news from Pennon Group Plc

PENNON GROUP PLC **25 May 2010**

PRELIMINARY RESULTS FOR THE YEAR ENDED 31 MARCH 2010

Pennon Group announces its unaudited results for the year ended 31 March 2010.

A presentation for City audiences will be held today, Tuesday 25 May 2010, at 9am at the King Edward Hall, The Merrill Lynch Financial Centre, 2 King Edward Street, London, EC1. A live webcast of the results presentation will be available on the Company's website, pennon-group.co.uk

For further information today, 25 May 2010, please contact :

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FINANCIAL HIGHLIGHTS

- Underlying profit before tax [(1)] up 14.2% to £189.1m
    - South West Water up 8.7% to £132.5m
    - Viridor up 34.8% to £55.4m
- Underlying earnings per share [(2)] up 9.2% to 41.6p
- Dividend
    - Recommended final dividend per share up 9.5% to 15.60p
    - Full year dividend up 7.4% to 22.55p
    - Board announces policy of 4% per annum real dividend increases from 2010/11 at least until 2014/15
- Strong liquidity and funding position
- Group businesses well positioned in current economic conditions

RECONCILIATION OF UNDERLYING AND STATUTORY RESULTS

	2009/10	2008/09*	Growth
	£m	£m	
PROFIT BEFORE TAX			
Statutory profit before tax	183.8	159.4	15.3%
Non-underlying costs :			
- Restructuring – South West Water	5.0	5.0	
- Intangibles amortisation – Viridor	0.3	1.2	
[(1)]Underlying profit before tax	189.1	165.6	14.2%
EARNINGS PER SHARE			
Statutory earnings per share	39.9p	25.8p	54.7%
Non-underlying costs :			
- Restructuring (after tax) – South West Water	1.2	0.9	
- Intangibles amortisation – Viridor	0.1	0.3	
Deferred tax	0.4	11.1	
[(2)]Underlying earnings per share	41.6p	38.1p	9.2%

* Restated for the application of IFRIC 12 ‘Service concession arrangements’.

Throughout this report, unless otherwise stated, all figures are underlying results excluding restructuring costs, intangibles amortisation and deferred tax. The Directors believe that the underlying measures provide a more useful comparison on business trends and performance.

OPERATIONAL HIGHLIGHTS

- **South West Water :**
  - Successful delivery of 2005 – 2010 Regulatory Contract
  - Strong growth in K4 Regulatory Capital Value significantly exceeded growth in net debt
  - Average funding cost 4.0%
  - Leakage target achieved despite severest winter for around 30 years
  - Operating efficiency including energy efficiency target exceeded
  - Delivery under way of K5 regulatory contract

- **Viridor :**
  - Continued strong growth in PBITA plus joint ventures[(1)] and PBT
    - recyclate prices very strong
    - benefit of favourable power prices contracted in May 2008
    - 44% of profits from recovering value in waste
  - Greater Manchester 25 year PFI contract operating successfully
  - Lakeside Energy from Waste plant handover from contractor in January 2010
    - contributed £2.0m in 2009/10[(1)]
  - Preferred bidder for Oxfordshire PPP and Exeter EfW; continuing to bid selectively for other contracts
  - London Recycling and Intercontinental Recycling acquired and successfully integrated.

(1) Comprises share of PAT and interest receivable on shareholder loan.

Ken Harvey, Chairman said "This has been another successful year for the Group. During the year South West Water has delivered strong operational performance and has outperformed the operating cost efficiency and financing targets set by Ofwat for the K4 period. Viridor has once again delivered a very strong financial performance. The Greater Manchester Waste PFI contract, Lakeside Energy from Waste project and the latest acquisitions are further major steps forward in the successful evolution of Viridor.

"Notwithstanding the lower returns envisaged by Ofwat's Final Determination and the impact of current economic conditions, the Group remains well positioned to continue to deliver shareholder value and meet future challenges. South West Water is well placed to achieve Ofwat's efficiency targets and outperform its financing cost assumptions for K5. Viridor expects to continue to deliver strong long-term growth through successfully leading the way in exploiting opportunities arising from the Government's landfill diversion, recycling and renewable energy targets. As a result the Board is pleased to announce its intention to increase the dividend by 4% per annum above inflation from 2010/11 at least until 2014/15."

GROUP OVERVIEW

- Revenue rose by 11.6% to £1,068.9m, exceeding £1 billion for the first time.
- Operating profit [(1)] rose by 4.9% to £269.6m.
- Profit before tax was up 14.2% to £189.1m.
- Earnings per share increased by 9.2% from 38.1p to 41.6p. Statutory earnings per share increased from 25.8p to 39.9p.
- Capital expenditure was £190.2m (2008/09 – £231.8m).
    - Investment in joint ventures of £30.8m (2008/09 £1.3m)
- Net borrowings at 31 March 2010 were £1,895m, an increase of £3m since 31 March 2009. Gearing, being net borrowings to shareholders' funds plus net borrowings, was 74.1% (2008/09 – 76.0%).
- The Group has substantial cash resources and committed facilities – well placed in current financial market conditions.
- South West Water net debt to RCV was 60.3% (31 March 2009 – 63.6%).
- Net interest cover (excluding pensions net interest, IFRIC 12 contract interest receivable and discount unwind on provisions) was 3.4 times (2008/09 – 2.9 times).
- The Board has recommended a final dividend of 15.60p, up 9.5%, subject to shareholder approval. Together with the interim dividend of 6.95p, this will result in a total dividend for the year of 22.55p, an increase of 7.4% on the total dividend for 2008/09. The Company is also offering a scrip dividend alternative.

	2009/10	**2008/09***	**Growth**
	£m	**£m**	
OPERATING PROFIT			
Statutory operating profit	264.3	250.8	5.4%
Non-underlying costs :			
- Restructuring – South West Water	5.0	5.0	
- Intangibles amortisation – Viridor	0.3	1.2	
[(1)]Underlying operating profit	269.6	257.0	4.9%

* Restated for the application of IFRIC 12 'Service concession arrangements'.

SOUTH WEST WATER

Financial Highlights

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).

Revenues increased by 2.9% (£12.5m) to £444.2m as a result of tariff increases and new connections. Approved tariff increases, including the 1.4% K factor, amounted to £20.9m. Customers switching from unmeasured to metered charging reduced turnover by £7.0m but 5,000 new customer connections contributed £0.6m of additional turnover. Customer demand remained constant, reversing the trend of consumption decline seen in recent years.

Operating profit rose by 2.6% (£4.9m) to £196.5m. Operating costs, excluding depreciation, increased from £150.3m to £154.1m. Cost increases including inflation of £6.5m, additional costs from new capital schemes of £1.8m and other cost impacts of £1.5m were offset by £4.4m of efficiency savings and £1.6m of other savings, primarily lower cost of sales. Depreciation increased by £3.8m to £93.6m principally as a result of new capital schemes. Profit before tax increased by 8.7% to £132.5m with net interest payable reduced by £5.7m primarily from lower interest rates.

Operational Highlights

Staff-led energy saving projects resulted in an overall energy saving of 6.5GWh, a reduction of around 3,500 tonnes of CO_2 and a cost saving of around £600,000 per annum. The PowerDown scheme has now been extended in 2010/11 with the aim of further reducing energy use.

South West Water has already purchased three quarters of its K5 energy requirements at a lower market price than that assumed in the Final Determination.

The direct impact of the current economic conditions on customer debt collections has been marginal to date. South West Water is introducing a range of customer debt management initiatives, and performance has benefited from new operational systems and processes resulting in a slight improvement in collections of older debt and a stable bad debt charge as a percentage of revenue.

Capital expenditure was £143.3m (2008/09 - £147.8m). £74m was invested in water supply improvements including water mains renovation and water treatment works enhancement. Continued high levels of investment in the £240m water mains renovation programme to replace or reline water mains were a key element during the K4 period and the programme finished ahead of schedule in December 2009 when a final 104km of water mains were completed.

The construction of a new trunk main will safeguard South Devon's water supply for decades to come and a second water main will augment that of Cornwall. Drinking water quality for the calendar year 2009 remained very high with a sample compliance rate of 99.96%.

South West Water has put in place a comprehensive strategy to ensure a continued secure supply of water for the region. 2009 was the 13th consecutive summer with no water restrictions and it is most unlikely that there will need to be any restrictions in 2010. Infrastructure work to connect Park and Stannon Lakes (disused china clay pits acquired in 2007 and 2008) to the distribution network has been completed. More cost effective solutions than building new reservoirs, these new lakes represent a significant addition to water resources in Cornwall and further increase the robustness of our water supply system. The two Lakes form the region's fourth and fifth largest reservoirs respectively (behind Roadford, Wimbleball and Colliford).

Despite the coldest winter for around 30 years leading to a surge in burst pipes for both our customers and our own network, South West Water has beaten the target of not more than 84 Megalitres per day with a best ever performance of 82 Megalitres per day. We have matched or beaten Ofwat's leakage targets every year since their inception. Our leakage remains amongst the lowest in the industry at 5.5 cubic metres per kilometre of pipe per day.

The region now features the highest proportion of high quality rivers in England and the most Blue Flag beaches of any region in the UK. In 2009 the population served by compliant waste water treatment works – the treated effluent from which is ultimately discharged into our rivers and coastal waters - was maintained at an all time high. Investment in waste water schemes totalled £60m, predominantly on small maintenance and improvement projects.

K4 Outperformance

The Ofwat target of efficiency cost savings by the end of the K4 period was achieved in 2008/09 ahead of schedule. New efficiency projects delivered in 2009/10 have created a platform to enable further improvements to operational and customer service performance. South West Water is continuing to drive and deliver efficiencies through investment in infrastructure to move the organisation towards a more centralised operational structure employing increased levels of automation and efficient supervision. The company has also implemented a significant programme of organisational restructuring across the business costing £14m to date of which £5m was incurred in 2009/10. A Management Academy was launched in October aimed at developing the skills of front line managers.

South West Water continues to deliver capital projects in line with Ofwat, Drinking Water Inspectorate and Environment Agency expectations. The company targeted and successfully delivered Ofwat's allowed K4 capital programme for 5% less than Ofwat's assumed £762m (2002/03 price base).

Regulatory Capital Value

Regulatory Capital Value (RCV) grew by 31% over the K4 period to £2.6bn by March 2010 – the highest actual percentage increase of any quoted UK water company. After adjusting for the effect of the 2006 capital return, the company's growth in RCV exceeded the growth in net borrowings up to 2010.

K5 Final Determination

The Water Services Regulatory Authority (Ofwat) published on 26 November 2009 its Final Determination in respect of the K5 period (2010 – 2015). There was a significant improvement between the Draft and Final Determinations.

Key elements of the Final Determination for South West Water included :

- A cost of capital for the industry of 4.5% (real, post tax basis and equivalent to 5.1% vanilla)
- '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

Plans for K5

The Final Determination represents a tough challenge for South West Water, but is one the company has accepted and is determined to meet.

To prepare for the 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 '$H_5$0' 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.

The focus for K5 will be to continue to strike the right balance for investors, customers and other stakeholders. The company has already delivered substantial efficiencies over the last two decades and will continue to focus on delivering further efficiency whilst satisfying its regulatory demands and improving services to its customers.

The South West Water strategy is to:

- target outperformance of the regulatory contract
- continues to rigorously control costs
- deliver investment through increased capital maintenance that will secure operating cost savings and protect the service improvements made over the last 20 years.

VIRIDOR

Financial Highlights

Viridor traded strongly in 2009/10, building further on the growth achieved over the past eight years. Revenue was up 18.7% (£98.5m) to £626.5m, of which the acquisitions of London Recycling and Intercontinental Recycling plus the Greater Manchester Waste subcontract accounted for £89.7m. Existing business increased by £8.8m (including an increase in landfill tax collected of £6.3m).

Viridor's earnings before interest, tax, depreciation and amortisation (EBITDA) rose 9.1% from £105.2m to £114.8m. Profit before interest, tax and amortisation of intangibles (PBITA) for the year increased by 15.1% (£9.6m) to £73.1m, compared with £63.5m in 2008/09.

The joint venture projects, Lakeside and Viridor Laing Greater Manchester, contributed £4.2m, (comprising share of PAT and interest receivable on shareholder loans), up from £1.4m in 2008/09. Lakeside has already contributed £1.0m of profit and £1.0m of interest on shareholder loans. Viridor Laing Greater Manchester broke even on an IFRIC 12 accounting basis, and made a £2.5m profit under UK GAAP in 2009/10. It also generated £2.1m of interest receivable on shareholder loans. Viridor's possible contribution of a further £40m mezzanine debt in 2010 to the Greater Manchester project – flagged at financial close in April 2009 - is now no longer required as it has been refinanced by lenders.

PBITA plus joint ventures increased 19.1% from £64.9m to £77.3m. Viridor has achieved PBITA plus joint venture compound growth averaging 22% per annum since 2000/01.

Profit before tax at £55.4m was up 34.8% on the previous year. Capital expenditure for the year was £46.6m (2008/09 - £84.0m) and we invested £30.8m in joint ventures (2008/09 - £1.3m).

Landfill

Total landfill disposal volumes decreased by 0.7m tonnes (15%) to 3.9m tonnes in the year. Site closures (including the Beddingham landfill site in East Sussex whose 2008/09 full year profit contribution was £4.5m) accounted for a decrease of 0.2m tonnes. The underlying decrease of 0.5m tonnes is believed to be primarily due to recession related reductions in third party industrial and commercial volumes. Average revenue per tonne increased by 1.1% (to £22 per tonne). Excluding the effect of the site closures, average gate fees increased by 3.1%. Consented landfill void reduced from 81m cubic metres at 31 March 2009 to 77m cubic metres at 31 March 2010, reflecting planning gains (1.2m cubic metres) and usage during the period (4.8m cubic metres).

Contracts

Contracts profits were well ahead with continued good performance from the West Sussex PFI and 10 other municipal contracts. The two sludge contract businesses that performed poorly in 2008/09 recovered and contributed to profits. There was also a significant contribution from the Greater Manchester Waste PFI sub-contract.

Recycling

The UK is required under the EU Landfill Directive to reduce the amount of biodegradable municipal waste going to landfill sites. (Municipal waste accounts for around one third of Viridor's landfill market. The alternatives to landfill sites for final waste disposal in the UK are currently limited.) To meet the requirements of the Landfill Directive, local authorities have been set statutory targets by the Government for the recycling of household waste and must also implement strategies for the diversion of biodegradable municipal waste away from landfill. The former Chancellor's Budget announcement of 24 March 2010, continuing the increase in landfill tax of £8 a year from £48 per tonne currently to £80 per tonne in 2014/15, will further enhance the long-term economics of recycling. In addition, recyclate costs are typically significantly lower than the cost of using virgin materials for manufacturers.

As noted in the Preliminary Results for 2008/09, recyclate prices were high in the first half of 2008/09 and low in the second half – reflecting the prevailing general world economic conditions. Overall recycling revenues per tonne in 2009/10 were back to the peak levels seen in the first half of last year. They are currently still increasing but are expected to ease back later in the summer. Recycling volumes traded increased by 3.5% to a little over 1.4m tonnes, with an improved recyclate mix. Our recycling revenues are derived from gate fees as well as recyclate sales. Profits per tonne in recycling are appreciably higher than the level of those achieved per tonne by landfilling waste. Viridor is now the largest operator of materials recycling facilities ('MRFs') in the UK.

In June 2009 Viridor acquired London Recycling Limited for a cash consideration of £10.6m, plus debt acquired of £1.5m. Headquartered in London E16, near West Ham, the business comprises a full range of recycling operations, including a fleet of collection vehicles, a waste electrical and electronic equipment ('WEEE') facility, paper processing, confidential destruction, a MRF and a waste auditing facility. It handles approximately 50,000 tonnes of material per annum. London Recycling has had a good track record over recent years in providing essential recycling services to businesses in the capital and has an excellent geographic and business fit with Viridor's operations in the South East of England.

Plastics in particular are a significant and growing part of Viridor's recycling business and, in July 2009, Viridor acquired Intercontinental Recycling Limited for a cash consideration of £4.2m, plus debt acquired of £3.9m. Headquartered in Skelmersdale, Lancashire, the company processes High Density

PolyEthylene (‘HDPE’) and PolyEthylene Terephthalate (‘PET’) plastic bottles, such as are recovered by Viridor’s MRFs. It converts the bottles to pellet or flake which are sold on to plastic manufacturers, mostly within the UK. The plant has the capacity to treat 40,000 tonnes of plastics waste per annum. Like London Recycling Limited, Intercontinental Recycling has a good geographic and business fit with Viridor’s existing operations and is particularly well placed to receive volumes from the Viridor/Laing Greater Manchester Waste PFI. Both the above acquisitions have been fully integrated into Viridor’s existing business.

Renewable Energy Generation - Landfill Gas

Viridor’s landfill gas power generation output increased by a further 10% to 555 Gigawatt hours (GWh) (figure excludes a small amount of sub-contract capacity in Suffolk) during the year reflecting capacity brought on at 2008/09 year end. All of the increase was accredited for full Renewables Obligation Certificates (‘ROCs’). Average revenues per Megawatt hour (‘MWh’) grew by 21% to £90 per MWh (2008/09 - £74 per MWh), reflecting higher energy contract prices and increased output under the Renewable Obligation. Taking advantage of favourable market conditions in May 2008, we sold forward the brown energy component of our ROC-able electricity to March 2010. Current market prices are around £30 per MWh lower than this, which will materially effect this year’s segment results (on ROC volumes only). At 31 March 2010, our landfill gas power generation operational capacity was 100MW (excluding Suffolk subcontract of 3MW), of which 63% was eligible for ROCs and 37% for Non Fossil Fuel Obligation (‘NFFO’).

Waste and Renewable Energy

Energy recovery from waste currently accounts for around 25% of total UK renewable energy (20% from landfill gas and 5% from thermal treatment noted above). This 25% equates to 1.5% of total UK electricity production (from both renewable and non-renewable sources). Viridor sees huge potential for increased energy generation from waste and Viridor estimates that waste could account for a total of 6% of total UK electricity generation by 2015 compared to 1.5% at present. We have called upon the new Government to set this as a UK target.

In addition to the 100MW of landfill gas capacity, Viridor is pursuing a number of other renewable energy opportunities :

- The Lakeside joint venture with Grundon Waste Management comprises a 410,000 tonnes per annum and up to 37MW EfW plant at Colnbrook, near Heathrow. The project was handed over by the contractors to Lakeside Energy from Waste in January and is now operational and trading profitably.

- The Greater Manchester Waste PFI includes the existing Bolton EfW facility (120,000 tonnes per annum, 9MW).

- Planning permission has been achieved for the 60,000 tonnes, 3MW Exeter EfW and contracts are being finalised.

- Planning permission was achieved in September 2008 and preliminary works are under way for the 750,000 tonnes, 120MW phases I and II Runcorn/Ineos Chlor EfW/CHP plant.

- We are pursuing other possible long-term EfW opportunities at Cardiff, Dunbar and Ardley near Oxford (which have all had planning permission turned down locally and are being appealed) and also at Avonmouth and Plymouth.

- We have commenced a construction programme of four anaerobic digestion ('AD') plants for Greater Manchester totalling up to 8MW of electricity. We have also received planning permission for two further plants which we are developing at Beddington (near Croydon) and Walpole (Somerset) respectively.

Public Private Partnerships and Private Finance Initiatives

Public Private Partnership (PPP) and Private Finance Initiative (PFI) contracts are a key part of Viridor's strategy.

Financial Close on the Greater Manchester Waste PFI 25 year contract was achieved on 8 April 2009. It is the UK's largest ever combined waste and renewable energy project, managing 1.3m tonnes of waste per year. The total potential energy generation will be approaching 140MW, including Phases I and II of the Runcorn plant, the four ADs and the existing 9MW of the Bolton EfW plant noted above.

The PFI is a joint venture between Viridor and John Laing Infrastructure ('VLGM'). Operation of the associated facilities (both existing facilities and those which are to be developed) is being carried out on a sub-contract basis by Viridor. In October 2009 it was confirmed that all required VLGM facilities planned for development had received planning permission. As of 31 March 2010, 22 of these 42 facilities had been completed and handed over to Viridor to operate.

The associated EfW/Combined Heat and Power ('CHP') facility (Runcorn Phase I) is a three way joint venture between Ineos Chlor, Viridor and John Laing. Planning permission was achieved by Ineos for both phases of the EfW/CHP plant at Runcorn in September 2008 and construction of the first phase has commenced.

Total capital expenditure for the PFI (VLGM) is projected to be £405m with an additional £235m for the associated EfW/CHP plant (Runcorn Phase I). Viridor's contribution will be £85m. In addition, we have also secured 100% of Phase II of the planned EfW/CHP facility at Runcorn. This will be targeted at the North West market more generally and is significant upside to the initial project given the rising landfill tax and the shortage of competing capacity in the North West.

In addition to the above contracts, we continue to bid selectively for other projects. We are preferred bidder for the Oxfordshire PPP and one of the last two for the Cheshire PFI, and the South West Devon Waste Partnership. We are one of the last three for the Peterborough EfW and MRF contracts and one of four still in the bidding for the Gloucester PFI and South London Waste Partnership. Most of these contracts include renewable energy plants.

GROUP FINANCIAL POSITION

The Group funding strategy utilises a mix of fixed, floating and index-linked rate borrowings. The Group has now fixed or put in place swaps to fix the interest rate on 50% of South West Water's net debt for the entire K5 period. The average rate achieved on the £803m fixed rate debt is circa 3.65%. In addition, £353m of South West Water's debt is index linked at an overall real rate of 1.66%. A substantial portion of debt is finance leasing which provides a long maturity profile and secured credit margins.

The Group had a strong liquidity and funding position as at 31 March 2010 and is well placed in current financial market conditions with :

- Cash balances of £494m (SWW £265m) including £92m restricted cash
- Committed undrawn facilities of £200m
- Committed funding in place for South West Water to at least mid 2011/12

During the year the following finance initiatives were implemented :

- £125m convertible bond
- £215m term loans and RCFs renewed
- £89m of new term loans
- Circa £200m finance lease extended to 2052 and converted to bullet repayment
- £25m finance lease facility for South West Water drawn in 2009/10
- £25m 5-10 year finance lease facility for Viridor
- New provider for £35m of Environment Agency bonds sourced

A further £100m of debt facilities were established/renewed in April 2010.

The fair value benefit (ie the difference between the book value and fair value of Group debt) has increased over the year from £221m to £287m at 31 March 2010 as a result of the Group having a high proportion of its debt at fixed credit margins while market credit margins have increased. The Group's average debt maturity is now 23 years.

PENSIONS

The Group's defined benefit pension schemes had a deficit (net of deferred tax) under IAS 19 at 31 March 2010 of circa £78m (£108m gross).

The £30m increase in the net deficit since 31 March 2009 is primarily due to a reduction in the discount rate and higher long-term expected inflation.

Fund assets increased from £276m to £402m reflecting increases in asset values and the inclusion of the Group's share of the Greater Manchester pension funds (£55m).

The net deficit represents less than 5% of current market capitalisation.

TAXATION

The mainstream corporation tax charge for the year was £43.0m (2008/09 - £31.3m) giving a mainstream effective current tax rate of 23% (2008/09 – 20%). Tax relief on pension contributions amounted to £5.2m (2008/09 - £10.7m).

The deferred tax for the year was £1.3m (2008/09 - £38.3m, of which £24.9m related to the abolition of industrial buildings allowances as contained in the 2008 Finance Act).

STRATEGY, PROSPECTS AND DIVIDEND POLICY

The Pennon Board's priority continues to be the creation of shareholder value through its strategic focus on water and sewerage services; waste management; recycling; and renewable energy.

The Board has considered South West Water's decision in January to accept the Final Determination from Ofwat and has also reviewed Viridor's prospects over the coming years. South West Water has successfully delivered the K4 regulatory contract and is well placed to achieve Ofwat's efficiency targets and outperform its financing cost assumptions for K5. Viridor expects to continue to deliver strong long-term growth through successfully leading the way in exploiting opportunities arising from the Government's landfill diversion, recycling and renewable energy targets – 44% of its profits are already from recovering value in waste. On this basis the Board is today announcing its intention to enhance its progressive dividend policy to grow the Group dividend at 4% above inflation from 2010/11 at least until 2014/15.

The Board is recommending a final dividend for 2009/10 of 15.60p, up 9.5%, subject to shareholder approval. Together with the interim dividend of 6.95p, this will result in a total dividend for the year of 22.55p, an increase of 7.4% on the total dividend for 2008/09. The Company is also offering a scrip dividend alternative. The final date for receipt of Forms of Election/Mandate in respect of the scrip dividend alternative for the final dividend will be 20 September 2010. Details are due to be posted out to shareholders on 27 August 2010.

PRINCIPAL RISKS AND UNCERTAINTIES

All companies operate in environments where there are risks to achieving their objectives. A summary of the principal risks and uncertainties that could impact Pennon Group's performance and the mitigating activities undertaken by the Group are set out at the end of this report.

Ken Harvey
Chairman
25 May 2010

CAUTIONARY STATEMENT IN RESPECT OF FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements relating to Pennon Group's operations, performance and financial position based on current expectations of, and assumptions and forecasts made by, Pennon Group management. Various known and unknown risks, uncertainties and other factors could lead to substantial differences between the actual future results, financial situation development or performance of the Group and the estimates and historical results given herein. Undue reliance should not be placed on forward-looking statements which are made only as of the date of this report. Nothing in this report should be construed as a profit forecast. Whilst the Group believes that the expectations reflected in the forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. It accepts no obligation publicly to revise or update these forward-looking statements or adjust them as a result of new information or for future events or developments, except to the extent legally required.

PENNON GROUP PLC

Consolidated income statement for the year ended 31 March 2010

	Note	**2010 (Unaudited) £m**	2009 (Restated note 3) £m
Revenue	4	**1,068.9**	958.2
Operating costs			
Manpower costs (excluding restructuring costs)		**(132.3)**	(108.6)
Raw materials and consumables used		**(76.3)**	(59.1)
Other operating expenses		**(455.6)**	(402.2)
Depreciation		**(135.1)**	(131.3)
Restructuring costs		**(5.0)**	(5.0)
Amortisation of intangibles		**(0.3)**	(1.2)
Operating profit	4	**264.3**	250.8
Finance income		**34.4**	45.8
Finance costs		**(116.0)**	(138.0)
Share of post-tax profit from joint ventures		**1.1**	0.8
Profit before tax	4	**183.8**	159.4
Taxation	5	**(44.3)**	(69.6)
Profit for the year		**139.5**	89.8
Profit attributable to equity shareholders		**139.5**	89.8
Earnings per share (pence per share)	6		
- Basic		**39.9**	25.8
- Diluted		**39.7**	25.7
Proposed dividend per share (pence per share)	7	**22.55**	21.0
Proposed dividend for the year (£m)	7	**79.6**	73.4

PENNON GROUP PLC

Consolidated statement of comprehensive income for the year ended 31 March 2010

	2010 (Unaudited) £m	2009 (Restated note 3) £m
Profit for the year	**139.5**	89.8
Other comprehensive income		
Actuarial losses on defined benefit schemes	**(44.4)**	(66.8)
Cash flow hedges		
Net fair value losses	**-**	(21.0)
Share of other comprehensive loss from joint ventures	**(3.2)**	-
Tax on items taken directly to or transferred from equity	**17.4**	18.7
Other comprehensive loss for the year net of tax	**(30.2)**	(69.1)
Total recognised income for the year	**109.3**	20.7
Total comprehensive income attributable to equity shareholders	**109.3**	20.7

PENNON GROUP PLC

Consolidated balance sheet at 31 March 2010

	Note	2010 (Unaudited) £m	2009 (Restated note 3) £m
Assets			
Non-current assets			
Goodwill		**254.4**	236.5
Other intangible assets		**5.1**	5.4
Property, plant and equipment		**2,822.7**	2,745.8
Other non-current assets		**101.0**	46.2
Derivative financial instruments		**-**	0.2
Investments in joint ventures		**0.2**	2.2
		3,183.4	3,036.3
Current assets			
Inventories		**6.4**	5.8
Trade and other receivables		**194.9**	178.3
Derivative financial instruments		**3.4**	-
Cash and cash deposits	10	**493.9**	353.3
		698.6	537.4
Liabilities			
Current liabilities			
Borrowings	10	**(229.0)**	(262.9)
Derivative financial instruments		**(3.6)**	(3.6)
Trade and other payables		**(195.8)**	(166.8)
Current tax liabilities		**(83.6)**	(44.8)
Provisions		**(21.5)**	(18.8)
		(533.5)	(496.9)
Net current assets		**165.1**	40.5
Non-current liabilities			
Borrowings	10	**(2,160.2)**	(1,982.4)
Other non-current liabilities		**(16.0)**	(3.7)
Derivative financial instruments		**(14.1)**	(16.5)
Retirement benefit obligations		**(107.9)**	(66.0)
Deferred tax liabilities		**(311.2)**	(328.4)
Provisions		**(78.2)**	(79.2)
		(2,687.6)	(2,476.2)
Net assets		**660.9**	600.6
Shareholders' equity			
Share capital	8	**145.3**	144.5
Share premium account		**10.9**	11.7
Capital redemption reserve		**144.2**	144.2
Retained earnings and other reserves		**360.5**	300.2
Total shareholders' equity		**660.9**	600.6

PENNON GROUP PLC

Consolidated statement of changes in equity

	Share capital (note 8) £m	Share premium account £m	Capital redemption reserve £m	Retained earnings and other reserves (Restated note 3) £m	Total equity (Restated note 3) £m
At 1 April 2008	144.5	11.7	144.2	345.1	645.5
Profit for the year	-	-	-	89.8	89.8
Other comprehensive loss for the year	-	-	-	(69.1)	(69.1)
Total comprehensive income for the year	-	-	-	20.7	20.7
Transactions with equity shareholders					
Dividends paid or approved	-	-	-	(69.1)	(69.1)
Adjustment in respect of share-based payments	-	-	-	1.9	1.9
Proceeds from treasury shares re-issued	-	-	-	1.6	1.6
Total transactions with equity shareholders	-	-	-	(65.6)	(65.6)
At 31 March 2009	144.5	11.7	144.2	300.2	600.6
Profit for the year	-	-	-	139.5	139.5
Other comprehensive loss for the year	-	-	-	(30.2)	(30.2)
Total comprehensive income for the year	-	-	-	109.3	109.3
Transactions with equity shareholders					
Dividends paid or approved	-	-	-	(73.4)	(73.4)
Adjustment in respect of share-based payments	-	-	-	2.9	2.9
Adjustment for shares issued under the scrip dividend alternative	0.8	(0.8)	-	9.6	9.6
Proceeds from treasury shares re-issued	-	-	-	1.9	1.9
Equity component of convertible bond issued	-	-	-	10.0	10.0
Total transactions with equity shareholders	0.8	(0.8)	-	(49.0)	(49.0)
At 31 March 2010	**145.3**	**10.9**	**144.2**	**360.5**	**660.9**

PENNON GROUP PLC

Consolidated cash flow statement for the year ended 31 March 2010

	Note	**2010 (Unaudited) £m**	2009 (Restated note 3) £m
Cash flows from operating activities			
Cash generated from operations	9	**363.4**	300.6
Interest paid		**(84.2)**	(103.9)
Tax paid		**(3.8)**	(30.8)
Net cash generated from operating activities		**275.4**	165.9
Cash flows from investing activities			
Interest received		**14.5**	23.8
Acquisition of subsidiary undertakings (net of cash acquired)		**(9.3)**	(3.4)
Investment in joint ventures		**(0.1)**	-
Loans to joint ventures		**(30.7)**	-
Purchase of property, plant and equipment		**(195.2)**	(237.9)
Proceeds from sale of property, plant and equipment		**3.5**	2.6
Net cash used in investing activities		**(217.3)**	(214.9)
Cash flows from financing activities			
Proceeds from treasury shares re-issued		**1.9**	1.6
Convertible bond issued (net proceeds)		**121.9**	-
(Deposit)/release of restricted funds (net)		**(73.3)**	93.0
Proceeds from new borrowing		**237.2**	100.0
Repayment of borrowings		**(234.9)**	(14.9)
Finance lease sale and leaseback		**38.9**	49.8
Finance lease principal repayments		**(18.5)**	(16.8)
Dividends paid		**(63.8)**	(69.1)
Net cash received from financing activities		**9.4**	143.6
Net increase in cash and cash equivalents		**67.5**	94.6
Cash and cash equivalents at beginning of year	10	**322.0**	227.4
Cash and cash equivalents at end of year	10	**389.5**	322.0

PENNON GROUP PLC

Notes

1. **General information**

Pennon Group Plc is a company incorporated in the United Kingdom under the Companies Act 2006. The address of the registered office is given at the end of these notes. Pennon Group's business is operated through two main subsidiaries. South West Water Limited holds the water and sewerage appointments for Devon, Cornwall and parts of Dorset and Somerset. Viridor Limited's business is waste treatment and disposal.

The financial information for the years ended 31 March 2010 and 31 March 2009 does not constitute full financial statements within the meaning of section 434 of the Companies Act 2006. The full financial statements for the year ended 31 March 2009 were approved by the Board of Directors on 25 June 2009 and have been delivered to the Registrar of Companies. The independent auditors' report on those financial statements was unqualified, did not contain an emphasis of matter paragraph and did not contain a statement under section 237 (2) or (3) of the Companies Act 1985.

2. **Basis of preparation**

Except as described below, the accounting policies adopted in this unaudited financial information are consistent with those applied and set out in the Pennon Group Plc Annual Report and Accounts for the year ended 31 March 2009 and are also in accordance with all IFRS and interpretations of the International Financial Reporting Interpretations Committee (IFRIC) applicable for the year ended 31 March 2010 in issue which have been adopted by the European Union.

3. **Accounting policies and prior year adjustments**

The following revised standard, new standard and interpretation, which are mandatory for the first time in the financial year beginning 1 April 2009, are relevant for the Group.

IAS 1 "Presentation of financial statements" (revised)

The revised standard requires non-owner changes in equity to be presented separately from owner changes in equity. The Group has elected to present two statements; an income statement and a statement of comprehensive income. These preliminary financial statements have been prepared under the revised disclosure requirements.

IFRS 8 "Operating segments"

The adoption of this standard has not required any changes in reported segments.

IFRIC 14 "IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction"

The application of this interpretation restricts the circumstances under which a defined benefit scheme asset (surplus) may be recognised. During the year the Group's acquisition of Greater Manchester Waste Limited involved two defined benefit pension schemes which had a combined surplus of £6.9m at 31 March 2010. This surplus has not been recognised in accordance with the requirements of IFRIC14.

The following new standards, which are mandatory for the first time in the financial year beginning 1 April 2009, are relevant for the Group but have had no material impact.

IFRS 2 "Share-based payment" (amendment)
IAS 23 "Borrowing costs" (revised)

Notes (continued)

3. **Accounting policies and prior year adjustments (continued)**

The following new interpretation is mandatory for the first time in the financial year beginning 1 April 2009 and the Group's accounting policies have been amended accordingly.

Accounting policy for service concession arrangements

The application of IFRIC 12 "Service concession arrangements" has necessitated a restatement of amounts for prior years. Where a contract for the provision of public services meets the scope of IFRIC 12 the service concession is to be treated as a contract receivable, split between the profit on the construction of assets, operation of the service and provision of finance through interest receivable. The Group's contract with West Sussex County Council for the provision of waste collection and disposal services falls within the scope of IFRIC 12 and accordingly comparatives have been restated. Viridor Waste (Greater Manchester) Limited was acquired during the year, its operations also fall within the scope of IFRIC 12.

As a result of the above changes in accounting policy and other restatements required, comparative figures have been restated :

	Year ended 31 March 2009 (Unaudited)		
	Previously reported £m	Application of IFRIC 12 £m	Restated now reported £m
INCOME STATEMENT			
Revenue	952.9	5.3	958.2
Other operating expenses	(394.2)	(8.0)	(402.2)
Depreciation	(132.0)	0.7	(131.3)
Finance income	43.5	2.3	45.8
Taxation – current tax	(30.7)	(0.6)	(31.3)
Taxation – deferred tax	(36.9)	(1.4)	(38.3)
Profit for the year	91.5	(1.7)	89.8

Viridor Waste (Greater Manchester) Limited was acquired during the year and its operations also fall within the scope of IFRIC 12.

Notes (continued)

3. **Accounting policies and prior year adjustments (continued)**

	31 March 2009 Previously reported £m	31 March 2009 Application of IFRIC 12 £m	31 March 2009 Restated now reported £m	31 March 2008 Previously reported £m	31 March 2008 Application of IFRIC 12 £m	31 March 2008 Restated now reported £m
BALANCE SHEET						
Non-current assets						
Property, plant and equipment	2,774.2	(28.4)	2,745.8	2,665.8	(21.1)	2,644.7
Trade and other receivables	10.6	35.6	46.2	10.4	28.0	38.4
Current liabilities						
Current tax	(43.2)	(1.6)	(44.8)	(43.1)	(1.0)	(44.1)
Non-current liabilities						
Deferred tax	(326.3)	(2.1)	(328.4)	(306.7)	(0.7)	(307.4)
Shareholder's equity						
Retained earnings						
Brought forward	341.3	5.2	346.5	318.2	2.9	321.1
Profit for the period	91.5	(1.7)	89.8	133.6	2.3	135.9
Carried forward	317.6	3.5	321.1	341.3	5.2	346.5
STATEMENT OF CASH FLOWS						
Cash generated from operations						
Profit for the period	91.5	(1.7)	89.8	133.6	2.3	135.9
Depreciation charge	132.0	(0.7)	131.3	127.9	(0.7)	127.2
Finance income	(43.5)	(2.3)	(45.8)	(42.0)	(1.8)	(43.8)
Taxation	67.6	2.0	69.6	16.0	0.4	16.4
Increase in trade and other receivables	(15.4)	(5.3)	(20.7)	(29.9)	(4.4)	(34.3)
Purchase of property, plant and equipment	(245.9)	8.0	(237.9)	(219.2)	4.2	(215.0)

At the date of approval of this unaudited financial information the following standards and interpretations which have not been applied in these financial statements were in issue, but not yet effective :

IFRS 3	"Business combinations" (revised) and consequential amendment to IAS 27 "Consolidated and separate financial statements"
IFRIC 15	"Agreements for the construction of real estate"
IFRIC 16	"Hedges of a net investment in a foreign operation"
IFRIC 17	"Distribution of non-cash assets to owners"
IFRIC 18	"Transfers of assets from customers"
IFRIC 19	"Extinguishing financial liabilities with equity instruments"

The presentational impact of these standards and interpretations is being assessed. The Directors expect that the adoption of these standards and interpretations in future periods will have no material impact on the financial statements of the Group.

PENNON GROUP PLC

Notes (continued)

4. **Segment information**

For management purposes the Group is organised into two principal operating subsidiaries and these form the basis on which the primary segment information is reported.

	2010 (Unaudited) £m	2009 (Restated note 3) £m
Revenue		
Water and sewerage	**444.2**	431.7
Waste management	**626.5**	528.0
Other	**8.5**	8.7
Less intra-segment trading *	**(10.3)**	(10.2)
	1,068.9	958.2
Underlying operating profit before interest, tax, depreciation and amortisation (EBITDA)		
Water and sewerage	**290.1**	281.4
Waste management	**114.8**	105.2
Other	**(0.2)**	1.7
	404.7	388.3
Underlying operating profit		
Water and sewerage	**196.5**	191.6
Waste management	**73.1**	63.5
Other	**-**	1.9
	269.6	257.0
Operating profit		
Water and sewerage	**191.5**	186.6
Waste management	**72.8**	62.3
Other	**-**	1.9
	264.3	250.8
Underlying profit before tax		
Water and sewerage	**132.5**	121.9
Waste management	**55.4**	41.1
Other	**1.2**	2.6
	189.1	165.6
Profit before tax		
Water and sewerage	**127.5**	116.9
Waste management	**55.1**	39.9
Other	**1.2**	2.6
	183.8	159.4

* Intra-segment trading between and to other segments by the water and sewerage and waste management segments is under normal commercial terms and conditions which would also be available to unrelated third parties. Intra-segment revenue of the other segment is at cost.

Underlying measures exclude restructuring costs in South West Water and amortisation of intangibles in Viridor. A reconciliation between underlying and reported measures is included in the financial highlights on page 2 and 4, and in note 6 for earnings per share.

Notes (continued)

5. **Taxation**

	2010 (Unaudited) £m	2009 (Restated note 3) £m
Analysis of charge in year		
UK corporation tax	**43.0**	31.3
Deferred tax	**1.3**	13.4
Deferred tax arising on abolition of industrial buildings allowances	**-**	24.9
Total deferred tax	**1.3**	38.3
Tax charge for year	**44.3**	69.6

UK corporation tax is calculated at 28% (2009 28%) of the estimated assessable profit for the year.

The deferred tax charge in 2009 was increased by a non-recurring charge of £24.9m reflecting the phasing out of industrial buildings allowances over three years commencing 1 April 2008.

The effective tax rate for the year was 23% and after the deferred tax charge 24%.

Tax on amounts included in the consolidated comprehensive income statement, or directly in equity, is included in those statements respectively.

6. **Basic and diluted earnings per share**

Basic earnings per share are calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period excluding those held in the employee share trust which are treated as cancelled. For diluted earnings per share the weighted average number of ordinary shares is adjusted to include all dilutive potential ordinary shares.

The weighted average number of ordinary shares and earnings used in the calculations were :

Number of ordinary shares (millions)	**2010 (Unaudited)**	2009
For basic earnings per share	**350.0**	348.1
Effect of dilutive potential ordinary shares from share options	**1.5**	1.7
For diluted earnings per share	**351.5**	349.8

PENNON GROUP PLC

Notes (continued)

6. **Basic and diluted earnings per share (continued)**

Underlying basic and diluted earnings per share

Underlying earnings per share are presented to provide a more useful comparison on business trends and performance. The term underlying is not a defined term under IFRS and may not be comparable with similarly titled profit measures reported by other companies. Underlying earnings have been calculated :

	2010 (Unaudited)			2009		
	Profit after tax	**Basic**	**Diluted**	Profit after tax (Restated note 3)	Basic (Restated note 3)	Diluted (Restated note 3)
	£m	**p**	**p**	£m	p	p
Statutory earnings per share	**139.5**	**39.9**	**39.7**	89.8	25.8	25.7
Restructuring costs (net of tax)	**4.4**	**1.2**	**1.2**	3.3	0.9	0.9
Amortisation of intangibles	**0.3**	**0.1**	**0.1**	1.2	0.3	0.3
Deferred tax	**1.3**	**0.4**	**0.4**	38.3	11.1	11.0
Underlying earnings per share	**145.5**	**41.6**	**41.4**	132.6	38.1	37.9

7. **Dividends**

	2010 (Unaudited) £m	2009 £m
Amounts recognised as distributions to equity holders in the year		
Interim dividend paid for the year ended 31 March 2009 : 6.75p (2008 6.25p) per share	**23.6**	21.8
Final dividend paid for the year ended 31 March 2009 : 14.25p (2008 13.56p) per share	**49.8**	47.3
	73.4	69.1
Proposed dividends		
Proposed interim dividend for the year ended 31 March 2010 : 6.95p (2009 6.75p) per share	**24.5**	23.6
Proposed final dividend for the year ended 31 March 2010 : 15.60p (2009 14.25p) per share	**55.1**	49.8
	79.6	73.4

The proposed interim and final dividends have not been included as liabilities in these financial statements. The proposed interim dividend for 2010 was paid on 1 April 2010 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting on 29 July 2010.

If approved at the Annual General Meeting the final dividend of 15.60p per share will be paid on 6 October 2010 to shareholders on the register at 13 August 2010.

PENNON GROUP PLC

Notes (continued)

8. **Share capital**

Allotted, called up and fully paid

	Number of shares		
	Treasury shares	Ordinary shares	£m
At 1 April 2008 Ordinary shares of 40.7p each	6,411,406	348,752,868	144.5
For consideration of £1.6m, shares re-issued under the Company's Sharesave Scheme	(687,275)	687,275	-
At 31 March 2009 Ordinary shares of 40.7p each	5,724,131	349,440,143	144.5
Shares issued under the scrip dividend alternative	-	1,986,553	0.8
For consideration of £1.9m, shares re-issued under the Company's Sharesave Scheme	(631,557)	631,557	-
At 31 March 2010 ordinary shares of 40.7p each	**5,092,574**	**352,058,253**	**145.3**

Shares held as treasury shares may be sold, re-issued for any of the Company's share schemes, or cancelled.

The weighted average price of the Company's shares at the date of exercise of Sharesave Scheme options during the year was 468p (2009 594p).

PENNON GROUP PLC

Notes (continued)

9. **Cash flow from operating activities**

Reconciliation of profit for the year to cash generated from operations :

Cash generated from operations	**2010 (Unaudited)**	2009 (Restated note 3)
	£m	£m
Profit for the year	**139.5**	89.8
Adjustments for:		
Employee share schemes	**2.8**	2.7
Profit on disposal of property, plant and equipment	**(3.6)**	(2.1)
Depreciation charge	**135.1**	131.3
Amortisation of intangible assets	**0.3**	1.2
Share of post-tax profit from joint ventures	**(1.1)**	(0.8)
Finance income	**(34.4)**	(45.8)
Finance costs	**116.0**	138.0
Taxation	**44.3**	69.6
Changes in working capital *(excluding the effect of acquisition of subsidiaries) :*		
Decrease in inventories	**0.3**	0.8
Increase in trade and other receivables	**(32.4)**	(20.7)
Increase/(decrease) in trade and other payables	**9.3**	(24.5)
Decrease in retirement benefit obligations from contributions	**(4.8)**	(28.7)
Decrease in provisions	**(7.9)**	(10.2)
Cash generated from operations	**363.4**	300.6

10. **Net borrowings**

	2010 (Unaudited)	2009
	£m	£m
Cash and cash deposits	**493.9**	353.3
Borrowings – current		
Bank overdrafts	**(12.7)**	(12.9)
Other current borrowings	**(184.1)**	(219.9)
Finance lease obligations	**(32.2)**	(30.1)
Total current borrowings	**(229.0)**	(262.9)
Borrowings – non-current		
Bank and other loans	**(681.5)**	(507.5)
Other non-current borrowings	**(273.6)**	(287.7)
Finance lease obligations	**(1,205.1)**	(1,187.2)
Total non-current borrowings	**(2,160.2)**	(1,982.4)
Total net borrowings	**(1,895.3)**	(1,892.0)

Notes (continued)

10. **Net borrowings (continued)**

Cash and cash equivalents comprise the following for the purposes of the cash flow statement :

	2010 (Unaudited) £m	2009 £m
Cash and cash deposits as above	**493.9**	353.3
Bank overdrafts as above	**(12.7)**	(12.9)
	481.2	340.4
Less : deposits with a maturity of three months or more	**91.7**	18.4
	389.5	322.0

Bank overdrafts at the balance sheet date arise from the timing of the payment of unpresented cheques.

11. **Acquisitions**

On 8 April 2009 the entire issued share capital of Greater Manchester Waste Limited (now renamed Viridor Waste (Greater Manchester) Limited) was purchased by Viridor Waste Management Limited for a nominal consideration. The acquisition has been accounted for using the acquisition method. Goodwill of £5.8m has been capitalised. The cash balances on acquisition of £6.3m will principally be applied to the previous retirement benefit obligations of the acquired business.

On 5 June 2009 the entire issued share capital of London Recycling Limited (now renamed Viridor London Recycling Limited) was purchased by Viridor Waste Management Limited for a cash consideration of £10.6m, excluding costs. The acquisition has been accounted for using the acquisition method. Provisional goodwill of £8.5m has been capitalised.

On 31 July 2009 the entire issued share capital of Intercontinental Recycling Limited (now renamed Viridor Polymer Recycling Limited) was purchased by Viridor Waste Management Limited for a cash consideration of £4.2m, excluding costs. The acquisition has been accounted for using the acquisition method. Provisional goodwill of £4.2m has been capitalised.

The goodwill arising on these acquisitions is attributed to the profitability of the acquired business.

12. The Annual Report for 2009/10 will be posted to shareholders on 30 June 2010 and will be available for viewing on the Company's website at www.pennon-group.co.uk on 1 July 2010.

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PRINCIPAL RISKS AND UNCERTAINTIES

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

PENNON GROUP

RISK	COMMENTARY AND MITIGATION
EARNINGS GROWTH/SHAREHOLDER VALUE	
It may not be possible to continue to sustain the same level of earnings and growth of the Group as in the past	This is dependent upon the correct strategies being pursued by strong and able management within the Group as well as on external factors.
There is a risk to shareholder value if the Group is not able to continue to grow its key businesses and produce sustainable earnings growth	The Group has maintained earnings and has successfully grown both South West Water and Viridor and intends to continue to create shareholder value through its strategic focus on water and sewerage services; waste management; recycling; and renewable energy.
TREASURY	
The Company may be unable to raise sufficient funds to finance its activities through:	Pennon Group has robust treasury policies in place. These include:
Liquidity risk	Ensuring that the Group has cash and committed loan facilities equivalent to at least one year's forecast requirements at all times. Borrowing repayment commitments are expected to be met as required during the coming period.
Refinancing risk	Ensuring that no more than 20% of Group net debt is permitted to mature in any one financial year. At 31 March 2010 the Group had cash and deposits of £494 million, and undrawn committed bank facilities of £200 million, giving access to total cash resources of £694 million. Loan repayments falling due by 31 March 2011 amount to £216 million.
Covenant compliance risk	Pennon Group and South West Water have entered into covenants with lenders. Whilst terms vary, these typically provide for limits on gearing (primarily based on South West Water's Regulatory Capital Value and Viridor's EBITDA) 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 Group's debt facilities are monitored on a regular basis. The financial covenants offered by the Group include a provision to re-test the covenants applying frozen GAAP accounting standards. This is to protect the Group from changes in accounting standards which may have a detrimental impact on the financial covenant testing methodology.
Counterparty risk	Surplus funds of the Group are usually placed in short-term fixed interest deposits or the overnight money markets. Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments.

RISK	COMMENTARY AND MITIGATION
PENNON GROUP (continued)	
	The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals, and rigorous monitoring procedures. All deposits are with counterparties which have a credit rating approved by the Board (A1 Moody's/ AA Standard & Poor's).
Interest rate risk	The Group's exposure to interest rate movements is managed by the use of interest rate derivatives. The Board's policy is that in any one year at least 50% of net debt is fixed. Interest rate swaps are used to manage the mix of fixed and floating rates. The Group has fixed approximately 65% of existing net debt as at 31 March 2010. At 31 March 2010 the Group had interest rate swaps to convert floating rate liabilities to fixed rate, and hedge financial liabilities, with a notional value of £775 million and a weighted average maturity of 3.0 years (2009 £760 million, with 2.4 years). The weighted average interest rate of the swaps for their nominal amount was 4.0% (2009 4.5%). The notional principal amounts of the interest rate swaps are used to determine settlement under those swaps and are not therefore an exposure for the Group. In addition South West Water has index-linked approximately 24% of its current net debt up to 2041 – 2057. South West Water's total index-linked debt of £353 million has an average real interest rate of 1.66%. The interest rate for index-linked debt is based upon an RPI measure which is also used in determining the tariff increase for South West Water customers.
PENSIONS	
The future costs of defined benefit schemes are subject to a number of risks including:	The Group's defined benefit schemes closed to new entrants on or before 1 April 2008. New employees have been offered defined contribution arrangements.
the returns achieved on pension fund investments	Pension trustees keep investment policy under review and use professional investment advisers.
movements in interest rates and inflation	The pension trustees review the investment strategy to improve the match of investments and liabilities. Employee and employer contributions are also kept under review and have been increased. Further employer contributions of £16 million were made in the year.
pensioner longevity	Independent actuaries have identified scheme-specific mortality experience which is reflected in liabilities.
SOUTH WEST WATER	
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 (including K4 (2005 – 2010)).
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.

RISK	COMMENTARY AND MITIGATION
SOUTH WEST WATER (continued)	
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 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.
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 the 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.
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.
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.

RISK	COMMENTARY AND MITIGATION
SOUTH WEST WATER (continued)	
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	South West Water 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.
<u>VIRIDOR</u>	
CURRENT UK AND WORLD ECONOMIC CONDITIONS:	Current UK and world economic conditions are highly uncertain. Though less affected than many companies, Viridor is by no means immune to general economic conditions. A full assessment of the key risks to Viridor's business arising from current economic uncertainties has been conducted, including the following:
Landfill volumes may decline due to contraction in economy	The majority of inputs are from long-term local authority contracts or Viridor's own collection fleet. This risk is most pertinent to the 40% of Viridor's volumes which are not either domestic landfill or landfill collected by Viridor's own fleet. These latter volumes have been less affected to date.
Landfill prices	To date, landfill prices in general have proved robust. In a prolonged recession such prices may be impacted by increased price competition.
Recyclate prices	Recyclate prices are, like any commodity, volatile and are directly impacted by world economic conditions. The effect is most significant on the 40% of Viridor's recycling volumes of internationally traded commodities such as paper, card, plastics and metals. However recyclate is typically cheaper than virgin materials which limits the impact on prices for good quality recyclate. As noted above recyclate prices have recovered to the levels pertaining before the global financial crisis.
Collection volumes (particularly industrial customers) are subject to economic conditions	Currently margins are holding up. However volumes have fallen significantly.
Bad debt collection more challenging in an economic downturn	Viridor's record of bad debts has been, and remains, good based on tight management controls and the ability to put customers 'on stop' and, for example, refusing to accept waste at its landfills if debts are not being paid.
Government funding cutbacks may lead to the delay or abandonment of major waste projects.	Viridor's existing business with local authorities is covered by contracts on a variety of terms up to 25 years. The letting of new contracts is likely to be subject to delays which could affect Viridor's bidding costs and growth.

RISK	COMMENTARY AND MITIGATION
VIRIDOR (continued)	
INCREASES IN LANDFILL COSTS MAY NOT BE RECOVERED THROUGH PRICE INCREASES:	The raising of environmental standards is leading to a gradual increase in landfill costs in general, including engineering (results in increased depreciation) and restoration and aftercare costs. Viridor, with landfills engineered to modern standards with good environmental control systems, should incur lower than average increases in costs.
Recovery of costs of legislative change	Municipal contracts typically last for up to seven years. They usually have provision for price increases under set formulae related to inflation and some include legislative or technical changes. Prices for other types of waste depend more on local markets and competitive conditions. Prices, as a long-term trend, have risen fast enough at least to cover cost increases.
Aftercare costs levels	Costs which are assessed over 30 years are best estimates based on Viridor's own experience and are updated at each stage of the capital expenditure programme.
Residual contamination	Viridor's landfill aftercare management includes restoration, maintenance, supervision, monitoring and management of gas and leachate levels after the landfilling activities have ceased. Provision is also made for estimated costs of remediation if required. The EA or SEPA will only grant a full or partial surrender of the permit once it is satisfied that the landfill no longer poses any environmental risk.
Recovery of costs of legislative change	Municipal contracts typically last for up to seven years. They usually have provision for price increases under set formulae related to inflation and some include legislative or technical changes. Prices for other types of waste depend more on local markets and competitive conditions. Prices, as a long-term trend, have risen fast enough at least to cover cost increases.
Estimated compaction rates (tonnes per cubic metre)	These are best estimates, based on current information, which are reviewed every year based on actual compaction rates assessed by external consultants.
THE UK GOVERNMENT'S WASTE STRATEGY, STEMMING FROM THE LANDFILL DIRECTIVE, WILL LEAD TO A REDUCTION IN VOLUMES OF WASTE BEING DISPOSED TO LANDFILL:	Government initiatives are having an impact and the amount of municipal waste being disposed of to landfill is declining. Assuming Landfill Directive targets are met, the total amount of municipal solid waste which will be landfilled from 2020 will be five to 10 million tonnes per annum. The Government is now seeking to reduce the amount of industrial and commercial waste to be landfilled. However it is believed there will still be a significant total landfill market in 2020. Scarcity of landfill will ensure available voidspace remains a valuable asset. With the exception of the most recent year Viridor has seen its underlying landfill volumes holding steady probably reflecting a greater share of the landfill market.

RISK	COMMENTARY AND MITIGATION
VIRIDOR (continued)	
PRICING AND OTHER RISKS RELATING TO RENEWABLE ENERGY:	
Fluctuating 'brown energy' prices	Viridor's 'brown energy' prices were fixed through to the end of March 2010. Brown energy prices will continue to be determined by the world and UK energy market and may go down as well as up. Current prices are around £30 per MWh lower than achieved in 2009/10 which will affect 2010/11 results.
Changes in ROC pricing mechanism	The Government has made a strong commitment to renewables which are key to meeting the UK's long-term carbon reduction strategy. To date, the major political parties have stressed their commitment to 'grandfather' rights under current ROC schemes, which are not subject to retrospective changes. Renewables are also important in minimising the UK's increasing reliance on imported energy.
UK renewable energy generating capacity & licensed electricity suppliers	The value of ROCs is increased by the sharing of the buy-out price monies among holders of ROCs. The value of a ROC depends on the supply of renewable electricity relative to the UK's annual increasing targets. It is also dependent on the financial strength of those suppliers who opt to pay the buy-out price. The insolvency of a licensed electricity supplier could lead to a drop in the value of the ROCs which Viridor sells.
Volume of gas generated	Current and future waste composition (including BMW diversion due to Landfill Directive and calorific value) is assessed against costs on each landfill gas project.
THE CURRENT PLANNING REGIME MAY RESTRICT THE AVAILABILITY OF FUTURE WASTE TREATMENT FACILITIES	Achievement of the Government's targets for waste management is critically dependent on the planning system delivering sufficient waste treatment facilities. Viridor employs best practice throughout the planning process.
RISKS ASSOCIATED WITH LONG-TERM INTEGRATED CONTRACTS (RISK TRANSFER IS A KEY PART OF GOVERNMENT PFI PROCUREMENT GUIDELINES)	Risks include waste volumes and mix, planning, technology, input costs and recyclate prices. A careful assessment of the risks and apportionment of them between client; main contractor; technology and equipment suppliers; and sub-contractors is a key part of the process of bidding and finalising a contract. Extensive due diligence is conducted so that risks are correctly identified. Viridor then seeks to protect itself through contractual documentation with its client, sub-contractors and sub-suppliers. Viridor takes a robust approach on this issue. If it cannot mitigate the risks satisfactorily or cannot get a reasonable commercial return for taking such risks, its policy is to accept the loss of such a contract rather than win it on unsatisfactory terms.