



Pennon Group Plc

annual report & accounts

06



PENNON GROUP PLC OPERATES AND INVESTS IN THE AREAS OF WATER AND SEWERAGE SERVICES AND WASTE MANAGEMENT. IT HAS ASSETS OF £2.7 BILLION AND EMPLOYS AROUND 3,000 PEOPLE.

There are two main subsidiaries – **South West Water Limited** and **Viridor Waste Limited**.

South West Water Limited holds the water and sewerage appointments for Devon, Cornwall and parts of Dorset and Somerset.

Viridor Waste Limited is one of the leading waste treatment and disposal businesses in the United Kingdom.

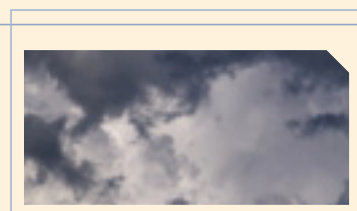
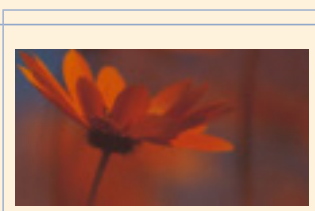
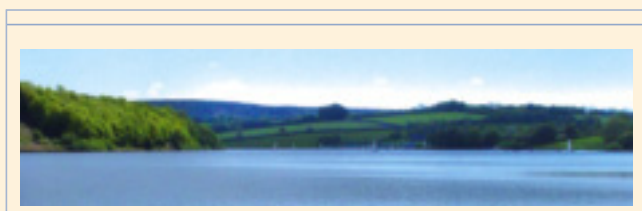
HIGHLIGHTS OF THE YEAR

- ⇒ REVENUE UP 17.1% TO £645.7 MILLION
- ⇒ OPERATING PROFIT UP 16.0% TO £175.1 MILLION⁽¹⁾
- ⇒ PROFIT BEFORE TAX UP 24.6% TO £110.9 MILLION⁽²⁾
- ⇒ EARNINGS PER SHARE UP 17.4% TO 75.5p⁽³⁾
- ⇒ DIVIDEND PER SHARE UP 20.0% TO 51.6p

(1) Before exceptional items of £14.5 million (2004/05 £4.9 million). Statutory result £160.6 million (2004/05 £146.0 million)

(2) Before exceptional items of £56.8 million (2004/05 £4.9 million). Statutory result £54.1 million (2004/05 £84.1 million)

(3) Before exceptional items and deferred tax. Basic earnings per share are 29.7p



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Ken Harvey
Chairman
Pennon Group Plc

CHAIRMAN'S STATEMENT

THE GROUP CONTINUED TO MAKE EXCELLENT PROGRESS DURING THE YEAR DELIVERING PROFITABLE GROWTH IN ALL AREAS OF THE BUSINESS. THE RESULTS AFFIRM OUR STRATEGY OF FOCUSING ON THE TWO KEY BUSINESSES, SOUTH WEST WATER LIMITED AND VIRIDOR WASTE LIMITED.

FINANCIAL OVERVIEW

Group revenue increased by 17.1% to £645.7 million, mainly due to increased revenue generated by the Ofwat approved tariff increases in South West Water and another year of strong trading by Viridor Waste.

Before exceptional items, operating profit increased by 16% to £175.1 million, profit before tax increased by 24.6% to £110.9 million, and earnings per share increased by 17.4% to 75.5p.

The Directors are recommending a final dividend of 35.1p, a 20.2% increase which is in line with the Board's previously stated dividend policy. Together with the interim dividend of 16.5p, this will result in a total dividend for the year of 51.6p, a 20.0% increase on the total dividend for the previous year.

The Board's policy is to grow the Group dividend by 3% per annum in real terms at least up to 2009/10. Shareholders will also be given the opportunity to participate in a Dividend Re-investment Plan, details of which will be circulated to shareholders in August 2006.

In December 2005, the Board announced its decision to increase the level of gearing in South West Water to further improve the efficiency of the Group's capital structure. As a consequence of this, circa £145 million has been returned to shareholders via a B Share Scheme and £55 million is being returned via a share buy back. In addition, £14.5 million has been paid to South West Water customers in the form of a one-off payment of £20 per customer. After the year end, the Board announced – subject to shareholder approval – a 3 for 1 share split to increase the liquidity and marketability of the Company's shares.

SOUTH WEST WATER LIMITED

South West Water's revenue increased by £41.5 million to £348.5 million and operating profit rose by 15.8% to £141.5 million before exceptional costs of £14.5 million. Operating costs, including depreciation, increased by £22.2 million to £207.0 million after efficiency savings of £4.0 million.

The efficiency targets set by the Director General of Water Services for the five year period 2005-2010 represent a tough challenge for South West Water, but results from the first full year of the K4 period indicate that the company is on track to achieve the necessary operating cost reductions.

South West Water continued to deliver high levels of product and customer service. In addition, the successful delivery of its waste water improvement programme, which provides significant environmental enhancement, enables the region to boast some of Europe's finest bathing waters, beaches and rivers.

During the five year period 2005-2010, a key element of South West Water's capital investment is in water mains renovation with an enhanced programme already well under way. During the year, a record length of 695 kilometres of water mains were either laid, replaced or refurbished, providing customers with even higher levels of drinking water quality. The programme is ahead of schedule and is on track to meet the delivery targets set by the Drinking Water Inspectorate.

Drinking water quality remains at a record high level and, as a direct consequence of careful planning and capital expenditure, the region's water storage, treatment and distribution capability has been progressively and significantly enhanced over the years.

There has not been a water restriction in the region since 1996 and none is envisaged. The company's leakage detection and reduction programme continues to deliver results in line with mandatory targets set by Ofwat.

VIRIDOR WASTE LIMITED

Viridor Waste's financial performance during the year was again strong with revenue increasing by 20.4% to £298.9 million and operating profit before intangibles amortisation rising by 19.7% to £35.9 million.



GROUP



Viridor Waste has, since 2000/01, increased operating profit before intangibles amortisation at a compound rate of 22.3% per annum with around 11% being via organic growth and the remainder as a result of acquisitions.

In June 2005, Viridor Waste acquired Brett Waste Management Limited, a landfill and power generation business for a cash consideration of £44.4 million. The company owns strategically located landfill sites in Kent and Essex with approximately 11 million cubic metres of consented capacity, landfill gas power generation schemes and other associated activities. The acquisition complements the company's existing facilities in the South East.

During the year, Viridor Waste established a 50:50 joint venture company with Grundon Waste Management Limited and the new business – Lakeside Energy from Waste Limited – will build and operate an energy from waste plant in Colnbrook, near Heathrow. The plant will have a capacity of 400,000 tonnes of waste per annum and will also provide a power generation capacity of 32 megawatts of electricity. The plant is now under construction with commissioning scheduled for mid 2008.

In May 2006, Viridor Waste acquired Wyvern Waste Services Limited from Somerset County Council for £25 million as part of a 25 year Public Private Partnership with the County. The acquisition includes 5 million cubic metres of consented landfill void, 7 megawatts of power generation capacity and associated recycling and treatment operations.

Viridor Waste's expansion via organic growth and acquisition has been a notable accomplishment within the waste sector and the company is well placed to deliver further strong financial performance in the future.

RETURN OF CAPITAL

On 15 February 2006, Pennon's shareholders approved the return of £200 million of cash to shareholders, with circa £145 million of this return by way of a B Share Scheme and circa £55 million through an on-market share buy back programme. The B Shares have now been issued with circa £138 million of capital returned in March and the balance in April 2006.

In order to maintain comparability of the share price after the B Share Scheme, Pennon undertook a share capital consolidation whereby shareholders received 10 new Ordinary shares for every 11 existing Ordinary shares. As a result, the number of Ordinary shares in issue was reduced from approximately 130.5 million to 118.6 million.

STRATEGY

The Board's priority continues to be the creation of shareholder value through its strategic focus on water, sewerage and waste management. The year's financial results are testament to the Board's strategy of focusing on these key business areas. The move to a more highly geared structure has enabled the Group to return value to shareholders and customers and provide an enhanced dividend.

PROSPECTS

The Board has confidence that South West Water will successfully deliver the new K4 regulatory contract and significantly grow its Regulatory Capital Value up to 2010. Viridor Waste's successful strategy of creating long term sustainable profit growth is expected to continue through capitalising on its landfill asset base, exploiting its landfill gas power generation potential and pursuing profitable opportunities in line with the Government's developing waste strategy.

BOARD MATTERS

Bob Baty, Chief Executive of South West Water, is due to retire at the end of July following 45 years' service in the industry. The Board would like to take this opportunity to express its gratitude to Bob for his significant contribution to South West Water since privatisation in 1989 and to wish him well in his retirement.

The Board looks forward to welcoming Chris Loughlin as an Executive Director of Pennon and Chief Executive of South West Water. He will take up his post on 1 August.

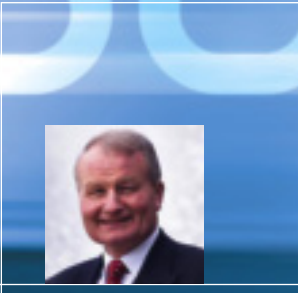
EMPLOYEES

During my years as Chairman of the Group, many structural and organisational changes have taken place. Throughout this time, employees have continued to demonstrate a high level of loyalty, commitment and professionalism and I thank them most sincerely for their efforts.

*KEN HARVEY, Chairman, Pennon Group Plc
22 June 2006*



SOUTH WEST WATER



Bob Baty
Chief Executive
South West Water Limited

OVERVIEW

SOUTH WEST WATER CONTINUED TO DELIVER EXCELLENT FINANCIAL PERFORMANCE, FIRST CLASS LEVELS OF PRODUCT AND ONGOING IMPROVEMENTS IN CUSTOMER SERVICE, WHILST OUTPERFORMING CHALLENGING REGULATORY TARGETS.

SOUTH WEST WATER LIMITED

The company's revenue increased by £41.5 million to £348.5 million. The main factors for this increase were Ofwat approved tariff increases and 7,400 new customer connections, offset by customers switching from an unmeasured to a measured charging basis.

South West Water's operating profit rose 15.8% to £141.5 million before exceptional costs of £14.5 million from the one-off customer payment (2004/05 exceptional restructuring costs £3.4 million). Operating costs, including depreciation, increased by £22.2 million to £207.0 million. Additional costs from new capital schemes of £7.7 million, inflation of £8.4 million (including energy and chemicals), and other cost increases of £10.1 million (including increases in depreciation and increases in direct charging of a proportion of leakage expenditure to operating cost), were offset by £4.0 million of efficiency savings.

South West Water is pursuing a long term restructuring and continuous improvement programme to reduce overhead and operating costs. This is designed to ensure that the company



continues to outperform the demanding operational and capital efficiency targets imposed by Ofwat. It is on track to continue to do so for the remainder of the current regulatory period (K4, 2005-2010). Since the first Periodic Review in 1995, base cost efficiency savings totalling £54.2 million have been achieved.

Despite the regulatory pressure to reduce operational expenditure, provision of first class levels of water and sewage treatment and ongoing improvements in customer service have remained key company objectives. Independent market research carried out amongst South West Water's customers confirms high levels of satisfaction with the overall service provided by the company, although levels of charges remain an issue for some groups of customers. Plentiful supplies of high quality drinking water are an absolute priority for customers and, as a direct consequence of careful planning and capital expenditure, the region's water storage, treatment and distribution infrastructure has been progressively and significantly enhanced over the years.

There have been no water restrictions in the region since 1996 and the company's leakage detection and reduction programme continues to deliver results in line with mandatory targets set by Ofwat. During the winter period, three key reservoirs were replenished by pumping water from downstream river flows to supplement the natural raw water inflow. The pumping infrastructure was installed several years ago to provide enhanced drought protection. This has contributed to reservoir levels being marginally higher than at the same time last year, despite lower levels of rainfall.

Capital expenditure increased by 42.0% to £191.0 million. £109.4 million was invested in water supply improvements, including water mains renovation and water treatment works enhancement. Over 695 kilometres of water mains were laid, replaced or refurbished during the year and the company's 'Putting the Sparkle Back into Your Water' water mains renovation programme has seen record levels of expenditure and refurbished water mains being achieved. Continued high levels of investment in the water mains renovation programme will be a key element during the remainder of the K4 period.



SOUTH WEST WATER



Improvements in water supply have been matched with improvements to water quality. During 2005, the company achieved its highest ever drinking water compliance level of 99.96% with the quality standards monitored by the Drinking Water Inspectorate (DWI).

Waste water investment expenditure totalled £81.6 million. The company's massive 'Clean Sweep' coastal sewage treatment improvement programme is now virtually complete apart from a small number of minor schemes which are being delayed because of planning and other related issues. 'Clean Sweep' has transformed the coastal environment of the South West and 89% of the region's bathing waters now meet the stringent EU guideline standards and 99% conform with EU mandatory standards. These quality achievements are amongst the very best in the UK and a testament to all those involved in the delivery of one of the largest environmental improvement programmes of its kind in the whole of Europe.

Inland waste water treatment works are also being updated and modernised as part of a rolling programme to ensure compliance with demanding environmental standards. The successful delivery of both coastal and river water quality improvement programmes has been a pivotal factor in the region's attainment of higher levels of environmental enhancement in support of economic prosperity.

Improvements within Ofwat's 'Overall Performance Assessment' (OPA) have been sustained as capital expenditure, previously constrained whilst the 'Clean Sweep' programme was delivered, is now being directed to address other areas. Improvements in waste water treatment works compliance within the OPA continue, but these have been marginally offset by the increased number of sewer flooding incidents caused by factors other than hydraulic overload, such as blockages.

This will be my final contribution to the Pennon Group Annual Report as I will be retiring from my role as Chief Executive of South West Water at the end of July this year. I am immensely proud of what South West Water has achieved since privatisation in 1989 and I feel very privileged to have been at the helm during a period of tremendous challenge and change. I consider myself fortunate to have led such a good team and I would like to take this opportunity to thank them and all those associated with the company who have enabled me to look back with pride on the progress made.





Colin Drummond
Chief Executive
Viridor Waste Limited

OVERVIEW

VIRIDOR WASTE CONTINUES TO DELIVER STRONG GROWTH.

VIRIDOR WASTE LIMITED

Viridor Waste continued to make excellent progress with its focused strategy of:

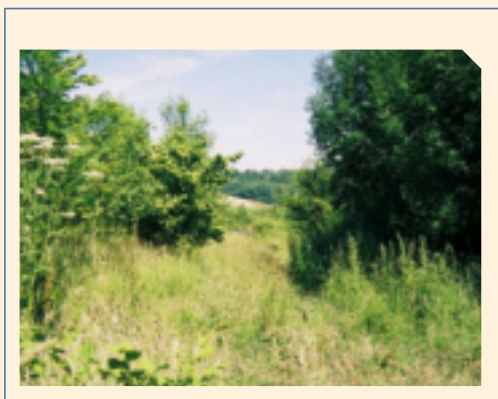
- capitalising on its strong position in landfill waste disposal
- exploiting opportunities in landfill gas power generation in line with the Government's target of increasing the proportion of electricity generated from renewable sources
- pursuing profitable opportunities arising from the Government's developing waste strategy (including Private Finance Initiative (PFI)/Public Private Partnership (PPP) and integrated waste management contracts).

Financial performance in 2005/06 was again strong. Revenue at £298.9 million increased by 20.4% over the previous year. Operating profit (before amortisation of intangibles) at £35.9 million increased by 19.7% over the previous year driven by good performance from the underlying landfill, power generation and contracts businesses combined with the positive effect of the Brett Waste Management Limited acquisition. In the five years since 2000/01, operating profit before amortisation of intangibles has grown by 22.3% per annum of which around 11% has been organic with the remainder being from acquisitions. Profit before tax at £21.9 million was 9.0% up on the previous year. This consistent strong financial performance reflects the success of Viridor Waste's focused strategy.

In June 2005, Viridor Waste acquired Brett Waste Management Limited for £44.4 million. Brett Waste Management comprised operational landfills in Kent and Essex with 11 million cubic metres of consented void, 6 megawatts (MW) of landfill power generation capacity and associated transfer station, recycling, composting and transport operations. The acquisition fits well with Viridor Waste's stated strategy and complements the company's existing facilities in the adjacent counties of East Sussex, Surrey and Suffolk. Brett Waste Management has now been successfully integrated and was earnings enhancing at profit before tax (PBT) level (after integration costs and amortisation of intangibles) in its first nine months, a year ahead of expectations.

In September 2005, Viridor Waste entered into a joint venture (Lakeside Energy from Waste Limited) with Grundon Waste Management Limited to develop and operate a large energy from waste (EfW) facility at Grundon's site in Colnbrook, near Heathrow. This strategically located facility is consented and is now under construction. It is due to come on stream in 2008, with a capacity of 400,000 tonnes (kt) waste per annum and power generation of 32MW. It is ideally located to assist councils in meeting their landfill diversion targets whilst at the same time generating significant electricity output. This £160 million project is being financed 86% by non-recourse bank debt with the balance of finance split equally between Viridor Waste and Grundon.

Landfill inputs excluding cover were 7% higher in 2005/06 compared with the previous year, at 4.3 million tonnes, of which Brett Waste Management accounted for 0.4 million tonnes. In the first half of 2005/06, Viridor Waste benefited from a large one-off disposal contract at its Masons landfill site whilst, as reported last year, in the first quarter of 2004/05, benefiting from additional volumes in advance of the change in hazardous waste regulations. Excluding the effect of the Brett Waste Management acquisition and the above non-recurring items, landfill volumes were unchanged. Average revenues per tonne increased by 9.0% reflecting a more favourable mix of business. Taking account of the Brett Waste Management acquisition and planning gain offset by usage during the year, Viridor Waste's consented landfill void increased from 80 million cubic metres last year to 87 million cubic metres at 31 March 2006.



WASTE



Viridor Waste's landfill gas power generation output increased from 327 Gigawatt Hours (GWH) to 367GWH due to organic growth and the Brett Waste Management acquisition. Reflecting the general increase in underlying energy prices and the renewable premium in the UK, Viridor Waste's average revenues per megawatt hour increased by 10% to £59. As at 31 March 2006 Viridor Waste's landfill gas power generation capacity was 61MW compared with 52MW at the previous year end.

Viridor Waste continues to explore suitable PFI/PPP opportunities as part of its overall strategy. In May 2006, Greater Manchester Waste Disposal Authority announced that the Viridor Waste Management Limited/ John Laing Plc joint venture was one of two parties shortlisted to submit Best and Final Offers for its waste management services contract.

The Government's target of diverting municipal waste from landfill up to 2020 may be expected over time to lead to a decline in the landfill market. However, with only around six years' consented capacity in the UK as a whole (Environment Agency estimate), Viridor Waste's 87 million cubic metres is likely to become an increasingly valuable resource. Meanwhile, the need for councils

to achieve their diversion targets creates attractive opportunities for PFI/PPP contracts, such as Viridor Waste's with West Sussex and Somerset, and for facilities such as the Lakeside EfW plant. As the UK increasingly relies on imports of energy and seeks to increase its output of renewables, Viridor Waste's gas business is also an increasingly valuable asset.

After the end of the financial year, Viridor Waste announced the acquisition of Wyvern Waste Services Limited from Somerset County Council for £25 million as part of a 25 year PPP contract with the County. The acquisition comprised 5 million cubic metres of consented landfill void, 7MW of power generation capacity and associated recycling and treatment operations. It is expected to be earnings enhancing before intangibles amortisation in its first full year. This acquisition and associated contract ties in well with the three clearly defined areas of Viridor Waste's strategy outlined on the facing page.



BUSINESS REVIEW

OVERVIEW AND STRATEGY

PENNON GROUP

Pennon Group operates and invests in the areas of water and sewerage services and waste management. It has assets of £2.7 billion and currently employs around 3,000 people. It has two main subsidiaries – South West Water Limited (South West Water) and Viridor Waste Limited (Viridor Waste).

The Company’s Mission Statement is to be a pre-eminent operator in the business areas of water and sewerage services and waste management. In these main business areas and for all future business developments, to ensure the hallmark of quality, efficiency and reliability which will help to meet the three key goals of:

- Satisfying customers
- Enhancing the environment
- Adding value for shareholders, employees and the community

The Board’s priority, pursuant to this Mission Statement, is the creation of shareholder value through its strategic focus on water and sewerage services and waste management.

Certain terms used throughout this Business Review, including how forward looking statements are to be interpreted, are explained in the Interpretation Section on page 26 and the Glossary on page 27.

SOUTH WEST WATER

South West Water is the licensed water and sewerage service provider for Devon, Cornwall and parts of Dorset and Somerset. It serves a region of nearly 10,300 square kilometres with 1.6 million residents and around eight million annual visitors. It supplies around 450 million litres of treated water per day through 15,000 kilometres of water mains and disposes of around 250 million litres of waste water each day via 9,000 kilometres of public sewers.

The asset base of South West Water comprises:

Distribution mains	15,000 kms
Sewers	9,000 kms
Impounding reservoirs	16
Water treatment works	39
Waste water treatment works	624
– including works with ultra violet treatment	52
Combined sewer overflows	1,064

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 a particular focus on improving coastal waste water treatment and disposal. The region currently has 143 EU designated bathing waters, almost one third of the total in England and Wales.

South West Water expects to create value through delivering the regulatory contract agreed with the Office of Water Services (subsumed into the Water Services Regulatory Authority from 1 April 2006 but which continues to be known as Ofwat), the size and content of which is reviewed at five-yearly intervals. As well as determining outputs, Ofwat sets prices, inter-alia, to enable efficient companies to earn a reasonable rate of return on their assets. In the K4 Determination, which covers the period from April 2005 to March 2010, Ofwat assumed that the equity cost of capital for all companies is 7.7% real after tax with an overall weighted average cost of capital of 5.1% real after tax. Ofwat’s Determination allows for further investment by South West Water to improve the quality of water and sewerage services. This is expected to result in the company’s Regulatory Capital Value increasing from around £1.95 billion in March 2005 to circa £2.6 billion in March 2010, thereby enlarging the base on which the return is calculated.

Additional value may be created where South West Water outperforms Ofwat’s assumptions by, for example, delivering services at lower operating and/or capital costs than Ofwat assumed, and/or financing the investment programme and operations at lower cost than Ofwat assumed.



BUSINESS REVIEW

Viridor Waste is one of the largest landfill site operators in the UK with a total consented landfill capacity of approximately 87 million cubic metres at 31 March 2006. The company is at present filling this at a rate of approximately 5 million cubic metres per annum which results in an average remaining life of 17 years at current rates of fill – significantly longer than of the industry as a whole. This capacity is located as shown on the map on the previous page.

Gas produced from decomposing waste on landfill sites is increasingly used to generate electricity. It is a form of renewable energy and now represents around 30% of the UK's total renewable energy generation. The Government's strategy is to increase the percentage of electricity generated from renewable sources from the current figure of around 4% to a target of 10% in 2010 and 15% in 2015, with an aspiration of 20% in 2020. Historically, renewable energy projects were supported by the Government through the non fossil fuel obligation (NFFO) scheme. Fixed price RPI indexed contracts with terms of up to 15 years were awarded to the most competitive renewable projects in five tranches of bidding. In April 2002, the NFFO regime was replaced by the renewable obligation certificates (ROCs) regime. The overall price for electricity supplied under ROCs is currently higher than that achieved under the most recent NFFO scheme. This, together with acquisitions, has enabled Viridor Waste to increase its total generation capacity to a current 61MW at 31 March 2006, compared with 28MW in March 2002.

To take advantage of opportunities presented by the Government's developing waste strategy, Viridor Waste is pursuing composting, energy from waste incineration, mechanical-biological treatment (MBT), civic amenity or household waste recycling sites (HWRS) management and other recycling opportunities. These may be combined in integrated waste management contracts.

In pursuing its strategy, Viridor Waste seeks to grow its waste management business, both organically and through acquisition. It has continued to be an active participant in the consolidation of the UK waste market to date and, since October 2001, has made nine acquisitions in the waste sector for an aggregate consideration of approximately £150 million in the period to 31 March 2006. They have been integrated into the Viridor Waste group. In May 2006, Viridor Waste acquired Wyvern Waste Services Limited, details of which are set out in the Chief Executive's Overview.

As a result of this focused strategy, Viridor Waste's revenue (including landfill tax) has grown from £106.1 million to £298.9 million over the period 2001 to 2006. Its operating profit (before amortisation of goodwill and intangibles) has increased from £13.1 million to £35.9 million, a compound annual growth rate of 22.3%. This has been the result of organic growth of the underlying business of around 11% per annum and the beneficial impact of recent acquisitions.

DIVIDEND POLICY AND SHAREHOLDER RETURNS

The Group is committed to a progressive dividend policy.

In December 2005, Pennon announced its decision to move South West Water to a more highly-g geared structure to enhance the Group's capital efficiency. As a consequence of this, following shareholder approval at an Extraordinary General Meeting of the Company in February 2006, a capital return was made to shareholders by way of a B Share Scheme of circa £145 million (equivalent to 110p per share), with an associated share capital consolidation. In addition to this, a share buy back of £55 million is being progressed.

The Board also announced its intention to step-up both the interim and full year Group dividend by 20% per share (after the share capital consolidation) and its policy to grow it by 3% per annum in real terms thereafter until 2009/10.

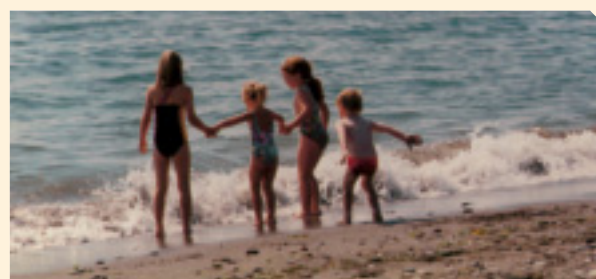
SOUTH WEST WATER REGULATORY & COMPETITIVE ENVIRONMENT

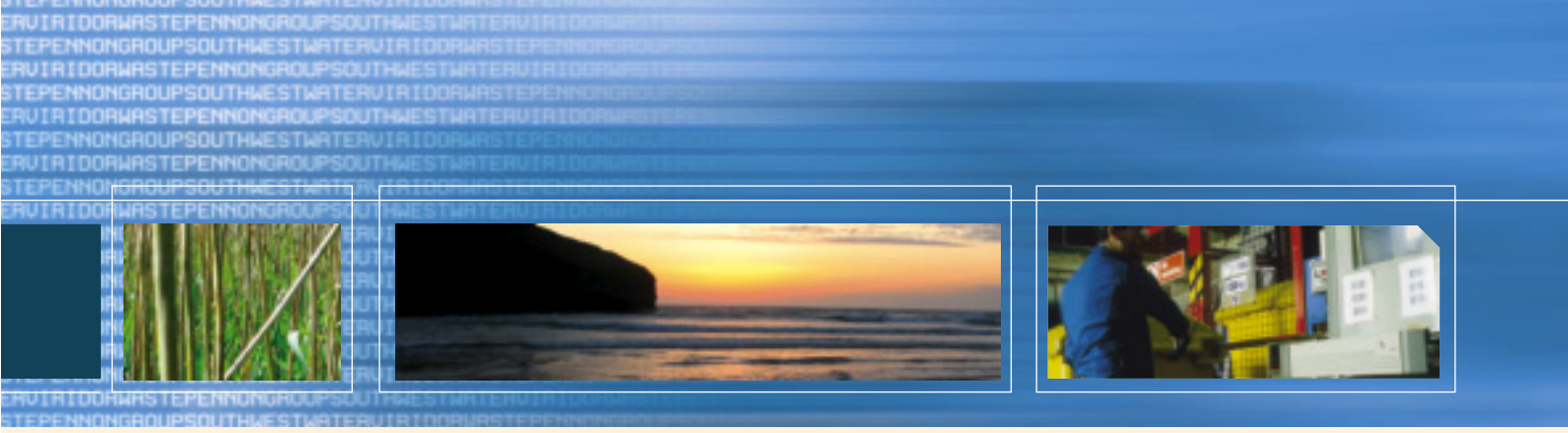
APPOINTMENTS

In 1989, the Government appointed companies (appointees) to provide water and waste water services (the Appointments). Economic regulation pursuant to the Appointments is the responsibility of Ofwat.

The Appointments impose conditions which Ofwat enforces, along with the appointees' principal duties under the Water Industry Act. An Appointment may be terminated on 25 years' notice by the Secretary of State, with more immediate revocation in certain specified circumstances (including, for example, failure to comply with an enforcement order made by Ofwat).

The water industry is also subject to Government direction and legislation in relation to investment requirements and social policy (for example the protection of vulnerable customers). From a customer interest perspective, water industry activities are also reviewed by the Consumer Council for Water, a separate statutory body which has replaced WaterVoice, which was part of Ofwat.





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 and which can vary for each year of the Review period. The size of a company's 'K' factor (which can be positive, negative or zero) reflects the scale of its capital investment programme, the cost of capital determined by the water regulator and its operational and environmental obligations offset by assumed efficiency improvements required of the company. Ofwat instituted a system of 'comparative competition' which compares South West Water's performance on a wide range of parameters, including efficiency, customer service, and environmental performance. Operating and capital cost comparisons are used by Ofwat to determine the level of efficiency improvement which might be achieved at each Periodic Review.

Companies are incentivised to be efficient both in terms of their operating costs and in the implementation of their capital expenditure programmes. The benefit of any efficiency savings achieved through effective management in excess of those assumed by the water regulator is retained by the companies for a period generally of five years, after which time the benefit is passed to customers. The cost of any underperformance due to poor management is borne by the companies. Companies are also incentivised to provide a high quality service and penalised, if they provide a poor quality service, by means of an adjustment to the 'K' factor at the subsequent Periodic Review.

Unexpected costs or savings arising from changes in certain regulatory assumptions or legal requirements during a Periodic Review period are recorded by South West Water and may, in certain circumstances agreed by Ofwat, be logged up or down, with prices adjusted at the next Periodic Review to compensate for the unexpected change. In addition, in certain circumstances, where the change is material, the company can request, and Ofwat can instigate, a re-setting of its price limits ('K' factors) during the five-year period, known as an 'Interim Determination of 'K'' (IDoK).

The 'K' factors for the period 2005-2010 for South West Water were determined by Ofwat in its Final K4 Determination in December 2004 and are shown below:

Year	Ofwat Final Determination '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

The K4 Determination provides for total capital expenditure of £762 million (2002/03 prices) over the five year period. The price limits are intended to enable South West Water to:

- Continue to maintain a safe, reliable water supply to customers and effective treatment and disposal of sewage, including increasing activity to maintain its pipes, sewers and sewage treatment works
- Implement new odour control measures at priority sites
- Meet the demands of new and existing customers for a reliable water supply and sewerage service
- Install 113,000 optional domestic customer water meters by 2009/10
- Deliver required drinking water and environmental quality improvements including:
 - renovation of more than 3,200kms of water distribution mains
 - improvements at 14 water treatment works
 - phosphorous removal at nine sewage treatment works
 - work to address 49 unsatisfactory intermittent effluent discharges
- Resolve or mitigate problems identified in the company's plan where overloaded sewers cause internal flooding
- Maintain access to capital markets to finance delivery of these outputs at a reasonable cost.

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

- Average annual operating efficiency improvements of 2.5% (water) and 2.0% (sewerage)
- Capital maintenance efficiency improvements of 5.0% (water) and 8.7% (sewerage)
- Capital enhancement efficiency improvements of 5.0% (water) and 16.4% (sewerage).



BUSINESS REVIEW

ENVIRONMENT/QUALITY REGULATION

The water industry in the UK is subject to substantial domestic and European Union (EU) regulation, placing significant statutory obligations on South West Water with regard to, amongst other things, the quality of treated water. Examples of relevant EU directives include the Drinking Water Directive, the Bathing Water Directive and the Urban Waste Water Treatment Directive. The Water Framework Directive was incorporated in 2003 into UK law and is intended to rationalise EU water legislation providing 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, member states will have to achieve the challenging target of 'good' status for groundwater and river water, as well as for estuarine and coastal water by the end of 2015.

Environmental regulation for water and waste water in England is the responsibility of the Secretary of State for Environment, Food and Rural Affairs, together with, among others:

- the Environment Agency (EA) which is responsible for the licensing of water abstraction and the regulation of discharges to controlled waters, including discharges from waste water treatment works
- the Drinking Water Inspectorate (DWI) which sets and enforces drinking water quality standards.

COMPETITION

As the licensed undertaker in Devon, Cornwall and small parts of Dorset and Somerset, South West Water has no direct competition for the provision of water and sewerage services to the vast majority of its customers. A new regime is in place whereby customers using more than 50 megalitres (ML) per year can contract with alternative suppliers for water supply. South West Water has only 36 customers in this category, whose aggregate water charges account for less than 2% of its total turnover. During the year, South West Water submitted indicative access prices and draft agreements to Ofwat pursuant to the new regime.

VIRIDOR WASTE REGULATORY & COMPETITIVE ENVIRONMENT

The UK is required under the EU Landfill Directive to reduce the amount of biodegradable municipal waste going to landfill sites as follows:

- to 75% of 1995 level by 2010
- to 50% of 1995 level by 2013
- to 35% of 1995 level by 2020

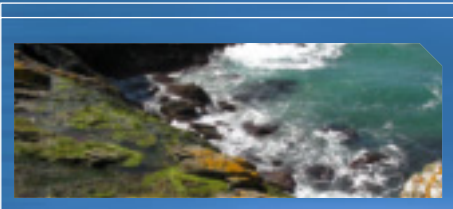
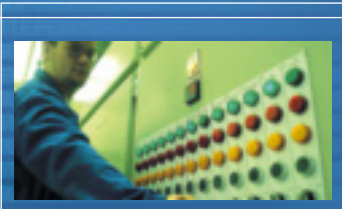
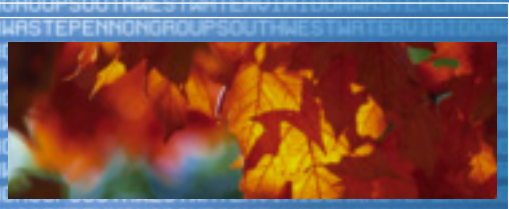
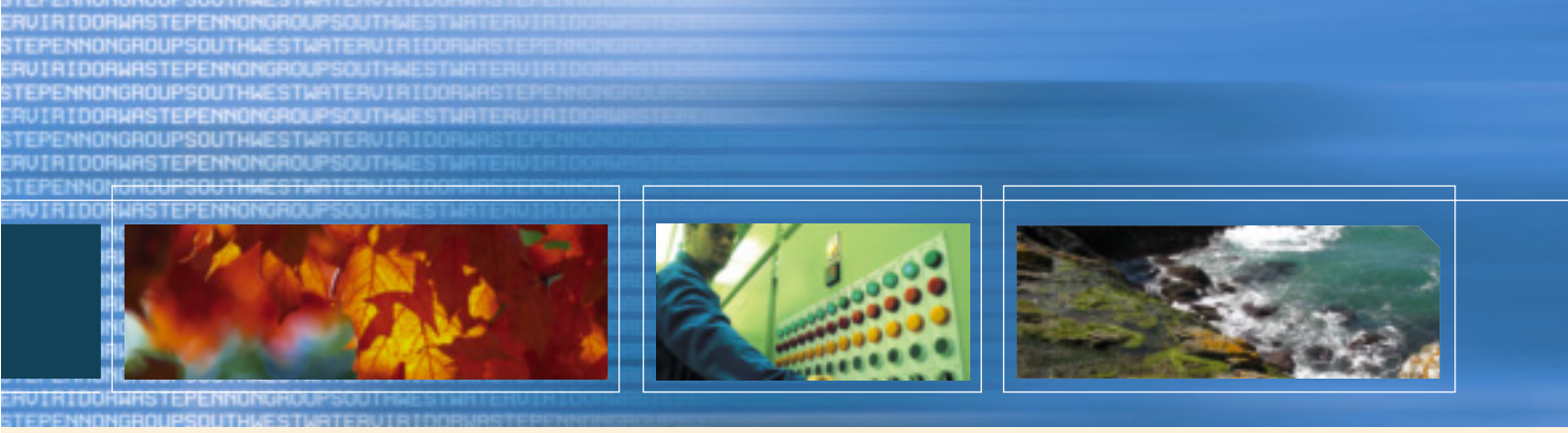
Municipal waste accounts for around one third of Viridor Waste's landfill market.

The alternatives to landfill sites for final waste disposal in the UK are currently limited. In order 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 from landfill.

Each waste disposal authority has been allocated an allowance of the amount of biodegradable waste it may dispose of to landfill for the years 2005 to 2020. These allowances are designed to ensure that the UK as a whole achieves the requirements of the EU Landfill Directive. Subject to some constraints, local authorities can carry forward or trade allowances under the Landfill Allowance Trading Scheme (LATS) allowances. Any authority exceeding its allocation without such an allowance faces a penalty of £150 per tonne in addition to the cost of disposing of the waste. This is expected to result in the introduction of alternative disposal processes at higher cost than current routes.

The Government introduced landfill tax as a further incentive to divert waste from landfill sites. Landfill tax applies to all waste disposed at a licensed landfill site, unless the waste is specifically exempt, such as soil from historically contaminated sites. Landfill tax is chargeable by weight. For inert waste, landfill tax is chargeable at £2 per tonne. A standard rate of £21 per tonne currently applies to all other taxable waste which is due to rise by at least £3 per tonne per annum in the next few years, to reach a medium to long term rate of £35 per tonne.





PLANNING FOR LANDFILL SITES AND WASTE AND RECYCLING INFRASTRUCTURE

All waste management facilities, including the development of new landfill sites and the expansion of existing landfill sites, are subject to planning permission from the relevant local authority. Landfill sites (and hazardous waste facilities) also require a Pollution, Prevention and Control (PPC) permit from the EA.

Viridor Waste believes that good environmental management is important in winning future planning consent. It has achieved ISO 14001 (Environmental Management Systems) accreditation at all of its key sites.

Planning applications are subject to rigorous assessment by local authorities who will consider them against the backdrop of policies contained within waste local plans that have been compiled for their areas. Applications have to address a wide range of issues, and the EA is a statutory consultee in this process.

INTEGRATED MUNICIPAL WASTE MANAGEMENT CONTRACTS AND THE ROLE OF PRIVATE FINANCE INITIATIVES (PFIs) OR PUBLIC PRIVATE PARTNERSHIPS (PPPs)

To assist in meeting their landfill diversion targets, local authorities are seeking to let integrated waste management contracts covering a range of activities which often include household waste recycling sites (HWRS); composting; recycling and recovery; waste transfer and bulk transport; and final disposal (both incineration and landfill). In a number of instances, these will be financed under the PFI regime.

Under the PFI regime local authorities apply to the Government for funding for capital projects which fall within the eligibility criteria. Successful applicants receive cash funds (known as PFI credits) which do not have to be repaid and can be used by the local authority to fund a proportion of the capital and operating expenditures needed for the project.

Considerable investment (potentially as high as £30 billion by 2020, as estimated by the Institution of Civil Engineers) is required by the UK to meet municipal waste landfill diversion targets.

Viridor Waste secured and began servicing a 25-year recycling and waste transfer PFI contract for West Sussex County Council in April 2004. The contract, designed to deliver a 45% recycling rate by 2015, involves the provision of 14 new or improved recycling and waste handling facilities and is supported by £25m of PFI credits.

In May 2006, a joint venture between Viridor Waste and John Laing Plc was chosen as one of two parties shortlisted to submit Best and Final Offers (BAFOs) for the Greater Manchester waste services PFI.

Councils may also choose to let long term contracts under the PPP regime. From the waste management contractor's point of view, the nature of the contract is very similar whether it is a PFI or a PPP.

In May 2006, Viridor Waste signed a 25 year PPP with Somerset County Council and at the same time acquired Somerset's Local Authority Waste Disposal Company (LAWDC), Wyvern Waste Services Limited.

Viridor Waste recognises that there is a range of risks associated with entering into such contracts, which are often for a 25-year term. However, subject to a careful assessment of the risks on a contract by contract basis, the company will continue to seek to secure such contracts.

WASTE REGULATION ENVIRONMENT

EU directives and related UK legislation, as well as planning and licensing, are referred to above.

The EA and Scottish Environment Protection Agency (SEPA) monitor performance against permit conditions and general environmental law. Breaches are subject to prosecutions. The EA and SEPA can also require the operator to undertake upgrades to ensure future compliance and, where a pollution incident has occurred, require clean-up action to be undertaken.

Waste facilities are also subject to the same regulations as other industries, including health and safety, control of substances hazardous to health and the Working Time Directive. In addition, the transport of waste is subject to specific controls.

CUSTOMER / SUPPLIER RELATIONSHIPS

The Group recognises that maintaining long term relationships with customers and suppliers is key to achieving its strategic objectives. Further details of supplier relationships are set out in the suppliers and contractors section of this Business Review on page 22.

SOUTH WEST WATER

No single customer accounts for more than 1% of turnover. No supplier (revenue) accounts for more than 5.0% of turnover and South West Water sources all its purchases from competitive markets with the exception of the purchase of magnetite for use at a water treatment works. Action is being taken to change this treatment process.

VIDIROR WASTE

Local authorities are the largest single customer group accounting in total for 30% of turnover. No individual authority accounts for more than 4%. Viridor Waste's ROC contracts account for 5% of turnover.

No supplier accounts for more than 1% of Viridor Waste's turnover. The company sources from competitive markets.



BUSINESS REVIEW

KEY PERFORMANCE INDICATORS (KPIs)

Key Performance Indicators (KPIs) used by the Directors to assess performance against their stated objectives are as follows:

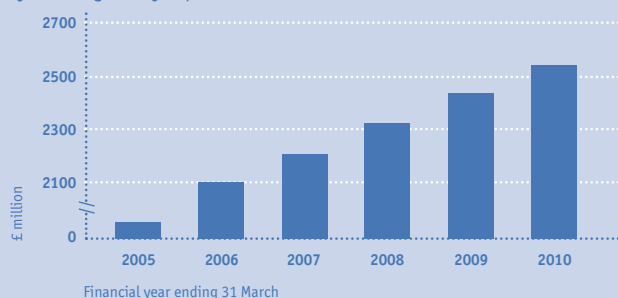
SOUTH WEST WATER

Growth in Regulatory Capital Value

Regulatory Capital Value (RCV) is the financial base on which Ofwat allows a rate of return and sets prices at the Periodic Review. The opening RCV is adjusted for projected capital and infrastructure renewals expenditure, grants and contributions, infrastructure renewals charge and current cost depreciation, together with the efficiency outperformance from the previous regulatory period. Ofwat then projects each component for each year of the Review period. The RCV is adjusted annually for Retail Price Index movements. At the following price review, the RCV is restated for outputs under-delivered, the logging-up of new obligations and the effect of construction price inflation on capital and infrastructure expenditure. A full explanation is given in the Ofwat letter to Regulatory Directors RD08/06, which is available on the Ofwat website – www.ofwat.gov.uk

The RCV at 31 March 2006 amounted to £2.1 billion.

Projected Regulatory Capital Value



Projected RCVs up to 2009/10 are based upon Ofwat's projections set out in 'Future Water and Sewerage Charges 2005-10' published in December 2004, adjusted by South West Water's estimates of RPI indexation.

The growth in RCV adds directly to shareholder value as a higher value and therefore return is attributed to South West Water's asset base by the Regulator.

Operating profit

South West Water achieved an operating profit before exceptional items of £141.5 million in 2005/06, up £19.3 million on 2004/05. For the five year period 2002 to 2006, operating profit was as follows:

Year ended 31 March	2002*	2003*	2004*	2005	2006
	£m	£m	£m	£m	£m
	107.0	111.5	118.9	122.2	141.5

* UK GAAP

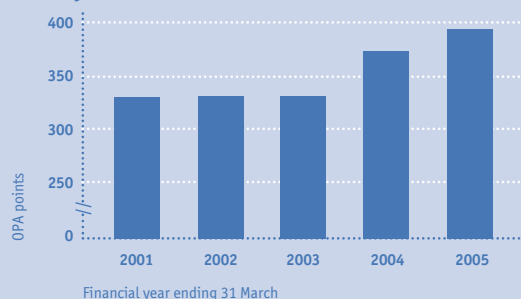
Overall Performance Assessment

The Overall Performance Assessment (OPA) index was devised 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.

Data is collated for 12 month periods, part calendar year and part financial year. The final OPA assessment is published as part of Ofwat's Annual Report on 'Levels of Service for the Water Industry in England and Wales', usually in the autumn.

Improvements within Ofwat's OPA index have been sustained as capital expenditure, previously constrained whilst the coastal clean-up was delivered, has now been directed to address other areas.

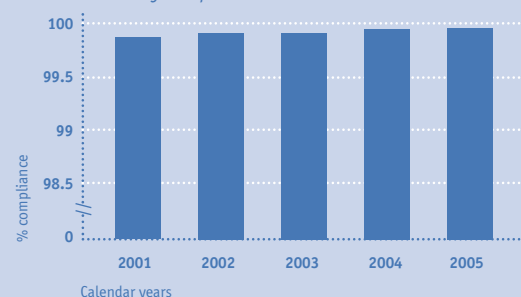
Overall Performance Assessment Scores

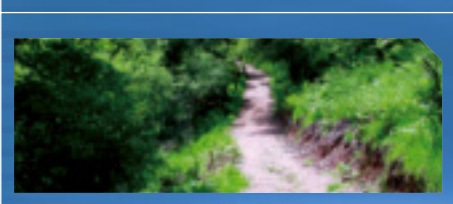
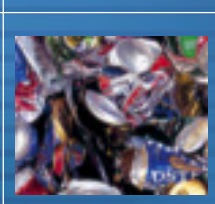
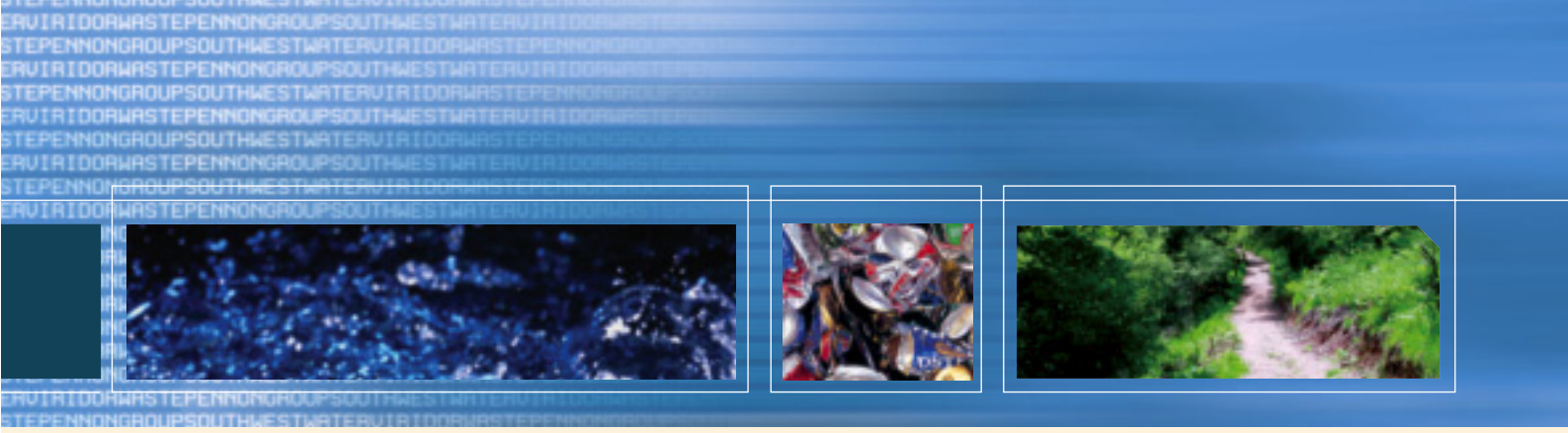


Drinking water compliance

During 2005, South West Water further improved its overall high level of compliance with the drinking water quality regulations with 99.96% of its regulatory tests meeting the required standards.

Overall Water Quality Compliance





VIRIDOR WASTE

Operating profit and profit before taxation (PBT)

Operating profit before intangibles amortisation and PBT are key measures of Viridor Waste's performance and are set out in the table below for the six year period 2001 to 2006.

The table also sets out the Compound Annual Growth Rate (CAGR) of these measures which is the rate of growth between 2001 and 2006 expressed as a single average figure over the period.

Year ended 31 March	2001*	2002*	2003*	2004*	2005	2006	CAGR 2001 - 06
	£m	£m	£m	£m	£m	£m	
Operating profit before intangibles amortisation	13.1	15.2	19.1	22.7	30.0	35.9	22.3%
Profit before taxation	11.7	13.5	14.2	14.7	20.1	21.9	13.4%
Return on equity investment after corporate overheads	6.1%	7.1%	7.4%	7.5%	10.3%	10.6%	-

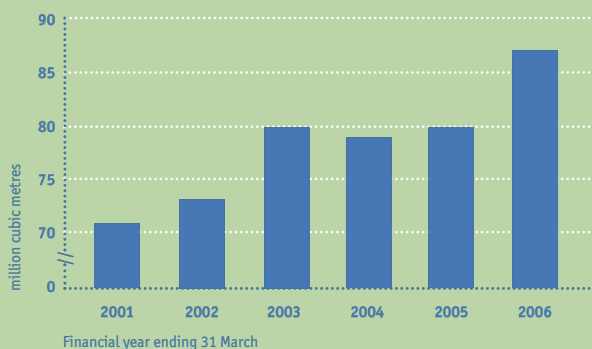
*UK GAAP

Consented landfill void

As at 31 March 2006, Viridor Waste had an assessed consented void capacity of 87 million cubic metres. This can be reconciled to the disclosed consented void capacity in last year's Annual Report, as follows:

	million cubic metres
As at 31 March 2005	80
Planning gains (net)	1
Acquisition	11
Used in the period	(5)
As at 31 March 2006	87

Consented Landfill Void



Return on equity investment

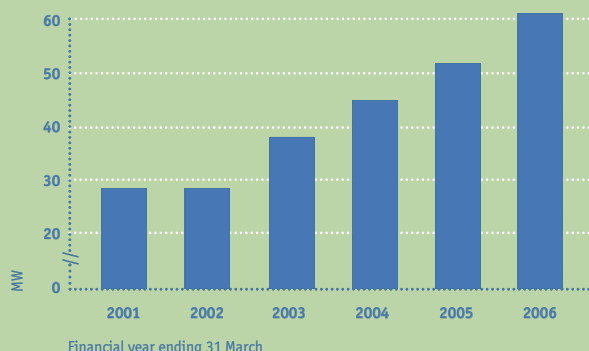
Return on equity investment is calculated as profit before taxation expressed as a percentage of Pennon Group's equity investment in Viridor Waste (£207 million at 31 March 2006). This is also set out in the table below.

Landfill gas electricity generation capacity

Electricity generated is sold to electricity suppliers, usually under NFFO contracts or under short-term contracts with ROCs.

As at 31 March 2006, Viridor Waste had 61MW of generating capacity, an increase of 9MW over the year.

Power Generation Capacity



CORPORATE RESPONSIBILITY

In accordance with its Mission Statement (as set out on page 8), the Pennon Group endeavours to achieve the appropriate balance between all its stakeholders, the environment and the needs of the Group. The Group’s social and ethical policy covers the key areas of finance, employees, customers and suppliers, community, management responsibility and communications.

A key objective of the Group is to uphold its reputation for integrity and fair dealing, which it considers is essential to the long-term well-being of the Group and its key stakeholders.

The Group also has a ‘Whistleblowing’ policy which supports its approach to ethical employment practices by encouraging employees to raise, in accordance with a formalised procedure, concerns which relate to potential unlawful conduct, financial malpractice, dangers to the public or damage to the environment. This policy is reviewed regularly.

The Group improved its overall score in the Business in the Community’s Environmental Index 2005 to 92.97% and was ranked 32nd out of 145 entrants.

The Group is a constituent member of the FTSE4Good Index which recognises the Company’s fulfilment of the Index’s criteria for corporate social responsibility.



EMPLOYEES

The Directors believe that the success of the strategies set out at the beginning of this Business Review depend inter-alia on the businesses’ ability to attract and retain appropriately qualified and motivated employees, provide them with a safe working environment and give them the necessary training and development to fulfil their roles.

South West Water

In 2005, South West Water undertook a major internal reorganisation including the establishment of a new asset management function, which is enabling a more efficient approach to its asset investment and providing improved performance information about the company’s assets. The reorganisation enabled the company to release a number of employees on early retirement or voluntary severance terms to assist with meeting the demanding efficiency targets arising from the K4 Determination. A second major project is currently underway to improve the service to customers in relation to the company’s day to day operational activities and to reduce operational costs. This will involve the establishment of a new Service Centre in Exeter in 2006, which will ultimately both manage the customer interface and plan the activities of field staff who are directly responsible for handling customer issues.

Occupational health and safety are key elements of South West Water’s risk management philosophy/process. Following privatisation, the company set out to build an occupational health and safety culture throughout its supply chain in partnership with stakeholders including trade unions, regulators, other water companies and construction partners. South West Water’s reportable accident rate was 12.56 accidents per 1,000 employees in the calendar year 2005, a slight increase on 12.0 per 1,000 employees in 2004. Whilst the significant reduction achieved in recent years has largely been maintained, the company continues to pursue initiatives to improve the health and safety of all its employees.

A similar business-focused approach is now underway to reduce work-related ill health. Although the company acknowledges that further work is required to improve health at work, at a major health conference hosted by the TUC during the year, South West Water was the only private sector organisation to be cited by the Minister of Health and Safety as effectively integrating ethical, commercial and statutory objectives.

Through the Chief Executive’s chairmanship of the Health and Safety Group of Water UK, South West Water continues to lead ‘Clear Water 2010’, a 10 year occupational health programme for the water industry. Independently verified data gathered across the industry has identified the industry’s greatest work-related challenges as stress and musculo-skeletal disorders.

An essential aspect of South West Water’s activities with regard to the safety, health, welfare and well-being of its own workers is the extensive provision of training in skills acquisition and health and safety, thus ensuring that employees have the knowledge and expertise to undertake their jobs in a well-motivated and productive manner.

Viridor Waste

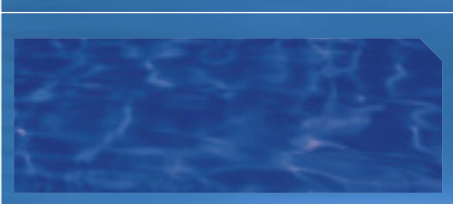
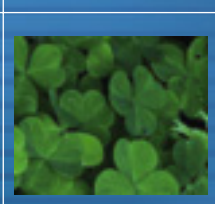
Viridor Waste is pursuing a number of occupational health and safety initiatives. It currently has seven sites accredited to the ISO18001 international health and safety standard and is planning to extend this across further sites. All other sites are covered by the company’s environmental management system (most accredited to ISO14001), which is the vehicle for delivering health and safety standards and procedures.

Viridor Waste’s reportable accident rate per 1,000 employees was 18.1 in 2005/06 (13.2 in 2004/05). Whilst this accident rate still compares favourably with the industry as a whole, it is recognised that an increasing focus on health and safety improvement and performance is necessary. The company has recruited additional health and safety professionals during the year and continues to raise the level of training and support available to its staff.

THE ENVIRONMENT

The Directors believe that sound environmental performance is critical to the success of both South West Water and Viridor Waste. The Group has a long established environmental policy, as set out in its annual Corporate Responsibility Report which is available on the Group’s website – www.pennon-group.co.uk/CR





Both businesses must comply with the high standards set by the EA to minimise their impact on the environment and are responsible for the treatment and disposal of society's waste in a carefully controlled and highly engineered manner. The businesses acknowledge the importance of environmental sustainability and have taken measures to ensure that their operations enhance the environment whenever possible and minimise any adverse impact.

The Group is a major generator of renewable energy which supports the Government's objective to reduce greenhouse gas emissions. In 2005/06, the Group generated 437GWh, which was the equivalent of 152% of the Group's total energy consumption.

South West Water

The percentage population served by sanitary compliant waste water treatment works improved to 99.41% (99.16% in 2004).

This high level of compliance is a major contributor to the region having a significant proportion of the finest bathing waters, beaches and rivers in the UK. In 2005, 99% of the region's 143 bathing waters achieved EU mandatory standards (98% in 2004) and 89% achieved the more stringent guideline standards (81% in 2004).

South West Water's region also has the highest percentage length of high quality rivers in England.

Viridor Waste

The most significant positive environmental impacts of Viridor Waste's operations arise from the safe and efficient disposal of society's waste materials, increased resource and energy efficiency from its recycling and recovery operations, the generation of renewable energy from non-fossil fuels and the restoration of despoiled landscapes such as disused mineral workings through the controlled deposit of waste materials. Significant negative impacts include transportation and associated emissions, methane production (where not harnessed for energy generation or flared), leachate production and potential local impacts such as dust, noise, litter and odour.

Viridor Waste developed its own Environmental Management System (EMS) in the early 1990s recognising the growing importance of measuring and monitoring the environmental impact of its operations. This has allowed targets to be set and achieved to maximise positive environmental impacts and reduce negative impacts, resulting in continuous improvement in environmental performance.

Viridor Waste was the first UK waste company to achieve ISO 14001 accreditation across all major operational sites and has 42 accredited centres covering 107 operational facilities as at 31 March 2006. It has also played a leading role in developing and reporting against the environmental performance indicators for the waste industry as promoted by the Green Alliance.

The amount of waste recycled by the company increased over the year to 951,155 tonnes (780,129 tonnes in 2004/05), a 22% increase.

INCIDENTS AND PROSECUTIONS

Both South West Water and Viridor Waste endeavour to manage their operational activities to minimise the occurrence and impact of any incidents that occur at operational sites.

South West Water

The number of incidents classified by the EA as 'Category Two' (significant pollution incidents) in 2005/06 was six, of which only three were determined as non-compliant with discharges consents, compared with three also determined as non-compliant in 2004/05.

During the year, the company was convicted on two occasions for environmental offences and fined a total of £6,000, compared with 12 convictions and £51,200 in fines in 2004/05. The company has strategies in place to reduce incidents which may lead to prosecutions.

In January 2006, an incident occurred in part of the Exeter water distribution network when diesel fuel entered the supply. To protect customers a 'Do Not Drink' notice was issued for a four day period.

Viridor Waste

In September 2005, Viridor Waste pleaded guilty to one charge of contravening Section 34 of the Environmental Protection Act – a littering offence from March 2004 at the Parkwood landfill site in Sheffield. The company was fined £2,000 plus costs. As a result of this incident, the company undertook a full review of operations at the site and has implemented a series of actions to prevent a recurrence.

SOCIAL AND COMMUNITY ISSUES

The Group is committed to supporting the communities in which it operates. It does this by carefully targeted sponsorship and charitable donations to social and community groups, further details of which can be found in the Group's Corporate Responsibility Report.

RESOURCES

SOUTH WEST WATER

Human resources

South West Water has a skilled management team and utilises remuneration and incentive policies which are focused on financial and operational targets. It has invested significant sums to ensure that its staff have the experience and competencies to undertake their roles. For example, NVQ training is provided to operators and craftsmen to ensure that basic skills are in place and health and safety requirements met. A range of training opportunities including assistance to obtain professional qualifications is offered to office-based staff and managers are encouraged to widen their knowledge and skills through participation in company-wide programmes as well as bespoke external courses. All training activity is undertaken under the 'Investor in People' (IIP) standard and is closely aligned with business requirements.



BUSINESS REVIEW

Staff turnover is below the national average. Job satisfaction is supported by encouraging role changes wherever possible around the company to help employees gain a broad experience of business activities. The company has introduced a number of 'Family Friendly' policies to ensure that a proper balance is maintained between work and home life. Regular benchmarking of salary levels is carried out to maintain the company's competitive position in the job market. The company will be carrying out an employee survey during 2006, having last done so towards the end of 2002, and will also be seeking IIP re-accreditation during this coming year.

Water resources

In 2005/06, South West Water abstracted 175,890 ML of raw water from its 61 licensed abstraction locations which have a total annual licensed volume of 384,466 ML. The abstraction locations are either reservoirs, rivers or groundwater aquifers. This raw water is treated to a high standard before being put into supply for customers' use.

The company continues to invest in its distribution network and has consistently met its Ofwat leakage target of 84 ML/d.

South West Water prepares and updates its Water Resources Plan every five years for a range of climate change and demand scenarios. The Plan, which is reviewed annually, indicates that no new reservoirs are required to be built before the planning horizon of 2030 but investment is needed to develop the overall trunk main infrastructure, to expand treatment capacity and to enhance certain pumped storage facilities.

At 26 March 2006, reservoir storage levels were 82.7% compared with 80.8% at 27 March 2005.

Systems

The company has a range of sophisticated financial, asset management and operational systems which are upgraded and renewed as necessary to ensure reliability, efficiency and operational effectiveness. In addition, it has back-up and standby arrangements in place in the event of damage, failure or other disruption.

VIRIDOR WASTE

Human resources

The company employs a comprehensive range of technical and professional managerial personnel and supervisory, administrative and clerical, semi-skilled and unskilled staff. Many are vocationally trained and have extensive operational experience. Membership of relevant trade and professional bodies is widespread and is encouraged.

Industry reputation and expertise

Viridor Waste is an active member of the Environmental Services Association, the leading trade body, and other relevant industry organisations such as the Chartered Institution of Wastes Management and the Renewable Power Association. Senior staff are also involved in leading positions on industry committees providing Government departments with economic and technical information.

Landfill and electricity generation resources

Details of these resources are set out on page 15.

RISKS AND UNCERTAINTIES

RISK FACTORS RELATING TO THE GROUP

It may not be possible to continue to sustain the same level of earnings and growth of the Group as in the past

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. This is dependent upon the correct strategies being pursued by strong and able management within the Group as well as on external factors. The Group has maintained earnings and has successfully grown both South West Water and Viridor Waste and intends to continue to create shareholder value through its strategic focus on water and sewerage services and waste management.

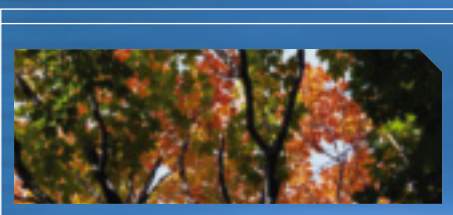
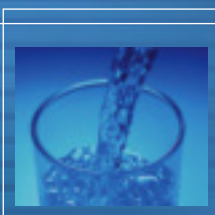
RISK FACTORS RELATING TO THE GROUP'S WATER AND WASTE WATER BUSINESS

Price controls over the turnover of the Group's regulated business could adversely affect profitability

The outcome of Ofwat's future Price Determinations may adversely affect South West Water for a number of reasons including an inadequate cost of capital allowance. There is also a risk that regulatory assumptions concerning operating expenses, required capital expenditure and revenue forecasts may prove to be unrealistic. However, South West Water has a track record of meeting Ofwat's efficiency expectations in the last two Periodic Review periods (K2 and K3).

Failure to deliver the capital investment programme could adversely affect profitability

South West Water requires significant capital expenditure for additions to and replacement of plant and equipment for its water distribution and waste water facilities and networks. The price limits set by Ofwat for the K4 period take into account the level of capital expenditure expected to be incurred and the associated funding costs. In the event of under performance, the water regulator could intervene to re-set price limits at lower levels.



The company may be unable to raise sufficient funds to finance its functions

Historically, the Group has financed expenditure from cash flows from operations and from debt financing. In setting price limits, the water regulator has a duty to ensure that a company can finance its functions. Whilst there can be no assurance that cash flows from operations will not decline or that additional debt financing or other sources of capital would be available to meet these requirements, the Group's policy is to ensure that it has committed facilities available for at least 12 months' anticipated net cash requirement.

If South West Water is unable to secure the anticipated capital efficiencies associated with the capital programme, or the programme falls behind schedule for other reasons, the profitability of the Group may suffer. The water regulator may factor such failure into future price reviews. In addition, the Group's ability to meet regulatory and environmental performance standards could be adversely affected. This could result in the potential for fines or other sanctions imposed by either the water regulator or the courts, including ultimately the loss of South West Water's Appointment. The company has a track record of delivering its capital programme in accordance with regulatory requirements.

Failure to deliver operating cost savings implicit in the regulatory review could adversely affect profitability

Operating cost savings to be achieved during the current K4 period are implicit in the regulatory review. In line with South West Water's track record, the Board remains confident of delivering the assumed operating cost savings. However, should operational performance deteriorate, the Group's profitability could suffer and the water regulator could seek to impose higher efficiency targets as part of future price reviews.

Environmental regulations and quality standards could increase the Group's costs and adversely affect profitability

Various environmental and consumer protection, health and safety laws and regulations govern the company's waste water and water distribution businesses. These laws and regulations establish, amongst other things, quality standards for drinking water, effluent treatment (including sewage sludge disposal) and discharges into the environment which affect South West Water's operations. In addition, South West Water is required to obtain various environmental permissions from regulatory agencies for its operations. South West Water endeavours to comply with all regulatory standards but cannot guarantee that it will be in total compliance at all times with these laws and regulations.

Environmental laws and regulations are complex and change frequently. These laws and their enforcement have tended to become more stringent over time. Whilst South West Water has budgeted for future capital and operating expenditures to achieve compliance with current and known future changes in law and

regulations, it is possible that new or stricter standards could be imposed that will raise South West Water's capital and operating expenditures by requiring modifications to its assets. It is also possible that future legislation will impose constraints on existing water abstractions requiring South West Water to source alternative water supplies. These costs are recoverable in part or in whole through the regulatory process of setting appropriate future price limits. In the event of these being significant, South West Water could apply to Ofwat for a revision of its price limits through an IDoK.

Contamination to water supplies could adversely affect profitability

Water supplies may be subject to contamination, including contamination from naturally occurring compounds and pollution resulting from man-made sources. In the event that one or more of the company's water supplies is contaminated and it is unable to substitute a water supply from an uncontaminated water source, or to adequately treat the contaminated water source in a cost-effective manner, there may be an adverse effect on its reputation, operating results and financial position. Some or all of these costs may be recoverable through future price reviews. South West Water could also be held liable for human exposure to hazardous substances in its water supplies or other environmental damage. The Group 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 could adversely affect profitability

The company is responsible for the billing, cash collection and debt management activities for around 760,000 domestic and business customers. Since 1997 water companies are prohibited from disconnecting domestic water supplies for non-payment. Non-recovery of debt is therefore a risk to the Group and may cause the Group's profitability to suffer, although allowance is made by Ofwat in the Determination for its estimate of debt deemed to be irrecoverable. In addition to existing strategies, South West Water is implementing new initiatives to improve and secure cash collection, including the use of property charging orders. However, there can be no assurance that the the amount allowed by the water regulator is adequate. Provision was made in the last Periodic Review for companies to make an application for an IDoK in the event of a significant shortfall.

Energy cost pressures

Energy costs are the second highest component of South West Water's operating costs. A proportion of recent increases was recognised and allowed for by Ofwat in the last Price Determination.



BUSINESS REVIEW

South West Water mitigates rising energy costs through careful system operation, by maximising renewable energy generation and by purchasing energy in the most efficient way.

Meter option take-up

Higher than national average water charges within the South West Water area have encouraged many customers to change from an unmeasured rateable value based charging system to a payment based on volume of water used as measured by a meter. Properties constructed since 1989 do not have a rateable value assessment and are therefore charged by the volume of water used. Most customers in properties built prior to 1989 can choose to opt for metered charges. In doing so they have an option to switch back to rateable value payment within 12 months of meter installation. The rate at which customers elect to switch to metered charges is estimated at each Periodic Review. South West Water expects that the proportion of customers charged on a metered basis will align with the estimates made at the last Review which allow for some 65% of domestic customers to pay by measured charges by 2010, compared with around 53% of such customers with meters at 31 March 2006. However, it is possible that a higher proportion of customers could switch to a metered supply and this could have an adverse impact on the company's revenues. As referred to in the price cap regulation section on page 11, an IDoK may be used to at least partially recover revenue losses if they exceed the prescribed materiality threshold.

Other potential uncertainties and risks

A failure of the equipment operated by South West Water could lead to the escape of water or waste water including sewage effluent and result in damage to third party property or personal injury. In such circumstances, South West Water may incur liability to those third parties. South West Water could also be prosecuted by the EA or DWI and/or be required to undertake costly upgrades.

A water shortage due to a severe drought could reduce the water supply available to customers, which could have a material impact on the profitability of South West Water. The company does have in place a number of schemes to maintain water resources (such as pumped storage for certain reservoirs) and has a number of water conservation measures which are applied on an ongoing basis.

RISK FACTORS RELATING TO THE WASTE MANAGEMENT BUSINESS

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. Particular areas of cost increases include site engineering (which results in increased depreciation), restoration and aftercare costs, leachate management, landfill gas management and general site management. Companies such as Viridor Waste, with landfills engineered to modern standards and which have good environmental control systems, should incur lower than average increases in costs. However, there remains a risk that rising standards may generate higher treatment and disposal costs than currently assumed.

Landfill sites are filled and restored on a cell by cell basis. Final restoration, in accordance with the planning permission, and aftercare of the site takes place after site closure and the costs related to aftercare are expected to continue for around 30 years post closure. These costs are best estimates based on Viridor Waste's own extensive experience and they are updated at each stage of the capital expenditure programme, typically every three years. Nevertheless, as with any estimate of future costs, there is a risk that circumstances may change which may affect the level of those costs.

Restoration and aftercare costs are recognised on a landfill usage basis, i.e. per tonne input. This is derived by dividing the total expected cost by the number of tonnes expected to be input into the site up to its closure. The number of tonnes expected to be input is derived from the remaining void space, as estimated by external consultants, and estimated compaction rates (tonnes per cubic metre). These are best estimates, based on current information, which are reviewed every year. However, to the extent that tonnages are over or underestimated, there is a risk that the amount provided may be too high or low at a particular point in time.

Municipal waste contracts typically last for a number of years; they usually have price increases under formulae related to inflation as measured by the RPI in the UK and in some cases take into account specific legislative or technical changes. Prices for other types of waste depend more on local markets and competitive conditions. Viridor Waste's experience over several years is that prices in general have risen at least fast enough to cover cost increases in the areas where it operates. There is a risk that landfill prices may not rise sufficiently in all locations to recover recent and projected cost increases.

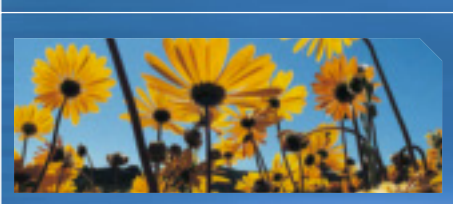
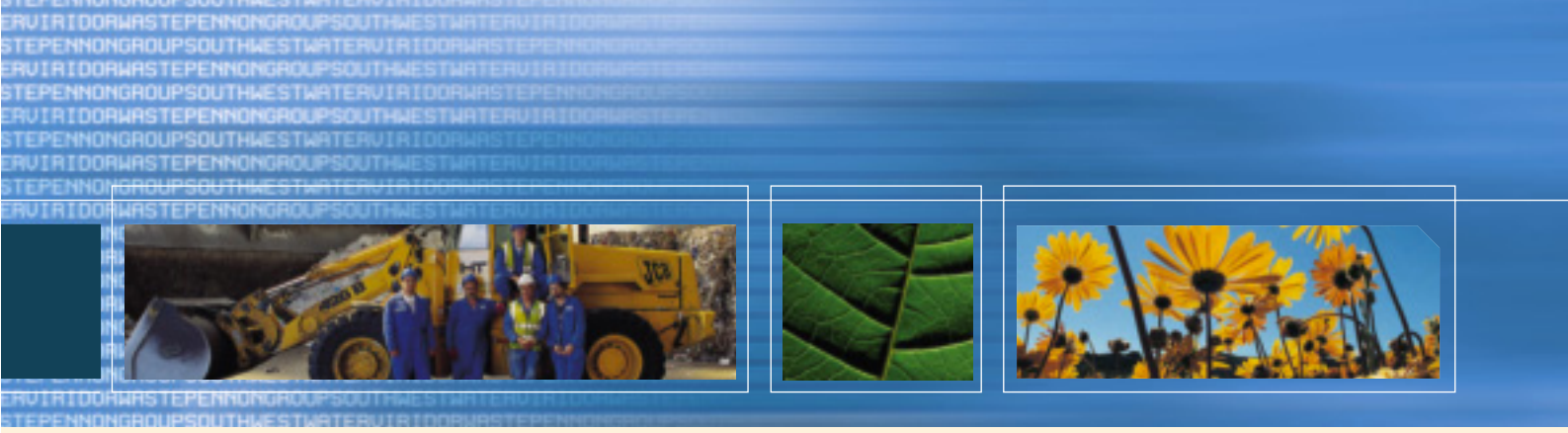
The Government's Waste Strategy, stemming from the Landfill Directive, may lead to a reduction in volumes of waste being disposed of via landfill.

The Government's waste strategy is currently under review and includes targets for diversion of municipal waste from landfill and increases in landfill tax as previously announced.

Viridor Waste focuses on the disposal of municipal; industrial and commercial; construction; and demolition waste. Of this, around one third (25 million tonnes) of the UK total for these waste streams is municipal (of which approximately two thirds is biodegradable municipal waste (BMW)). These figures are based on estimates from DEFRA, the EA, SEPA and HM Revenue & Customs.

Existing Government initiatives are starting to have an impact and the amount of municipal waste being disposed to landfill appears now to be declining. Assuming the EU Landfill Directive targets are met, the total amount of municipal solid waste (MSW) which will be landfilled from 2020 will be around 10 million tonnes per annum (depending on the precise interpretation of the Directive). If there is no change in other waste streams, this would still leave a substantial landfill market in 2020.

This should be seen in the context of an EA estimate of a current consented landfill capacity UK-wide of around six years.



Viridor Waste has seen its underlying landfill volumes holding steady or slowly increasing, perhaps reflecting an increasing share of the landfill market. However, the combined effect of the various Government measures may reduce the total amount of waste being landfilled in the future.

Not all landfills may meet the standards of the Integrated Pollution Prevention and Control Directive and the Landfill Directive, or requirements may be imposed which would impact on the economics of landfill

Landfills (and other industrial processes) in the UK are subject to a new permitting regime pursuant to the Pollution Prevention and Control (England and Wales) Regulations 2000 (PPC Regulations). Existing landfills opened before July 2001 operate under waste management licences. In future, they (and landfills opened since July 2001) will require a PPC permit granted under the PPC Regulations. The replacement of waste management licences with PPC permits is occurring in a series of application tranches due to run through to 2007. PPC permits are expected to impose higher standards and costs in general. At the same time, it is possible that some current landfills may fail to obtain a PPC permit and will therefore have to seek to agree a closure plan with the EA or SEPA.

The net result of this is that it is expected that, after a transitional period, the average technical and operational standards of landfill in the UK will improve and it is possible that the number of landfills may decrease.

All but one of Viridor Waste’s operational landfills have achieved PPC permits, although in some cases the company is appealing against certain of the conditions proposed, which might have cost or other implications for the landfills. The operational landfill which has not yet received a PPC permit is due to close in three years’ time in any event. The company is in the process of applying for PPC permits for two new landfills and whilst it is expected that these applications will be successful, the EA’s or SEPA’s conclusions cannot be pre-judged.

Under both waste management licences and PPC permits, landfills require expenditure on restoration when the site is closed and subsequently on aftercare (maintenance, supervision, monitoring and management of gas and leachate levels) long after the landfilling activities have ceased. The EA or SEPA will only grant a full or partial PPC permit or waste management licence surrender once it is satisfied that the landfill is inert and no longer poses any environmental risk. There may still be a risk of liability arising from any residual contamination following the surrender of the PPC permit. Landfill licences or permits cannot be surrendered during the aftercare period.

Pricing and other risks relating to renewable energy

Renewable energy prices under the current ROCs scheme are primarily a function of the underlying ‘brown’ energy price and the premium achieved from the sale of ROCs.

Recent underlying ‘brown’ energy prices have risen significantly reflecting the general energy supply/demand position in the UK and worldwide. ‘Brown’ energy prices will continue to be determined by the world and UK energy market and may go down as well as up. Any changes in underlying energy prices will directly affect Viridor Waste’s revenues when its sales contracts come up for renewal. (In general, Viridor Waste has sold its energy one year ahead).

Without a pricing mechanism such as ROCs as identified on page 10, further investment in renewables energy generation would not generally be economic. The Government has made a strong commitment to renewables which are key to meeting the long term carbon reduction strategy set out in the energy white paper and the UK’s 2010 targets for carbon dioxide reductions under the Kyoto Protocol. Renewables are also important in minimising the UK’s increasing reliance on imported energy. Nevertheless, there remains a risk that the Government may change the current regime.

In its recent consultation on the ROCs regime, the Government concluded that new landfill gas schemes starting from 2009 onwards will have reduced eligibility for ROCs. It intends to consult further on what this means in practice. This will not, however, affect Viridor Waste’s existing schemes which are likely to form the vast bulk of its output.

The value of ROCs is increased by the sharing of the buy-out price monies among holders of ROCs and is therefore dependent on the financial strength of those suppliers who opt to pay the buy-out price. There is a risk that the insolvency of a licensed electricity supplier could lead to a drop in the value of the ROCs which Viridor Waste sells to licensed suppliers.

A landfill gas project must be able to collect and burn sufficient gas to produce electricity. Ultimately, the volume of gas generated will depend on the amount and composition of the waste landfilled. For example, if the amount of BMW diverted away from landfill is increased in the future in accordance with the EU Landfill Directive obligations, the total biodegradable component of the waste going to landfill will affect volumes of landfill gas produced. It is therefore possible that the gas obtained will not be available, either in the amounts or of the calorific value required, to make a project cost effective.

Lakeside construction and technical risks

The Lakeside joint venture involves building a 400kt waste to energy plant at a cost of circa £160 million and operating it for 25 years. 86% of the project is funded by non-recourse bank debt which limits the risk to Pennon Group. The remainder is funded by the joint venture, of which Viridor Waste has 50% of the equity.

The plant is a modern conventional waste to energy facility. As a result of a competitive procurement procedure it is being supplied by the Japanese engineering consortium Itochu/Takuma. There are a significant number of similar plants operating successfully worldwide.



BUSINESS REVIEW

The plant is being supplied on a fixed price contract which was drawn up with the assistance of specialist external consultants. Nevertheless, as with any major infrastructure project, unforeseen circumstances may arise which may affect the construction process.

Efficiencies and output of the plant will be affected by the precise calorific value of the waste throughput. The plant is well proven with robust conventional technology designed to take currently projected waste mix. Nevertheless, if the mix of the waste changes significantly over the next 25 years, there may be some impact on efficiencies and output.

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. Obtaining planning permission for any type of waste treatment facility is difficult and represents a major challenge for the waste management industry.

Viridor Waste may be unable to recruit/retain adequate numbers of staff with the necessary skills

Good quality staff with the required technical skills and certification are essential in the waste industry. Viridor Waste recognises that there is a risk of losing staff to competitors and seeks to address this by its employment policies.

OTHER GROUP RISKS

Pension costs may increase due to factors outside the Group's control

The Group has defined benefit pension schemes for existing staff of Pennon and South West Water, and for certain employees of Viridor Waste. Pennon Group set up a defined contribution scheme in July 2003 for new entrants to Viridor Waste and employees from certain acquired waste companies. Future employer costs have been mitigated from 1 April 2006 through the closure of the existing defined benefit scheme to new entrants (replaced by a new scheme with reduced benefits) and an increase in employee contributions.

The last actuarial valuation of the Group defined benefit schemes was undertaken at 1 April 2004. Under International Accounting Standard 19 "Employee Benefits", the Group pension schemes had net liabilities (after deferred tax) at 31 March 2006 of £29 million (2005 £56 million). A sound investment performance plus a £44 million prepayment of employer contributions in August 2005 have been partially offset by an increase in liabilities due to a reduction in the interest rates used to discount liabilities. The net liabilities represent circa 2% of the Group's total market capitalisation as at 31 March 2006.

The future costs of defined benefit schemes are subject to a number of factors including:

- The returns achieved on pension fund investments
- Movements in interest rates and inflation
- Pensioner longevity.

Insurance

The Group manages property and third party risks by the purchase of insurance policies from the insurance market. The Group's insurance brokers assist in sourcing appropriate insurance cover from insurance companies that have good credit ratings. Main insurance policies cover property, business interruption, public liability, environmental pollution and employers' liability. There are three tiers of insurance for most policies. The first tier is self-insurance in the form of a moderate deductible. The second tier is covered by the Group's subsidiary, Peninsula Insurance Limited, which insures the layer of risk between the deductible and the cover provided by external insurers. The third tier of risk is placed with the external insurance market.

RELATIONSHIPS

SOUTH WEST WATER

Regulatory and customers

South West Water views relationships with regulators, Government bodies, customer representative organisations and its customers as central to its operations.

The company maintains a continuing dialogue with Ofwat, the EA and DWI and inputs into national dialogue on developing issues through its representation at Water UK, the industry trade body.

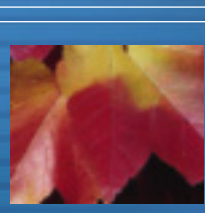
It works with the Consumer Council for Water South West to ensure that customer issues and concerns are addressed and a full understanding of the company's activities is maintained. In addition, there is a proactive policy of informing customers through a customer newspaper entitled 'Waterlevel' and through regular press releases and media briefings.

Suppliers and contractors

South West Water's procurement strategy is focused on the proactive management of around 50 key and strategic suppliers who account for the large majority of expenditure. Regular meetings are held to manage performance and to identify and deliver 'continuous improvement' opportunities for further reducing cost while improving performance and service levels.



David Dupont
Group Director of Finance
Pennon Group Plc



VIRIDOR WASTE

Regulation

Landfill (and many other facilities) require waste management licences or PPC permits, issued and monitored by the EA. Viridor Waste maintains a positive working relationship with the EA, proactively liaising on and managing issues at both a site-specific and strategic level.

Liaison groups

A 'good neighbour' policy is implemented at all facilities managed by Viridor Waste with local liaison groups at all major sites consisting of locally elected representatives of the community meeting regularly to be consulted about the company's plans and operating procedures. Liaison groups also include representatives of the EA and the relevant planning authority and other key local stakeholders.

There were three exceptional items during the year:

- Costs of £14.5 million for the one-off payment of £20 to each South West Water customer following the financial restructuring.
- Costs of £50.2 million relating to the financial restructuring which involved the capital return to shareholders and the retirement of the £150 million 10.625% Bond (due 2012).
- £7.9 million proceeds arising from a consent fee received upon the sale of finance leases between financial institutions.

Group earnings before interest, taxation, depreciation and intangibles amortisation (EBITDA) amounted to £279.2 million before exceptional items (2004/05 £243.0 million) including South West Water £213.4 million (2004/05 £186.4 million) and Viridor Waste £66.7 million (2004/05 £56.4 million).

Total Group operating costs were £470.6 million excluding exceptional items (2004/05 £400.5 million) and included the following major categories of expenditure:

FINANCIAL PERFORMANCE

ANALYSIS OF THE GROUP'S FINANCIAL PERFORMANCE

International Financial Reporting Standards

All numbers in this Annual Report are published in accordance with International Financial Reporting Standards (IFRS) with prior year figures restated. The principal differences between UK Generally Accepted Accounting Principles (UK GAAP) and IFRS are shown on pages 84 to 91 of the notes to the consolidated financial statements.

The Group's financial results showed growth in both revenue and profit before tax and exceptional items from continuing operations.

Revenue and operating profit

Revenue rose by 17.1% to £645.7 million. South West Water revenue was £348.5 million, up 13.5% on 2004/05, principally resulting from the additional increase in tariffs approved by the water regulator. Revenue for Viridor Waste at £298.9 million was 20.4% up on 2004/05. The acquisitions accounted for £21.3 million of the increase and underlying business £29.3 million. Landfill tax within revenue increased by £19.8 million.

Group operating profit before exceptional items increased by £24.2 million. South West Water achieved a £141.5 million operating profit, up £19.3 million on 2004/05. Viridor Waste contributed £34.3 million (after intangibles amortisation of £1.6 million), up £5.7 million on 2004/05 and representing 19.6% of the operating profit of the Group in 2005/06 (2004/05 19.0%).

	£m
Depreciation and intangibles amortisation	104.1
Manpower	79.9
Landfill tax	76.5
Raw materials and consumables	24.0
Property costs	18.9
Transport	18.1
Power	14.6
Abstraction and discharge consent costs	7.7
Statutory operating licences and royalties	5.4
Lease rentals – plant and machinery	6.9

Offsetting the above power costs was revenue from power generation of £22.9 million.

Finance costs

Net interest payable before exceptional items was £64.3 million (2004/05 £62.0 million), which was 2.7 times (2004/05 2.4 times) covered by Group operating profits.

Before exceptional items gross interest payable was £96.8 million and interest receivable of £32.5 million was derived from the investment of temporarily surplus funds.

Net interest payable represents a rate of 5.1% when measured against average net debt (2004/05 5.6%).



BUSINESS REVIEW

Profit before tax

Profit before tax was £110.9 million before exceptional items, £21.9 million up on 2004/05, an increase of 24.6%.

Taxation

The corporation tax charge for the year was £14.8 million (2004/05 £7.9 million) before the impact of tax relief on exceptional items. The deferred tax charge for the year was £20.2 million (2004/05 £15.6 million). Under IFRS, deferred tax is accounted for without discounting (as previously permitted by UK GAAP).

Earnings per share

Earnings per share before deferred tax and exceptional items increased by 17.4% to 75.5p. Basic earnings per share fell to 29.7p due to the net exceptional costs of £38.1 million.

Dividends and retained earnings

The Directors recommend the payment of a final dividend of 35.1p per share for the year ended 31 March 2006. Together with the interim dividend of 16.5p per share paid on 13 April 2006, this gives a total dividend for the year of 51.6p per share, an increase of 20.0% on the dividend for 2004/05.

Proposed dividends of £61.0 million (2004/05 £55.1 million) are covered 1.6 times (2004/05 1.5 times) by profit after tax, excluding exceptional items and deferred tax. Under IFRS, dividends are recognised in the profit and loss account in the year in which they are paid.

The retained profit of £37.8 million has been transferred to reserves.

SUBSIDIARY COMPANY FINANCIAL PERFORMANCE

Details of the financial performance of South West Water and Viridor Waste are set out in the Chief Executives' Overviews on pages 4 to 7.

GROUP INVESTMENT

Capital expenditure by the Group on tangible fixed assets was £249.7 million (2004/05 £181.0 million). The major categories of expenditure comprised:

South West Water

	£m
Water mains renovation	45
Water treatment works	24
Waste water treatment works and sludge	46
Sewerage	29

Viridor Waste

	£m
Landfill	36
Power generation	3
Collection	3
Other	17

Other expenditure included investment in recycling facilities, including £12 million in respect of the West Sussex PFI contract.

In the opinion of the Directors, the current market value of land and buildings is not significantly different from the holding cost shown in the financial statements.

Share capital

At an Extraordinary General Meeting (EGM) in February 2006, shareholders approved the return of cash, by way of a B Share Scheme, of 110p for each existing issued Ordinary share held at the close of business on 17 February 2006 and the consolidation of the existing Ordinary shares on the basis of 10 new Ordinary shares for every 11 existing Ordinary shares. Shareholder approval was also obtained to carry out an on-market share buy back programme of approximately £55 million of the new Ordinary shares. The Directors intend to progress the share buy back programme during 2006/07. No shares had been bought back as at 31 March 2006.

B Shares with a total value of £143.5 million were created from the existing share premium reserve. A corresponding capital redemption reserve was created upon payment to shareholders or cancellation of deferred shares. Following the share capital consolidation the weighted average number of shares in issue during the year was 127.3 million (2004/05 126.0 million).

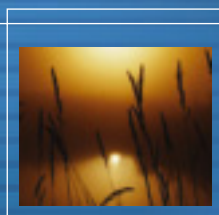
The value of net assets per share at book value at 31 March 2006 was 490p.

Shareholder approval was obtained at the Annual General Meeting in July 2005 to purchase up to 10% of the Company's then existing ordinary share capital. Renewal of the authority will be sought at the July 2006 Annual General Meeting.

CAPITAL STRUCTURE

Overall position

With year end net debt of £1,427 million, the Group year end debt to equity plus debt ratio was 71% (2004/05 61%). Following the return of capital through the B Share scheme, the Directors intend to progress the share buy back programme to further enhance the overall balance sheet efficiency of the Group.



The borrowing powers of the Directors are limited to two and a half times adjusted capital and reserves, as defined in the Company's Articles of Association. At 31 March 2006, the limit was £2.1 billion. The Directors confirm that the Group can meet its short-term requirements from the existing borrowing facilities without breaching covenants or other borrowing restrictions.

South West Water

South West Water's debt to Regulatory Capital Value (RCV) was circa 62% at 31 March 2006 (2004/05 52%), within Ofwat's 'optimum range' of 55% – 65%. The completion of the current financial restructuring including the share buy back programme referred to above is expected to increase the debt to RCV of South West Water on a pro forma basis to circa 65%.

Viridor Waste

Viridor Waste is funded by a combination of Pennon Group equity and debt (raised by Pennon Group) and direct borrowings by Viridor Waste. At the year end, Viridor Waste's net debt stood at £201 million (2004/05 £131 million), equivalent to 3.0 times EBITDA (2004/05 2.3 times).

TREASURY POLICIES AND OBJECTIVES

The Group's treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintains reasonable headroom for contingencies and manages interest rate risk. It operates within policies approved by the Board and does not undertake any speculative trading activity.

Debt profile

At 31 March 2006, loans and finance lease obligations were £1,526 million and the Group held current asset investments and cash of £99 million.

During 2005/06, the Group drew down £142 million additional financing under new finance lease arrangements, £70 million additional credit facilities from the European Investment Bank and £57 million bilateral bank loans. In January 2006, the £150 million Sterling bond, due for repayment in February 2012, was retired.

Pennon Group debt has a maturity of 0 – 35 years with an average maturity of 12 years. The major components of debt finance are:

- Finance leasing – £955 million
- EIB loans – £236 million
- Bank bilateral debt – £313 million

Interest rate management

Net interest costs before exceptional items of £64 million equated to an average interest rate of 5.1% for the Group. South West Water's average interest rate equated to 4.7%.

The Group's exposure to interest rate movements is managed by the use of interest rate derivatives. The Board 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. Relatively low interest rates have resulted in the Group fixing 67% of existing net debt up to 31 March 2007, and 62% up to 31 March 2010. In addition, South West Water has index linked 10% of its current net debt up to 2041. 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. These instruments are analysed in more detail in note 21 to the financial statements.

Refinancing risk management

Refinancing risk is managed under the Group Policy that no more than 20% of Group net debt is permitted to mature in any financial year.

Counterparty risk management

Surplus funds of the Group are usually placed in short-term fixed interest deposits or the overnight money markets. All deposits are with counterparties that have a credit rating threshold approved by the Board.

Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments. The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals, and rigorous monitoring procedures.

CASH FLOWS

The net cash inflow from operations was £232 million (2004/05 £242 million). Capital expenditure cash outflow in 2005/06 was £214 million, an increase of £49 million from £165 million in 2004/05. The net cash outflow for acquisitions was £41 million (2004/05 £29 million). Equity dividends paid and servicing of net debt involved a cash outflow of £140 million (2004/05 £87 million). There was a £44 million outflow for the prepayment of pension contributions and £138 million for the B Share Scheme.

Group net debt increased from £1,118 million at 31 March 2005 to £1,427 million at 31 March 2006.

Overall, the net cash outflow of the Group was £40 million (2004/05 £38 million inflow).

BUSINESS REVIEW

LIQUIDITY

It is Group policy to ensure that the Group has committed loan facilities equivalent to at least one year's forecast requirements at all times. This is achieved through the use of credit facilities which are utilised as required and re-financed using drawdowns for longer-term facilities.

INTERNAL TRANSFERS

For regulatory purposes, South West Water funding is treated as effectively ring-fenced. Funds raised by or for South West Water are used in the appointed business (provision of water and sewerage services) and are not available as long term funding for the rest of the Group.

COVENANTS

Pennon Group and South West Water have entered into covenants with lenders. Whilst terms vary, these typically provide for limits on gearing and interest cover.

INTERPRETATION

LANDFILL VOID SPACE AND POWER GENERATION CALCULATIONS

The landfill void space figures quoted in this review in relation to Viridor Waste are in respect of consented void only (void with planning permission for landfilling).

The void space figures are based upon Viridor Waste's most recent assessment of void available to the company for waste and daily cover materials. The void figures have been assessed using pre-settlement levels (based upon the extent of the planning consent), proposed base levels (based upon the terms of the site licence/permit) and existing waste surfaces (determined by survey). These calculations necessarily involve an element of management judgement and are based on certain other assumptions (such as the waste mix profile of a site). However, Viridor Waste is of the opinion that its calculation methodologies are in line with convention typical in the landfill industry. The void actually available at any one time may be different from the figures quoted.

Gas/electricity generating capacity of Viridor Waste is defined by the megawatt capacity of the engines installed on landfill sites through which the gas passes to generate electricity.

Modelling future power generation requires consideration of a number of factors including the waste mass and composition already in place and volumes of gas currently being extracted. In addition, the model requires an assessment of how the current position is expected to change throughout each site's remaining life as an operational landfill and beyond into the aftercare period. Any such assessment requires certain assumptions to be made including in relation to the amount of waste in the site, its biodegradable content, the age of the waste and the likelihood of obtaining a grid connection at an economic cost.

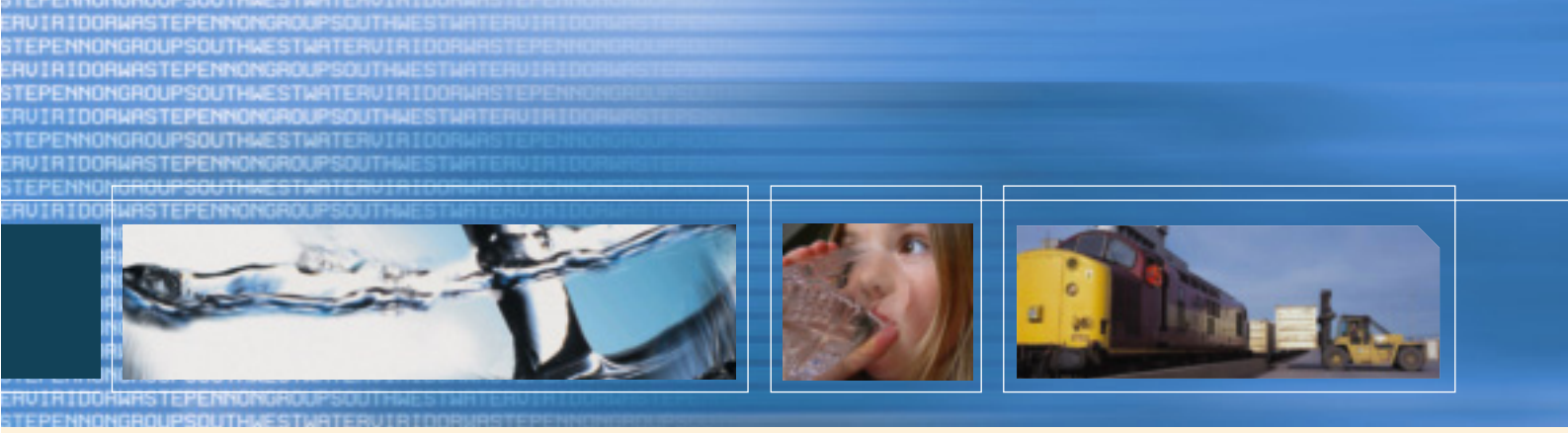
FORWARD LOOKING STATEMENTS

This Business Review contains forward looking statements regarding the financial position, results of operations, cash flows, dividends, financing plans, business strategies, operating efficiencies, capital and other expenditures, competitive positions, growth opportunities, plans and objectives of management and other matters. These forward looking statements, including, without limitation, those relating to the future business prospects, revenues, working capital, liquidity, capital needs, interest costs and income in relation to the Pennon Group and its subsidiaries, wherever they occur in this Business Review, are necessarily based on assumptions reflecting the views of Pennon Group and its subsidiary companies, as appropriate. They involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward looking statements. Such forward looking statements should, therefore, be considered in light of relevant factors, including those set out in the section entitled 'Risks and uncertainties' on pages 18 to 22.

By Order of the Board

KEN WOODIER, Group General Counsel & Company Secretary
22 June 2006





GLOSSARY

The following are descriptions of some of the terms used in this Business Review:

Appointments	Licences of appointments of companies by Government to provide water and waste water services
BMW	Biodegradable municipal waste
DEFRA	Department for Environment, Food and Rural Affairs
Determination or Price Determination	The price limits and expenditure plans determined by Ofwat for South West Water for a five year period
DWI	Drinking Water Inspectorate
EA	Environment Agency
EfW	Energy from Waste
GWh	Gigawatt hours
HWRS	Household waste recycling sites
IDoK	Interim Determination of 'K'
IFRS	International Financial Reporting Standards
ISO 14001	International environmental accreditation standard
K3	Periodic Review period 2000 – 2005 for South West Water
K4	Periodic Review period 2005 – 2010 for South West Water
LATS	Landfill Allowance Trading Scheme
LAWDC	Local Authority Waste Disposal Company
LTCS	Landfill Tax Credit Scheme
ML	Megalitres
ML/d	Megalitres per day
MSW	Municipal solid waste
MW	Megawatts
MWh	Megawatt hours
NFFO	Non fossil fuel obligation
Ofwat or water regulator	Water Services Regulatory Authority
OPA	Ofwat Overall Performance Assessment system
PFI	Private finance initiative
PPC	Pollution, Prevention and Control
PPP	Public Private Partnership
Periodic Review	The process of determining the price limits and expenditure plans of South West Water for the next five-year regulatory period
RCV	Regulatory capital value
RPI	The UK Government's Retail Price Index
ROCs	Renewable obligation certificates
SEPA	Scottish Environment Protection Agency
UK GAAP	United Kingdom Generally Accepted Accounting Principles



BOARD OF DIRECTORS

— Kenneth George Harvey BSc, CEng, FIEE (65)

Non-executive Chairman

Was appointed on 1 March 1997. Ken was formerly chairman and chief executive of Norweb Plc. He was chairman of National Grid Holdings in 1995 and was previously deputy chairman of London Electricity and earlier its engineering director. He has also been Chairman of a number of limited and private equity funded companies. Currently he is the senior independent non-executive director of National Grid Plc.

— Robert John Baty OBE, FEng, CEng, FICE, FCIWEM, CCMI, ACI Arb (62)

Chief Executive, South West Water Limited

Was appointed on 1 March 1996. Bob was formerly engineering and scientific director of South West Water Services Limited having joined South West Water Authority in 1988. Previously he held engineering and operational appointments with North West Water Authority. He is also currently a non-executive director of the Royal Devon & Exeter NHS Foundation Trust. He will retire as the Chief Executive of South West Water and as a director of Pennon Group on 31 July 2006.

— Colin Irwin John Hamilton Drummond MA, MBA, LTCL, CCMI (55)

Chief Executive, Viridor Waste Limited

Was appointed on 1 April 1992. Prior to joining the Company, Colin was a divisional chief executive of Coats Viyella, having previously been corporate development director of Renold plc, a strategy consultant with the Boston Consulting Group and an official of the Bank of England. He is Chairman of the Government's Environmental Sector Advisory Group and was a member of the Government's Advisory Committee for Business in the Environment between 2001 and 2003.

— David Jeremy Dupont MA, MBA (52)

Group Director of Finance

Was appointed on 2 March 2002. David was formerly regulatory and finance director of South West Water Limited, having joined Pennon Group Plc (then South West Water Plc) in 1992 as strategic planning manager. Previously he held business planning and development roles with Gateway Corporation. He is a member of the South West Council of the Confederation of British Industry.

— Gerard Dominic Connell MA, (48)

Senior Independent Non-executive Director

Was appointed on 1 October 2003. Gerard is currently Group Finance Director of Wincanton Plc. He was previously a director of Hill Samuel and managing director of Bankers Trust and has held other corporate finance and business development positions in the City and in industry.

— Katharine Mary Hope Mortimer MA, BPhil (60)

Non-executive Director

Was appointed on 1 May 2000. Kate is currently a freelance financial consultant, a member of the Crown Agents Foundation Council and a director of Crown Agents Asset Management Limited and Crown Agents Financial Securities Limited. She was formerly a director of N M Rothschild & Sons Limited, Director of Policy at the Securities and Investments Board, Chief Executive of Walker Books and was a member of the Competition Commission between 1995 and 2001.

— Dinah Alison Nichols CB, BA Hons (62)

Non-executive Director

Was appointed on 12 June 2003. Dinah was formerly Director General Environment at the Department for Environment, Food and Rural Affairs and previously held various senior appointments within Government departments including being Head of the Water Directorate during the period of water privatisation. She is also a Crown Estate Commissioner, a non-executive director of Shires Smaller Companies Plc, chair of the National Forest Company, a board member of Toynbee Housing Association and chair of Toynbee Partnership Housing Association.

COMMITTEES OF THE BOARD

Audit

Gerard Connell (Chairman)
Kate Mortimer
Dinah Nichols

Environment

Bruce Hewett (Chairman) (co-opted member)
Bob Baty
Colin Drummond

Nomination

Ken Harvey (Chairman)
Gerard Connell
Kate Mortimer
Dinah Nichols

Remuneration

Kate Mortimer (Chairman)
Gerard Connell
Dinah Nichols

Group General Counsel & Company Secretary

Ken Woodier

Registered office

Peninsula House, Rydon Lane, Exeter EX2 7HR
Registered in England No 2366640

Auditors

PricewaterhouseCoopers LLP
Chartered Accountants
31 Great George Street, Bristol BS1 5QD

Registrars

Lloyds TSB Registrars
The Causeway, Worthing, West Sussex BN99 6DA



DIRECTORS' REMUNERATION REPORT

THE REMUNERATION COMMITTEE

The Remuneration Committee comprises three Non-executive Directors: Kate Mortimer, who chairs the Committee, Gerard Connell and Dinah Nichols. The Committee's terms of reference include advising the Board on the framework of executive remuneration for the Group and responsibility for determining the remuneration and terms of employment/engagement of the Chairman, the Executive Directors and senior management of the Group. During the year, the Committee met on seven occasions and received advice, or services, that materially assisted the Committee in the consideration of remuneration matters from Ken Harvey (Chairman of the Company), Ken Woodier (Group General Counsel & Company Secretary) and Hewitt Bacon & Woodrow Limited, pensions and remuneration consultants (appointed by the Committee), in respect of executive pensions and calculating total shareholder return for the Company's Restricted Share Plan.

Hewitt Bacon & Woodrow also provided actuarial and investment pensions advice to the Group during the year.

GROUP REMUNERATION POLICY

The policy of the Group continues to be to provide for Executive Directors a remuneration package which is adequate to attract, retain and motivate good quality executives and which is commensurate with the remuneration packages provided by companies of similar size and complexity. This policy will be applied by the Remuneration Committee in 2006/07 and currently it is also intended to be applied in each subsequent year. The policy in respect of Non-executive Directors is set out on page 32 in the Non-executive Directors' remuneration section.

EXECUTIVE DIRECTORS

The remuneration package of the Executive Directors is summarised below. It comprises salary, annual bonus, long term incentives, pensions, car benefit and health cover. In 2006/07 (subject to fluctuations in the Company's share price) it is expected that just under 45% of Directors' potential direct remuneration (i.e. excluding pensions, car benefit and health cover) will be performance related compared with just over 60% in 2005/06. This reduced percentage is because there will not be the potential for a Restricted Share Plan award to vest in 2006/07 (no award was made in 2003 because of the existence of unpublished price sensitive information). Nonetheless, the Committee's overall policy remains that around 60% of total possible remuneration will be performance related in the normal course and it is intended that this balance will continue to apply for subsequent financial years.

Bob Baty, with the Board's consent, is a non-executive director of the Royal Devon & Exeter NHS Trust. For this appointment he received a fee of £11,000 in 2005/06 from the Trust and the Board has determined that he may retain such earnings.

(i) Basic salary and benefits – These are set out on page 33 for each Executive Director and are not related to performance. The Committee determines revised salaries, usually on an annual basis, for Executive Directors based upon surveys generally available conducted by remuneration consultants and the performance of the individual Executive Directors which the Committee assesses with the advice of Ken Harvey, Chairman. Other benefits, (not mentioned below, include contributory pension provision (with four times salary life assurance cover), a fully expensed car (or a cash equivalent alternative) and health cover.

(ii) Performance related bonus – Annual performance related bonuses are awarded in accordance with an Incentive Bonus Plan for Executive Directors and are based on the achievement of overall corporate and individual objectives established by the Committee. The maximum bonus achievable under the Plan for Executive Directors is 80% of basic salary with half of any payment being in the form of shares in the Company which must usually be held for a period of three years before release. During this period, the Directors are entitled to receive any dividends declared by the Company in respect of these shares. Because the award of these shares is based on performance, no additional performance conditions are considered appropriate by the Committee apart from continuous service with the Company.

The following corporate and individual objectives of the Executive Directors applicable to the performance related bonus award for 2006/07 were determined by the Committee as appropriate having regard to the activities of the Group that each individual Director could most influence and also to the overall performance of the Group, all of which seek to align the interests of the Directors with those of shareholders (the references to a percentage bonus relate to a percentage of the annual basic salary of each Executive Director in 2006/07):

Bob Baty

– As Bob Baty is due to retire as the Chief Executive of South West Water and as a director of the Company on 31 July 2006, any bonus will be determined on a pro-rata basis to the date of his retirement and will not include any conditional share awards. It will be based on personal performance targets set by the Remuneration Committee which relate to key business issues of South West Water which Bob Baty can influence up to the date of his retirement.

Colin Drummond

– A bonus of up to a maximum of 20% for outperformance of Group earnings per share against budget and up to 60% bonus calculated by reference to outperformance of the profit before tax and net debt budgets of Viridor Waste; and for personal objectives relating to key business targets for Viridor Waste.

David Dupont

– A bonus of up to a maximum of 20% for outperformance of Group earnings per share against budget and up to 60% bonus for outperformance against budget relating to net debt and net interest of the Group; profit before tax of South West Water and Viridor Waste; and for personal objectives relating to Group financing and Group initiatives.

DIRECTORS' REMUNERATION REPORT

The achievements of the Executive Directors against their individual performance objectives are assessed by the Committee following the financial year end when the audited results of the Company and performance against parameters set are known (with the exception of Bob Baty whose performance for the period to his retirement will be assessed following his retirement at the end of July 2006). This enables the Committee to apply largely objective criteria in determining the level of bonus (if any) that should be awarded, with the advice of Chairman, Ken Harvey.

(iii) Long Term Incentive Plan – A Restricted Share Plan for Executive Directors and senior management, as approved by shareholders at the Annual General Meeting on 29 July 1997, was operated by the Company during the year. The Executive Directors received a conditional award of shares in the Company up to a value of 75% of their basic salary on the basis that they provided a matching investment in shares of the Company (by way of shares they already hold or which they purchase) in the ratio of one investment share for every four shares awarded. The eventual number of shares, if any, which the Directors may receive is dependent upon the achievement of the performance condition of the Plan over the restricted period, being not less than three years. During the restricted period the Directors are entitled to receive, in respect of the awarded shares, any dividends declared by the Company.

During the year (in September 2005) 50% of the shares awarded pursuant to the Plan in 2002 to Directors vested at the end of the three year restricted period because the performance condition had been met to the extent necessary to permit a 50% vesting only. The remaining 50% of the award lapsed. For each of the years 2002 to 2005 the performance condition to be satisfied for at least 50% of the award to vest was:

The total shareholder return (TSR) achieved by the Company in the performance period must be greater than that of the company at or nearest to (but not above) the 50th percentile position of the comparator group.

If the TSR performance condition is met then 50% of an award for the year in question will vest with 100% of an award vesting if the Company achieves the position equal or closest to, but not above, the 75th percentile position or a position above the 75th percentile position of the comparator group. The achievement of a position between the 50th percentile position and the 75th percentile position will result in vesting in steps reflecting the number of companies within that third quartile of the comparator group.

The comparator group applicable for awards made during the year to 31 March 2006 was as follows, with the comparator group applicable to other previous award years being similar in content and size:

awg Plc
Bristol Water Holdings Plc
British Energy Plc
Centrica Plc
Dee Valley Group Plc
East Surrey Holdings Plc
International Power Group Plc
Kelda Plc
National Grid Plc
Northumbrian Water Group Plc
Pennon Group Plc
Scottish & Southern Energy Plc
Scottish Power Plc
Severn Trent Plc
United Utilities Plc
Viridian Plc

It is expected that the comparator group applicable to any awards that may be made by the Committee in the current year will be similar in content and size to the above group.

The TSR performance condition was applied by the Committee because, based upon advice received previously from remuneration consultants, Meis, it believes that this is an appropriate measure to align the interests of the Executive Directors with those of shareholders. In addition, the Committee believes that comparing the TSR of the Company to the other companies in the comparator group is appropriate because the other companies operate in sectors similar to that of the Company and therefore it is possible to demonstrate superior performance by the Company if its TSR is at least higher than 50% of the other companies in the comparator group.

The TSR of each company in the comparator group is measured by Hewitt Bacon & Woodrow assuming that all dividends are reinvested and is calculated by taking the average market value of each company's shares for the whole of March before the beginning of the three year performance period and comparing this to the average market value of the same shares for the whole of March at the end of the three year period. The share price is averaged for the whole of the month of March to avoid any distortion of the TSR values from any significant daily share price movements during the month. No retesting of performance is permitted for any shares that do not vest after the three year performance period and any such shares lapse.

DIRECTORS' REMUNERATION REPORT

NON-EXECUTIVE DIRECTORS AND THE CHAIRMAN

Non-executive Directors' remuneration (excluding that of the Chairman, Ken Harvey) consisting of fees only as set out below, is determined by the Board of Directors (in the absence of the Non-executive Directors) and is usually reviewed biennially. However, since 2003/04 it has been reviewed each year to take account of market changes in non-executive directors' fees arising from the impact of the Higgs Review on non-executive directors' duties and obligations. The level of fees was last reviewed in September 2005. In reviewing the fees, the Chairman and the Executive Directors take account of market information on non-executive directors' fees, most recently from the Monks Partnership. With effect from 1 October 2005, Non-executive Directors' fees were revised to a base fee of £30,000 per annum and a fee of £3,500 per annum for membership of each of the Audit and Remuneration Committees, together with fees of £5,000 and £2,500 per annum for the Chairmanship of the Audit and Remuneration Committees respectively. The policy to be applied in 2006/07 (which is also currently intended to be applied in each subsequent year) continues to be to set fees around the median level compared to the market. The Chairman and the Executive Directors believe that this policy is appropriate to attract and retain suitably experienced non-executive directors on the Board.

The dates of their contracts are:

Director	Date of contract	Expiry of contract
Gerard Connell	30 September 2003	30 September 2006*
Kate Mortimer	19 March 2005	30 April 2009
Dinah Nichols	10 June 2003	11 June 2009

*The Board has approved the extension of the contract with Gerard Connell to 30 September 2009.

The Chairman, Ken Harvey, has a contract for services dated 1 April 2005 which is subject to 12 months' notice. No provision is made for any termination payments under this contract.

The contracts for services of the Chairman and the Non-executive Directors reflect corporate governance good practice (as suggested in the Higgs Report appended to the Combined Code) and, together with the Executive Directors' service contracts, are available for inspection at the Company's registered office during normal business hours.

The information set out on the remaining pages of this Remuneration Report (pages 33 to 35) has been audited by PricewaterhouseCoopers LLP.

EMOLUMENTS OF DIRECTORS

The Emoluments of individual Directors are shown in the table below:

Director	Salary/fees £000	Performance related bonus payable† £000	Other emoluments* £000	Payments related to supplementary pension £000	Total 2006 £000	Total 2005 £000
<i>Chairman:</i>						
Ken Harvey	175	–	20	–	195	190
<i>Executive Directors:</i>						
Bob Baty	210	65	15	–	290	289 **
Colin Drummond	210	80	22	85	397	350
David Dupont	210	78	17	63	368	322
<i>Non-executive Directors:</i>						
Gerard Connell	38	–	–	–	38	35
Kate Mortimer	36	–	–	–	36	33
Dinah Nichols	34	–	–	–	34	31
Total	913	223	74	148	1,358	1,250

**Bob Baty waived £74,000 of this total in 2005 which represented the cash element of his performance related bonus.

*Other emoluments are car benefit, health cover and professional subscriptions.

† In addition to the performance related cash bonus, Executive Directors are due to receive a conditional award of shares as referred to in a note to (c) "Performance Related Bonus Plan (Deferred Bonus Shares)" on page 35.

No expense allowances chargeable to tax or termination/compensation payments were made during the year.

DIRECTORS' PENSIONS

Defined benefit pensions accrued and payable on retirement for Directors holding office during 2005/06 are shown in the table below:

Director	Increase in accrued pension during 2005/06 (net of inflation) £000 <i>a</i>	Increase in accrued pension during 2005/06 £000 <i>b</i>	Accrued pension at 31 March 2006 £000 <i>c</i>	Transfer value at 31 March 2006 £000 <i>d</i>	Transfer value at 31 March 2005 £000 <i>e</i>	Increase in transfer value (net of Directors' contributions) £000 <i>f</i>	Transfer value of Column a (net of Directors' contributions) £000 <i>g</i>
Bob Baty	8	11	158	3,016	2,903	102	133
Colin Drummond	6	8	81	1,488	1,030	447	104
David Dupont	5	7	68	1,076	744	321	73

Column *a* above is the increase in accrued pension during 2005/06 (net of inflation). It recognises:

- i* the accrual rate for the additional period's service based upon the pensionable pay at the end of the period; and
- ii* the effect of pay changes in real terms (net of inflation) upon the accrued pension at the start of the year.

Column *b* is the actual increase in accrued pension during 2005/06.

Column *c* is the accrued pension at 31 March 2006 payable at normal retirement age.

Column *d* is the transfer value of the accrued pension set out in column *c* as at 31 March 2006.

Column *e* is the transfer value of the accrued pension at the end of the previous financial year on 31 March 2005.

Column *f* is the increase in the transfer value during the year (column *d* minus column *e*) after deducting Directors' contributions.

Column *g* is the transfer value of column *a*, less Directors' contributions.

Columns *d*, *e*, *f* and *g* have been calculated in accordance with Actuarial Guidance Note GN11.

DIRECTORS' REMUNERATION REPORT

DIRECTORS' PENSIONS (continued)

The Supplementary Pension Scheme, which funded pension provision above the Earnings Cap, provided benefits in tax-paid lump sum form at retirement. Appropriate figures have been included in the accrued pension totals shown on page 33. Immediately following the year end, the Supplementary Pension Scheme was terminated by the Company. Future accrual of pension provision above the Earnings Cap is to be provided in the Pennon Group Executive Pension Scheme as described in (vi) 'Provision for Pension' on page 31.

Directors have the option to pay additional voluntary contributions; neither the contributions nor the resulting benefits are included in the table shown on page 33.

DIRECTORS' SHARE INTERESTS

(a) Shareholdings

The number of shares of the Company in which Directors held beneficial interests at 31 March 2006 and 31 March 2005 were:

Director	2006 Deferred shares [†] (110p each)	2006 B Shares* (110p each)	2006 Ordinary shares (122 1/10p each)	2005 Ordinary shares (110p each)	Director	2006 Deferred shares [†] (110p each)	2006 B Shares* (110p each)	2006 Ordinary shares (122 1/10p each)	2005 Ordinary shares (110p each)
Bob Baty	–	111,785	55,145	49,959	Ken Harvey	–	–	2,403	2,644
Colin Drummond	24,562	7,900	35,541	29,062	Kate Mortimer	–	–	250	265
David Dupont	33,644	26,330	29,882	25,595					

[†] B Shares were converted into Deferred Shares upon shareholders electing to take the B Share dividend of 110p per share on 27 February 2006 pursuant to the B Share Scheme approved by shareholders at an Extraordinary General Meeting on 15 February 2006 as part of a return of cash to shareholders. The Deferred Shares were all redeemed by the Company on 6 April 2006 pursuant to the provisions of the B Share Scheme. The Directors received no payment for the redemption of these shares.

*The remaining B Share holdings of the Directors were redeemed on 6 April 2006 at 110p each in accordance with the provisions of the B Share Scheme.

Additional Ordinary shares (122 1/10p each) have been acquired by the Directors since 31 March 2006 as follows as a result of participation in Personal Equity Plans and Individual Savings Accounts:

Bob Baty	39	David Dupont	13	Colin Drummond	37
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There have been no other changes in the beneficial interests or the non-beneficial interests of the Directors in the Deferred Shares, B Shares or the Ordinary shares of the Company between 1 April 2006 and 30 May 2006.

(b) Restricted Share Plan (Long Term Incentive Plan)

In addition to the above beneficial interests, the following Directors have or had a contingent interest in the number of Ordinary shares shown below, representing the maximum number of shares to which they would or have become entitled under the Group's Long Term Incentive Plan with the relevant criterion being met in full.

Director and date of award	Conditional awards held at 1 April 2005	Conditional awards made in year	Market price upon award in year	Vesting in year*	Value of shares upon vesting (before tax) £	Conditional awards held at 31 March 2006	Date of end of period for qualifying condition to be fulfilled
Bob Baty							
16/9/02	18,514	–	638p	9,257 *	98,772	–	–
16/9/04	37,059	–	809.5p	–	–	33,690 †	15/9/07
27/9/05	–	14,719	1,070p	–	–	13,380 †	26/9/08
Colin Drummond							
16/9/02	18,514	–	638p	9,257 *	98,772	–	–
16/9/04	37,059	–	809.5p	–	–	33,690 †	15/9/07
27/9/05	–	14,719	1,070p	–	–	13,380 †	26/9/08
David Dupont							
16/9/02	14,694	–	638p	7,347 *	78,392	–	–
16/9/04	35,206	–	809.5p	–	–	32,005 †	15/9/07
27/9/05	–	14,719	1,070p	–	–	13,380 †	26/9/08

[†] The number of shares in each of the awards for the years 2004 and 2005 have been reduced to the numbers shown (in the ratio 10 for 11) consequent upon the Company's share capital consolidation on 17 February 2006.

* 50% of the 2002 awards vested on 19 September 2005 at a price of 1067p per share because the criterion described in paragraph (iii) on page 30 was met to the extent necessary to permit a 50% vesting only. The balance of the shares of 50% lapsed on 19 September 2005.

Because of the existence of unpublished price-sensitive information, no award was made during 2003 to the Executive Directors. Accordingly, with Shareholder approval, the usual award was made in 2004 together with a further award of shares equivalent to 75% of basic salary.

DIRECTORS' SHARE INTERESTS (continued)

During the year, the Directors received dividends on the above shares in accordance with the conditions of the Restricted Share Plan, as follows: Bob Baty £23,896; Colin Drummond £23,896; David Dupont £21,457. In addition, the Directors received a B Share in respect of each of the above shares in accordance with the B Share Scheme (as noted in "(a) Shareholdings" on page 34) and either upon their election received a dividend of 110p in respect of each of the shares (whereupon they became deferred shares of nil value to the Director) or they redeemed the shares for 110p each (or a combination of each option).

(c) Performance Related Bonus Plan (Deferred Bonus Shares)

Director and date of award	Conditional awards held at 1 April 2005	Conditional awards made in year	Market price upon award in year	Vesting in year*	Value of shares upon vesting (before tax) £	Conditional awards held at 31 March 2006	Date of end of period for qualifying condition to be fulfilled
Bob Baty							
26/7/02	7,885	–	652p	7,885	80,506	–	–
25/7/03	6,435	–	652p	–		5,850 †	24/7/06
28/6/04	6,262	–	778.5p	–		5,692 †	27/6/07
10/8/05		7,479	984p			6,799 †	9/8/08
Colin Drummond							
26/7/02	5,554	–	652p	5,554	56,706	–	–
3/12/02	1,161	–	607p	1,161	13,677	–	–
25/7/03	7,990	–	652p	–		7,263 †	24/7/06
28/6/04	7,579	–	778.5p	–		6,890 †	27/6/07
10/8/05		6,910	984p			6,281 †	9/8/08
David Dupont							
26/7/02	4,728	–	652p	4,728	48,273	–	–
25/7/03	6,146	–	652p	–		5,587 †	24/7/06
28/6/04	5,834	–	778.5p	–		5,303 †	27/6/07
10/8/05		6,823	984p			6,202 †	9/8/08

† The number of shares in each of the awards for the years 2003, 2004 and 2005 have been reduced to the numbers shown (in the ratio 10 for 11) consequent upon the Company's share capital consolidation on 17 February 2006.

* The July 2002 award vested on 5 August 2005 at a price of 1,021p per share and the December 2002 award vested on 16 January 2006 at a price of 1,178p per share.

A further conditional award of shares will be made in 2006/07 to the value of the amount of the performance related cash bonus shown in the Emoluments of Directors table on page 33. (Paragraph (ii) on page 29 sets out the provisions relating to the conditional award of shares pursuant to the Performance Related Bonus Plan).

During the year, the Directors received dividends on the above shares in accordance with the conditions of the long term incentive element of the Bonus Plan as follows: Bob Baty £8,850; Colin Drummond £9,582; David Dupont £7,185. In addition, the Directors received a B Share in respect of each of the above shares in accordance with the B Share Scheme (as noted in "(a) Shareholdings" on page 34) and either, upon their election, received a dividend of 110p in respect of each of the shares (whereupon they became deferred shares of nil value to the Director) or they redeemed the shares for 110p each (or a combination of either option).

It is anticipated that the shares will vest under the 2003 awards in 2006/07 as the criterion (described in "(ii) Performance related bonus" on page 29) is expected to be met.

(d) Sharesave Scheme

Details of options to subscribe for shares of the Company under the all-employee Sharesave Scheme were:

Director and date of grant	Options held at 1 April 2005	Granted in year	Exercised in year	Market price on exercising	Options held at 31 March 2006	Exercise price	Exercise period/maturity date
Bob Baty							
8/7/03	1,047	–	–	–	1,047	530p	1/9/06 – 1/3/07
Colin Drummond							
8/7/03	1,745	–	–	–	1,745	530p	1/9/06 – 1/3/07
David Dupont							
9/7/02	2,924	–	–	–	2,924	566p	1/9/07 – 1/3/08

(e) Share price

The market price of the Company's shares at 31 March 2006 was 1,341p (2005 976p) and the range during the year was 947p to 1,429p (2005 677p to 1,016p).

By Order of the Board

KEN WOODIER, Group General Counsel & Company Secretary

22 June 2006

COMPLIANCE

The Board is committed to the highest standards of corporate governance with the aim of continuing to enhance its effectiveness. The Annual Report is the principal means of reporting to shareholders on the Board's governance policies. This section sets out how the main and supporting principles of good corporate governance contained in Section 1 of the Combined Code have been applied by the Company in practice. Throughout the year, the Company considers that it has complied with the provisions of the Code.

THE BOARD

The Board of Directors at the end of the year comprised the Chairman, three Executive Directors and three Non-executive Directors. All of the Non-executive Directors are considered to be independent and Gerard Connell is the Senior independent Non-executive Director. The biographies on page 28 demonstrate a broad range of business and financial experience and there is a clear division of responsibilities between the roles of Chairman and the Chief Executives of South West Water and Viridor Waste as recorded in the descriptions of the roles approved by the Board. All Directors are subject to re-election when they have held office for three years or more.

During the year, the Board met in accordance with its schedule of meetings on 11 occasions and at each meeting all Directors were present with the exception of Bob Baty and Gerard Connell each on one occasion and Dinah Nichols on two occasions. The Board also held two special meetings during the year at which all Directors were present with the exception of Bob Baty and Kate Mortimer each on one occasion. In accordance with Group Policy, the Board has a schedule of matters reserved for its decision and delegates more detailed consideration of certain matters to Board Committees, to the subsidiary boards of South West Water and Viridor Waste and to the Executive Directors and Group General Counsel & Company Secretary as appropriate. Recognising this policy, the matters reserved to the Board include the approval of financial statements, acquisitions and disposals, major items of capital expenditure, authority levels for other expenditure, risk management and approval of the Strategic Plan and annual operating budgets. The Board operates by receiving written reports circulated in advance from the Executive Directors and the Group General Counsel & Company Secretary on matters within their respective business areas within the Group. Under the guidance of the Chairman, all matters before the Board are discussed openly and presentations and advice are received on occasions from other senior executives within the Group or external advisers.

Directors have access to the advice and services of the Group General Counsel & Company Secretary and the Board has established a procedure whereby Directors, in order to fulfil their duties, may seek independent professional advice at the Company's expense. The training needs of Directors are reviewed on a regular basis.

The Board has an internal procedure to evaluate the performance of the whole Board, each Committee, the Chairman, each individual Director and the Group General Counsel & Company Secretary. This evaluation procedure was carried out for the year by the Group General Counsel & Company Secretary seeking all participants' views on a range of prescribed questions designed to ensure objective evaluation of performance. The participants' responses were then summarised and evaluated by the Group General Counsel & Company Secretary for the Board to consider and determine whether any changes were necessary for the Board to be more effective. Overall performance was considered to be satisfactory but a number of minor issues were identified where changes could be made to improve performance. The Chairman's performance was evaluated separately by the Non-executive Directors, led by the Senior Independent Non-executive Director.

All Directors are equally accountable for the proper stewardship of the Group's affairs with the Non-executive Directors having a particular responsibility for ensuring strategies proposed for the development of the business are critically reviewed. The Non-executive Directors also critically examine the operational and financial performance of the Group and fulfil a key role in corporate accountability through their membership of various Committees of the Board. Group Policy allocates the tasks of giving detailed consideration to specified matters, to monitoring executive actions and to assessing reward to the Board Committees as follows:

AUDIT COMMITTEE

The Audit Committee was chaired by Gerard Connell, who has current and relevant financial experience, and the other members of the Committee were Kate Mortimer and Dinah Nichols. During the year, the Committee met on six occasions and all members were present at each meeting. In discharging its Terms of Reference, the Committee receives reports and meets regularly in particular to:

- monitor the integrity of the financial statements of the Group, including a review of significant reporting judgements, prior to approval by the Board;
- keep under review the effectiveness of the Group's internal controls, including all material financial, operational and compliance controls and risk management systems;
- monitor and review the effectiveness of the Group's internal audit function and approve the annual internal audit plan; review the findings of the internal audit function and review and monitor management's responsiveness to such findings;
- oversee the relationship with the external auditors including their remuneration, appointment, re-appointment and removal and in addition monitor their independence and objectivity including the supply of non-audit services; receive internal control reports from the external auditors and meet with them in the absence of management at least once a year to discuss their remit and any issues arising from the audit.





The Committee pays particular attention to the independence and objectivity of the auditors and has established a policy for the engagement of the auditors for non-audit work by the Group. This involves the Group Director of Finance setting out in a report to the Committee reasons for appointing the auditors for any material work and obtaining the approval of the Committee to such appointment which the Committee will only grant if it is satisfied that the auditors' independence and objectivity are safeguarded. This is achieved by reviewing the appointment with the auditors as considered appropriate and receiving from the auditors at the year end a letter setting out how the auditors believe their independence and objectivity have been maintained. In addition, the Company's current auditors ensure that the senior partner responsible for the external audit of the Group remains responsible for such audit for no more than five years and that there is an independent partner who is involved in planning and in the reviewing of the final accounts of the Company and also any critical matters that may be identified in the audit. Details of audit and non-audit fees are contained in note 6 to the financial statements on page 59. The Executive Directors attend by invitation and the Company's auditors have the right of direct access to the Committee without the presence of any Executive Director.

Towards the end of the year, in accordance with guidance issued by the Audit Committee, a review was undertaken of the provision of external audit services and a number of audit firms were invited to submit and present proposals to the Company for audit services. Following a detailed selection process, including presentations by a shortlist of audit firms to the Audit Committee, the Chairman of the Company and the Group Director of Finance, PricewaterhouseCoopers LLP were selected to continue as the auditors of the Group to be recommended at the Annual General Meeting on 27 July 2006.

REMUNERATION COMMITTEE

The Remuneration Committee was chaired by Kate Mortimer. Gerard Connell and Dinah Nichols were the other members of the Committee. The Committee met on seven occasions during the year at which all members were present. The Committee is responsible for determining the remuneration and terms of engagement of the Chairman and the remuneration and terms of employment of the Executive Directors and senior management of the Group. Members of the Remuneration Committee do not participate in decisions concerning their own remuneration. The Directors' report on remuneration, which also provides more information on the activities of the Remuneration Committee, appears on pages 29 to 35.

NOMINATION COMMITTEE

The Nomination Committee was chaired by Ken Harvey and also comprised Kate Mortimer, Dinah Nichols and Gerard Connell. It meets as and when required to select and recommend to the Board suitable candidates for appointment as Executive and Non-executive Directors, determine the nomination process and review succession plans. During the year it met on one occasion (at which all members were present) to review succession plans for the Executive Directors of the Board and senior management; to formally determine the selection process for an Executive Director appointment which involved open advertising and the engagement of an external search consultancy followed by interviews of a shortlist of candidates by the Committee and subsequent meetings with the preferred candidate by the Executive Directors; and to consider the appointment for a third three year term of a Non-executive Director.

The Terms of Reference of the Audit, Remuneration and Nomination Committees are available upon request to the Company Secretary and are also set out on the Company's website at www.pennon-group.co.uk

ENVIRONMENT COMMITTEE

The Environment Committee was chaired by Bruce Hewett (a co-opted member and former Non-executive Director of the Company) and also comprised the Chief Executives of South West Water and Viridor Waste. The Committee met four times during the year with all members present except for Bob Baty on one occasion. It is responsible for reviewing and monitoring the environmental policies of Group companies, their achievement of environmental and social objectives and targets and for considering the Group's annual corporate responsibility report.

INTERNAL CONTROL

Wider aspects of internal control

The Board is responsible for the Company's system of internal control (including financial control) and for reviewing its effectiveness. The system is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss. There is an ongoing process for identifying, evaluating and managing the significant risks faced by the Company that have been in place throughout the year 2005/06 and up to the date of the approval of this Annual Report and Accounts. The Board confirms that it continues to apply procedures in accordance with the 'Guidance on Internal Control' (The Turnbull Guidance) annexed to the Combined Code. As part of these procedures, the Board has a formalised risk management policy which provides for the identification of key risks in relation to the achievement of the business objectives of the Group. This policy is applied by all business units within the Group in accordance with an annual timetable.

Risk identification

A full risk and control assessment is undertaken annually by the management of each business to identify financial and non-financial risks and is continuously updated. Each business then receives as part of its regular management reports an enhanced and focused assessment of key risks against corporate objectives. The Board at each meeting receives from Executive Directors details of any new high level risks identified and how they are to be managed, together with details of any changes to existing risks and their management. The subsidiary Boards of South West Water and Viridor Waste also receive at each meeting similar reports in respect of their own areas of responsibility. All senior managers are required to certify on an annual basis that they have established effective controls to manage risks and to operate in compliance with legislation and Group procedures. All of these processes serve to ensure that a culture of effective control and risk management is embedded within the organisation and that the Group is in a position to react appropriately to new risks as they arise. Details of key risks affecting the Group are set out in the Business Review on pages 18 to 22.

Internal control framework

As well as the risk management policy of the Group 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 of operating units;
- (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 budget;
- (c) documented financial control procedures. Managers of operating units 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; and
- (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.

Internal control review

An evaluation of the effectiveness of overall internal control compliance by the Group is now undertaken in respect of each calendar year (previously each financial year ending 31 March) to assist the Audit Committee in considering the Group internal audit plan for the forthcoming financial year and also the Business Review for the Annual Report. The Group General Counsel & Company Secretary initially carried out the review with Directors and senior management for consideration by the Audit Committee and subsequently for final evaluation by the Board.

In addition, the Audit Committee regularly reviews the operation and effectiveness of the internal control framework and also annually reviews the scope of work, authority and resources of the Company's internal audit function and reports to the Board on such reviews. For

2005 and up to the date of the approval of the Annual Report and Accounts, both the Audit Committee and the Board were satisfied with the effectiveness of the risk management policy and the internal control framework and their operation within the Group.

GOING CONCERN

The Directors consider, after making appropriate enquiries, that the Company and the Group have adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

DIRECTORS' RESPONSIBILITIES STATEMENT

The Directors are required by the Companies Act 1985 to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and the Group as at the end of the financial year and of the profit or loss of the Group for the financial year.

In preparing the financial statements, appropriate accounting policies have been used and consistently applied and reasonable and prudent judgements and estimates have been made. All relevant accounting standards which the Directors consider to be applicable have been followed.

The Directors have responsibility for ensuring that accounting records are kept which disclose with reasonable accuracy the financial position of the Company and the Group and which enable them to ensure that the financial statements comply with the Companies Act 1985. They are responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

RELATIONS WITH SHAREHOLDERS

The Company maintains a regular dialogue with its institutional shareholders and has a well developed investor relations programme. During the year, meetings with institutional shareholders were held and were attended by the Group Director of Finance and the Company's Investor Relations Manager and, on certain occasions, the Chairman, the Chief Executive of South West Water and the Chief Executive of Viridor Waste also attended. The Board encourages the participation of shareholders at the Annual General Meeting and complies with the provisions of the Combined Code in respect of relations with shareholders. The Group Director of Finance reports to the Board regularly on major shareholders' views about the Company. The Group Director of Finance also conducts surveys of shareholder opinion, usually on an annual basis, which are evaluated and reported on to the Board.

By Order of the Board
KEN WOODIER, Group General Counsel & Company Secretary
 22 June 2006

THE DIRECTORS SUBMIT THEIR REPORT AND AUDITED FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2006

PRINCIPAL ACTIVITIES AND BUSINESS REVIEW

The principal activities of the Company and its subsidiaries ('the Group') continue to be the provision of water and sewerage services and waste management. Further information regarding the Group, including important events and its progress during the year, events since the year end and likely future developments is contained in the Chairman's Statement, in the Chief Executives' Overviews and in the Business Review on pages 2 to 27. The information that fulfils the requirements of the Business Review (as required by Section 234ZZB of the Companies Act 1985), which is incorporated in this Directors' Report by reference, can be found on the following pages of this Annual Report:

Information	Location	Pages
Development and performance during the financial year	Chairman's statement and Chief Executives' overviews	2-7
Position at the year end including analysis and key performance indicators	Business Review	14-15, 23-25
Other performance, including environmental and employee matters	Business Review	16-18
Principal risks and uncertainties facing the business	Business Review	18-22
Explanation of amounts included in the annual accounts	Business Review and Notes to financial statements	23-26, 46-91

The principal subsidiaries of the Company are listed in note 37 to the financial statements on page 82.

FINANCIAL RESULTS AND DIVIDEND

Group profit for the year after taxation was £37.8 million. The Directors recommend a final dividend of 35.1p per Ordinary share to shareholders on the register on 4 August 2006, making a total for the year of 51.6p.

The Business Review on pages 8 to 27 analyses the results in more detail and sets out other financial information, including the Directors' opinion on asset values (page 24).

DIRECTORS

Bob Baty will retire as Chief Executive of South West Water Limited and from the Board on 31 July 2006. Chris Loughlin has been appointed by the Board as Bob Baty's successor and as a Director with effect from 1 August.

No Director has, or has had, a material interest, directly or indirectly, at any time during the year under review in any contract significant to the Company's business.

A list of all the Directors during the year is set out in the emoluments table on page 33. Further details relating to the Directors and their service contracts or contracts for services are set out on pages 29 to 35 and details of the Directors' interests in shares of the Company are given on pages 34 and 35.

STATEMENT AS TO DISCLOSURE OF INFORMATION TO AUDITORS

- So far as each of the Directors is aware, there is no relevant audit information of which the Company's auditors are unaware, and
- Each of the Directors has taken all the steps they ought to have taken individually as a director in order to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

FINANCIAL INSTRUMENTS

Details of the financial risk management objectives and policies of the Group and the exposure of the Group to price, credit, liquidity and cash flow risk are set out in the Business Review on page 25 and also note 3 to the financial statements on page 53.

EMPLOYMENT POLICIES AND EMPLOYEE INVOLVEMENT

The Group has a culture of continuous improvement through investment in people at all levels within the Group.

The Group is committed to pursuing equality and diversity in all its employment activities including recruitment, training, career development and promotion and ensuring there is no bias or discrimination in the treatment of people. In particular, applications for employment are welcome from disabled persons and special arrangements and adjustments as necessary are made to ensure disabled applicants are treated fairly when attending interviews or for pre-employment aptitude tests. Wherever possible, the opportunity is taken to retrain people who become disabled during their employment in order to maintain their employment within the Group.

Employees are consulted regularly about changes which may affect them either through their Trade Union appointed representatives or by means of the elected Staff Council which operates in South West Water for staff employees. These forums, together with regular meetings with particular groups of

DIRECTORS' REPORT

employees, are used to ensure that employees are kept up to date with the operating and financial performance of the Company. The Group also uses a monthly information cascade process to provide employees with important and up to date information about key issues and events.

The Group encourages share ownership amongst its employees by operating an HM Revenue & Customs approved Sharesave Scheme open to all eligible employees and has recently launched an HM Revenue & Customs approved Share Incentive Plan to further encourage share ownership.

Further information relating to employee matters is set out in the Business Review on page 16.

RESEARCH AND DEVELOPMENT

Research and development activities within the Group involving water and waste treatment processes amounted to £0.1 million during the year (2004/05 £0.1 million).

CHARITABLE DONATIONS

During the year, charitable donations amounting to £47,000 were made to registered charities involved in a wide range of activities and initiatives where funding assists groups including disadvantaged adults and children, local community organisations, educational establishments, special needs groups and other similar deserving causes. Further details relating to charitable donations are set out in the Group's Corporate Responsibility Report. No political donations were made.

TAX STATUS

The Company is not a close company within the meaning of the Income and Corporation Taxes Act 1988.

PAYMENTS TO SUPPLIERS

It is the Group's payment policy for the year ending 31 March 2007 to follow the Code of The Better Payment Practice Group on supplier payments. Information about the Code can be obtained from www.payontime.co.uk

The Company will agree payment terms with individual suppliers in advance and abide by such terms. The ratio, expressed in days, between the amount invoiced to the Company by its suppliers during 2005/06 and the amount owed to its trade creditors at 31 March 2006, was 33 days.

ACQUISITION OF SHARES

The Company has authority from shareholders to repurchase up to 10% of its own ordinary shares (expiring at the conclusion of the Annual General Meeting to be held on 27 July 2006). This authority was not used during 2005/06 but has been used subsequent to the year end to buy back through the market ordinary shares (of nominal value 122¹/_{10p} each). Up to and including 14 June 2006 160,000 shares were repurchased for an aggregate consideration of £2,090,045,

representing 0.135% of the issued share capital of the Company prior to the commencement of the repurchases.

The shares have been repurchased pursuant to the return of cash to shareholders as set out in the Circular to shareholders dated 23 January 2006 and in connection with the decision to move South West Water to a more highly-g geared structure to enhance the Group's balance sheet. The shares have been repurchased for cancellation.

SUBSTANTIAL SHAREHOLDINGS

Details are set out in the Shareholder information section on page 107.

AUDITORS

PricewaterhouseCoopers LLP were appointed auditors until the conclusion of the seventeenth Annual General Meeting. A resolution for their re-appointment upon the recommendation of the Audit Committee of the Board will be proposed at the Annual General Meeting. The auditors have indicated their willingness to continue in office.

APPOINTED BUSINESS

South West Water Limited is required to publish additional financial information relating to the 'appointed business' as water and sewerage undertaker in accordance with the Instrument of Appointment from the Secretary of State for the Environment. A copy of this information will be available from 14 July 2006 upon application to the Company Secretary at Peninsula House, Rydon Lane, Exeter EX2 7HR.

ANNUAL GENERAL MEETING

The seventeenth Annual General Meeting will be held at the Plymouth Pavilions, Millbay Road, Plymouth, Devon PL1 3LF on Thursday, 27 July 2006 at 11.00am.

In addition to routine business, resolutions will be proposed at the Annual General Meeting to:

- renew the existing authorities to issue a limited number of shares and to purchase up to 10% of the issued share capital
- seek authority to make political donations under the Political Parties, Elections and Referendums Act 2000
- undertake a share split
- eliminate authorised share capital created for the purposes of the return of cash to shareholders earlier this year, which is no longer required.

Details of the resolutions are set out in the separate Notice of Annual General Meeting circulated to shareholders with this Annual Report.

By Order of the Board
KEN WOODIER, Group General Counsel & Company Secretary
22 June 2006



INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF PENNON GROUP PLC

We have audited the group financial statements of Pennon Group Plc for the year ended 31 March 2006 which comprise the Group income statement, the Group statement of recognised income and expense, the Group balance sheet, the Group cash flow statement and the related notes. These group financial statements have been prepared under the accounting policies set out therein.

We have reported separately on the parent company financial statements of Pennon Group Plc for the year ended 31 March 2006 and on the information in the Directors' remuneration report that is described as having been audited.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The Directors' responsibilities for preparing the Annual Report and the Group financial statements in accordance with applicable law and International Financial Reporting Standards (IFRS) as adopted by the European Union are set out in the Directors' responsibilities statement.

Our responsibility is to audit the Group financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the Group financial statements give a true and fair view and whether the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We report to you whether in our opinion the information given in the Directors' report is consistent with the Group financial statements. We also report to you if, in our opinion, we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We review whether the Corporate governance statement reflects the Company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited Group financial statements. The other information comprises only the Chairman's statement, the Chief Executives' overviews, the Business review, the Directors' report and the corporate governance statement. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Group financial statements. Our responsibilities do not extend to any other information.

BASIS OF AUDIT OPINION

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the group financial statements. It also includes an assessment of the significant estimates and judgments made by the Directors in the preparation of the Group financial statements, and of whether the accounting policies are appropriate to the Group'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 Group financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the Group financial statements.

OPINION

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRS as adopted by the European Union, of the state of the Group's affairs as at 31 March 2006 and of its profit and cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation; and
- the information given in the Directors' report is consistent with the Group financial statements.

*PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
Bristol
22 June 2006*

CONSOLIDATED INCOME STATEMENT

for the year ended 31 March 2006

	Notes	Before exceptional items 2006 £m	Exceptional items (note 9) 2006 £m	Total 2006 £m	Before exceptional items 2005 £m	Exceptional items (note 9) 2005 £m	Total 2005 £m
<i>Continuing operations</i>							
Revenue	5	645.7	–	645.7	551.4	–	551.4
Operating costs	6						
Manpower costs		(79.9)	–	(79.9)	(68.3)	(3.0)	(71.3)
Raw materials and consumables used		(40.7)	–	(40.7)	(32.8)	–	(32.8)
Other operating expenses		(245.9)	(14.5)	(260.4)	(207.3)	(1.9)	(209.2)
Depreciation		(102.5)	–	(102.5)	(90.7)	–	(90.7)
Amortisation of intangibles		(1.6)	–	(1.6)	(1.4)	–	(1.4)
Operating profit	5	175.1	(14.5)	160.6	150.9	(4.9)	146.0
Interest payable and similar charges	7	(96.8)	(50.2)	(147.0)	(89.3)	–	(89.3)
Interest receivable	7	32.5	7.9	40.4	27.3	–	27.3
Share of post-tax profit from joint venture		0.1	–	0.1	0.1	–	0.1
Profit before tax		110.9	(56.8)	54.1	89.0	(4.9)	84.1
Tax on ordinary activities	8	(35.0)	18.7	(16.3)	(23.5)	–	(23.5)
Profit/(loss) for the year from continuing operations		75.9	(38.1)	37.8	65.5	(4.9)	60.6
<i>Discontinued operations</i>							
Post-tax business disposal profit		–	–	–	–	5.0	5.0
Profit/(loss) for the year		75.9	(38.1)	37.8	65.5	0.1	65.6
Profit/(loss) attributable to equity shareholders		75.9	(38.1)	37.8	65.5	0.1	65.6
Earnings per share (pence per share)	10						
– Basic				29.7			52.1
– Diluted				29.4			51.7
Earnings per share from continuing operations							
– Basic				29.7			48.1
– Diluted				29.4			47.8

The notes on pages 46 to 91 form part of these financial statements.



CONSOLIDATED STATEMENT OF RECOGNISED INCOME AND EXPENSE

for the year ended 31 March 2006

	Notes	2006 £m	2005 £m
Profit for the year		37.8	65.6
Actuarial (losses)/gains on defined benefit schemes	27	(2.8)	1.9
<i>Cash flow hedges</i>			
Net fair value gains		1.0	–
Tax on items taken directly to or transferred from equity		0.8	(0.6)
Net (losses)/gains not recognised directly in income statement	33	(1.0)	1.3
Total recognised income for the year		36.8	66.9
Adjustments on adoption of IAS 32/39 1 April 2005 (net of tax)	33	8.6	–
		45.4	66.9
Attributable to equity shareholders		45.4	66.9

The notes on pages 46 to 91 form part of these financial statements.

CONSOLIDATED BALANCE SHEET

at 31 March 2006

	Notes	2006 £m	2005 £m
Assets			
Non-current assets			
Goodwill	14	98.6	64.4
Intangible assets	15	5.7	6.0
Property, plant and equipment	16	2,415.9	2,218.5
Trade and other receivables	17	6.0	3.3
Investments accounted for using equity method	18	1.3	–
		2,527.5	2,292.2
Current assets			
Inventories	19	5.0	4.7
Trade and other receivables	20	94.5	99.6
<i>Financial assets</i>			
Derivative financial instruments	21	3.1	–
Cash and cash equivalents	22	99.4	303.4
		202.0	407.7
Liabilities			
Current liabilities			
<i>Financial liabilities</i>			
Borrowings	25	(54.7)	(54.8)
Derivative financial instruments	21	(3.0)	–
Trade and other payables	23	(170.1)	(127.8)
Current tax liabilities	24	(24.0)	(23.6)
Provisions for liabilities and charges	29	(11.4)	(8.4)
		(263.2)	(214.6)
Net current (liabilities)/assets		(61.2)	193.1
Non-current liabilities			
<i>Financial liabilities</i>			
Borrowings	25	(1,471.8)	(1,366.8)
Other non-current liabilities	26	(2.2)	(19.1)
Retirement benefit obligations	27	(41.7)	(79.8)
Deferred tax liabilities	28	(302.8)	(282.8)
Provisions for liabilities and charges	29	(66.6)	(27.9)
		(1,885.1)	(1,776.4)
Net assets		581.2	708.9
Shareholders' equity			
Share capital	30	184.2	142.0
Share premium account	31	10.2	153.7
Capital redemption reserve	32	98.4	–
Retained earnings and other reserves	33	288.4	413.2
Total shareholders' equity		581.2	708.9

The notes on pages 46 to 91 form part of these financial statements.

The financial statements on pages 42 to 91 were approved by the Board of Directors on 22 June 2006 and were signed on its behalf by:

K G HARVEY, *Chairman*





CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 March 2006

	Notes	2006 £m	2005 £m
Cash flows from operating activities			
Cash generated from operations	34	232.1	242.4
Interest paid (including exceptional item, note 9)	7, 9	(128.9)	(68.5)
Forward interest rate swap settlement		-	(3.4)
Tax paid		(2.2)	(0.4)
Net cash generated from operating activities		101.0	170.1
Cash flows from investing activities			
Interest received (including exceptional item, note 9)		22.5	12.8
Acquisition of subsidiaries (net of cash acquired)	36	(44.7)	(28.6)
Investment in joint venture	18	(1.1)	-
Proceeds of business disposal		5.0	-
Proceeds from sale of available for sale investments		-	4.2
Purchase of intangible assets		-	(0.2)
Purchase of property, plant and equipment		(218.6)	(167.1)
Proceeds from sale of property, plant and equipment		4.8	2.3
Net cash used in investing activities		(232.1)	(176.6)
Cash flows from financing activities			
Net proceeds from issue of ordinary share capital		1.6	0.8
Release of restricted deposits	22	177.1	-
Net proceeds from new borrowing		182.5	150.0
Repayment of borrowings		(224.3)	(130.2)
Finance lease drawdowns		141.6	57.3
Finance lease principal repayments		(15.8)	(5.4)
Dividends paid		(34.1)	(28.3)
B Share payments	30	(137.8)	-
Net cash received from financing activities		90.8	44.2
Net (decrease)/increase in cash and cash equivalents		(40.3)	37.7
Cash and cash equivalents at beginning of the year		120.6	82.9
Cash and cash equivalents at end of the year		80.3	120.6

The notes on pages 46 to 91 form part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. GENERAL INFORMATION

Pennon Group Plc is a company incorporated in the United Kingdom under the Companies Act 1985. The address of the registered office is given on page 28. The nature of the Group's operations and its principal activities are set out in the Directors' report on page 39.

These consolidated financial statements have been approved by the Board of Directors on 22 June 2006.

2. SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies adopted in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented unless otherwise stated.

(a) Basis of preparation

These are the first financial statements to have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The disclosures required by IFRS 1 "First-time adoption of IFRS" concerning the transition from UK Generally Accepted Accounting Principles (UK GAAP) to IFRS are set out in note 42.

These financial statements have been prepared under the historical cost convention in accordance with International Financial Reporting Standards and International Financial Reporting Interpretation Committee (IFRIC) interpretations, as adopted by the European Union (EU), with those parts of the Companies Act 1985 applicable to companies reporting under IFRS and the requirements of the Financial Services Authority. A summary of the main 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.

IFRS 7 "Financial Instruments: Disclosure" has been adopted by the EU for implementation in 2007, but has not been adopted early in these financial statements.

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best assessment of the amounts, events or actions, actual results ultimately may differ from those estimates.

(b) First time adoption of IFRS

The Group's date of transition to IFRS was 1 April 2004 and all comparative information in the financial statements has been restated to reflect the Group's adoption of IFRS, except where otherwise required or permitted by IFRS 1 "First Time Adoption of International Financial Reporting Standards".

All accounting policies have been consistently applied except where the Group has taken advantage of the exemption in IFRS 1 from the requirement to restate comparative information for IAS 32 and 39. These Standards have been applied with effect from 1 April 2005.

IFRS 1 requires an entity to comply with each IFRS effective at the reporting date for its first IFRS financial statements. As a general principle, IFRS 1 requires the standards effective at the reporting date to be applied retrospectively. There are, however, a number of optional exemptions from full retrospective application. The Group has elected to take advantage of certain exemptions under IFRS 1 as follows:

- not to apply IFRS 3 "Business Combinations" retrospectively to past business combinations;
- to establish a deemed cost for the opening balance sheet carrying value of the water and waste water infrastructure fixed assets by reference to the fair value of these assets at the date of transition to IFRS, 1 April 2004. All non-infrastructure assets have been carried forward using the depreciated historical cost UK GAAP balances as the deemed IFRS cost;
- to recognise all cumulative actuarial gains and losses relating to defined benefit pension schemes at the date of transition;
- not to apply the requirements of IFRS 2 "Share-based Payment" to options granted under the Group's share incentive schemes prior to 7 November 2002.



2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(c) Basis of consolidation

The financial statements include the results of Pennon Group Plc and its subsidiary and joint venture undertakings.

The results of subsidiaries and joint venture undertakings are included from the date of acquisition or incorporation, and excluded from the date of disposal. The results of subsidiaries are consolidated where the Group has the power to control a subsidiary. The results of joint venture undertakings are accounted for on an equity basis where the company exercised joint control under a contractual arrangement.

On acquisition, the assets and liabilities and contingent liabilities of a subsidiary or joint venture acquired are measured at their fair values and any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired is credited to profit and loss in the year of acquisition.

(d) Revenue recognition

Revenue represents the fair value of consideration receivable, excluding value added tax, trade discounts and intercompany sales, in the ordinary course of business for goods and services provided.

Revenue is not recognised until the service has been provided to the customer, or the goods which the sale relates to have been despatched to the customer.

Income from main water and waste water charges includes an estimation of the amount of unbilled charges at the period end based upon a defined methodology reflecting historical consumption and current tariffs.

(e) Landfill tax

Landfill tax is included within both revenue and operating costs.

(f) Segmental reporting

Each of the Group's business segments provide services which are subject to risks and returns which are different from those of the other business segments. The Group's internal organisation and management structure and its system of internal financial reporting is based primarily on business segments. The business segments comprise the regulated water and sewerage services undertaken by South West Water Limited and the waste management business of Viridor Waste Limited. Segmental revenue, expense and results include transactions between businesses. Inter-segmental transactions are eliminated on consolidation.

(g) Goodwill

Goodwill arising on consolidation from the acquisition of subsidiary and joint venture undertakings represents the excess of the purchase consideration over the fair value of net assets acquired.

Goodwill is recognised as an asset and reviewed for impairment at least annually. Any impairment is recognised immediately in the income statement and is not subsequently reversed. Further details are contained in accounting policy (l).

When a subsidiary or joint venture undertaking is sold, the profit or loss on disposal is determined after including the attributable amount of unamortised goodwill.

Goodwill arising on acquisitions before the date of transition to IFRS has been retained at the previous UK GAAP amounts subject to being tested for impairment at that date and annually thereafter. Goodwill written off to reserves under UK GAAP prior to 1998 has not been reinstated and will not be included in determining any subsequent profit or loss on disposal.

NOTES TO THE FINANCIAL STATEMENTS

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

(h) Intangible assets

Intangible assets acquired in a business combination are capitalised at fair value at the date of acquisition. Following initial recognition, finite life intangible assets are amortised on a straight-line basis over their estimated useful economic lives, with the expense taken to the income statement through operating expenses.

(i) Property, plant and equipment

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

Infrastructure assets are included at fair value on transition to IFRS and subsequent additions at cost less accumulated depreciation. Expenditure to increase capacity or enhance infrastructure assets is capitalised where it can be reliably measured and it is probable that incremental future economic benefits will flow to the entity. The cost of day to day servicing of infrastructure components is recognised in the income statement as it arises.

Infrastructure assets are depreciated over their useful economic lives on a straight-line basis, which are principally as follows:

Dams and impounding reservoirs	200 years
Water mains	40 – 100 years
Sewers	40 – 100 years

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

ii) Landfill sites

Landfill sites are included within land and buildings at cost less accumulated depreciation. Cost includes acquisition and development expenses. The cost of a landfill is depreciated to its residual value (which is linked to gas production at the site post-closure) over its estimated operational life taking account of the usage of void space.

Where the obligation to restore a landfill site gives access to future economic benefits, a tangible fixed asset is recognised and depreciated based on the usage of void space.

iii) Other assets (including properties, over-ground plant and equipment)

Other assets are included at cost less accumulated depreciation.

Freehold land is not depreciated. Other assets are depreciated evenly over their estimated economic lives to their residual value, which are principally as follows:

Freehold buildings	30 – 60 years
Leasehold buildings	Over the period of the lease
Operational structures	40 – 80 years
Fixed plant	20 – 40 years
Vehicles, mobile plant and computers	3 – 10 years

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

The cost of assets includes directly attributable labour and overhead costs which are incremental to the Group. Borrowing costs that are directly attributable to the construction of a qualifying asset (an asset which necessarily takes a substantial period of time to be prepared for its intended use) are capitalised as part of the asset.

Asset lives and residual values are reviewed annually.

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(j) Grants and contributions

Grants and contributions receivable in respect of property, plant and equipment are deducted from the cost of those assets.

Grants and contributions receivable in respect of expenditure charged against profits in the year have been included in the income statement.

(k) 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 borrowings. The interest element of the rental costs 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.

(l) Impairment of assets

Assets which have an indefinite useful life are not subject to amortisation and are tested annually for impairment, or whenever events or changes in circumstance indicate that the carrying amount may not be recoverable.

Assets which are subject to amortisation are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be fully recoverable.

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). Value in use represents the present value of projected future cash flows expected to be derived from a cash-generating unit, discounted using a pre-tax discount rate which reflects an assessment of the cost of capital of the cash-generating unit.

Impairments are charged to the income statement in the year in which they arise.

(m) Joint ventures

Joint ventures are entities over which the group has joint control. Investments in joint ventures are accounted for using the equity method of accounting. Any excess of the cost of acquisition over the Group's share of the fair values of the identifiable net assets of the joint venture at the date of acquisition is recognised as goodwill.

The carrying value of the Group's investment is adjusted for the Group's share of post-acquisition profits or losses recognised in the income statement. Losses of a joint venture in excess of the Group's interest are not recognised unless the Group has a legal or constructive obligation to fund those losses.

(n) Inventories

Inventories and work in progress are stated at the lower of cost and net realisable value. Cost includes labour, materials and attributable overheads.

(o) Cash and cash equivalents

Cash and cash equivalents includes 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.

2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(p) Derivatives and other financial instruments

The Group has taken advantage of the IFRS 1 exemption from application of IAS 32 "Financial Instruments: Disclosure and Presentation" and IAS 39 "Financial Instruments: Recognition and Measurement" and has applied these standards from 1 April 2005. Accordingly, for the 2005 comparative information, financial instruments are accounted for and presented under UK GAAP. As a result of applying IAS 39 at 1 April 2005, net assets have been reduced by £1 million for the Group's debt interest rate swaps, by £1 million reflecting the discounted proceeds of receivables and increased by £10 million (net of tax) following the release of deferred income which does not qualify as a hedge under IFRS.

The Group has classified its financial instruments in the following categories from 1 April 2005.

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 income statement when the liabilities are de-recognised or impaired. Premiums, discounts and other costs and fees are recognised in the income statement through the amortisation process.

Borrowings are classified as current liabilities unless the Group 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 Group 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.

The gain or loss on re-measurement is taken to the income statement 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 equity, and the ineffective portion in the income statement. The gains or losses deferred in equity in this way are subsequently recognised in the income statement in the same period in which the hedged underlying transaction or firm commitment is recognised in the income statement.

In order to qualify for hedge accounting, the Group is required to document in advance the relationship between the item being hedged and the hedging instrument. The Group 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 receivables

Trade receivables 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.

iv) Trade payables

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



2. SIGNIFICANT ACCOUNTING POLICIES *(continued)*

(q) Taxation including deferred tax

Tax payable for the year is provided at current rates. Deferred taxation is provided in full, using the liability method, on temporary differences between the tax basis of assets and liabilities and their carrying amounts in the financial statements. A deferred tax asset is only recognised to the extent it is probable that sufficient taxable profits will be available in the future to utilise it.

(r) Provisions for liabilities and charges

Provisions are made where there is a present legal or constructive obligation as a result of a past event and it is probable that there will be an outflow of economic benefits to settle this obligation and a reliable estimate of this amount can be made. The Group's policy on provisions for specific areas is as follows:

i) Landfill restoration costs

Provisions for the cost of restoring landfill sites are made when the obligation arises. Where the obligation recognised as a provision gives access to future economic benefits, a tangible fixed asset is recognised. Provisions are otherwise charged against profits.

ii) Environmental control and aftercare costs

Environmental control and aftercare costs are incurred over the operational life of each landfill site and may be incurred for a considerable period thereafter. Provision for all such costs is made over the operational life of the site and charged to the income statement on the basis of the usage of void space.

Provisions for restructuring costs are recognised when the Group has a detailed formal plan for the restructuring that has been communicated to affected parties.

Where the effect of the time value of money is material, the current amount of a provision is the present value of the expenditures expected to be required to settle obligations. The unwinding of the discount to present value is included as a financial item within interest payable and similar charges.

(s) Share capital and treasury shares

Debt and equity instruments are identified according to their underlying factors, as required by IAS 32 "Financial Instruments: Disclosure and Presentation".

Shareholders approved a £200 million return of capital, by way of a B Share Scheme and an on-market buy back programme, at the Company's Extraordinary General Meeting on 15 February 2006. Shareholders were given the options of receiving an initial dividend payment of 110 pence for each B Share held, or redeeming the B Shares on 27 February 2006, the Initial Redemption Date, or on 6 April 2006, the Final Redemption Date, or a combination of these options.

Ordinary shares are classified as equity and B Shares as debt.

The Group balance sheet incorporates the shares held by the Pennon Employee Share Trust and which have not vested by the balance sheet date. These are shown as a deduction from shareholders' equity until such time as they vest.

(t) Dividend distributions

Dividend distributions are recognised as a liability in the Group's 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 approved in general meeting by shareholders.

NOTES TO THE FINANCIAL STATEMENTS

2. SIGNIFICANT ACCOUNTING POLICIES (continued)

(u) Employee benefits

i) Pension obligations

The Group operates defined benefit and defined contribution pension schemes.

Defined benefit schemes

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 Group'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 income.

Actuarial gains and losses arising from experience adjustments, changes in actuarial assumptions and amendments to pension plans are charged or credited to equity and recorded in the statement of recognised income and expense.

Defined contribution schemes

Costs of the defined contribution pension scheme are charged to the income statement in the period in which they arise.

ii) Share-based payment

The Group operates a number of equity settled, share-based payment plans for employees. The fair value of the employee services required 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.

(v) Pre-contract costs

Pre-contract costs are expensed as incurred, except where it is virtually certain that the contract will be awarded, in which case they are recognised as an asset which is amortised to the income statement over the life of the contract.

(w) Fair values

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.

The fair values of short-term deposits, loans and overdrafts with a maturity of less than one year are assumed to approximate to their book values. In the case of bank loans and other loans due in more than one year, the fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate available to the Group for similar financial instruments.



3. FINANCIAL RISK MANAGEMENT

The Group's treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintains reasonable headroom for contingencies and manages interest rate risk.

Treasury operations are managed in accordance with policies established by the Board. Major transactions are individually approved by the Board. Treasury activities are reported to the Board and are subject to review by internal audit.

Financial instruments are used to raise finance and to manage risk. The Group does not engage in speculative activity.

The principal financial risks faced by the Group relate to interest rate and counterparty risk.

i) Interest rate risk

The Group has both interest bearing assets and interest bearing liabilities. The Group has a policy of maintaining at least 50% of interest bearing liabilities at fixed rates. At the year end 68% of net borrowings were at fixed rates. The Group uses a combination of fixed rate borrowings and fixed rate interest swaps as cash flow hedges of future variable interest payments to achieve this policy. 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, a £142 million finance lease was converted to an RPI-linked basis (1.365% real) during the year to take advantage of historically low index-linked rates and also to reduce earnings volatility. These instruments are analysed in more detail in note 25.

ii) Liquidity risk

The Group actively maintains a mixture of long-term and short-term committed facilities that are designed to ensure the Group has significant available funds for operations and planned expansions and facilities equivalent to at least one year's forecast requirements are maintained at all times. Details of undrawn committed facilities and short-term uncommitted facilities are provided in note 25.

iii) Refinancing risk management

Refinancing risk is managed under the Group policy that no more than 20% of Group net borrowings is permitted to mature in any financial year.

iv) Counterparty risk management

Counterparty risk arises from the investment of surplus funds and from the use of derivative instruments. The Board has agreed a policy for managing such risk, which is controlled through credit limits, counterparty approvals, and rigorous monitoring procedures. The Group has no other significant concentration of credit risk. Surplus funds of the Group are usually placed in short-term fixed interest deposits or the overnight money markets. All deposits are with counterparties that have a credit rating threshold approved by the Board.

NOTES TO THE FINANCIAL STATEMENTS

4. CRITICAL ACCOUNTING JUDGEMENTS

The Group's principal accounting policies are set out in note 2 to these financial statements. Management is required to exercise significant judgement and make use of estimates and assumptions in the application of these policies.

Areas which management believes require the most critical accounting judgements are:

Exceptional items

The Directors consider that items of income or expense which are material and non-recurring by virtue of their nature and amount should be disclosed separately if the financial statements are to fairly present the financial position and financial performance of the Group. The Directors label these items collectively as "exceptional items".

Landfill restoration and aftercare

Restoration and aftercare provisions are recognised in the financial statements at the net present value of the future expenditure required to settle the Group's restoration and aftercare obligations. The discount implicit in recognising the restoration and aftercare liability is unwound over the life of the provision and is included in the profit and loss account as a financial item within the net interest charge.

Where a provision gives access to future economic benefits, an asset is recognised and depreciated in accordance with the Group's depreciation policy. For the year ended 31 March 2006 the Directors believe the appropriate accounting methodology is to record the full amount of the discounted restoration cost of landfills as a tangible fixed asset and then depreciate according to the usage of void space. This is a change from the previous methodology of creating restoration provisions through a charge to operating cost as void space is filled. The financial effects of this change in methodology are to create an asset with a corresponding liability as shown in notes 16 and 29 to these financial statements.

Private Finance Initiative (PFI) projects

PFI contracts are reviewed to ascertain whether the risks and rewards of assets acquired lie substantially with the Group or the client entity. All current contracts indicate that the most significant risks remain with the Group and therefore assets are accounted for as tangible fixed assets, with depreciation charged over the shorter of the useful life of the asset or the concession period.

Joint ventures

The results, assets and liabilities of joint ventures are accounted for using the equity method of accounting as this reflects the contractual and control arrangements with the joint venture partners.

Borrowing costs

The Group capitalises borrowing costs which are material and directly attributable to the construction of qualifying assets, which are assets that necessarily take a substantial period of time to be prepared for their intended use. Currently only the assets under construction in the Lakeside Energy from Waste joint venture meet the criteria for capitalisation.

Retirement benefit obligations

The Group operates defined benefit schemes plus a defined contribution section. Actuarial valuations of the schemes are carried out as determined by the trustees at intervals of not more than three years.

The pension cost under IAS19 is assessed in accordance with the advice of an independent qualified actuary based on the latest actuarial valuation and assumptions determined by the actuary. The assumptions are based on information supplied to the actuary by the Company, supplemented by discussions between the actuary and management. The assumptions are disclosed in note 27 of the financial statements.



4. CRITICAL ACCOUNTING JUDGEMENTS *(continued)*

Areas which management believes require the most critical accounting estimation are as follows:

Landfill costs

The estimation of landfill reserves is of particular importance in assessing landfill costs, since the cost of a landfill site is depreciated over its estimated operational life taking into account the usage of void space. The Group's estimates of landfill reserves are regularly reviewed and updated during the financial year for usage and other events (for example site extensions). Estimates are also subject to physical review by external advisors. A number of factors impact on the value of landfill reserves, including the available landfill space, future capital expenditure and operating costs. The valuation is subject to revision as these factors change.

Carrying value of long-life assets

The Group's accounting policy for tangible fixed assets is detailed in note 2 of the consolidated financial statements. The carrying value of tangible fixed assets as at 31 March 2006 was £2,416 million. In the year ended 31 March 2006 additions to tangible fixed assets totalled £250 million and the depreciation charge was £104 million. The estimated useful economic lives of tangible fixed assets are based on management's judgement and experience. When management identifies that actual useful lives differ materially from the estimates used to calculate depreciation, that charge is adjusted prospectively. Due to the significance of tangible fixed asset investment to the Group, variations between actual and estimated useful lives could impact operating results both positively and negatively. Historically, only minor changes to estimated useful lives have been required.

Revenue recognition

The Group recognises revenue generally at the time of delivery. Payments received in advance of revenue recognition are recorded as deferred revenue.

In South West Water's case, the Group raises bills and recognises revenue in accordance with its entitlement to receive revenue in line with the limits established by the Periodic Review price setting process. For water and waste water customers with water meters, income recognised is dependent upon the volume supplied including an estimate of the sales value of units supplied between the date of the last meter reading and the year end. Estimated usage is based on historic data, judgement and assumptions; actual results could differ from these estimates which would result in operating revenue being adjusted in the period that the revision to the estimates is determined.

Provision for doubtful debts

At each balance sheet date, each subsidiary evaluates the collectability of trade debtors and records provisions for doubtful debts based on experience including, for example, comparisons of the relative age of accounts and consideration of actual write-off history. The actual level of debt collected may differ from the estimated levels of recovery, which could impact operating results positively or negatively. As at 31 March 2006 trade debtors were £95 million.

Impairment of intangible assets

The Group records all assets and liabilities acquired in business acquisitions, including goodwill, at fair value. Intangible assets which have an indefinite useful life, principally goodwill, are assessed annually for impairment.

The initial goodwill recorded and subsequent impairment analysis require management to make estimations of future cash flows, terminal values and an assessment of the long-term pre-tax discount rate to be applied to those cash flows to reflect the cost of capital of the cash-generating unit.

NOTES TO THE FINANCIAL STATEMENTS

5. SEGMENTAL REPORTING

	2006 £m	2005 £m
<i>Continuing operations</i>		
Revenue		
Water and sewerage	348.5	307.0
Waste management	298.9	248.3
Other	7.3	6.9
Less intra-segment trading*	(9.0)	(10.8)
	645.7	551.4
Segment result		
Operating profit before depreciation, amortisation and exceptional items (EBITDA)		
Water and sewerage	213.4	186.4
Waste management	66.7	56.4
Other	(0.9)	0.2
	279.2	243.0
Operating profit before amortisation and exceptional items		
Water and sewerage	141.5	122.2
Waste management	35.9	30.0
Other	(0.7)	0.1
	176.7	152.3
Operating profit before exceptional items		
Water and sewerage	141.5	122.2
Waste management	34.3	28.6
Other	(0.7)	0.1
	175.1	150.9
Operating profit		
Water and sewerage	127.0	118.8
Waste management	34.3	28.6
Other	(0.7)	(1.4)
	160.6	146.0
Profit before tax and exceptional items		
Water and sewerage	87.4	70.0
Waste management	21.9	20.1
Other	1.6	(1.1)
	110.9	89.0
<i>Discontinued operations</i>		
Other	–	5.0

The exceptional items are detailed in note 9.

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



5. SEGMENTAL REPORTING (continued)

	Water and sewerage £m	Waste management £m	Other £m	Eliminations £m	Group £m
Balance sheet					
31 March 2006					
Assets (excluding investment in joint ventures)	2,229.3	472.7	534.0	(507.8)	2,728.2
Investments in joint ventures	–	1.3	–	–	1.3
Total assets	2,229.3	474.0	534.0	(507.8)	2,729.5
Liabilities	(1,795.5)	(390.6)	(470.0)	507.8	(2,148.3)
Net assets	433.8	83.4	64.0	–	581.2
31 March 2005					
Assets	2,302.6	343.6	638.4	(584.7)	2,699.9
Liabilities	(1,700.1)	(271.9)	(603.7)	584.7	(1,991.0)
Net assets	602.5	71.7	34.7	–	708.9

	Water and sewerage £m	Waste management £m	Other £m	Group £m
Other information				
31 March 2006				
Amortisation of intangible assets (note 15)	–	1.6	–	1.6
Capital expenditure (including acquisitions)	191.0	104.5	–	295.5
Depreciation	71.9	30.8	(0.2)	102.5
31 March 2005				
Amortisation of intangible assets (note 15)	–	1.4	–	1.4
Capital expenditure (including acquisitions)	134.5	78.1	0.3	212.9
Depreciation	64.2	26.4	0.1	90.7

	2006	2005
Employees (average) number		
The average monthly number of employees (including executive directors) was:		
Water and sewerage	1,299	1,336
Waste management	1,388	1,169
Other	35	39
Group totals	2,722	2,544

NOTES TO THE FINANCIAL STATEMENTS

5. SEGMENTAL REPORTING *(continued)*

The total number of employees at 31 March 2006 was 2,775 (2005 2,566).

The water and sewerage business comprises the regulated water and sewerage services undertaken by South West Water Limited. The waste management business is the waste treatment, recycling and disposal services provided by Viridor Waste Limited. Other includes parent company financing of business acquisitions made before 1999. Segment assets include goodwill and other intangible assets, property, plant and equipment, inventories, trade and other receivables and operating cash and mainly exclude investments. Segment liabilities comprise operating liabilities and exclude taxation and certain corporate borrowings. Capital expenditure, comprises additions to property, plant and equipment, including additions resulting from acquisitions through business combinations.

Geographical segments

Separate disclosure by geographical segment is not shown since the operations of the Group are substantially all located in the United Kingdom and management do not use geographical location to control or monitor the Group's activities.

6. OPERATING COSTS

	2006 £m	2005 £m
Manpower costs (note 12)	79.9	68.3
Raw materials and consumables	40.7	32.8
Other operating expenses include:		
Profit on disposal of fixed assets	(1.1)	(1.4)
Operating lease rentals payable:		
– Plant and machinery	6.9	4.8
– Property	1.3	3.8
Research and development expenditure	0.1	0.1
Trade receivables impairment	5.6	6.9
Depreciation of property, plant and equipment:		
– Owned assets	77.7	69.2
– Under finance leases	24.8	21.5
Amortisation of intangible assets (note 15)	1.6	1.4

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

	2006 £000	2005 £000
Audit services		
– Statutory audit	307	308
– Audit – related regulatory reporting	36	29
Other assurance services	321	220
Tax services		
– Compliance services	24	24
– Advisory services	83	105
Other services	102	66
	873	752

Other assurance services and tax advisory services in 2006 include costs relating to the transition to IFRS and the financial restructuring in the Company. 2005 includes costs relating to the abortive acquisition of the UK landfill operations of Shanks Group Plc.

A description of the work of the Audit Committee is set out on pages 36 and 37 which includes an explanation of how auditor objectivity and independence are safeguarded when non-audit services are provided by the auditors.

The Group's pension schemes are also audited by PricewaterhouseCoopers LLP.

NOTES TO THE FINANCIAL STATEMENTS

7. NET FINANCE COSTS

	2006 £m	2005 £m
Interest payable (before the exceptional item)		
Bank borrowings and overdrafts	(25.7)	(23.5)
Other loans	–	(16.2)
Interest element of finance lease rentals	(39.4)	(32.7)
Other finance costs	(11.7)	(0.6)
Interest cost on retirement benefit obligations	(16.6)	(15.3)
Unwinding of discounts in provisions	(3.4)	(1.0)
Interest payable and similar charges	(96.8)	(89.3)
Interest receivable (before the exceptional item)	14.7	13.3
Expected return on pension scheme assets	17.8	14.0
Interest receivable	32.5	27.3
Net finance costs	(64.3)	(62.0)

The exceptional interest items, totalling £42.3 million, are detailed in note 9.

8. TAXATION

	Before exceptional items 2006 £m	Exceptional items (note 9) 2006 £m	Total 2006 £m	2005 £m
Analysis of charge in year				
<i>Continuing operations</i>				
Current tax	14.8	(18.7)	(3.9)	7.9
Deferred tax (note 28)	20.2	–	20.2	15.6
	35.0	(18.7)	16.3	23.5

No tax charge arose from the business disposal profit in relation to the prior year.

UK corporation tax is calculated at 30% (2005 30%) of the estimated assessable profit for the year. The tax for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK (30%). The differences are explained below:

	2006 £m	2005 £m
Profit before tax: Continuing operations	54.1	84.1
Profit before tax multiplied by standard rate of corporation tax in the UK of 30% (2005: 30%)	16.2	25.2
Effects of:		
Expenses not deductible for tax purposes	1.4	2.8
Other	(1.4)	(2.5)
Adjustments to tax in respect of prior year	0.1	(2.0)
Tax charge for year	16.3	23.5

The average effective tax rate for the year was 30% (2005 28%).

In addition to the amount charged to the income statement, a deferred tax credit relating to share-based payment of £1.2 million (2005 £0.3 million) and a deferred tax credit relating to actuarial losses on defined benefit schemes of £0.8 million (2005 £0.6 million charge on actuarial gains) have been credited directly to equity.

9. EXCEPTIONAL ITEMS

	2006 £m	2005 £m
The exceptional items are:		
<i>Continuing operations</i>		
Customer payment	14.5	–
Abortive acquisition costs	–	1.5
Business restructuring costs		
Manpower costs	–	3.0
Other external charges	–	0.4
Operating profit	14.5	4.9
Net finance costs		
Bond retirement	50.2	–
Receipt on transfer of lease	(7.9)	–
	42.3	–
Profit before tax	56.8	4.9
Tax arising on exceptional items	(18.7)	–
	38.1	4.9
<i>Discontinued operations</i>		
Post-tax disposal profit	–	(5.0)
	38.1	(0.1)

The customer payment and bond retirement relate to financial restructuring in the Company and South West Water Limited.

The receipt on transfer of lease relates to a consent fee paid to South West Water Limited arising from the sale of finance leases between financial institutions.

The abortive acquisition costs arose from negotiations to acquire the UK landfill and landfill gas operations of Shanks Group Plc where discussions were terminated on 25 May 2004.

The business restructuring costs arose in the water and sewerage segment.

The business disposal profit relates to the balance of proceeds due from the 1998 arrangement to dispose of the Group's interest in Societa Italo Britannica dell' Acqua Srl.

No tax charge arose from the business disposal profit.

10. 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 year, excluding those held in the employee share trust (note 30), which are treated as cancelled.

For diluted earnings per share, the weighted average number of ordinary shares in issue is adjusted to include all dilutive potential ordinary shares. The Group has two types of dilutive potential ordinary shares: those share options granted to employees where the exercise price is less than the average market price of the Company's ordinary shares during the year and the contingently issuable shares under the Group's Restricted Share Plan and the deferred shares element of the Performance Related Bonus Plan to the extent that the performance criteria for vesting of the awards are expected to be met.

A reconciliation of the weighted average number of shares and earnings used in the calculations is set out below.

	2006	2005
Number of shares (millions)		
For basic earnings per share	127.3	126.0
Effect of dilutive potential ordinary shares:		
Share options	1.1	0.9
For diluted earnings per share	128.4	126.9
Earnings per share from discontinued operations (in pence per share)		
– Basic	–	4.0
– Diluted	–	3.9

NOTES TO THE FINANCIAL STATEMENTS

10. EARNINGS PER SHARE *(continued)*

Adjusted basic and diluted earnings per share

Adjusted earnings per share have been calculated to exclude the impact of the exceptional items and deferred tax on the results, as these items can have a distorting effect on earnings from year to year and therefore warrant separate consideration. Adjusted earnings have been calculated:

	2006			2005		
	Profit after tax £m	Earnings per share Basic p	Earnings per share Diluted p	Profit after tax £m	Earnings per share Basic p	Earnings per share Diluted p
Earnings per share from continuing operations	37.8	29.7	29.4	60.6	48.1	47.8
Exceptional items (net of tax)	38.1	29.9	29.7	4.9	3.9	3.8
Deferred tax	20.2	15.9	15.7	15.6	12.3	12.3
Adjusted earnings per share from continuing operations	96.1	75.5	74.8	81.1	64.3	63.9

11. DIVIDENDS

	2006 £m	2005 £m
Amounts recognised as distributions to equity holders in the year:		
Interim dividend paid for the year ended 31 March 2005: 13.8p (2004: 13.2p) per share	17.7	16.4
Final dividend paid for the year ended 31 March 2005: 29.2p (2004 27.8p) per share	37.4	34.7
	55.1	51.1
Proposed dividends		
Proposed interim dividend for the year ended 31 March 2006: 16.5p (2005: 13.8p) per share	19.4	17.7
Proposed final dividend for the year ended 31 March 2006: 35.1p (2005: 29.2p) per share	41.6	37.4
	61.0	55.1

The proposed interim and final dividends have not been included as liabilities in these financial statements. The proposed interim dividend was paid on 13 April 2006 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting.

12. EMPLOYMENT COSTS

	2006 £m	2005 £m
<i>Employment costs comprise:</i>		
Wages and salaries	72.5	64.8
Social security costs	6.5	5.6
Pension costs	9.8	9.2
Share-based payments	1.7	1.5
Total employment costs	90.5	81.1
<i>Charged as follows:</i>		
Manpower costs:		
Before exceptional costs	79.9	68.3
Exceptional costs (note 9)	–	3.0
Capital schemes	10.0	9.8
Restructuring provision	0.6	–
Total employment costs	90.5	81.1

12. EMPLOYMENT COSTS *(continued)*

Details of Directors' emoluments are set out in note 13. There are no personnel other than Directors, who as key management exercise authority and responsibility for planning, directing and controlling the activities of the Group.

13. DIRECTORS' EMOLUMENTS

	2006 £000	2005 £000
Executive Directors:		
Salary	630	590
Performance related bonus payable	223	209
Vesting of Restricted Share Plan awards	276	607
Vesting of Performance Related Bonus Plan awards	199	–
Other emoluments	54	54
Payments in respect of tax liability from supplementary pension arrangements	148	108
Non-executive Directors	303	289
Total emoluments	1,833	1,857

The performance related bonus payable represents the cash element. In addition, Directors receive a conditional award of shares for a matching amount which is subject to a future service criterion.

Total gains made by Directors on the exercise of share options were nil (2005 £3,000).

Total emoluments include £828,000 (2005 £911,000) payable to Directors for services as directors of subsidiary undertakings.

At 31 March 2006 and 31 March 2005 retirement benefits were accruing to three Directors under defined pension schemes. The accrued pension entitlement at 31 March 2006 under defined benefit schemes of the highest paid Director was £81,000 (2005 £73,000). No pension contributions were payable to defined contribution schemes in 2006 or 2005.

More detailed information concerning Directors' emoluments, shareholdings and share options is shown in the Directors' remuneration report on pages 29 to 35.

NOTES TO THE FINANCIAL STATEMENTS

14. GOODWILL

	£m
Cost:	
At 1 April 2004	47.6
Recognised on acquisition of subsidiaries	16.8
At 1 April 2005	64.4
Recognised on acquisition of subsidiaries (note 36)	34.2
At 31 March 2006	
Carrying amount:	98.6
At 31 March 2005	64.4
At 31 March 2006	98.6

Goodwill acquired in a business combination is allocated at acquisition to the cash-generating unit (CGU) expected to benefit from that business combination. All of the carrying amount of goodwill is allocated to the waste management segment which is considered to be a single CGU, as it is an integrated business.

Goodwill is reviewed annually or when other events or changes in circumstances indicate that the carrying amount may not be fully recoverable.

The recoverable amount of the waste management segment is determined from value in use calculations. The key assumptions in those calculations relate to discount rates, cash flows, price increases and for landfill, the compaction rate. Cash flow projections are based on approved budgets and plans for the next five years and beyond this period on long-term growth rates for the waste sector based on GDP. The cash flows have been discounted using a pre-tax discount rate of 13%.

15. INTANGIBLE ASSETS

	Customer contracts £m	Patents £m	Total £m
<i>Acquired intangible assets</i>			
Cost:			
At 1 April 2004	–	–	–
Acquisitions	7.2	–	7.2
Additions	–	0.2	0.2
At 31 March 2005	7.2	0.2	7.4
Acquisitions	1.3	–	1.3
At 31 March 2006	8.5	0.2	8.7
Aggregate amortisation and impairment:			
At 1 April 2004	–	–	–
Charge for the year	1.4	–	1.4
At 31 March 2005	1.4	–	1.4
Charge for year	1.6	–	1.6
At 31 March 2006	3.0	–	3.0
Carrying amount:			
At 31 March 2005	5.8	0.2	6.0
At 31 March 2006	5.5	0.2	5.7



15. INTANGIBLE ASSETS (continued)

Customer contracts are amortised over the useful economic life of each contract which at acquisition ranged between 3 and 8 years. The average remaining life is 6 years.

Patents are amortised over their estimated useful economic lives which at acquisition was 13 years. The average remaining life is 11 years.

The carrying value of intangible assets are reviewed annually or when events or changes in circumstance indicate that the carrying amount may not be recoverable.

16. PROPERTY, PLANT & EQUIPMENT

	Land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Landfill restoration £m	Construction in progress £m	Total £m
Cost:							
At 1 April 2004	206.0	976.4	545.0	840.8	–	74.8	2,643.0
Arising on acquisitions	9.0	–	–	9.8	–	–	18.8
Additions	23.9	39.0	0.6	54.1	–	63.4	181.0
Grants and contributions	(0.3)	(2.8)	–	(5.8)	–	–	(8.9)
Disposals	(2.1)	–	(0.9)	(12.2)	–	(0.1)	(15.3)
Transfers/reclassifications	(3.8)	16.5	2.6	52.4	–	(67.7)	–
At 31 March 2005	232.7	1,029.1	547.3	939.1	–	70.4	2,818.6
Arising on acquisitions	18.4	–	–	5.1	3.1	–	26.6
Additions	26.7	56.4	3.5	66.8	–	96.3	249.7
Other (note 29)	–	–	–	–	32.3	–	32.3
Grants and contributions	–	(1.1)	–	(2.5)	–	–	(3.6)
Disposals	(13.1)	–	(5.8)	(68.7)	–	–	(87.6)
Transfers/reclassifications	0.6	23.6	12.3	30.3	–	(66.8)	–
At 31 March 2006	265.3	1,108.0	557.3	970.1	35.4	99.9	3,036.0
Depreciation:							
At 1 April 2004	80.4	–	108.6	333.4	–	–	522.4
Charge for year	15.1	11.6	9.7	55.7	–	–	92.1
Disposals	(2.1)	–	(0.9)	(11.4)	–	–	(14.4)
Transfers/reclassifications	(0.2)	–	(0.5)	0.7	–	–	–
At 31 March 2005	93.2	11.6	116.9	378.4	–	–	600.1
Charge for year	14.1	13.2	10.3	63.6	2.7	–	103.9
Disposals	(10.2)	–	(5.8)	(67.9)	–	–	(83.9)
At 31 March 2006	97.1	24.8	121.4	374.1	2.7	–	620.1
Net book value:							
At 31 March 2005	139.5	1,017.5	430.4	560.7	–	70.4	2,218.5
At 31 March 2006	168.2	1,083.2	435.9	596.0	32.7	99.9	2,415.9

Landfill restoration assets have been included following a change in accounting methodology, as described in note 4 to these financial statements.

Out of the total depreciation charge of £103.9 million (2005 £92.1 million), £1.4 million (2005 £1.4 million) has been charged to capital projects and £102.5 million (2005 £90.7 million) against profits.

Asset lives and residual values are reviewed annually.

NOTES TO THE FINANCIAL STATEMENTS

16. PROPERTY, PLANT & EQUIPMENT *(continued)*

Assets held under finance leases included above:

	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Total £m
Cost:					
At 31 March 2005	147.1	315.0	248.1	59.0	769.2
At 31 March 2006	188.2	318.8	261.2	147.2	915.4
Depreciation:					
At 31 March 2005	1.5	49.0	112.9	–	163.4
At 31 March 2006	13.7	54.6	126.5	–	194.8
Net book amount:					
At 31 March 2005	145.6	266.0	135.2	59.0	605.8
At 31 March 2006	174.5	264.2	134.7	147.2	720.6

17. TRADE AND OTHER RECEIVABLES NON-CURRENT

	2006 £m	2005 £m
Amounts owed by joint ventures	2.8	0.2
Other receivables	3.2	3.1
	6.0	3.3

The fair values of trade and other receivables are as follows:

	2006 £m	2005 £m
Amounts owed by joint ventures	4.8	0.2
Other receivables	3.3	3.2
	8.1	3.4

18. INVESTMENTS

	Shares £m	Loans £m	Total £m
Joint ventures			
At 1 April 2004	–	–	–
At 31 March 2005	–	–	–
Acquisitions	–	0.2	0.2
Additions	1.1	–	1.1
At 31 March 2006	1.1	0.2	1.3

Details of principal subsidiary and joint venture undertakings of the Group are set out in note 37.

The Group's share of the results of its joint ventures and its share of the joint ventures assets and liabilities are:

	Assets		Liabilities		Revenues £m	Profit £m
	Non-current £m	Current £m	Non-current £m	Current £m		
2005						
Echo South West Limited	0.2	0.7	(0.3)	(0.9)	4.5	0.1
2006						
Echo South West Limited	0.1	0.7	(0.1)	(0.9)	4.9	0.1
Lakeside Energy from Waste Holdings Limited	25.3	1.6	(25.7)	(1.5)	–	–
	25.4	2.3	(25.8)	(2.4)	4.9	0.1

19. INVENTORIES

	2006 £m	2005 £m
Raw materials and consumables	4.8	4.6
Work in progress	0.2	0.1
	5.0	4.7

20. TRADE AND OTHER RECEIVABLES – CURRENT

	2006 £m	2005 £m
Trade receivables	91.2	83.6
Less: provision for impairment of receivables	(27.6)	(19.7)
Trade receivables net	63.6	63.9
Amounts owed by joint ventures	1.1	1.1
Other receivables	4.6	10.1
Other prepayments and accrued income	25.2	24.5
	94.5	99.6

The Directors consider that the carrying amount of trade and other receivables approximates to their fair value.

NOTES TO THE FINANCIAL STATEMENTS

21. DERIVATIVE FINANCIAL INSTRUMENTS

	IFRS 2006 £m	UK GAAP 2005 £m
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Interest rate swaps – cash flow hedges:

Assets	3.1	–
Liabilities	(3.0)	–

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 2006 68% of net borrowings was at fixed rate (2005 69%).

At 31 March 2006 interest rate swaps to hedge financial liabilities with a notional principal value of £676.0 million existed, with a weighted average maturity of 3.5 years (2005 £365.0 million, with 2.4 years) to swap from floating to fixed rate. The weighted average interest rate of the swaps was 4.9% (2005 5.0%).

The amounts above are the fair value of swaps based on the market value of equivalent instruments at the balance sheet date. All the interest rate swaps are designated and effective as cash flow hedges and the fair values have been deferred in equity.

22. CASH AND CASH EQUIVALENTS

	2006 £m	2005 £m
Cash at bank and in hand	7.7	4.4
Short-term bank deposits	91.7	299.0
	99.4	303.4

The effective interest rate on short-term deposits was 4.7% (2005 4.9%) and these deposits have an average maturity of 3 days.

During the year restricted deposited funds of £177.1 million as at 31 March 2005, used to counter-indemnify letters of credit by financial institutions to lessors in order to secure rental obligations, were released (note 25).

23. TRADE AND OTHER PAYABLES – CURRENT

	2006 £m	2005 £m
Trade payables	93.8	61.2
Amounts owed to joint venture	0.4	0.4
Other tax and social security	24.8	19.2
Other payables	17.4	15.9
Accruals	33.5	31.1
Deferred income	0.2	–
	170.1	127.8

The Directors consider that the carrying amount of trade and other payables approximates to their fair value.

24. CURRENT TAX LIABILITIES

	2006 £m	2005 £m
Corporation tax	24.0	23.6



25. BORROWINGS

	2006 £m	2005 £m
Current		
Bank overdrafts	18.5	5.1
Short-term loans	0.1	0.1
European Investment Bank	4.2	14.7
Unsecured loan stock notes	3.9	5.6
	26.7	25.5
Obligations under finance leases	28.0	29.3
	54.7	54.8
Non-current		
Sterling bond	–	150.0
European Investment Bank	232.2	166.4
Bank loans	312.7	255.3
	544.9	571.7
Obligations under finance leases	926.9	795.1
	1,471.8	1,366.8
Total borrowings	1,526.5	1,421.6

The Sterling bond, due for repayment in February 2012, was retired in January 2006.

The Directors consider that the carrying amounts of current borrowings approximate to their fair value.

The fair value of the non-current borrowings are:

	2006		2005	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Sterling bond	–	–	150.0	196.1
European Investment Bank	232.2	226.9	166.4	163.2
Bank loans	312.7	312.7	255.3	255.3
	544.9	539.6	571.7	614.6
Obligations under finance leases	926.9	884.5	795.1	749.2
	1,471.8	1,424.1	1,366.8	1,363.8

Where market values are not available, fair values of borrowings have been calculated by discounting expected future cash flows at prevailing interest rates.

The exposure to interest rate changes and the re-pricing dates at the balance sheet date is:

	2006 £m	2005 £m
6 months or less	384.0	373.5
6 – 12 months	140.7	245.5
1 – 5 years	896.8	547.6
Over 5 years	105.0	255.0
	1,526.5	1,421.6

NOTES TO THE FINANCIAL STATEMENTS

25. BORROWINGS (continued)

The maturity of non-current borrowings is:

	2006 £m	2005 £m
Between 1 and 2 years	64.4	92.0
Between 2 and 5 years	150.4	297.9
Over 5 years	1,257.0	976.9
	1,471.8	1,366.8

The effective interest rates at the balance sheet date were:

	2006 %	2005 %
Bank overdrafts	5.5	5.7
Short-term loans	5.5	5.7
European Investment Bank	4.7	5.5
Unsecured loan stock notes	4.0	4.3
Sterling bond	–	10.6
Bank loans	4.9	5.3
Finance leases	3.8	3.9

Finance lease liabilities – minimum lease payments:

	2006 £m	2005 £m
Within one year	38.8	39.4
In the second to fifth years inclusive	219.1	191.3
After five years	1,379.2	1,172.0
	1,637.1	1,402.7
Less: future finance charges	(682.2)	(578.3)
	954.9	824.4

Included above are accrued finance charges arising on obligations under finance leases totalling £109.2 million (2005 £104.6 million), of which £23.8 million (2005 £22.7 million) is repayable within one year.

Within obligations under finance leases, South West Water Limited has utilised finance lease facilities of £180.0 million for certain water and sewerage business tangible fixed assets and had at 31 March 2005 deposited amounts equal to the present value of rental obligations arising from those finance leases, with United Kingdom financial institutions, to counter-indemnify the letters of credit issued by those financial institutions to the lessors in order to secure those rental obligations.

During the year, these deposited funds, which at 31 March 2005 totalled £177.1 million (including interest earned) were released. The existing bank letters of credit, covering the full period of the finance leases, remain in place, but are renewable between the financial institutions and South West Water Limited at five-yearly intervals, the next being March 2011.



25. BORROWINGS *(continued)*

The Group has undrawn committed borrowing facilities:

	2006 £m	2005 £m
Floating rate:		
Expiring within one year	50.0	–
Expiring after one year	160.0	240.0
	210.0	240.0

In addition, the Group has short-term uncommitted bank facilities of £90.0 million.

26. OTHER NON-CURRENT LIABILITIES

	2006 £m	2005 £m
Other creditors	2.2	19.1

27. RETIREMENT BENEFIT OBLIGATIONS

The Group operates a number of pension schemes including a defined contribution section within the main scheme. The assets of the Group's pension schemes are held in separate trustee administered funds.

Defined contribution schemes

Pension costs for defined contribution schemes were £0.5 million (2005 £0.3 million).

Defined benefit schemes

In the most recent actuarial valuation under IFRS of the Pennon Group Pension Scheme, the principal assumptions made by the qualified actuary were:

	2006 %	2005 %	2004 %
Rate of increase in pensionable pay	3.8	3.7	3.7
Rate of increase for present and future pensions	2.8	2.7	2.7
Rate used to discount schemes' liabilities	5.0	5.5	5.5
Inflation	2.8	2.7	2.7

The amounts recognised in the income statement were:

	2006 £m	2005 £m
Current service cost	(8.3)	(8.3)
Past service cost	(1.0)	(0.6)
Total included within employment costs (note 12)	(9.3)	(8.9)
Expected return on pension schemes' assets	17.8	14.0
Interest cost on retirement benefit obligations	(16.6)	(15.3)
Total included within net finance costs (note 7)	1.2	(1.3)
Total charge	(8.1)	(10.2)

The actual return on schemes' assets was £52.0 million (2005 £23.8 million).

NOTES TO THE FINANCIAL STATEMENTS

27. RETIREMENT BENEFIT OBLIGATIONS (continued)

The amounts recognised in the statement of recognised income and expense were:

	2006 £m	2005 £m
Actuarial (losses)/gains recognised in the year	(2.8)	1.9

The amounts recognised in the balance sheet were:

	2006 £m	2005 £m
Fair value of schemes' assets	317.5	223.8
Present value of defined benefit obligations	(359.2)	(303.6)
Net liability recognised in the balance sheet	(41.7)	(79.8)

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

	2006		2005		2004	
	Return %	Value £m	Return %	Value £m	Return %	Value £m
Equities	7.7	198.5	7.8	172.0	7.7	154.3
Property	7.7	14.9	4.8	5.3	–	–
Bonds	4.7	91.6	4.8	42.7	4.7	38.2
Other	4.7	12.5	4.8	3.8	4.3	8.4
		317.5		223.8		200.9

Movements in the balance sheet liability were:

	2006 £m	2005 £m
At 1 April	(79.8)	(77.5)
Income statement	(8.1)	(10.2)
Statement of recognised income and expenditure	(2.8)	1.9
Regular contributions	4.8	6.0
Prepayment of contributions	44.2	–
At 31 March	(41.7)	(79.8)

Movements in the fair value of schemes' assets were:

	2006 £m	2005 £m
At 1 April	223.8	200.9
Expected return on schemes' assets	17.8	14.0
Actuarial gains	34.2	9.8
Members' contributions	2.0	1.9
Benefits paid	(9.3)	(8.8)
Group regular contributions	4.8	6.0
Prepayment of Group regular contributions	44.2	–
At 31 March	317.5	223.8

27. RETIREMENT BENEFIT OBLIGATIONS *(continued)*

Movements in the present value of defined benefit obligations were:

	2006 £m	2005 £m
At 1 April	(303.6)	(278.4)
Service costs	(9.3)	(8.9)
Interest cost	(16.6)	(15.3)
Members' contributions	(2.0)	(1.9)
Benefits paid	9.3	8.8
Actuarial losses	(37.0)	(7.9)
At 31 March	(359.2)	(303.6)

The Group's transition date to IFRS was 1 April 2004 and the following historical data has been presented from that date. The historical data will be built up to a rolling five-year record over the next three years.

	2006 £m	2005 £m
Fair value of schemes' assets	317.5	223.8
Present value of defined benefit obligations	(359.2)	(303.6)
Net liability recognised	(41.7)	(79.8)
Experience gains on schemes' assets		
Amount (£m)	34.2	9.8
Percentage of schemes' assets	10.8%	4.4%
Experience losses on defined benefit obligations		
Amount (£m)	(37.0)	(7.9)
Percentage of defined benefit obligations	(10.3)%	(2.6)%

As a result of the prepayment of contributions made in 2006 no further Group regular contributions are expected to be paid to the schemes during the year ended 31 March 2007.

28. DEFERRED TAX LIABILITIES

Deferred tax is calculated in full on temporary differences under the liability method using a tax rate of 30% (2005 30%).

Movements on the deferred tax account were:

	2006 £m	2005 £m
At 1 April	282.8	263.9
Charged to the income statement	20.2	15.6
(Released)/charged to equity	(2.0)	0.3
Arising on acquisitions	1.8	3.0
At 31 March	302.8	282.8

Deferred tax assets have been recognised in respect of all temporary differences giving rise to deferred tax assets because it is probable that these assets will be recovered.

NOTES TO THE FINANCIAL STATEMENTS

28. DEFERRED TAX LIABILITIES *(continued)*

All deferred tax assets and liabilities are within the same jurisdiction and may be offset as permitted by IAS12. Movements in deferred tax assets and liabilities during the year were:

Deferred tax liabilities

	Accelerated tax depreciation £m	Other £m	Total £m
At 1 April 2004	275.6	21.6	297.2
Charged/(credited) to the income statement	18.9	(0.6)	18.3
Arising on acquisitions	(1.1)	4.7	3.6
At 31 March 2005	293.4	25.7	319.1
Charged/(credited) to the income statement	15.9	(1.3)	14.6
Arising on acquisitions	(3.2)	5.3	2.1
At 31 March 2006	306.1	29.7	335.8

Deferred tax assets

	Provisions £m	Retirement benefit obligations £m	Other £m	Total £m
At 1 April 2004	(9.5)	(23.3)	(0.5)	(33.3)
Charged/(credited) to the income statement	0.7	(1.2)	(2.2)	(2.7)
Charged/(credited) to equity	–	0.6	(0.3)	0.3
Arising on acquisitions	(0.6)	–	–	(0.6)
At 31 March 2005	(9.4)	(23.9)	(3.0)	(36.3)
Charged/(credited) to the income statement	2.0	12.2	(8.6)	5.6
Credited to equity	–	(0.8)	(1.2)	(2.0)
Arising on acquisitions	(0.3)	–	–	(0.3)
At 31 March 2006	(7.7)	(12.5)	(12.8)	(33.0)
Net deferred tax liability				
At 31 March 2005				282.8
At 31 March 2006				302.8

The deferred tax credited/(charged) to equity during the year was:

	2006 £m	2005 £m
Actuarial gains/(losses) on defined benefit schemes	0.8	(0.6)
Share-based payment (note 33)	1.2	0.3
	2.0	(0.3)

29. PROVISIONS FOR LIABILITIES AND CHARGES

	Environmental and landfill restoration £m	Restructuring £m	Other provisions £m	Total 2006 £m
At 1 April 2005	33.5	2.6	0.2	36.3
Charged to the income statement	4.3	0.9	–	5.2
Arising on acquisitions	9.3	–	–	9.3
Landfill restoration	32.3	–	–	32.3
Utilised during year	(2.8)	(2.3)	–	(5.1)
At 31 March 2006	76.6	1.2	0.2	78.0

A landfill restoration provision has been included following a change in accounting methodology with a matching addition of £32.3 million to tangible fixed assets, as described in note 4 and shown in note 16 to these financial statements.

The analysis of provisions between current and non-current is:

	2006 £m	2005 £m
Current	11.4	8.4
Non-current	66.6	27.9
	78.0	36.3

Environmental and landfill restoration provisions will be utilised over the period from 2007 to beyond 2050. The provisions have been established assuming current waste management technology based upon estimated costs at future prices which have been discounted to present value. The restructuring provision principally relates to severance costs which are expected to be incurred in the next financial year.

30. CALLED-UP SHARE CAPITAL

	2006 £m	2005 £m
Authorised		
143,325,090 Ordinary shares of £1.22 $\frac{1}{10}$ each	175.0	–
131,818,190 B Shares of £1.10 each (35,858,521 converted to Deferred Shares of £1.10 each) (2005 157,657,600 Ordinary shares of £1.11 each)	145.0	–
	–	175.0
Allotted, called-up and fully paid		
118,608,847 Ordinary shares of £1.22 $\frac{1}{10}$ each	144.8	–
35,858,521 Deferred Shares of £1.10 each (2005 127,944,340 Ordinary shares of £1.11 each)	39.4	–
	–	142.0
	184.2	142.0

Ordinary shares allotted during the year

	2006 number (Ordinary shares of £1.11 each) £1.22 $\frac{1}{10}$ each)	2005 number (Ordinary shares of £1.11 each)
In lieu of £21.0 million (2005 £22.8 million) cash under scrip dividend alternative	2,087,293	–
For consideration of £1.6 million under the Company's Sharesave Scheme (2005 £0.8 million)	314,962	5,683
Issued in respect of share options granted	116,886	–
	2,519,141	5,683
		3,659,561

NOTES TO THE FINANCIAL STATEMENTS

30. CALLED-UP SHARE CAPITAL (continued)

During the year a capital return to shareholders was made by way of the B Share Scheme amounting to £143.5 million, of which £39.4 million was by way of the initial dividend payment and £104.1 million was through share redemption. The B Shares which received the initial dividend were subsequently converted into Deferred Shares, redeemed at the close of business on 6 April 2006 for a total aggregate consideration of one pence and then were cancelled. At 31 March 2006, £39.4 million of the capital return via the B Share Scheme was outstanding and held in Share Capital and £5.7 million of the B Shares not redeemed until 6 April 2006 were held within other payables, note 23.

In addition, there was a consolidation of the Ordinary shares of the Company whereby for every 11 existing Ordinary shares of £1.11 each held on 17 February 2006, shareholders received 10 new Ordinary shares of £1.22 $\frac{1}{10}$ each. As a result, the number of Ordinary shares in issue was reduced by 11,860,317.

Employee share schemes

The Group 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 executive 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 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 certain specific circumstances such as redundancy, lapse if the employee leaves the Group before the option exercise period commences.

Outstanding options to subscribe for shares of £1.22 $\frac{1}{10}$ each under the Company's share option schemes are:

Nature of scheme	Date granted and subscription price fully paid		Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March	
				2006	2005
Sharesave	7 July 1998	775p	2001 – 2005	–	8
	6 July 1999	825p	2002 – 2006	6	6
	5 July 2000	461p	2003 – 2007	67	258
	4 July 2001	489p	2004 – 2008	60	63
	9 July 2002	566p	2005 – 2009	82	198
	8 July 2003	530p	2006 – 2010	417	441
	6 July 2004	601p	2007 – 2011	284	308
	5 July 2005	810p	2008 – 2012	239	–
				1,155	1,282

At 31 March 2006 there were 1,121 participants in the Sharesave Scheme (2005 1,133).

The number and weighted average exercise price of Sharesave options are:

	2006		2005	
	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 1 April	1,282	540	1,208	524
Granted	248	810	323	601
Exercised	(321)	508	(163)	514
Expired	(54)	587	(86)	558
At 31 March	1,155	603	1,282	540

The weighted average price at the date of exercise of Sharesave options during the year was 1,034p (2005 827p). The options outstanding at 31 March 2006 had a weighted average exercise price of 603p (2005 540p) and a weighted average remaining contractual life of 2.0 years (2005 2.1 years).

30. CALLED-UP SHARE CAPITAL *(continued)*

Employee share schemes *(continued)*

i) *Savesave Scheme (continued)*

The aggregate fair value of options granted during the year was £0.6 million (2005 £0.5 million), determined using the Black-Scholes valuation model. The significant inputs into the valuation model were:

	2006	2005
Weighted average share price	779p	654p
Weighted average exercise price	623p	523p
Expected volatility	23.7%	25.0%
Expected life	3.9 years	3.8 years
Risk-free rate	4.5%	4.6%
Expected dividend yield	4.2%	5.5%

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

ii) *Long-term incentive plan*

Under this plan, Executive Directors and senior management receive a conditional award of shares in the Company. 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:

	2006		2005	
	Number of Ordinary shares (thousands)	Weighted average price per share p	Number of Ordinary shares (thousands)	Weighted average price per share p
At 1 April	512	738	390	585
Granted	141	1,070	305	810
Vested	(75)	638	(183)	610
Lapsed	(84)	638	–	–
Share consolidation	(45)	–	–	–
At 31 March	449	861	512	738

The awards outstanding at 31 March 2006 had a weighted average price of 861p (2005 738p) and a weighted average remaining contractual life of 1.7 years (2005 1.8 years). The Company's share price at the date of the awards ranged from 585p to 1,070p.

The aggregate fair value of awards granted during the year was £0.9 million (2005 £1.6 million), determined using a Monte-Carlo simulation model. The significant inputs into the valuation model were:

	2006	2005
Weighted average share price	861p	779p
Expected volatility	23.6%	25.0%
Risk-free rate	4.6%	4.8%

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

NOTES TO THE FINANCIAL STATEMENTS

30. CALLED-UP SHARE CAPITAL *(continued)*

Employee share schemes *(continued)*

iii) Performance Related Bonus Plan

Awards under the plan to Executive Directors and senior management involve the release of Ordinary shares in the Company to participants, usually conditional upon continuous service with the Group for a period of three years from the award.

The number and weighted average price of shares in the performance related bonus plan are:

	2006		2005	
	Number of Ordinary shares (thousands)	Weighted average price per share p	Number of Ordinary shares (thousands)	Weighted average price per share p
At 1 April	178	696	118	652
Granted	62	984	62	778
Vested	(54)	652	–	–
Lapsed	(3)	652	(2)	652
Share consolidation	(16)	–	–	–
At 31 March	167	806	178	696

The awards outstanding at 31 March 2006 had a weighted average price of 806p (2005 696p) and a weighted average remaining contractual life of 1.5 years (2005 2.2 years). The Company's share price at the date of the awards ranged from 652p to 984p.

The aggregate fair value of awards granted during the year was £0.6 million (2005 £0.5 million), determined from market value. No option pricing issues arise as dividends declared on the shares are receivable by the participants in the scheme.

Options granted to Directors, included above, are shown in the Directors' remuneration report on pages 29 to 35.

31. SHARE PREMIUM ACCOUNT

	£m
At 1 April 2004	154.2
Adjustment for shares issued under the scrip dividend alternative	(3.5)
Premium on shares issued for cash consideration	3.0
At 31 March 2005	153.7
Adjustment for shares issued under the scrip dividend alternative	(2.3)
Premium on shares issued	2.3
Utilised on creation of 130,463,483 B Shares of £1.10 each	(143.5)
At 31 March 2006	10.2

32. CAPITAL REDEMPTION RESERVE

	£m
At 1 April 2004	–
At 31 March 2005	–
Transferred from retained earnings on redemption of 89,404,091 B Shares of £1.10 each	98.4
At 31 March 2006	98.4

33. RETAINED EARNINGS AND OTHER RESERVES

	Hedging reserve £m	Own shares £m	Retained earnings £m	Total £m
At 1 April 2004	–	(4.7)	380.5	375.8
Profit for the year	–	–	65.6	65.6
Other recognised income and expense for the year	–	–	1.3	1.3
Adjustment for shares issued under the scrip dividend alternative	–	–	22.8	22.8
Dividends paid	–	–	(51.1)	(51.1)
Goodwill on previously acquired business	–	–	(0.2)	(0.2)
Adjustment in respect of share-based payment	–	–	1.5	1.5
Deferred tax in respect of share-based payment	–	–	0.3	0.3
Own shares issued to the Pennon Employee Share Trust				
in respect of share options granted	–	(2.8)	–	(2.8)
Adjustment in respect of share options vesting	–	1.6	(1.6)	–
At 31 March 2005	–	(5.9)	419.1	413.2
Adjustments on adoption of IAS32/39 1 April 2005	(0.9)	–	9.5	8.6
Profit for the year	–	–	37.8	37.8
Other recognised income and expense for the year	1.0	–	(2.0)	(1.0)
Adjustment for shares issued under the scrip dividend alternative	–	–	21.0	21.0
Dividends paid	–	–	(55.1)	(55.1)
Adjustment in respect of share-based payment	–	–	1.7	1.7
Deferred tax in respect of share-based payment	–	–	1.2	1.2
Own shares issued to the Pennon Employee Share Trust				
in respect of share options granted	–	(1.2)	–	(1.2)
Adjustment in respect of share options vesting	–	1.1	(1.1)	–
B Share payments	–	–	(137.8)	(137.8)
At 31 March 2006	0.1	(6.0)	294.3	288.4

The own shares reserve represents the cost of shares in Pennon Group Plc issued to or purchased in the market and held by the Pennon Employee Share Trust to satisfy awards under the Group's Long Term Incentive Plan and Performance Related Bonus Plan.

During the year, 117,000 of the Company's Ordinary shares of £1.11 each were issued to the trustees of the Employee Share Ownership Plan, financed through non-interest bearing advances made by sponsoring group companies (2005 345,000).

The market value of the 616,000 Ordinary shares of £1.22¹/₁₀ each (2005 690,000 Ordinary shares of £1.11 each) held by the trust at 31 March 2006 was £8.3 million (2005 £6.7 million).

The B Share payments of £137.8 million comprise £98.4 million for shares redeemed and £39.4 million for amounts paid as dividend.

NOTES TO THE FINANCIAL STATEMENTS

34. CASH FLOW FROM OPERATING ACTIVITIES

Reconciliation of operating profit to cash generated from operations:

Cash generated from operations

	2006 £m	2005 £m
Continuing operations		
Profit for the year	37.8	60.6
Adjustments for:		
Employee share schemes	1.7	1.5
Deferred income released to profits	(0.3)	(0.2)
Profit on disposal of property, plant and equipment	(1.1)	(1.4)
Depreciation charge	102.5	90.7
Amortisation of intangible assets	1.6	1.4
Share of post-tax profit from joint venture	(0.1)	(0.1)
Interest payable and similar charges	147.0	89.3
Interest receivable	(40.4)	(27.3)
Taxation	16.3	23.5
Changes in working capital (<i>excluding the effect of acquisition of subsidiaries</i>)		
Increase in inventories	(0.3)	(0.2)
Decrease/(increase) in trade and other receivables	2.0	(0.9)
Decrease in long-term deposits	–	(3.5)
Increase in trade and other payables	8.4	8.5
(Decrease)/increase in retirement benefit obligations	(39.7)	2.9
Decrease in provisions for liabilities and charges	(3.3)	(2.4)
Cash generated from operations	232.1	242.4

35. NET BORROWINGS

	2006 £m	2005 £m
Cash and cash equivalents	99.4	303.4
<i>Borrowings – current</i>		
Bank overdrafts	(18.5)	(5.1)
Other current borrowings	(8.2)	(20.4)
Finance lease obligations	(28.0)	(29.3)
Total current borrowings	(54.7)	(54.8)
<i>Borrowings – non current</i>		
Bank loans	(312.7)	(255.3)
Other non-current borrowings	(232.2)	(316.4)
Finance lease obligations	(926.9)	(795.1)
Total non-current borrowings	(1,471.8)	(1,366.8)
Total net borrowings	(1,427.1)	(1,118.2)

36. ACQUISITIONS

On 21 June 2005 the entire issued share of Brett Waste Management Limited (now renamed Viridor Waste Kent Limited) was purchased by Viridor Waste Management Limited for a cash consideration of £44.7 million, including costs of £0.3 million. The acquisition has been accounted for using the acquisition method.

Viridor Waste Kent Limited contributed revenues of £21.3 million and net profit of £3.4 million for the period from 21 June 2005 to 31 March 2006. If the acquisition had occurred on 1 April 2005, Group revenues for the year would have been £28.2 million and profit for the year would have been £4.4 million. These amounts have been calculated after applying the Group's accounting policies and adjusting the results to reflect the fair value adjustments as if they had applied from 1 April 2005.

All intangible assets have been recognised at their respective fair values. The residual excess over the net assets acquired has been recognised as goodwill. The goodwill is attributed to the profitability of the acquired business and the anticipated future operating synergies arising from the combination.

	Book value £m	Fair value adjustment £m	Fair value £m
Intangible fixed assets	–	1.3	1.3
Property, plant and equipment	26.9	(0.3)	26.6
Investment in joint venture	0.2	–	0.2
Inventories	0.3	(0.3)	–
Receivables	5.4	(0.2)	5.2
Payables	(7.0)	–	(7.0)
Provisions – environmental	(8.1)	(1.2)	(9.3)
Taxation – current	–	(2.0)	(2.0)
Taxation – deferred	0.5	(2.3)	(1.8)
Loans	(2.7)	–	(2.7)
Net assets acquired	15.5	(5.0)	10.5
Goodwill			34.2
Total consideration			44.7
Satisfied by:			
Cash			44.4
Directly attributable costs			0.3
			44.7

NOTES TO THE FINANCIAL STATEMENTS

36. ACQUISITIONS (continued)

Net cash outflow arising on acquisition

	£m
Cash consideration	44.7

The intangible assets acquired as part of the acquisition relate to customer contracts.

On 30 September 2005, Viridor Waste Management Limited acquired 50% of the entire issued share capital of Lakeside Energy from Waste Limited for a cash consideration of £1.1 million. The joint venture has been accounted for using the equity method.

On 21 December 2005, Viridor Waste Management Limited acquired 50% of the entire issued share capital of Lakeside Energy from Waste Holdings Limited in return for its 50% interest in Lakeside Energy from Waste Limited. Neither company has traded in the year.

Lakeside Energy from Waste Limited is constructing an energy from waste plant which is expected to be operational in 2008.

On 13 May 2006, the entire share capital of Wyvern Waste Services Limited (now renamed Viridor Waste (Somerset) Limited) was purchased by Viridor Waste Management Limited for a cash consideration of £25.0 million before costs. The acquisition will be accounted for using the acquisition method. Provisional goodwill of £9.9 million and intangible assets of £7.5 million will be capitalised. The intangible fixed assets will be amortised evenly over the Directors' estimate of their useful economic life. Cash balances on acquisition amounted to £3.0 million. This acquisition will be accounted for in the 2006/07 financial year.

37. PRINCIPAL SUBSIDIARY AND JOINT VENTURE UNDERTAKINGS AT 31 MARCH 2006

	Country of incorporation, registration and principal operations
Water and sewerage	
South West Water Limited*	England
Peninsula Leasing Limited	England
Peninsula Properties (Exeter) Limited	England
Waste management	
Viridor Limited*	England
Viridor Waste Limited	England
Viridor Waste Disposal Limited	England
Viridor Waste Exeter Limited	England
Dragon Waste Limited	England
Viridor Waste Management Limited	England
Viridor EnviroScot Limited	Scotland
Viridor Glass Recycling Limited	England
Viridor Parkwood Holdings Limited	British Virgin Islands †
Parkwood Group Limited	England
Viridor Waste Kent Limited	England
Viridor Waste (Landfill Restoration) Limited	England
Viridor Waste (Bristol Holdings) Limited	England
Viridor Waste (Bristol) Limited	Scotland
Viridor Waste Suffolk Limited	England
Viridor Waste (Thames) Limited	England
Viridor Waste (West Sussex) Limited	England
Other	
Peninsula Insurance Limited*	Guernsey
Peninsula Water Limited*	England

* Indicates the shares are held directly by Pennon Group Plc, the Company.

† Operations are carried out in England.

37. PRINCIPAL SUBSIDIARY AND JOINT VENTURE UNDERTAKINGS *(continued)*

During the year Viridor Limited was acquired as a dormant company with an issued share capital of £2. In consideration for the Company's investment in Viridor Waste Limited of £195.2 million, a further share was allotted to the Company.

All shares in issue are Ordinary shares. The subsidiary undertakings are wholly-owned, except Dragon Waste Limited where 81% of the Ordinary shares are held by Viridor Waste Exeter Limited, a wholly-owned subsidiary of Viridor Waste Limited. All companies above are consolidated in the Group financial statements.

Joint ventures

Both joint ventures and the subsidiary of Lakeside Energy from Waste Holdings Limited are incorporated and registered in England which is also their country of operation.

	Share capital in issue	Percentage held	Activity
Echo South West Limited	100,000 A Ordinary shares 100,000 B Ordinary shares	100% –	Customer contact management
Shares in Echo South West Limited are held by South West Water Limited.			
Lakeside Energy from Waste Holdings Limited	1,000,000 A Ordinary shares 1,000,000 B Ordinary shares	– 100%	Waste management
Lakeside Energy from Waste Limited			

Shares in Lakeside Energy from Waste Holdings Limited are held by Viridor Waste Management Limited.

38. OPERATING LEASE COMMITMENTS – MINIMUM LEASE PAYMENTS

	2006 £m	2005 £m
Commitments under non-cancellable operating leases expiring:		
Within one year	0.5	0.4
Later than one year and less than five years	1.5	1.0
After five years	2.4	2.2
	4.4	3.6

The group leases various offices, warehouses under non-cancellable operating lease agreements. The leases have various terms, escalation clauses and renewal rights. The Group also leases plant and machinery under non-cancellable operating lease agreements.

39. CONTINGENT LIABILITIES

	2006 £m	2005 £m
Guarantees:		
Performance bonds	80.8	60.2
Letters of credit	7.6	–
Other	6.9	6.9
	95.3	67.1

Guarantees in respect of performance bonds are entered into in the normal course of business. No liability is expected to arise in respect of the guarantees.

The guarantee in respect of letters of credit has been given by Viridor Waste Limited in support of the borrowings of the joint venture of Viridor Waste Management Limited, Lakeside Energy from Waste Holdings Limited. In addition, Viridor Waste Management Limited has given a commitment to supply 200,000 tonnes of waste per annum (or pay market-price based compensation) to the energy from waste plant of the joint venture. The plant is expected to be commissioned by July 2008. The Directors consider that the committed waste volume will be available in the ordinary course of business.

Other contingent liabilities relate to a possible obligation to pay further consideration in respect of a previously acquired business when the outcome of planning applications is known.

NOTES TO THE FINANCIAL STATEMENTS

40. CAPITAL COMMITMENTS

	2006 £m	2005 £m
Contracted but not provided	66.6	46.1
Share of commitment contracted but not provided by joint venture	64.2	–
	130.8	46.1

41. RELATED PARTY TRANSACTIONS

During the year, group companies entered into the following transactions with joint ventures:

	2006 £m	2005 £m
<i>Sales of goods and services</i>		
Echo South West Limited	2.5	2.5
<i>Purchase of goods and services</i>		
Echo South West Limited	9.0	8.0

Year end balances

	2006 £m	2005 £m
<i>Receivables due from related parties (notes 17 and 20)</i>		
Echo South West Limited	1.2	1.3
Lakeside Energy from Waste Limited	2.7	–
	3.9	1.3
<i>Payables due to related parties (note 23)</i>		
Echo South West Limited	0.4	0.4

All amounts relate to trading balances except for £2.8 million of loans included within receivables due for repayment in instalments between 2009 and 2030. Interest is charged at 6% until 2008 then 15% thereafter.

42. EXPLANATION OF TRANSITION TO IFRS

Pennon Group Plc reported under UK GAAP in its previously published financial statements for the year ended 31 March 2005. The analysis opposite shows a reconciliation of net assets and profit as reported under UK GAAP as at 31 March 2005 to the revised net assets and profit under IFRS as reported in these financial statements. In addition, there is a reconciliation of net assets under UK GAAP to IFRS at the transition date, which for the Group was 1 April 2004.

42. EXPLANATION OF TRANSITION TO IFRS (continued)

i) Consolidated balance sheet

Reconciliation at 31 March 2005

	Reported under UK GAAP £m	Impact of IFRS						IFRS £m
		IFRS 3 Goodwill £m	IAS 10 Dividend £m	IAS 12 Tax £m	IAS 16 Infrastructure renewals £m	IAS 19 Pensions £m	Other £m	
Assets								
Non-current assets								
Goodwill	63.0	1.0					0.4	64.4
Intangible assets	0.2	5.8						6.0
Property, plant and equipment	2,248.1				(5.6)		(24.0)	2,218.5
Trade and other receivables	3.3							3.3
	2,314.6	6.8	–	–	(5.6)	–	(23.6)	2,292.2
Current assets								
Inventories	4.7							4.7
Trade and other receivables	99.6							99.6
Cash and cash equivalents	303.4							303.4
	407.7	–	–	–	–	–	–	407.7
Liabilities								
Current liabilities								
<i>Financial liabilities</i>								
Borrowings	(54.8)							(54.8)
Trade and other payables	(192.5)		55.1			4.0	5.6	(127.8)
Current tax liabilities	(23.6)							(23.6)
Provisions for liabilities and charges	(8.4)							(8.4)
	(279.3)	–	55.1	–	–	4.0	5.6	(214.6)
Net current assets	128.4	–	55.1	–	–	4.0	5.6	193.1
Non-current liabilities								
<i>Financial liabilities</i>								
Borrowings	(1,366.8)							(1,366.8)
Other non-current liabilities	(37.8)						18.7	(19.1)
Retirement benefit obligations	–					(79.8)		(79.8)
Deferred tax liabilities	(72.4)	(4.7)		(230.2)		23.9	0.6	(282.8)
Provisions for liabilities and charges	(27.9)							(27.9)
	(1,504.9)	(4.7)	–	(230.2)	–	(55.9)	19.3	(1,776.4)
Net assets	938.1	2.1	55.1	(230.2)	(5.6)	(51.9)	1.3	708.9
Shareholders' equity								
Share capital	142.0							142.0
Share premium account	153.7							153.7
Retained earnings and other reserves	642.4	2.1	55.1	(230.2)	(5.6)	(51.9)	1.3	413.2
Total shareholders' equity	938.1	2.1	55.1	(230.2)	(5.6)	(51.9)	1.3	708.9

The UK GAAP balances have been restated in IFRS format.

NOTES TO THE FINANCIAL STATEMENTS

42. EXPLANATION OF TRANSITION TO IFRS (continued)

ii) Consolidated income statement

Reconciliation for the year ended 31 March 2005

	Reported under UK GAAP £m	Impact of IFRS					IFRS £m
		IFRS 3 Goodwill £m	IAS 12 Tax £m	IAS 16 Infrastructure renewals £m	IAS 19 Pensions £m	Other £m	
<i>Continuing operations</i>							
Revenue	554.2					(2.8)	551.4
Operating costs							
Manpower costs	(73.1)				4.7	0.1	(68.3)
Raw materials and consumables used	(32.8)						(32.8)
Other operating expenses	(201.7)			(7.3)		1.7	(207.3)
Depreciation	(95.1)			3.3		1.1	(90.7)
Amortisation of intangibles	(3.5)	2.1					(1.4)
Abortive acquisition costs	(1.5)						(1.5)
Business restructuring costs	(3.4)						(3.4)
Operating profit	143.1	2.1	–	(4.0)	4.7	0.1	146.0
Operating profit before depreciation amortisation exceptional items	246.6	–	–	(7.3)	4.7	(1.0)	243.0
Operating profit before exceptional items	148.0	2.1	–	(4.0)	4.7	0.1	150.9
Abortive acquisition costs	(1.5)						(1.5)
Business restructuring costs	(3.4)						(3.4)
Operating profit	143.1	2.1	–	(4.0)	4.7	0.1	146.0
Interest payable and similar charges	(74.0)				(15.3)		(89.3)
Interest receivable	13.3				14.0		27.3
Share of post-tax profit from joint venture	0.1						0.1
Profit before tax	82.5	2.1	–	(4.0)	3.4	0.1	84.1
Tax on profit on ordinary activities	(18.7)		(6.2)		1.2	0.2	(23.5)
Profit for the year from continuing operations	63.8	2.1	(6.2)	(4.0)	4.6	0.3	60.6
<i>Discontinued operations</i>							
Post-tax business disposal profit	5.0						5.0
Profit for the year	68.8	2.1	(6.2)	(4.0)	4.6	0.3	65.6
Profit attributable to equity shareholders	68.8	2.1	(6.2)	(4.0)	4.6	0.3	65.6

The UK GAAP balances have been restated in IFRS format.

42. EXPLANATION OF TRANSITION TO IFRS (continued)

iii) Consolidated balance sheet

Reconciliation at 1 April 2004

	Reported under UK GAAP £m	IAS 10 Dividend £m	IAS 12 Tax £m	Impact of IFRS IAS 16 Infrastructure renewals £m	IAS 19 Pensions £m	Other £m	IFRS £m
Non-current assets							
Goodwill	47.6						47.6
Property, plant and equipment	2,141.1			(1.6)		(18.9)	2,120.6
Trade and other receivables	7.0				(3.9)		3.1
	2,195.7	–	–	(1.6)	(3.9)	(18.9)	2,171.3
Current assets							
Inventories	4.5						4.5
Trade and other receivables	92.3				(0.7)		91.6
<i>Financial assets</i>							
Available for sale investments	4.2						4.2
Cash and cash equivalents	264.1						264.1
	365.1	–	–	–	(0.7)	–	364.4
Liabilities							
Current liabilities							
<i>Financial liabilities</i>							
Borrowings	(107.0)						(107.0)
Trade and other payables	(170.9)	51.1			1.0	1.5	(117.3)
Current tax liabilities	(15.7)						(15.7)
Provisions for liabilities and charges	(9.0)						(9.0)
	(302.6)	51.1	–	–	1.0	1.5	(249.0)
Net current assets	62.5	51.1	–	–	0.3	1.5	115.4
Non-current liabilities							
<i>Financial liabilities</i>							
Borrowings	(1,234.8)						(1,234.8)
Other non-current liabilities	(38.8)					17.9	(20.9)
Retirement benefit obligations	–				(77.5)		(77.5)
Deferred tax liabilities	(63.3)		(224.0)		23.3	0.1	(263.9)
Provisions for liabilities and charges	(21.7)						(21.7)
	(1,358.6)	–	(224.0)	–	(54.2)	18.0	(1,618.8)
Net assets	899.6	51.1	(224.0)	(1.6)	(57.8)	0.6	667.9
Shareholders' equity							
Share capital	137.9						137.9
Share premium account	154.2						154.2
Retained earnings and other reserves	607.5	51.1	(224.0)	(1.6)	(57.8)	0.6	375.8
Total shareholders' equity	899.6	51.1	(224.0)	(1.6)	(57.8)	0.6	667.9

The UK GAAP balances have been restated in IFRS format.

42. EXPLANATION OF TRANSITION TO IFRS *(continued)*

iv) Notes to the reconciliation of net assets and profit

First time adoption

IFRS 1 "First-time Adoption of International Financial Reporting Standards" requires that IFRS be applied retrospectively unless a specific exemption is applied. In preparing these financial statements, the Group has adopted the following exemptions:

- not to apply IFRS 3 "Business Combinations" retrospectively to past business combinations;
- to establish a deemed cost for the opening balance sheet carrying value of the water and waste water infrastructure fixed assets by reference to the fair value of these assets at the date of transition to IFRS, 1 April 2004. All non-infrastructure assets have been carried forward on transition using the depreciated historical cost UK GAAP balances as the deemed IFRS costs;
- to recognise all cumulative actuarial gains and losses relating to defined benefit pension schemes at the date of transition;
- not to apply the requirements of IFRS 2 "Share-Based Payment" to options granted under the Group's share incentive schemes prior to 7 November 2002.

Property, plant and equipment

UK GAAP (FRS 15) permitted the use of "renewals accounting" as a method for estimating depreciation on infrastructure assets and was adopted by the UK water industry. The depreciation charge represented the level of annual expenditure required to maintain the operating capacity of the infrastructure network at a specified level of service potential by the continuing replacement and refurbishment of its components. South West Water used an independently certified Asset Management Plan to determine the level of annual expenditure required.

IFRS does not permit the use of renewals accounting. Instead, infrastructure assets are capitalised and depreciated over the estimated useful lives of major components.

Infrastructure assets in the opening balance sheet under IFRS have consequently been restated from their existing UK GAAP net book value. In accordance with the first time adoption rules set out in IFRS 1, fair value has been used as deemed cost of the infrastructure assets on restatement. This value is depreciated over the estimated remaining asset life.

Shareholders' equity at 31 March 2004 has not been significantly affected since the opening fair value of infrastructure assets under IFRS in South West Water Limited was close to the net book value under UK GAAP.

Reported operating profit for the year ended 31 March 2005 has been reduced by £4 million as a result of calculating specific depreciation compared to the previous normative long-term charge based upon the 1999 Periodic Review Asset Management Plan.

However, the revised total infrastructure depreciation cost of £19 million for 2004/05 is £2 million lower than the level of infrastructure renewals charge assumed by Ofwat in the Final Determination for 2005/06.

The Group has also reclassified all grants and contributions received for non-infrastructure assets to property, plant and equipment, totalling £19 million.

42. EXPLANATION OF TRANSITION TO IFRS *(continued)*

iv) Notes to the reconciliation of net assets and profit (continued)

Retirement benefits

Under UK GAAP (SSAP 24) the pensions charge was established by reference to the triennial valuation of the Group's pension schemes and was set at a level amount to recognise both the on-going service cost and the spreading of any actuarial surplus or deficit over the expected average employee remaining service lives.

Under IFRS (IAS 19) only the on-going service cost is charged against operating profit. A net financing cost or credit to reflect expected interest on liabilities and asset investment return is included within interest payable or receivable. An annual update of the valuation of scheme assets and liabilities will take place, and any movements in the total actuarial gains or losses are to be recognised in the IFRS Statement Of Recognised Income and Expenditure (SORIE).

The gross pension deficit, £80 million at 31 March 2005, is shown as a balance sheet liability, with the related deferred tax asset, £24 million, netted within the deferred tax liability.

The recognition of the pension deficit (net of deferred tax) and other pension adjustments under IFRS, reduced shareholders' equity by £58 million at 1 April 2004 and £52 million at 31 March 2005. Reported profit before tax increased by £3 million, principally due to the pension charge no longer containing an element of deficit recovery.

Acquisition accounting, goodwill and intangibles

Under UK GAAP, goodwill arising on acquisitions was amortised over its useful life, assessed by the Directors as being 20 years. No separately identifiable intangible assets were included in the fair values established for acquisitions.

Under IFRS (IFRS 3) a wider range of potential intangible assets arising on acquisition is required to be considered, identified and amortised according to the useful lives of the individual components.

In addition, the amortisation of goodwill is not permitted, but all goodwill balances are subject to an annual test for impairment by comparing the carrying values of assets to their recoverable amounts, being the higher of value-in-use (discounted cash flows arising from future use of those assets for identifiable cash generating units) and fair value less costs of sale.

Shareholders' equity at 1 April 2004 was not affected since the Group is bringing forward historic balances (as allowed under the IFRS 1 exemption referred to above).

The 2004/05 reported operating profit was increased by a net £2 million, comprising the elimination of goodwill amortisation, £3 million, partially offset by a charge of £1 million for the amortisation of intangible assets acquired under the purchase of Thames Waste Management Limited. No impairment charge was required in 2004/05 in relation to the goodwill balances recorded.

NOTES TO THE FINANCIAL STATEMENTS

42. EXPLANATION OF TRANSITION TO IFRS *(continued)*

iv) Notes to the reconciliation of net assets and profit (continued)

Deferred taxation

Under UK GAAP the Group created a discounted provision for deferred taxation, as allowed under FRS 19, to reflect an assessment of the period over which timing differences are expected to reverse.

Under IFRS a discounting methodology is not permitted and consequently the deferred tax provision increases, with a commensurate reduction to shareholders' equity, as indicated below:

	31 March 2005 £m	31 March 2004 £m
Discounted provision – UK GAAP	72	63
Undiscounted provision – IFRS	283	264
Increase in provision	211	201

Other significant deferred tax effects arise from the recognition under IFRS of deferred tax on property revalued at the time of acquisitions by Viridor Waste, £13 million, and the recognition of the pension deficit in the balance sheet, as outlined above in the retirement benefits note.

The amount of deferred tax charged against 2004/05 profits increased from £11 million under UK GAAP to £16 million under IFRS, primarily through the impact of not discounting liabilities.

The significant on-going level of capital expenditure projected for the Group's operations means that actual payment of tax is expected to continue to be deferred through the creation of further timing differences.

Dividends payable

Under UK GAAP dividends payable were recognised in the profit and loss account for the period to which they related.

Under IFRS (IAS 10) dividends are only recognised when there is a legal or constructive obligation for them to be paid. Dividends on equity instruments are therefore recognised under IFRS as follows:

- Final dividends – when authorised by shareholders at the Annual General Meeting.
- Interim dividends – when paid, as they are revocable and discretionary until that time.

Shareholders' equity is consequently increased at the balance sheet date by £51 million at 1 April 2004, and by £55 million at 31 March 2005 as a result of adding-back, for each of the 2003/04 and 2004/05 financial years, the final dividend not authorised until after the year end and the interim dividend not paid until after the year end.

Other differences

All other differences between IFRS and UK GAAP are included within the "Other" column, with the principal adjustment to profit before taxation being the impact of fair valuing shares awarded under employee share options granted under the Group's share schemes after 7 November 2002. The fair value cost of shares awarded is charged to the income statement over the vesting period, in accordance with IFRS 2.

42. EXPLANATION OF TRANSITION TO IFRS *(continued)*

iv) Notes to the reconciliation of net assets and profit (continued)

Financial instruments

IFRS 1 permits the Group to continue to apply UK GAAP in respect of financial instruments for the year ended 31 March 2005 and to apply IAS 32 and 39 with effect from 1 April 2005. The comparative information for 2004/05 within the 31 March 2006 IFRS financial statements therefore reflects financial instruments accounted for according to existing UK GAAP accounting policies.

The Group uses derivative financial instruments, principally interest rate swaps, to manage the mix of fixed and floating rate debt. Relatively low interest rates resulted in the Group fixing 70% of existing net debt at March 2005.

Under UK GAAP, debt is initially recorded as the net proceeds of issue. In subsequent periods, this is adjusted for accrued finance costs and payments made. The fair values of derivatives are not recognised in the balance sheet, but are disclosed in the notes to the financial statements.

Under IAS 39, debt is carried at amortised cost, whilst derivatives are recognised separately on the balance sheet at fair value with movements in those fair values reflected through the income statement. In the case of cash flow hedges, movements in the fair value of derivatives are deferred within reserves until they can be recycled through the income statement to offset the future income statement effect of changes in the hedged risk.

In order to apply this treatment, it must be demonstrated that the derivative has been, and will continue to be, an effective hedge of the hedged risk in the underlying debt within the criteria set out in IAS 39. Any hedge ineffectiveness outside the range deemed acceptable by IAS 39 is recognised immediately within the income statement. At 1 April 2005, the Group held interest rate swaps as hedges against its exposure to interest rate fluctuations for periods up to 2010. The swap portfolio is designed to hedge the debt portfolio and provide an overall effective economic hedge. The swaps are individually designated to particular liabilities and therefore meet the criteria for hedge accounting under IAS 39.

As a result of applying IAS 39 at 1 April 2005 net assets have been reduced by £1 million for the Group's debt interest rate swaps, by £1 million reflecting the amortised proceeds of trade receivables and increased by £10 million (net of tax), following release of deferred income which does not qualify as a hedge under IFRS.

v) Cash flow statement

The move from UK GAAP to IFRS does not change any of the cash flows of the Group. The IFRS cash flow format is similar to UK GAAP but presents some cash flows in different categories and in a different order from the UK GAAP cash flow statement. All of the IFRS adjustments net out but differences in disclosure arise from the change in treatment of infrastructure assets (see above) and the inclusion of liquid investments with a maturity of less than three months as cash and cash equivalents under IFRS.

FIVE YEAR FINANCIAL SUMMARY

	IFRS 2006 £m	IFRS 2005 £m	UK GAAP 2004 £m	UK GAAP 2003 £m	UK GAAP 2002 £m
INCOME STATEMENT					
Revenue	645.7	551.4	471.3	417.2	423.9
Operating profit	160.6	146.0	129.8	127.0	121.8
Net interest payable	(106.6)	(62.0)	(57.2)	(52.1)	(49.0)
Share of operating profit/(loss) in joint ventures	0.1	0.1	(0.3)	(0.7)	(0.5)
Business disposal profit	–	5.0	–	–	5.1
Profit before tax	54.1	89.1	72.3	74.2	77.4
Taxation	(16.3)	(23.5)	(10.8)	(17.1)	(3.3)
Profit for the year	37.8	65.6	61.5	57.1	74.1
Dividends proposed	61.0	55.1	51.1	144.3	51.4
Earnings per share (basic): <i>From continuing and discontinued operations</i>					
Before exceptional items and deferred tax	75.5p	64.3p	57.7p	55.0p	53.0p
Exceptional items	(29.9)p	(3.9)p	(5.3)p	–	3.7p
Deferred tax	(15.9)p	(12.3)p	(2.6)p	(10.7)p	(2.4)p
After exceptional items and deferred tax	29.7p	48.1p	49.8p	44.3p	54.3p
Proposed dividend per share	51.6p	43.0p	41.0p	109.1p	37.5p
CAPITAL EXPENDITURE					
Acquisitions	45.8	30.8	19.8	41.8	12.1
Property, plant and equipment	249.7	181.0	170.0	204.6	186.4
BALANCE SHEET					
Non-current assets	2,527.5	2,292.2	2,191.3	2,084.6	1,920.5
Net current (liabilities)/assets	(61.2)	193.1	75.9	17.5	100.8
Non-current liabilities	(1,885.1)	(1,776.4)	(1,367.6)	(1,213.3)	(1,047.3)
Net assets	581.2	708.9	899.6	888.8	974.0
NUMBER OF EMPLOYEES					
(average for year)					
Water and sewerage business	1,299	1,336	1,341	1,343	1,485
Waste management	1,388	1,169	895	685	605
Instrumentation	–	–	–	–	421
Other businesses	35	39	39	35	51
	2,722	2,544	2,275	2,063	2,562

Information prior to 31 March 2004 was reported under UK GAAP which may differ materially from IFRS. The main differences relate to the treatment of infrastructure assets, retirement benefits, goodwill and intangibles, deferred tax, dividends payable and financial instruments. An explanation of the impact of these changes is given in note 42.



SEPARATE FINANCIAL STATEMENTS FOR PENNON GROUP PLC

INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS OF PENNON GROUP PLC

We have audited the parent company financial statements of Pennon Group Plc for the year ended 31 March 2006 which comprise the balance sheet and the related notes. These parent company financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' remuneration report that is described as having been audited.

We have reported separately on the Group financial statements of Pennon Group Plc for the year ended 31 March 2006.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The Directors' responsibilities for preparing the Annual Report, the Directors' remuneration report and the parent company financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Directors' responsibilities statement.

Our responsibility is to audit the parent company financial statements and the part of the Directors' remuneration report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the Company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come, save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the parent company financial statements give a true and fair view and whether the parent company financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We report to you whether in our opinion the information given in the Directors' report is consistent with the parent company financial statements. We also report to you if, in our opinion, the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

We read the other information contained in the Annual Report and consider whether it is consistent with the audited parent company financial statements. The other information comprises only the Chairman's statement, the Chief Executives' overviews, the unaudited part of the Directors' remuneration report, the statements of compliance on corporate governance and internal control and the Directors' report. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the parent company financial statements. Our responsibilities do not extend to any other information.

BASIS OF AUDIT OPINION

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the parent company financial statements and the part of the Directors' remuneration report to be audited. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the parent company financial statements 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 parent company financial statements and the part of the Directors' remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the parent company financial statements and the part of the Directors' remuneration report to be audited.

OPINION

In our opinion, the parent company financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the Company's affairs at 31 March 2006, the parent company financial statements and the part of the Directors' remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985 and the information given in the Directors' report is consistent with the parent company financial statements.

PRICEWATERHOUSECOOPERS LLP
Chartered Accountants and Registered Auditors
Bristol
22 June 2006

COMPANY BALANCE SHEET – UK GAAP

at 31 March 2006

	Notes	2006 £m	2005 Restated (note Q) £m
Fixed assets			
Tangible assets	D	0.1	0.2
Investment in subsidiary companies	E	943.8	931.8
		943.9	932.0
Current assets			
<i>Financial assets</i>			
Derivative financial instruments	F	0.6	–
Debtors: amounts falling due after more than one year	G	129.2	239.7
Debtors: amounts falling due within one year	H	45.2	32.7
Investments	I	40.0	57.5
Cash at bank and in hand		20.8	–
		235.8	329.9
Current liabilities			
Creditors: amounts falling due within one year	J	(308.3)	(303.0)
Net current (liabilities)/assets		(72.5)	26.9
Total assets less current liabilities			
Creditors: amounts falling due after more than one year	K	(166.1)	(293.6)
Net assets excluding pension deficit		705.3	665.3
Pension deficit	M	(2.3)	(4.5)
Net assets including pension deficit		703.0	660.8
Capital and reserves			
Called-up share capital	N	184.2	142.0
Share premium account	O	10.2	153.7
Capital redemption reserve	P	98.4	–
Profit and loss account and other reserves	Q	410.2	365.1
Shareholders' funds		703.0	660.8

The notes on pages 95 to 106 form part of these financial statements.

Approved by the Board on 22 June 2006 and signed on its behalf by:

K G HARVEY, Chairman



A ACCOUNTING POLICIES

The main policies are:

(a) Accounting convention

The financial statements have been prepared under the historical cost convention and in compliance with all applicable UK accounting standards, the requirements of the Financial Services Authority and with the Companies Act 1985. The principal accounting policies adopted in the preparation of these financial statements are set out below.

(b) Changes in accounting policies

The Company has adopted FRS 17 “Retirement Benefits”, FRS 20 “Share-based Payment”, FRS 21 “Events After the Balance Sheet Date”, FRS 25 “Financial Instruments: Disclosure and Presentation”, FRS 26 “Financial Instruments: Measurement” and FRS 28 “Corresponding Amounts” in these financial statements. The adoption of each of these standards represents a change in accounting policy and the comparative figures have been restated accordingly except where the exemption to restate comparatives has been taken. Details of the effect of the prior year adjustments are given in note Q.

(c) Tangible fixed assets and depreciation

Vehicles, mobile plant and computers are depreciated evenly over their estimated economic lives on a straight-line basis, which are principally 3–10 years.

(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 costs 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) Investments

Investments in subsidiaries are initially recorded at cost, being the fair value of the consideration paid, including associated acquisition costs. Subsequently, investments are reviewed for impairment on an individual basis, if events or changes in circumstances indicate that the carrying value may not be fully recoverable.

(f) Share-based payment

Share-based compensation

The Company operates a number of equity settled, share-based compensation plans for employees. The fair value of the employee services required 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 in assumptions as to the number of awards which are expected to vest.

Employee share ownership plan

The Company balance sheet incorporates the shares held by the Pennon Employee Share Trust to meet the awards of share-based compensation and which have not vested by the balance sheet date. The consideration paid for the shares is shown as a deduction from shareholders’ funds until such time as they vest.

The application of FRS 20 “Share-based Payment”, has resulted in a change in the method of accounting for share-based payments. The effect of this change in accounting policy is disclosed in note Q.

(g) Pension obligations

The company operates a defined benefit pension scheme for its employees.

Defined benefit pension scheme assets are measured at their fair value at the balance sheet date. 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 scheme 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 equity and recorded in the statement of total recognised gains and losses.

The application of FRS 17 "Retirement Benefits", has resulted in a change in the method of accounting for pension obligations. The effect of this change in accounting policy is disclosed in note Q.

(h) Taxation

Tax payable on profits for the year is provided 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 in full. Where the effect of the time value of money is material, the current amount of the reversals of tax deferred 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.

(i) Dividend distributions

Dividend distributions are recognised as a liability in the Group's 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.

The application of FRS 21 "Events After the Balance Sheet Date", has resulted in a change in the method of accounting for dividend distributions. The effect of this change in accounting policy is disclosed in note Q.

(j) Derivative financial instruments

The Company uses derivative financial instruments, principally interest rate swaps, to hedge its risk 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.

The gain or loss on re-measurement is taken to profits, except for cash flow hedges which meet the conditions for hedge accounting, when the portion of the gain or loss on the hedging instruments, which is determined to be an effective hedge, is recognised directly in equity, and the ineffective portion in the profit and loss account. The gains or losses deferred in equity 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.

The Company has taken advantage of the exemption allowed in applying FRS 25 "Financial Instruments: Disclosure and Presentation", and FRS 26 "Financial Instruments: Measurement", and has applied these standards from 1 April 2005. Accordingly, the 2005 comparative information has not been restated. However, if FRS 25 and FRS 26 had been adopted there would have been no fair value gains or losses to be recognised at 31 March 2005.

B PROFIT FOR THE YEAR

As permitted by section 230 of the Companies Act 1985, no profit and loss account, statement of total recognised gains and losses and cash flow are presented for the Company.

	2006	2005 Restated (note Q)
	£m	£m
Profit on ordinary activities after taxation	215.6	86.0

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

	2006 £000	2005 £000
Audit services		
– Statutory audit	67	46
Other assurance services	273	217
Tax services		
– Compliance services	24	24
– Advisory services	83	105
	447	392

Other assurance services and tax advisory services in 2006 include costs relating to the transition to IFRS and the financial restructuring in the Company. 2005 includes costs relating to the abortive acquisition of the UK landfill operations of Shanks Group Plc.

A description of the work of the Audit Committee is set out on pages 36 and 37 which includes an explanation of how auditor objectivity and independence are safeguarded when non-audit services are provided by the Auditors.

The Company has taken advantage of the exemption in SSAP25 'Segmental Reporting', and no geographical or segmental analysis of results is provided, as this analysis is contained in note 5 to the consolidated financial statements.

C DIRECTORS AND EMPLOYEES

The average number of persons (including Directors) employed by the Company was 35 (2005 37).

	2006 £m	2005 £m
Employment costs comprise:		
Wages and salaries	2,199	2,299
Social security costs	322	317
Pension costs	661	748
Share-based payments	358	389
	3,540	3,753

For details of the Company's share-based payment schemes, refer to note 30 of the Group financial statements.

The remuneration of the Company's Directors is disclosed on pages 29 to 35.

NOTES TO THE COMPANY FINANCIAL STATEMENTS – UK GAAP

D TANGIBLE FIXED ASSETS

Fixed and mobile plant, vehicles and computers.

	£m
Cost:	
At 1 April 2005	0.3
Disposals	(0.1)
At 31 March 2006	0.2
Depreciation:	
At 1 April 2005	0.1
Charge for year	0.1
Disposals	(0.1)
At 31 March 2006	0.1
Net book value:	
At 31 March 2005	0.2
At 31 March 2006	0.1

E INVESTMENTS IN SUBSIDIARY COMPANIES

	£m
At 1 April 2005	931.8
Additions	207.2
Disposals	(195.2)
At 31 March 2006	943.8

During the year Viridor Limited was acquired as a dormant company with an issued share capital of £2. In consideration for the Company's investment in Viridor Waste Limited of £195.2 million a further share was allotted to the Company. Subsequently a further investment of £12.0 million was made.

Details of the Company's principal subsidiaries are set out in note 37 of the Group accounts.

F DERIVATIVE FINANCIAL INSTRUMENTS

	2006 £m	2005 £m
Interest rate swaps – cash flow hedges:		
Assets	0.6	–

Interest rate swaps and fixed rate borrowings are used to manage the mix of fixed and floating rates to ensure at least 50% of Group net borrowings is at fixed rate. At 31 March 2006, 68% of Group net borrowings was at fixed rate (2005 69%).

At 31 March 2006, interest rate swaps to hedge financial liabilities of the Company with a notional principal value of £50.0 million existed, with a weighted average maturity of 4.0 years (2005 nil) to swap from floating to fixed rates. The weighted average interest rate of the swaps was 4.5%.

The amounts above are the fair value of swaps based on the market value of equivalent instruments at the balance sheet date. All the interest rate swaps are designated and effective as cash flow hedges and the fair values have been deferred in equity.

G DEBTORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	2006	2005 Restated (note Q)
	£m	£m
Amounts owed by subsidiary undertakings	127.4	238.4
Other debtors	1.0	1.1
Deferred tax (note L)	0.8	0.2
	129.2	239.7

H DEBTORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	2006	2005 Restated (note Q)
	£m	£m
Amounts owed by subsidiary undertakings	44.8	32.6
Other debtors	0.3	0.1
Other prepayments and accrued income	0.1	–
	45.2	32.7

I CURRENT ASSET INVESTMENTS

	2006	2005 Restated (note Q)
	£m	£m
Other investments:		
Overnight deposits	40.0	29.4
Other	–	28.1
	40.0	57.5

J CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR

	2006	2005 Restated (note Q)
	£m	£m
Loans:		
Bank loans and overdrafts	–	1.6
Unsecured loan stock	3.9	5.6
	3.9	7.2
Trade creditors	0.5	0.1
Amounts owed to subsidiary undertakings	293.3	288.7
Other creditors	8.8	6.4
Other taxation and social security	0.2	0.2
Accruals and deferred income	1.6	0.4
	308.3	303.0

NOTES TO THE COMPANY FINANCIAL STATEMENTS – UK GAAP

K CREDITORS: AMOUNTS FALLING DUE AFTER MORE THAN ONE YEAR

	2006 £m	2005 £m
Loans:		
Sterling bond	–	150.0
Other bank loans	157.4	134.9
	157.4	284.9
Amounts owed to subsidiary undertakings	8.7	8.7
	166.1	293.6

The Sterling bond, due for repayment in February 2012, was retired in January 2006.

L DEFERRED TAXATION

	2006 £m	2005 Restated (note Q) £m
Share-based payment	(0.8)	(0.1)
Other timing differences	–	(0.1)
Asset for deferred tax	(0.8)	(0.2)
Asset at 1 April 2005	(0.2)	
Credited to profit and loss account	(0.4)	
Credited to equity (note Q)	(0.2)	
Asset at 31 March 2006	(0.8)	

The deferred tax asset is included within debtors falling due after more than one year (note G).

M PENSIONS

The full actuarial valuation at 1 April 2004 was updated at 31 March 2006 by the independent qualified actuary. The financial assumptions used by the actuary were:

	2006	2005	2004
Rate of increase in pensionable pay	3.8	3.7	3.7
Rate of increase for present and future pensions	2.8	2.7	2.7
Rate used to discount schemes' liabilities	5.0	5.5	5.5
Inflation	2.8	2.7	2.7

The Company's share of the assets in the schemes and the expected long-term rates of return at the year end were:

	2006		2005		2004		2003	
	Return %	Value £m	Return %	Value £m	Return %	Value £m	Return %	Value £m
Equities	7.5	15.9	7.8	13.8	7.7	12.3	7.0	9.5
Property	7.5	1.2	4.8	0.4	–	–	–	–
Bonds	4.5	7.3	4.8	3.4	4.7	3.1	4.5	2.5
Other	4.5	1.0	4.8	0.3	4.3	0.7	3.5	0.7
Total market value of assets		25.4		17.9		16.1		12.7
Present value of schemes' liabilities		(28.7)		(24.3)		(22.3)		(19.5)
Deficit in schemes		(3.3)		(6.4)		(6.2)		(6.8)
Related deferred tax asset		1.0		1.9		1.9		2.0
Net pension liabilities		(2.3)		(4.5)		(4.3)		(4.8)

	2006 £m	2005 £m
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Analysis of amounts charged to operating profit of the Company

Current service cost	0.4	0.3
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Analysis of amounts charged to other finance income of the Company

Expected return on pension schemes' assets	2.4	1.1
Interest on pension schemes' liabilities	(1.4)	(1.2)
Net income/(cost)	1.0	(0.1)

Analysis of amounts recognised in statement of total recognised gains and losses (STRGL) of the Company

Actual return less expected return on pension schemes' assets	3.9	0.9
Experience losses arising on schemes' liabilities	(0.3)	(1.1)
Changes in assumptions underlying the present value of schemes' liabilities	(2.9)	–
Actuarial gain/(loss) to be recognised in STRGL	0.7	(0.2)

NOTES TO THE COMPANY FINANCIAL STATEMENTS – UK GAAP

M PENSIONS (continued)

	2006 £m	2005 £m
Movement in the Company's share of the deficit in schemes during the year		
Deficit at 1 April	(6.4)	(6.2)
Movement in year:		
Current service cost	(0.4)	(0.3)
Contributions	1.8	0.4
Other finance income	1.0	(0.1)
Actuarial gain	0.7	(0.2)
Deficit at 31 March	(3.3)	(6.4)

	2006	2005	2004	2003
History of experience gains and losses				
Difference between the expected and actual return in schemes' assets:				
Amount (£m)	3.9	0.9	2.6	(4.9)
Percentage of schemes' assets	15.4%	5.0%	16.5%	(38.3)%
Experience gains and losses on schemes' liabilities:				
Amount (£m)	(0.3)	(1.1)	0.3	(0.1)
Percentage of the present value of schemes' liabilities	(1.0)%	(4.5)%	1.5%	(0.6)%
Total amount recognised in statement total recognised gains and losses:				
Amount (£m)	0.7	(0.2)	1.0	(6.0)
Percentage of the present value of schemes' liabilities	2.4%	(0.8)%	4.4%	(30.7)%

N CALLED-UP SHARE CAPITAL

	2006 £m	2005 £m
Authorised		
143,325,090 Ordinary shares of £1.22 ¹ / ₁₀ each	175.0	–
131,818,190 B Shares of £1.10 each (35,858,521 converted to Deferred Shares of £1.10 each)	145.0	–
(2005 157,657,600 Ordinary shares of £1.11 each)	–	175.0
Allotted, called-up and fully paid		
118,608,847 Ordinary shares of £1.22 ¹ / ₁₀ each	144.8	–
35,858,521 Deferred Shares of £1.10 each	39.4	–
(2005 127,944,340 Ordinary shares of £1.11 each)	–	142.0
	184.2	142.0

	2006 number (Ordinary shares of £1.11 each)	2006 number (Ordinary shares of £1.22 ¹ / ₁₀ each)	2005 number (Ordinary shares of £1.11 each)
In lieu of £21.0 million (2005 £22.8 million) cash under scrip dividend alternative	2,087,293	–	3,151,305
For consideration of £1.6 million under the Company's Sharesave Scheme (2005 £0.8 million)	314,962	5,683	163,276
Issued in respect of share options granted	116,886	–	344,980
	2,519,141	5,683	3,659,561



N CALLED-UP SHARE CAPITAL *(continued)*

Shareholders approved a £200 million return of share capital, by way of a B Share Scheme and an on-market buy back programme, at the Company's Extraordinary General Meeting on 15 February 2006. Shareholders were given the options of receiving an initial dividend payment of 110 pence for each B Share held or redeem the B Shares on 27 February 2006, the Initial Redemption Date, or on 6 April 2006, the Final Redemption Date, or a combination of these options.

The total capital return to shareholders by way of the B Share Scheme amounted to £143.5 million, of which £39.4 million was by way of the initial dividend payment and £104.1 million was through share redemption. The B Shares which received the initial dividend were subsequently converted into Deferred Shares, redeemed at the close of business on 6 April 2006 for a total aggregate consideration of one pence and then were cancelled. At 31 March 2006, £39.4 million of the capital return via the B Share Scheme was outstanding and held in Share Capital and £5.7 million of the B Shares not redeemed until 6 April 2006 were held within other creditors note J.

In addition, there was a consolidation of the Ordinary shares of the Company whereby for every 11 existing Ordinary shares of £1.11 each held on 17 February 2006, shareholders received 10 new Ordinary shares of £1.22 $\frac{1}{10}$ each. As a result, the number of Ordinary shares in issue was reduced by 11,860,317.

O SHARE PREMIUM ACCOUNT

	£m
At 1 April 2004	154.2
Adjustment for shares issued under the scrip dividend alternative	(3.5)
Premium on shares issued for cash consideration	3.0
At 31 March 2005	153.7
Adjustment for shares issued under the scrip dividend alternative	(2.3)
Premium on shares issued	2.3
Utilised on creation of 130,463,483 B Shares of £1.10 each	(143.5)
At 31 March 2006	10.2

P CAPITAL REDEMPTION RESERVE

	£m
At 1 April 2004	–
At 31 March 2005	–
Transferred from retained earnings on redemption of 89,404,091 B Shares of £1.10 each	98.4
At 31 March 2006	98.4

NOTES TO THE COMPANY FINANCIAL STATEMENTS – UK GAAP

Q PROFIT AND LOSS ACCOUNT AND OTHER RESERVES

	Hedging reserve £m	Own shares £m	Profit and loss account £m	Total £m
At 1 April 2005 as previously reported	–	–	314.6	314.6
<i>Prior year adjustments</i>				
FRS 17	–	–	(4.7)	(4.7)
FRS 20	–	(1.2)	1.3	0.1
FRS 21	–	–	55.1	55.1
At 1 April 2005 restated now reported	–	(1.2)	366.3	365.1
Adjustments on adoption of FRS 25/26 1 April 2005	–	–	–	–
Profit for the year	–	–	215.6	215.6
Fair value gains on derivative financial instalments	0.6	–	–	0.6
Actuarial loss on pension schemes	–	–	(0.2)	(0.2)
Adjustment for shares issued under the scrip dividend alternative	–	–	21.0	21.0
Dividends paid	–	–	(55.1)	(55.1)
Adjustment in respect of share-based payment	–	–	0.4	0.4
Deferred tax in respect of share-based payment	–	–	0.2	0.2
Own shares issued to the Pennon Employee Share Trust				
in respect of share options granted	–	(0.8)	–	(0.8)
Adjustment in respect of share options vesting	–	0.3	(0.3)	–
Receipt on allocation of shares in the				
Pennon Employee Share Trust to subsidiaries	–	1.2	–	1.2
B Share payments	–	–	(137.8)	(137.8)
At 31 March 2006	0.6	(0.5)	410.1	410.2

The B Share payments of £137.8 million comprise £98.4 million for shares redeemed and £39.4 million for amounts paid as dividend.

Prior year adjustments

The prior year adjustments relate to the implementation of FRS17, FRS20 and FRS21, while FRS25 and FRS26 do not affect comparatives and are only applied in the current period.

The adoption of FRS17 has resulted in a decrease in staff costs of £0.1 million (2005 £0.4 million) and a decrease in net finance costs of £1.0 million (2005 £0.1 million increase), resulting in an increase in profit for the year of £1.1 million (2005 0.3 million). Total recognised gains have increased by £0.7 million (2005 £0.2 million increased losses).

The increase in staff costs as a result of the adoption of FRS20 is offset by the reversal of the change under UITF17 (revised 2003) in both 2006 and 2005. The deferred tax asset arising from the adoption of FRS20 has resulted in a reduction to the tax charge of £0.5 million (2005 nil).

The adoption of FRS21 has resulted in an increase in shareholders funds of £55.1 million at 1 April 2005 (2004 £51.1 million) due to the write-back of the proposed dividend at 31 March 2005.

This restatement of the profit and loss reserve at 31 March 2005 includes a prior year adjustment of £47.5 million.

Q PROFIT AND LOSS ACCOUNT AND OTHER RESERVES *(continued)*

Prior year adjustments *(continued)*

	FRS17 £m	FRS20 £m	FRS21 £m	Total £m
Adjustment to the profit and loss reserve funds at 31 March 2004	(4.8)	1.2	51.1	47.5
Adjustment to profit for the year ended 31 March 2005	0.3	–	55.1	55.4
Adjustment to statement of recognised gains and losses for the year ended 31 March 2005	(0.2)	–	–	(0.2)
Adjustment to amounts recognised in equity for the year ended 31 March 2005	–	0.1	(51.1)	(51.0)
Adjustment to the profit and loss reserve at 31 March 2005	(4.7)	1.3	55.1	51.7

Employee share ownership plan

During the year 117,000 of the Company's Ordinary shares of £1.11 each were issued to the trustees of the Employee Share Ownership Plan, financed through non-interest bearing advances made by sponsoring group companies (2005 345,000).

The market value of the 162,000 Ordinary shares of £1.22¹/₁₀ each (2005 200,000 Ordinary shares of £1.11 each) held for the Company by the trust at 31 March 2006 was £2.2 million (2005 £1.9 million).

R DIVIDENDS

	2006 £m	2005 £m
Amounts recognised as distributions to equity holders in the year:		
Interim dividend paid for the year ended 31 March 2005: 13.8p (2004: 13.2p) per share	17.7	16.4
Final dividend paid for the year ended 31 March 2005: 29.2p (2004: 27.8p) per share	37.4	34.7
	55.1	51.1
Proposed dividends		
Proposed interim dividend for the year ended 31 March 2006: 16.5p (2005: 13.8p) per share	19.4	17.7
Proposed final dividend for the year ended 31 March 2006: 35.1p (2005: 29.2p) per share	41.6	37.4
	61.0	55.1

The proposed interim and final dividends have not been included as liabilities in these financial statements. The proposed interim dividend was paid on 13 April 2006 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting.

NOTES TO THE COMPANY FINANCIAL STATEMENTS – UK GAAP

S LOANS AND OTHER BORROWINGS

Loans

	2006 £m	2005 £m
Repayable:		
Over five years	–	150.0
Over two and up to five years	157.4	114.9
Over one and up to two years	–	20.0
Falling due after more than one year (note K)	157.4	284.9
Falling due within one year (note J)	3.9	7.2
	161.3	292.1

£0.1 million floating rate unsecured loan stock notes were issued in the year, repayable at par in 2009 or on notice being given by the noteholders to satisfy further consideration payable in connection with the December 1997 acquisition of Terry Adams Limited.

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

	2006 £m	2005 £m
Sterling bond	–	150.0

The rate of interest on the Sterling bond, outstanding at March 2005 and repayable in 2012, was 10.6%. The bond was retired in January 2006.

T COMMITMENTS AND CONTINGENT LIABILITIES

	2006 £m	2005 £m
Contingent liabilities:		
Guarantees	738.7	623.8
Other	6.9	6.9
	745.6	630.7

Guarantees by the Company are principally in respect of borrowing facilities of subsidiary undertakings. No liability is expected to arise in respect of the guarantees. Other contingent liabilities relate to a possible obligation to pay further consideration in respect of a previously acquired business when the outcome of planning applications is known.

U RELATED PARTY TRANSACTIONS

The Company has taken advantage of the exemption allowed by FRS 8, not to disclose transactions with entities which form part of the Group.

SHAREHOLDER INFORMATION

FINANCIAL CALENDAR

Financial year end	31 March
Seventeenth Annual General Meeting	27 July 2006
2006 Final dividend payable	3 October 2006
2006 Interim results announcement	November 2006
2007 Interim dividend payable	April 2007
2007 Preliminary results announcement	May 2007
Eighteenth Annual General Meeting	July 2007
2007 Final dividend payable	October 2007

SHAREHOLDER ANALYSIS AT 31 MARCH 2006

Range	Number of shareholders	Percentage of total shareholders	Percentage of ordinary shares
1 – 100	4,894	21.02	0.19
101 – 1,000	15,101	64.85	5.48
1,001 – 5,000	2,745	11.79	4.12
5,001 – 50,000	373	1.60	4.94
50,001 – 100,000	52	0.22	3.01
100,001 – HIGHEST	122	0.52	82.26
	23,287	100.0	100.0
Holder			
Individuals	21,102	90.62	8.87
Companies	186	0.80	1.42
Trust companies (pension funds, etc)	3	0.01	–
Banks and nominees	1995	8.57	89.71
Insurance companies	1	–	–
	23,287	100.0	100.0

SUBSTANTIAL SHAREHOLDINGS

At 13 June 2006, the following interests in the issued share capital had been notified pursuant to sections 198 to 208 of the Companies Act 1985.

Ameriprise Financial, Inc	11.05%*
Lansdowne Partners Limited Partnership	7.89%
Zurich Financial Services and its Group companies	5.03%*
AXA SA and its Group companies	4.53%
Legal & General Plc and its Group companies	3.21%

* The percentage shareholding of Zurich Financial Services is also included within the 11.05% shareholding of Ameriprise Financial, Inc as the Zurich Group is part of the Ameriprise Group of companies.

Further shareholder information may be found at:
www.pennon-group.co.uk

SHAREHOLDER INFORMATION

SHAREHOLDER SERVICES

Share dealing service

The low-cost share dealing service offered by Stocktrade enables shareholders to buy and sell shares in the Company on a low-cost basis and to make regular investments in the Company. Telephone Stocktrade on **0845 601 0995** and quote: LOW C0107. Commission is 0.5% (subject to a minimum charge of £15, to £10,000, then 0.2% thereafter).

Share gift service

Through Sharegift, an independent charity share donation scheme, shareholders who only have a small number of shares with a value that makes it uneconomical to sell them, can donate such shares to charity. Donations can be made by completion of a simple share transfer form which is available from Lloyds TSB Registrars.

Individual Savings Accounts

By holding their shares in the Company in a Mini or a Maxi Individual Savings Account (ISA), shareholders may gain tax advantages. The corporate ISA is administered by Lloyds TSB Registrars.

Dividend re-investment plan

The Company is introducing a Dividend Re-investment Plan commencing with the next dividend, the final dividend for the year ended 31 March 2006. The plan will provide shareholders with the opportunity to invest the whole of the cash dividend they receive on their Pennon Group shares to buy further shares in the Company at favourable commission rates. Full details of the Plan, including how to join, will be sent out to shareholders on 21 August 2006.

Details of the above shareholder services are available from the Company Secretary's Department, telephone: **01392 443024**.

Online portfolio service

The online portfolio service provided by Lloyds TSB Registrars gives shareholders access to more information on their investments. Details of the portfolio service are available from Lloyds TSB Registrars online at www.shareview.co.uk

Electronic communications

Shareholders can elect to receive shareholder communications electronically by signing up through www.shareview.co.uk – a website operated by Lloyds TSB Registrars. Shareholders need only their 'shareholder reference' printed on the proxy form enclosed with this Annual Report. There is no charge to register and shareholders will also have access to information about their shareholding.

ANNUAL GENERAL MEETING

The 2006 Annual General Meeting will be held on Thursday 27 July 2006. Further details are set out in the Notice of Annual General Meeting sent to all shareholders.

Appointing a proxy

A Form of Proxy is enclosed with the Notice of Annual General Meeting and instructions for its use are shown on the form.

Electronic proxy voting

Shareholders also have the opportunity to register the appointment of a proxy for any general meeting of the Company once notice of the meeting has been given and may do so for the 2006 Annual General Meeting and any adjournment(s) thereof via www.sharevote.co.uk – a website operated by Lloyds TSB Registrars.

Electronic proxy appointment through CREST

CREST members who wish to appoint a proxy or proxies through the CREST electronic proxy appointment service may do so for the 2006 Annual General Meeting and any adjournment(s) thereof by following the procedures described in the CREST manual.

THE PENNON WEBSITE

The Pennon website at www.pennon-group.co.uk provides news and details of the Company's activities plus links to Group websites. The investor information section contains up-to-date information including dividend payment dates and amounts. It also holds historical details and a comprehensive share price information section.

Visit: www.pennon-group.co.uk/investorInfo

