter. The corresponding liability is recorded as a creditor. The interest element of the rental cost is charged against profits, using the actuarial method, over the period of the lease.

Rental costs arising under operating leases are charged against profits in the year they are incurred.

(e) Grants and contributions

Grants and contributions receivable in respect of capital expenditure on non-infrastructure assets are included in the balance sheet as deferred income and are released to profits over the depreciable lives of the assets to which they relate.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

1. Accounting Policies (continued)

(e) Grants and contributions (continued)

Grants and contributions receivable relating to infrastructure assets are deducted from the cost of tangible fixed assets. This is not in accordance with the Companies Act 2006 which requires tangible fixed assets to be shown at cost and hence grants and contributions as deferred income. This departure from the requirements of the Companies Act 2006 is, in the opinion of the Directors, necessary for the financial statements to show a true and fair view as, while a provision is made for depreciation of infrastructure assets, these assets do not have determinable finite lives and therefore no basis exists on which to recognise grants and contributions as deferred income. The effect of this treatment on the value of tangible fixed assets is disclosed in note 11.

Grants and contributions receivable in respect of expenditure charged against profits in the year have been included in the profit and loss account.

(f) Investments

Listed investments held as current assets are stated at the lower of cost and net realisable value.

Short-dated unlisted securities held as current assets are stated at cost plus accrued income.

(g) Stocks

Stocks are stated at the lower of cost and net realisable value.

(h) Cash and cash deposits

Cash and cash deposits comprise cash in hand, short-term deposits held at banks and other short-term highly liquid deposits subject to insignificant risk of changes in value. Bank overdrafts are shown within current borrowings.

(i) Pension costs

The company operates defined benefit and defined contribution pension schemes through its parent company.

Defined benefit pension scheme assets are measured using bid price. Defined benefit pension scheme liabilities are measured by an independent actuary using the projected unit method and discounted at the current rate of return on high quality corporate bonds of equivalent term to the liability. The increase in the present value of the liabilities of the Company's defined benefit pension schemes expected to arise from employee service in the period is charged to operating profit. The expected return on scheme assets and the increase during the period in the present value of scheme liabilities, arising from the passage of time, are included in other finance income or cost. Past-service costs are recognised immediately in the profit and loss account.

Actuarial gains and losses arising from experience adjustments, changes in actuarial assumptions and amendments to pension plans are charged or credited to reserves and recorded in the Statement of Total Recognised Gains and Losses.

Costs of the defined contribution pension scheme are charged to the profit and loss account in the period in which they arise.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

1. Accounting Policies (continued)

(j) Share based payments

The Company operates a number of equity settled, share-based compensation plans for employees. The fair value of the employee services received in exchange for the grant is recognised as an expense over the vesting period of the grant.

Fair values are calculated using an appropriate pricing model. Non-market based vesting conditions are adjusted for assumptions as to the number of awards which are expected to vest.

(k) Research and Development Expenditure

Research and development expenditure is charged against profits in the year in which it is incurred.

(l) Taxation

Tax payable is provided on taxable profits at current rates. Tax deferred or accelerated as a result of timing differences between the treatment of certain items for taxation and for accounting purposes is provided for in full. Where the effect of the time value of money is material the current amount of the reversals of tax deferred or accelerated is discounted to its present value. The unwinding of the discount to present value is included in the tax charge. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that there will be suitable taxable profits against which the deferred tax asset can be recovered in future periods.

(m) Dividend distributions

Dividend distributions are recognised as a liability in the financial statements in the period in which the dividends are approved by the Company's shareholders. Interim dividends are recognised when paid; final dividends when authorised in general meeting by shareholders.

(n) Derivatives and other financial instruments

The Company classifies its financial instruments in the following categories.

i) Loans and receivables

All loans and borrowings are initially recognised at cost, being the net fair value of the consideration received. Following initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost.

Gains and losses are recognised in the profit and loss account when the liabilities are derecognised or impaired. Premiums, discounts and other costs and fees are recognised in the profit and loss account through the amortisation process.

Borrowings are classified as current liabilities unless the Company has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

ii) Derivative financial instruments

The Company uses derivative financial instruments, principally interest rate swaps, to hedge its risks associated with interest rate fluctuations. Such derivative instruments are initially recorded at cost and subsequently re-measured at fair value for the reported balance sheet.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

1. Accounting Policies (continued)

(n) Derivatives and other financial instruments (continued)

The gain and loss on re-measurement is taken to the profit and loss account except for cash flow hedges that meet the conditions for hedge accounting, when the portion of the gain or loss on the hedging instrument which is determined to be an effective hedge is recognised directly in reserves, and the ineffective portion in the profit and loss account. The gains or losses deferred in reserves in this way are subsequently recognised in the profit and loss account in the same period in which the hedged underlying transaction or firm commitment is recognised in the profit and loss account.

In order to qualify for hedge accounting, the Company is required to document in advance the relationship between the item being hedged and the hedging instrument. The Company is also required to document and demonstrate an assessment of the relationship between the hedged item and the hedging instrument, which shows that the hedge will be highly effective on an on-going basis. This effectiveness testing is re-performed at the end of each reporting period to ensure that the hedge remains highly effective.

(iii) Trade debtors

Trade debtors do not carry any interest and are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts and the impact of discounting. The allowance for estimated irrecoverable amounts is calculated by applying expected recovery rates to debts outstanding at the end of the accounting period. The expected recovery rates take into account age of the debt, payment history and credit characteristics.

(iv) Trade creditors

Trade creditors are not interest bearing and are stated at their nominal value.

(o) Fair value estimate

The fair value of the interest rate swaps is based on the market price of comparable instruments at the balance sheet date if they are publicly traded.

2. Segmental analysis

The Directors believe that the whole of the Company's activities constitute a single class of business.

The Company's turnover is wholly generated from within the United Kingdom.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

3. Operating Costs

	2010 £m	2009 £m
Manpower costs (note 8)	36.8	34.7
Raw materials and consumables	13.8	12.9
Rentals under operating leases:-		
Hire of plant and machinery	0.8	0.7
Other operating leases	1.4	1.3
Research and development expenditure	0.2	0.2
Auditors' remuneration	0.2	0.2
Other external charges	87.3	85.8
Infrastructure renewals charge	28.1	26.3
Other operating charges	16.5	17.9
	185.1	180.0

Fees payable to the Group's auditors in the year were as follows:-

	2010 £000	2009 £000
Audit services	108	100
Audit-related regulatory reporting	28	124
Other services	79	24
	215	248

Expenses reimbursed to the auditors in relation to the audit of the Company were £14,000 (2009: £14,000).

4 Depreciation

	2010 £m	2009 £m
On owned non-infrastructure assets	52.1	50.9
On non-infrastructure assets held under finance leases	22.1	21.5
	74.2	72.4
Deferred income released to profits	(1.3)	(1.6)
	72.9	70.8

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

5. Net Interest Payable

	2010 £m	2009 £m
Interest payable:-		
To subsidiary company	(10.8)	(12.7)
Bank loans and overdrafts	(10.9)	(10.5)
Interest element of finance lease rentals	(44.7)	(53.8)
Other finance charges – pension cost (see note 22)	(17.5)	(18.8)
Other finance charges	-	(3.8)
	<hr style="width: 100%; border: 0.5px solid black;"/> (83.9)	<hr style="width: 100%; border: 0.5px solid black;"/> (99.6)
Interest receivable:-		
From parent undertaking	0.0	1.6
From subsidiary company	0.1	0.1
Expected return on pension scheme assets (see note 22)	15.0	17.8
Other finance income	0.7	-
Other investments (as defined in note 15)	4.0	10.2
	<hr style="width: 100%; border: 0.5px solid black;"/> 19.8	<hr style="width: 100%; border: 0.5px solid black;"/> 29.7
Net interest payable	<hr style="width: 100%; border: 0.5px solid black;"/> (64.1)	<hr style="width: 100%; border: 0.5px solid black;"/> (69.9)

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

6. Tax on Profit on Ordinary Activities

	2010	2009
	£m	£m
(a) Analysis of charge for year		
Current tax :		
UK corporation tax at 28% (2009: 28%) :-		
Current year	33.5	22.2
Prior year	(2.7)	(1.7)
Amounts receivable from Pennon Group companies in respect of surrender of taxable losses and advance corporation tax	(0.1)	-
Total current tax (note 6(b))	30.7	20.5
Deferred tax :		
Origination and reversal of timing differences	0.1	11.8
Increase in discount	(11.9)	1.9
Total deferred tax charged to profit & loss in year (note 20)	(11.8)	13.7
Derecognition of deferred tax liabilities related to industrial buildings (note 20)	-	(4.9)
Tax on profit on ordinary activities	18.9	29.3

	2010	2009
	£m	£m
(b) Factors affecting current tax charge for the year		
The tax assessed for the year is lower than the standard rate of corporation tax in the UK of 28% (2009: 28%)		
The differences are explained below:		
Profit on ordinary activities before tax	125.7	114.2
Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 28% (2009: 28%)	35.2	32.0
Tax effects of:		
Expenses not deductible for tax purposes	0.5	0.7
Income not charged to profits	0.5	1.1
Capital allowances for year in excess of depreciation	(3.1)	(1.2)
Other timing differences	0.3	(10.4)
Adjustments to tax charge in respect of prior year	(2.7)	(1.7)
Current tax charge for the year (note 6(a))	30.7	20.5

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

7. Dividends

	2010 £m	2009 £m
2006/07 Outperformance dividend	-	3.6
Base dividend of 66.4p per ordinary share in respect of 2007/08 and 2008/09 paid 30 January 2009	-	100.2
Base dividend of 36.0384p per share in respect of 2009/10 paid 13 November 2009	54.4	-
	54.4	103.8

8. Employees and Employment Costs

The average number of persons (including Directors) employed by the Company was:-

	2010	2009
Regulated water and sewerage activities	1,191	1,227

	2010 £m	2009 £m
Employment costs comprise:-		
Wages and salaries	33.7	33.0
Social security costs	2.7	2.5
Share-based payments	1.3	1.2
Pension costs	9.5	7.9
Total employment costs	47.2	44.6
Charged as follows:-		
Manpower costs (note 3)	32.4	32.5
Restructuring	4.4	2.2
	36.8	34.7
Capital schemes	10.4	9.9
	47.2	44.6

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

9. Directors' emoluments	2010 £000	2009 £000
Total emoluments of the Directors of the Company :		
Salary	611	602
Fees (non-executive Director)	3	-
Performance related	240	159
Other emoluments	132	133
Total emoluments	986	894

The performance related payment represents the cash element. In addition Directors receive a conditional award of shares in Pennon Group Plc for a matching amount which is subject to a future service criterion.

Performance related and other emoluments apply to Executive Directors only.

Other emoluments include car benefit and health care, and, in respect of the highest paid Director, a cash payment of 30% of his annual basic salary in lieu of any pension provision by the Company.

The emoluments of the highest paid Director were £466,000 (2009: £421,000).

At 31 March 2010 retirement benefits were accruing to 3 Directors (2009: 3 Directors) under defined benefit pension schemes operated by the parent company.

The highest paid Director did not participate in a company pension scheme.

The Chairman, K G Harvey, is a director of Pennon Group Plc and his remuneration is disclosed in the financial statements of that company.

Background

Directors of South West Water have their remuneration and terms of employment determined by the Remuneration Committee ('the Committee') of Pennon Group Plc, the ultimate holding company. Further details of the operation of this Committee can be found in the financial statements of Pennon Group Plc.

Elements of Remuneration

The remuneration of the Executive Directors comprises salary, payments related to performance against agreed standards, long term incentives, contributory pension provision or a cash alternative, car benefit and health cover.

Payments related to performance against agreed standards

As required by the Water Act 2003 and Regulatory Accounting Guidance from the Water Services Regulation Authority (Ofwat), additional information is given regarding this aspect of remuneration.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

9. Directors' emoluments (continued)

C Loughlin (the highest paid Director) is an Executive Director of Pennon Group Plc and details of the performance related bonus arrangements for him and the amounts paid to him under those arrangements are described in the Directors' remuneration report within the Pennon Group Annual Report and Accounts.

In respect of the other Executive Directors, for the year 2009/10, maximum performance related bonus payments achievable in respect of service as executive directors of South West Water Limited are, expressed as a percentage of salary up to a maximum of 37.5%, as follows:

- i Based on an estimate of the Overall Performance Assessment (OPA) points to be awarded by Ofwat for 2009/10 0.25% up to a maximum of 2.5% for each position above 10th compared to the published scores for 2008/09 for the water and sewerage companies. This reflects the importance South West Water attaches to all round performance.
- ii Up to a maximum of 5% in relation to a series of discrete individual Director's targets for performance on Ofwat DG measures, pollution and waste water measures set by the Environment Agency, drinking water compliance and level of customer debt. Performance under each of these standards reflects customer and stakeholder measures.
- iii 0.5% bonus for each area of service achieving a 'stable' classification of serviceability to a maximum of 2%
- iv A bonus for outperformance of South West Water against its operating cost budget, the maximum bonus of 7.5% being achieved if outperformance is 3% or higher. Cost control and efficiency are key factors in South West Water's long term performance.
- v A bonus for outperformance of South West Water against its budget for profit before tax, the maximum bonus of 5.0% being achieved if outperformance is 5.0% or higher. Profit before tax is a key measure of performance.
- vi A bonus for capital expenditure being below budget, up to a maximum of 3% if expenditure is 2.5% below budget. Cost control and efficiency are key factors in South West Water's long term performance.
- vii A bonus of up to 2.5% if net debt is 1% below budget. Cash control is a key factor in South West Water's long term performance.
- viii Up to a maximum of 10% in relation to personal objectives set for each Director and focused on development and delivery of the Company's strategic objectives.

These arrangements were approved by the Remuneration Committee of Pennon Group Plc on 30 April 2009.

For 2009/10 no Director achieved the maximum bonus available of 37.5% of salary. The actual payments relating to performance against agreed standards amounted to:

	£000	% bonus achieved
S C Bird	43.2	30.5
S J Davy	37.6	30.0
M S Read	25.4	27.5

As set out above, Executive Directors received a conditional award of shares in Pennon Group Plc for a matching value which is subject to future service criteria.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

9. Directors' emoluments (continued)

Awards made under the Pennon Group Performance and Co-investment Plan are linked to the Total Shareholder Return of the Pennon Group only. Further details are given in the financial statements of that company.

10. Directors' Interests

No Director has held any beneficial interest in the shares of the Company during the year. Messrs K G Harvey and C Loughlin are Directors of Pennon Group Plc and their interests in the shares of Pennon Group Plc are disclosed in the financial statements of that company.

The interests of the other Directors holding office at 31 March 2010 in the shares of Pennon Group Plc at 31 March 2010 and 31 March 2009 were:

(a) Shareholdings

	2010 Ordinary Shares (40.7p each)	2009 Ordinary Shares (40.7p each)
S C Bird	11,828	13,197
S J Davy	7,215	3,067
M S Read	53,861	44,632

(b) Share Incentive Plan

In addition, the Partnership shares held in Pennon Group Plc on behalf of the Directors under the Share Incentive Plan were:

	2010 Ordinary shares (40.7p each)	2009 Ordinary shares (40.7p each)
S J Davy	624	299
M S Read	1,133	786

(c) Sharesave scheme

Options to subscribe for shares in Pennon Group Plc under the all-employee Sharesave Scheme were:

	Options over Ordinary Shares of 40.7p each				
	31 March 2010	Granted in Period	Exercised in Period	Lapsed In Period	31 March 2009
S C Bird	2,351	2,351	783	1,270	2,053
S J Davy	2,351	2,351	-	1,818	1,818
M S Read	4,865	2,417	5,715	-	8,163

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

10. Directors' Interests (continued)

(d) Restricted Share Plan

In addition to the above beneficial interests, the Directors had a contingent interest in the shares of Pennon Group Plc under the terms of the Pennon Group Long Term Incentive Plan, described in note 24, as follows :

	Contingent interest in Ordinary Shares of 40.7p each				
	31 March 2010	Granted in Period	Vested in Period	Lapsed In Period	31 March 2009
S C Bird	-	-	-	15,041	15,041
M S Read	-	-	-	9,048	9,048

During the year the Directors received dividends on the above shares in accordance with the conditions of the Restricted Share Plan.

(e) Incentive Bonus Plan

The Directors also had a contingent interest in the shares of Pennon Group Plc under the terms of the Pennon Group Incentive Bonus Plan, described in note 24, as follows :

	Contingent interest in Ordinary Shares of 40.7p each				
	31 March 2010	Granted in Period	Vested in Period	Lapsed In Period	31 March 2009
S C Bird	14,241	8,656	9,546	-	15,131
M S Read	8,854	5,193	6,243	-	9,904
S J Davy	9,728	6,777	-	-	2,951

The above represent the maximum number of shares to which the Directors would usually become entitled if they remain employed by the Pennon Group for a further three years from the date of the awards. The awards vested during the year at a price of 502p per share. It is anticipated that all the shares will vest under the 2007 awards as the service criteria are expected to be met.

During the year the Directors received dividends on the above shares in accordance with the conditions of the Incentive Bonus Plan.

A further conditional award of shares will be made in 2010/11 to match the amount of the cash bonus shown in Note 9.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

10. Directors' Interests (continued)

(f) Performance and Co-investment Plan

In addition to the above beneficial interests, the Directors had a conditional interest in the shares of Pennon Group Plc under the terms of the Pennon Group Performance and Co-investment Plan, described in note 24, as follows :

	Conditional interest in Ordinary Shares of 40.7p each				
	31 March 2010	Granted in Period	Vested in Period	Lapsed In Period	31 March 2009
S C Bird	60,413	23,268	-	-	37,145
M S Read	39,428	15,194	-	-	24,234
S J Davy	35,110	20,554	-	-	14,556

Additional ordinary shares (40.7p each) have been acquired by the Directors since 31 March 2010 as follows as a result of participation in the Pennon Group's Dividend Re-investment plan or the Pennon Group's Share Incentive Plan:

M S Read 324 S J Davy 77

M S Read sold 4,500 ordinary shares on 15 June 2010.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

11. Tangible Fixed Assets

	Freehold land and buildings	Infra- structure assets	Operational properties	Fixed & mobile plant, vehicles and computers	Construc- tion in progress	Total
	£m	£m	£m	£m	£m	£m
Cost:-						
At 1 April 2009	18.9	1,227.4	618.5	1,059.5	94.2	3,018.5
Additions	0.6	19.1	0.8	33.1	74.7	128.3
Grants and contributions	-	(3.4)	-	-	-	(3.4)
Transfers / reclassifications	0.9	39.6	8.1	35.5	(84.1)	0.0
Disposals	-	-	(0.2)	(13.6)	-	(13.8)
At 31 March 2010	20.4	1,282.7	627.2	1,114.5	84.8	3,129.6
Depreciation:-						
At 1 April 2009	4.2	-	160.3	501.9	-	666.4
Charge for year	0.3	-	11.3	63.9	-	75.5
Disposals	-	-	(0.2)	(13.4)	-	(13.6)
At 31 March 2010	4.5	-	171.4	552.4	-	728.3
Net Book Value:-						
At 31 March 2010	15.9	1,282.7	455.8	562.1	84.8	2,401.3
At 31 March 2009	14.7	1,227.4	458.2	557.6	94.2	2,352.1

Out of the total depreciation charge for the Company of £75.5m (2009: £74.0m), the sum of £1.3m (2009: £1.6m) has been charged to capital projects, and £74.2m (2009: £72.4m) against profits.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

11. Tangible Fixed Assets (continued)

Assets held under finance leases included above:-

	Infra- structure assets	Opera- tional properties	Fixed & mobile plant, vehicles and computers	Construction in progress	Total
	£m	£m	£m	£m	£m
Cost:- At 31 March 2010	366.1	459.9	299.1	9.7	1,134.8
Depreciation:- Charge for year	6.7	7.6	14.8	-	29.1
Depreciation:- At 31 March 2010	37.0	81.4	142.0	-	260.4

12. Fixed Asset Investments

	Joint Venture £m	Subsidiary Undertakings £m	Total Investments £m
At 1 April 2009 and 31 March 2010	0.1	3.3	3.4

The Company holds 99,999 (100%) A ordinary shares in Echo South West Limited, a joint venture engaged in customer contact management, established between the Company and Echo Managed Services Limited, a subsidiary of South Staffordshire Group Plc. The proportion of the nominal value of ordinary shares held by the Company remains at 50%. The joint venture in Echo South West Limited ceased operations on 31 March 2008.

The Company has four wholly-owned subsidiaries, Peninsula Properties (Exeter) Limited, Peninsula Leasing Limited, South West Water Finance Plc and Haldon Collections Limited. All companies are incorporated, registered and have their operation in England.

Consolidated financial statements have not been prepared, as explained in note 1(a).

In the opinion of the Directors the total value of investments in subsidiary and joint venture undertakings is not less than the amount at which they are shown in the balance sheet.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

13. Stocks

	2010 £m	2009 £m
Raw materials and consumables	<u>3.5</u>	<u>4.1</u>

14. Debtors

	2010 £m	2009 £m
Amounts falling due within one year:-		
Trade debtors	80.7	68.0
Less: provision for bad debts	<u>(51.3)</u>	<u>(44.0)</u>
	29.4	24.0
Amounts owed by subsidiary companies	2.8	3.5
Amounts owed by parent undertaking	1.0	1.0
Other debtors	6.5	10.0
Prepayments and accrued income	<u>31.3</u>	<u>29.1</u>
	<u>71.0</u>	<u>67.6</u>

The effective interest rate on loans to subsidiary companies is 4.7% (2009: 4.8%). No interest is charged on trading balances with other group companies.

15. Current Asset Investments

	2010 £m	2009 £m
Other investments:-		
Overnight deposits	81.4	63.8
Other short-term deposits	150.2	170.1
Other deposits	<u>33.2</u>	<u>16.7</u>
	<u>264.8</u>	<u>250.6</u>

Other deposits include £33.2m (2009: £16.7m) of restricted funds to settle long-term liabilities (note 18)

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

16. Creditors: Amounts Falling Due Within One Year

	2010 £m	2009 £m
Loans:- (note 18)		
European Investment Bank loans	14.1	14.1
Loan from subsidiary company	100.0	-
Bank loans and overdrafts	17.3	17.0
	<hr/>	<hr/>
	131.4	31.1
Obligations under finance leases (note 18)	23.9	24.2
Trade creditors	14.8	13.1
Capital creditors	33.8	37.1
Amounts owed to subsidiary companies	2.9	1.6
Amounts owed to fellow subsidiary undertakings	0.1	0.1
Other creditors	5.3	1.3
Corporation Tax	51.9	23.2
Other taxation and social security	1.3	1.0
Accruals and deferred income	15.5	16.2
	<hr/>	<hr/>
	280.9	148.9

17. Creditors: Amounts Falling Due After More Than One Year

	2010 £m	2009 £m
Loans:- (note 18)		
European Investment Bank loans	273.6	287.7
Loan from subsidiary company	218.7	318.0
	<hr/>	<hr/>
	492.3	605.7
Obligations under finance leases (note 18)	1,164.5	1,161.8
	<hr/>	<hr/>
	1,656.8	1,767.5

At the balance sheet date the effective interest rate on loans from subsidiary companies is 4.7% (2009: 1.3%).

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

18. Loans and Other Borrowings

	2010 £m	2009 £m
Loans		
Repayable:-		
Over five years	397.9	428.3
Over two and up to five years	73.3	63.3
Over one and up to two years	21.1	114.1
Falling due after more than one year (note 17)	<u>492.3</u>	<u>605.7</u>
Falling due within one year (note 16)	<u>131.4</u>	<u>31.1</u>
	<u>623.7</u>	<u>636.8</u>
	2010 £m	2009 £m
Obligations under finance leases		
Repayable:-		
Over five years	1,076.0	1,010.8
Over two and up to five years	72.5	117.5
Over one and up to two years	16.0	33.5
Falling due after more than one year (note 17)	<u>1,164.5</u>	<u>1,161.8</u>
Falling due within one year (note 16)	<u>23.9</u>	<u>24.2</u>
	<u>1,188.4</u>	<u>1,186.0</u>

Included above are accrued finance charges arising on obligations under finance leases totalling £135.3m (2009: £136.0m), of which £11.9m (2009: £13.8m) is repayable within one year.

Included above is £7.7m (2009: £14.6m) due to Peninsula Leasing Limited, a subsidiary company, under finance lease agreements of which £7.4m (2009: £7.2m) is repayable within one year.

Loans and obligations under finance leases

Included above are instalment debts, of which any part falls due for payment after five years, and non-instalment debts due after five years:-

	2010 £m	2009 £m
Loans	506.4	519.8
Obligations under finance leases	<u>1,180.7</u>	<u>1,171.4</u>
	<u>1,687.1</u>	<u>1,691.2</u>

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

18. Loans and Other Borrowings (continued)

The Company has undrawn committed borrowing facilities:

	2010	2009
	£m	£m
Floating rate:		
Expiring after one year	<u>110.0</u>	<u>124.0</u>
	<u>110.0</u>	<u>124.0</u>

In addition, the Company has short-term uncommitted bank facilities of £60.0m (2008: £80.0m).

Within obligations under finance leases, South West Water Limited has utilised finance lease facilities of £180.0m for certain water and sewerage business tangible fixed assets that are secured by bank letters of credit issued by United Kingdom financial institutions. These letters of credit, covering the full period of the finance leases, are renewable between the financial institutions and South West Water Limited at five-yearly intervals, the next being March 2011.

During 2007 the period for repayment of these leases was extended with an agreement to deposit with the lessor group amounts comparative to the difference between the original and revised payments due. The accumulated deposits of £24.0m at 31 March 2010 (2009: £16.6m) are being held to settle the lease liability over the period from the end of the original lease term. The deposits are subject to a registered charge given as security to the lessor for the balance outstanding.

During 2010 the period for repayment of certain existing leases was extended with an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The deposit at 31 March 2010 of £9.2m is being held to settle the lease liability at the end of the lease term, subject to rights to release by negotiation with the lessor.

19. Derivative Financial Instruments

Numerical financial instruments disclosures are set out below. Additional disclosures are set out in notes 18 and 25.

	2010	2009
	£m	£m
<i>Interest rate swaps – cash flow hedges:</i>		
Assets	-	0.2
Liabilities	(17.6)	(16.6)
<i>Derivatives deemed held for trading</i>		
Liabilities	(0.1)	(2.1)

Interest rate swaps and fixed rate borrowings are used to manage the mix of fixed and floating rates to ensure at least 50% of net borrowings is at fixed rate. At 31 March 2010 73% of net borrowings after the impact of derivatives, was at fixed rate (2009: 62%).

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

19. Derivative Financial Instruments (continued)

At 31 March 2010 interest rate swaps to hedge financial liabilities with a notional principal value of £775m existed, with a weighted average maturity of 4.4 years (2009: £540.0m, with 2.5 years) to swap from floating to fixed rate. The weighted average interest rate of the swaps was 3.95% (2009: 4.8%).

The amounts above are the fair value of swaps based on the market value of equivalent instruments at the balance sheet date.

20. Provisions for Liabilities and Charges

	Restruc- turing £m	Deferred Tax £m	Total £m
At 1 April 2009	0.3	93.6	93.9
Charged / (released) against profits	5.0	(12.3)	(7.3)
Utilised during year	(2.2)	-	(2.2)
At 31 March 2010	3.1	81.3	84.4

Deferred Taxation

	2010 £m	2009 £m
Accelerated capital allowances	292.2	290.2
Other timing differences	(2.9)	(0.5)
Undiscounted provision for deferred tax	289.3	289.7
Discount	(208.0)	(196.1)
Discounted provision for deferred tax	81.3	93.6
		£m
Provision at 1 April 2009		93.6
Deferred tax credit in profit and loss account for year		(11.8)
Deferred tax charge relating to pension liability		(0.3)
Deferred tax credited to reserves for the period		(0.2)
Provision at 31 March 2010		81.3

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

21. Deferred Income

	Grants and contributions £m
At 1 April 2009:	
Amount to be released :	
after more than one year	15.1
within one year	1.3
	<hr/> 16.4
Additions	0.0
Released to profits	(1.2)
	<hr/> 15.2
At 31 March 2010:	
Amount to be released:	
within one year	(1.2)
after more than one year	<hr/> 14.0

22. Pensions

The Company's employees are eligible to participate in funded defined benefit schemes, operated by the parent company. The assets of the group's pension schemes are held in separate trustee administered funds. The trustees of the funds are required to act in the best interest of the funds' beneficiaries. The appointment of schemes' trustees is determined by the schemes' trust documentation. The Group has a policy that one-half of all trustees other than the Chairman are nominated by members of the fund, including current pensioners.

The principal actuarial assumptions at the balance sheet date were :

	2010	2009
	%	%
Rate of increase in pensionable pay	4.10	3.75
Rate of increase for present and future pensions	3.60	2.75
Rate used to discount schemes' liabilities	5.53	6.50
Inflation	3.60	2.75

Assumptions regarding future mortality experience are set based on actuarial advice in accordance with published statistics and experience. The mortality assumption uses a scheme-specific 'medium cohort' basis.

The average life expectancy in years of a member having retired at age 62 on the balance sheet date is projected at:

	2010	2009
Male	22.0	21.9
Female	25.4	25.4

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

22. Pensions (continued)

The average life expectancy in years of a future pensioner retiring at age 62 twenty years after the balance sheet date is projected at:

	2010	2009
Male	23.4	23.4
Female	26.6	26.5

The amounts recognised in the profit and loss account were :

	2010 £m	2009 £m
Current service cost	(6.5)	(6.8)
Past service cost	(1.2)	(1.6)
Total included within operating costs	(7.7)	(8.4)
Expected return on pension scheme's assets	15.0	17.8
Interest cost on retirement benefit obligations	(17.5)	(18.8)
Total included within net interest payable (note 5)	(2.5)	(1.0)
Total charge	(10.2)	(9.4)

The actual return on scheme's assets was an increase of £56.5m (2009: decrease of £27.6m).

The amounts recognised in the statement of total recognised gains and losses were :

	2010 £m	2009 £m
Actuarial (losses) / gains recognised in the year	(32.8)	(50.6)

The amounts recognised in the balance sheet were :

	2010 £m	2009 £m
Fair value of schemes' assets	264.3	209.9
Present value of defined benefit obligations	(347.6)	(261.3)
Deficit in scheme	(83.3)	(51.4)
Related deferred tax asset	23.3	14.3
Net liability recognised in the balance sheet	(60.0)	(37.1)

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

22. Pensions (continued)

The assets in the scheme and the expected long-term rates of return at the year end were:

	Expected return %	2010 Value £m	Fund %	Expected Return %	2009 Value £m	Fund %
Equities	8.5	161.8	61	8.8	126.8	60
Property	9.0	16.5	6	7.9	7.7	4
Bonds	5.0	83.9	32	5.2	72.5	35
Other	4.5	2.1	1	8.8	2.9	1
		264.3	100		209.9	100

Asset values have been reanalysed to show other assets which principally represent cash contributions received from the company towards the year-end which are invested during the subsequent financial year. Comparatives have been restated accordingly.

The expected return on plan assets is determined by considering the long-term returns and the balance between risk and reward on the various categories of investment assets held. Expected returns on equity and property investments reflect long-term rates of return experienced in the respective markets. Expected yields on fixed interest investments are based on gross redemption yields as at the balance sheet date.

In conjunction with its investment advisers, the trustees have structured the schemes' assets with the objectives of balancing investment returns and levels of risk. The asset allocation has three main elements:

- holding of bonds which is expected to be less volatile than most other asset classes and reflects the schemes' liabilities.
- a proportion of equities, with fund managers having freedom in making investment decisions to maximise returns.
- investment of a relatively small proportion of the schemes' assets (circa 10%) in alternative asset classes which give the potential for gaining higher returns (property and currency).

Equities held by the scheme are spread between the UK and international markets circa 50% each.

Movements in the balance sheet liability were:-

	2010 £m	2009 £m
At 1 April 2009	(51.4)	(21.7)
Income statement	(10.2)	(9.4)
Statement of recognised income and expenditure	(32.8)	(50.6)
Regular contributions	1.2	1.5
Other employer contributions	9.9	28.8
At 31 March 2010	(83.3)	(51.4)

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

22. Pensions (continued)

Movements in the fair value of schemes' assets were :

	2010	2009
	£m	£m
At 1 April 2009	209.9	255.4
Expected return on schemes' assets	15.0	17.8
Actuarial losses	41.5	(81.5)
Members' contributions	0.2	0.4
Benefits paid	(13.3)	(12.5)
Company regular contributions	1.1	1.5
Other employer contributions	9.9	28.8
At 31 March 2010	<u>264.3</u>	<u>209.9</u>

Movements in the present value of defined benefit obligations were:

	2010	2009
	£m	£m
At 1 April 2009	(261.3)	(277.1)
Service costs	(7.7)	(8.4)
Interest cost	(17.5)	(18.8)
Members' contributions	(0.2)	(0.4)
Benefits paid	13.3	12.5
Actuarial (losses) / gains	(74.2)	30.9
At 31 March 2010	<u>(347.6)</u>	<u>(261.3)</u>

The Company adopted FRS 17 from 1 April 2004 and the following historical data has been presented from that date.

	2010	2009	2008	2007	2006
	£m	£m	£m	£m	£m
Fair value of schemes' assets	264.3	209.9	255.4	285.5	266.7
Present value of defined benefit obligations	(347.6)	(261.3)	(277.1)	(320.0)	(301.7)
Net liability recognised	(83.3)	(51.4)	(21.7)	(34.5)	(35.0)
Experience (losses)/gains on schemes' assets					
Amount (£m)	41.7	(80.7)	(53.6)	3.2	33.7
Percentage of schemes' assets	15.8%	(38.4)%	(21.0)%	1.1%	12.6%
Experience losses/(gains) on defined benefit obligations					
Amount (£m)	2.8	18.3	(5.8)	(4.4)	(32.2)
Percentage of defined benefit obligations	0.8%	7.0%	(2.1)%	(1.4)%	(10.7)%

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

22. Pensions (continued)

The Company's current service cost during the year was 16.4% of pensionable earnings (2009: 16.4%). The Company's existing defined benefit schemes have been closed to new entrants from 1 April 2008.

In 2008 the Pennon Group completed the triennial actuarial valuation of its defined benefit schemes as at 1 April 2007 which resulted in higher future service and deficit recovery contributions. The Group further updated the valuation of the main scheme to 31 March 2009 and the company has made further other contributions in the year totalling £9.9m (2009: £28.8m).

The Pennon Group monitors funding levels on an annual basis.

23. Called-up Share Capital

	2010 £m	2009 £m
Authorised, 500,000,000 Ordinary shares of £1 each	<u>500.0</u>	<u>500.0</u>
Allotted, called-up and fully paid:-		
150,950,000 (2009: 150,950,000) Ordinary shares of £1 each	<u>150.9</u>	<u>150.9</u>

24. Employee share schemes

The Company operates a number of share plans for the benefit of employees. Details of each plan are set out below.

i) Sharesave Scheme

An all-employee savings related plan is operated which enables employees, including Directors, to invest up to a maximum of £250 per month for three or five years. These savings can then be used to buy shares in Pennon Group Plc, the parent company, at a price set at a 20% discount to the market value at the start of the savings period at the third, fifth or seventh anniversary of the option being granted. Options expire six months following the exercise date and, except for specific circumstances such as redundancy, lapse if the employee leaves the Pennon Group before the exercise period commences.

Outstanding options to subscribe for Pennon Group Plc shares of 40.7p under the Sharesave Scheme are:

Date granted and subscription price fully paid		Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March	
			2010	2009
9 July 2002	189p	2005 - 2009	-	27
8 July 2003	177p	2006 - 2010	39	41
6 July 2004	200p	2007 - 2011	52	187
5 July 2005	270p	2008 - 2012	176	188
4 July 2006	358p	2009 - 2013	94	381
3 July 2007	522p	2010 - 2014	178	294
8 July 2008	517p	2011 - 2015	148	247
6 July 2009	386p	2012 - 2016	800	-
			<u>1,487</u>	<u>1,365</u>

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

24. Employee share schemes (continued)

i) Sharesave Scheme (continued)

At 31 March 2010 there were 767 participants in the Sharesave Scheme (2009: 723).
The number and weighted average exercise price of Sharesave options:

	2010		2009	
	Number of ordinary shares (thousands)	Weighted average exercise price per share p	Number of ordinary shares (thousands)	Weighted average exercise price per share p
At April 1	1,365	379	1,610	313
Granted	854	386	262	517
Exercised	(460)	289	(438)	221
Expired	(272)	492	(69)	353
At March 31	<u>1,487</u>	<u>388</u>	<u>1,365</u>	<u>379</u>

The weighted average price at the date of exercise of Sharesave options during the year was 468p (2009: 594p). The options outstanding at 31 March 2010 had a weighted average exercise price of 388p (2009: 379p) and a weighted average remaining contractual life of 2.3 years (2009: 1.8 years).

The aggregate fair value of options granted during the year was £0.9m (2009: £0.4m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model were:

	2010	2009
Weighted average share price	482p	646p
Weighted average exercise price	386p	517p
Expected volatility	29.0%	21.3%
Expected life	3.8 years	3.8 years
Risk-free rate	2.5%	4.9%
Expected dividend yield	4.7%	3.3%

Expected volatility was determined by calculating the historical volatility of the Pennon Group Plc share price over the previous two years.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

24. Employee share schemes (continued)

ii) Restricted Share Plan

Under this plan, Directors and senior management receive a conditional award of ordinary shares in Pennon Group Plc. The eventual number of shares, if any, which vest is dependent upon the achievement of the performance condition of the plan over the restricted period, being not less than three years.

The number and weighted average price of shares in the Restricted Share Plan are:

	2010		2009	
	Number of ordinary shares (thousands)	Weighted average price per share p	Number of ordinary shares (thousands)	Weighted average price per share p
At April 1	124	494	325	411
Vested	-	-	(96)	392
Lapsed	(124)	494	(105)	410
At March 31	-	-	124	494

The plan was succeeded in 2007 by the Performance and Co-investment Plan

iii) Performance and Co-investment Plan

Directors and senior management receive a conditional award of ordinary shares in Pennon Group Plc and are also required to hold a substantial personal holding in Pennon Group Plc shares. The eventual number of shares, if any, which vest is dependent upon the achievement of conditions of the plan over the restricted period, being not less than three years.

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

24 Employee share schemes (continued)

iii) Performance and Co-investment Plan (continued)

The number and exercise price of shares in the Performance and Co-investment Plan are:

	2010		2009	
	Number of ordinary shares (thousands)	Exercise price per share p	Number of ordinary shares (thousands)	Exercise price per share p
At April 1	233	598	112	557
Granted	160	487	121	638
At March 31	393	553	233	598

The awards outstanding at 31 March 2010 had an exercise price of 553p (2009: 598p) and a remaining contractual life of 1.4 years (2009: 1.9 years). The aggregate fair value of awards granted during the year was £0.5m (2009: £0.5m), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2010	2009
Share price	486p	638p
Expected volatility	29.0%	21.3%
Risk-free rate	2.5%	4.9%

Expected volatility was determined by calculating the historical volatility of the Group's share price over the previous two years.

iv) Annual Incentive Bonus Plan – Deferred Shares

Awards under this plan to Directors and senior management involve the release of ordinary shares in Pennon Group Plc to participants. There is no performance condition since vesting is usually conditional upon continuous service with the Pennon Group for a period of three years from the award.

The number and weighted average price of shares in the Incentive Bonus Plan are:

	2010		2009	
	Number of ordinary shares (thousands)	Weighted average price per share p	Number of ordinary shares (thousands)	Weighted average price per share p
At April 1	118	578	122	457
Granted	69	476	58	620
Vested	(41)	502	(62)	411
At March 31	146	551	118	578

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

24. Employee share schemes (continued)

The awards outstanding at 31 March 2010 had a weighted average price of 551p (2009: 578p) and a weighted average remaining contractual life of 1.6 years (2009: 1.4 years). The Pennon Group Plc share price at the date of the awards ranged from 473p to 620p.

The aggregate fair value of awards granted during the year was £0.3m (2009: £0.4m), determined from market value. No option pricing issues arise as dividends declared on the shares are receivable by the participants in the scheme.

25. Reserves

	Profit and loss account £m	Hedging Reserve £m	Total £m
At 1 April 2009	476.5	(16.4)	460.1
Profit on ordinary activities after taxation	106.8	-	106.8
Dividends paid (note 7)	(54.4)	-	(54.4)
Actuarial loss recognised in the pension scheme	(32.8)	-	(32.8)
Movement on deferred tax relating to actuarial loss	9.2	-	9.2
Share based payments	0.8	-	0.8
Deferred tax in respect of share schemes recognised directly in equity	(0.2)	-	(0.2)
Net movement on interest rate swaps	-	(1.2)	(1.2)
At 31 March 2010	505.9	(17.6)	488.3

26. Statement of Movements in Shareholders' Funds

	2010 £m	2009 £m
Profit on ordinary activities after taxation	106.8	84.9
Dividends paid	(54.4)	(103.8)
Share-based payments	0.8	0.5
Other recognised gains and losses relating to the year	(24.8)	(55.5)
Deferred tax in respect of share schemes recognised directly in equity	(0.2)	(0.5)
Net change in Shareholders' Funds	28.2	(74.4)
Shareholders' Funds as at 1 April	611.0	685.4
Shareholders' Funds as at 31 March	639.2	611.0

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

27. Commitments and Contingent Liabilities

	2010 £m	2009 £m
Capital commitments		
Contracted but not provided	95.6	76.2
Commitments under operating leases		
Rentals during the year following the balance sheet date		
Land and buildings leases expiring:-		
within one year	0.1	-
Between one and five year	0.1	0.1
after five years	1.2	1.3
	1.4	1.4
	2010 £m	2009 £m
Contingent Liabilities		
Contractors' claims on capital schemes	3.1	1.3
Guarantee of borrowings of subsidiary undertaking	300.0	300.0
	303.1	301.3

28. Notes to the Cash Flow Statement

(a) Reconciliation of Operating Profit to Net Cash Inflow from Operating Activities

	2010 £m	2009 £m
Operating profit	189.0	183.3
Depreciation charge	74.2	72.4
Adjustment for employee share schemes	0.6	1.1
Deferred income released to profits	(1.3)	(1.6)
(Decrease) in retirement benefit obligations	(3.4)	(22.1)
Increase/(decrease) in provisions for liabilities and charges	2.8	(1.3)
Decrease in stocks	0.6	-
Decrease in debtors (amounts falling due within and over one year)	(6.2)	(9.1)
Decrease/(increase) in creditors (amounts falling due within and over one year)	0.7	(12.5)
Other income	0.8	0.8
Infrastructure renewals charge	28.1	26.3
Profit on disposal of tangible fixed assets	(1.0)	(1.7)
Net cash inflow from operating activities	284.9	235.6

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

28. Notes to the Cash Flow Statement (continued)

(b) Analysis of Cash Flows for Headings Netted in the Cash Flow Statement

	2010	2009
	£m	£m
(i) Returns on Investments and Servicing of Finance		
Interest received	3.7	11.6
Interest paid	(20.5)	(20.2)
Interest element of finance lease rentals	(39.6)	(47.5)
Net cash outflow for returns on investments and servicing of finance	(56.4)	(56.1)
(ii) Capital Expenditure and Financial Investment		
Purchase of tangible fixed assets	(130.2)	(138.9)
Grants and contributions: Infrastructure assets	3.4	6.2
: Non-infrastructure assets	-	0.1
Receipts from disposal of tangible fixed assets	1.3	2.2
Infrastructure renewals expenditure	(23.8)	(27.4)
Net cash outflow for capital expenditure and financial investment	(149.3)	(157.8)
(iii) Management of Liquid Resources		
Purchase of current asset investments	(590.6)	(804.3)
Sale of current asset investments	610.6	724.3
Net cash (inflow)/outflow from management of liquid resources	20.0	(80.0)
(iv) Financing		
Decrease in debt due within one year (other than bank overdrafts)	-	-
(Decrease)/Increase in debt due after more than one year	(14.1)	85.8
Finance lease drawdowns	14.4	25.4
Capital element of finance lease rental payments	(11.3)	(10.6)
Transfers to restricted deposit accounts	(16.2)	(5.9)
Loans to parent undertaking	-	16.8
Net cash (outflow)/inflow from financing	(27.2)	111.5

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

28. Notes to the Cash Flow Statement (continued)

(c) Analysis of Net Debt

	At 1 April 2009 £m	Cash flow £m	Non-cash movements £m	At 31 March 2010 £m
Cash at bank and in hand	1.1	(1.0)	-	0.1
Current asset investments:-				
Overnight deposits	63.8	17.6	-	81.4
Bank overdrafts	(17.0)	(0.3)	-	(17.3)
	<u>47.9</u>	<u>16.3</u>	<u>-</u>	<u>64.2</u>
Restricted deposit accounts	16.7	16.2	0.3	33.2
Debt due within one year (other than bank overdrafts)	(14.1)	14.1	(114.1)	(114.1)
Debt due after more than one year	(605.7)	0.1	113.3	(492.3)
Finance lease obligations	(1,186.0)	(3.1)	0.7	(1,188.4)
	<u>(1,789.1)</u>	<u>27.3</u>	<u>0.2</u>	<u>(1,761.6)</u>
Current asset investments:- other than overnight deposits	170.1	(20.0)	0.1	150.2
	<u>(1,571.1)</u>	<u>23.6</u>	<u>0.3</u>	<u>(1,547.2)</u>

Non-cash movements include transfers between categories of debt for changing maturities, increased accrued finance charges within finance lease obligations and increased accrued interest on unlisted investments.

(d) Reconciliation of Net Cash Flow to Movement in Net Debt

	2010 £m	2009 £m
Increase /(Decrease) in cash in year	16.3	(72.4)
Cash inflow/(outflow) from increase in debt and finance leasing	27.3	(111.5)
Cash (outflow)/inflow from decrease in liquid resources	(20.0)	80.0
Decrease/(Increase) in net debt arising from cash flows	23.6	(103.9)
Non-cash movements:-		
Decrease/(Increase) in accrued finance charges on finance lease obligations	0.7	(6.1)
Other	(0.4)	(5.9)
Decrease/(Increase) in net debt in the year	23.9	(115.9)
Net debt at 1 April	(1,571.1)	(1,455.2)
Net debt at 31 March	(1,547.2)	(1,571.1)

NOTES TO THE HISTORICAL COST REGULATORY ACCOUNTS

29. Related Party Transactions

Under FRS8, transactions with other wholly owned subsidiaries of the Pennon Group Plc are not required to be set out herein since the Company is a wholly owned subsidiary within that group.

There were no related party transactions involving Directors during the year.

30. Parent Company

The parent company, and ultimate controlling party, is Pennon Group Plc which is registered in England. Group financial statements are included in the Annual Report of Pennon Group Plc which is available from Peninsula House, Rydon Lane, Exeter, EX2 7HR.

RECONCILIATION BETWEEN STATUTORY ACCOUNTS AND HISTORICAL COST REGULATORY ACCOUNTS

South West Water prepares its statutory accounts under the historical cost convention in accordance with International Financial Reporting Standards (IFRSs) and International Financial Reporting Interpretation Committee (IFRIC) interpretations, as adopted by the European Union, with those parts of the Companies Act 2006 applicable to companies reporting under IFRS.

The regulatory accounts contained in this document are prepared on the basis of regulatory accounting guidelines and UK accounting standards. The principal differences between the Company's statutory accounts and its regulatory accounts are set out below.

Profit and loss account / income statement

	2010 £m	2009 £m
Turnover		
Per statutory accounts	444.5	432.0
IFRS: revenue not recognised under IFRS as deemed uncollectible	5.3	5.7
Infrastructure charges credited to fixed assets in regulatory accounts	(3.0)	(4.5)
Rental income classified as 'other income' in regulatory accounts	(0.8)	(0.8)
Per regulatory accounts	<u>446.0</u>	<u>432.4</u>
Operating profit		
Per statutory accounts	191.6	186.8
Infrastructure charges credited to fixed assets in regulatory accounts	(3.0)	(4.5)
Rental income classified as 'other income' in regulatory accounts	(0.8)	(0.8)
IFRS: difference between infrastructure renewals charge and depreciation	(7.6)	(7.5)
IFRS: capitalisation policy difference	8.8	9.3
Per regulatory accounts	<u>189.0</u>	<u>183.3</u>
Profit before tax		
Per statutory accounts	127.5	116.9
Infrastructure charges credited to fixed assets in regulatory accounts	(3.0)	(4.5)
IFRS: difference between infrastructure renewals charge and depreciation	(7.6)	(7.5)
IFRS: capitalisation policy difference	8.8	9.3
Per regulatory accounts	<u>125.7</u>	<u>114.2</u>
Taxation		
Tax charge per statutory accounts	30.7	51.3
IFRS: difference in deferred tax charge because provision not discounted	(11.9)	1.9
IFRS: deferred tax differences on industrial buildings	-	(23.9)
Deferred tax: other timing differences between IFRS and UK GAAP	0.1	-
Tax charge per regulatory accounts	<u>18.9</u>	<u>29.3</u>
Retained Profit		
Profit for year per statutory accounts	96.8	65.6
Profit before tax differences as above	(1.8)	(2.7)
Taxation differences as above	11.8	22.0
Dividends (not shown in income statement for IFRS)	(54.4)	(103.8)
Retained (loss) / profit per regulatory accounts	<u>52.4</u>	<u>(18.9)</u>

RECONCILIATION BETWEEN STATUTORY ACCOUNTS AND HISTORICAL COST REGULATORY ACCOUNTS (continued)

Balance Sheet

	2010 £m	2009 £m
Fixed assets		
Net book value per statutory accounts	2,425.7	2,377.9
Infrastructure charges current year (see operating profit above)	(3.0)	(4.5)
Infrastructure charges brought forward	(32.1)	(27.6)
IFRS: difference in infrastructure assets net book value as renewals accounting not used	(2.9)	(8.3)
IFRS: grants and contributions netted against fixed assets	13.6	14.6
Net book value per regulatory accounts	<u>2,401.3</u>	<u>2,352.1</u>
Current assets		
Per statutory accounts	339.0	322.3
Infrastructure prepayment in regulatory accounts	8.9	13.1
IFRS: derivative assets displayed as long-term assets	-	0.2
IFRS: receivables displayed as long-term assets	0.4	1.1
Per regulatory accounts	<u>348.3</u>	<u>336.7</u>
	2010 £m	2009 £m
Current liabilities		
Per statutory accounts	286.5	150.3
IFRS: current element of provisions shown in current liabilities	(3.1)	(0.3)
IFRS: current element of derivative financial instruments shown in current liabilities	(3.6)	(2.1)
IFRS: current element of grants & contributions netted against fixed assets	1.0	1.0
Rounding	0.1	-
Per regulatory accounts	<u>280.9</u>	<u>148.9</u>
Deferred tax provision		
Per statutory accounts	302.6	316.9
IFRS: discounting not permitted	(208.0)	(196.1)
IFRS: deferred tax differences on industrial buildings	(41.5)	(41.5)
IFRS: deferred tax asset recognised on hedging reserve for statutory accounts but not UK GAAP	4.9	-
IFRS: deferred tax asset relating to pension fund deficit disclosed within other deferred tax balances rather than netted against deficit	23.3	14.3
Per regulatory accounts	<u>81.3</u>	<u>93.6</u>
Pension fund deficit		
Per statutory accounts	83.3	51.4
IFRS: deferred tax asset relating to pension fund deficit disclosed within other deferred tax balances rather than netted against deficit	(23.3)	(14.3)
Per regulatory accounts	<u>60.0</u>	<u>37.1</u>

RECONCILIATION BETWEEN STATUTORY ACCOUNTS AND HISTORICAL COST REGULATORY ACCOUNTS (continued)

	2010 £m	2009 £m
Net assets		
Per statutory accounts	423.8	400.6
Opening difference	210.4	191.3
Profit before tax difference in year per above	(1.8)	(2.7)
Taxation difference in year per above	11.8	27.8
Less: deferred tax on pension scheme included in above taken to reserves in regulatory accounts	(0.2)	(5.9)
Less: deferred tax asset recognised on hedging reserve for statutory accounts but not UK GAAP	(4.9)	-
Rounding	0.1	(0.1)
Net assets per regulatory accounts	<u>639.2</u>	<u>611.0</u>

**CURRENT COST PROFIT AND LOSS ACCOUNT
FOR THE APPOINTED BUSINESS
for the year ended 31 March 2010**

	Notes	2010 £m	2009 £m
Turnover	2	438.6	424.7
Current cost operating costs	3	(275.3)	(263.7)
Current cost profit on sale of fixed assets	2	1.0	1.6
		<hr/>	<hr/>
		164.3	162.6
Working capital adjustment		0.3	(0.1)
		<hr/>	<hr/>
Current Cost Operating Profit		164.6	162.5
Other income		0.3	0.2
Net interest payable		(64.1)	(69.9)
Financing adjustment		73.1	(6.0)
		<hr/>	<hr/>
Current Cost Profit Before Taxation		173.9	86.8
Tax on profit on ordinary activities:			
- Current tax		(30.5)	(20.1)
- Deferred tax		11.9	(8.8)
		<hr/>	<hr/>
Current Cost Profit on Ordinary Activities After Taxation		155.3	57.9
Dividends		(54.4)	(103.8)
		<hr/>	<hr/>
Current Cost Surplus/(deficit) Transferred to Reserves		100.9	(45.9)
		<hr/>	<hr/>

CURRENT COST BALANCE SHEET FOR THE APPOINTED BUSINESS at 31 March 2010

	Notes	2010 £m	2009 £m
Fixed Assets			
Tangible fixed assets	4 (a,b,c)	8,533.7	8,143.3
Third party contributions since 1989/90		(140.0)	(137.2)
Infrastructure Renewals Prepayment		8.9	13.1
Working capital	5	1.6	(7.3)
Net operating assets		8,404.2	8,011.9
Cash and investments		263.2	250.8
Non-trade debtors		8.6	12.2
Non-trade creditors due within one year		(234.1)	(100.4)
Creditors due after more than one year		(1,658.3)	(1,769.1)
Provisions for liabilities and charges:			
- Deferred tax		(81.3)	(93.6)
- Other provisions		(3.1)	(0.3)
Net assets excluding pension liability		6,699.2	6,311.5
Pension liability		(60.0)	(37.1)
Net assets employed including pension liability		6,639.2	6,274.4
Capital and Reserves			
Called-up share capital		150.9	150.9
Profit and loss account	6a	443.2	366.6
Current cost reserve	6b	6,045.1	5,756.9
Total Capital and Reserves		6,639.2	6,274.4

Approved by the Board on 25 June 2010 and signed on its behalf by:-

C Loughlin
Chief Executive

S Davy
Finance Director

CURRENT COST CASH FLOW STATEMENT

for the year ended 31 March 2010

	Notes	2010		2009	
		Appointed Business		Appointed Business	
		£m	£m	£m	£m
Net cash flow from operating activities	7		283.2		234.3
Returns on investment & servicing of finance:					
Interest received		3.7		11.6	
Interest paid		(20.5)		(20.2)	
Interest in finance lease rentals		(39.6)		(47.5)	
			<hr/>		<hr/>
Net cashflow from returns on investment & servicing of finance			(56.4)		(56.1)
Taxation			(1.0)		(21.4)
Capital expenditure and financial investment:					
Gross cost of purchase of fixed assets		(130.2)		(138.9)	
Receipt of grants and contributions		3.4		6.3	
Infrastructure renewals expenditure		(23.8)		(27.4)	
Disposal of fixed assets		1.3		2.2	
Movements on long term loans to group companies		0.7		-	
			<hr/>		<hr/>
Net cash outflow from investing activities			(148.6)		(157.8)
Acquisitions and disposals			-		-
Equity dividends paid			(54.4)		(103.8)
Management of liquid resources:					
Disposal or redemption of other liquid assets		610.6		724.3	
Purchase of other liquid investments		(590.6)		(804.3)	
			<hr/>		<hr/>
Net cash inflow/(outflow) from management of liquid resources			20.0		(80.0)
Net cash inflow/(outflow) before financing			42.8		(184.8)
Financing:					
Capital element in finance lease rentals		(11.3)		(10.6)	
New bank loans		-		-	
Draw down/ (repayment) of borrowings		(15.9)		122.1	
			<hr/>		<hr/>
Net cash (outflow)/inflow from financing			(27.2)		111.5
Increase/(Decrease) in cash and cash equivalents			15.6		(73.3)

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

1. Current Cost Accounting Policies

(a) General

These Financial Statements have been prepared for the Appointed Business of South West Water Limited in accordance with guidance issued by the Water Services Regulation Authority (Ofwat) for modified real terms financial statements suitable for regulation in the water industry. They measure profitability on the basis of real financial capital maintenance in the context of assets which are valued at their current cost value to the business.

The accounting policies used are the same as those adopted in the Historical Cost Regulatory Accounts except as set out below.

(b) Tangible Fixed Assets

Assets in operational use are valued at the replacement cost of their operating capability. To the extent that the regulatory regime does not allow such assets to earn a return high enough to justify that value, this represents a modification of the value to the business principle. Also, no provision is made for the possible funding of future replacements of assets by contributions from third parties and, to the extent that some of those assets would be so funded on replacement, replacement cost again differs from value to the business. Redundant assets are valued at their recoverable amounts.

The Periodic Review process provides for a re-assessment of asset valuations through a refinement of asset records as part of the Company's Asset Management Plan (AMP). The current cost gross asset values and depreciation used in the current cost statement for 2009/2010 have been based on data derived from this review.

(i) Land and Buildings

Non-specialised operational properties are valued on the basis of open market value for existing use and have been expressed in real terms by indexation using the Retail Prices Index (RPI).

Specialised operational properties are valued at the lower of depreciated replacement cost and recoverable amount, restated annually between Periodic Reviews by adjusting for inflation as measured by changes in RPI. The unamortised portion of third party contributions received is deducted in arriving at net operating assets (as described below).

(ii) Infrastructure Assets

Mains, sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls are valued at replacement cost determined principally on the basis of data provided by the Asset Management Plan.

In the intervening years between Periodic Reviews, values are restated to take account of changes in the general level of inflation as measured by changes in the RPI over the year.

(iii) Other Fixed Assets

All other fixed assets are valued periodically at depreciated replacement cost. Between periodic AMP reviews, values are restated for inflation as measured by changes in the RPI.

(iv) Surplus Land

Surplus land is valued at recoverable amount taking into account that part of any proceeds to be passed on to customers under Condition B of the Licence.

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

1. Current Cost Accounting Policies (continued)

(b) Tangible Fixed Assets (continued)

(v) Grants and Other Third Party Contributions

Grants, infrastructure charges and other third party contributions received since 31 March 1990 are carried forward to the extent that any balance has not been credited to revenue. The balance carried forward is restated for the change in the RPI for the year and treated as deferred income.

(c) Real Financial Capital Maintenance Adjustments

These adjustments are made to historical cost profit in order to arrive at profit after the maintenance of financial capital in real terms.

(i) Working Capital Adjustment

This is calculated by applying the change in the RPI over the year to the opening total of trade debtors and stock less trade creditors.

(ii) Financing Adjustment

This is calculated by applying the change in the RPI over the year to the opening balance of net finance which comprises all monetary assets and liabilities in the balance sheet apart from those included in working capital.

2. Analysis of Turnover and Operating Income for the Appointed Business

	Water Services £m	2010 Sewerage Services £m	Appointed Business £m	Water Services £m	2009 Sewerage Services £m	Appointed Business £m
Turnover						
Measured	123.3	135.9	259.2	111.1	125.3	236.4
Unmeasured	66.9	88.4	155.3	67.4	94.4	161.8
Trade effluent	-	4.4	4.4	-	4.5	4.5
Large user revenues	6.7	7.1	13.8	6.2	7.0	13.2
Third party services	4.7	1.2	5.9	7.3	1.5	8.8
	201.6	237.0	438.6	192.0	232.7	424.7
Current Cost Profit / (Loss) on Sale of Fixed Assets	0.5	0.5	1.0	0.8	0.8	1.6

The figures for large user revenues include any trade effluent turnover arising from those customers.

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

3. Analysis of Operating Costs and Current Cost Fixed Asset Net Book Values by Service 2010

	WATER SUPPLY			SEWERAGE SERVICES					BUSINESS ACTIVITIES		
	Resources and Treatment £m	Distribution £m	Water Supply Total £m	Sewerage £m	Sewerage Treatment £m	Sludge Treatment and Disposal £m	Sewerage Treatment and Disposal Sub Total £m	Sewerage Services Total £m	Customer Services £m	Scientific Services £m	Cost of Regulation £m
Direct Costs											
Employment costs	4.3	4.1	8.4	0.6	6.2	0.7	6.9	7.5			
Power	2.7	4.1	6.8	1.9	9.1	1.1	10.2	12.1			
Agencies	-	-	-	-	-	-	-	-			
Hired and contracted services	1.0	8.4	9.4	3.0	2.7	5.3	8.0	11.0			
Materials and consumables	3.2	0.4	3.6	0.3	3.0	1.6	4.6	4.9			
Service charges	4.3	0.1	4.4	0.7	2.9	-	2.9	3.6			
Other direct costs	0.3	0.8	1.1	0.2	0.6	0.2	0.8	1.0			
Total Direct Costs	15.8	17.9	33.7	6.7	24.5	8.9	33.4	40.1	10.3	3.3	2.1
General & support expenditure	4.9	5.4	10.3	1.6	8.8	4.2	13.0	14.6	3.7	1.2	0.4
Functional Expenditure	20.7	23.3	44.0	8.3	33.3	13.1	46.4	54.7	14.0	4.5	2.5
Business activities			11.4					9.6			
Rates			8.8					4.2			
Doubtful debts			5.4					7.1			
Exceptional Item			0.0					0.0			
Service Costs			69.6					75.6			
Third party services			5.0					0.6			
Total Operating Expenditure			74.6					76.2			
Capital Costs											
Infrastructure renewal :											
- expenditure	1.6	11.8	13.4	10.5	-	-	-	10.5			
- (prepayment)/accrual	0.2	0.4	0.6	3.5	-	-	-	3.5			
Current cost depreciation	19.7	12.6	32.3	9.5	50.0	4.8	54.8	64.3			
Business activities capital costs			0.7					0.3			
Amortisation of deferred credits			-0.5					-0.7			
Capital Maintenance excl.			46.5					77.9			
Third Party Services											
Third party services			0.0					0.1			
Total Capital Maintenance			46.5					78.0			
Total Operating Costs			121.1					154.2			

Total Operating Expenditure above includes Planned and Reactive Maintenance Expenditure of:											
Infrastructure	0.1	12.4	12.5	2.6	-	-	-	2.6			
Non Infrastructure	2.7	1.4	4.1	1.5	4.5	1.4	5.9	7.4			
			16.6					10.0			

Service activities	683.7	3,025.0	3,708.7	4,055.4	694.2	71.0	765.2	4,820.6			
Business activities			2.1	0.1			0.5	0.6			
Service Totals			3,710.8	4,055.5			765.7	4,821.2			
Third party services			0.0					1.7			
Total			3,710.8					4,822.9			

The allocation of operating costs within the Company to specific service areas within the appointed business and to the non-appointed business is based on activity analysis and principles which result in both direct and support costs being apportioned.

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

3. Analysis of Operating Costs and Current Cost Fixed Asset Net Book Values by Service 2009

	WATER SUPPLY			SEWERAGE SERVICES					BUSINESS ACTIVITIES		
	Resources and Treatment £m	Distribution £m	Water Supply Total £m	Sewerage £m	Sewage Treatment £m	Sludge Treatment and Disposal £m	Sewage Treatment and Disposal Sub Total £m	Sewerage Services Total £m	Customer Services £m	Scientific Services £m	Cost of Regulation £m
Direct Costs											
Employment costs	3.9	3.1	7.0	0.7	5.6	0.7	6.3	7.0			
Power	2.2	3.9	6.1	1.8	7.8	1.0	8.8	10.6			
Agencies	-	-	-	-	-	-	-	-			
Hired and contracted services	1.1	8.7	9.8	2.5	2.2	5.5	7.7	10.2			
Materials and consumables	2.7	0.1	2.8	0.1	2.2	1.7	3.9	4.0			
Service charges	4.3	0.0	4.3	0.9	3.3	0.0	3.3	4.2			
Other direct costs	0.2	1.0	1.2	0.1	0.4	0.0	0.4	0.5			
Total Direct Costs	14.4	16.8	31.2	6.1	21.5	8.9	30.4	36.5	11.9	3.4	3.1
General & support expenditure	5.5	5.0	10.5	1.9	9.4	3.3	12.7	14.6	3.1	1.1	0.2
Functional Expenditure	19.9	21.8	41.7	8.0	30.9	12.2	43.1	51.1	15.0	4.5	3.3
Business activities			13.0					9.9			
Rates			8.3					4.4			
Doubtful debts			5.3					6.7			
Exceptional Item			0.0					0.0			
Service Costs			68.3					72.1			
Third party services			6.3					0.7			
Total Operating Expenditure			74.6					72.8			
Capital Costs											
Infrastructure renewal : - expenditure - (prepayment)/accrual	1.7	11.7	13.4	12.9	0.0	0.0	0.0	12.9			
Current cost depreciation	16.2	13.5	29.7	7.4	44.1	9.0	53.1	60.5			
Business activities capital costs			0.7					0.4			
Amortisation of deferred credits			-0.5					-1.1			
Capital Maintenance excl.			43.3					72.7			
Third Party Services											
Third party services			0.1					0.2			
Total Capital Maintenance			43.4					72.9			
Total Operating Costs			118.0					145.7			

Total Operating Expenditure above includes Planned and Reactive Maintenance Expenditure of:										
Infrastructure	0.1	11.3	11.4	2.2	0.0	0.0	0.0	2.2		
Non Infrastructure	2.6	1.7	4.3	1.4	4.3	1.3	5.6	7.0		
			15.7					9.2		

Current Cost Net Book Values of Fixed Assets										
Service activities	685.6	2,829.5	3,515.1	3,898.2	598.3	122.6	720.9	4,619.1		
Business activities			3.6	0.4			1.6	2.0		
Service Totals			3,518.7	3,898.6			722.5	4,621.1		
Third party services			0.3					3.2		
Total			3,519.0					4,624.3		

The allocation of operating costs within the Company to specific service areas within the appointed business and to the non-appointed business is based on activity analysis and principles which result in both direct and support costs being apportioned.

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

4a. Current Cost Analysis of Fixed Assets by Asset Type

Water Services	Specialised Operational Assets £m	Non- specialised Operational Properties £m	Infra- structure Assets £m	Other Tangible Assets £m	Total £m
Gross Replacement Cost:-					
At 1 April 2009	940.1	7.7	3,025.3	101.3	4,074.4
RPI adjustment	41.8	0.3	134.7	4.5	181.3
Disposals	-	-	-	(7.4)	(7.4)
Additions	29.3	-	32.3	7.1	68.7
At 31 March 2010	1,011.2	8.0	3,192.3	105.5	4,317.0
Depreciation:-					
At 1 April 2009	490.9	6.4		58.1	555.4
RPI adjustment	21.9	0.2		2.6	24.7
Disposals	-	-		(7.4)	(7.4)
Charge for year	28.3	0.4		4.8	33.5
At 31 March 2010	541.1	7.0		58.1	606.2
Net Book Value:-					
At 31 March 2010	470.1	1.0	3,192.3	47.4	3,710.8
At 1 April 2009	449.2	1.3	3,025.3	43.2	3,519.0

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

4b. Current Cost Analysis of Fixed Assets by Asset Type (continued)

Sewerage Services	Specialised Operational Assets £m	Non- specialised Operational Properties £m	Infra- structure Assets £m	Other Tangible Assets £m	Total £m
Gross Replacement Cost:-					
At 1 April 2009	1,595.9	16.4	3,788.6	83.0	5,483.9
RPI adjustment	71.0	0.7	168.6	3.7	244.0
Disposals	-	-	-	(8.8)	(8.8)
Additions	42.9	-	8.3	8.3	59.5
At 31 March 2010	<u>1,709.8</u>	<u>17.1</u>	<u>3,965.5</u>	<u>86.2</u>	<u>5,778.6</u>
Depreciation:-					
At 1 April 2009	795.4	6.4		57.8	859.6
RPI adjustment	35.4	0.2		2.6	38.2
Disposals	-	-		(8.6)	(8.6)
Charge for year	60.0	0.4		6.1	66.5
At 31 March 2010	<u>890.8</u>	<u>7.0</u>		<u>57.9</u>	<u>955.7</u>
Net Book Value:-					
At 31 March 2010	<u>819.0</u>	<u>10.1</u>	<u>3,965.5</u>	<u>28.3</u>	<u>4,822.9</u>
At 1 April 2009	<u>800.5</u>	<u>10.0</u>	<u>3,788.6</u>	<u>25.2</u>	<u>4,624.3</u>

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

4c. Current Cost Analysis of Fixed Assets by Asset Type (continued)

Total	Specialised Operational Assets £m	Non- specialised Operational Properties £m	Infra- structure Assets £m	Other Tangible Assets £m	Total £m
Gross Replacement Cost:-					
At 1 April 2009	2,536.0	24.1	6,813.9	184.3	9,558.3
RPI adjustment	112.8	1.0	303.3	8.2	425.3
Disposals	-	-	-	(16.2)	(16.2)
Additions	72.2	-	40.6	15.4	128.2
At 31 March 2010	<u>2,721.0</u>	<u>25.1</u>	<u>7,157.8</u>	<u>191.7</u>	<u>10,095.6</u>
Depreciation:-					
At 1 April 2009	1,286.3	12.8		115.9	1,415.0
RPI adjustment	57.3	0.4		5.2	62.9
Disposals	-	-		(16.0)	(16.0)
Charge for year	88.3	0.8		10.9	100.0
At 31 March 2010	<u>1,431.9</u>	<u>14.0</u>		<u>116.0</u>	<u>1,561.9</u>
Net Book Value:-					
At 31 March 2010	<u>1,289.1</u>	<u>11.1</u>	<u>7,157.8</u>	<u>75.7</u>	<u>8,533.7</u>
At 1 April 2009	<u>1,249.7</u>	<u>11.3</u>	<u>6,813.9</u>	<u>68.4</u>	<u>8,143.3</u>

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

5. Working Capital

	2010	2009
	£m	£m
Stocks	3.5	4.1
Trade debtors		
- measured household	6.8	1.5
- unmeasured household	12.7	13.4
- measured non-household	7.8	7.1
- unmeasured non-household	0.3	0.3
-other	0.4	0.3
Measured Income Accrual	28.1	25.1
Prepayments and other debtors	4.8	6.3
Trade creditors	(14.2)	(12.4)
Deferred income - customer advance receipts	(5.6)	(5.2)
Capital creditors	(33.8)	(37.1)
Accruals and other creditors	(9.2)	(10.7)
	<u>1.6</u>	<u>(7.3)</u>

6. Reserves

(a) Profit and Loss Account

	£m
At 1 April 2009	366.6
Profit on ordinary activities after taxation	155.3
Dividends paid	(54.4)
Actuarial loss recognised in the pension scheme	(32.8)
Movement on deferred tax relating to pension liability	8.9
Share-based payments	0.8
Net movement on interest rate swaps	(1.2)
At 31 March 2010	<u>443.2</u>

(b) Current Cost Reserve

	2010	2009
	£m	£m
At 1 April	5,756.9	5,782.8
RPI Adjustments:-		
Fixed assets	362.2	(32.5)
Working capital	(0.3)	0.1
Financing	(73.1)	6.0
Grants and third party contributions	(0.6)	0.5
At 31 March	<u>6,045.1</u>	<u>5,756.9</u>

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

7. Notes to the Cash Flow Statement

Reconciliation of Operating Profit to Net Cash Inflow from Operating Activities

	2010	2009
	£m	£m
Current cost operating profit	164.6	162.5
Working capital adjustment	(0.3)	0.1
Increase in working capital	(5.7)	(7.4)
Receipts from other income	0.3	0.3
Current cost depreciation	96.6	90.0
Current cost profit on sale of fixed assets	(1.0)	(1.6)
Intrastructure renewals charge	28.1	26.3
Movement in provisions	0.6	(35.9)
Net cash flow from operating activities	283.2	234.3

8. Analysis of Net Debt

	Interest rate risk profile			Total
	Fixed rate	Floating rate	Index linked	
<u>Maturity Profile</u>	£m	£m	£m	£m
Less than one year	121.9	33.3	0.1	155.3
Between one and two years	29.6	7.4	0.1	37.1
Between two and five years	105.3	40.1	0.4	145.8
Between five and twenty years	393.7	105.7	27.1	526.5
In more than twenty years	287.1	334.3	326.0	947.4
Borrowings (excluding preference shares)	937.6	520.8	353.7	1,812.1
Preference share capital				0.0
Total Borrowings (including overdraft of £17.0m)				1,812.1
Cash				(0.1)
Short term deposits				(264.8)
Net Debt				1,547.2

NOTES TO THE CURRENT COST REGULATORY ACCOUNTS

9. Regulatory Capital Value

	Note	2010 £m
Opening RCV for the year (indexed by RPI)	(a)	2,570
Capital Expenditure	(a)	158
Infrastructure renewals expenditure		26
Grants and contributions		(5)
Depreciation		(96)
Infrastructure renewals charge		(24)
Outperformance of Regulatory Assumptions (5 years in arrears)		(8)
		<hr/>
Closing RCV carried forward	(a)	2,621
		<hr/>
Average regulatory capital value		2,538
		<hr/>

(a) The table shows the RCV used in setting the price limits for 2009/10. The differences between the assumptions for the component parts such as capital expenditure shown above and the actual amounts do not affect the price limits in the current review period. Capital efficiencies achieved in the current price setting period have been taken into account in the calculation of the RCV used to set prices for the next review period. Other adjustments to the RCV used for the next review period have been agreed with Ofwat through the process of logging up / logging down of capital expenditure. The opening RCV for the year shown above is inflated from the closing RCV for the previous year by RPI.

ADDITIONAL INFORMATION REQUIRED UNDER CONDITION F OF THE COMPANY'S LICENCE

(i) Statement of compliance with condition F and RAG 5.04

It is confirmed that to the best of the directors' knowledge, all transactions between the Appointed Business and Associated Companies have been disclosed and that these transactions have been conducted at arm's length and that cross subsidy is not occurring.

(ii) Sales of services between the Appointed Business and Associated Companies

(a) Services supplied to the appointee by associated companies:

Nature of transaction	Company	Turnover of associated company £m	Terms of supply	Value £m
Group expenses	Pennon Group Plc	7.4	Recharge of appropriate costs	3.7
Dry waste and sludge transport	Viridor Waste Group	626.5	Competitive letting/ other market testing	0.7
Property sales	Peninsula Properties (Exeter) Ltd	0.3	Other market testing	0.3
Insurance premiums	Peninsula Insurance Ltd	1.1	Other market testing	0.5
				5.2*

* £0.2m of expenditure relates to capital work conducted by the appointed business.

(b) Services supplied by the appointee to associated companies:

Nature of transaction	Company	Terms of supply	Value £m
Administrative services	Pennon Group Plc	Recharge of appropriate costs	0.5
Tankered waste & trade effluent charges	Viridor Waste Group	Commercial at arms length.	0.9
Other services	Various	Recharge of appropriate costs	0.2
			1.6

ADDITIONAL INFORMATION REQUIRED UNDER CONDITION F OF THE COMPANY'S LICENCE (Continued)

(iii) Dividends Paid to Associated Companies

The Company has established a dividend policy which involves the following components:

- a sustainable level of base dividend growth, determined by a number of factors including the shareholders' investment and the cost of capital.
- a further level of growth funded by efficiency out-performance.
- consistency with the assumptions made by Ofwat in setting prices for the K4 period.

Dividend payments ensure that key financial ratios are not prejudiced and that the ability of the Appointee to finance its Appointed Business is not impaired.

Dividends totalling £54.4m (2009: £103.8m) were paid to the parent undertaking, representing a base dividend for 2009/10 of £53.3m plus an additional £1.1m in respect of the previous two years taking into account actual movements in RPI. (The 2008/09 figure represented a 'catch up' after the share capital reduction during that year created sufficient distributable reserves on a statutory, IFRS basis, to release a backlog). These dividends were calculated with reference to the projections in the Final Determination 09.

(iv) Borrowings from Associated Companies

Company	Principal Amount £m	Repayment date	Interest rate %
South West Water Finance Plc: loan notes 2050	100.0	2010/2050	4.13% (fixed until June 2010)
South West Water Finance Plc: index-linked bond 2057	218.7	2057	RPI + 1.99%
Peninsula Leasing Limited: Finance leases in respect of motor vehicles	0.7	2009/10 to 2011/12	6.06%
Peninsula Leasing Limited: Finance leases in respect of plant & machinery	7.7	1 April 2010	12month LIBOR

ADDITIONAL INFORMATION REQUIRED UNDER CONDITION F OF THE COMPANY'S LICENCE (Continued)

(v) Loans to Associated Companies

Company	Principal £m	Repayment date	Interest rate %	Interest received £m
Pennon Group Plc	-	Overnight lending	Money market variable	0.0
Peninsula Leasing Ltd	1.1	2009/10 to 2011/12	Variable	0.1

(vi) Guarantees

(i) The Company has provided guarantees to third party lenders in respect of loans and finance leases extended to its subsidiaries, South West Water Finance Plc (£318.7m at 31 March 2010) and Peninsula Leasing Limited (£7.0m at 31 March 2010). The funds raised were lent to the Company on 'back to back' terms, as described in section (iv) above.

ADDITIONAL INFORMATION REQUIRED UNDER CONDITION F OF THE COMPANY'S LICENCE (Continued)

(vii) The role of South West Water Ltd's Directors in associated companies

The Company has taken a conscious decision to minimise the role of its Directors on the boards of associated companies and hence avoid the potential risk of conflict of interest.

Apart from the roles of the Non-executive Chairman and Company Secretary, and that of the Chief Executive on the Board of the parent company, the only cross-directorships are that of the Chief Executive on the Boards of Peninsula Water Ltd, Echo South West Ltd and South West Water Finance Plc, S J Davy on the Boards of Peninsula Leasing Ltd, Peninsula Properties (Exeter) Ltd, South West Water Finance Plc and Haldon Collections Ltd and M S Read on the Boards of Echo South West Ltd and Haldon Collections Ltd.

Full details are provided in the following table:

Name	Position in appointed business	Associated company	Position in associated company
K G Harvey	Chairman	Pennon Group Plc Viridor Waste Ltd Viridor Limited Peninsula Trustees Ltd Pennon Pension Trustees Ltd	Chairman Chairman Chairman Chairman
C Loughlin	Chief Executive	Pennon Group Plc Peninsula Water Ltd Echo South West Ltd South West Water Finance Plc	Director Chairman Director Director
K D Woodier*	Company Secretary	Echo South West Ltd Peninsula Properties (Exeter) Ltd Peninsula Leasing Ltd Pennon Group Plc Peninsula Water Limited Viridor Waste Ltd Viridor Waste Suffolk Ltd Viridor Waste (Thames) Limited Viridor Limited South West Water Finance Plc	Secretary Secretary Director/Secretary Secretary Secretary Secretary Secretary Secretary Secretary Secretary Director/Secretary
S C Bird	Operations Director	Peninsula Trustees Ltd	Director
S J Davy	Finance Director	Peninsula Leasing Ltd Peninsula Properties (Exeter) Ltd South West Water Finance Plc Haldon Collections Ltd	Director Director Director Director
M S Read	Customer Services Director	Echo South West Limited Haldon Collections Ltd	Director Director
H C B Shapland	Gen. Manager	Peninsula Properties (Exeter) Ltd	Director

* Mr K D Woodier, in his capacity as Company Secretary for the Pennon Group, is a Director and / or Secretary for most companies in the Pennon Group in addition to South West Water and its subsidiaries. He does not participate in the executive management of South West Water Limited and its subsidiaries.

ADDITIONAL INFORMATION REQUIRED UNDER CONDITION F OF THE COMPANY'S LICENCE (Continued)

(viii) Methodology for Allocating Costs Between Services (Note 3)

Direct operating and capital costs are incurred directly by specific service and have not required allocation. Indirect costs are allocated on either a causal link basis or according to local managers' assessments.