



Annual Report
and Accounts
2014

PENNON
GROUP PLC



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Who we are

At the top end of the FTSE 250 Pennon Group Plc is one of the largest environmental and resource management groups in the UK. We own South West Water Limited and Viridor Limited. The Group has assets of around £5.0 billion and a workforce of around 4,500 people.

What we do

We carry out our business through:

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

Viridor Limited one of the leading UK recycling, renewable energy and waste management businesses.

As one of the largest environmental and resource management groups in the UK, Pennon's business is all about sustainability.



Group highlights

Pennon Group



£1.3bn
cash and
committed facilities

£434m
invested
in key
infrastructure

We create value for our shareholders by continuing to develop our two environmental utility infrastructure businesses, South West Water and Viridor, and by the efficient financing and strong management of the Group as a whole.

Financial highlights

Revenue

£1,321.2m

+10.0%

Profit before tax

(before exceptional net charges.
Statutory basis £158.7m)

£207.3m

+9.1%*

Assets

£5.0bn

Dividend

+6.5%

* Comparatives restated for IAS 19 (Revised)

Strategy

Our strategy is to promote the success of the Group for the benefit of our shareholders, customers and other stakeholders through our focus on water and sewerage services, recycling, renewable energy and waste management. We aim to be a pre-eminent provider of customer services to high standards of quality, efficiency and reliability.

Highlights of the year

- Continuing delivery of shareholder value – 6.5% dividend increase and 5.7% increase in earnings per share (before exceptional items and deferred tax)
- Substantial progress in delivery of major capital programmes
- Strong liquidity and funding position – £1.3 billion cash and committed facilities at 31 March 2014 (of which £173 million were restricted funds) including £0.6 billion of new and refinanced facilities sourced during the year
- Group businesses well positioned for the future.

Strategy in action

- Committed to an annual dividend increase of 4% above inflation up to 2014/15
- Continued focus on our two environmental utility infrastructure businesses undertaking sustainable activities which make a positive impact on communities and the environment
- £434 million invested in key infrastructure supporting the development of the UK economy
- Group well funded with efficient long-term financing.

Key performance indicators*

Profit before tax

before exceptional net charges (£m)

2009/10	185.8
2010/11	188.5
2011/12	200.5
2012/13 ⁽¹⁾	190.0
2013/14	207.3 (+9.1%)

Earnings per share

before exceptional net charges and deferred tax (pence)

2009/10	40.8
2010/11	42.3
2011/12	47.3
2012/13 ⁽¹⁾	40.3
2013/14	42.6 (+5.7%)

Dividend per share

(pence)

2009/10	22.55
2010/11	24.65
2011/12	26.52
2012/13	28.46
2013/14	30.31 (+6.5%)

Interest rate on average net debt

(%)

2009/10	4.3
2010/11	4.4
2011/12	4.2
2012/13	4.0
2013/14	3.8

Creating value for our shareholders by continued development

⁽¹⁾ Restated for IAS 19 (Revised)

*These are key performance indicators we use to measure the performance of our businesses as described in our business model on page 8.



Group businesses

South West Water

The water and sewerage services provider for Devon, Cornwall and parts of Dorset and Somerset – delivering strong operational and financial performance.



Chris Loughlin
Chief Executive, South West Water

Financial highlights

Revenue

£520.0m

+4.3%

Profit before tax

£162.5m

+10.8%⁽¹⁾⁽²⁾

KPIs

Operating profit (£m)

2009/10	193.5
2010/11	189.8
2011/12	204.7
2012/13 ⁽³⁾	214.8
2013/14	227.0

+5.7%

Regulatory capital value as at 31 March (£m)

2010	2,555
2011	2,703
2012	2,827
2013	2,916
2014	2,959

+1.5%

Drinking water quality Mean zonal compliance (%)

2009	99.98
2010	99.97
2011	99.99
2012	99.97
2013	99.98

Service Incentive Mechanism (SIM) (%)

2011/12	66.9
2012/13	70.5
2013/14	73.9

+4.8%

Bathing water compliance (%)

2011	98.6
2011	95.1
2012	91.1
2012	60.3
2013	99.3
2013	91.0

- EU mandatory standard
- Guideline standard

Population equivalent sanitary compliance (%)

2009	99.70
2010	99.55
2011	99.57
2012	99.98
2013	94.38

RIDDOR incidence rate (per 100,000 employees)

2009	1,334
2010	2,008
2011	1,628
2012	565 ⁽⁴⁾
2013	243⁽⁴⁾

Actual number of incidents was 3

Strategy

At the core of South West Water's strategy is the company's commitment to delivering the services its customers depend on in the most efficient way possible while minimising its environmental impact.

Highlights of the year

- Ongoing outperformance of efficiency targets
- Improved customer satisfaction levels
- Best bathing water quality for seven years
- 17th year without water restrictions
- Outstanding drinking water quality
- Leakage control on target
- Business plan to 2020 assessed as 'enhanced'.

Strategy in action

- Pure Water – providing a reliable, clean and safe supply of drinking water
- Pure Service – delivering responsive and cost-effective customer services that meet customers' needs
- Pure Environment – protecting and enhancing the environment through sustainable actions and initiatives
- Financial Management – making resilient business decisions while outperforming the regulatory contract.

⁽¹⁾Before prior year exceptional net income

⁽²⁾Comparatives restated for IAS 19 (Revised)

⁽³⁾Restated for IAS 19 (Revised)

⁽⁴⁾Change in RIDDOR reporting criteria (see page 42 for details).

Viridor

One of the leading UK recycling, renewable energy and waste management businesses – achieving further significant progress in its long-term energy from waste strategy.



Ian McAulay
 Chief Executive, Viridor

Financial highlights

Revenue

£802.0m

+14.0%

Profit before tax

(before exceptional net charges.
 Statutory basis loss £21.0 million)

£27.6m

-19.5%⁽¹⁾

Strategy

Viridor's stated company purpose is to give resources new life. Its strategy remains to focus on transforming waste – into high quality recyclables, raw materials and energy.

Highlights of the year

- Significant developments in long-term energy from waste (EfW) business
- Substantial recovery in recycling margins but ongoing trend decline in landfill – aggressive action to reduce costs
- Exceptional net charges – total £40 million net of tax
- Four more key long-term Public Private Partnership PPP/EfW/contract developments.

Strategy in action

- Strong progress in long-term PPP/EfW strategy
- Landfill Energy – focus on reducing landfill operations and maximising energy production.

KPIs

Operating profit plus joint ventures⁽³⁾ (£m)

2009/10	77.0
2010/11	82.6
2011/12	75.2
2012/13 ⁽²⁾	45.9
2013/14	43.6

-4.6%

Recycling volumes traded (million tonnes)

2009/10	1.4
2010/11	1.7
2011/12	1.8
2012/13	1.9
2013/14	1.8

-3%

Total renewable energy generation (GWh)

2009/10	612
2010/11	752
2011/12	760
2012/13	820
2013/14	778

-5.1%

Renewable energy generation capacity as at 31 March (MW)

2010	128
2011	136
2012	136
2013	137
2014	136

Total waste inputs (million tonnes)

2010/11	7.6
2011/12	7.3
2012/13	7.2 ⁽⁴⁾
2013/14	7.4

Share of profit from recovering value in waste (%)

2009/10	45
2010/11	46
2011/12	49
2012/13	35
2013/14	54

RIDDOR incidence rate (per 100,000 employees)

2009	2,445
2010	2,165
2011	1,238
2012	1,429 ⁽⁵⁾
2013	1,197 ⁽⁵⁾

Actual number of incidents was 37

⁽¹⁾Comparatives restated for IAS 19 (Revised)

⁽²⁾Restated for IAS 19 (Revised)

⁽³⁾Before exceptional net charges

⁽⁴⁾Previous years restated, excluding waste not treated at Viridor facilities

⁽⁵⁾Change in RIDDOR reporting criteria (see page 42 for details).

Chairman's statement

This has been a year of significant achievement for the Group.



Dear Shareholder

Business performance

Group revenue was up by 10% to £1,321 million and profit before tax⁽¹⁾ increased by 9.1%⁽²⁾ to £207 million. We continue to maintain substantial cash resources and facilities to fund our capital programme and we ended the year with a record level of £1.3 billion (including £173 million of restricted funds).

South West Water

Despite another year of extreme weather events – a hot dry summer followed by storms over the winter – South West Water continued to deliver good operational performance against the K5 (2010-2015) regulatory contract. The company made further improvements to customer service and continued its delivery of efficiencies, all of which were reflected in strong financial results.

In December 2013 the company submitted its well evidenced and well-supported business plan, which met or exceeded all of Ofwat's assessment areas. As a consequence South West Water was the only water and sewerage company to have its business plan assessed as 'enhanced', resulting in the receipt of an early Draft Determination on 30 April 2014. This allows the accelerated delivery of key projects. With the company's track record of efficiency and outperformance, South West Water is well placed to deliver its business plan in K6 (2015-2020) and will have an opportunity to outperform the assumed returns on equity.

Viridor

Financial performance before exceptional items at Viridor has been in line with management expectations. Notwithstanding the difficult trading conditions, Viridor's PBIT plus joint ventures is broadly similar to last year.

Recycling activities are focused on the production of high quality recyclate materials and management of the cost base to improve margins. The focus in the landfill energy business is to maximise the value of landfill gas generation across all Viridor's landfill sites, while managing the expected decline in landfill inputs by concentrating on strategic operational sites and optimising returns on other sites through alternative uses such as photovoltaic installations.

Viridor is continuing to make strong progress with the construction of its growing Public Private Partnership (PPP)/Energy Recovery Facilities (ERFs) asset base with operations expected to commence at five facilities in 2014/15. We believe ERFs are

central to the UK's waste and renewable energy strategies as the long-term, low-cost alternative to landfill for disposal of residual waste. Viridor expects to have a 15% market share by 2020 with a network of strategic facilities which will underpin the company's long-term profit growth.

To align the structure of the organisation with the strategy, the company has recently created two operating divisions: Recycling & Resources (comprising recycling, contracts and collection); and Energy (including ERFs, landfill energy and other renewable power).

Dividend

The Board is committed to its policy to grow dividends for shareholders by 4% above inflation per annum up to the end of 2014/15. We will review the dividend policy for the next period following the Final Determination for South West Water and will make an announcement at the 2014/15 Preliminary Results.

We are recommending a final dividend per share of 20.92p, which represents a 6.2% increase on last year's final dividend. This will result in a total dividend for the year of 30.31p, an increase of 6.5% (reflecting inflation of 2.5%) on the total dividend for 2012/13. Subject to obtaining shareholder approval at this year's Annual General Meeting, we will again be offering a Scrip Dividend Alternative to shareholders in respect of the final dividend. The timetable is given on page 160.

Sustainability and governance

Our strategic and sustainability reports set out our ongoing commitment to environmental, social and governance (ESG) matters and the Sustainability Committee of the Board continues to oversee our performance in maintaining a responsible approach to ESG.

Notable achievements for South West Water during the year include best bathing water quality results for seven years, improved customer service and customer satisfaction levels, and the further delivery of sustainable catchment schemes.

Viridor achieved a two star rating in the Business in the Community (BitC) annual Corporate Responsibility Index, and continued its strong progress in energy and water saving initiatives in line with its carbon reduction plan.

⁽¹⁾Before exceptional net charges

⁽²⁾Comparatives restated for IAS 19 (Revised)

The Group's governance arrangements continue to be reviewed annually to ensure we develop and improve our governance structures and practices, taking account of market developments and new best practice guidance.

South West Water has issued its own leadership, transparency and governance code in accordance with Ofwat's principles concerning the water industry relating to governance of boards, public trust and the transparency of companies.

Health and safety

We continue to focus on improvements in health and safety across our Group businesses.

Tragically, while there has been a continued reduction in the number of reportable incidents, there was one very sad fatality in South West Water and our thoughts are with the family, friends and colleagues who have been deeply affected.

There was a very significant reduction in the number of reportable incidents in Viridor, reflecting the company's step-change approach to health and safety and increased focus on improving its performance in this area.

Board developments

During the year Ian McAulay was appointed chief executive of Viridor and Executive Director of the Board upon Colin Drummond's retirement from both positions. Colin is now the non-executive chairman of Viridor.

Gerard Connell, the Senior Independent Director and chairman of the Audit Committee, has now been a Non-executive Director of the Company for over 10 years and was due to retire at this year's Annual General Meeting (AGM). Accordingly the Nomination Committee has been seeking a suitable replacement for Gerard and it is anticipated that it will be possible to make an announcement about a successor shortly. However the new Non-executive Director will be unable to take up the appointment until after the AGM. The Board is of the view that a suitable handover period with Gerard is essential because the Company, subject to approval at the AGM, will be changing its external auditors and the new Non-executive Director is expected to take up the chairmanship of the Audit Committee. The Board therefore believes it would be in the interests of the Company and shareholders for Gerard to be re-appointed for a further year despite his period of office exceeding normal corporate governance standards. Gerard continues to demonstrate independence of character and judgement in the performance of his role, and his skills and experience continue to be valuable to the Board.

Diversity

The Board continues to promote diversity across the Group and in accordance with its diversity policy is focused by 2015 on once again achieving at least 25% female representation on the Board, which we fell below after Dinah Nichols's retirement at last year's Annual General Meeting.

Our customers

Provision of the highest possible levels of service to our customers is vitally important for both our businesses and is reflected in our Group strategy.

During the year South West Water was among the first of the water companies to introduce a social tariff aimed at its most hard-pressed customers.

Viridor continues to partner its customers across all sectors by identifying the most robust and cost-effective waste treatment options in a changing market and by continuing to focus on delivering vital infrastructure and quality services to provide essential renewable energy, resource recovery and waste management.

Our employees

The skills and commitment of our employees continue to be key to the success of our Group. We continue to engage with and provide opportunities for our employees to develop through a number of initiatives and strategies, details of which are given in the strategic report. I personally thank every one of them for their outstanding contribution to the Group and, in particular, I should like to congratulate all those staff involved in helping South West Water to achieve 'enhanced' status for its business plan, which has resulted in the company being well placed for the K6 regulatory period.

In addition I am very grateful to my Board colleagues for their continuing support and significant contribution in what has been a successful twelve months.

Outlook

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

South West Water is continuing its strong performance, with robust operational delivery, high standards of customer service and financial performance and expects to complete the successful delivery of the K5 regulatory contract. The company has put in place a platform to deliver further efficiencies for K6 and, having now received its Draft Determination for the K6 period, preparations are underway for delivery of the K6 regulatory contract.

Viridor's financial performance before exceptional items over the year has been in line with management expectations. The company continues to make excellent progress in establishing its EfW business and securing base-load contracts, which already contribute to its bottom line and are expected to drive Viridor's long-term profit growth.

The Group, with efficient long-term financing, continues to be well positioned for the future. We remain confident about the future success of our business.

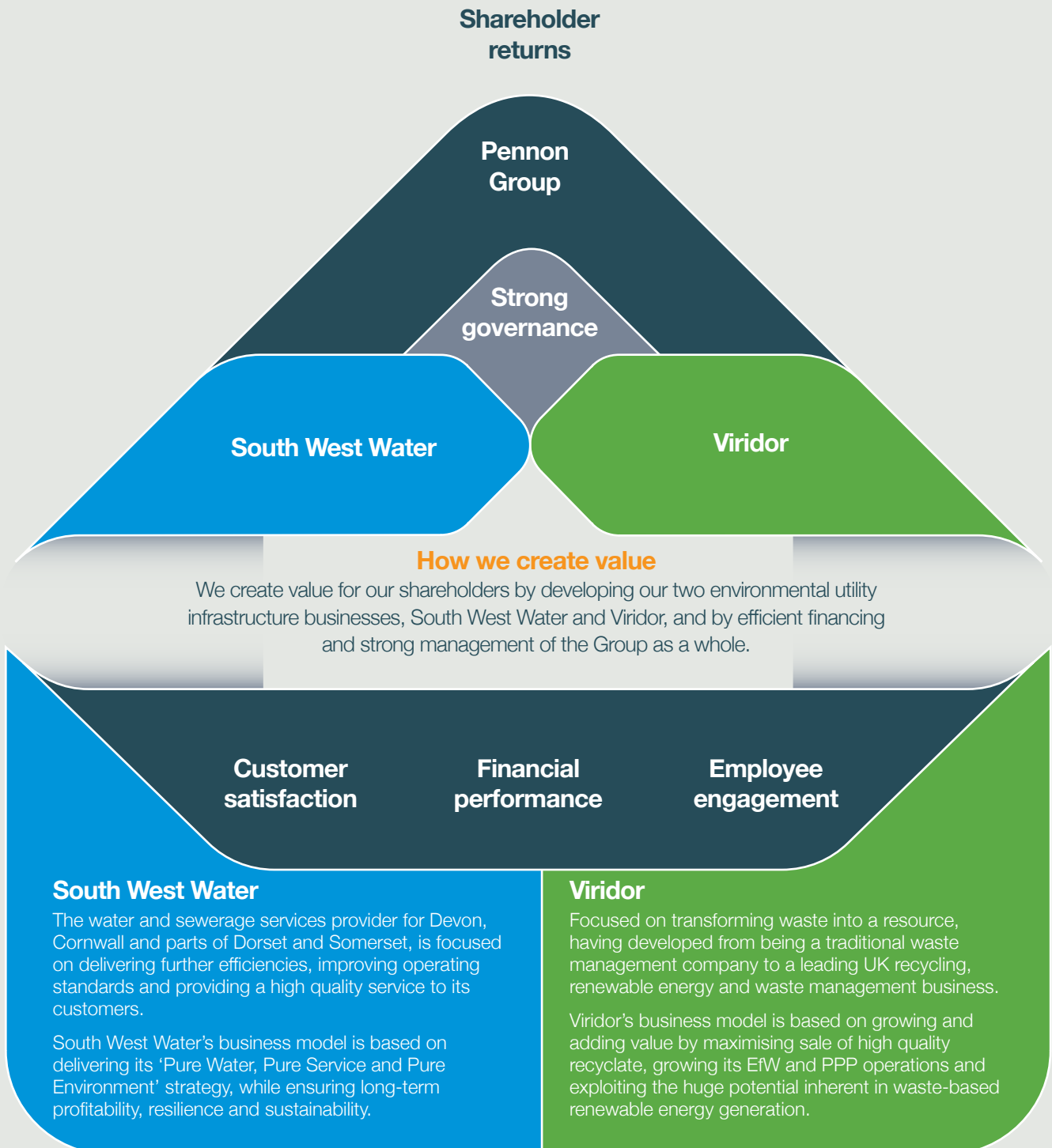


Ken Harvey
 Chairman
 Pennon Group Plc
 23 June 2014

Business model

How we generate and preserve value

Pennon's business model is driven by its strategy of promoting the success of the Group for the benefit of shareholders, customers and other stakeholders through its focus on the business areas of water and sewerage services, recycling, renewable energy generation and waste management. We aim to be a pre-eminent provider of customer services to high standards of quality, efficiency and reliability, and to provide value for our shareholders.



How we manage our businesses to create value



Customer satisfaction

Both South West Water and Viridor are fully committed to meeting the needs of their customers. This is key to the success of each business.

How we respond to our customers' needs and assess customer satisfaction is set out on pages 12, 13, 16, 21 and 23 of the strategic report.



Financial performance

Our Group has set challenging financial targets against which performance is measured through a range of key performance indicators (KPIs). These KPIs include profit before tax (before exceptional net charges), earnings per share (before exceptional net charges and deferred tax), dividend per share and the interest rate on average net debt.

Our focus in setting such targets is to achieve sustainable performance over the short and long-term.

Our financial performance is set out in more detail on pages 24-29.



Shareholder returns

We are committed to delivering sustainable shareholder returns. An example of this is our policy to grow the Group dividend by 4% above inflation per annum up to the end of 2014/15.

We will announce our dividend policy for the next period at the 2014/15 Preliminary Results.



Strong governance

We are aware that our businesses can, and do, have a material impact on the environment and communities in which they operate. To address this we take a responsible and transparent approach to environmental, social and governance (ESG) matters.

Our sustainable practices not only benefit communities but enable our businesses to be more successful.

More information on our sustainability activities are set out on pages 36-47 in our sustainability report.



Employee engagement

We know that the success of our Group is due to the talent, commitment and hard work of our employees and we aim to be a responsible employer.

We are focused on ensuring employee well-being, retention, efficiency and productivity.

More information on the initiatives we have introduced to improve employee engagement in each of our businesses is set out on pages 15, 23, 43 and 55.

How we operate and manage risks

Essential to achieving our strategic aims and creating value within our businesses is our operating framework, which is based on the principles of good governance.

Our operating framework includes a comprehensive and fully embedded risk management process which assists us in managing our risks and opportunities to deliver the Group's strategy and the other essential elements of our business model.

Further information on our control and risk management environment is described on page 59 and our principal risks and uncertainties and how we mitigate them are set out on pages 30-35.

South West Water

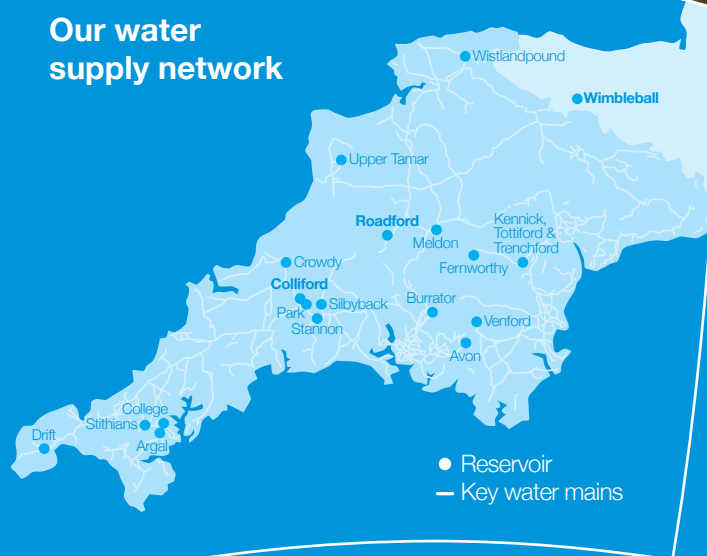
Investing in quality



1.7m
Resident population

29
Drinking water treatment works

Our water supply network



Operational highlights

- Best bathing water quality in seven years
- Improved customer satisfaction levels
- 17th consecutive year without water restrictions
- Outstanding drinking water quality
- Leakage control on target.

Revenue

(£m)

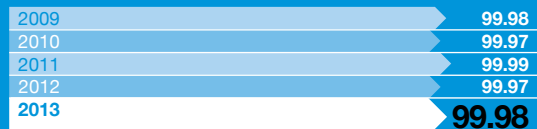


Profit before tax

(£m)



Drinking water quality Mean zonal compliance (%)



Service Incentive Mechanism (SIM) (%)



Bathing water compliance (%)



- EU mandatory standard
- Guideline standard

Operating profit (£m)



*Before exceptional net income.
⁽¹⁾Restated for IAS 19 (Revised).

Notable achievements

- Business plan to 2020 received 'enhanced' status from Ofwat and early Draft Determination already received
- Largest ever customer consultation in support of the business plan
- Major investment in sewer network and assets to better protect bathing waters
- Winner of Living Wetlands Award from the Chartered Institution of Water and Environment Management (CIWEM) for 'Upstream Thinking'
- One of the first water companies to launch a social tariff.

Strategy and performance

South West Water remains committed to its Pure Water, Pure Service and Pure Environment vision. The company strives to achieve the highest standards possible in every sphere of its activities, delivering efficiency through innovation, meeting the needs of those it serves and meeting its responsibilities to the environment, while keeping its costs as low as possible.

Pure Water

Providing a reliable, clean and safe supply of drinking water.

Performance

Drinking water quality among the best in the industry; 17th consecutive year without water restrictions and leakage control on target.

Pure Service

Delivering responsive and cost-effective customer services that meet customers' needs.

Performance

Increased customer satisfaction, 78% of customers metered, social tariff launched to assist those who struggle to pay, increased use of digital media to improve customer communications. Prices frozen for 2014/15.

Pure Environment

Protecting and enhancing the environment through sustainable actions and initiatives.

Performance

Bathing water quality at best standard in seven years, increased renewable energy generation, reduction in greenhouse gas emission levels.

Financial Management

Making resilient business decisions while outperforming the regulatory contract.

Performance

Continued efficiency delivered, increased operating profit underpinned by increased revenue and rigorous cost control. Business plan to 2020 published, 'enhanced' status achieved; the only water and sewerage company to receive Ofwat's top assessment.

Strategic review

South West Water continued to outperform its efficiency targets for the current regulatory period, delivering strong financial results supported by robust operational performance despite extremes of weather, including a hot dry summer followed by severe storms in winter 2013/14.



Business performance

Increased revenue and rigorous cost control were underpinned by the continued delivery of efficiencies resulting in operating profit increasing by £12.2 million to £227.0 million.

An overall reduction in demand of 1.0% and the effect of customers switching to a metered tariff was offset by tariff increases and new connections with revenue rising by 4.3% to £520.0 million. Excluding exceptional net income in 2012/13 profit before tax increased by 10.8% to £162.5 million.

The company front-end loaded delivery of the required 2.8% per annum average cost efficiencies. Cumulatively the efficiency delivered for the four years of K5 is 14% ahead of Ofwat's target as a result of early delivery. Annual operating costs are £22.2 million lower as a consequence with £3.6 million delivered in 2013/14 through a combination of the following:

- improved operational ways of working from the integration of customer services management and asset improvements through the PUROS* programme
- energy procurement and usage – energy efficiency schemes alongside additional power generation through renewable sources
- rationalising administration and support services
- right-sourcing and innovative contracting – tendering to achieve the 'right price'.

Capital expenditure for the year was £141.6 million compared with £116.5 million in 2012/13.

*Phased Utilisation of Remote Operating Systems

The focus for the programme remains weighted towards the maintenance of our existing assets, increasing the resilience of our infrastructure and delivering environmental improvements. Investments during the year included:

- improvements in water quality with treatment upgrades at two key sites (Restormel and Wendron) which provide 50% of the water supply for Cornwall
- investments in assets to improve bathing water quality to meet revised European Guidelines in 2015
- delivering additional capacity to meet growth – including supply to two new towns within the region
- focusing on compliance at waste water sites to manage periods of extreme weather conditions
- safeguarding water resources – upgrades to four reservoirs across the region
- innovative investments to reduce flooding for those customers previously highlighted as at risk.

South West Water continues to deliver capital projects in line with Ofwat, the Drinking Water Inspectorate and Environment Agency expectations. Performance cumulatively to date is in line with targets.

Pure Water

Drinking water quality

Despite the challenges of a dry summer with high levels of demand followed by an intensely wet winter, South West Water continued to deliver outstanding water quality with an official result (as measured by Mean Zonal Compliance) of 99.98%. This reflects investment made in water mains rehabilitation; the maintenance and improvement of treatment works and processes; and the efforts and expertise of operational staff.

South West Water also took steps to improve the aesthetic qualities (taste, smell and colour) of its water supplies, recognising the importance of this to customers. Significant investments during the year included water treatment process enhancements at its Restormel and Wendron water treatment works, both in Cornwall.

Water resources

Despite the very dry weather over the summer months coinciding with the peak tourist season, South West Water continued to deliver unrestricted supplies to its customers for the 17th consecutive year.

Building on the significant investment made in reservoirs and the supply network in previous years, the company's water resources strategy is now focused on targeting the careful management and optimisation of water resources in order to continue to meet its customers' needs.

Reservoir levels reached near 100% capacity in early 2014 and consequently the company is in a healthy resource position for the coming year.

Leakage control

South West Water's solid track record in controlling leakage was maintained in 2013/14 with the company minimising leakage in line with its target of no more than 84 megalitres lost on average per day. Improved response times to leaks and bursts are now being targeted alongside ongoing investment in the maintenance of the supply network and assets.

A key part of the company's leakage strategy is the use of improved monitoring and control technologies. This includes advanced diagnostic tools and remote communication technologies in order to better predict, and respond to, any issues on the drinking water supply network.

Upstream Thinking

South West Water is investing circa £8 million during 2010-2015 in its award-winning catchment management programme, known as 'Upstream Thinking'.

Designed to improve natural water quality and storage in the landscape using low-impact ecologically sensitive solutions, the two main strands of activity are moorland restoration work and farm improvements to reduce the impact of agricultural activity on the region's watercourses.

In early 2014 independent studies by the University of Exeter confirmed that the restoration work on Exmoor (Exmoor Mires Project) was making significant headway in improving water quality and reducing flood risk by easing the flow of water from the land.

'Upstream Thinking' won the Chartered Institution of Water and Environment Management (CIWEM) Living Wetlands Award in 2013.

Pure Service

Customer satisfaction

Since the start of K5 (2010-2015) the investment South West Water has made in its frontline customer services has, alongside operational improvements, resulted in a 97% increase in its customer service score, as measured by the Service Incentive Mechanism (which takes into account a range of customer service aspects and the results of customer satisfaction surveys). The number of written complaints has also more than halved over this period.

Recognising that there is still work to be done to improve customer satisfaction levels, the company is targeting a range of improvements including enhancements to the systems and processes for dealing with queries, complaints and requests for information.

The more integrated approach to resolving issues first time is being complemented by the increased use of digital media to provide better outbound communications. This reduces the likelihood of a customer needing to contact the company.

Metering

In 2013/14 there were fewer new meter installations than in previous years, which reflects the already high level of meter penetration in the region. At the year-end the percentage of South West Water household customers on a metered supply had increased to 78%.

Affordability

Recognising that there are customers in the region who genuinely struggle to pay their bills, South West Water continues to offer a range of affordability schemes and initiatives, in addition to advice and support on aspects such as water efficiency.

In 2013 the company was one of the first water companies to launch a social tariff. Means-tested, the tariff has already assisted 1,100 customers in the region by reducing their bills to an amount they can better afford to pay. The company also successfully managed the implementation of the £50 Government payment for eligible household customers.

Furthermore, and in recognition of the importance customers attach to keeping bills as low as possible, the company has frozen prices for 2014/15. This announcement coincided with the publication of the company's business plan to 2020 in December 2013 and has been well received by customers, regional MPs, media and stakeholder groups.

Business customers

South West Water provides water and waste water services to over 73,000 businesses and other non-household customers such as schools and hospitals. Many of them are small to medium-sized enterprises with the tourism and agriculture sectors accounting for 45% of non-household water use.

Strategic review Continued

Through the 'Source for Business' service brand, South West Water provides additional commercial services, including dedicated contact routes to business customer specialists; account managers for larger organisations; water efficiency support; and a range of innovative supplementary products and services.

From 2017 onwards all non-household customers will be able to choose their water and waste water service provider. South West Water is currently preparing for these changes and exploring the options for diversification as new opportunities arise.

Pure Environment

Bathing waters

In 2013 the region's bathing water quality reached the highest standards in seven years. Out of the 145 designated bathing waters sampled, only one failed to meet the minimum mandatory European water quality standard while 132 or 91% met the tighter guideline standard.

South West Water recognises the major benefits that high quality bathing water brings to the region, both in terms of attracting visitors and enhancing quality of life for residents. In preparation for the more stringent standards of the European Union's revised Bathing Water Directive, which comes into force in 2015, the company is investing circa £18 million on a range of bathing water quality improvement schemes.

South West Water also continues to work alongside partner organisations such as local councils and tourism authorities to look at how the variety of factors that potentially affect water quality (for example agricultural run-off, misconnections, impurities from birds and animals) can be addressed.

Downstream Thinking

In 2013 South West Water began preparatory work on the first of a series of pilot schemes designed to tackle the root causes of sewer flooding and pollution.

Taking a lead from the holistic approach to catchment management adopted for 'Upstream Thinking', 'Downstream Thinking' spans a range of low-impact activities including Sustainable Urban Drainage schemes (SuDs), habitat management and the targeting of minimising misconnections.

This initiative is being led by South West Water and is set to be rolled out in 2014/15 in partnership with a range of stakeholder groups including the Environment Agency, local councils, the Highways Agency and lead local flood authorities.

Waste water treatment standards

Targeted investment to raise the compliance rate of South West Water's waste water treatment assets continued in 2013/14.

The below target performance of two waste water treatment works earmarked for improvement caused a noticeable drop in compliance to 94.38% from 99.98% the previous year as measured by the percentage of population served by works that meet the criteria (Population Equivalent Sanitary Compliance).

Improvement work on those sites has since been carried out and the company continues to work towards delivering improved treatment standards in line with the revised Bathing Water Directive.

Pollution prevention

Compared with the previous year, 2013 saw a rise in the total number of pollutions although South West Water successfully avoided any 'major' or Category 1 incidents. The number of serious or harmful pollution incidents (which relates to both Categories 1 & 2) did increase to 10 from four the previous year. Of these, six related to cases in which amenities such as beaches were closed as a precautionary measure.



Flooding

After the extremely wet weather of the previous year, 2013/14 saw an overall reduction in floodings. This was despite above average rainfall and a spate of severe storms and high seas causing disruption and damage to infrastructure during the winter.

The number of internal floodings caused by hydraulic overload (sewers becoming overwhelmed by the sheer volume of water) was 50 — significantly fewer than the previous year although above the average for the 2010 – 2015 regulatory period.

The number of floodings resulting from other causes (for example blockages and sewer collapses) remained below the K5 average although additional work is required in order to reduce this number further.

Energy and carbon

In 2013/14 South West Water successfully reduced greenhouse gas emissions. Emissions were kept at a level lower than the company's baseline position at the beginning of the K5 investment period.

South West Water has maintained its investment in renewable energy, bringing the total expenditure for K5 to over £4 million. This has included the installation of the company's largest solar panel array to date at its Exeter headquarters. Along with hydro generation, combined heat and power (CHP) and the wind turbine at Lowermoor Water Treatment Works, South West Water's 34 solar panel schemes now bring the total capacity for renewable energy generation to over 10MW.

People

Integral to the long-term success of South West Water are the efforts and ingenuity of its 1,400-strong workforce. In 2013/14 the company continued to develop its 'People Strategy', which is designed to attract, develop and retain a motivated and highly skilled staff base, not least through a number of internal development and upskilling programmes and initiatives.

With the recruitment of 24 new apprentices, the total number rose to 43 across the business. The apprenticeship programme has been developed alongside regional educational establishments. South West Water is also playing a key role in the creation of a new University Technical College (UTC) in the area, which is due to open in 2015. This will help to educate and develop the next generation of engineers and scientists.

The company continually reviews its health and safety standards and makes improvements as appropriate to ensure best working practice.

In 2013/14 the number of injuries to our staff reportable under the RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences Regulations) was three.

The incident which resulted in a fatality at the company's Falmouth Waste Water Treatment Works on 30 December 2013 is not included in this figure. The coroner's inquest to establish the cause of death has not yet taken place. South West Water very much regrets that this incident occurred and our thoughts are with the family, friends and colleagues who have been deeply affected.

South West Water wishes to thank its staff both for their hard work over the past year and their ongoing dedication and commitment as the company prepares for the new regulatory period 2015-2020.



Strategic review Continued

Key relationships

Regulators and others

South West Water actively engages with a wide range of environmental and regulatory stakeholders. The company ensures that communication is handled in the most appropriate way and that the information provided is of high quality and consistent.

A range of commercial channels including traditional and online platforms are used to communicate with the company's stakeholders.

The company contributes to national policy on developing issues through its membership of Water UK, the industry trade body, and its work with the Consumer Council for Water to ensure that customers' issues and concerns are addressed and a full understanding of the company's activities is maintained.

WaterFuture customer panel

The independent 'challenge panel' comprising regional regulatory, business and consumer representatives played a key role in scrutinising and challenging South West Water's proposals and customer engagement process in the run-up to the publication in December 2013 of its business plan to 2020.

Tasked with ensuring that the business plan would meet the needs and priorities of customers while also fulfilling legislative and regulatory obligations, the panel met regularly with the South West Water management and executive teams.

Procurement and suppliers

South West Water's procurement strategy is focused on partnering and strategic alliances with around 60 key suppliers who account for the large majority of expenditure. All aspects of sustainability are included in the procurement process and this is a central theme of the company's procurement strategy and support for the regional economy.

At the start of the K5 period an innovative 'mixed economy' model was introduced to source capital programme suppliers. This means using a significant number of smaller local contractors to provide specialised services as well as developing long-term relationships with more major supply chain partners.

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

Business Plan to 2020

On 2 December 2013 South West Water submitted its K6 (2015-2020) business plan and following Ofwat's risk-based review, on 4 April 2014 Ofwat assessed the plan as 'enhanced'. An early Draft Determination was received on 30 April 2014. The Final Determination will follow on 12 December 2014.

The business plan was balanced, well evidenced and well supported and met or exceeded all of Ofwat's assessment areas. Ofwat commended South West Water on achieving 'enhanced' status through an excellent business plan and strong management. It acknowledged that South West Water had risen to the challenge set by the regulatory approach for the 2014 price review and considered the company's business plan to be an example of good practice. The Environment Agency also welcomed the commitment made by South West Water to meet its environmental obligations.

The benefits received from the 'enhanced' assessment include an initial financial award of £11 million reflected as an addition to the Regulatory Capital Value with up to 50% invested. It also includes an enhanced total expenditure (Totex) menu with an extra 5% enhanced sharing rate and a 'do no harm' principle as the company and Ofwat work towards the Final Determination.

Water Act

The new Water Act became statute in May 2014. As well as setting out a range of reforms for the water sector in England, the Act enables further retail and wholesale competition. Preparations are underway for the retail market opening in April 2017.

South West Water is fully engaged in the 'Open Water' programme, governed by the Department for Environment, Food and Rural Affairs and Ofwat, which will shape market reform in the sector. Building on the success of its 'Source for Business' range of specialist advice and support measures, the company has been awarded supply licences covering Scotland, England and Wales, which will allow it to retail water to customers outside the region currently served.





Outlook for South West Water

South West Water enters the final year of the current regulatory period in a strong and confident position.

To date the company has delivered substantial efficiencies which benefit all stakeholders and is focused on the continued delivery of efficiencies through a combination of innovation, investment in new technologies and the pioneering of cost-effective sustainable solutions.

In 2014/15 the company will continue to target:

- outperformance of the regulatory contract
- rigorous cost control
- investment in the asset base to safeguard past successes and prepare for the challenges and opportunities of the future.

South West Water continues to focus on efficient service delivery, improvements in service to customers and the satisfaction of its regulatory and legislative obligations. It is on track to outperform the K5 regulatory contract. Profits for 2014/15 will be impacted by the 2014/15 tariff freeze already announced. However, the revenues foregone have been taken account of in the Draft Determination for K6 on an NPV neutral basis.

With an 'enhanced' business plan for K6, South West Water has already received the Draft Determination for the 2015-2020 period. The company is engaged in the development of Ofwat's ongoing regulatory reform agenda and is well positioned for future Government legislative changes.

Viridor

Giving resources new life

317
Operating facilities

26
Materials recycling facilities

5
Anaerobic digestion power plants

7.4m
Tonnes of material handled

33
Landfill gas power plants

Energy recovery facilities (ERFs)

3 operational **7** under construction

Where we operate



Operational highlights

- Financial performance before exceptional items delivered in line with management expectations
- Strong progress in long-term Public Private Partnership (PPP)/Energy Recovery Facilities (ERFs) strategy
- Recovery in recycling margins from low of 2012/13
- Landfill Energy – focus on managing the decline in landfill operations and maximising energy production
- Exceptional charges of:
 - £43 million landfill asset impairment
 - £6 million increased landfill provisions net of tax these totalled £40 million

Revenue

(£m)

2009/10	626.5
2010/11	712.0
2011/12	761.1
2012/13	703.8
2013/14	802.0 (+14.0%)

Operating profit plus joint ventures*

(£m)

2009/10	77.0
2010/11	82.6
2011/12	75.2
2012/13 ⁽¹⁾	45.9
2013/14	43.6 (-4.6%)

Profit before tax*

(£m)

2009/10	55.1
2010/11	62.9
2011/12	57.6
2012/13 ⁽¹⁾	34.3
2013/14	27.6 (-19.5%)

Total renewable energy generation (GWh)

2009/10	612
2010/11	752
2011/12	760
2012/13	820
2013/14	778 (-5.1%)

Renewable energy generation capacity as at 31 March (MW)

2010	128
2011	136
2012	136
2013	137
2014	136 (-0.7%)

Recycling volumes traded (million tonnes)

2009/10	1.4
2010/11	1.7
2011/12	1.8
2012/13	1.9
2013/14	1.8 (-3%)

*Before exceptional charges.
⁽¹⁾Restated for IAS 19 (Revised).

Notable achievements

- Excellent continuing progress in strategic reorientation of Viridor's business model
- Significant developments in long-term EfW business:
 - Runcorn Phase 1 and Exeter Energy Recovery Facilities (ERFs) – 'hot commissioning'
 - Ardley (Oxfordshire) ERF in commissioning
 - Runcorn Phase 2 and Trident Park (Cardiff) ERFs – shortly to enter commissioning
 - South East Wales residual waste project (Prosiect Gwyrdd) signed December 2013
 - Glasgow and Peterborough ERFs under construction
 - South London Waste Partnership PPP (Beddington) ERF – planning secured but 'Notice to Proceed' delayed due to expected judicial review.

Strategy and performance

Viridor's stated company purpose is to give resources new life. Its strategy remains focused on transforming waste into high quality recyclables, raw materials and energy.

The company continues to build its business through a combination of securing long-term contracts, driving quality in recycling and growing capacity in waste-derived renewable energy.

Long-term profit growth is expected to be driven by its PPP contracts, ERF projects and focused recycling opportunities.

Performance – recycling and resources

- Recovery in recycling margins – although remain cautious with respect to future prospects
- Continued focus on quality and adding value
- £25 million investment in new glass and polymers facilities in Newhouse, Scotland and Rochester, Kent to maximise the value of recyclates processed – both due to be operational in autumn 2014
- Profits in contracts and collection up overall.

Performance – energy

- Excellent progress in long-term PPP/EfW projects, including financial close achieved for South East Wales, residual waste 25-year PPP (Prosiect Gwyrdd) securing fuel for Trident Park ERF
- Lakeside ERF continuing to perform strongly
- Walpole AD facility now operational
- Landfill gas power generation profit up 26.5%
- Increase in profits for landfill gas power generation more than offset by the continued decline in landfill.

Strategic review



UK landfill diversion is being achieved by a major increase in recycling and energy recovery from residual waste.

Strategy and UK context

The UK is required under the EU Landfill Directive to reduce the amount of biodegradable municipal waste going to landfill sites. This is being achieved by a major increase in recycling, with residual waste increasingly being used for energy recovery. Energy recovery from waste (both biodegradable and non-biodegradable) accounted for 8% of total UK renewable energy generated in 2012*. Viridor believes that by 2020 UK energy recovery from waste could produce 15,000 GWh of the total forecasted UK renewable energy generation (120,000 GWh), accounting for circa 13%. This is particularly significant given predicted capacity shortages in the energy sector.

The Government's main mechanism for diverting waste from landfill and incentivising recycling and ERFs remains landfill tax. The Government has confirmed that landfill tax will rise in line with inflation from 1 April 2015 from the current rate of £80 per tonne. This continues to influence the long-term economics of both recycling and energy recovery. In addition, recycle costs are typically significantly lower than the cost of using virgin materials for manufacturers.

Viridor is giving resources new life through its focus on recycling and waste-based renewable energy. Investment in technology and operational practices has been successfully made to enhance recycle quality to differentiate Viridor from its competitors. This, aligned with management of the cost base, continues to improve recycling margins.

Significant progress has also been made in the development of the EfW business, with a substantial asset base being constructed in conjunction with the development of the associated business capability processes across the whole 'source to supply' EfW production cycle.

EfW is central to the UK's waste and renewable energy strategies as the long-term, low-cost alternative to landfill for disposal of residual waste. Viridor expects to have 15% market share by 2020 with a network of strategic ERFs which will underpin the company's long-term profit growth.

For the landfill energy business the focus is to maximise the value of landfill gas generation across all sites, managing the expected decline in landfill inputs by concentrating on strategic operational sites and optimising returns on other sites through alternative uses such as photovoltaic installation.

To align the structure of the organisation with its strategy, two divisions have been created: Recycling & Resources (comprising recycling, contracts and collection) and Energy (comprising ERFs, landfill energy and other renewable power).

* Figures for 2013 not yet available

Business performance

Revenue was up 14% to £802 million. Landfill revenue was up £43.1 million due to higher landfill tax revenues and construction revenues were up reflecting growth in assets under construction, partly offset by a decrease in recycling revenue of £17.1 million primarily due to lower prices.

Before exceptional charges Viridor's earnings before interest, tax, depreciation and amortisation (EBITDA) for the year were broadly flat, with a small decrease of £1.4 million (1.8%) to £76.3 million. PBIT fell £0.4 million (1.3%) to £30.2 million. PBIT plus joint ventures decreased by £2.1 million (4.6%) to £43.6 million.

Profit before tax and exceptional charges decreased £6.7 million (19.5%) to £27.6 million reflecting lower PBIT plus joint ventures and the increased interest charge from higher landfill provisions.

Exceptional charges

The profitability of the landfill business has declined faster than anticipated due to aggressive pricing from other landfill operators (in response to local authority austerity and increasing levels of landfill tax) who are competing for volume to allow closure of their sites with suitable landforms, and higher ongoing capital costs.

While there will always be a need for strategically located landfill sites, Viridor expects these trends to continue for the foreseeable future. As a result a net pre-tax exceptional impairment charge of £42.9 million has been recognised to write-down the carrying value of landfill property, plant and equipment. The impairment charge has no immediate cash impact.

Landfill provisioning has been increased by £5.7 million due to revisions to site life costings.

Investment

Investments in the future capabilities and strength of Viridor's business included capital investment of £292 million (2012/13 £324 million), of which £254 million was for growth projects (largely EfW). This investment is part of the overall £1.5 billion programme to deliver essential infrastructure which will make a substantial contribution to energy and resource security in the UK.

Recycling and resources

During the year recycling volumes traded decreased marginally by 63,000 tonnes (3.0%) to 1.8 million tonnes. Recyclate prices have stabilised to some degree for most commodities but remain under pressure, reflecting world economic conditions and competitive markets and, in the near term, higher shipping costs. Overall average revenues per tonne from recyclate sales and gate fees for the year fell to £93, 6.1% lower than for 2012/13.

Action has been, and continues to be, taken to reduce the cost base with the average cost per tonne reduced to £83 from last year's total of £93, including the benefit of circa £3 per tonne from the 2012/13 impairment charge. Allied to an emphasis on the production of high quality recyclate, the business has been benefitting from improvements in margins. The company remains cautious on the prospects for recyclate prices and therefore continues to focus on revenue optimisation, facilities rationalisation and cost reduction.

Investment is also being made in technology with a new plastic/polymer separation plant at Rochester, costing circa £15 million, and a new glass reprocessing plant in Scotland, costing circa £10 million. These investments will enable Viridor to enhance product quality and continue to differentiate itself in the sector. Viridor now has the most extensive Materials Recycling Facility (MRF) capacity in the UK with accreditations for export to China, and is established as a quality brand in other Asian markets.

Profits in 'Contracts & Other' were up overall across the 15 municipal contracts around the UK (the more significant contracts include Lancashire, Glasgow, Lakeside, Manchester, Somerset and West Sussex) and the Thames Water contract. The increase also reflected higher profits on property sales. Profits in the collection business were also ahead, reflecting increased management action.

Additional contracts have been won since the year-end but profits in the first half of 2014/15 are expected to be impacted by the expiry of some old contracts.

Energy

Energy can be recovered in two ways, either via gas (notably landfill gas and anaerobic digestion (AD)) or combustion in ERF and similar facilities, some of which may be a part of Combined Heat and Power (CHP) schemes. Bio-energy (including landfill gas, biodegradable EfW and AD) and energy recovery from non-biodegradable waste accounted for 39% of total renewable energy in 2012*.

(a) Landfill gas power generation

Profit contribution from gas generation was £30.1 million, an increase of 26.5% on 2012/13. Viridor's landfill gas power generation output fell 2% to 606 Gigawatt hours (GWh) after reaching peak output in 2012/13 and is expected to reduce gradually over the coming years.

Average revenue per Megawatt hour (MWh) increased by 9.2% to £89.74 reflecting the switch from Non Fossil Fuel Obligation (NFFO) contracts to Renewables Obligation Certificates (ROCs). Total landfill gas power generation operational capacity

* Figures for 2013 not yet available

Strategic review Continued

declined by 2MW to 105MW (excluding 3MW capacity at sub-contract sites in Suffolk). The proportion of operational capacity eligible for ROCs increased to 85%, with the remaining 15% being on (lower priced) NFFO contracts. Further NFFOs migrate to ROCs during 2014/15 with the balance moving across by 2016/17.

Average costs were reduced by 8.4% to £40.05 per MWh with a continuing focus on managing the cost base.

(b) Energy Recovery Facilities (ERFs) and Anaerobic Digestion (AD)

As well as the 105MW of landfill gas capacity, Viridor has a further 31MW of renewable energy capacity across its share of the Lakeside ERF, the Bolton ERF and its AD operations.

In addition to the above operational projects, Viridor is pursuing a number of other renewable energy opportunities. Most notably, the company has been successfully implementing its strategy to develop the EfW business, which will drive long-term profit momentum. This includes establishing a significant asset base of ERFs. Viridor and its partners have a total operational/committed ERF capacity of 2.5 million tonnes. The company has now secured circa 80% of the required waste inputs for the opening of the committed ERFs, of which circa 60% is from long-term contracts.

Five plants, being Runcorn Phases 1 and 2, Exeter, Ardley (Oxfordshire) and Trident Park (Cardiff), have reached advanced stages of build with all expected to come on-stream in financial year 2014/15. Two others, Glasgow and Peterborough, commenced construction in the year. 70% of spend on ERF projects under construction is now complete.

At the start of 2014 there was a successful appeal to have the planning restriction on road-borne waste inputs to both phases of Runcorn lifted from 85,000 to 480,000 tonnes per annum. Planning consent for the Beddington ERF was issued in March 2014. However the project has been delayed pending a judicial review, which was expected.

As part of continuing to secure waste for the ERFs, the South East Wales residual waste project (Prosiect Gwyrdd) was signed in December 2013.

Viridor has also reached the final bid stage as one of two bidders on the Edinburgh and Midlothian residual waste contract.

The Walpole AD plant, which has a 1MW export capacity, is now producing power. A further 'closed loop' opportunity to use digestate as a biofertiliser is being assessed with the Environment Agency.

EfW contracts and projects already contribute to the bottom line and reflect the realisation of a strategy which is expected to contribute around £100 million to Viridor's EBITDA within the next three years.

(c) Landfill

The business continues to be strongly cash generative and contributed £33.6 million to EBITDA in the year. Volumes increased marginally (0.8%) to 2.7 million tonnes over the year.

Average gate fees decreased by 9.0% to £23.06 per tonne. Consented landfill capacity reduced from 61.5 million m³ at 31 March 2013 to 57.7 million m³ at 31 March 2014, reflecting usage during the year. As previously stated and provided for last year, around 39 million m³ is not expected to be used.

Future alternative uses for sites are now also being assessed in detail. Early success has been achieved at Westbury with planning permission granted for a 2.75MW photovoltaic installation. Construction started in May 2014. An £8 million partnership with, and fully funded by, the Department of Energy and Climate Change to deliver a demonstration cryogenic energy storage plant has been signed and construction is scheduled to commence in the first quarter of 2014/15.

Landfill tax, which is passed directly to the customer, was £72 per tonne throughout the year and rose further to £80 per tonne in April 2014.

Joint ventures

Total joint ventures' contribution, which consists of interest on shareholder loans and share of profit after tax, fell 11.3% to £13.4 million (2012/13 £15.1 million) reflecting developments explained below.

(a) Lakeside

Lakeside, the first of Viridor's EfW pipeline projects, continues to perform very strongly and is ahead of original expectations in terms of both waste inputs and energy output. The contribution was £5.9 million in 2013/14; comprising interest receivable on shareholder loans unchanged at £1.4 million and share of profit after tax from Lakeside £4.5 million (down £1.3 million on the previous year reflecting higher outage costs). A further £2.9 million contribution came from the sub-contract profit.

(b) Viridor Laing (Greater Manchester) (VLGM)

The 25-year Greater Manchester Waste PFI contract (being delivered through VLGM) is the UK's largest ever combined waste and renewable energy project. VLGM is a joint venture between Viridor and John Laing Infrastructure. Operation of the associated facilities (both existing facilities and those which are to be developed) is being carried out on a sub-contract basis by Viridor.

Solid recovered fuel produced from the waste will be used to generate heat and power at a plant being built at Runcorn in Cheshire. Runcorn Phase 1 is being built primarily for the Greater Manchester Waste PFI contract.

As part of the VLGM contract, a separate contractor was mandated to construct 43 facilities. As at 31 March 2014, 42 of these facilities had been formally taken over by Viridor. The 43 facilities include four mechanical biological treatment (MBT) plants. Three of these MBTs have been taken over and the remaining one is substantially complete, but has not yet been taken over due to isolated process elements not performing satisfactorily. The delay in takeover of the remaining plant is being addressed and is not expected to affect the financing of the project or have a material impact on the performance of the PFI.

Interest receivable on shareholder loans from the VLGM joint venture was £5.3 million, up £0.2 million (2012/13 £5.1 million). Share of results after tax from VLGM on an IFRIC 12 basis was a loss of £0.5 million, down £0.5 million due to a reduction in construction margin profits as construction completion is reached.



(c) Runcorn Phase 1 (TPSCo)

Interest receivable on shareholder loans from the Runcorn Phase 1 EfW joint venture was £3.0 million, up £0.2 million on 2012/13. Share of profit after tax was a loss of £0.3 million, down £0.3 million on 2012/13.

Hot commissioning has now commenced on-site. First burn of waste occurred in March 2014. Full testing of rail operations has been completed and rail-borne fuel transfer from Greater Manchester is now operational. Viridor does not expect previously reported delays to have a material impact on the completion and operation of the Greater Manchester PFI or TPSCo.

Key relationships

With regard to Viridor's largest customer groups, local authorities account for 31% of the company's revenue, although no individual authority accounts for more than 12%. Viridor's ROC energy contracts account for 7% of revenue, primarily with one customer.

Recycling and waste management operations in England and Wales require Environmental Permits issued and regulated by the Environment Agency (EA) and Natural Resources Wales. In Scotland the Scottish Environmental Protection Agency issues and regulates similar waste management licences or pollution, prevention and control (PPC) permits. Viridor maintains a positive working relationship with these and other relevant regulatory bodies by means of proactive liaison and management of any issues at both site and strategic levels.

A full update of Viridor's industry-leading 'OpenSpace' web portal, through which 'live' data is shared with the regulators, was completed during the year. This transparent and proactive approach continues to save time and resources for all parties.

People

Recognising the importance and performance benefits of an engaged workforce, Viridor has developed plans to fully monitor and improve engagement across the company. This includes a commissioned survey, roadshows and other programmes as it rolls out its Enterprise Resource Platform and associated business process improvements.

Viridor has reviewed its overall approach to the health, safety and welfare of its employees and is aiming to achieve a step change in overall health and safety

performance. A full company-wide health and safety survey is informing developing action plans that will be implemented during 2014/15. There was a continued fall in the RIDDOR incidence rate over the previous year, with 37 reportable incidents, giving a rate of 1,197 per 100,000 employees (1,429 last year).*

The company remains committed to the ongoing training, professional development and 'upskilling' of its employees. 4,352 training days and an additional 1,001 Certificate of Professional Competence driver training days were delivered across the company. 245 employees are participating in sustainable resource management apprenticeships, alongside 17 current full-time apprentices in the business. 41 managers are enrolled in the innovative and sector-leading Viridor Foundation Degree course, developed and delivered in partnership with Edge Hill University.

Outlook for Viridor

Viridor continues its transformation from being predominantly a landfill and collections operator to becoming one of the country's leading recycling, renewable energy and waste management companies.

While there are some signs of improving economic trends, the company remains appropriately cautious about the future prospects for recycle prices. Viridor remains strongly focused on a stringent programme to optimise revenues, achieve efficiencies through facilities rationalisation and cost reduction to sustain margin improvement.

Excellent progress has been achieved in the realisation of the EfW business. Five major ERFs are due to become operational in the current financial year while two others started construction in 2013/14 and the Beddington ERF recently gained planning permission.

Viridor's first half year EBITDA figure in 2014/15 is expected to be materially lower than the half year figure for 2013/14 (primarily due to the expected continuation of landfill decline but also the gradual decline in power generation and the near term recycling and contracts factors noted above). However the ERFs coming on-stream this year are expected to increase EBITDA in the second half of the year resulting in the full year EBITDA for 2014/15 exceeding 2013/14. These assets represent a strategic ERF portfolio which is already making a significant contribution to Viridor's bottom line and reflect the realisation of a strategy which is expected to contribute circa £100 million to Viridor's EBITDA within the next three years.

* From 2012 reportable incidents are now reported on seven days' absence; in previous years they would have been reported on three days' absence.

Group

Financial review

Pennon Group delivered revenue and profit before tax (before exceptional net charges) around 10% ahead of last year.

Performance overview

The principal measures used to assess the Group's financial performance are profit before tax and earnings per share (both before exceptional net charges and deferred tax); and the interest rate on average net debt.

Profit before tax

before exceptional net charges (£m)

2009/10	185.8
2010/11	188.5
2011/12	200.5
2012/13 ⁽¹⁾	190.0
2013/14*	207.3

+9.1%

* Statutory basis £158.7 million.

Dividend per share

(pence)

2009/10	22.55
2010/11	24.65
2011/12	26.52
2012/13	28.46
2013/14	30.31

+6.5%

Earnings per share

before exceptional net charges and deferred tax (pence)

2009/10	40.8
2010/11	42.3
2011/12	47.3
2012/13 ⁽¹⁾	40.3
2013/14	42.6

+5.7%

Interest rate on average net debt

(%)

2009/10	4.3
2010/11	4.4
2011/12	4.2
2012/13	4.0
2013/14	3.8

* Excluding pensions net interest, discount unwind on provisions, IFRIC 12 contract interest receivable and interest receivable from joint ventures.

Reconciliation of earnings

	2013/14 Profit after tax (£m)	2013/14 Basic earnings per share (p)	2012/13 ⁽¹⁾ Profit after tax (£m)	2012/13 ⁽¹⁾ Basic earnings per share (p)
Statutory earnings	142.5	38.8	20.6	5.7
Deferred tax before exceptional net charges	(25.8)	(7.0)	(14.1)	(4.0)
Exceptional net charges (post-tax)	39.7	10.8	140.2	38.6
Earnings before exceptional net charges and deferred tax	156.4	42.6	146.7	40.3

Note: Earnings per ordinary share figures in this strategic report exclude exceptional net charges and deferred tax. The Directors believe excluding deferred tax provides a more useful comparison on business trends and performance. Deferred tax distorts earnings per share through the effects of changes in corporation tax rates and the level of long-term capital investment.

⁽¹⁾ Restated for IAS 19 (Revised)

A continuing low net interest rate was achieved, coupled with raising cash and facilities to fund future growth: £1,303 million cash and facilities at 31 March 2014, including £640 million of new and refinanced facilities sourced during the year.



David Dupont
 Group Director of Finance

**The year's financial highlights
 (before exceptional net charges)**

Group profit before tax increased by £17.3 million (9.1%) to £207.3 million, driven by increased profits in South West Water. Earnings per share before deferred tax increased by 5.7% to 42.6p.

South West Water recorded a strong performance against the 2010-2015 regulatory contract and is well placed to deliver outcomes and outperform assumptions. South West Water profit before tax was up £15.8 million (10.8%) to £162.5 million reflecting higher revenues and good cost control.

Viridor PBIT plus joint ventures was broadly similar to last year, slightly down by £2.1 million to £43.6 million. Earnings before interest, tax, depreciation and amortisation (EBITDA) was slightly down by £1.4 million to £76.3 million. This reflects continuing declines in landfill more than outweighing growth in landfill gas power generation and a recovery in recycling.

We have secured further funding to finance continuing growth. By the year end we had £1,303 million in cash and facilities (including £173 million of restricted funds) in place to fund the major growth in Viridor's EfW business, together with South West Water's K5 (2010-2015) capital programme.

Capital investment remained significant this year at £434 million due to continuing major investment in Viridor's ERFs which are expected to drive future growth. 70% of capital expenditure is now complete on Viridor's EfW projects under construction. South West Water's capital expenditure increased by 22% during the year.

We have secured funding at a cost that is low in absolute terms. The Group interest rate on average net debt improved to 3.8% (2012/13 4.0%).

Revenue

Group revenue increased by 10.0% to £1,321.2 million. South West Water's revenue increased by 4.3% to £520.0 million as a result of tariff increases, new connections and higher other revenue, partially offset by lower demand and a reduction in revenue from customers switching from unmeasured to metered charges. Viridor's revenue increased by 14.0% to £802.0 million due primarily to higher landfill revenues and increased construction spend on service concession arrangements, partly offset by lower recycling revenues.

**Operating profit
 (before exceptional charges)**

Group operating profit increased by 4.8% to £257.5 million with South West Water up by 5.7% to £227.0 million, but Viridor down by 1.3% to £30.2 million. Ongoing operational cost efficiencies in South West Water are cumulatively 14% ahead of the K5 target. Viridor's overall operating profit was broadly similar to last year, as improvements in recycling and landfill gas generation were offset by continuing declines in landfill.

**Net finance costs
 (before prior year exceptional net income)**

We continued our effective management of interest rates in 2013/14 with interest payable (including capitalised interest) net of interest receivable, on average net debt equating to 3.8% (2012/13 4.0%) which included lower interest payable on RPI linked debt.

Net finance costs of £53.9 million are £7.5 million lower than last year, reflecting an £8.2 million increase in capitalised interest. The overall interest cost on borrowings remained broadly unchanged compared to last year, due primarily to net cash outflows in the year being funded by the £300 million hybrid capital securities issued in March 2013. The associated £15.6 million (net of tax) hybrid capital periodic return, paid in March 2014, has been recognised directly in equity.

Investment income totalling £9.0 million (2012/13 £10.8 million) has been achieved with the objective of enhancing returns on the Group's substantial pre-funding of £613 million.

During the year net finance costs (excluding pensions net interest, discount unwind on provisions and IFRIC 12 contract interest receivable) were £49.1 million (2012/13 £59.3 million); covered 5.2 times (2012/13 4.1 times) by Group operating profit.

Financial review Continued

A strong liquidity and funding position to finance growth.

Profit before tax (before exceptional net charges)

Profit before tax was £207.3 million, an increase of 9.1%. Pages 10 and 17 give a detailed description of the financial performance of South West Water and Viridor respectively. On a statutory basis profit before tax was £158.7 million reflecting exceptional net charges of £48.6 million.

Taxation (before exceptional net charges)

The Group's UK corporation tax charge for the year was £35.3 million (2012/13 £43.3 million) after the release of prior year credits of £16.5 million (2012/13 £13.0 million). The decrease primarily reflects a reduction in the rate of corporation tax and an increase in prior year credits. Deferred tax for the year was a credit of £25.8 million (2012/13 £14.1 million) which included a credit of £40.1 million reflecting the enacted 3% reduction in the future rate of UK corporation tax.

Earnings per share (before exceptional net charges and deferred tax)

Earnings per ordinary share increased by 5.7% to 42.6p reflecting higher underlying profit. The weighted average number of shares in issue during the year was 367.4 million (2012/13 363.6 million). Net assets per share at book value at 31 March 2014 were 323p.

Exceptional net charges

An exceptional net impairment charge of £42.9 million has been recognised to write down the carrying values of property, plant and equipment in landfill activities, to reflect reducing landfill prices and higher ongoing capital costs. Landfill provisioning has been increased by £5.7 million due to revisions to site life costings. The net impairment charge has no immediate cash impact.

The exceptional net charges total £39.7 million net of tax.

Dividends and retained earnings

The statutory net profit attributable to ordinary shareholders of £142.5 million has been transferred to reserves.

The Directors recommend the payment of a final dividend of 20.92p per share for the year ended 31 March 2014. With the interim dividend of 9.39p per share paid on 3 April 2014 this gives a total dividend for the year of 30.31p, an increase of 6.5% over 2012/13 (reflecting 4% real growth plus RPI of 2.5% for the 12 months to 31 March 2014).

Proposed dividends totalling £112.7 million are covered 1.4 times by net profit (before exceptional net charges and deferred tax) (2012/13 1.4 times). Dividends are charged against retained earnings in the year in which they are paid.

Dividend policy

The Group's policy is to increase the dividend each year by 4% above inflation up to the end of 2014/15. The Group is well positioned to meet future challenges and to continue delivering shareholder value.

Operating costs (before exceptional charges)

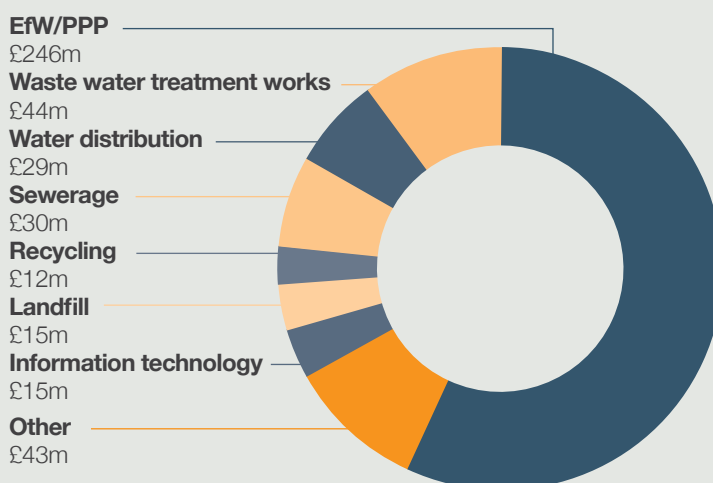
Operating costs for the year totalled £1,064 million. The most significant areas of expenditure were:

Expenditure	£m
Landfill tax	192
Manpower	161
Depreciation	147
Raw materials and consumables*	81
Transport	65
Power	34
Business rates	32
Abstraction and discharge consents	7

* Excludes elements of transport costs.

Group investment

The Group's capital expenditure on property, plant and equipment, including service concession arrangements, remained significant at £434 million (2012/13 £439 million) primarily from investment in Viridor's growth projects of £254 million. The major categories of expenditure were:



Cash flow

In 2013/14 the Group once again had a strong operating cash flow. However the ongoing high level of capital investment to support future growth resulted in net debt increasing by £185 million.

Summarised cash flow £m	2013/14	2012/13
Cash inflow from operations	407	385
Net interest paid	(39)	(50)
Tax paid	(58)	(19)
Dividends paid	(69)	(78)
Hybrid periodic return	(20)	-
Capital expenditure	(392)	(422)
Acquisitions/investment in joint ventures	-	(14)
Loan repayments and dividends received from joint ventures	9	9
Pension contributions	(18)	(14)
Net cash outflow	(180)	(203)
Hybrid securities issuance	-	295
Shares issued	2	4
Debt acquired with acquisitions	-	(1)
Debt indexation/interest accruals	(7)	1
(Increase)/decrease in net borrowings	(185)	96

Liquidity and debt profile

The Group has a strong liquidity and funding position with £1,303 million cash and facilities at 31 March 2014. This includes cash and deposits of £613 million (including £173 million of restricted funds representing deposits with lessors against lease obligations) and undrawn facilities of £690 million. A total of £640 million in new or renewed debt facilities were arranged during the year, being:

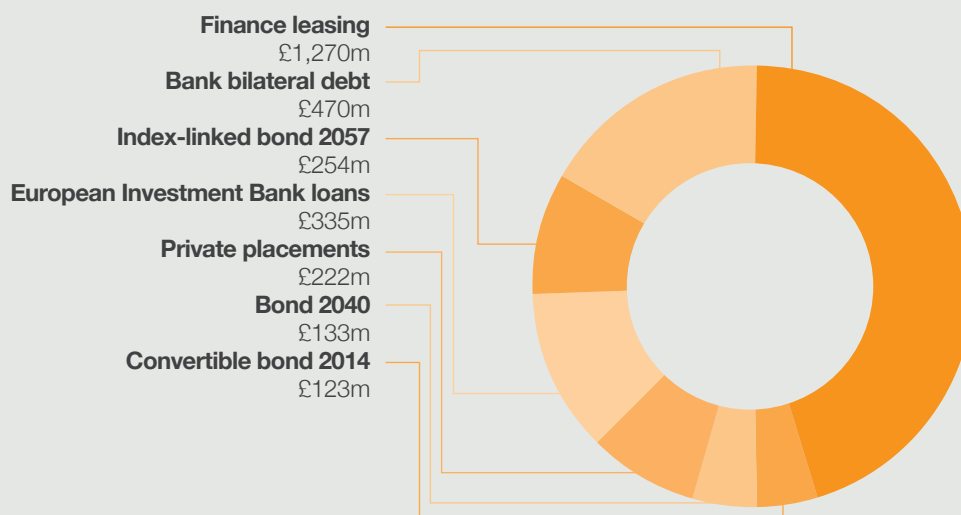
- £235 million term loans and revolving credit facilities renewed
- £315 million of new term loans and revolving credit facilities
- £90 million of new finance leases.

At 31 March 2014 the Group's loans and finance lease obligations totalled £2,807 million. After the £613 million held in cash this gives a net debt figure of £2,194 million, an increase of £185 million during the year. Debt incurred for the construction in progress of Viridor's portfolio of ERFs at Runcorn Phase 2, Ardley (Oxfordshire), Exeter, Trident Park (Cardiff) and Glasgow increased to £663 million at 31 March 2014, which represents 30% of Group net debt.

The Group's debt has a maturity of up to 43 years with an average maturity of 21 years. The Group has fixed, or put swaps in place to fix, the interest rate on at least 50% of South West Water's debt for the entire K5 period at an average interest rate of 3.5%.

A further £388 million of South West Water's debt is index-linked to 2041-2057 at an overall real rate of 1.7%. As a result of these initiatives South West Water's cost of finance is among the lowest in the industry.

Major components of the Group's debt finance at 31 March 2014



Financial review Continued

The Group's financing structure gives us the scope and flexibility we need to implement our strategic objectives with a view to maximising value for our shareholders.

The Group's and South West Water's interest rates on average net debt for the year to 31 March 2014 are both 3.8% (after adjusting for capitalised interest of £21.8 million, notional interest items totalling £4.8 million and interest received from shareholder loans to joint ventures of £9.8 million, as detailed in note 9 to the financial statements).

Just under half of the Group's gross debt is finance leasing giving us a long maturity profile. Interest payable benefits from the fixed credit margins which were secured at the inception of each lease.

The £125 million convertible bond matures in August 2014. It is expected that full conversion to equity will take place and up to 23 June 2014; notices of conversion for £61.3 million have already been received.

At 31 March 2014 the fair value of the Group's non-current borrowings was £275 million less than its book value (2013 £208 million) as detailed in note 29 to the financial statements. This reflects the benefit of securing interest rates below the current market rate.

Capital structure – overall position

At the end of the financial year the Group's net debt of £2,194 million gave a gearing ratio of net debt to (equity plus net debt) of 64.7% at 31 March 2014 (2013 65.2%).

In March 2013 the Group issued a £300 million hybrid capital security recognised as equity as set out in note 38 to the financial statements.

During the year the Company continued to benefit from offering a scrip dividend alternative. £34.5 million of potential cash dividend was retained in the business and instead distributed by issuing five million shares.

South West Water's debt to Regulatory Capital Value (RCV) was 56% at 31 March 2014 (2013 55%) which compares to Ofwat's optimum range of 55%–65%.

Viridor is funded by a combination of Pennon Group equity and debt (raised by Pennon Group) and direct borrowing by Viridor. At the year end Viridor's net debt was £901 million (2013 £676 million) equivalent to 11.8 times EBITDA (2013 8.7 times).

Treasury policies

The role of the Group's treasury function is to ensure that we have the funding to meet foreseeable needs to maintain reasonable headroom for future contingencies and to manage interest rate risk. The Group enters into certain structured financing transactions that have and are expected to provide an improved return on surplus funds and overall interest rate performance. It operates only within policies approved by the Board and undertakes no speculative trading activity.

The Board regularly monitors expected financing needs for at least the next 12 months. These are intended to be met for the coming year from existing cash balances, loan facilities and operating cash flows.

The Group has considerable financial resources and a broad spread of business activities. The Directors therefore believe that it is well placed to manage its business risks.

Internal borrowing

South West Water's funding is treated for regulatory purposes as ring-fenced. This means that funds raised by, or for, the company are not available as long-term funding for other areas of the Group.

Going concern

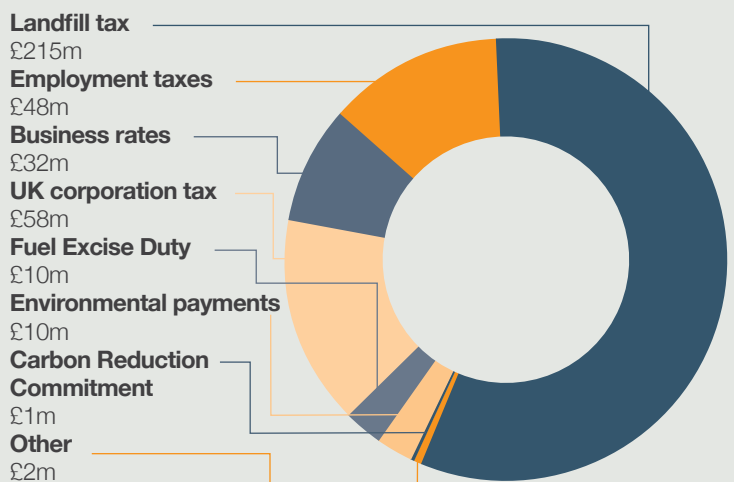
The Directors have a reasonable expectation that the Group has adequate resources to continue its operational existence for the foreseeable future. They therefore have continued to adopt the going concern basis in preparing the financial statements.

Taxation objectives and policies

Our tax strategy, as approved by the Board, is to fulfil our statutory obligations by the application of relevant tax legislation in a reasonable way, engaging in tax planning only when it is aligned with the commercial and economic activity of the Company. This is in line with the principles published by the Confederation of British Industry (CBI) in 2013.

The Group made a net payment of £58.1 million of UK corporation tax in the year (2012/13 £18.5 million). The main elements of the payment were £36.1 million in relation to 2013/14 and £21.3 million in relation to 2012/13. South West Water paid £44.1 million (2012/13 £34.0 million) of UK corporation tax on profit before tax of £162.5 million (2012/13 £159.1 million).

Tax contribution 2013/14



The total tax charge for the year (before exceptional net charges) of £9.5 million was less than the charge which would have arisen had the accounting profit before tax after exceptional net charges been taxed at the statutory rate of 23%. A reconciliation is provided in note 10 to the financial statements.

The Group's total tax contribution extends significantly beyond the UK corporation tax charge.

Total taxes amounted to £347 million of which a net amount of £6 million was collected on behalf of the authorities for employee payroll taxes and VAT.

In addition to corporation tax the most significant taxes involved, together with their profit impact, were:

- landfill tax of £186 million collected by the Group on behalf of HM Revenue & Customs (HMRC). This amount includes £12 million paid to local environmental bodies via the Landfill Tax Credits Scheme. Landfill tax is an operating cost which is recovered from customers and is recognised in revenue. In addition the Group incurred landfill tax of £29 million on the disposal of waste to third parties. This principally relates to the Manchester contract and should reduce in future years as waste is sent to EfWs. This is an operating cost for the Group and reduces profit before tax. The net amount of landfill tax paid to HMRC by the Group and via third parties represents 17% of the total landfill receipts of HMRC in the year
- Value Added Tax (VAT) of £29 million recovered by the Group from HMRC. The repayment has arisen chiefly as a result of the large capital expenditure incurred by Viridor on EfW plants. VAT has no material impact on profit before tax
- business rates of £32 million paid to local authorities. This is a direct cost to the Group and reduces profit before tax
- employment taxes of £48 million including employees' Pay As You Earn (PAYE) and total National Insurance Contributions (NICs). Employer NICs of £13 million were charged approximately 96% to operating costs with 4% capitalised to property, plant and equipment. This amount includes PAYE of £2 million on pension payments made by the Group pension scheme
- Fuel Excise Duty of £10 million related to transport costs. This reduces profit before tax
- payments to Environment Agency and other regulatory bodies total £10 million. This reduces profit before tax
- Carbon Reduction Commitment payment for the Group of £1 million; this payment includes a credit of £0.5 million arising from Viridor energy production. The net payment in relation to South West Water Limited is the lowest of the water and sewerage companies. This reduces profit before tax.

The corporation tax rate for 2013/14 used to calculate the current year's tax is 23%. The corporation tax rate has been reduced to 21% for 2014/15 and will decrease further to 20% for 2015/16 following changes in the Finance Act 2013.

Pensions

The Group operates defined benefit pension schemes for certain employees of Pennon Group, South West Water and Viridor. The main schemes were closed to new entrants on or before 1 April 2008.

At 31 March 2014 the Group's pension schemes showed a deficit (before deferred tax) of £79 million (2012/13 £100 million), the decrease primarily reflecting an increase in the schemes' asset values.

Net liabilities of £63 million (after deferred tax) represented around 2% of the Group's market capitalisation at 31 March 2014. The revision to IAS 19, effective in 2013/14, resulted in a net finance cost in 2013/14 of circa £4 million (2012/13, prior to restatement, credit of £4 million). A further circa £1 million was charged to operating profit to recognise administration costs. Opening pension liabilities reduced by circa £10 million as at 31 March 2013 as a result of the change. South West Water's cash contributions to the schemes remain within Ofwat's Final Determination for the K5 period.

The last actuarial valuation of the main scheme was at 31 March 2010 and the triennial valuation at 31 March 2013 is currently being finalised.

Insurance

Pennon Group manages its property and third party liability risks through insurance policies that mainly cover property and business interruption, motor, public liability, environmental pollution and employers' liability.

The Group uses three tiers of insurance to cover operating risks:

- self-insurance – Group companies pay a moderate excess on most claims
- cover by the Group's subsidiary (Peninsula Insurance Limited) of the layer of risk between the self-insurance and the cover provided by external insurers
- cover provided by the external insurance market, arranged by our brokers with insurance companies which have good credit ratings.







Principal risks and uncertainties

How we manage risk


We operate a well established and fully embedded Group wide risk management process from which we seek to identify significant risks at the earliest possible stage and determine whether they are acceptable risks which we can manage and mitigate satisfactorily. More detail on our risk management process is set out in our corporate governance report.

The risks and uncertainties set out in this section have been identified from our risk management process as potentially having a material adverse effect on our business, financial condition, results of operations and reputation. They are managed as described but are not wholly within our control and may still result in having a material adverse impact on the Group and its business activities, as may factors besides those listed.


Key		Risk Level	
Increased during year	  	Low	The colouring (red, amber, green) is our estimate of the inherent risk level to the Group after mitigation. It is important to note that risks are difficult to estimate with accuracy and therefore may be more or less significant than indicated.
Unchanged during the year	  	Medium	
Reduced during the year	  	High	

South West Water




Law and regulation

Risk	Mitigation	Change
Changes in law, regulation or decisions by governmental bodies or regulators.	<p>South West Water's PR14 business plan is aligned with the changes in the regulatory framework. South West Water's business plan has been assessed by Ofwat as 'enhanced' and the Draft Determination for 2015-2020 has already been received. This allows the company to begin to implement the strategy for K6 earlier than might otherwise be possible.</p> <p>South West Water continues to contribute fully to consultations with all regulators and seeks to influence emerging changes through strong relationships with our stakeholders.</p>	

Economic conditions

Risk	Mitigation	Change
Non-recovery of customer debt.	<p>In addition to existing strategies, which are kept under review, South West Water continues to implement new initiatives to improve and secure cash collection through:</p> <ul style="list-style-type: none"> • use of third party collection agencies • external trace data to track down previous occupiers • continued use of property charging orders. <p>The company has also continued to fund and promote ways to help customers struggling to pay bills (WaterCare, Restart, Fresh Start Fund) which seek to reduce bad debt exposure.</p> <p>South West Water is one of the few companies to have implemented a social tariff following the introduction of the WaterCare tariff from 2013/14. During the year 1,100 customers have benefited from reducing bills to an amount they can better afford to pay.</p> <p>The Government Payment reducing eligible household customer bills by £50 per year has also been effectively implemented and administered during the year.</p> <p>In future changes to benefits and universal credits (particularly the impact of the 'bedroom tax' and limiting the total level of benefits available) may further affect the ability of some customers to pay their bills.</p>	


Operating performance

Risk	Mitigation	Change
Extreme weather and climate change can place pressure on the company's water resources and networks.	<p>Despite recent extreme weather, service to customers has been maintained and the business continues to be well placed to manage such situations. Key mitigation is having detailed contingency plans, sufficient emergency resources and a capital programme that supports ongoing efforts to manage these risks.</p> <p>In the longer term, the impact of climate change is being considered. The company has plans in place and will adapt the way it conducts its business to respond effectively to the anticipated hotter, drier summers and wetter winters.</p>	
Poor service provided to customers. South West Water could incur a financial penalty under Ofwat's Service Incentive Mechanism (SIM) for below average customer service performance.	<p>The company has delivered further improvements in customer service resulting in its best ever SIM score and South West Water's best ever score in the last quarter of 2013/14.</p> <p>While South West Water's performance continues to improve, a financial penalty would be incurred by the company under Ofwat's SIM for a below average customer service performance.</p>	
Non-compliance or occurrence of avoidable health and safety incident.	<p>There are rigorous health and safety policies and procedures in place across South West Water.</p> <p>Senior management and Executive Director visits are undertaken during the year across a number of the company's sites and a behavioural safety programme launched in 2012 badged 'TAP' has continued to be publicised.</p>	


Principal risks and uncertainties Continued

South West Water

Operating performance (continued)

Risk	Mitigation	Change
	<p>The number of accidents reportable under RIDDOR (Reporting for Injuries, Diseases and Dangerous Occurrences Regulations) for 2013 continued to fall with three incidents⁽¹⁾ reported in the year compared to seven in 2012.</p> <p>South West Water continually reviews health and safety standards and makes improvements as necessary to best working practice.</p> <p>Continuous training is being provided to ensure that appropriate health and safety working practices are embedded in the business, and the accident review panel continues to complete thorough investigations of root causes and ensure a consistent approach to RIDDOR management is adopted.</p> <p>⁽¹⁾ This does not include the tragic fatality of a waste water team member at a waste water site.</p>	
<p>Significant operational failure or incident occurs</p> <p>This could include: contamination of water supplies, pollution events, water resource restrictions and flooding events.</p>	<p>South West Water has established procedures and controls in place, as well as contingency plans and incident management procedures.</p> <p>South West Water has a number of schemes in place to maintain water resources (such as pumped storage for certain reservoirs) and promotes conservation measures and customer water efficiency measures.</p> <p>South West Water also considers the longer term resource situation. It prepares a new Water Resources Management Plan every five years and reviews it annually for a range of climate change and demand scenarios.</p> <p>In recent years South West Water has worked in partnership with other representatives to identify a wide range of factors that can cause and exacerbate flooding events.</p> <p>The company has identified targeted capital investments to reduce the risk to specific customers in key affected areas and, working alongside lead local flood authorities, other partner agencies, developers and environmental groups, is identifying best practice management of extreme rainfall and flooding.</p>	

Market

Risk	Mitigation	Change
<p>Uncertainty arising from market reform.</p>	<p>As part of the risk management and business strategic planning processes, the company continues to evaluate developments and proposals for competition. With the introduction of retail competition from 2017, South West Water is fully engaged in Defra's 'Open Water' project, which is managing the development of the central market.</p> <p>South West Water is prepared for the development of retail competition for non-household customers during the next regulatory period and has developed enhanced services which it offers to commercial customers through 'Source for Business'.</p> <p>South West Water is participating in discussions for the design of Upstream reform.</p>	

Viridor

Law and regulation

Risk	Mitigation	Change
Changes in law, regulation or decisions by governmental bodies or regulation.	Viridor operates within regulatory EU and UK established frameworks. It engages at all levels and contributes fully to any consultations on possible changes to the regulatory policy, legislation and framework.	↔
Removal or modification of renewable energy incentives.	Existing investments that qualify for renewable obligation certificates are protected under the 'grandfathering' procedure.	↑

Economic conditions

Risk	Mitigation	Change
Reduced waste volumes to landfill and in the overall market, due to the long-term trend towards waste minimisation, recycling and energy from waste (EfW).	Viridor regularly conducts detailed forward-looking market assessments. It has a diversified strategy focused on growing stable volumes in recycling and EfW where margins per tonne are much higher than in landfill. Viridor is exploring alternative uses for its landfill assets.	↔

Operating performance

Risk	Mitigation	Change
Business interruption, particularly in the growing EfW business, through equipment failure, fire, power outages and campaign groups.	Equipment failure is being managed by more sophisticated planned preventative maintenance regimes with improved stocks and stores controls. The risk from local disruption is alleviated by good public liaison and communications. Police are consulted regarding campaign groups and the risk of cybercrime is being addressed as part of Project Enterprise (see business systems risk).	↔
Downward pressure on UK wholesale power prices.	Viridor enters into forward sale contracts for a certain proportion of electricity generated from landfill gas power generation. To a certain extent downward pressure on power prices is naturally offset by usage across Viridor and the wider Group.	↑
Non-compliance or occurrence of avoidable health and safety incident.	Viridor has rigorous compliance systems, health and safety policies and procedures in place. Professionally qualified and highly experienced health and safety advisers are in place for every region, reporting to the Head of Compliance. Continual training, toolbox talks and briefings focus on key topics. Formal health and safety qualifications are required for line managers, senior managers and Directors. Risk assessments are undertaken at every appropriate level. Safe operating procedures are subject to audit and review.	↔

Principal risks and uncertainties Continued

Viridor

Capital investment

Risk	Mitigation	Change
Failure or increased costs of capital projects and/or joint ventures not achieving predicted revenues or performance.	<p>Increased skilled management resource including the establishment of 'oversight boards' for each of the major projects has added additional rigour to their delivery.</p> <p>Wherever possible back-to-back agreements with, and guarantees from, suppliers are entered into which provide a significant degree of protection.</p> <p>Viridor's experienced and dedicated project/contract teams carry out detailed due diligence on all projects, suppliers, technologies and acquisitions prior to commencement.</p> <p>There is also regular monthly reporting on performance on major contracts and post project appraisals are carried out, which all assist in being able to improve future performance.</p>	↓
Exposure to contractor failure to deliver construction progress, increasing costs and potentially requiring lengthy legal action or other redress.	<p>Extensive due diligence and significant protection of back-to-back contracts and/or penalty clauses in contracts to deliver new technologies on time and on budget.</p> <p>Viridor, through its Capital Projects and Engineering Director, proactively manages its contractors. It has enhanced its team, both from internal and external resources, to reflect the increased scale of its capital programme.</p>	↓

Competitive pressures

Risk	Mitigation	Change
Reduced customer base, increased competition affecting prices or reduced demand for services.	<p>Viridor provides recycling and waste management services which are locally delivered services from locally managed facilities and a significant proportion of its revenue is contracted over the medium or long-term. In general terms Viridor's strategy is to establish a long-term sustainable competitive advantage in the business in which it operates; this is designed to protect long-term shareholder returns.</p> <p>With regard to major competitive projects being pursued there are barriers to entry due to planning permissions being difficult to obtain and significant investment requirements. Viridor believes there is competitive shake-out taking place among marginal competitors, which will in due course benefit Viridor.</p>	↔
Potential overcapacity in the UK EfW market could impact demand for Viridor's new plants.	Viridor has fully evaluated projected demand and competing capacity for each of its planned facilities and is confident that they can be filled profitably. As landfill tax reached £80 per tonne in April 2014, large-scale energy from waste facilities of the type Viridor is building will be one of the low-cost ways of disposing of residual waste.	↔
Overcapacity in parts of Europe could impact the UK EfW market. UK waste could be converted into solid recovered fuel (SRF) or refuse derived fuel (RDF) and exported under EA licence for disposal in Europe.	The costs of producing SRF and RDF to the required quality and of shipping it to Europe are broadly at the cost of landfill tax. Disposal and generation of the associated renewable energy in ERFs in the UK is generally lower cost (and better for the UK economy). Despite the availability of export, Viridor is successfully winning new contracts for its ERF plants. Nevertheless amounts of SRF and RDF may continue to be exported especially if UK ERF capacity remains insufficient.	↔

Business Systems

Risk	Mitigation	Change
Some of Viridor's IT systems require replacement, development or upgrading to meet the growing requirements of the business.	Project Enterprise, charged with developing a fully scalable Enterprise Resource Planning (ERP) type platform is now well advanced and involves external consultancy as required, with a focus on best practice and minimising implementation risk.	↔

Group Finance and funding

Risk	Mitigation	Change
The Group may be unable to raise sufficient funds to finance its activities or such funds may be only available at higher cost.	<p>The Company has robust treasury policies in place.</p> <p>The Group had £1.3 billion of cash and facilities as at 31 March 2014 including around £0.6 billion of new and refinanced facilities sourced during the year.</p> <p>Policies include always having pre-funded at least one year's estimated cash flow through cash and/or committed facilities and ensuring no more than 20% of net borrowings mature in any one year.</p> <p>In addition in respect of South West Water, the economic regulator has a statutory duty to ensure that it is able to finance its functions in the normal course of business.</p> <p>The Group has to date obtained funding at lower effective average interest rates compared with many other companies in its sector and is well placed to meet the funding requirements of both South West Water and Viridor in the foreseeable future.</p>	

Pensions

Risk	Mitigation	Change
Pension costs may increase due to higher costs for future service and growing deficits in relation to past service in the defined benefit schemes.	<p>All defined benefit schemes (apart from the Greater Manchester Waste PFI scheme) have been closed to new entrants since April 2008.</p> <p>Employee and employer contributions are kept under review and a formal actuarial valuation is being undertaken as at 31 March 2013.</p> <p>Pension trustees keep investment policies under review and use professional investment advisers to seek to maximise investment returns at an appropriate level of risk.</p>	

Forward-looking statements

This strategic report 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 Pennon

Group and its subsidiaries, wherever they occur in this strategic report, 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 the light of relevant factors, including those set out in this section on principal risks and uncertainties.

Sustainability report

The drive for sustainability underpins every aspect of Pennon’s long-term environmental, social and economic strategy. As one of the largest environmental and resource management groups in the UK, the Group is committed to responsible business and operational practices, minimising its impact on the environment and having a positive effect on the communities it serves.

South West Water provides high quality drinking water, together with effective waste water treatment for Devon, Cornwall and parts of Dorset and Somerset.

Viridor is one of the leading UK recycling, renewable energy and waste management businesses.

2013/14 achievements

South West Water

- 17 consecutive years without water restrictions; a reduction in interruptions; industry-leading leakage control; top quality drinking water
- Best bathing water quality results for seven years
- Improved customer service score and customer satisfaction levels
- Increased renewable energy technology – solar PV and hydro power generation
- Further delivery of sustainable catchment schemes under ‘Upstream Thinking’ programme
- One of the first water companies to introduce a social tariff
- Largest ever customer engagement programme carried out in support of the Business Plan to 2020.

Viridor

- Two star rating achieved in the Business in the Community Corporate Responsibility Index 2014
- Overall recycling volumes broadly maintained, with a sharp focus on quality leadership in recyclates traded
- Growing contribution to UK resource efficiency and £292 million further investment in recycling and recovery infrastructure
- Continued sector leadership with 152 sites accredited to ISO50001 standard
- Six closed landfill sites have now attained the Wildlife Trust’s Biodiversity Benchmark
- £13.3 million provided by Viridor for environmental, amenity and community projects across the UK via the Landfill Communities Fund. 301 projects supported.

We are pleased to report our performance against our strategic sustainability objectives and KPIs.

Objective:

Manage Pennon Group as a sustainable and successful business for the benefit of shareholders and other stakeholders.

As a well-managed and responsible Group, with sustainability driving its business strategy and at the core of its operations, we aim to deliver strong performance and lasting value for all our stakeholders. Our services and methods of operation are designed to provide clear community benefits and to protect and enhance the environment.

In addition to our long-term investment performance, Pennon was pleased to have sustained its 2013 score (4.2 out of 5) in the FTSE4Good Index – Environmental, Social and Governance ratings assessment.

Objective:

Aim to ensure that all our business activities have a positive economic, social and environmental impact on the communities in which we operate.

Pennon recognises it has a responsibility to contribute positively towards communities affected by our operations.

In addition to investing in a high quality water and waste management service, we create local employment, use local supply chains, provide financial support to community projects and enhance the environment.

Pennon Group and its subsidiaries support communities and charities within their operational areas and Viridor continues to provide substantial funding to environmental and community projects via the Landfill Communities Fund. Viridor and South West Water also both fundraise for their preferred charities: WaterAid, the Cystic Fibrosis Trust and Trees for Cities.

Pennon Group

Earnings per share

before deferred tax and exceptional net charges (pence)



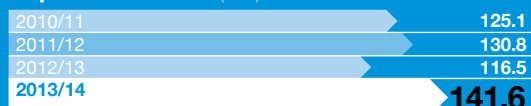
Pennon Group

Charitable donations (£)



South West Water

Capital Investment (£m)



South West Water

Community support, sponsorship & donations (£)



Viridor

Capital Investment (£m)



Viridor

Community support, sponsorship & donations (£m)



* In October 2013 the Pennon Charitable Donations Committee was split into two committees, one operated by South West Water, the other by Viridor. The charitable donations amount allocated by each committee post October 2013 is included in the figure given in the 'Community support, sponsorship & donations' bar charts for each company.

⁽¹⁾ Restated for IAS 19 (Revised)

Sustainability report Continued

Objective:

Aim to ensure that all our business activities have a positive economic, social and environmental impact on the communities in which we operate.

Economic impact

South West Water

The major investment South West Water has made in water and waste water services since privatisation has helped support regional economic growth. Key business sectors such as agriculture and tourism have directly benefited from the company's efforts to increase environmental protection (for example in areas such as bathing water quality), and the company continues to be one of the largest private employers and users of third party suppliers and contractors in the region.

Recent studies show that South West Water supports more than 4,000 jobs in the regional

economy, in addition to the 1,400 engineers, technicians, scientists, office staff and other skilled professionals in direct employment. The company has a growing apprenticeship scheme and is committed to support for education. In 2013/14 this has included playing a key role in the development of a new Devon-based University Technical College (UTC), which is set to open in 2015.

In 2013/14 approximately £100 million of order value was placed with companies with a south west base. At the start of the current regulatory period South West Water adopted a 'mixed economy' supply chain model,

designed to use small specialist companies based in the region alongside larger contract partners. Through its supplier forum and other cross-company initiatives South West Water continues to encourage and promote a culture of innovation and sharing of ideas. The company also has stringent procurement policies in place to ensure that supply chain partners adhere to a shared vision of sustainable working practices and corporate responsibility.

Viridor

Viridor's investment programme totalling £1.5 billion in recycling and energy from waste facilities includes £292 million of capital investment in growth projects in 2013/14 and continues to create significant direct and indirect employment and training opportunities, including construction jobs and supply chain opportunities.

For example Viridor's Trident Park ERF construction project in central Cardiff is generating jobs and investment in the capital city and the wider region. Latest statistics show that in 2013/14 an average of 565

operatives have been employed on-site each month. 35 permanent skilled roles are being created for which recruitment is underway.

In addition £17.5 million has been placed with local companies for materials, plant hire and sub-contracted work and the local economy has benefited from an estimated additional £2 million to date. Viridor currently has seven ERF construction projects in progress.

Viridor's infrastructure projects were listed by the UK Government as contributors to Britain's long-term plan for economic growth. A quarter of the 20 waste management projects, listed

in the overall £36 billion planned investment in UK infrastructure, are being delivered by Viridor.

Viridor's developing sustainable procurement policy and practice will further enhance the overall environmental and social benefits across the company's supply chain.



Social impact

Viridor

Through its integrated contracts and major projects, Viridor is able to demonstrate clear community benefits across the UK. For example in Glasgow Viridor continues to deliver education, training and local capacity building as an integral service element in addition to core recycling and waste management services required under a 25-year waste contract. Similarly, a full and ongoing assessment of community benefits is conducted for its major infrastructure construction projects.

Recognising that improved awareness and perceptions of recycling, waste and resource management issues within businesses and households is vitally important in driving further the UK's recycling and recovery rates, and in attracting talent into the sector, Viridor continues to focus its proactive community sponsorship programmes

on education initiatives. In particular in 2013/14 it has supported Science, Technology, Engineering and Maths (STEM) and environmental education initiatives. These include the Scottish flagship educational partnership with the Engineering Development Trust, GO4SET (Go for Science, Engineering and Technology).

Viridor continues to operate or support 10 education centres across the UK, helping to promote better understanding and best practice in recycling and resource management. These centres welcomed 14,000 visitors from schools, colleges and community groups during the year.

The company encourages employees to get involved in a wide and inspiring range of community projects in its areas of operation. This includes match-funding of employee fund-raising efforts as well as a wide

programme of sponsorship and support for projects and events in local communities. The company was pleased to provide £178,000 of direct community sponsorship and charitable funding in 2013/14.

Viridor continues to provide funding to a broad range of amenity, community and environmental improvements projects across the UK via the Landfill Communities Fund. In 2013/14 Viridor provided £13.3 million, supporting a total of 301 projects. It is estimated that these projects benefited some 218,000 people. Funding is distributed via Viridor Credits, an independent Environmental Body.

South West Water

Recognising that affordability is one of its customers' key concerns, South West Water has continued to develop its range of affordability initiatives, partnering with consumer organisations such as the Citizens Advice Bureau and Age UK to provide advice and support.

In 2013 the company was among the first in the industry to launch a social tariff and a pilot scheme was launched alongside local social housing providers to offer targeted assistance to low income tenants. South West Water has also frozen prices for 2014/15 and pledged to reduce bills by up to 13% in

real terms by 2020.

South West Water seeks to have a positive impact on the communities it serves. This includes the steps it takes to minimise the disruption or disturbance caused by construction activities (for example the repair or replacement of sections of water and sewerage mains). In 2013 a successful example of this was the handling of a major water mains replacement scheme in Newton Poppleford, Devon. This generated positive local press coverage.

Beach cleans and habitat management were among the activities carried out by South West Water staff as part of

the employee volunteering programme. The company also continued to promote and support the health and recreation opportunities available at reservoir sites across the region, including those managed on its behalf by South West Lakes Trust.

In addition to its apprenticeship scheme, South West Water continued to support education through the provision of talks and materials to local schools, work experience, placements and giving lectures at the regional universities.



Case study

Stepps Park, Glasgow, a popular park in Stepps, near Glasgow, has been transformed due to the efforts of the 'Friends of Stepps Park'. Consultation with regular park users informed the design of the park, with a strong emphasis on inclusion of all members of the community. An award of £101,000 from Viridor Credits helped towards new play equipment, seating, access and drainage.



Case study

Meeth Quarry, a man-made quarry, has been given over to wildlife indefinitely due to an award of £590,000 from Viridor Credits. The award enabled Devon Wildlife Trust to purchase the site with the aim of protecting the ecology of the site as well as opening it up to the public for the first time.

Sustainability report Continued

Environmental impact

South West Water

In recent years South West Water has adopted a holistic approach to protecting the environment. Alongside investment in the maintenance and improvement of its infrastructure, this includes work to identify and pioneer ecologically sensitive sustainable solutions, often in partnership with other regional agencies and organisations.

In 2013/14 the company continued its award-winning 'Upstream Thinking' programme of catchment management, which is designed to improve natural water quality and water storage in the landscape.

In early 2014 a study by Exeter University recognised the significant progress made by the Exmoor Mires Project (part of the wider 'Upstream Thinking' programme), noting how the peat bog restoration is successfully improving water quality while also improving carbon retention. Additional environmental benefits of such work include reduced enhanced biodiversity, with several of the restored sites now recognised as habitats for rare species of bird and insect life. The project is also reducing flood risk.

A similar philosophy is at the heart of South West Water's new 'Downstream Thinking' programme, which is designed to help tackle waste water issues such as sewer flooding and pollution through ecologically sensitive 'soft' engineering schemes, Sustainable Urban Drainage schemes (SuDs), habitat management and the targeting of misconnections. In 2013/14 the company carried out planning activity ahead of the roll-out of the first pilot scheme in Cornwall in the 2014/15 financial year.

The region's bathing water quality reached its highest standard in seven years with 99.3% meeting or exceeding the minimum EU standard and 91% meeting the tighter EU 'guideline' standard. South West Water remains committed to investing in the maintenance and improvement of its waste water treatment assets and networks in order to meet existing and emerging legislation. This includes the revised Bathing Waters Directive which comes into force in 2015.

Compared with the previous year, 2013 saw a rise in the total number of pollution incidents

and the number of harmful pollution incidents (Categories 1 and 2). While this is disappointing, this year's performance should be seen in the context of changes in the scope of reporting and the steps South West Water has taken to increase its capacity to monitor, identify and 'self-report' pollution incidents when they occur.

With regard to its carbon footprint, South West Water successfully met its target of keeping emissions at a level lower than that of the baseline position at the start of the current investment period. The company also expanded its use of renewable energy. This included two hydro generation schemes and the installation of a solar panel array at the company's Exeter-based headquarters – its largest solar installation to date.

Viridor

Viridor is responsible for the management and stewardship of substantial landholdings, including 27 closed landfill sites, 19 operating landfills and five Sites of Special Scientific Interest. These landholdings (particularly closed landfill sites) can have significant benefits to plants and wildlife. In order to better understand the potential of these sites the company carries out detailed ecological assessments, leading to the development of

Biodiversity Action Plans on key sites, to enhance habitats and species of national importance.

At these locations Viridor works in partnership with the Wildlife Trusts, local communities and employees to enhance amenity and biodiversity wherever practicable. Viridor has worked hard to manage and enhance biodiversity on its closed sites and six have

now attained the Wildlife Trust's Biodiversity Benchmark standard. The next stage of roll-out is to start working on three additional sites in 2014. This maintains Viridor's position as industry leader in respect of the proportion of sites covered by the Biodiversity Benchmark.



Objective:

Engage with all our stakeholders and foster good relationships with them.

Pennon aims to be a good neighbour and liaises with its stakeholders in order to determine and respond to their priorities.

Both subsidiaries are actively engaging with stakeholders via social media, developing their online presence to enable customer and community queries and issues to be raised and addressed in this way.

South West Water

In support of its Business Plan to 2020 South West Water carried out its largest ever programme of research and engagement with customers and stakeholders during 2013/14.

Designed to gauge priorities for future investment, the formal research element was supported by a region-wide multi-platform media campaign (including digital media).

An independent panel comprising representatives from key consumer, business, environmental and regulatory stakeholder groups also helped ensure the plan achieved a sustainable balance of investment for the region. The 'WaterFuture Customer

Panel' played a key role in scrutinising and challenging South West Water's engagement activities and the resultant plans.

When the plan was published in December 2013 it had achieved 84% acceptability and endorsement from the WaterFuture Customer Panel. Evidence of 'exceptional' customer engagement was highlighted by Ofwat in its subsequent assessment.

In preparation for the opening of the retail market to business customers in 2017, the company is successfully engaging with the business community through 'Source for Business'. This offers an expansive and innovative

range of supplementary advice and support services (for example dedicated account managers, water and energy audits and laboratory services) and products designed to improve water efficiency and ensure non-household customers get the best possible value for money.

At a wider level, South West Water is taking steps to improve its communications with customers and stakeholders. This includes an increased use of digital media and a focus on improving the responsiveness of customer services.

Viridor

In its second year of participation Viridor was awarded two stars in the Business in the Community Corporate Responsibility (CR) Index 2014, a step up on its previous year's assessment.

Developed in consultation with business leaders, the CR Index is a powerful tool that has helped leading companies drive progress on corporate responsibility for more than a decade.

This year the evaluation criteria were stricter than previously. The CR Index is based on a detailed assessment in the key areas of 'Workplace', 'Marketplace', 'Environment' and 'Community'. Many of the company's achievements in these areas are outlined elsewhere in this section of the Annual Report.

Within this framework Viridor continues to operate an 'open door' policy at its facilities, encouraging visits and engagement with customers,

community groups and interested stakeholders. The company again took part in the English Heritage Open Days, encouraging local people to explore Viridor's facilities.

Viridor also continues to operate community liaison groups at its major facilities, including those under construction, to ensure active and open dialogue between the company and its stakeholders and regulators.



Sustainability report Continued

Objective:

Strive for the highest standards of health and safety in the workplace so as to minimise accidents, incidents and lost time.

South West Water

RIDDOR incidence rate per 100,000 employees

2010	2,008
2011	1,628
2012	565*
2013	243*

Actual number of incidents was 3

Viridor

RIDDOR incidence rate per 100,000 employees

2010	2,165
2011	1,238
2012	1,429*
2013	1,197*

Actual number of incidents was 37

A safe and healthy workforce will always be a top priority for the Pennon Group.

South West Water

The health and safety of employees is South West Water's foremost concern and the company has rigorous health and safety policies and procedures in place.

Tragically, on 30 December 2013 there was an incident at Falmouth Waste Water Treatment Works which involved the death of a member of our waste water team.

As the coroner's inquest to establish the material facts relating to the death has yet to take place, this incident is not included in our 2013/14 figures for RIDDOR (Reporting of Injuries, Diseases and Dangerous Occurrences Regulations).

South West Water continually reviews its health and safety standards and makes improvements as necessary to ensure best working practice. In recent years this has

included the introduction of an independent occupational health service and a third-party nurse-led absence reporting process. This supports the reduction of absence while providing employees with advice on specific medical issues.

Viridor

Viridor is committed to achieving a step change in its health, safety and welfare performance. It already has rigorous and comprehensive health and safety policies, procedures and systems in place and is now focusing on behavioural safety and a fully engaged culture to achieve this.

A major review of health and safety management, systems and culture was launched in January 2014, and an HSE-endorsed health and safety employee survey was conducted towards the end of 2013/14.

The results will help inform action plans in this priority area for 2014/15.

This work complements the HSE-published Waste Industry Safety and Health (WISH) Blueprint for Accident Reduction in the Recycling and Waste Industry (of which Viridor was an author). A revised health and safety strategy was also endorsed by the Viridor Board in January 2014.

Regrettably an HSE Improvement Notice was issued to Viridor in October 2013 at its East

Killbride Household Waste Recycling Centre relating to site layout and reversing vehicles. The notice was immediately actioned and complied with.

HSE action is also pending in Scotland relating to an incident at Bargeddie MRF, which is likely to result in a prosecution. The matter, involving serious injury to an employee, has been fully investigated and corrective actions have been implemented.

* From 2012 reportable incidents are reported on seven days' absence; in previous years they were reported on three days' absence.



Objective:

Develop and motivate our employees, treat them fairly and ensure that they are fully engaged in all aspects of the Pennon Group's objectives.

Pennon's success is fundamentally due to the quality and diligence of our employees. We recruit talented and committed people and provide training packages to equip them with the skills they need to deliver the Group's objectives.

Both **South West Water** and **Viridor** are equal opportunities employers. Their employment policies are non-discriminatory and every effort is made to ensure that no current or future employee is disadvantaged because of age, gender, religion, ethnic origin, marital status, sexual orientation or disability. Employees are supported through a range of 'family-friendly' policies and other benefits. Employees are also entitled to participate in Pennon Group all-employee share schemes. Any changes to policies are communicated and consulted upon in detail.

South West Water

South West Water's 'People Strategy' is designed to foster a culture of support, motivation and reward for staff. Comprehensive development programmes are in place at all levels of the business to encourage career development. These include management training initiatives and the GROW programme, which focuses on increasing business awareness and giving employees the tools and techniques for personal development.

During 2013/14 the company also carried out a major upskilling programme for operational staff.

The company prides itself on recruiting and retaining a highly skilled workforce and in 2013/14 its apprenticeship programme continued to gather momentum with 23 new recruits. Various internal schemes are in place to promote innovation and reward those whose performance has excelled. The 'Pure Awards',

for example, are given to those who have made a significant contribution towards the company vision of delivering 'Pure Water, Pure Service and Pure Environment'.

Viridor

The achievements, professionalism and commitment of its employees is a source of pride to Viridor. The company is continuing its transition from a traditional waste collection and disposal company into a sector-leading renewable energy, recycling and resources business. To do this it is creating a business that is 'future-fit', which means having a well-trained, skilled and engaged workforce along with excellent business processes and systems.

The world's top-performing organisations understand that

employee engagement is a force that drives business outcomes. Engaged employees help to drive safety, productivity, profitability and customer focus. As part of Viridor's renewed commitment to employee engagement, it will now be working with Gallup and using their well-known and established 'Q12' employee engagement programme, starting with the Viridor survey.

Reflecting its ongoing focus on positive professional development and training, 245 Viridor employees are registered for the sustainable resource

apprenticeship and the company currently employs a further 17 'traditional' apprentices. A full range of NVQs and other training qualifications is available to ensure the required levels of skills and expertise across the workforce.

As part of its innovative partnership with Edge Hill University, Viridor's business leadership and management foundation degree course continues for its next generation of leaders. The first Viridor Degree cohort have completed the course and will graduate in July 2014.



Sustainability report Continued

Pennon Group Plc greenhouse gas emissions

	2013/14	2012/13
Scope 1	1,223,568	1,200,591
Scope 2	143,478	143,528
Scope 3	60,080	57,493
Total gross emissions	1,427,126	1,401,613
Carbon offsets	0	0
Netted off renewable electricity export to grid up to total amount of electricity purchased and consumed by organisation	(143,478)	(143,528)
Total annual net emissions	1,283,648	1,258,084
Biogenic emissions outside of scopes	936,133	957,425
Intensity measure: tCO₂e (gross Scope 1 + 2)/£100,000 revenue	103 tCO ₂ e/£100,000 revenue	112 tCO ₂ e/£100,000 revenue

Scope 1 (Direct emissions) Activities owned or controlled by our organisation that release emissions straight into the atmosphere, for example the combustion of fuels in company owned and controlled stationary equipment and transportation, emissions from site based processes and site based fugitive emissions.

Scope 2 (Indirect emissions) Emissions released into the atmosphere associated with our consumption of purchased electricity, heat, steam and cooling. These are indirect emissions that are a consequence of our activities but which occur at sources we do not own or control.

Scope 3 (Other indirect emissions) Emissions that are a consequence of our actions, which occur at sources which we do not own or control and which are not classed as scope 2 emissions.

Notes

Change in emissions

Our GHG emissions increased between 2012/13 and 2013/14 largely as a result of additional fugitive emissions from our landfills. However our emissions intensity measure of tCO₂e/£100,000 revenue decreased as a result of our revenue increasing at a faster rate than our emissions.

In order to maintain emissions comparability between reporting years we have taken the decision to rebase our historical emissions following a recent change in the Government's methodology for calculating the emissions conversion factors associated with imported electricity usage. The Government's modification has resulted in an approximate 7% reduction in emissions from imported electricity (Scope 2 emissions) compared with the previous methodology and this has been significant enough to prompt us to rebase our 2012/13 reportable emissions.

Our second methodological change is to remove biogenic emissions from our Scope 1 emissions and report them separately so that they are no longer included within our total gross and net emissions. This accords with the latest Government guidance on reporting emissions reductions such as those emissions that have their origins in biological matter.

Methodology and approach

We have followed the Government's environmental reporting guidelines for mandatory greenhouse gas emissions reporting published by DEFRA in June 2013. In calculating our emissions we have used the Greenhouse Gas Protocol Corporate Accounting and Reporting Standard (revised edition) and the web-based conversion factors provided by DEFRA.

Organisational boundary

The emissions listed here cover the Pennon Group of companies using the financial control approach.

Operational scopes

We have measured our Scope 1, 2 and some Scope 3 emissions where information is available.

Intensity measurement

We have chosen an intensity measure of Scope 1 and 2 gross emissions in tCO₂e per £100,000 revenue.

External assurance statement

Our greenhouse gas emissions data has been independently audited and verified for accuracy, completeness and consistency by an external assurance assessor.

Carbon offsets

We do not purchase any carbon offsets, instead we rely on self-generated renewable energy to reduce our overall emissions.

Green tariffs/renewable energy export

We do not purchase green tariff electricity; instead we can reduce our net emissions by exporting our self-generated renewable energy to other users.



Objective:

Aspire to leadership in minimising emissions that contribute to climate change, and develop climate change adaption strategies

South West Water

In 2013/14 South West Water increased its capacity for renewable energy and continued to invest in the fine-tuning of its assets, systems and working practices in order to make them more energy efficient. Compared with its 2009/10 baseline, carbon emissions were successfully reduced and energy consumption was 2.4GWh lower than for the previous year.

Since the start of the current investment period (2010-2015) South West Water has improved the way it manages energy and emission levels through a combination of the following:

- optimising asset performance and refurbishing pump systems
- renewable energy generation
- new technologies (e.g. operating equipment and systems remotely under the PUROS* scheme)
- promotion of energy efficiency through the in-house Powerdown initiative.

The company's holistic, catchment-based approach to the management of water and waste water is also working towards a reduction in carbon emissions. This spans everything from the carbon capture in the restored peat bogs that have been developed as part

of the 'Upstream Thinking' initiative, through to the more general move away from a dependency on engineering and energy intensive schemes.

* Phased Utilisation of Remote Operating Systems

Viridor

Carbon management and energy efficiency are now well established disciplines within Viridor. During the year there was continued progress with the deployment of energy and water saving initiatives in line with the company's five-year carbon reduction and energy efficiency plan. This aims to reduce its overall fossil fuel related carbon footprint and improve energy efficiency by 20% (against a 2010/11 baseline).

Through its energy recovery operations using residual and organic wastes as fuel, Viridor is a significant exporter of (largely renewable power generated) electricity to the national grid. The company's materials recycling operations also make a positive contribution towards helping reduce embodied carbon within supply chains (by replacing virgin materials in manufacturing).

The largest source of Scope 1 GHG emissions as CO₂ equivalent tonnes are landfill gas 'fugitive' emissions. These continue to reduce as capture rates improve (harnessing methane for power generation), landfill volumes reduce and the composition of inputs continues to change. Thermal emission increases with increased utilisation of ERFs will be more than offset by the decline in landfill emissions and emissions that would be otherwise generated by fossil fuel fired power stations to provide the same amount of energy.

Although Viridor exports almost 12 times the amount of electricity that it uses from the national grid, it cannot 'net' one off against the other for carbon reporting purposes. As an operator of a fleet of 650 collection trucks and 200 other company vehicles, the company also continues to focus on reducing its transport-

related emissions through business and technical efficiency initiatives. These emissions reduced by 15% over the three years since 2011. Almost half of these reductions have been achieved in 2013/14.

The roll-out of the first phase of a company-wide LED lighting retrofit has been completed at 26 of Viridor's largest energy-consuming facilities.

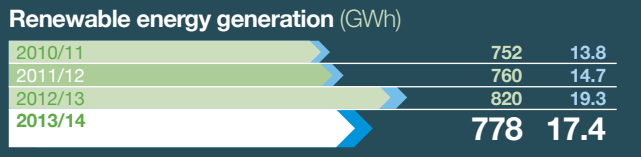
Viridor has shown continued sector leadership with the accreditation to ISO 50001 Energy Management Standard now at 150 of its sites. This represents 43% of the total certified sites (from all sectors) in the UK and 2% worldwide.



Sustainability report Continued

Objective:

Aspire to leadership in all aspects of waste prevention and resource efficiency.



■ South West Water

■ Viridor

Penron is delivering solutions for society to address the environmental challenge of depleting natural resources by maximising the value of residual materials, transforming waste and improving energy efficiency.



South West Water

South West Water has successfully avoided water restrictions for 17 years due to its past investment in resources and its careful management of supplies. The company's water resource position is healthy and its strategy going forwards is to invest in ways to move water to where it is needed most rather than developing any new reservoir sites. South West Water continues to achieve industry-leading leakage control and the company is taking steps to reduce the amount of time it takes for leaks to be fixed. This is being delivered, in part, through increased monitoring and investment in analytical technologies to better predict any issues on the mains.

With regard to waste prevention, South West Water recycles sludge using anaerobic digestion techniques to create a biosolid product for agricultural use. The company has also invested in creating energy from waste and currently has seven operational CHP (Combined Heat and Power) plants. Part of South West Water's long-term strategy is to further develop each of these activities.

South West Water is also currently working with its supply chain partners to minimise the amount of waste on construction sites and make use of by-product materials such as rock, grit, plastics and other materials. In the past year this has included the recycling of excavated concrete at Radford Wastewater

Treatment Works in Plymouth and the use of recycled plastics at Ashford Waste Water Treatment Works, North Devon.

In addition the company continues to take steps to reduce the amount of waste sent to landfill through the recycling and composting of grit and screenings (solid materials extracted in the early stage of waste water treatment). In particular grit is being used for land restoration activities at Park and Stannon reservoirs – the former china clay pits (purchased for reservoir use in 2011) that South West Water is working alongside local authorities and conservation groups to restore.

Viridor

Today's business practices continue to largely rely on increasing resource consumption to create and drive economic growth. There is increasing pressure on resources such as minerals, metals and fossil fuels, and rising and volatile prices for materials and energy demonstrate the increasing risk of impending 'resource crunch'. Addressing this and changing 'linear' business models ('extract, make, consume, dispose') requires the adoption of the business strategies of a more 'circular economy'. The principles of this include higher levels of reuse and recycling, products as services, collaborative production and consumption, and renewable power generation and use.

Viridor provides services in line with its stated purpose of giving resources new life. It provides essential waste prevention, recycling, resource management and renewable energy services

to its clients across all sectors. The company continues to identify and exploit economic and policy drivers and opportunities to deliver services contributing to greater resource efficiency and energy security.

Despite ongoing price volatility for recycled commodities, Viridor broadly maintained the overall volume of material recovered for recycling at 1.8 million tonnes in 2013/14 (1.9 million tonnes 2012/13) while focusing on producing higher quality materials.

Renewable power generation decreased by 5.1% to 778 GWh (from 820 GWh in 2012/13). The greatest contribution of renewable power was from 33 landfill gas power plants, followed by ERF plants and a modest contribution from AD plants and solar power arrays. The contribution from ERFs will increase significantly as five plants are due to become operational during 2014/15. Viridor commissioned an additional AD facility at

Walpole during 2013/14 and installed solar power arrays at Westbury closed landfill and at Lakeside EfW.

A partnership between Viridor and Highview Power Storage was awarded over £8 million in February 2014 to spur innovation in storing energy. The contract to build and operate a 5MW energy storage demonstration project at a Viridor landfill site has been awarded by the Department of Energy and Climate Change.

The company was also pleased to see the introduction of the Materials Recycling Facilities (MRF) Code of Conduct, introducing quality assessment criteria for output materials at all UK MRFs, during the year. Viridor has been leading the call for the introduction of such standards, and helped develop the protocols now required by all operators.

Governance

Programmes and performance contributing to the sustainability of the businesses are overseen by the Pennon Sustainability Committee and in the case of South West Water, its own sustainability committee. Details of the Pennon Sustainability Committee are given on page 67. The subsidiaries develop a range of targets as part of their business planning processes and monitor and report progress to their respective boards and to the Pennon and South West Water Sustainability Committees throughout the year.

Verification

Pennon's sustainability performance and reporting has been audited by Carnstone Partners LLP, an independent management consultancy, specialising in corporate responsibility and sustainability.

South West Water and Viridor sustainability reports

The full sustainability report for Viridor will be published in August and this year South West Water will be incorporating its sustainability reporting in its annual report and accounts which will be published in July. Both documents will be available to view at www.pennon-group.co.uk and also on the subsidiaries' websites. Full details of the sustainability targets for South West Water and Viridor for 2013/14, and their performance against them, are given in their respective reports.



Governance and remuneration

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Chairman's letter to shareholders

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Dear Shareholder

I am pleased to introduce the corporate governance report for 2014 on behalf of the Board. Part of my role, together with the Board, is to ensure that Pennon Group operates to the highest standards of corporate governance. This provides a framework for the Board to deliver effectively and efficiently the Group's strategy to add shareholder value. This is in the interests of the long-term success of the Company.

The Annual Report remains the principal means of reporting to our shareholders on the Board's governance policies and therefore I welcome this opportunity to set out how the main and supporting principles of good corporate governance set out in the UK Corporate Governance Code (the UK Code), (latest 2012 edition), have been applied in practice. The UK Code is publicly available on the Financial Reporting Council (FRC) website, www.frc.org.uk

Chairman's letter to shareholders Continued

Role of the Board and its effectiveness

My primary role as Chairman continues to be to provide leadership to the Board and to provide the right environment to enable the Directors and the Board as a whole to perform effectively to promote the success of the Company for the benefit of its shareholders. In doing so we take account of the interests of our customers, employees, suppliers, communities in which we operate and other interested stakeholders including, in particular, Ofwat in relation to the business of our subsidiary, South West Water.

I believe that we continue to demonstrate that we have good governance in place and that we operate effectively and cohesively as a Board. As always, there is room for improvement and each year we carry out a detailed performance evaluation of the Board and each of the Committees as well as of the Directors and the Group General Counsel & Company Secretary. This year we decided to revert to undertaking our review internally, which enabled us to refresh our approach to performance evaluation and to the searching questions we ask ourselves. The results of this review are set out later in this report.

It remains vital that the whole Board and not just the Non-executive Directors continue to have appropriate up-to-date knowledge and understanding of both South West Water, as it enters into a new regulatory period having successfully achieved 'enhanced' status for its business plan with Ofwat, and Viridor, as it continues to transform the business into a recycling and resources and energy (EfW and landfill energy) business. Accordingly I have ensured that the Board has received presentations in the last year from senior management on material developments including South West Water's business plan for the next regulatory period and developments in respect of the Viridor EfW business.

Governance and subsidiary boards

During the last year we have enhanced the governance in our two subsidiary boards, South West Water and Viridor, by establishing Committees to these boards chaired by these companies' non-executive directors. For South West Water this also demonstrates our support for Ofwat's board leadership, transparency and governance principles which were formally published in January 2014. Our corporate governance framework, including that of our subsidiaries, is set out on page 56 of this governance report.

New governance and remuneration reporting

We have revised our governance and corporate reporting arrangements in accordance with the requirements of the updated UK Code and the new reporting regulations which came into effect for our 2013/14 financial reporting year. The principal changes we have made to comply with these new reporting requirements are:

- inclusion of a strategic report in the Annual Report this year instead of a business review. The strategic report contains a fair review of the Company's business, a description of the principal risks and uncertainties facing the Company and a balanced and comprehensive analysis of the development and performance of the Company's business during the year and the position of the Company's business at the end of the year. In addition we set out the main trends and factors likely to affect the future development, performance and position of the Company's business, information about environmental matters, the Company's employees and community issues as well as a description of the Company's strategy, its business model and diversity information relating to the Group;
- additional information in the Audit Committee report setting out the significant issues relating to the financial statements that the Committee considered and addressed during the year as well as the key areas of focus of the Committee during the year; and
- a restructured and enhanced Directors' remuneration report including the single total figure table which relates to the average remuneration of our three Executive Directors as we do not have a Group chief executive officer.

Shareholder engagement

Appropriate and regular communications with our shareholders is recognised by the Board as vital to ensuring that we are able to explain our actions and that shareholders are able to provide feedback on the matters they consider to be important and any issues which require addressing.

Before the AGM last year it became apparent that one of our major shareholders was concerned about the ongoing high level of non-audit fees paid to our external auditors. As a consequence we took steps to reassure that shareholder that we would be reviewing our external audit arrangements in the forthcoming year. The audit tender process we carried out, culminating in the recommendation to the AGM this year of the appointment of a new external auditors, is set out in our Audit Committee report on page 66 of this governance report.

Regular dialogue with the Company's institutional shareholders is maintained through a comprehensive investor relations programme both in the UK and Europe. During the year some 70 meetings and 11 conference calls were held with institutional shareholders and prospective shareholders. In addition the Company was represented at four utilities conferences hosted by investment banks specifically aimed at the fund management community. All were attended by the Group Director of Finance and the Company's Investor Relations Manager. I, together with the Chief Executive of South West Water and the Chief Executive of Viridor, also participated when appropriate.

The Group Director of Finance continues to report to the Board regularly on major shareholders' views about the Group, and every six months the Company's brokers give a presentation to the Board on equity market developments and shareholder perceptions. This ensures that the Board is fully briefed on the views and aspirations of our shareholders.

Those shareholders that attend our AGMs will know that I also actively encourage their participation and welcome questions on any business issues affecting the Group. As usual at our 2014 AGM on 31 July all our Directors intend to be present together with a number of directors and executives of South West Water and Viridor to meet with shareholders to further explain the business of the Group.

Compliance with the UK Corporate Governance Code and other requirements

I am once again pleased to report that throughout the year the Company complied with the provisions and applied the main principals set out in the UK Corporate Governance Code (latest 2012 edition) with no exceptions to report.

My introduction to this corporate governance report and the following sections are made in compliance with the UK Code, FCA Listing Rule 9.8.6 and FCA Disclosure & Transparency Rules 7.1 and 7.2 and cover the work of our Board and its Committees; our internal control systems and procedures including risk management; our corporate governance statements relating to share capital and control; and our going concern and Directors' responsibilities statements. Finally, this year in accordance with the new reporting requirements the Board is confirming on page 61 to shareholders that it considers that the Annual Report & Accounts taken as a whole are fair, balanced and understandable and provide the information necessary to assess the Company's performance, business model and strategy.

Ken Harvey
 Chairman
 23 June 2014



To view our online annual report:
www.pennonannualreport.co.uk/2014

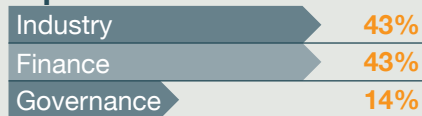
Board of Directors

Composition



The Board considers each of its Non-executive Directors to be independent in accordance with the UK Corporate Governance Code.

Experience



The Board has a target in its diversity policy to achieve 25% female representation by 2015.

Tenure



The Board believes its Directors have an appropriate range of experience to the business of the Group.

Chairman



Kenneth George Harvey

CBE, BSc

Chairman

Appointed on 1 March 1997

Committees: Nomination (Chairman)

Ken was formerly chairman and chief executive of Norweb Plc. He 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. He was until July 2013 the senior independent director of National Grid Holdings Plc.

Executive Directors



David Jeremy Dupont

MA, MBA

Group Director of Finance

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 CBI South West Regional Council and the Theatre Royal Plymouth Development Advisory Group.



Christopher Loughlin

BSc Hons, MICE, CEng, MBA

Chief Executive, South West Water

Appointed on 1 August 2006

Committees: Sustainability

Chris was previously chief operating officer with Lloyd's Register and earlier in his career was an executive director of British Nuclear Fuels Plc and executive chairman of Magnox Electric Plc. He was also a senior diplomat in the British Embassy, Tokyo. Chris started his career as a chartered engineer working in both the consulting and contracting sectors and subsequently held a number of senior positions with British Nuclear Fuels. Between April 2008 and March 2012 he was chairman of Water UK. Currently Chris is vice-chairman of the Cornwall Local Enterprise Partnership and a trustee and member of the audit committee of the global charity WaterAid. Until June he was also president of the Institute of Water.



Ian James McAulay

BEng, CEng, VIWEM

Chief Executive, Viridor

Appointed on 9 September 2013

Committees: Sustainability

Ian was previously chief of global strategy and corporate development with MWH Global based in the US. Previously he was the managing director, capital programmes, at United Utilities Plc. Ian started his career as a consulting civil engineer and held a number of positions with Crouch and Hogg in Glasgow and subsequently Montgomery Watson, which merged in 2001 with Harza to form MWH Global.

Non-executive Directors



Martin David Angle

BSc Hons, FCA, MCSI

Non-executive Director

Appointed on 1 December 2008

Committees: Audit, Sustainability, Nomination, Remuneration (Chairman)

Martin currently holds non-executive directorships with Savills Plc, OAO Severstal, Shuaa Capital psc and The National Exhibition Group where he is chairman. In addition he sits on the board of the FIA Foundation where he is vice-chairman. Formerly he held senior positions with Terra Firma Capital Partners and various of its portfolio companies, including the executive chairmanship of Waste Recycling Group Limited. Before that he was the group finance director of TI Group Plc and held a number of senior investment banking positions with SG Warburg & Co. Ltd, Morgan Stanley and Dresdner Kleinwort Benson.



Gerard Dominic Connell

MA

Senior Independent Non-executive Director

Appointed on 1 October 2003

Committees: Audit (Chairman), Sustainability, Nomination, Remuneration

Gerard currently is also a non-executive director and chairman of the audit committee of the Defence Science and Technology Laboratory, a non-executive director of the Land Registry, an independent director of the Nuclear Decommissioning Fund Company Limited and a council member of the Science & Technology Facilities Council. He was previously group finance director of Wincanton plc. Before that he was a director of Hill Samuel and a managing director of Bankers Trust, having trained originally at Price Waterhouse. He is also a governor of King's College School, Wimbledon. Subject to re-election at the Annual General Meeting in 2014 Gerard is due to retire following the 2015 Annual General Meeting.

Group Company Secretary



Gill Ann Rider

CB, PhD, FCIPD

Non-executive Director

Appointed on 1 September 2012

Committees: Audit, Sustainability (Chairman with effect from 2 August 2013), Nomination, Remuneration

Gill currently holds non-executive directorships with Charles Taylor Plc, the Chartered Institute of Personnel & Development where she is president and De La Rue Plc where she is chairman of the remuneration committee. She is also chair of council of the University of Southampton. Formerly Gill was head of the Civil Service Capability Group in the Cabinet Office reporting to the Cabinet Secretary and prior to that held a number of senior positions with Accenture culminating in the post of chief leadership officer for the global firm.



Kenneth David Woodier

Solicitor, CMA, DMS, CPE (Law)

Group General Counsel & Company Secretary

Appointed Company Secretary to the Board in March 1998

Ken was formerly the head of group legal services at Pennon Group Plc (then South West Water Plc) from February 1990. Previously he held senior legal positions with H.P. Bulmer (Holdings) Plc, Investors in Industry Plc (3i) and Severn Trent Water. He is a director of the Devon & Somerset Law Society and a member of its Governance Committee.

Directors' report

Introduction

This Directors' report is prepared in accordance with the provisions of the Companies Act 2006 and regulations made thereunder. It comprises the following two pages and the matters disclosed elsewhere in this Annual Report as follows:

- list of Directors during the year (single total figure of remuneration tables on page 84 of the Directors' remuneration report);
- internal control and risk management systems (pages 59 and 60 of the governance report);
- likely future developments of the Company (pages 7, 17 and 23 of the strategic report);
- inclusion and diversity (page 55 of this report and page 68 of the governance report);
- provision of information to and consultation with employees (page 55 of this report);
- carbon emissions (page 44 of the sustainability report);
- Directors' responsibilities statements (page 60 of the governance report)
- financial instruments (pages 109, 110 and 130 of the notes to the financial statements);
- important post-balance sheet events (page 157 of the financial statements);
- governance information relating to the securities of the Company, voting rights and in the event of a takeover bid (page 61 of the governance report).

Financial results and dividend

The Directors recommend a final dividend of 20.92p per Ordinary share to be paid on 3 October 2014 to shareholders on the register on 8 August 2014, making a total dividend for the year of 30.31p, the cost of which will be £112.7 million,⁽¹⁾ leaving a transfer to reserves of £29.8 million⁽²⁾. The strategic report on pages 2 to 47 analyses the Group's financial results in more detail and sets out other financial information.

Directors' insurance and indemnities

The Directors have the benefit of the indemnity provisions contained in the Company's Articles, and the Company has maintained throughout the year Directors' and officers' liability insurance for the benefit of the Company, the Directors and its officers. The Company has entered into qualifying third party indemnity arrangements for the benefit of all its Directors in a form and scope which comply with the requirements of the Companies Act 2006 and which were in force throughout the year and remain in force.

Statement as to disclosure of information to the Auditors

- a. So far as each of the Directors in office at the date of the signing of the report is aware, there is no relevant audit information of which the Company's auditors are unaware; and
- b. each of the Directors has taken all the steps each Director ought to have taken individually as a Director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

⁽¹⁾The cost of the proposed final dividend for the year ended 31 March 2014 excludes the impact of any conversion of the £125 million convertible bond between the year end and 8 August 2014.

⁽²⁾The amount transferred to retained earnings is after a payment of £15.6 million (net of tax) to holders of the Company's perpetual capital securities.

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 welcomed from persons with disabilities, and special arrangements and adjustments as necessary are made to ensure that applicants are treated fairly when attending for interview 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. The Board also has a diversity policy and encourages gender diversity in particular. Further details are set out in the report of the Nomination Committee on page 68.

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 employees, are used to ensure that employees are kept up-to-date with the operating and financial performance of their employer.

The Group also cascades information monthly to all employees to provide them with important and up to date information about key events and to obtain feedback from them.

Further information about employment matters relating to the Group are set out on pages 15, 23 and 43 of the strategic report.

The Group encourages share ownership among its employees by operating an HM Revenue & Customs approved Sharesave Scheme and Share Incentive Plan which are, subject to shareholder approval at this year's AGM, being amended to provide for the increased savings limits approved by Government. At 31 March 2014 around one-third of the Group's employees were participating in these plans.

Research and development

Research and development within the Group involving water and waste treatment processes amounted to £0.1 million during the year (2012/13 £0.2 million).

Pennon Group donations

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party (2012/13 nil).

Purchase of own ordinary shares

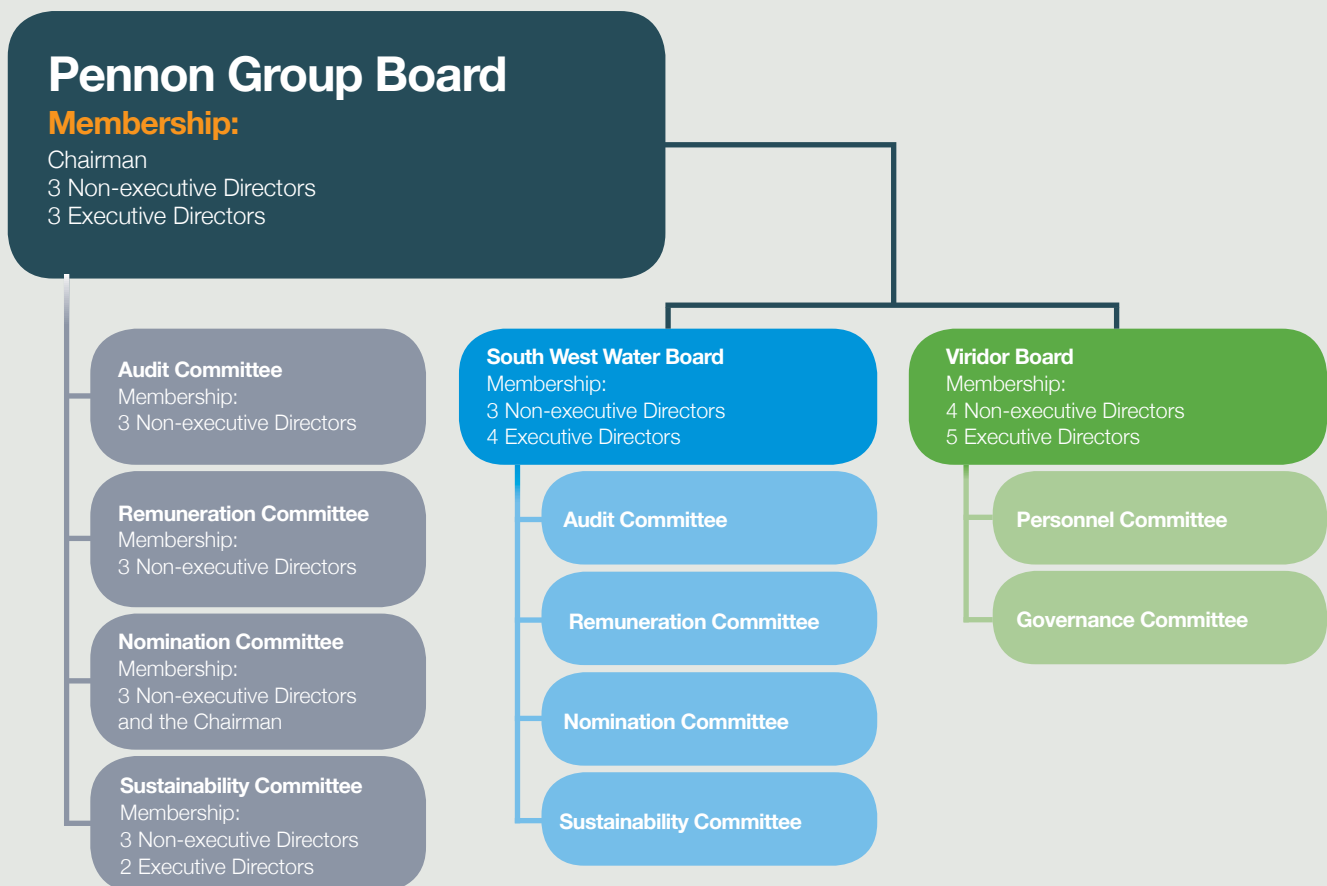
The Company has authority from shareholders to purchase up to 10% of its own ordinary shares (as renewed at the Annual General Meeting in 2013), which was valid as at 31 March 2014 and remains currently valid. Of the 2,105,836 shares held in Treasury at 31 March 2013, 823,146 were subsequently re-issued under the Company's employee share schemes for proceeds of £2.4 million.

By Order of the Board

Ken Woodier
Group General Counsel & Company Secretary
 23 June 2014

The Board and its governance framework

The Board and its governance framework, and that of its subsidiary boards, is set out below. Each board has a ‘matters reserved’ setting out its responsibilities and each committee has a detailed terms of reference setting out its responsibilities, accountabilities and reporting obligations to each board. Together with the risk management and internal control frameworks described on pages 59 and 60 they form an effective and robust governance structure designed to manage and develop the Group in accordance with the Group’s strategy to maintain and grow shareholder value.



The Board and its Committees

- Strategic overview
- South West Water
- Viridor
- Group
- Governance**
- Financial statements

The Directors, their independence and responsibilities

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 were considered by the Board to be independent throughout the year. None of the relationships or circumstances set out in provision B.1.1 of the UK Corporate Governance Code (latest 2012 edition) (the UK Code) applied to them other than in respect of Gerard Connell who, following the Annual General Meeting last year, has served on the Board for more than nine years since his first selection and Dinah Nicholls who retired at last year's AGM but at that time had served on the Board for 10 years. Following this year's Annual General Meeting and subject to re-election, Gerard will continue on the Board for a further year for reasons explained by the Chairman on page 7. Gerard has been determined by the Board to be independent as was Dinah up to the date of her retirement. The Board is satisfied that Gerard does and will continue to demonstrate independence of character and judgement in the performance of his role on the Board.

All of the Non-executive Directors are considered to have the appropriate skills, experience in their respective disciplines and personality to bring independent and objective judgement to the Board's deliberations. Their biographies on pages 52 and 53 demonstrate collectively a broad range of business, financial and other relevant experience. Gerard Connell is the Senior Independent Non-executive Director and his duties include leading the annual evaluation of the performance of the Chairman by the Non-executive Directors and being available as an additional point of contact on the Board for shareholders. Gerard is also chairman of the Audit Committee and in accordance with the code of principles relating to Audit Committee membership he has recent and relevant financial experience (as set out in his biography on page 53). Martin Angle is also a member of the Audit Committee and he has relevant financial experience as set out in his biography, also on page 53.

There is a clear division of responsibilities between the roles of Chairman and the Chief Executives of South West Water and Viridor as recorded in the descriptions of the roles approved by the Board. All Directors are subject to re-election each year in accordance with provision B.7.1 of the UK Code.

Operation of the Board in the year and its activities

The Directors on the Board and their attendance at the 10 scheduled meetings of the Board during 2013/14 are shown below.

Members	Appointment date	Attendance
Kenneth Harvey (Chairman)	March 1997	10/10
Non-executive Directors:		
Martin Angle	December 2008	10/10
Gerard Connell	October 2003	10/10
Dinah Nichols*	June 2003	4/4
Gill Rider	September 2012	9/10
Executive Directors:		
Colin Drummond*	April 1992	5/5
David Dupont	March 2002	10/10
Christopher Loughlin	August 2006	10/10
Ian McAulay	September 2013	6/6

*Dinah Nichols retired in August 2013 and Colin Drummond retired in September 2013 from the Board.

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 that 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 the Committees of the Board. In addition the Chairman holds meetings with the Non-executive Directors, without the Executive Directors present, to discuss performance and strategic issues.

The Board and its Committees Continued

In accordance with the governance framework set out on page 56 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; to the Executive Directors and the Group General Counsel & Company Secretary, as appropriate. The matters reserved for the Board include:

- approval of the preliminary and half year results announcements;
- approval of the Annual Report & Accounts (including the financial statements);
- all acquisitions and disposals;
- major items of capital expenditure;
- authority levels for other expenditure;
- risk management process and monitoring of risks;
- approval of the strategic plan and annual operating budgets;
- Group policies, procedures and delegations; and
- appointments to main and subsidiary boards.

The Board operates by receiving written reports circulated usually in advance of the meetings from the Executive Directors and the Group General Counsel & Company Secretary on matters within their respective business areas of the Group. When considered appropriate the Board also receives presentations on key areas of the business and undertakes site visits to gain a better understanding of the operation of the business initiatives.

Under the guidance of the Chairman all matters before the Board are discussed openly and presentations and advice are received frequently from other senior executives within the Group and from external advisers to facilitate the decision making of the Board.

In addition to the governance framework, due to the Company not having a Group Chief Executive Officer, the Chairman meets regularly with the Executive Directors and the Group General Counsel & Company Secretary to consider Group matters.

Directors have access to the advice and services of the Group General Counsel & Company Secretary and the Board has an established 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 as part of the Board's performance evaluation process each year. Training consists of attendance at external courses organised by professional advisers and also internal presentations from senior management.

Performance evaluation

The Board continues to have well-developed internal procedures to evaluate the performance of the whole Board, each Committee of the Board, the Chairman, each individual Director and the Group General Counsel & Company Secretary. The evaluation procedure relating to the Board and its Committees has previously been externally facilitated. This year the Board decided it was appropriate to revert to an internally managed evaluation operated by the Group General Counsel & Company Secretary. All participants' views were sought via a questionnaire on a range of questions which were specifically designed to ensure objective evaluation of performance and based on key trends followed in previous years to enable the monitoring of performance. Responses were then summarised and evaluated by the Group General Counsel & Company Secretary for the Board to consider and determine whether any changes should be made to be more effective or to improve governance.

The Board considered the finding of the evaluation and, while performance was again considered to be satisfactory overall, a number of areas were identified where Board practice could be enhanced or refocused in line with the future development of the Group. These included:

- providing more time for consideration of strategic matters;
- considering the appointment of an additional Non-executive Director;
- reviewing new Director induction arrangements; and
- developing of closer links with subsidiary boards.

The Board will be monitoring implementation of these action areas over the coming months to ensure that they are successfully implemented.

The Chairman's performance was evaluated separately by the Non-executive Directors, led by the Senior Independent Non-executive Director. The Chairman no longer has any significant commitments outside the Group which could impact on his performance in relation to his Group role.

Dealing with Directors' conflicts of interest

In accordance with the directors' interest provision of the Companies Act 2006 and the Company's Articles of Association the Board has in place a procedure for the consideration and authorisation of Directors' conflicts or possible conflicts with the Company's interests.

Board Committees and their terms of reference

In accordance with Group policies a range of key matters are delegated to the Board's Committees as set out on pages 62 to 69 of this governance report.

The terms of reference of each of the Board's Committees are set out on the Company's website, www.pennon-group.co.uk or available upon request to the Group Company Secretary.

Corporate governance and internal control

Internal control

Wider aspects of internal control

The Board is responsible for maintaining the Group's system of internal control to safeguard shareholders' investment and the Group's assets 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 Group that has been in place throughout 2013/14 and up to the date of the approval of this Annual Report & Accounts.

The Board confirms that it continues to apply procedures in accordance with the UK Code and the 'Guidance on Internal Control' (The Turnbull Guidance) that suggests means of applying the internal control part of the Code. As part of these procedures the Board has a Group risk management policy which provides for the identification of key risks in relation to the achievement of the business objectives of the Group, monitoring of such risks and annual evaluation of the overall process, as described in more detail below. The 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, which are then regularly updated. Each business compiles (as part of regular management reports) an enhanced and focused assessment of key risks against corporate objectives. At each meeting the Board receives from the 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 also receive at each meeting similar reports in respect of their own areas of responsibility. In addition the Group Director of Finance is responsible for monitoring the Group risk register and for reporting on key risks and how they are managed at regular intervals to the Audit Committee and to the Board.

All Executive Directors and senior managers are required to certify on an annual basis that they have effective controls in place to manage risks and to operate in compliance with legislation and Group procedures.

We also have a whistleblowing policy and we thoroughly investigate any allegations of misconduct and irregularity and consider the implications for our control environment in accordance with the policy. In the normal course of business investigations into irregularities may be ongoing as of the date of the approval of the financial statements.

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 strategic report on pages 30 to 35.

Internal control framework

The Group also has a well-established internal control framework which is operated and which applies in relation to the process for preparing the Group's consolidated accounts.

This framework comprises:

- 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
- a comprehensive budgeting and reporting function with an annual budget approved by the Board, which also monitors the financial reporting process, monthly results and updated forecasts for the year against budget
- 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 and tested by the Company's internal audit function
- 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
- a post-investment evaluation process for major capital expenditure and acquisitions to assess the success of the project and learn any lessons to be applied to future projects.

Corporate governance and internal control Continued

Internal control review

An evaluation of the effectiveness of overall internal control compliance by the Group is undertaken in respect of each financial year (and subsequently up to the date of this report) to assist the Audit Committee in considering the Group internal audit plan for the forthcoming financial year and also the strategic report for the Annual Report. The Group General Counsel & Company Secretary initially carries out the evaluation with Executive 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 annually reviews the scope of work, authority and resources of the Company's internal audit function. The Committee reports and makes recommendations to the Board on such reviews. For 2013/14 and up to the date of the approval of the Annual Report & Accounts, both the Audit Committee and the Board were satisfied with the effectiveness of the Group risk management policy and the internal control framework and their operation within the Group.

Further information on the internal control review is set out in the Audit Committee report on page 63.

Going concern

Having considered the Group's funding position and financial projections the Directors have a reasonable expectation that the Group has adequate resource 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 statements

The Directors are responsible for preparing the Annual Report, the Directors' remuneration report and the financial statements in accordance with applicable law and regulations.

Company law requires the Directors to prepare financial statements for each financial year. Under that law the Directors have prepared the Group and Company financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Under company law the Directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Group and the Company and of the profit or loss of the Group for the year.

In preparing these financial statements the Directors are required to:

- select suitable accounting policies and then apply them consistently
- make judgements and accounting estimates which are reasonable and prudent
- state whether applicable IFRSs as adopted by the European Union have been followed, subject to any material departures disclosed and explained in the financial statements.

The Directors confirm that they have complied with the above requirements in preparing the financial statements.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions, and disclose with reasonable accuracy at any time the financial position of the Group and the Company; and enable them to ensure that the financial statements and the Directors' remuneration report comply with the Companies Act 2006 and, as regards the Group financial statements, article 4 of the International Accounting Standards (IAS) Regulation. They are also responsible for safeguarding the assets of the Group and the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Each of the Directors, whose names and functions are listed on pages 52 and 53, confirms that, to the best of his or her knowledge:

- a. The financial statements, which have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the Group and of the Company, and
- b. The Directors' report contained on pages 54 and 55 includes a fair review of the development and performance of the business and position of the Company and the Group, together with a description of the principal risks and uncertainties they face.

The Directors are responsible for the maintenance and integrity of the Company's website www.pennon-group.co.uk Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Corporate governance statements

The following disclosures are made pursuant to Part 6 of Schedule 7 of the Large and Medium-sized Companies and Groups (Accounts & Reports) Regulations 2008 and Rule 7.2.3.R of the UK Listing Authority's Disclosure and Transparency Rules (DTR).

As at 31 March 2014:

- a. Details of the Company's issued share capital, which consists of Ordinary shares of nominal value 40.7 pence each, are set out in note 34 to the financial statements on pages 148 to 150. All of the Company's issued shares are fully paid up, rank equally in all respects and are listed on the Official List and traded on the London Stock Exchange. The rights and obligations attaching to the Company's shares, in addition to those conferred on their holders by law, are set out in the Company's Articles of Association ('Articles'), copies of which can be obtained from Companies House in the UK or by writing to the Group Company Secretary at the Company's registered office. The holders of the Company's shares are entitled to receive the Company's reports and accounts and in relation to general meetings of the Company they have the right to attend and speak, exercise voting rights and appoint proxies;
- b. There are no restrictions on the transfer of issued shares of the Company or on the exercise of voting rights attached to them, except where the Company has exercised its right to suspend their voting rights or to prohibit their transfer following the omission of their holder or any person interested in them to provide the Company with information requested by it in accordance with Part 22 of the Companies Act 2006 or where their holder is precluded from exercising voting rights by the Financial Conduct Authority's Listing Rules or the City Code on Takeovers and Mergers;
- c. Details of significant direct or indirect holdings of securities of the Company are set out in the shareholder analysis on page 160;
- d. The Company's rules about the appointment and replacement of Directors are contained in the Articles and accord with usual English company law provisions. The powers of Directors are determined by UK legislation and the Articles in force from time to time. Changes to the Articles must be approved by the Company's shareholders by passing a special resolution;
- e. The Directors have the power to make purchases of the Company's own shares in issue as set out in the Directors' report on page 55 'Purchase of own ordinary shares'. No such purchases have been made during the year. The Directors also have the authority to allot shares up to an aggregate nominal value of: (i) £49,521,023 (such amount to be reduced by any shares allotted or rights granted under (ii) below in excess of £49,521,023) or; (ii) £99,042,046 by way of a rights issue (such amount to be reduced by any shares allotted or rights granted from (i)) above), which were approved by shareholders at the 2013 Annual General Meeting (AGM). In addition shareholders approved a resolution giving the Directors a limited authority to allot shares for cash other than pro rata to existing shareholders. These resolutions remain valid until the conclusion of this year's AGM. Similar resolutions will be proposed at this year's AGM. The Directors have no present intention to issue Ordinary shares other than pursuant to the Company's employee share schemes, Scrip Dividend Alternative and the convertible bond referred to in the financial review on page 28; and
- f. There are a number of agreements which take effect, alter or terminate upon a change of control of the Company following a takeover bid, such as bank loan agreements, eurobond documentation, hybrid capital securities documentation, private placement debt and employees' share plans. This may result in certain funding agreements being altered or repaid early. The impact on employees' share plans is not considered significant

The UK Corporate Governance Code – statement of compliance

Upon the advice of the Audit Committee the Board considers that the Annual Report, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the Group's performance, business model and strategy. As required by the Financial Conduct Authority's Listing Rules, the independent auditors have considered the Directors' statement of compliance in relation to those provisions of the UK Corporate Governance Code which are specified for their review.

Corporate governance and internal control Continued

The Audit Committee



Dear Shareholder

I am pleased to introduce the report on the Audit Committee's activities during the year. Our two key tasks have again been to consider the integrity and balance of the Group's financial reporting and to discuss, challenge and test our risk assurance processes. Our primary objectives have therefore been to seek to ensure that our external reporting is fair, balanced and understandable and that our risk assurance processes continue to give clear and comprehensive oversight and control of risks and opportunities across the business.

During the year South West Water was heavily engaged in the regulatory review of its industry with consequent uncertainty for its business and operations over the next regulatory period. Viridor continued its process of transformation towards a new business model with significant management focus on the future shape of its organisational structure, the renewal of its business systems and the delivery of its major capital programme.

In the course of the year we discussed and considered developments in the subsidiary companies and Group risk registers as a consequence of these changes, kept under review the focus and prioritisation of our assurance activities and challenged the executive teams to consider changes to our existing processes and controls where we thought it necessary to do so. As part of our year-end-work we then reflected upon whether judgements in relation to significant issues remained valid given developments in the year and whether any new issues of significance had emerged which required more detailed review and assessment. Both significant matters considered by the Committee during 2013/14 and significant issues considered in relation to the year-end financial statements are further explained in this report.

This is my last report as chairman of the Group Audit Committee. I would therefore like to thank both executive and non-executive colleagues, our internal audit team and our external auditors for the open, challenging and constructive nature of discussions at the Committee. Debates have been robust and I am confident that the Group is better positioned for resilience and growth as a result.

Gerard Connell

Audit Committee Chairman

Senior Independent Non-executive Director

Audit Committee composition and meetings

The membership of the Committee, together with appointment dates and attendance at meetings during 2013/14 is set out below:

Members	Appointment date	Attendance
Gerard Connell (Committee chairman)	October 2003	7/7
Martin Angle	December 2008	7/7
Dinah Nichols*	June 2003	3/3
Gill Rider	September 2012	6/7

* Retired August 2013.

Other regular attendees to our meetings include:

- Group Director of Finance
- Chief Executive, South West Water
- Chief Executive, Viridor
- Group General Counsel & Company Secretary
- Finance & Regulatory Director, South West Water
- Finance Director, Viridor
- Group Financial Controller
- Group Audit Manager
- External auditors.

In addition the Chairman of the Group, Ken Harvey, has an open invitation to attend the meetings and during the last year has attended when the Committee has reviewed the half year and full year financial results of the Group.

In accordance with the UK Code the Board has determined that Gerard Connell and Martin Angle both have recent and relevant financial experience. In addition, Gerard Connell, who has now been a non-executive director and chairman of the Audit Committee since October 2003, has been determined by the Board as continuing to be independent in character and judgement notwithstanding his length of tenure. He will step down as chairman of the Audit Committee following the appointment of a further non-executive director who is expected to have recent and relevant financial experience.

All of the Committee members are also members of the Remuneration Committee, which allows them to provide input into both Committees on any Group performance matters and on the management of any risk factors relevant to remuneration matters.

Significant matters considered by the Committee during 2013/14

The Committee has an established annual calendar of business which assists in ensuring that it manages its affairs efficiently and effectively throughout the year concentrating on the key matters which affect the Group.

The most significant matters which the Committee considered and made decision on during the year are set out below:

Financial reporting	Internal control and compliance	External auditors	Risk management	Governance
<p>Monitored the integrity of the financial statements of the Company and the half year and full year results announcements relating to the Company's financial performance including reviewing significant financial reporting judgements contained in the statements.</p> <p>Reviewed and recommended to the Board the approval of the 2012/13 preliminary results announcement, the 2013 Annual Report & Accounts including the financial statements and the 2013/14 half year results announcement.</p> <p>Considered and approved a process for confirming and recommending to the Board that the 2013/14 Annual Report and Accounts including the financial statements is fair, balanced and understandable in accordance with new reporting requirements.</p>	<p>Reviewed quarterly internal audit reports on audit reviews across the Group during the year including on major contracts, site operations and recycling activities.</p> <p>Reviewed the internal control framework for the Group.</p> <p>Monitored the financial performance on specific matters including Viridor's Project Enterprise (business transformation project).</p>	<p>Considered the auditors' report on their review of the 2012/13 Annual Results focusing on key findings.</p> <p>Reviewed and monitored the ratio of audit/non-audit expenditure during 2013/14.</p> <p>Assessed the external auditors and their effectiveness in respect of the 2012/13 external audit process.</p> <p>Recommended to the Board the re-appointment of the external auditors for 2013/14 and for approval at the Annual General Meeting and also for the Committee to agree the external auditor's remuneration.</p> <p>Considered and approved the 2013/14 audit plan and audit fee proposal and set performance expectations for the external auditors.</p> <p>Considered the initial results of the 2013/14 audit.</p> <p>Agreed and monitored the provision of non-audit services for 2013/14 by the external auditors' firm in accordance with the Group policy.</p>	<p>Reviewed risk management framework and compliance with that framework during 2012/13 and after the year 2013/14.</p> <p>Reviewed the assessment of the risks by the Executive Directors.</p> <p>Reviewed Group risk register and considered appropriate areas of focus and prioritisation for the audit work programme for the year.</p> <p>Received as part of the risk management review the annual report on any whistleblowing.</p>	<p>Discussed annual evaluation exercise of the Committee and agreed action plans to further improve the Committee's performance including a review of the Committee's terms of reference.</p> <p>Considered and approved new annual report disclosure requirements including the audit report.</p> <p>Reviewed a number of updated Group policies covering treasury arrangements, guarantees and tax.</p> <p>Confirmed compliance with the UK Code.</p> <p>Regularly held separate meetings with the external auditors and the internal group audit manager without members of management being present.</p> <p>Considered and approved external audit tender process for appointment of new auditor firm from 2014/15. Also received presentations from auditor candidates and recommended to the Board appointment of new auditors from 2014/15.</p>

Corporate governance and internal control Continued

The Audit Committee Continued

In respect of the monitoring of the integrity of the financial statements, which is a key responsibility of the Committee identified in the UK Code, the significant issues considered in relation to the financial statements for the year ended 31 March 2014 are set out in the following table, together with details of how each matter was addressed by the Committee. At the

Committee's meetings throughout the year the Committee and the external auditors have discussed the significant issues arising in respect of financial reporting during the year and the areas of particular audit focus, as reported on in the independent auditors' report on pages 97 to 101.

Significant issues the Committee considered in relation to the financial statements	How the issue was addressed by the Committee
Going concern basis for the preparation of the financial statements.	The Board, on a monthly basis, receives an update from the Group Finance Director on the financial performance of the Group including forward looking assessments of covenant compliance and funding levels. The Board also regularly reviews and challenges rolling 5-year strategy projections and the resultant headroom relative to borrowings. A report to the Audit Committee, prepared by the Group Finance Director at each half year and year-end, focuses on the Group's liquidity over the 18 months subsequent to a period end and the Group's solvency over a longer period. This report, and the external auditors' comments and views on the validity of the going concern assumption which are set out in their year-end report, provide the basis for a detailed review and discussion of the key issues at the Committee. These discussions, together with the ongoing monitoring of the Group's business model and financial performance, provide the evidence on which the Committee forms its assessment.
Viridor: asset impairment and provisions.	There has again been considerable focus at this year-end on the provisions and the carrying value of assets in the Viridor and Group balance sheets. Underlying assumptions, both in respect of markets and individual operating sites, have been discussed and reviewed with executive management, including consideration of external market research where appropriate, at both subsidiary and Group Board levels, before being considered and challenged again at the Audit Committee. At our year-end audit clearance meeting, the Group Director of Finance tabled a report summarising the key issues, and Committee members asked questions of both the Viridor Chief Executive and the Group Director of Finance and discussed the detailed sensitivity analysis in respect of key assumptions carried out by the external auditors in respect of both a 'base case' and a 'sensitised case'.
South West Water: bad debt provision.	Both the South West Water board and the Group Board receive regular updates, and more detailed reports if felt necessary, on progress against debt collection targets. Performance is monitored regularly against both South West Water's historical collection record and the track record of other companies in the sector. At the year-end the external auditors reported on the work they had performed. The Committee discussed the results of this report at the year-end and asked questions of both the South West Water Chief Executive and the Finance Director before forming a view on management's assessment of the year-end position.
Tax and treasury.	The Group takes a prudent view of its tax position and has a general policy of only releasing tax provisions when matters under discussion are expected to be cleared by HM Revenue & Customs. If any outstanding issues are considered potentially material, such matters are also discussed, and challenged where necessary, at Group Board level. Expert external legal advice is sought as and when appropriate. The external auditors reported on the work they had performed in respect of tax provisions in the Group balance sheet. Questions raised by this review were addressed at the year-end audit clearance meeting of the Audit Committee and the Group Director of Finance was asked to justify the proposed treatment of certain items. The Committee also considered at the year-end the tax and accounting treatment of certain structured treasury transactions used to seek to enhance yield and overall interest performance on the Group's cash balances and sought the views of both the external auditors and the Group Director of Finance. During the year the Committee received external assurance reports on both the Group tax and treasury functions and updated policies in certain areas as a consequence. Further consideration will be given in 2014/15 to the Group's policies and activities in relation to tax and treasury.
Revenue recognition.	The key issues reviewed by the Audit Committee at year-end in respect of revenue recognition related to the accrual for metered billing within South West Water and service concession arrangements under IFRIC 12 at Viridor. The Committee relied primarily on South West Water's track record of assessing appropriate levels of accrual at previous year-ends, and Viridor's internal processes for analysing complex long-term contracts. The Committee also considered the work in respect of these areas at the year-end by the external auditors.

Effectiveness of the external audit process

As reported in previous Annual Reports we continue to monitor carefully the effectiveness of our external auditors as well as their independence, bearing in mind that it is recognised there is an ongoing need to use our external auditors' firm for non-audit services. We have full regard to the Auditing Practices Board's ethical standards and ensure that our procedures and safeguards meet these standards.

We reported last year that our policy was to review the provision of the external audit in accordance with best practice and in line with the UK Code, which included putting out to tender the external audit service at least every 10 years. As the last review was undertaken in 2006 when the current auditors were appointed following a comprehensive competitive tender process, apart from the usual annual reviews, the intention of the Committee was not to re-tender the audit until after the rotation of the current audit partner. However, while the Committee is satisfied with the auditor's independence and objectivity, following discussion with a major shareholder and upon the recommendation of the Committee the Board decided to re-tender the audit a year early. The process followed in re-tendering and the outcome of the re-tender is reported on later in this section.

The effectiveness review of the external auditors is undertaken as part of the Committee's annual performance evaluation. This includes reviewing and testing the work of the external auditors in respect of the audits that the auditors undertakes, the challenges to management on financial judgements being made, demonstrating up-to-date knowledge of technical issues and communicating best practice and industry trends in reporting. The performance of the external auditors following the preparation of the financial statements for 2012/13 was highly rated.

Auditor independence

The Committee carefully reviews on an ongoing basis the relationship with the external auditors to ensure that the auditors' independence and objectivity is fully safeguarded. This is supported by the external auditors ensuring that the senior partner responsible for the external audit of the Group remained responsible for such audit for no more than five years and that there is a quality review partner who is involved in planning the audit and in the reviewing of the final accounts of the Company including assessing any significant matters which may be identified in the audit.

The external auditors have reported on their independence and have confirmed to the Committee that they have complied with all relevant guidance issued by the Auditing Practices Board and have implemented appropriate safeguards for all non-audit services including:

- all non-audit related services, where necessary, being performed by personnel independent of the audit engagement team;
- the auditors being in a position whereby they will appropriately evaluate the results of a judgement or service;
- no work being undertaken that would require the auditors to act in a capacity as an advocate;
- no aspect of the auditing engagement partner's performance being assessed on the level of non-audit fees charged to the Company; and
- the Committee chairman meeting with the auditors' independent senior partner periodically to discuss the scope and performance of their work.

Provision of non-audit services

The Committee has a new more restrictive policy for the engagement of the external auditors' firm for non-audit work. The policy involves the Group Director of Finance setting out in a report to the Committee the reasons why the auditors' firm should be appointed for any material work. The Committee carefully reviews whether it is necessary for the auditors' firm to carry out such work and will only grant approval for their appointment if they are satisfied that the auditors' independence and objectivity is fully safeguarded. Also if there is another accounting firm which can provide the required level of experience and expertise in respect of non-audit services then such firm would be chosen in preference to the external auditors.

It is once again recognised that the level of non-audit fees payable to the Company's audit firm in the past year was in excess of the audit fee paid. This was primarily due to fees paid to the corporate finance arm of the auditors' firm in relation to the major new Public Private Partnership (PPP) contract gains by Viridor, agreed upon procedures and advisory services in relation to South West Water's PR14 submissions and pensions advisory services. The Committee considered that the external auditors were best placed to provide certain agreed upon procedures and advisory services in connection with South West Water's PR14 submissions because of their knowledge of South West Water's business, accounting policies and practices. Furthermore, Ofwat's best practice guidance included an expectation of external auditors reporting in relation to the submissions. The Committee also considered that the external auditors were best placed to provide Group pension advisory services because of their relevant experience in the water sector. The Committee carefully considers the reasons for the engagement of the auditors' firm in accordance with the process described above. The external auditors' firm has only been engaged to undertake the non-audit work on the basis that the Committee was fully satisfied that the continuing independence of the external auditors was maintained due to the safeguards followed by the auditors' firm described in the previous section.

Corporate governance and internal control Continued

The Audit Committee Continued

PPP and similar contracts are of vital importance to the long-term strategic development of Viridor and it is critical that Viridor is able to benefit from the best advice available in the market. The number of such contract opportunities is now declining, which would have led to a corresponding decline in fees payable to the corporate finance arm of the current external auditors. Nevertheless as described in the following section the current external auditors, subject to approval at the Company's forthcoming AGM, will no longer be the external auditors to the Company from August 2014.

The Group Director of Finance regularly reports to the Committee on the extent of services provided to the Company by the external auditors and the level of fees paid. The fees paid to the external auditors' firm for non-audit services and for audit services are set out in note 8 to the financial statements on page 120.

Audit firm tendering

Due to the decision of the Board to re-tender audit services for the Company in the current year rather than wait until the end of the 10-year period in 2015, the Committee approved an audit tender process recommended by the Group Director of Finance in September 2013. This process followed the notes on best practice in respect of audit tenders published by the Financial Reporting Council in July 2013. The process followed was:

- initial identification of a selection criteria and assessment mechanism;
- consideration of the candidates to be invited to tender including those outside the 'Big Four';
- discussion with the potential auditors to ensure they were free to compete under independence rules;
- design of a detailed tender document with input from the chairman of the Committee;
- initial review of tenders received by the Group Director of Finance and his team involving the chairman of the Committee;
- interviewing of the preferred candidates initially by the Group Director of Finance and the Group Financial Controller and then subsequently by the Committee followed by a recommendation to the Board on the preferred appointment; and
- allowing for sufficient time for an orderly handover and transition involving the incoming auditors at key stages in the prior period's audit.

Subject to approval at the forthcoming AGM the Board approved the appointment of Ernst & Young in February as the incoming auditors with effect from August 2014. Since February Ernst & Young have followed an orientation programme with key management in the Company and attended, with the current external auditors, the meeting of the Committee at which the preliminary results for the year were considered and discussed for recommendation to the Board.

Internal audit

The internal audit activities of the Group remain particularly important to the Committee. The Group has a long-standing and effective centralised internal audit function led by an experienced head of function who makes a significant contribution to the ability of the Committee to deliver its responsibilities.

A Group internal audit plan continues to be approved in September each year. It takes account of the activities to be undertaken by the external auditors and also the Group's annual and ongoing risk management reviews. This approach seeks to ensure that there is a programme of internal and external audit reviews focused on key risk areas throughout the Group.

The Group Audit Manager reports quarterly to the Committee on audit reviews undertaken and their findings and there are regular information discussions and meetings between the Group Audit Manager and the Committee chairman.

The areas of the business that received attention from Group internal audit over the past year included:

- Pennon – Group treasury, Group treasury log audits, Group taxation and Group carbon management and reporting;
- South West Water – customer service, accounts payable, payroll and related HR processes, cash processing, credit management and debt collection; and
- Viridor – bank and cash management; Greater Manchester sub-contract process (Joint Venture); TPSCo (Joint Venture) processes; capital expenditure; payroll and related HR processes; purchasing and procurement; environmental provisioning revisit; and Project Enterprise (business transformation project).

Fair, balanced and understandable assessment

To enable the Committee to provide support to the Board in making its statement that it considered that the Company's Annual Report and Accounts is fair, balanced and understandable (FBU) on page 61, the Committee initially received advice from its external auditors on an appropriate FBU assessment process. It subsequently approved its own FBU process which had been prepared by the Group Company Secretary following consultation with the chairman of the Committee and the Group Director of Finance. The FBU process took account of the Group's well-documented verification process undertaken in conjunction with the preparation of the Annual Report & Accounts. This is in addition to the formal process carried out by the external auditors to enable the preparation of the independent auditors' report which is set out on pages 97 to 101.

In preparing and finalising the 2014 Annual Report and Accounts the Committee considered a report on the actions taken by management in accordance with the FBU process and an FBU assessment undertaken by the subsidiary boards. This assisted the Committee in carrying out its own assessment and being able to advise the Board that it considered that the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy.

The Sustainability Committee



Members	Appointment date	Attendance
Dinah Nichols (Committee chairman)*	November 2006	4/4
Gill Rider (Committee chairman)	September 2012	6/6
Martin Angle	December 2008	6/6
Gerard Connell	November 2006	6/6
Colin Drummond #	November 2006	4/4
Christopher Loughlin	November 2006	6/6
Ian McAulay	September 2013	2/2

* Retired in August 2013. Dinah Nichols was replaced as chairman by Gill Rider in August 2013.

Retired in September 2013.

The Sustainability Committee's duties, in the context of the requirement for companies to conduct their business in a responsible manner (in relation to environmental, social and governance (ESG) matters), are to review the strategies, policies, management, initiatives, targets and performance of the Pennon Group of companies in the areas of occupational health and safety and security; environment; workplace policies; non-financial regulatory compliance and the role of the Group in society.

During the year the Committee considered a wide range of matters in accordance with its terms of reference including:

- developments and progress in carbon management and reduction
- the Group's pollution and compliance performance
- division of responsibilities between the Pennon Group and South West Water Sustainability Committees
- the impact of the Group's charitable donations and community support
- the Group's health and safety performance and plans
- the Group's workplace and other Group policies and performance.

In addition the Committee considered:

- the 2013/14 Group, South West Water and Viridor sustainability reports; and the associated verifier's reports for 2013/14 and his recommendations for the 2014/15 reports
- progress against the sustainability targets for 2013/14
- sustainability targets for 2014/15
- the annual review of the coverage and appropriateness of Group policies.
- Committee performance evaluation results
- the Group's participation in external benchmarking systems.

In reporting on sustainability, the Company has sought to comply with the Association of British Insurers' Guidelines on Responsible Investment Disclosure. The strategic report on pages 36 to 47 contains the Group's 2014 annual sustainability report.

Corporate governance and internal control Continued

The Nomination Committee



The Nomination Committee meets in accordance with an annual calendar to consider succession planning, equality and diversity reports and periodically as necessary to manage the Board appointment process and recommend to the Board suitable candidates for appointment as executive and non-executive directors to the Board and also to the boards of South West Water and Viridor.

It is the practice of the Committee, led by the chairman, to appoint an external search consultancy to assist in board appointments to ensure that an extensive and robust search can be made for suitable candidates.

During the year the Committee considered:

- its annual performance evaluation;
- the appointment of a new Chief Executive, Viridor, and a chairman of the Viridor board;
- reviewed succession plans throughout the Group
- reviewed diversity and equality policies and practice throughout the Group.

The appointment of the Chief Executive, Viridor, was undertaken with the assistance of an external search consultant (Zygos), which had no other connection with the Company. After the year end the same external search consultant has assisted on a non-executive director appointment to the Board, which is expected to culminate in an appointment shortly.

Members	Appointment date	Attendance
Kenneth Harvey (Committee chairman)	March 1997	2/2
Martin Angle	December 2008	2/2
Gerard Connell	October 2003	2/2
Dinah Nichols*	June 2003	1/1
Gill Rider	September 2012	2/2

*Retired in August 2013.

Diversity policy

The Board's diversity policy confirms that the Board is committed to:

- the search for Board candidates being conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the Board, including gender;
- satisfying itself that plans are in place for orderly succession of appointments to the Board and to senior management to maintain an appropriate balance of skills and experience within the Group and on the Board and to ensure progressive refreshing of the Board. In addition within the spirit of Principle B.2 of the UK Code, the Board will endeavour to achieve and subsequently maintain:-
 - a minimum of 25% female representation on the Board by 2015; and
 - a minimum of 25% female representation on the Group's senior management team by 2015.

Currently as disclosed with the Directors' biographies on page 52 the Group has 14% female representation at Board level. This represents a reduction from 25% when Dinah Nichols retired from the Board on 1 August 2013. The Board remains committed to achieving the 25% level by 2015.

In a workforce of around 4,500 at 31 March 2014 around 19% were women.

As well as its diversity policy the Group has a number of policies in place embracing workplace matters, including non-discrimination and equal opportunities policies which are reported on separately in the strategic report.

The Committee is required by the Board to review and monitor compliance with the Board's diversity policy and report on the targets, achievement against those targets and overall compliance in the Annual Report each year.

The Remuneration Committee



Directors' remuneration report

The Directors' remuneration report for 2013/14 is set out separately on pages 70 to 96.

The Remuneration Committee meets in accordance with an annual calendar to consider remuneration matters in respect of the Group and in particular is responsible for:

- advising the Board on the framework of executive remuneration for the Group; and
- determining the remuneration and terms of engagement of the Chairman, the Executive Directors and senior management of the Group.

Members	Appointment date	Attendance
Martin Angle (Committee chairman)	December 2008	9/9
Gerard Connell	October 2003	9/9
Dinah Nichols*	June 2003	4/5
Gill Rider	September 2012	9/9

*Retired in August 2013.

The Committee's activities during the financial year

During the year the Committee dealt with the following matters:

- annual review of the pay and benefits policies and practices for the staff below Board level in the Group;
- annual executive salary review;
- determining performance targets in respect of the annual incentive bonus plan for 2013/14;
- reviewing final drafts of the Directors' remuneration report for 2012/13 and recommending it to the Board for approval for inclusion in the 2013 Annual Report;
- reviewing early drafts of the Directors' remuneration report for 2013/14;
- review and determination of the Group Chairman's fee;
- determining bonuses and deferred bonus awards pursuant to the Company's annual incentive bonus plan in respect of the year 2012/13;
- approving the terms of the appointment of the new non-executive chairman of Viridor;
- approving the performance & co-investment plan awards for the year;
- reviewing the annual performance evaluation results of the Committee;
- approving the remuneration arrangements for the new chief executive, Viridor, and Executive Director of the Board;
- approving the release of the 2010 deferred bonus share awards and the vesting of executive share options pursuant to the annual incentive bonus plan;
- determining the outcome of the 2010 long-term incentive plan awards;
- reviewing the operation of the annual incentive bonus plan and determining revised performance targets and the inclusion of malus and clawback provisions in the plan rules; and
- determining subsidiary board non-executive director fees.

The Board approved this governance report set out on pages 49 to 53 and 56 to 69 on 23 June 2014.

By Order of the Board

Ken Woodier
Group General Counsel & Company Secretary
 23 June 2014

Directors' remuneration report

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Annual Statement from Martin Angle, Chairman of the Remuneration Committee



Dear Shareholder

I am pleased to present the Directors' remuneration report, on behalf of the Board. In accordance with the new remuneration reporting requirements this year shareholders will be asked to vote separately on both our remuneration policy and our annual report on remuneration.

Remuneration decisions for the year

In April 2013 the basic salaries of the Executive Directors increased by 2% except for the Chief Executive of Viridor, who retired at the end of September 2013, where his salary remained unchanged. The salary increases were in line with those across the organisation. For 2014/15 salaries were increased by 2.5%. These increases were in line with those awarded generally across the Group.

The bonus outturns for the Executive Directors for the year were between 42.6% and 85% of salary (with half deferred as set out on page 85). This reflects the achievements of the Group businesses in the year, the Company's performance against corporate financial targets and the Executive Directors' individual targets.

As regards the Company's long-term incentive plan, the overall estimated outturn for awards vesting at the end of the three year period ending 31 March 2014 is 28.3% of the maximum 100%. This reflects that the Company's total shareholder return is estimated to exceed the waste/water comparator index performance by 5.7% but is expected to rank below the median of the FTSE 250.

Board changes

Colin Drummond, Chief Executive of Viridor, retired from the Board on 30 September 2013 following 21 years of service with the Company. As a good leaver, the Committee awarded him a part-year bonus based on the predetermined performance measures and targets, but pro-rated for his period of employment in the year. His outstanding deferred share awards were released to him. Awards under the long-term incentive plan were pro-rated and will be subject to performance measured at the normal time.

In September 2013 Ian McAulay became Chief Executive of Viridor and joined the Board. His remuneration package is in line with those of the other Executive Directors, except that his salary has been set at an initially lower level with a view to providing for scope for increases depending on performance over the next two years. As part of the recruitment he was made an award of shares to the value of £112,000 to compensate him for share awards forfeited from his previous employer due to his resignation. These

shares were of a lower value to the value he has foregone with his previous employer. The shares will be released on the third anniversary of the date of the award subject to Mr McAulay remaining employed by the Company. No cash sign-on payments were made. Mr McAulay relocated from the US on joining the Company and received reimbursement of relocation costs.

Looking forward

During the year we reviewed our remuneration and benefits structure with the assistance of our independent remuneration consultants. To ensure that our Executive Directors incentives were focused on key performance targets for the Group we revised the corporate performance objectives for the annual incentive plan (details on page 83). We also introduced malus and clawback provisions in our bonus arrangements in accordance with best practice.

No other changes have been made to our remuneration package. In particular all maximum opportunities will remain the same in 2014/15.

Best practice reporting

The structure of our report reflects the new reporting requirements and the sections of this remuneration report are:

- **Directors' remuneration policy** – this is the Company's proposed policy on Directors' remuneration which is intended to apply from the 2014 AGM. This part of the report is subject to a binding shareholder vote at this year's AGM and after that at least every third year.
- **Annual report on remuneration** – contains the remuneration of the Directors for the year 2013/14 including the 'single remuneration figure' table providing a value for each element of remuneration for each Director, together with the details of the link between Company performance and remuneration during the year (pages 84 to 87). It also provides details of how our policy will be applied for 2014/15. This section of the report together with this letter is subject to an advisory shareholder vote at this year's AGM.

The membership and the role of the Remuneration Committee including how it has operated during the year is set out separately in this Governance and remuneration section on page 69.

Last year the Remuneration Committee was pleased to note that 98% of shareholders approved the 2012/13 Directors' remuneration report and the Committee appreciates the continuing support of its shareholders.

In conclusion I hope you find our report this year informative and that we can rely on your vote in favour of the Annual report on remuneration and our proposed Directors' remuneration policy for future years.

Martin Angle

Remuneration Committee Chairman

Directors' remuneration report Continued

Directors' remuneration policy

Introduction

The remuneration policy described in this part of the report is intended to apply to the Company, subject to shareholder approval, following the date of the Company's 2014 AGM which is scheduled to be held on 31 July 2014.

The Directors' remuneration policy will be displayed on the Company's website in the investor relations section, immediately after the 2014 AGM and will be available upon request from the Group Company Secretary.

Future policy table – Executive Directors

The table below sets out the elements of the total remuneration package for the Executive Directors which are comprised in this Directors' remuneration policy.

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
Base salary			
Set at a competitive level to attract appropriate candidates to meet Company's strategic objectives and to aid retention.	Salaries are generally reviewed annually and any changes are normally effective from 1 April each year. In normal circumstances salary increases will not be materially different to general employee pay increases but there may be exceptions such as where there has been the recruitment of a new executive director at an initially lower salary.	When reviewing salaries the Committee has regard to the following factors: <ul style="list-style-type: none"> • salary increases generally for all employees in the Company and the Group • market rates • performance of individual and the Company; and • other factors it considers relevant. There is no overall maximum.	None, although individual and Company performance are one of the factors considered when reviewing salaries.
Benefits			
Benefits are provided which are consistent with the market and level of seniority and which aid retention of key skills to assist in meeting strategic objectives.	Benefits currently include the provision of a company vehicle, fuel, health insurance and life assurance. Other benefits may be provided if the Committee considers it appropriate. In the event that an Executive Director is required to relocate, relocation benefits may be provided.	The cost of insurance benefits may vary from year to year depending on the individual's circumstances. There is no overall maximum benefit value but the Committee aims to ensure that the total value of benefits remain proportionate.	None.

Directors' remuneration policy Continued

Future policy table – Executive Directors Continued

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
Annual bonus			
<p>Linked to achievement of key performance objectives aligned to the strategy of the Company.</p>	<p>Annual bonuses are paid following finalisation of the financial results for the year to which they relate and paid usually 3 months after the end of the financial year.</p> <p>A portion of any bonus is deferred into shares in the Company which are normally released after three years. Normally 50% is deferred. Any dividends on the shares during this period are paid to the Directors.</p> <p>The deferred bonus plan is operated in conjunction with the Company's HMRC approved executive share option scheme (ESOS) on the basis that the pre-tax value of awards under both are the same as if the deferred bonus plan had operated alone.</p> <p>For bonuses awarded in respect of the 2014/15 financial year and going forward malus and clawback provisions apply which permit net cash bonuses and/or deferred bonus shares to be forfeited, repaid or made subject to further conditions where the Committee considers it appropriate in the event of any significant adverse circumstances, including (but not limited to) a material failure of risk management, serious reputational damage, a financial misstatement or misconduct. Clawback may be applied for the period of three years following determination of the cash bonus.</p>	<p>The maximum bonus potential for each Director is 100% of base salary.</p>	<p>Performance targets relate to corporate and personal objectives which are reviewed each year. Normally at least 70% relates to financial targets or quantitative measures.</p> <p>The measures, weighting and threshold levels may be adjusted for future performance years.</p> <p>Following the financial year end the Committee, with advice from the Chairman of the Board and following consideration of the outturn against target by the chairman of the Audit Committee, assesses to what extent the targets are met and determines bonus levels accordingly. In doing so the Committee takes into account overall Company performance and may adjust the bonus upwards or downwards for any specific factors such as exceptional out-performance or under-performance.</p>

Directors' remuneration report Continued

Directors' remuneration policy Continued

Future policy table – Executive Directors Continued

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
Long term incentive plan (Performance and co-investment plan)			
Provide alignment to shareholders and to longer term Company performance.	<p>Annual grant of conditional shares (or equivalent). Share awards vest dependent upon the achievement of specific performance conditions measured over a performance period of no less than three years.</p> <p>A grant is only made if the Director has acquired or is due to acquire co-investment shares equivalent to one-fifth of the value of the award.</p> <p>Dividend equivalents (including dividend reinvestment) may be paid on vested awards.</p> <p>An "underpin" applies which allows the Committee to reduce or withhold vesting if the Committee is not satisfied with the underlying operational and economic performance of the Company.</p>	The maximum annual award is 100% of base salary.	<p>The current performance conditions are based on TSR with 50% based on TSR against the water/waste peer group index (chosen because these companies are regarded as the Company's key listed comparators) and 50% based on TSR against constituents of the FTSE 250 index (excluding investment trusts) (chosen because this is the FTSE index to which the Company belongs currently). No more than 30% of maximum vests for minimum performance.</p> <p>The "underpin" evaluation includes consideration of environmental, social and governance (ESG) factors and safety performance as well as financial performance.</p> <p>The Committee will keep the performance measures under review and may change the performance condition for future awards if this were considered to be aligned with the Company's interests and strategic objectives. However, the Committee would consult with major shareholders in advance of any proposed material change in performance measures.</p>
Pension			
Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.	<p>Defined benefit pension arrangements are closed to new entrants. Defined contribution pension arrangements are available to new staff since 2008. A cash allowance may be provided as an alternative and/or in addition where pension limits have been reached.</p>	<p>The maximum annual pension contribution or cash allowance is 20% of salary. For Executive Directors who commenced employment prior to April 2013 the maximum annual pension contribution or cash allowance is 30% of salary.</p> <p>Legacy defined benefit pension arrangements will continue to be honoured.</p> <p>Whilst one Executive Director is a pension member there are no further prospective accruals in respect of defined benefit pension arrangements.</p>	None.

Directors' remuneration policy Continued

Future policy table – Executive Directors Continued

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of any payment)	Maximum potential value of the component	Description of framework used to assess performance
All-employee share plans			
To align interests of all employees with Company share performance.	Executive Directors may participate in HMRC approved all-employee plans on the same basis as employees.	The maximum is as prescribed under the relevant HMRC legislation governing the plans.	None.

Notes to the policy table

The Company also operates a shareholding policy. The way in which this currently operates is set out on page 91.

The Committee reserves the right to make any remuneration payments and payments for loss of office (including exercising any discretions available to it in connection with such payments) that are not in line with the policy set out in this report where the terms of the payment were agreed before the policy came into effect or at a time when the relevant individual was not a Director of the Company and, in the opinion of the Committee, the payment was not in consideration for the individual becoming a Director of the Company. For these purposes "payments" includes pension payments under legacy defined benefit pension plans and the satisfaction of awards of variable remuneration and, in relation to an award over shares, the terms of the payment are "agreed" at the time the award is granted.

The Performance and Co-Investment Plan (PCP) will be operated in accordance with the rules of the plan as approved by shareholders. The deferred bonus awards will be governed by the rules adopted by the Board from time to time. In accordance with those rules the Committee has discretion in the following areas:

- awards can be granted as forfeitable shares, conditional share awards, nil or nominal cost options or awards in other forms it determines has a substantially similar purpose or effect. Awards may be settled in cash;

- the Committee may adjust the number of shares under an award if there is a capitalisation, rights issue, subdivision, reduction or any other variation in the share capital, a demerger or special dividend or any other exceptional event which in the opinion of the Committee justifies an adjustment;
- a performance condition applicable to a PCP award may be amended in accordance with its terms or if an event occurs which causes the Committee to consider that an amended performance condition would be appropriate (taking into account the interests of shareholders) and would be no less difficult to satisfy had the relevant event not occurred;
- on a change of control or voluntary winding up of the Company, PCP awards may vest to the extent determined by the Committee having regard to the performance of the Company and the period of time that has elapsed since grant. Deferred bonus awards may vest early in full. Alternatively, participants may have the opportunity, or be required, to exchange their awards for equivalent awards in another company although the Committee may decide in these circumstances to amend the performance conditions; and
- the Committee has the discretion to treat a demerger, special dividend or other transaction that may affect the current or future value of awards as an early vesting event on the same basis as a change of control.

The Committee may make minor amendments to the policy (for example for regulatory, exchange control, tax or administrative purposes or to take account of a change in legislation) without obtaining shareholder approval for that amendment.

Directors' remuneration report Continued

Directors' remuneration policy Continued

Notes to the policy table Continued

Performance measures and targets

The performance conditions for the annual incentive bonus plan are selected by the Committee each year to reflect key performance indicators for the Company and each year key metrics used by the Board to oversee the operation of the businesses. These targets are determined annually by the Committee following a review of the Company's forecasts and market expectations. Targets may be adjusted by the Committee to take account of events such as significant capital transactions.

In respect of the current long-term incentive plan performance conditions the Committee chose the two total shareholder return measures as it believes that performance against these measures aligns the Executive Directors' interests with those of shareholders including how successful performance is compared to both the general market and a bespoke sector peer group.

Differences in remuneration policy for all employees

All administrative based employees of the Group are entitled to base salary and pension provision including life assurance. In addition all administrative staff in Pennon Group and South West Water and all senior and middle management staff in the operations functions in Viridor are entitled to participate in annual bonus arrangements, the levels of which are based on the seniority and responsibility of the role. Other benefits such as car allowance and medical insurance are generally available only to more senior employees at management level and above and long-term incentive share awards are only available to senior executives and Directors. Generally senior executives and Directors receive a higher proportion of their total pay in the form of variable remuneration and share awards.

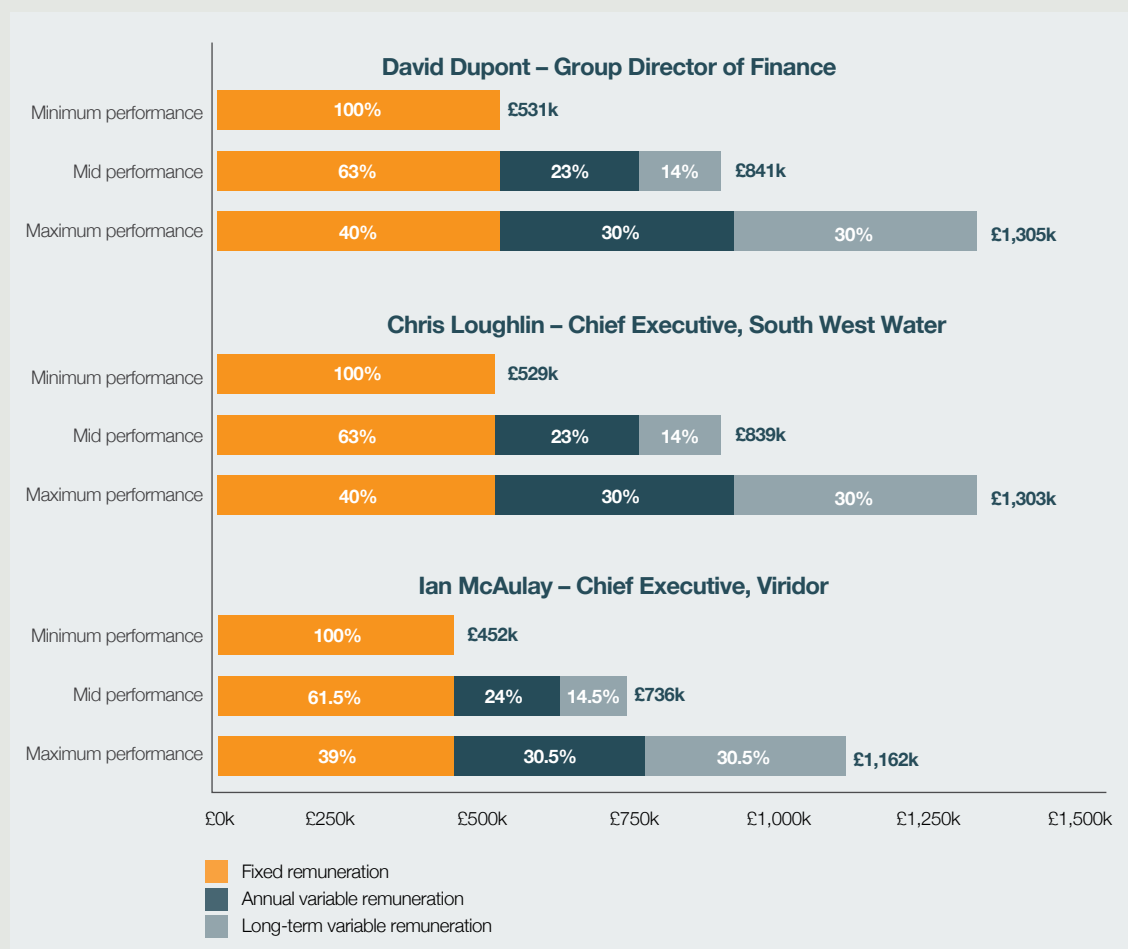
Future policy table – Non-executive Directors

The table below sets out the Company's policy in respect of the setting of fees for Non-executive Directors.

How the components support the strategic objectives of the Company	How the component operates	Maximum potential value of the component
Fees		
Set at a market level to attract Non-Executive Directors who have appropriate experience and skills to assist in determining the Group's strategy.	<p>Fees are set by the Board with the Chairman's fees being set by the Committee. The relevant Directors are not present at the meetings when their fees are being determined.</p> <p>Non-executive Directors normally receive a basic fee and an additional fee for any specific Board responsibility such as membership or chairmanship of a Committee or occupying the role of Senior Independent Director.</p> <p>In reviewing the fees the Board, or Committee as appropriate, consider the level of fees payable to Non-executive Directors in other companies of similar scale and complexity.</p>	Total fees paid to Non-executive Directors will remain within the limits stated in the Articles of Association.
Benefits		
Benefits for the Chairman are provided which are consistent with the market and level of seniority	<p>Expenses incurred in the performance of non-executive duties for the Company may be reimbursed or paid for directly by the Company (including any tax due on the expenses).</p> <p>The Chairman's benefits include the provision of a company vehicle, fuel and health insurance.</p>	None.

Illustrations of applications of remuneration policy

The total remuneration for each of the Executive Directors that could result from the proposed remuneration policy in 2014/15 is shown below.



Scenario	Assumptions
Minimum performance	Fixed pay, which constitutes base salary, pension and benefits in kind. These values are made up of the salaries for 2014/15 (set out on page 82) and an estimate of the value of the benefits and pension.
Mid performance	Fixed pay and 50% of the maximum annual bonus and 30% of the maximum long term incentive award.
Maximum	Fixed pay and 100% vesting of the annual bonus and long term incentive awards.

No adjustments have been made for potential share price growth or payment of dividends. Benefits from all-employee schemes have also been excluded.

Directors' remuneration report Continued

Directors' remuneration policy Continued

Approach to recruitment remuneration

When considering the appointment of Executive Directors the Committee seeks to balance the need to offer remuneration to attract candidates of sufficient calibre to deliver the Company's strategy whilst remaining mindful of the need to pay no more than is necessary.

Where possible, salaries may be set at an initially lower level with the intention of providing potential for higher than usual increases over the following two years to reflect experience gained and performance in the role. Other elements of remuneration would be in line with the Company's policy set out in the future policy table on page 72.

The maximum variable pay opportunity on recruitment (excluding 'buyouts') would be in line with the future policy table on page 72.

The Committee may determine for the first year of appointment that any annual bonus will be subject to different weightings or objectives.

To facilitate recruitment it may be necessary to recompense a new Executive Director for the expected value of incentive rewards foregone with their previous employer ('buyout' awards). The Committee may make buyout awards under LR9.4.2 of the Listing Rules. The Committee will ensure that any such award would at a maximum match the value of the awards granted by the previous employer and be made only where a Director is able to demonstrate that a loss has been incurred from leaving his or her previous employment. Any buyout would take into account the terms of the arrangement forfeited, including in particular any performance conditions and the time over which they vest. The award would have time horizons which are in line with or greater than the awards forfeited.

For interim positions a cash supplement may be paid rather than salary (for example a Non-executive Director taking on an executive function on a short-term basis).

Where an employee is promoted to the position of Executive Director (including if an Executive Director is appointed following an acquisition or merger), pre-existing awards and contractual commitments would be honoured in accordance with their established terms.

Non-executive Directors fees would be in line with the policy set out in the table on page 76.

Dates of Directors' service contracts/letters of appointment

The dates of Directors' service contracts and letters of appointment and details of the outstanding term are shown below.

Executive Directors	Date of service contract	Expiry date of service contract
Colin Drummond	5 March 1992	30 September 2013 (retired on this date)
David Dupont*	2 January 2003	No expiry date
Chris Loughlin*	16 May 2006	No expiry date
Ian McAulay*	2 August 2013	On normal retirement date at age 65 (25 April 2030)

* Each of the Executive Directors' service contracts is subject to 12 months notice on either side.

Non-executive Directors	Date of letter of appointment	Expiry date of appointment
Ken Harvey	1 April 2005	Ongoing – subject to 12 months notice from either side
Martin Angle	28 November 2008	30 November 2014
Gerard Connell	30 September 2003	31 July 2015
Dinah Nichols	10 June 2003	1 August 2013 (retired on this date)
Gill Rider	22 June 2012	30 August 2015

The policy is for Executive Directors' service contracts to provide for 12 months notice from either side.

The policy is for Non-executive Directors' letters of appointment to contain three months notice period from either side and for the Chairman's letter of appointment to contain a 12 months' notice period from either side.

All Non-executive Directors are subject to annual re-election and are appointed for an initial three-year term.

Copies of Directors' service contracts and letters of appointment are available for inspection at the Company's registered office.

Directors' remuneration report Continued

Directors' remuneration policy Continued

Policy on termination of service agreements and payment for loss of office

In the event that the employment of an Executive Director is terminated, any compensation payable will be determined by reference to the terms of the service contract between the Company and the employee, as well as the rules of the various incentive plans as set out in the table below.

The Company's policy is that Executive Directors' service agreements normally continue until the Director's agreed retirement date or such other date as the parties agree. Otherwise they are terminable on one year's notice and provide no entitlement to the payment of a pre-determined amount on determination of employment in any circumstances.

There are no liquidated damages provisions for compensation on termination within Executive Directors' service agreements. Taking into account the circumstances of any termination the Committee may determine that a payment in lieu of notice should be made. Any such payments would be restricted to salary and benefits. In these circumstances consideration would be given to phasing of payments and an individual's duty and opportunity to mitigate losses.

The Company may meet ancillary costs, such as outplacement consultancy and/or reasonable legal costs if the Company terminates the Executive Director's service contract.

Annual bonus	<p>Normally no bonus is payable unless an Executive Director is employed on the date of payment.</p> <p>In certain good leaver circumstances (death, disability, redundancy, retirement and any other circumstance at the Committee's discretion) a bonus may be payable. Any such bonus would be based on performance and pro-rated to reflect the period of service with performance normally assessed at the same time as other employees. The Committee retains discretion to adjust the timing and pro-rating of any award to take account of any prevailing exceptional circumstances which they consider would be fair to the Company and to the employee. Share deferral would not normally apply.</p>
Deferred shares (including ESOS)	<p>Unvested awards would normally lapse upon cessation. In certain good leaver circumstances awards are released to participants on cessation of employment.</p> <p>Good leaver circumstances are death, injury, ill-health, disability, redundancy, retirement, the sale of the individual's employing business or company out of the Group and any other circumstance at the Committee's discretion.</p>
Performance and Co-investment Plan	<p>Any unvested awards would normally lapse upon cessation of the individual's employment within the Group. In certain good leaver circumstances awards vest to the extent determined by the Committee taking into account the extent to which the performance target has been satisfied, the extent to which the co-investment condition has been satisfied, the period of time elapsed since grant and such other factors as the Committee may deem relevant. Awards would normally vest on the original normal vesting date unless the Committee determines awards should vest earlier.</p> <p>Good leaver circumstances are death, ill health, injury, disability, redundancy, retirement, the sale of the individual's employing company or business out of the Group and any other circumstance at the Committee's discretion.</p> <p>All awards would lapse if a participant was summarily dismissed.</p>
All-employee awards	<p>Leavers will be treated in accordance with the HMRC approved rules.</p>
Other awards	<p>Where a buyout award is made recruitment leaver provisions would be determined at the time of award. The buyout award to Mr McAulay has the same leaver provisions as the deferred bonus plan.</p>

Statement of consideration of employment conditions elsewhere in the Company

In setting executive remuneration the Committee not only takes account of employment market conditions, but also of the pay and benefits differentials across the Group. The Committee considers annual summary reports of workforce remuneration and the terms and conditions of employment within each operating company and has regard to these in setting salary and other benefits for the Executive Directors and senior management although these reports do not include comparison metrics.

The Committee does not consult with employees when drawing up the Directors' remuneration policy but does take account of the Group-wide policy as described above.

Statement of consideration of shareholder views

The Committee has taken into account general good governance, best practice and shareholder views when formulating the remuneration policy. Where there is a significant change to policy the Committee would consult with major shareholders. For example shareholders were consulted when the Performance & Co-investment Plan was introduced. The Company's pay policy for Executive Directors has remained consistent for a number of years and has enjoyed shareholder support over that period.

Directors' remuneration report Continued

Annual report on remuneration

Introduction

This section sets out how the Company has applied its remuneration policy in the year, and details how the policy will be implemented for the year 2014/15. In accordance with section 439 of the Companies Act, this section will be put to an advisory vote at the Company's AGM which is scheduled to be held on 31 July 2014.

Operation of the remuneration policy for 2014/15

During 2013 the Committee reviewed the incentive framework for Executive Directors. The key changes made were:

- adjustment of the corporate performance objectives for the annual bonus to ensure that they were aligned with the areas of challenge in the strategy; and
- as part of this review the Committee introduced malus and clawback arrangements in the annual bonus in accordance with best practice.

A summary of the specific remuneration arrangements for Executive Directors in 2014/15 is described below;

Base salary	<p>Salary increases of 2.5%, generally in line with increases for all employees, effective 1 April 2014 except for Ian McAulay who received a 9.23% increase to reflect his performance in the role after joining in accordance with the Committee's pay policy on recruitment as set out in the Directors' remuneration policy on page 78.</p> <p>2014/15 salaries are:</p> <ul style="list-style-type: none"> • David Dupont: £387,000 • Chris Loughlin: £387,000 • Ian McAulay: £355,000
Pension and benefits	<p>No changes. Defined contribution pension or salary supplement cash allowance of between 20% and 30%.</p>
Annual bonus	<p>No change to maximum opportunity of 100% of salary.</p> <p>No change to operation of deferral. 50% of the bonus is delivered as deferred shares.</p> <p>Following a review of the performance measures, annual bonus will be based on the following for 2014/15:</p> <ul style="list-style-type: none"> • 30% EPS (before deferred tax and exceptional net charges) performance • 30% personal strategic objectives • 40% measures which are specific to the role including net debt, division operating profit, SIM performance and serviceability South West Water (SWW), EBITDA and JVs (Viridor). <p>More detail on the measures and weightings is provided on the following page. The objective was to ensure alignment to measures identified as key for each role with an appropriate balance between hard financial measures and objectives aligned to the strategic success of the business.</p> <p>For bonuses from 2014/15 both malus and clawback will apply as described in the Remuneration policy report.</p>
Performance and Co-Investment Plan (PCP)	<p>No changes.</p> <p>Awards of 100% of base salary.</p> <p>Awards subject to co-investment of 20% of the award.</p> <p>Performance measures:</p> <ul style="list-style-type: none"> • 50% TSR vs FTSE 250 (excluding investment trusts) • 50% TSR vs a Water/Waste peer group index. <p>"Underpin" relating to overall Group performance.</p>
Shareholding guidelines	<p>No change.</p> <p>100% of salary to be built up in the first five years of joining.</p>

Forward-looking performance targets

Details of the annual bonus framework that will apply for each Executive Director for 2014/15 are set out in the table below:

Group Director of Finance, David Dupont	EPS*	30%
	Net debt	10%
	Operating profit of SWW and Viridor	30% (15% each)
	Personal	30%

Chief Executive, SWW, Chris Loughlin	EPS*	30%
	Average SWW Directors' performance:	40%
	(i) operating profit	
	(ii) SIM performance	
	(iii) Serviceability	
(iv) Net debt		
Personal	30%	

Chief Executive, Viridor, Ian McAulay	EPS*	30%
	Average Viridor Directors' performance:	40%
	(i) operating profit	
	(ii) Net debt	
	(iii) EBITDA+JVs	
Personal	30%	

*EPS is before deferred tax and exceptional net charges

The specific bonus targets are considered to be commercially sensitive. However the Committee intends to disclose details of the targets set

retrospectively to the extent they are not considered commercially sensitive. For the PCP (long-term incentive plan) the targets are set out below:

	Threshold (30% of maximum vests)	Maximum (100% of maximum vests)
Water/Waste Index (50% of award)	Equal to index	15% above the index
FTSE 250 (excluding investment trusts) (50% of award)	Above 50 th percentile	At or above 75 th percentile

The Water/Waste Index will comprise:

- Shanks Group
- Séché Environnement
- Suez Environnement
- Severn Trent
- United Utilities
- National Grid
- Veolia Environnement

Non-executive Director fees

Non-executive Director fees for 2014/15 are set out below. They include an increase of 2.5% approved by the Committee for the Chairman and an overall 2.5%

for the other Non-executive Directors approved by the Board, all effective from 1 April 2014.

Role	Fees £
Chairman	262,400
Basic Non-executive Director fee	44,500
Additional fees:	
Additional fee for Chairman of the Audit Committee	11,000
Additional fee for Chairman of the Remuneration Committee	7,900
Additional fee for Chairman of the Sustainability Committee	7,900
Committee fee	4,000

Directors' remuneration report Continued

Annual report on remuneration Continued

Single total figure of remuneration tables (Audited information)

	Base salary/fees (£000)		Benefits (including Sharesave) (£000)		Annual bonus (cash and deferred shares) (£000)		Performance and co- investment plan (£000)		Pension (£000)		Total remuneration (£000)	
	2013/14	2012/13	2013/14	2012/13	2013/14	2012/13	(iv) 2013/14	2012/13	2013/14	2012/13	2013/14	2012/13
Executive Directors												
Colin Drummond, Chief Executive, Viridor (retired 30 September 2013)	185	370 ⁽ⁱ⁾	13	27	79	74	94	241	55	111	426	823
David Dupont, Group Director of Finance	377	370	28	27	274	212	126	241	113	25	918	875
Chris Loughlin, Chief Executive, South West Water	377	370	30	25	321	236	126	241	113	111	967	1,179
Ian McAulay, Chief Executive, Viridor (appointed 9 September 2013)	182	–	117 ⁽ⁱⁱ⁾	–	240 ⁽ⁱⁱⁱ⁾	–	–	–	36	–	575	–
Non-executive Directors												
Ken Harvey, Chairman	256	248	25	24	–	–	–	–	–	–	281	272
Gerard Connell	62	60	–	–	–	–	–	–	–	–	62	60
Dinah Nichols (retired 1 August 2013)	20	57	–	–	–	–	–	–	–	–	20	57
Martin Angle	59	57	–	–	–	–	–	–	–	–	59	57
Gill Rider (appointed 1 September 2012)	58	31	–	–	–	–	–	–	–	–	58	31

⁽ⁱ⁾In 2012/13 Colin Drummond decided to forego his salary increase in the year and arranged for an equivalent sum (£11,000) to be paid into the Viridor staff welfare fund. The salary he received was therefore £359,000.

⁽ⁱⁱ⁾Benefits include reimbursement of relocation costs (including income tax) of £107,187.

⁽ⁱⁱⁱ⁾For Ian McAulay £112,000 related to a buyout award as referred to on page 88.

^(iv)Based on an estimated 28.3% vesting as referred to on page 86 and based on the Company's share price of £7.695 as at 19 June 2014, together with an estimate of the accrued dividends payable on the vesting shares.

Annual bonus outturn for 2013/14

The performance targets set and the performance achieved in respect of the annual bonus for 2013/14 in respect of each Executive Director is set out below. In line with the Committee's policy 50% of any bonus is payable into shares except in the case of Colin Drummond who retired during the year.

David Dupont

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
EPS [^]	40%	35.9p	39.8p	45.8p	42.6p	27.1%
SWW PBT	10%	£138m	£145m	£160m	162.5m	10%
Viridor PBT ⁺	10%	£27.4m	£30.4m	£33.4m	£27.6m	0.4%
Net interest	10%	No payout for below target. Maximum payout for net interest of 5% below target.*			£53.9m	10%
Net debt	10%	No payout for below target. Maximum payout for net debt of 2.5% below target.*			£2,194m	10%
Personal objectives	20%	Objectives relating to key finance business objectives for the Group.*			–	15%
Total outturn						72.5%

* Actual targets considered commercially confidential + Before exceptional net charges ^ EPS is before deferred tax and exceptional net charges.

Ian McAulay

Ian McAulay became Chief Executive of Viridor and joined the Board in September 2013. Ian's employment with the Company commenced on 9 September 2013 and the bonus percentage was paid in respect of total salary received in the year.

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
EPS [^]	20%	35.9p	39.8p	45.8p	42.6p	14.6%
Viridor PBT ⁺	15%	£27.4m	£30.4m	£33.4m	£27.6m	0.65%
Personal objectives	65%	Personal objectives relating to developing role as new chief executive of Viridor*			–	54.75%
Total outturn						70%

* Actual targets considered commercially confidential + Before exceptional net charges ^ EPS is before deferred tax and exceptional net charges.

Colin Drummond

Colin Drummond retired on 30 September 2013. The bonus percentage was paid in respect of total salary received in the year to this date.

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Viridor PBT (half-year results)	45%	£14.6m	£16.6m	£18.3m	£15.3m	8.6%
Personal objectives	55%	Objectives relating to a range of targets concerning key Viridor activities and the handover to a new chief executive when appointed.*			–	34.0%
Total outturn						42.6%

* Actual targets considered commercially confidential

Directors' remuneration report Continued

Annual report on remuneration Continued

Annual bonus outturn for 2013/14 Continued

Chris Loughlin

Measure	Weighting	Threshold	Target	Maximum	Actual outturn	Bonus outturn
EPS [^]	40%	35.9p	39.8p	45.8p	42.6p	27.1%
SWW performance	40%	<p>The average of the bonus earned by the other Executive Directors of South West Water which relate to:</p> <ul style="list-style-type: none"> • out-performance against operating costs; • profit before tax, capital expenditure and net debt targets of the company; • the position the company achieves in the 'Service Incentive Mechanism' of water and sewerage companies established by Ofwat; • the achievement of a range of service standards set for the company by Ofwat; and • personal objectives relating to key initiatives, projects and compliance targets for South West Water.* <p>SWW PBT targets were £138 million to £160 million and were exceeded. Actual SWW PBT performance was £162.5 million.</p> <p>In considering the outcome for this element the Committee exercised discretion in relation to the excellent performance in achieving 'enhanced status' for the SWW business plan with Ofwat. The increase in outturn in relation to this achievement was 10% of salary. The benefits of this assessment included:</p> <ul style="list-style-type: none"> • an initial financial award of £11 million as an addition to the Regulatory Capital Value; and • an enhanced total expenditure (Totex) menu with an enhanced sharing rate. 				40%
Personal objectives	20%	Implementing South West Waters new strategies and projects and meeting compliance targets.*			–	18%
Total outturn						85.1%

*Actual targets considered commercially confidential ^ EPS is before deferred tax and exceptional net charges.

Performance & Co-investment Plan outturn for 2013/14

The PCP award included in the single figure table relates to the awards made on 1 July 2011, which are due to vest on 30 June 2014.

50% of the awards will vest subject to the Company's TSR performance measured against an index made up of the following six listed water and waste comparator companies. These companies were considered to be the Company's key listed comparators:

- Northumbrian Water Group
- Shanks Group
- S  ch   Environnement
- Suez Environnement
- Severn Trent
- United Utilities

Northumbrian Water Group delisted from the London Stock Exchange in October 2011. The Committee therefore decided to include this company in the calculation of the index up to the date of delisting and exclude the company from the date of delisting.

The remaining 50% of the awards will vest subject to the Company's ranked TSR performance against the constituents of the FTSE 250 (excluding investment trusts).

The calculation of TSR performance over the three year performance period (being 1 April 2011 to 1 April 2014) for the PCP awards was undertaken by Deloitte LLP for the Committee.

Vesting of the award is according to the schedule on the following page:

	Threshold (30% of maximum vests)	Maximum (100% of maximum vests)	Achievement in the period to 1 April 2014*	Vesting outturn*
Water/Waste Index (50% of award)	Equal to index	15% above the index	5.7% out performance	28.3%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile	35.3%	0%
TOTAL				28.3 %

Straight line vesting between points.

For below threshold performance, 0% vests

*As the calculation requires averaging TSR performance over the first three months of the performance period and comparing it to the average over the three months following the end of the performance period (1 April 2014 to 30 June 2014) the achievement and the outturn is an estimate at the date of calculation (16 June 2014)

Vesting of the award is also subject to the 'underpin' described on page 74 which the Committee has determined to the date of this report would be satisfied.

Total pension entitlements (Audited information)

	Defined benefit pension accrued at 31 March 2014 ⁽¹⁾ £000 p.a.	Normal retirement age	Description of additional benefits available to the Director on early retirement
Colin Drummond	134	Not applicable – Director retired	Not applicable – Director retired
David Dupont	140	Not applicable – Director in receipt of pension	Not applicable – Director in receipt of pension

⁽¹⁾ Colin Drummond and David Dupont are both pensioner members of Pennon Group's schemes. Therefore the accrued pension shown is the actual pension in payment as at 31 March 2014.

Colin Drummond and David Dupont were both pensioner members of the Pennon Group's defined benefit pension arrangements during the year. Neither Director has a prospective entitlement to defined benefits or other arrangements which include such benefits.

Ian McAulay joined Pennon Group's defined contribution arrangement during the year and received an overall pension benefit from the Company equivalent to 20% of his salary. Chris Loughlin is not a member of any of the Pennon Group's pension schemes and receives a sum in lieu of pension entitlement equivalent to 30% of salary. David Dupont also receives a cash allowance of 30% of salary in lieu of ongoing pension. Colin Drummond received a similar cash allowance of 30% of salary in lieu of ongoing pension up to his retirement date of 30 September 2013.

No additional benefits will become receivable by a Director in the event that the Director retires early. David Dupont and Chris Loughlin had normal retirement dates of 60 but they have both reached agreement with the Company to continue in office subject to one year's notice on either side. Ian McAulay's normal retirement age is 65 which will be reached on 25 April 2030.

Directors' remuneration report Continued

Annual report on remuneration Continued

Director changes – additional information

Leaving arrangements – Colin Drummond (Audited information)

Colin Drummond retired on 30 September 2013. This followed 21 years of service with the Company.

The Committee determined that Mr Drummond's retirement was a "good leaver" circumstance. Consequently he received a performance related annual bonus, pro-rated for his period of employment in the year which was not subject to share deferral and his outstanding deferred bonus awards were released to him. Under the rules of the PCP his PCP awards remain in force subject to performance conditions tested at the normal time and subject to pro-rating for time.

Mr Drummond received no payment in lieu of notice or compensation for loss of office.

Upon his retirement as an executive director Mr Drummond was appointed non-executive chairman of the board of Viridor Limited. He received fees amounting to £45,000, health insurance to the value of £465 and expenses amounting to £1,582 in respect of this role for the remaining six months of the year.

Recruitment of Ian McAulay

Ian McAulay joined the Board in September as an executive director and as Chief Executive of Viridor. His remuneration package is in line with those of the other Executive Directors, except that his salary has been set at an initially lower level with a view to providing for scope for increases depending on performance over the next two years.

As part of the recruitment he was made an award of shares to the value of £112,000 to compensate him for share awards and bonus forfeited from his previous employment due to his

resignation. These shares are of a lesser value to the value which was forgone. The shares will be released on the third anniversary of the date of the award subject to Mr McAulay remaining in employment with the Company, being a longer period than the time horizons of the awards forfeited. No cash sign-on payments were made.

Mr McAulay also received the reimbursement of relocation costs from the US to the value of £107,187 (including income tax).

Outside appointments

Executive Directors may accept one board appointment in another company. Board approval must be sought before accepting an appointment. Fees may be retained by the Director. Currently, no Executive Directors hold outside company appointments other than with industry bodies or governmental or quasi governmental agencies.

Non-executive Director fees and benefits

The Chairman and the other Non-executive Directors' fees were increased by 3.3% for 2013/14 compared to the previous year following an assessment of the appropriate up to date fee levels for directors in similar positions and taking account of the time commitment of each Director.

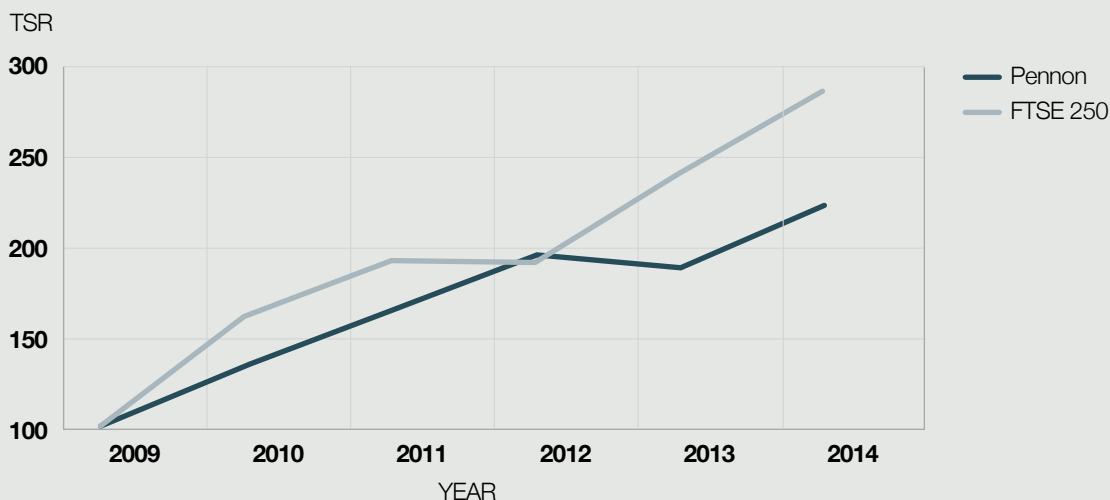
The Chairman's benefits comprise of a company vehicle, fuel and private health insurance.

All employee, performance and other contextual information

Historical TSR and Executive Director remuneration

The graph below shows the value, over the five-year period ending on 31 March 2014, of £100 invested in Pennon Group on 31 March 2009 compared with the value of £100 invested in the FTSE 250 Index. This Index is considered appropriate as it is a broad equity market index of which the Company is a constituent.

Total shareholder return (TSR)



Equivalent chief executive officer remuneration

As the Company does not have a Group CEO, the Committee has decided to provide historic single figure information in the form of the average remuneration of the Executive Directors. Their remuneration is considered to be the most appropriate to use for this exercise as they are the most senior executives in the Company.

	2009/10	2010/11	2011/12	2012/13	2013/14 ^①
Average Executive Director single figure of remuneration (£000)	916	1,091	1,221	959	962
Annual bonus payout (% of maximum)	91.79	94.69	72.87	47.00	67.56
LTIP vesting (% of maximum) ^②	67.30	50.00	79.30	50.00	28.30

^① Due to the change in the post holder of Chief Executive, Viridor, (Colin Drummond to Ian McAulay) in the year the total paid to both post holders has been included except the LTIP vesting which only Colin Drummond was eligible to receive.

^② The LTIP vesting percentage excludes accrued dividends which are added on vesting.

Comparison of Executive Director remuneration to employee remuneration

The table below shows the percentage change between 2012/13 and 2013/14 in base salary, benefits and annual bonus for the average of the Executive Directors and all employees.

The percentage increase in average remuneration for employees is calculated using wages and salaries (excluding share-based payments) of £134.3 million (2012/13 £134.3 million), analysed into the three components in the table and the average number of employees of 4,451 (2012/13 4,584) both as detailed in note 14 to the Group financial statements.

	Percentage change in salary	Percentage change in benefits	Percentage change in annual bonus
Average Executive Director remuneration	1.08	142.31 ^①	28.93
All employees	2.76	0.62	27.66

^① This figure includes relocation costs for Ian McAulay. Without these costs the change would have been 2.5%.

Directors' remuneration report Continued

Annual report on remuneration Continued

Relative importance of spend on pay

	2013/14 (£ million)	2012/13 (£ million)	Percentage change
Overall expenditure on pay ¹	157.9	155.5	+1.5
Distributions to Ordinary shareholders	103.9	96.0	+8.2
Distributions to perpetual/capital security holders	20.3	–	N/A
Purchase of property, plant and equipment (cash flow)	346.7	397.2	-12.7

¹ Excludes employer's social security costs

The above table illustrates the relative importance of spend on pay compared with distributions to shareholders and other Group outgoings. The distributions to perpetual capital security holders and the purchase of property, plant and equipment (cash flow) have been included as these were the most significant outgoings for the Company in the last financial year.

Share award and shareholding disclosures (Audited Information)

Share awards granted during 2013/14

The table below sets out details of share awards made in the year to Executive Directors.

Executive Director	Type of interest	Basis of Award	Face value £000	Percentage vesting at threshold performance	Performance period end date
Colin Drummond	PCP	100% of salary	–	30% of maximum	31 March 2016
David Dupont			377		
Chris Loughlin			377		
Colin Drummond	Deferred bonus / ESOS	50% of bonus awarded	37	n/a	4 August 2016
David Dupont			106		
Chris Loughlin			118		
Ian McAulay	Buy-out award	Equivalent or lower value to awards forfeited	112	n/a	29 September 2016

Sharesave (SAYE) awards were also made, as detailed on the next page.

PCP awards were calculated using the share price at the date of grant (2 July 2013) which was £6.53 per share. Deferred bonus awards were calculated using the share price at the date of grant (5 August 2013) which was £6.93. The buy-out award was calculated using the share price at the deemed date of grant (30 September 2013) which was £6.96.

The deferred bonus plan is operated in conjunction with the Company's HMRC approved executive share option scheme (ESOS). This is on the basis that the aggregate pre-tax value of the awards made under both the annual bonus and the ESOS would be the same as they would have been if the bonus plan had operated alone. This is achieved by requiring that an amount of deferred shares, equal in value to any gain made on the exercise of ESOS options, is forfeited by the Directors at the end of the 3 year deferral period.

Directors' shareholding and interest in shares

The Remuneration Committee believes that the interests of Executive Directors and senior management should be closely aligned with the

interests of shareholders. To support this, the Committee operates shareholding guidelines. The Executive Directors are expected to build up a shareholding in the Company in accordance with the Company's shareholding guideline which amounts to a shareholding interest equivalent to 100% of salary to be built up within the first five years of joining the Company at the rate of at least 20% per year by the end of each year. This level of shareholding is then expected to be maintained by each Director and is revalued each year in accordance with the then prevailing share price and the Executive Director's salary.

The beneficial interests of the Executive Directors in the ordinary shares (40.7p each) of the Company as at 31 March 2014 (or date of cessation, if earlier) and 31 March 2013 together with their shareholding guideline obligation and interest are shown in the table below:

	Share interests (including connected parties) at 31 March 2014	Share interests (including connected parties) at 31 March 2013	Shareholding guideline	Shareholding guideline met?	Unvested awards				
					Performance shares (subject to performance conditions)	SAYE	Deferred Bonus shares	ESOS	Buyout award
Colin Drummond	350,061	332,841	100%	No longer applicable –retired	58,634*	–	–	–	–
David Dupont	350,194	316,415	100%	Yes	157,387	–	56,220	4,329	–
Chris Loughlin	193,543	150,766	100%	Yes	157,387	2,788	59,769	4,329	–
Ian McAulay	–	–	20%	In first year	–	–	–	–	16,091

*Following his retirement on 30 September 2013 Colin Drummond's continuing interest in performance shares has been pro-rated to the period he was employed during each restricted period.

Since 31 March 2014, 3,512 additional Ordinary shares in the Company have been acquired by Chris Loughlin as a result of participation in the Company's Scrip Dividend Alternative and the Company's Share Incentive Plan; and 361 additional Ordinary shares in the Company have been acquired by David Dupont as a result of dividend reinvestment in an ISA. There have been no other changes in the beneficial interests or the non-beneficial interests of the Directors in the Ordinary shares of the Company between 1 April 2014 and 19 June 2014.

Directors' remuneration report Continued

Annual report on remuneration Continued

Non-executive Directors' shareholding

The beneficial interests of the Non-executive Directors, including the beneficial interests of their spouses, civil partners, children and step-children, in the ordinary shares (40.7p) of the Company, are shown in the table below:

Director	Shares held at 31 March 2014	Shares held at 31 March 2013
Ken Harvey	26,209	26,209
Martin Angle	–	–
Gerard Connell	4,271	4,098
Dinah Nichols	4,549	4,549
Gill Rider	2,500	–

There is no formal shareholding guideline for the Non-executive Directors; however they are encouraged to purchase shares in the Company.

Shareholder dilution

The Company can satisfy awards under all of its share plans with new issue shares or shares issued from Treasury up to a maximum of 10% of its issued share capital in a rolling ten year period to employees under all its share plans. Within this 10% limit the Company can only issue (as newly issued shares or from Treasury) 5% of its issued share capital to satisfy awards under discretionary or executive plans. The percentage of shares awarded within these guidelines and the headroom remaining available as at 20 June 2014 is as set out below:

	Awarded	Headroom	
Discretionary schemes	1.44%	3.56%	Total 5%
All schemes	4.01%	5.99%	Total 10%

Details of share awards

(a) Performance and co-investment 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 (40.7p each) of the Company shown below, representing the maximum number of shares to which they would become entitled under the plan should the relevant criteria be met in full:

Director and date of award	Conditional awards held at 1 April 2013	Conditional awards made in year	Market price upon award in year	Vesting in year ^①	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2014	Date of end of period for qualifying conditions to be fulfilled
Colin Drummond							
2/7/10	63,186	–	546.00p	35,194	241	–	1/7/13
1/7/11	51,432	–	698.00p	–	–	38,574 ^②	30/6/14
3/7/12	48,145	–	768.50p	–	–	20,060 ^②	2/7/15
David Dupont							
2/7/10	63,186	–	546.00p	35,194	241	–	1/7/13
1/7/11	51,432	–	698.00p	–	–	51,432	30/6/14
3/7/12	48,145	–	768.50p	–	–	48,145	2/7/15
2/7/13	–	57,810	653.00p	–	–	57,810	1/7/16
Chris Loughlin							
2/7/10	63,186	–	546.00p	35,194	241	–	1/7/13
1/7/11	51,432	–	698.00p	–	–	51,432	30/6/14
3/7/12	48,145	–	768.50p	–	–	48,145	2/7/15
2/7/13	–	57,810	653.00p	–	–	57,810	1/7/16

^①50% of the July 2010 award shares vested on 8 August 2013 at a market price of 683.55p per share. The total number of shares that vested included additional shares equivalent in value to such number of shares as could have been acquired by reinvesting the dividends which would otherwise have been received on the vested shares during the restricted period of three years. The balance of the award lapsed.

^②Following retirement on 30 September 2013 Colin Drummond's award shares have been pro-rated to the period of the restricted period he was employed by the Company. The remainder of the awards lapsed.

Directors' remuneration report Continued

Annual report on remuneration Continued

(b) Annual incentive bonus plan – deferred bonus shares (long-term incentive element)

The following Directors had or have a contingent interest in the number of ordinary shares (40.7p each) of the Company shown below, representing the total number of shares to which they have or would become entitled under the deferred bonus element of the annual incentive bonus plan (the bonus plan) at the end of the relevant qualifying period:

Director and date of award	Conditional awards held at 1 April 2013	Conditional awards made in year	Market price upon award in year	Vesting in year	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2014	Date of end of period for qualifying conditions to be fulfilled
Colin Drummond							
27/7/10	27,091	–	572.50p	27,091 ⁽⁴⁾	191	–	26/7/13
27/7/11	23,079	–	725.00p	23,079 ⁽²⁾	161	–	26/7/14
27/7/12	12,823	–	754.50p	12,823 ⁽²⁾	90	–	26/7/15
5/8/13	–	5,339	693.00p	5,339 ⁽²⁾	37	–	4/8/16
David Dupont							
27/2/10	755	–	524.50p	755 ⁽⁴⁾	5	–	26/2/13
27/7/10	25,938	–	572.50p	25,938 ⁽⁴⁾	183	–	26/7/13
27/7/11	22,365	–	725.00p	–	–	22,365	26/7/14
27/7/12	18,532	–	754.50p	–	–	18,532	26/7/15
5/8/13 ⁽¹⁾	–	15,323	693.00p	–	–	15,323	4/8/16
Chris Loughlin							
27/2/10	1,261	–	524.50p	1,261 ⁽⁴⁾	9	–	26/2/13
27/7/10	25,133	–	572.50p	25,133 ⁽⁴⁾	177	–	26/7/13
27/7/11	22,141	–	725.00p	–	–	22,141	26/7/14
27/7/12	20,650	–	754.50p	–	–	20,650	26/7/15
5/8/13 ⁽¹⁾	–	16,978	693.00p	–	–	16,978	4/8/16
Ian McAulay							
30/9/13 ⁽³⁾	–	16,091	696.00p	–	–	16,091	29/9/16

⁽¹⁾In addition to the awards made on 5 August 2013 the Directors also received options pursuant to the Company's executive share option scheme (ESOS), details of which are set out on page 95. These awards were made in conjunction with the operation of the bonus plan, details of which are set out on page 73.

⁽²⁾Following Colin Drummond's retirement on 30 September 2013 these awards vested early at £6.992 per share as explained on page 88.

⁽³⁾This was a buy-out award to Ian McAulay following his appointment on 9 September 2013 as explained on page 88.

⁽⁴⁾These shares vested on 2 August 2013 at £7.052 per share.

During the year the Directors received dividends on the above shares in accordance with the conditions of the bonus plan as follows:

Colin Drummond £8,124; David Dupont £16,354; Chris Loughlin £17,387.*

*Chris Loughlin received his dividend in the form of ordinary shares (40.7p each) in the Company as a result of participation in the Company's scrip dividend alternative and these shares are included in the figure

given for the additional ordinary shares (40.7p each) in the Company that he acquired since 31 March 2014 given on page 91.

(c) Executive Share Option Scheme (ESOS)

The following Directors had a contingent interest in the number of options shown in the ordinary shares (40.7p each) of the Company pursuant to the Company's ESOS. Further details relating to the operation of the scheme are set out on page 91.

Date of award	Options held at 1 April 2013	Granted in year	Exercised in year	Exercise price per share	Market price of each share on exercising	Market value of each share at 31 March 2014	Options held at 31 March 2014	Maturity Date
David Dupont								
5/8/13	–	4,329	–	693.00p	–	742.50p	4,329	5/8/16
Chris Loughlin								
5/8/13	–	4,329	–	693.00p	–	742.50p	4,329	5/8/16

(d) Sharesave scheme

Details of options to subscribe for ordinary shares (40.7p each) of the Company under the all-employee sharesave scheme were:

Date of grant	Options held at 1 April 2013	Granted in year	Exercised in year	Exercise price per share	Market price of each share on exercising	Market value of each share at 31 March 2014	Options held at 31 March 2014	Exercise period/maturity date
Colin Drummond*								
29/6/12	1,530	–	807	588.00p	756.00p	–	–	–
Chris Loughlin								
3/7/13	–	2,788	–	538.00p	–	742.50p	2,788	1/9/18 – 28/2/19

* Option exercised early due to retirement. The balance has lapsed.

Directors' remuneration report Continued

Annual report on remuneration Continued

Advisors to the Remuneration Committee

During the year the Committee received advice or services which 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 from the following advisors who were appointed directly by the Committee:

- Deloitte LLP on calculating the Company's total shareholder return compared with two comparator groups for the Company's long-term incentive plan, on remuneration trends and on the Committee's review of the Executive Directors' annual incentive bonus plan performance targets and subsequent to the year-end Deloitte LLP provided advice to the Committee on the form of the Directors' remuneration report. Deloitte LLP's fees in respect of advice which

materially assisted the Committee during 2013/14 was £24,550. Deloitte LLP also provided tax, consulting and share scheme advice to the Company during the year. Deloitte LLP is a member of the Remuneration Consultants' Group and as such voluntarily operates under the code of conduct in relation to executive remuneration consulting in the UK. The Committee is satisfied that the advice they have received from Deloitte LLP has been objective and independent.

Statement of Voting at General Meeting

The table below sets out the voting by the Company's shareholders on the resolution to approve the Directors' remuneration report at the Annual General Meeting held on 1 August 2013, including votes for, against and withheld.

	Total number of votes	% of votes cast
For	227,613,968	98.39%
Against	3,732,980	1.61%
Total votes cast	231,346,948	100%
Withheld	1,622,724	–

A vote withheld is not counted in the calculation of the proportion of votes 'for' and 'against' a resolution.

The Remuneration Committee is pleased to note that 98.39% of shareholders approved the 2012/13 Directors' remuneration report. The Committee appreciates the continuing support of its shareholders.

On behalf of the Board

Martin Angle

Chairman of the Remuneration Committee
23 June 2014

Independent auditors' report

Independent auditors' report to the members of Pennon Group Plc

Report on the financial statements

In our opinion:

- the financial statements, defined below, give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 March 2014 and of the Group's profit and of the Group's and Parent Company's cash flows for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union;
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

This opinion is to be read in the context of what we say in the remainder of this report.

What we have audited

The Group financial statements and Parent Company financial statements (the "financial statements"), which are prepared by Pennon Group Plc, comprise:

- the Group and Parent Company balance sheets as at 31 March 2014;
- the consolidated income statement and statement of comprehensive income for the year then ended;
- the Group and Parent Company statements of changes in equity and cash flows statements for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in their preparation comprises applicable law and IFRSs as adopted by the European Union and, as regards the Parent Company, as applied in accordance with the provisions of the Companies Act 2006.

What an audit of financial statements involves

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) (ISAs (UK & Ireland)). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the Group's and Parent Company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

In addition, we read all the financial and non-financial information in the Annual Report and Accounts (the "Annual Report") to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Overview of our audit approach

Materiality

We set certain thresholds for materiality. These helped us to determine the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the Group financial statements as a whole to be £10 million. This represents 5% of the profit before tax adjusted for exceptional items, which in our view was the most relevant measure of the business's operations.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.5 million as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Independent auditors' report Continued

Independent auditors' report to the members of Pennon Group Plc

Overview of the scope of our audit

The Group is structured as two business operations, being water and sewage and waste management. The Group financial statements are a consolidation of three reporting units, comprising the Group's two operating businesses and centralised functions.

In establishing the overall approach to the Group audit, we determined the type of work that needed to be performed at the reporting units to be able to conclude whether sufficient appropriate audit evidence had been obtained as a basis for our opinion on the Group financial statements as a whole.

Accordingly we identified that, in our view, both of the Group's operating businesses required an audit of their complete financial information due to their size, together with the Group centralised functions. These accounted for 100 percent of Group revenue and Group profit before tax adjusted for exceptional items.

The component audit teams working on the operating businesses were both led by the Group engagement partner, and work on the centralised functions was performed directly by the Group engagement team.

Areas of particular audit focus

In preparing the financial statements, the directors made a number of subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. We primarily focused our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

In our audit, we tested and examined information, using sampling and other auditing techniques, to the extent we considered necessary to provide a reasonable basis for us to draw conclusions. We obtained audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

We considered the following areas to be those that required particular focus in the current year. This is not a complete list of all risks or areas of focus identified by our audit. We discussed these areas of focus with the Audit Committee. Their report on those matters that they considered to be significant issues in relation to the financial statements is set out on page 64.

Area of focus	How the scope of our audit addressed the area of focus
<p>Impairment of goodwill, investment and long-lived assets of Viridor</p> <p>We focused on this area because, as set out in the critical accounting judgements and estimates in note 4, the determination of whether or not an impairment charge of either the investment in the waste management business, the long lived assets within the waste management business, or the associated goodwill was necessary involved complex and significant judgements about the future results of the waste management business.</p> <p>The goodwill arose principally from a series of acquisitions in the waste business. The waste management segment is considered to be an integrated business and this is the lowest level to which goodwill is allocated, monitored and tested by management.</p> <p>The directors recorded an impairment charge of £42.9 million to the assets within the waste management business, which was treated as an exceptional item.</p> <p>We needed to obtain evidence for the remaining assets and the associated £339.3 million of goodwill in this part of the business.</p> <p>We also needed to assess the carrying value of the investment carried in the Parent Company balance sheet.</p>	<p>We evaluated the directors' future cash flow forecasts, and the process by which they were drawn up, including comparing them to the latest Board approved budgets and strategic plans, and testing the underlying calculations. We challenged:</p> <ul style="list-style-type: none"> the directors' key assumptions for short-term growth rates in the forecasts by comparing them to historical results and the prospects for the business and industry; the directors' key assumptions for long-term growth rates in the forecasts by comparing them to historical results, economic and industry forecasts; and the discount rate by assessing the cost of capital for the company and comparable organisations, forming a view of risk premiums as appropriate. <p>We also performed sensitivity analysis on the key assumptions including recycle margins, electricity prices, discount rates, the level of corporate overheads and landfill capital expenditure.</p> <p>Having ascertained the extent of change in those assumptions that either individually or collectively would be required for the investments, assets and goodwill to be impaired, we considered the likelihood of such a movement in those key assumptions arising.</p> <p>We discussed the progress of the construction and takeover of waste plants under construction and any potential exposure, being landfill diversion penalties and claims from and against the contractors, with senior Group management and the in-house legal experts.</p> <p>We evaluated the appropriateness of the associated disclosures including the treatment of the impairment charge as an exceptional item.</p>
<p>Environmental provisions</p> <p>As noted in the critical accounting estimates in note 4, estimates are made for aftercare and restoration costs for each landfill site.</p> <p>We focused on this area because the associated costs are material to the financial statements and require judgement in assessing the appropriate accounting treatment for this year.</p> <p>An increase of £5.7 million to the provision was treated as an exceptional item.</p>	<p>We used our specialist knowledge of environmental issues to evaluate the directors' future cost assumptions, detailed plans for capital expenditure and to test the underlying calculations.</p> <p>The key areas of challenge included:</p> <ul style="list-style-type: none"> the directors' assumptions for the provision of aftercare and restoration; and the inflation and discount rates used. <p>We also challenged the treatment of the additional aftercare provision as an exceptional item due to its size and nature.</p>

Area of focus	How the scope of our audit addressed the area of focus
<p>Accounting for service concession arrangements</p> <p>We focused on this area within the waste management business as the accounting for long term projects under IFRIC 12 ‘service concession arrangements’ can be complex.</p> <p>As the Group expands the EfW portfolio within the waste business it is required to review the associated long-term contracts to assess whether these fall within the scope of IFRIC 12 which could mean that the Group recognises the consideration received from the local authority as either a financial asset or intangible asset rather than recognising a tangible fixed asset under construction.</p> <p>The amounts are material and significant judgements are required in assessing the appropriate accounting treatment for the recording of revenue and associated assets.</p>	<p>We evaluated the Group’s process for applying IFRIC 12 and reviewed the associated contracts to assess whether these fall within the scope of IFRIC 12 and where necessary tested the associated IFRIC 12 accounting models.</p> <p>We assessed the impact of any significant short term changes in the construction or operating phases on the long term assumptions in the models. We focused in particular on the allocation of revenue and profit margin between the various phases of the contracts.</p>
<p>Bad debt provisions</p> <p>As noted in the critical accounting estimates in note 4, estimates are made for the level of bad debts.</p> <p>We focused on this because the provisions for bad debts within the water and sewage business are material to the financial statements and require judgement in assessing the appropriate level of provision.</p>	<p>We identified and challenged the key assumptions and judgements made by management in their calculation of the bad debt provision.</p> <p>The key area of challenge being the level of provision applied to different customer payment profile categories which we have challenged based on historical collection rates, industry experience, macro-economic factors and through sensitivity analysis of provision rates.</p>
<p>Provision for tax liabilities</p> <p>As noted in the critical accounting estimates in note 4, estimates are made with respect to the tax position for prior fiscal years not yet agreed with the tax authorities.</p> <p>We focused on this area because there are historical open tax positions that are both material to the financial statements and require judgement in assessing the appropriate accounting treatment for this year.</p>	<p>We requested and read the latest correspondence between the Group and HM Revenue and Customs.</p> <p>We discussed the potential tax exposure with senior Group management, including the basis and evidence for their positions with the Group’s in-house tax specialists.</p> <p>We used our experience and specialist tax knowledge to independently challenge the evidence described above.</p>
<p>Fraud in revenue recognition</p> <p>ISAs (UK & Ireland) presume there is a risk of fraud in revenue recognition because of the pressure management may feel to achieve the planned results. We focused on this area because, as set out in note 4 on critical accounting judgements and estimates, there is a significant level of judgement in areas such as estimating the level of revenue for metered customers in the water and sewage business and in relation to long-term contracts in the waste management business.</p>	<p>As the foundation of the evidence we obtained regarding the revenue recognised during the year, we evaluated the relevant IT systems and tested the internal controls over the completeness, accuracy and timing of revenue recognised in the financial statements. We also tested journal entries posted to revenue accounts to identify unusual or irregular items.</p> <p>For metered revenue we evaluated the assumptions, being that average past usage is indicative of current unbilled usage and tested the methodology including seasonality adjustments as well as considering accuracy of previous judgements.</p> <p>For a sample of long-term contracts we read the relevant contracts and checked the models used to calculate the revenue recorded.</p> <p>For all other revenue, we tested a sample back to supporting documentation for revenue recognition.</p>
<p>Risk of management override of internal controls</p> <p>ISAs (UK & Ireland) require that we consider this.</p>	<p>We assessed the overall control environment of the Group, including the arrangements for staff to “whistle-blow” inappropriate actions, and interviewed senior management and the Group’s internal audit function. We examined the significant accounting estimates and judgements relevant to the financial statements for evidence of bias by the directors that may represent a risk of material misstatement due to fraud. In addition we carried out unpredictable audit procedures in areas that may be susceptible to fraud. We also tested a sample of journal entries.</p>

Independent auditors' report Continued

Independent auditors' report to the members of Pennon Group Plc

Going Concern

Under the Listing Rules we are required to review the directors' statement, set out on page 60, in relation to going concern. We have nothing to report having performed our review.

As noted in the directors' statement, the directors have concluded that it is appropriate to prepare the Group's and Parent Company's financial statements using the going concern basis of accounting. The going concern basis presumes that the Group and Parent Company have adequate resources to remain in operation, and that the directors intend them to do so, for at least one year from the date the financial statements were signed. As part of our audit we have concluded that the directors' use of the going concern basis is appropriate.

However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the Group's and the Parent Company's ability to continue as a going concern.

Opinions on matters prescribed by the Companies Act 2006

In our opinion:

- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements;
- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Corporate Governance Statement set out on pages 59 to 61 in the Annual Report with respect to internal control and risk management systems and about share capital structures is consistent with the financial statements.

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept by the Parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the Parent Company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law have not been made. We have no exceptions to report arising from this responsibility.

Corporate Governance Statement

Under the Companies Act 2006, we are required to report to you if, in our opinion a corporate governance statement has not been prepared by the Parent Company. We have no exceptions to report arising from this responsibility.

Under the Listing Rules we are required to review the part of the Corporate Governance Statement relating to the Company's compliance with nine provisions of the UK Corporate Governance Code ('the Code'). We have nothing to report having performed our review.

On page 61 of the Annual Report, as required by the Code Provision C.1.1, the directors state that they consider the Annual Report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the Group's performance, business model and strategy.

On page 64, as required by C.3.8 of the Code, the Audit Committee has set out the significant issues that it considered in relation to the financial statements, and how they were addressed. Under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

- the statement given by the directors is materially inconsistent with our knowledge of the Group acquired in the course of performing our audit; or
- the section of the Annual Report describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We have no exceptions to report arising from this responsibility.

Other information in the Annual Report

Under ISAs (UK & Ireland), we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the Group and Parent Company acquired in the course of performing our audit; or
- is otherwise misleading.

We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Directors' Responsibilities Statement set out on page 60, the directors are responsible for the preparation of the Group and Parent Company financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the Group and Parent Company financial statements in accordance with applicable law and ISAs (UK & Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, 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.

David Charles (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers LLP
 Chartered Accountants and Statutory Auditors
 Bristol

23 June 2014

Consolidated income statement

For the year ended 31 March 2014

	Notes	Before exceptional items 2014 £m	Exceptional items (Note 7) 2014 £m	Total 2014 £m	Before exceptional items 2013 (Restated note 5) £m	Exceptional items (Note 7) 2013 £m	Total 2013 (Restated note 5) £m
Revenue	6	1,321.2	-	1,321.2	1,201.1	-	1,201.1
Operating costs	8						
Manpower costs		(161.4)	-	(161.4)	(159.3)	-	(159.3)
Raw materials and consumables used		(111.6)	-	(111.6)	(125.2)	-	(125.2)
Other operating expenses		(640.9)	(5.7)	(646.6)	(521.8)	(104.9)	(626.7)
Depreciation, amortisation and impairment		(149.8)	(42.9)	(192.7)	(149.2)	(84.0)	(233.2)
Operating profit	6	257.5	(48.6)	208.9	245.6	(188.9)	56.7
Finance income	9	43.3	-	43.3	95.3	15.4	110.7
Finance costs	9	(97.2)	-	(97.2)	(156.7)	(2.9)	(159.6)
Net finance costs	9	(53.9)	-	(53.9)	(61.4)	12.5	(48.9)
Share of post-tax profit from joint ventures	21	3.7	-	3.7	5.8	-	5.8
Profit before tax	6	207.3	(48.6)	158.7	190.0	(176.4)	13.6
Taxation (charge)/credit	10	(9.5)	8.9	(0.6)	(29.2)	36.2	7.0
Profit for the year		197.8	(39.7)	158.1	160.8	(140.2)	20.6
Attributable to:							
Ordinary shareholders of the parent		182.2	(39.7)	142.5	160.8	(140.2)	20.6
Perpetual capital security holders		15.6	-	15.6	-	-	-
Earnings per ordinary share							
(pence per share)	12						
- Basic				38.8			5.7
- Diluted				38.6			5.7

Consolidated statement of comprehensive income

For the year ended 31 March 2014

	Notes	Before exceptional items 2014 £m	Exceptional items (Note 7) 2014 £m	Total 2014 £m	Before exceptional items 2013 (Restated note 5) £m	Exceptional items (Note 7) 2013 £m	Total 2013 (Restated note 5) £m
Profit for the year		197.8	(39.7)	158.1	160.8	(140.2)	20.6
Other comprehensive income/ (loss)							
<i>Items which will not be reclassified to profit or loss</i>							
Actuarial gains/(losses) relating to retirement benefit obligations	31	26.2	-	26.2	(6.0)	-	(6.0)
Income tax on items that will not be reclassified	10, 32	(10.2)	-	(10.2)	-	-	-
Total items that will not be reclassified to profit or loss		16.0	-	16.0	(6.0)	-	(6.0)
<i>Items that may be reclassified subsequently to profit or loss</i>							
Share of other comprehensive income from joint ventures	21	4.8	-	4.8	2.7	-	2.7
Cash flow hedges		32.8	-	32.8	(0.9)	2.9	2.0
Income tax on items that may be reclassified	10, 32	(7.0)	-	(7.0)	0.7	(0.7)	-
Total items that may be reclassified subsequently to profit or loss		30.6	-	30.6	2.5	2.2	4.7
Other comprehensive income/ (loss) for the year net of tax	37	46.6	-	46.6	(3.5)	2.2	(1.3)
Total comprehensive income for the year		244.4	(39.7)	204.7	157.3	(138.0)	19.3
Total comprehensive income attributable to:							
Ordinary shareholders of the parent		228.8	(39.7)	189.1	157.3	(138.0)	19.3
Perpetual capital security holders		15.6	-	15.6	-	-	-

The notes on pages 107 to 158 form part of these financial statements.

Balance sheets

At 31 March 2014

	Notes	Group			Company		
		2014 £m	2013 (Restated note 5) £m	2012 (Restated note 5) £m	2014 £m	2013 (Restated note 5) £m	2012 (Restated note 5) £m
Assets							
Non-current assets							
Goodwill	16	339.3	339.3	326.5	–	–	–
Other intangible assets	17	30.6	13.7	22.0	–	–	–
Property, plant and equipment	18	3,450.4	3,278.6	3,083.6	0.2	0.2	0.2
Other non-current assets	20	230.3	183.3	138.4	834.0	502.5	352.0
Deferred tax assets	32	–	–	–	1.3	2.1	4.4
Derivative financial instruments	24	25.9	31.0	21.9	0.2	–	–
Investments in subsidiary undertakings	21	–	–	–	1,323.3	1,323.3	1,172.1
Investments in joint ventures	21	0.1	0.1	0.1	–	–	–
		4,076.6	3,846.0	3,592.5	2,159.0	1,828.1	1,528.7
Current assets							
Inventories	22	12.1	10.5	9.0	–	–	–
Trade and other receivables	23	278.2	267.6	238.5	11.4	136.3	91.7
Financial assets at fair value through profit	25	0.4	1.2	0.5	–	–	–
Derivative financial instruments	24	2.6	10.5	9.7	–	9.7	8.9
Current tax recoverable		–	–	–	–	–	2.6
Cash and cash deposits	26	613.1	634.5	425.3	326.7	398.9	158.9
		906.4	924.3	683.0	338.1	544.9	262.1
Liabilities							
Current liabilities							
Borrowings	29	(273.9)	(138.6)	(325.5)	(407.5)	(357.1)	(534.4)
Derivative financial instruments	24	(20.8)	(21.7)	(16.6)	(2.4)	–	–
Trade and other payables	27	(298.8)	(276.7)	(242.5)	(7.4)	(7.7)	(10.8)
Current tax liabilities	28	(37.7)	(66.9)	(60.3)	(1.1)	(18.9)	–
Provisions	33	(33.3)	(41.9)	(26.3)	–	–	–
		(664.5)	(545.8)	(671.2)	(418.4)	(383.7)	(545.2)
Net current assets/(liabilities)		241.9	378.5	11.8	(80.3)	161.2	(283.1)
Non-current liabilities							
Borrowings	29	(2,533.2)	(2,504.6)	(2,204.4)	(691.3)	(692.7)	(356.8)
Other non-current liabilities	30	(82.8)	(77.9)	(76.9)	(8.7)	(8.7)	(8.7)
Financial liabilities at fair value through profit	25	(15.6)	(23.0)	(16.7)	–	–	–
Derivative financial instruments	24	(3.9)	(31.5)	(32.0)	(0.1)	–	–
Retirement benefit obligations	31	(79.3)	(99.6)	(89.4)	(6.2)	(7.9)	(6.9)
Deferred tax liabilities	32	(227.1)	(245.1)	(279.5)	–	–	–
Provisions	33	(179.0)	(170.7)	(76.3)	–	–	–
		(3,120.9)	(3,152.4)	(2,775.2)	(706.3)	(709.3)	(372.4)
Net assets		1,197.6	1,072.1	829.1	1,372.4	1,280.0	873.2
Shareholders' equity							
Share capital	34	151.3	149.2	148.2	151.3	149.2	148.2
Share premium account	35	4.9	7.0	8.0	4.9	7.0	8.0
Capital redemption reserve	36	144.2	144.2	144.2	144.2	144.2	144.2
Retained earnings and other reserves	37	602.4	476.9	528.7	777.2	684.8	572.8
Total shareholders' equity		902.8	777.3	829.1	1,077.6	985.2	873.2
Perpetual capital securities	38	294.8	294.8	–	294.8	294.8	–
Total equity		1,197.6	1,072.1	829.1	1,372.4	1,280.0	873.2

The notes on pages 107 to 158 form part of these financial statements.

The financial statements on pages 102 to 158 were approved by the Board of Directors and authorised for issue on 23 June 2014 and were signed on its behalf by:

K G Harvey, Chairman, Pennon Group Plc, Registered Office: Peninsula House, Rydon Lane, Exeter, Devon, England EX2 7HR. Registered in England Number 2366640

Statements of changes in equity

For the year ended 31 March 2014

Group	Share capital (Note 34) £m	Share premium account (Note 35) £m	Capital redemption reserve (Note 36) £m	Retained earnings and other reserves (Note 37) (Restated note 5) £m	Perpetual capital securities (Note 38) £m	Total equity (Restated note 5) £m
At 1 April 2012	148.2	8.0	144.2	528.7	–	829.1
Profit for the year	–	–	–	20.6	–	20.6
Other comprehensive loss for the year	–	–	–	(1.3)	–	(1.3)
Total comprehensive income for the year	–	–	–	19.3	–	19.3
Transactions with equity shareholders						
Dividends paid	–	–	–	(96.0)	–	(96.0)
Adjustment for shares issued under the Scrip Dividend Alternative	1.0	(1.0)	–	18.1	–	18.1
Adjustment in respect of share-based payments (net of tax)	–	–	–	3.1	–	3.1
Issue of perpetual capital securities	–	–	–	–	294.8	294.8
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	–	–	–	(0.9)	–	(0.9)
Proceeds from treasury shares re-issued	–	–	–	4.6	–	4.6
Total transactions with equity shareholders	1.0	(1.0)	–	(71.1)	294.8	223.7
At 31 March 2013	149.2	7.0	144.2	476.9	294.8	1,072.1
Profit for the year	–	–	–	142.5	15.6	158.1
Other comprehensive income for the year	–	–	–	46.6	–	46.6
Total comprehensive income for the year	–	–	–	189.1	15.6	204.7
Transactions with equity shareholders						
Dividends paid	–	–	–	(103.9)	–	(103.9)
Adjustment for shares issued under the Scrip Dividend Alternative	2.1	(2.1)	–	34.5	–	34.5
Adjustment in respect of share-based payments (net of tax)	–	–	–	3.8	–	3.8
Distributions to perpetual capital security holders	–	–	–	–	(20.3)	(20.3)
Current tax relief on distributions to perpetual capital security holders	–	–	–	–	4.7	4.7
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	–	–	–	(0.4)	–	(0.4)
Proceeds from treasury shares re-issued	–	–	–	2.4	–	2.4
Total transactions with equity shareholders	2.1	(2.1)	–	(63.6)	(15.6)	(79.2)
At 31 March 2014	151.3	4.9	144.2	602.4	294.8	1,197.6

The notes on pages 107 to 158 form part of these financial statements.

Company	Share capital (Note 34) £m	Share premium account (Note 35) £m	Capital redemption reserve (Note 36) £m	Retained earnings and other reserves (Note 37) (Restated note 5) £m	Perpetual capital securities (Note 38) £m	Total equity (Restated note 5) £m
At 1 April 2012	148.2	8.0	144.2	572.8	–	873.2
Profit for the year (note 11)	–	–	–	185.3	–	185.3
Other comprehensive loss for the year	–	–	–	(0.8)	–	(0.8)
Total comprehensive income for the year	–	–	–	184.5	–	184.5
Transactions with equity shareholders						
Dividends paid	–	–	–	(96.0)	–	(96.0)
Adjustment for shares issued under the Scrip Dividend Alternative	1.0	(1.0)	–	18.1	–	18.1
Adjustment in respect of share-based payments (net of tax)	–	–	–	0.8	–	0.8
Issue of perpetual capital securities	–	–	–	–	294.8	294.8
Proceeds from treasury shares re-issued	–	–	–	4.6	–	4.6
Total transactions with equity shareholders	1.0	(1.0)	–	(72.5)	294.8	222.3
At 31 March 2013	149.2	7.0	144.2	684.8	294.8	1,280.0
Profit for the year (note 11)	–	–	–	157.9	15.6	173.5
Other comprehensive income for the year	–	–	–	0.7	–	0.7
Total comprehensive income for the year	–	–	–	158.6	15.6	174.2
Transactions with equity shareholders						
Dividends paid	–	–	–	(103.9)	–	(103.9)
Adjustment for shares issued under the Scrip Dividend Alternative	2.1	(2.1)	–	34.5	–	34.5
Distributions to perpetual capital security holders	–	–	–	–	(20.3)	(20.3)
Current tax relief on distributions to perpetual capital security holders	–	–	–	–	4.7	4.7
Adjustment in respect of share-based payments (net of tax)	–	–	–	0.8	–	0.8
Proceeds from treasury shares re-issued	–	–	–	2.4	–	2.4
Total transactions with equity shareholders	2.1	(2.1)	–	(66.2)	(15.6)	(81.8)
At 31 March 2014	151.3	4.9	144.2	777.2	294.8	1,372.4

The notes on pages 107 to 158 form part of these financial statements.

Cash flow statements

For the year ended 31 March 2014

	Notes	Group		Company	
		2014 £m	2013 £m	2014 £m	2013 £m
Cash flows from operating activities					
Cash generated/(outflow) from operations	39	338.0	341.1	(208.0)	(205.2)
Interest paid	39	(65.3)	(75.8)	(28.6)	(23.4)
Tax (paid)/repaid		(58.1)	(18.5)	(16.6)	26.7
Net cash generated/(outflow) from operating activities		214.6	246.8	(253.2)	(201.9)
Cash flows from investing activities					
Interest received		26.5	26.0	60.3	30.3
Dividends received	46	8.5	8.5	162.1	177.6
Acquisition of subsidiary undertakings (net of cash acquired)		-	(14.8)	-	-
Investments in subsidiary undertakings	21	-	-	-	(151.2)
Loan repayments received from joint ventures		0.3	0.3	-	-
Purchase of property, plant and equipment		(346.7)	(397.2)	(0.1)	(0.1)
Proceeds from sale of property, plant and equipment		5.4	4.5	-	-
Net cash (used in)/received from investing activities		(306.0)	(372.7)	222.3	56.6
Cash flows from financing activities					
Proceeds from treasury shares re-issued	37	2.4	4.6	2.4	4.6
Proceeds from issue of perpetual capital securities	38	-	294.8	-	294.8
Purchase of Ordinary shares by the Pennon Employee Share Trust		(0.4)	(0.9)	-	-
Deposit of restricted funds (net)		(29.6)	(21.0)	-	-
Proceeds from new borrowing		294.0	409.9	171.0	409.9
Repayment of borrowings		(146.1)	(267.2)	(125.0)	(246.1)
Finance lease sale and lease back		40.5	85.0	-	-
Finance lease principal repayments		(30.3)	(103.1)	-	-
Dividends paid		(69.4)	(77.9)	(69.4)	(77.9)
Perpetual capital securities periodic return	38	(20.3)	-	(20.3)	-
Net cash received from/(used in) financing activities		40.8	324.2	(41.3)	385.3
Net (decrease)/increase in cash and cash equivalents		(50.6)	198.3	(72.2)	240.0
Cash and cash equivalents at beginning of the year	26	490.5	292.2	397.5	157.5
Cash and cash equivalents at end of the year	26	439.9	490.5	325.3	397.5

The notes on pages 107 to 158 form part of these financial statements.

Notes to the financial statements

1. General information

Pennon Group Plc is a company registered in the United Kingdom under the Companies Act 2006. The address of the registered office is given on page 103. Pennon Group's business is operated through two main subsidiaries. South West Water Limited holds the water and sewerage services appointments for Devon, Cornwall and parts of Dorset and Somerset. Viridor Limited's business is recycling, renewable energy and waste management.

2. Principal 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.

(a) Basis of preparation

These financial statements have been prepared on the historical cost accounting basis (except for fair value items, principally acquisitions, transfers of assets from customers and certain financial instruments as described in accounting policy notes (b), (v) and (n) respectively) and in accordance with International Financial Reporting Standards (IFRS) and interpretations of the IFRS Interpretations Committee as adopted by the European Union, and with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. A summary of the principal accounting policies is set out below, together with an explanation where changes have been made to previous policies on the adoption of new accounting standards and interpretations in the year.

The going concern basis has been adopted in preparing these financial statements as stated by the Directors on page 60.

The following standards have been adopted by the Group for the first time for the financial year beginning on 1 April 2013 and have a material impact on the Group:

- IAS 19 (revised) 'Employee Benefits' adopted by the Group with effect from 1 April 2013, has been applied retrospectively in accordance with the transition provision in the standard. The impacts of the revised standard resulted in a net finance cost in the year of circa £4 million (2013, prior to restatement, credit circa £4 million). A further circa £1 million was charged to operating costs. The comparative financial information has been restated accordingly (see note 5).

The following standards have been adopted by the Group for the first time for the financial year beginning on 1 April 2013 and have an impact on disclosure:

- IAS 1 (amended) 'Financial statement presentation' changes the grouping of items presented in the Group's Statement of Comprehensive Income so that items which may be reclassified to profit or loss in the future are presented separately from items that will never be reclassified. The amendment affects presentation only and has no impact on the Group's financial position or performance.
- IFRS 13 'Fair Value Measurement' adopted by the Group with effect from 1 April 2013, requires additional disclosures on fair value measurement and categorisation. These financial statements have been prepared under the revised disclosure requirements.

Other standards or interpretations which were mandatory for the first time in the year beginning 1 April 2013 did not have a material impact on the net assets or results of the Group.

Standards and interpretations in issue, but not yet effective, are not expected to have a material effect on the Group's net assets or results.

The preparation of financial statements in conformity with IFRS requires the use of estimates and assumptions which 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, actual events or actions and results may ultimately differ from those estimates.

(b) Basis of consolidation

The Group financial statements include the results of Pennon Group Plc and its subsidiaries, joint ventures and associate undertakings.

The results of subsidiaries, joint ventures and associate 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 the financial and operating policies of a subsidiary. The results of joint ventures and associate undertakings are accounted for on an equity basis.

Intra-group trading and loan balances and transactions are eliminated on consolidation.

The acquisition method of accounting is used to account for the purchase of subsidiaries. The excess of the value transferred to the seller in return for control of the acquired business, together with the fair value of any previously held equity interest in that business over the Group's share of the fair value of the identifiable net assets, is recorded as goodwill.

(c) Revenue recognition

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

Revenue is recognised once the services or goods have been provided to the customer.

Income from main water and waste water charges includes billed amounts for estimated usage and also an estimation of the amount of unbilled charges at the year-end based upon a defined methodology reflecting historical consumption and current tariffs.

Income from electricity generated from waste management landfill gas production during the year includes an estimation of the amount to be received under Renewables Obligation Certificates.

Accrued income from waste management contracts at the balance sheet date is recognised using management's expectation of amounts to be subsequently billed for services rendered to the client in accordance with the terms of the contract.

Income from recycling activities within waste management includes amounts based upon market prices for recycle products and industry schemes for waste electrical and electronic equipment ('WEEE' notes) and packaging volumes ('PRNs') processed.

Revenue from long-term service concession arrangements is recognised based on the fair value of work performed. Where an arrangement includes more than one service, such as construction and operation of waste management facilities, revenue and profit are recognised in proportion to a fair value assessment of the total contract value split across the services provided.

Notes to the financial statements

Continued

2. Principal accounting policies Continued

(d) Landfill tax

Landfill tax is included within both revenue and operating costs.

(e) Segmental reporting

Each of the Group's business segments provides 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 reportable business segments comprise the regulated water and sewerage services undertaken by South West Water Limited and the waste management business of Viridor Limited. Segmental revenue and results include transactions between businesses. Inter-segmental transactions are eliminated on consolidation.

(f) 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, less any subsequent impairment charges.

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. For the purpose of impairment testing, goodwill acquired in a business combination is allocated to each of the cash generating units or group of cash generating units, that is expected to benefit from the synergies of the combination. Each unit or group of units to which goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal reporting purposes. Goodwill is allocated and monitored at the reportable operating segment level. Further details are contained in accounting policy (j).

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.

(g) Other intangible assets

Other intangible assets are recognised in relation to long-term service concession contracts to the extent that future amounts to be received are not certain.

Other intangible assets include 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 charged to the income statement through operating costs.

(h) 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 were included at fair value on transition to IFRS and subsequent additions are recorded at cost less accumulated depreciation and impairment charges. 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 Group. The cost of day-to-day servicing of infrastructure components is recognised in the income statement as it arises.

Infrastructure assets are depreciated evenly over their useful economic lives, and are principally:

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 site 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.

iii) Landfill restoration

Where the obligation to restore a landfill site is an integral part of its future economic benefits, a non-current asset within property, plant and equipment is recognised. The asset recognised is depreciated based on the usage of void space.

iv) Other assets (including property, overground plant and equipment)

Other assets are included at cost less accumulated depreciation.

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

Land and buildings – Freehold buildings	30 – 60 years
Land and buildings – Leasehold buildings	Over the estimated economic lives or the finance lease period, whichever is the shorter
Operational properties	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 directly attributable to the construction of a qualifying asset (an asset necessarily taking a substantial period of time to be prepared for its intended use) are capitalised as part of the asset. Assets transferred from customers are recognised at fair value as set out in accounting policy (v).

The assets' residual values and useful lives are reviewed annually, and adjusted if appropriate.

Gains and losses on disposal are determined by comparing sale proceeds with carrying amounts. These are included in the income statement.

(i) Leased assets

Assets held under finance leases are included as property, plant and equipment at the lower of their fair value at commencement or the present value of the minimum lease payments, 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.

(j) Impairment of non-financial assets

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

An impairment loss is recognised for the amount by which an 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 market cost of capital of the cash-generating unit.

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

Non-financial assets other than goodwill that have been impaired are reviewed for possible reversal of the impairment at each reporting date.

(k) Investment in subsidiary undertakings

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

(l) Investment in joint ventures

Joint ventures are entities over which the Group exercises 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 and is included in the carrying value of the investment in the joint venture.

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 and statement of comprehensive income. 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.

(m) Cash and cash deposits

Cash and cash deposits comprise cash in hand and short-term deposits held at banks. Bank overdrafts are shown within current borrowings.

(n) Derivatives and other financial instruments

The Group classifies its financial instruments in the following categories:

i) Loans and receivables

All loans and borrowings are initially recognised at fair value, net of transaction costs incurred. Following initial recognition interest-bearing loans and borrowings are subsequently stated at amortised cost using the effective interest method.

Gains and losses are recognised in the income statement when the instruments are derecognised or impaired. Premia, 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.

The fair value of the liability component of a convertible bond is determined using the market interest rate for an equivalent non-convertible bond. This amount is recorded as a liability on an amortised cost basis using the effective interest method until extinguished on conversion or maturity of the bonds. The remainder of the proceeds are allocated to the conversion option. This is recognised in shareholders' equity.

ii) Trade receivables

Trade receivables do not carry any interest receivable and are recognised initially at fair value and subsequently at amortised cost using the effective interest method, less provision for impairment. A provision for impairment of trade receivables is established when there is objective evidence that the Group will not be able to collect all amounts due in accordance with the original terms of the receivables.

iii) Trade payables

Trade payables are not interest-bearing and are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

iv) Financial assets arising from service concession arrangements

Where the provision of waste management services is performed through a contract with a public sector entity which controls a significant residual interest in asset infrastructure at the end of the contract, then consideration is treated as contract receivables, split between profit on the construction of assets, operation of the service and the provision of finance which is recognised in notional interest within finance income.

v) Derivative financial instruments and hedging activities

The Group uses derivative financial instruments, principally interest rate swaps and foreign exchange forward contracts, to hedge risks associated with interest rate and exchange rate fluctuations. Derivative instruments are initially recognised at fair value on the date the derivative contract is entered into and subsequently remeasured at fair value for the reported balance sheet.

Notes to the financial statements

Continued

2. Principal accounting policies Continued

The Group designates certain hedging derivatives as either:

- a hedge of a highly probable forecast transaction or change in the cash flows of a recognised asset or liability (a cash flow hedge) or
- a hedge of the exposure to change in the fair value of a recognised asset or liability (a fair value hedge).

The gain or loss on remeasurement is recognised to the income statement except for cash flow hedges which 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 ongoing basis. This effectiveness testing is reperformed at the end of each reporting period to ensure that the hedge remains highly effective.

Where a non-derivative transaction or series of transactions with the same counterparty has the aggregate effect in substance of a derivative instrument, the transaction or series of transactions shall be recognised as a single derivative instrument at fair value with associated movements recorded in the income statement.

The full fair value of a hedging derivative is classified as a non-current asset or liability when the remaining maturity of the hedged item is more than one year, and as a current asset or liability when the remaining maturity of the hedged item is less than one year.

Derivative financial instruments deemed held for trading which do not qualify for hedge accounting are classified as a current asset or liability with any change in fair value recognised immediately in the income statement.

vi) Financial instruments at fair value through profit

Financial instruments at fair value through profit reflect the fair value movement of the hedged risk on a hedged item which has been designated in a fair value hedging relationship. The fair values of these financial instruments are initially recognised on the date the hedging relationship is entered into and subsequently remeasured at each subsequent balance sheet date. The gain or loss on remeasurement for the period is recognised in the income statement.

(o) Taxation including deferred tax

The tax charge for the year comprises current and deferred tax. Tax is recognised in the income statement, except to the extent that it relates to items recognised in the statement of comprehensive income or directly in equity. In this case the tax is also recognised in the statement of comprehensive income or directly in equity.

Current tax is calculated on the basis of tax laws enacted or substantively enacted at the balance sheet date. Management periodically evaluates tax items subject to interpretation and establishes full provisions on individual tax items where in the judgement of management the position is uncertain.

The Group includes a number of companies, including the parent company, which are part of a tax group for certain aspects of the tax legislation. One of these aspects relates to group relief whereby current tax liabilities can be offset by current tax losses arising in other companies within the same tax group. Payment for group relief is made equal to the tax benefit and amounts are included within the current tax disclosures.

Deferred tax is provided in full on temporary differences between the carrying amount of assets and liabilities in the financial statements and the tax base, except if it arises from initial recognition of an asset or liability in a transaction, other than a business combination, that at the time of the transaction affects neither accounting nor taxable profit or loss. Deferred tax assets are recognised only to the extent that it is probable that future taxable profits will be available against which the assets can be realised. Deferred tax is determined using the tax rates enacted or substantively enacted at the balance sheet date, and expected to apply when the deferred tax liability is settled or the deferred tax asset is realised.

(p) Provisions

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. 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 notional interest within finance costs.

The Group's policies on specific provisions are:

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, an asset in property, plant and equipment is recognised. Provisions are otherwise charged against profits based on the usage of void space.

ii) Environmental control and aftercare costs

Environmental control and aftercare costs are incurred during the operational life of each landfill site and 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 at the site. Further provisions required after the operational life of a site are recognised immediately in the income statement.

iii) Onerous contracts

Where the unavoidable costs of meeting a contract's obligations exceed the economic benefits derived from that contract, the unavoidable costs, less revenue anticipated under the terms of the contract, are recognised as a provision and charged to the income statement. An impairment loss on any assets dedicated to that contract is also recognised as described in accounting policy (j).

(q) Share capital and treasury shares

Ordinary shares are classified as equity.

Where the Company purchases the Company's equity share capital (treasury shares) the consideration paid, including any directly attributable costs, is deducted from equity until the shares are cancelled or re-issued. Where such shares are subsequently re-issued any consideration received, net of any directly attributable transaction costs, is included in equity.

The Group balance sheet includes the shares held by the Pennon Employee Share Trust, relating to employee share-based payments, which have not vested at the balance sheet date. These are shown as a deduction from shareholders' equity until such time as they vest.

(r) Dividend distributions

Dividend distributions are recognised as a liability in the financial statements in the period in which the dividends are approved by the Company's shareholders. Interim dividends are recognised when paid; final dividends when approved by shareholders at the Annual General Meeting.

(s) Employee benefits

i) Retirement benefit obligations

The Group operates defined benefit and defined contribution pension schemes.

Defined benefit pension schemes

The liability recognised in the balance sheet in respect of defined benefit pension plans is the present value of the defined benefit obligation at the end of the year less the fair value of plan assets. The defined benefit obligation is calculated by independent actuaries who advise on the selection of Directors' best estimates, using the projected unit credit method. The present value of the defined benefit obligation is determined by discounting the estimated future cash outflows using interest rates of high quality corporate bonds, and that have terms to maturity approximating to the terms of the related pension obligation. The increase in liabilities of the Group's defined benefit pension schemes, expected to arise from employee service in the year, is charged against operating profit.

Changes in benefits granted by the employer are recognised immediately as past service cost in the income statement.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to equity in the statement of comprehensive income in the period of which they arise.

Defined contribution scheme

Costs of the defined contribution pension scheme are charged to the income statement in the year in which they arise. The Group has no further payment obligations once the contributions have been paid.

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 in assumptions as to the number of shares which are expected to vest.

(t) Pre-contract and development costs

Pre-contract and development costs including bid costs are expensed as incurred, except where it is probable that the contract will be awarded or the development completed, in which case they are recognised as an asset which is amortised to the income statement over the life of the contract.

(u) Fair values

The fair value of 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 non-current bank loans and other loans 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.

(v) Transfers of assets from customers

Where an item of property, plant and equipment that must be used to connect customers to the network is received from a customer, or where cash is received from a customer for the acquisition or construction of such an item, that asset is recorded and measured on initial recognition at its fair value. The credit created by the recognition of the asset is recognised in the income statement. The period over which the credit is recognised depends upon the nature of the service provided, as determined by the agreement with the customer. Where the service provided is solely a connection to the network, the credit is recognised at the point of connection. If the agreement does not specify a period, revenue is recognised over a period no longer than the economic life of the transferred asset used to provide the ongoing service.

The fair value of assets on transfer from customers is determined using a cost valuation approach allowing for depreciation.

(w) Foreign exchange

Transactions denominated in foreign currencies are translated at the exchange rate at the date of the transaction. Monetary assets and liabilities denominated in a foreign currency are translated at the closing balance sheet rate. The resulting gain or loss is recognised in the income statement.

(x) Perpetual capital securities

Perpetual capital securities are issued securities that qualify for recognition as equity. Accordingly any periodic returns are accounted for as dividends and recognised directly in equity and as a liability at the time the Company becomes obligated to pay the periodic return. This reflects the nature of the periodic returns being only made at the Company's discretion. Any associated tax impacts are recognised directly in equity.

(y) Exceptional items

Exceptional items are those that in the Directors' view are required to be separately disclosed by virtue of their size or incidence to enable a full understanding of the Group's financial performance.

Notes to the financial statements

Continued

3. Financial risk management

(a) Financial risk factors

The Group's activities expose it to a variety of financial risks: liquidity risk, market risk (interest rate and foreign currency risk) and credit risk. The Group's treasury function seeks to ensure that sufficient funding is available to meet foreseeable needs, maintains reasonable headroom for contingencies and manages inflation and interest rate risk.

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

These risks and treasury operations are managed by the Group Director of Finance 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, manage risk, optimise the use of surplus funds and manage overall interest rate performance. The Group does not engage in speculative activity.

i) Liquidity risk

The Group actively maintains a mixture of long-term and short-term committed facilities which are designed to ensure the Group has sufficient available funds for operations and planned expansions equivalent to at least one year's forecast requirements at all times. Details of undrawn committed facilities and short-term facilities are provided in note 29.

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

The Group and South West Water have entered into covenants with lenders. Whilst terms vary, these typically provide for limits on gearing (primarily based on South West Water Limited's Regulatory Capital Value and Viridor Limited's EBITDA) and interest cover.

Contractual undiscounted cash flows, including interest payments, at the balance sheet date were:

	Due within 1 year £m	Due between 1 and 2 years £m	Due between 2 and 5 years £m	Over 5 years £m	Total £m
Group					
31 March 2014					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	155.4	143.6	468.5	1,582.1	2,349.6
Interest payments on borrowings	26.3	24.8	62.2	642.9	756.2
Finance lease liabilities including interest	62.5	73.2	224.6	2,037.7	2,398.0
Derivative financial liabilities					
Derivative contracts – net payments/(receipts)	15.3	4.3	1.9	(43.8)	(22.3)
31 March 2013					
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	97.0	216.5	440.8	1,397.7	2,152.0
Interest payments on borrowings	24.5	21.8	47.6	630.4	724.3
Finance lease liabilities including interest	60.7	70.1	247.8	2,068.4	2,447.0
Derivative financial liabilities					
Derivative contracts – net payments	19.1	26.3	26.3	8.6	80.3
Company					
31 March 2014					
Non-derivative financial liabilities					
Borrowings	124.3	112.5	356.7	222.0	815.5
Interest payments on borrowings	16.0	13.4	25.9	10.9	66.2
Derivative financial liabilities					
Derivative contracts – net payments	1.2	0.8	1.1	–	3.1
31 March 2013					
Non-derivative financial liabilities					
Borrowings	75.9	185.4	347.5	160.2	769.0
Interest payments on borrowings	15.3	12.5	19.2	12.8	59.8

ii) Market risk

The Group has a policy of maintaining at least 50% of interest-bearing liabilities at fixed rates. The Group uses a combination of fixed rate and index-linked borrowings and fixed rate interest swaps as cash flow hedges of future variable interest payments to achieve this policy. At the year-end 62% (2013 54%) of Group net borrowings were at fixed rates (including at least 50% of South West Water's borrowings fixed for the period to March 2015) and 18% (2013 19%) index-linked, after the impact of financial derivatives. 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 note 24.

The interest rate for index-linked debt is based upon an RPI measure which is also used in determining the amount of income from customers in South West Water.

The Group has no significant interest-bearing assets upon which the net return fluctuates from market risk. Deposit interest receivable is expected to fluctuate in line with interest payable on floating rate borrowings. Consequently the Group's income and cash generated from operations (note 39) are independent of changes in market interest rates.

For 2014 if interest rates on variable net borrowings had been on average 0.5% higher/lower with all other variables held constant, post-tax profit for the year and equity would have decreased/increased by £1.2 million (2013 £2.0 million).

For 2014 if RPI on index-linked borrowings had been on average 0.5% higher/lower with all other variables held constant, post-tax profit for the year and equity would have decreased/increased by £1.4 million (2013 £1.4 million).

Foreign currency risk occurs at transactional and translation level from borrowings and transactions in foreign currencies. These risks are managed through forward contracts which provide certainty over foreign currency risk.

iii) Credit risk

Credit counterparty risk arises from cash and cash deposits, derivative financial instruments and exposure to customers, including outstanding receivables. Further information on the credit risk relating to trade receivables is given in note 23.

Counterparty risk arises from the investment of surplus funds and from the use of derivative financial 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. The Group's surplus funds are managed by the Group's treasury function and are usually placed in short-term fixed interest deposits or the overnight money markets. Deposit counterparties must meet a credit rating threshold set by the Board of P1 (Moody's) or A1 (Standard and Poor's).

(b) Capital risk management

The Group's objectives when managing capital are to safeguard the Group's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders and to maintain an optimal capital structure to minimise the cost of capital.

The group's policy is to have a minimum of 12 months pre-funding of projected capital expenditure. At 31 March 2014 the Group had cash and facilities excluding restricted funds of over £1 billion, meeting this objective.

In order to maintain or adjust the capital structure the Group seeks to maintain a balance of returns to shareholders through dividends and an appropriate capital structure of debt and equity for each business segment and the Group.

The Group monitors capital on the basis of the gearing ratio. This ratio is calculated as net borrowings divided by total capital. Net borrowings are analysed in note 40 and calculated as total borrowings less cash and cash deposits. Total capital is calculated as total shareholders' equity plus net borrowings.

The gearing ratios at the balance sheet date were:

	2014 £m	2013 £m
Net borrowings (note 40)	2,194.0	2,008.7
Total equity	1,197.6	1,072.1
Total capital	3,391.6	3,080.8
Gearing ratio	64.7%	65.2%

South West Water Limited is also monitored on the basis of the ratio of its net borrowings to Regulatory Capital Value. Ofwat's optimum range for gearing is 55% – 65%.

	2014 £m	2013 £m
Regulatory Capital Value	2,958.8	2,915.7
Net borrowings	1,645.7	1,600.3
Net borrowings/Regulatory Capital Value	55.6%	54.9%

The Group has entered into covenants with lenders and, whilst terms vary, these typically provide for limits on gearing and interest cover. The Group has been in compliance with its covenants during the year.

Notes to the financial statements

Continued

3. Financial risk management Continued

(c) Determination of fair values

The Group uses the following hierarchy for determining the fair value of financial instruments by valuation technique:

- quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1)
- inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2)
- inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3).

The Group's financial instruments are valued principally using level 2 measures as analysed in note 24.

The fair value of financial instruments not traded in an active market (for example over-the-counter derivatives) is determined by using valuation techniques. A variety of methods and assumptions are used based on market conditions existing at each balance sheet date. Quoted market prices or dealer quotes for similar instruments are used for long-term debt. Other techniques, such as estimated discounted cash flows, are used to determine fair value for the remaining financial instruments. The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows.

The carrying values, less impairment provision, of trade receivables and payables are assumed to approximate to their fair values. The fair value of financial liabilities, principally environmental provisions, is estimated by discounting the future contractual cash flows at the current market interest rate available to the Group for similar financial instruments.

4. Critical accounting judgements and estimates

The Group's principal accounting policies are set out in note 2. Management is required to exercise significant judgement and make use of estimates and assumptions in the application of these policies. Estimates are based on factors including historical experience and expectations of future events that management believe to be reasonable. However, given the judgemental nature of such estimates, actual results could be different from the assumptions used.

Impairment of non-financial assets and goodwill

In order to determine whether impairments are required the Group estimates the recoverable amount of an individual asset or assets grouped at the lowest level for which there are separately identifiable cash flows (cash generating units). For the purposes of assessing impairment of goodwill, the waste management segment is considered an integrated business and this is the lowest level to which goodwill is allocated, monitored and tested by management

Impairment calculations are based on projections of future cash flows for the cash generating unit and the use of a terminal value to incorporate expectations of growth after the period covered by specific plans. The cash flows are discounted by the weighted average cost of capital appropriate to the business activity which is reviewed on an annual basis.

If the cash flow or discount rate assumptions were to change because of market conditions, the level of impairment could be different and could result in the impairment being increased or reversed, in part or in full, at a future date.

The principal assumptions used to assess impairment are set out in notes 16 and 18 of the financial statements.

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 at least 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 which reflects an assessment of the cost of capital of the cash-generating unit.

Environmental and landfill restoration provisions

Environmental control and aftercare costs are incurred during the operational life of each landfill site and for a considerable period thereafter. The period of aftercare post-closure and the level of costs expected are uncertain and can vary significantly from site to site. Key factors are the type of waste, the speed at which it decomposes, the volume of leachate requiring treatment and regulatory requirements specific to the site. The amounts expected to be incurred are based on landfill site operating lives, taking account of the anticipated decline in landfill activity.

During the year to 31 March 2013 the estimate of the aftercare period rose to 60 years after site closure, previously 30 years, to align with updated technical assessment using independent external advice.

The provisions are based on latest assumptions reflecting recent historic data and future cost estimates.

The provisions are recognised in the financial statements at the net present value of the estimated future expenditure required to settle the Group's obligations. A discount rate is applied to recognise the time value of money and is unwound over the life of the provision. This is included in the income statement as a financial item within finance costs.

As at 31 March 2014 the Group's environmental and landfill restoration provisions were £190.5 million (2013 £185.5 million) (note 33).

Where a restoration provision gives access to future economic benefits, an asset is recognised and depreciated in accordance with the Group's depreciation policy. As at 31 March 2014 these assets had a net book value of £20.8 million (2013 £35.5 million) (note 18).

Retirement benefit obligations

The Group operates defined benefit pension schemes for which actuarial valuations are carried out as determined by the trustees at intervals of not more than three years. The last valuation of the main scheme was at 31 March 2010 and the 31 March 2013 valuation is being finalised.

The pension cost and liabilities under IAS 19 (Revised) assessed in accordance with Directors' best estimates using the advice of an independent qualified actuary and assumptions in the latest actuarial valuation. The assumptions are based on member data supplied to the actuary and market observations for interest rates and inflation, supplemented by discussions between the actuary and management. The mortality assumption uses a scheme-specific calculation based on CMI 2013 actuarial tables with an allowance for future longevity improvement. The principal assumptions used to measure schemes' liabilities, sensitivities to changes in those assumptions and future funding obligations are set out in note 31 of the financial statements.

Taxation

The Group current income tax provision of £37.7 million (note 28) reflects management's judgement of the amount of tax payable for fiscal years with open tax computations where liabilities remain to be agreed with HM Revenue & Customs. Management periodically evaluates items detailed in tax returns where the tax treatment is subject to interpretation. The Group establishes provisions on a full basis for individual tax items where the tax position is assessed as uncertain.

Service concession arrangements

Consideration from public sector entities for the operation of waste management service concessions is treated as contract receivables or other intangible assets, depending upon the right to receive cash from the asset. Consideration relating to contract receivables is split between profit on the construction of assets, operation of the service and provision of finance recognised as interest receivable. Management's allocation between these three elements is assessed to reflect external market conditions according to the type of service provided.

Landfill costs

The estimation of landfill reserves is of particular importance in assessing landfill costs, since the projected cost of a landfill site is depreciated over its estimated operational life taking into account the usage of void space and gas production at the site post-closure. In estimating the operational life of a landfill site consideration is given to the expected ongoing decline in the landfill market. Where Viridor plans to build a competing energy from waste facility at certain existing landfill sites, the void which consequently is no longer expected to be used is excluded from the calculation of operational life. The 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 depreciation of landfill reserves including the available void space, future capital expenditure and operating costs. The assumptions are revised as these factors change.

The estimate of gas production at landfill sites post-closure reduces the depreciation of landfill reserves. An assessment is undertaken for individual sites of the historic profile of gas production during landfilling activity and the projected generation post-closure according to the type of waste contained in the landfill and expected profile of gas production over time.

Revenue recognition

The Group recognises revenue at the time of delivery of services. Payments received in advance of services delivered are recorded as a liability.

South West Water 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, revenue 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.

Viridor estimates income from certain contractual revenue streams based on tonnages, cost and historic data which are dependent on agreement with the customer after the delivery of the service.

Provision for doubtful debts

At the balance sheet date each subsidiary evaluates the collectability of trade receivables and records provisions for doubtful debts based on experience including 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. As at 31 March 2014 the Group's current trade receivables were £206.4 million, against which £86.1 million had been provided for impairment (note 23).

Exceptional items

Exceptional items are those that in the Directors' view are required to be separately disclosed by virtue of their size or incidence to enable a full understanding of the Group's financial performance.

Notes to the financial statements

Continued

5. Restatements

IAS 19 (revised) 'Employee Benefits' has been applied retrospectively in accordance with the transition provision in the standard; comparative information has been restated accordingly.

At 31 March 2013 the accounting for the acquisition of JWT Holdings Limited (renamed Viridor Waste (Atherton) Limited) was provisional. In addition at 31 March 2013 the accounting for the acquisition of Pulp Friction Limited (renamed Viridor (Erith) Limited) and the trade and assets of SBS Paper LLP, a related business, was also provisional. The completion of the accounting for these acquisitions has resulted in changes to comparative amounts.

The impact of these changes are as follows:

	2013		
	Previously reported £m	Application of IAS 19R £m	Restated now reported £m
Consolidated Income Statement			
Manpower costs	(158.6)	(0.7)	(159.3)
Operating Profit	57.4	(0.7)	56.7
Finance income	143.0	(32.3)	110.7
Finance costs	(184.4)	24.8	(159.6)
Profit before tax	21.8	(8.2)	13.6
Taxation – deferred tax	32.8	1.9	34.7
Profit for the year	26.9	(6.3)	20.6
Earnings per ordinary share (pence per share)			
– Basic	7.4	(1.7)	5.7
– Diluted	7.4	(1.7)	5.7
Consolidated Statement of Comprehensive Income			
Other comprehensive loss (net of tax)	(8.4)	7.1	(1.3)
Total comprehensive income	18.5	0.8	19.3

	2013				2012		
	Previously reported £m	Application of IAS 19R £m	Acquisitions restatements £m	Restated now reported £m	Previously reported £m	Application of IAS 19R £m	Restated now reported £m
Balance sheet							
Group							
Non-current assets							
Goodwill	339.0	–	0.3	339.3	326.5	–	326.5
Other intangible assets	12.5	–	1.2	13.7	22.0	–	22.0
Property, plant and equipment	3,279.6	–	(1.0)	3,278.6	3,083.6	–	3,083.6
Current assets							
Trade and other receivables	267.7	–	(0.1)	267.6	238.5	–	238.5
Current liabilities							
Trade and other payables	(277.2)	–	0.5	(276.7)	(242.5)	–	(242.5)
Current tax	(67.0)	–	0.1	(66.9)	(60.3)	–	(60.3)
Provisions	(40.6)	–	(1.3)	(41.9)	(26.3)	–	(26.3)
Non-current liabilities							
Retirement benefit obligations	(109.7)	10.1	–	(99.6)	(98.6)	9.2	(89.4)
Deferred tax	(243.1)	(2.3)	0.3	(245.1)	(277.3)	(2.2)	(279.5)
Equity							
Retained earnings and other reserves	469.1	7.8	–	476.9	521.7	7.0	528.7
Company							
Non-current assets							
Deferred tax	2.3	(0.2)	–	2.1	4.6	(0.2)	4.4
Non-current liabilities							
Retirement benefit obligations	(8.7)	0.8	–	(7.9)	(7.8)	0.9	(6.9)
Equity							
Retained earnings and other reserves	684.2	0.6	–	684.8	572.1	0.7	572.8

6. Segmental information

Operating segments are reported in a manner consistent with internal reporting provided to the Chief Operating Decision-Maker, which has been identified as the Pennon Group Plc Board.

The water and sewerage business comprises the regulated water and sewerage services undertaken by South West Water Limited. The waste management business is the recycling, renewable energy and waste management services provided by Viridor Limited. Segment assets include goodwill and other intangible assets, property, plant and equipment, inventories, trade and other receivables and cash and cash deposits. Segment liabilities comprise operating liabilities and exclude taxation. The other segment liabilities include the Company's financing of business acquisitions and Group taxation liabilities. Capital expenditure comprises additions to property, plant and equipment, including additions resulting from acquisitions through business combinations.

	2014 £m	2013 (Restated note 5) £m
Revenue		
Water and sewerage	520.0	498.6
Waste management	802.0	703.8
Other	11.2	10.8
Less intra-segment trading*	(12.0)	(12.1)
	1,321.2	1,201.1
Segment result		
Operating profit before depreciation, amortisation and exceptional items (EBITDA)		
Water and sewerage	330.9	317.1
Waste management	76.3	77.7
Other	0.1	–
	407.3	394.8
Operating profit before exceptional items		
Water and sewerage	227.0	214.8
Waste management	30.2	30.6
Other	0.3	0.2
	257.5	245.6
Profit before tax and exceptional items		
Water and sewerage	162.5	146.7
Waste management	27.6	34.3
Other	17.2	9.0
	207.3	190.0
Profit/(loss) before tax		
Water and sewerage	162.5	159.2
Waste management	(21.0)	(154.6)
Other	17.2	9.0
	158.7	13.6

* 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.

Notes to the financial statements

Continued

6. Segmental information Continued

	Water and sewerage £m	Waste management £m	Other £m	Eliminations £m	Group £m
Balance sheet					
31 March 2014					
Assets (excluding investments in joint ventures)	3,051.5	1,659.6	1,472.5	(1,200.7)	4,982.9
Investments in joint ventures	-	0.1	-	-	0.1
Total assets	3,051.5	1,659.7	1,472.5	(1,200.7)	4,983.0
Liabilities	(2,215.8)	(1,377.5)	(1,392.8)	1,200.7	(3,785.4)
Net assets	835.7	282.2	79.7	-	1,197.6
31 March 2013 (Restated note 5)					
Assets (excluding investments in joint ventures)	2,922.6	1,450.4	1,347.9	(950.7)	4,770.2
Investments in joint ventures	-	0.1	-	-	0.1
Total assets	2,922.6	1,450.5	1,347.9	(950.7)	4,770.3
Liabilities	(2,150.7)	(1,108.1)	(1,390.1)	950.7	(3,698.2)
Net assets/(liabilities)	771.9	342.4	(42.2)	-	1,072.1

Segment liabilities of the water and sewerage and waste management segments comprise operating liabilities. The other segment liabilities include the Group taxation liabilities.

	Notes	Water and sewerage £m	Waste management £m	Other £m	Group £m
Other information					
31 March 2014					
Amortisation of other intangible assets	17	-	2.7	-	2.7
Capital expenditure (including acquisitions)		141.6	219.1	0.1	360.8
Depreciation	18	103.9	43.4	(0.2)	147.1
Impairment	18	-	42.9	-	42.9
Finance income	9	3.0	18.8	21.5	43.3
Finance costs	9	67.5	12.0	17.7	97.2
31 March 2013 (Restated note 5)					
Amortisation of other intangible assets	17	-	3.7	-	3.7
Capital expenditure (including acquisitions)		116.5	308.3	0.1	424.9
Depreciation	18	102.3	43.4	(0.2)	145.5
Impairment	17,18	-	84.0	-	84.0
Finance income	9	18.9	16.1	75.7	110.7
Finance costs	9	74.5	6.6	78.5	159.6

Geographic analysis of revenue based on location of customers

	2014 £m	2013 £m
Revenue		
United Kingdom	1,265.2	1,142.1
Rest of European Union	13.1	11.2
China	35.8	39.7
Rest of World	7.1	8.1
	1,321.2	1,201.1

The Group's country of domicile is the United Kingdom and is the country in which it generates the majority of its revenue. The Group's non-current assets are all located in the United Kingdom.

7. Exceptional items

Exceptional items are those that in the Directors' view are required to be separately disclosed by virtue of their size or incidence to enable a full understanding of the Group's financial performance.

	Notes	2014 £m	2013 £m
Operating costs			
Impairment of property, plant and equipment (a)	18	(42.9)	(78.2)
Environmental and landfill restoration provisions (b)	33	(5.7)	(90.1)
Onerous contracts and other (c)		–	(20.6)
		(48.6)	(188.9)
Net finance costs	9		
Receipt on transfer and subsequent termination of lease (d)		–	15.4
Fair value loss on associated interest rate swap transferred from equity on termination of lease (d)		–	(2.9)
		–	12.5
Loss before tax		(48.6)	(176.4)
Tax credit arising on exceptional items (e)	10	8.9	36.2
Loss for the year		(39.7)	(140.2)

(a) The 2014 impairment charge relates to a write-down of the carrying values of property, plant and equipment in landfill, reflecting reduced prices and higher ongoing capital costs.

The 2013 impairment charge related to a write-down of the carrying values of property, plant and equipment in landfill and recycling activities reflecting reduced landfill volumes and recyclate prices. The 2013 impairment charge was net of a credit arising from the reassessment of landfill site residual values linked to gas production at landfill sites post-closure.

(b) Environmental control and aftercare costs are incurred during the operational life of each landfill site and for a considerable period thereafter. The period of aftercare post-closure and the level of costs expected are uncertain and can vary significantly from site to site. Key factors are the type of waste, the speed at which it decomposes, the volume of leachate requiring treatment and regulatory requirements specific to the site. The amounts expected to be incurred have been re-assessed, re-estimated and aligned to the revised landfill site operating lives established from the anticipated decline in landfill activity.

In 2014 provisioning has been increased by £5.7 million due to revisions to site life costings. The 2013 provision reassessments additionally reflected a change in the estimate of the aftercare period to 60 years after site closure, previously 30 years, to align with updated technical assessment using independent external advice.

(c) Onerous contracts principally arise from long-term contractual obligations to purchase materials for recycling at input prices, which in 2013, lead to an expected loss after reflecting directly attributable and unavoidable costs of processing.

(d) In 2013 South West Water Limited received a consent fee related to the transfer and subsequent termination of a lease arising from the sale of a finance lease between financial institutions.

(e) The total tax credit on exceptional items is below the current rate of corporation tax of 23% (2013 24%) due to tax relief falling due in the future when the corporation tax rate will be 20% and tax relief not being available on ineligible expenditure on which no deferred tax has previously been accounted for (principally land and buildings).

Notes to the financial statements

Continued

8. Operating costs

	Notes	2014 £m	2013 (Restated note 5) £m
Manpower costs	14	161.4	159.3
Raw materials and consumables		111.6	125.2
Other operating expenses include:			
Profit on disposal of property, plant and equipment		(4.2)	(1.8)
Operating lease rentals payable:			
– Plant and machinery		13.2	12.9
– Property		8.4	8.9
Research and development expenditure		0.1	0.2
Trade receivables impairment	23	10.2	9.9
Depreciation of property, plant and equipment:			
– Owned assets		109.2	107.8
– Under finance leases		37.9	37.7
– Impairment of property, plant and equipment		42.9	84.0
Amortisation of other intangible assets	17	2.7	3.7

Fees payable to the Company's auditors in the year were:

	2014 £000	2013 £000
Fees payable to the Company's auditors and its associates for the audit of parent Company and consolidated financial statements	136	124
Fees payable to the Company's auditors and its associates for other services:		
The audit of Company's subsidiaries	527	597
Audit related assurance services	303	172
Tax advisory services	99	361
Corporate finance services	843	880
Other non-audit services	409	177
Total fees	2,317	2,311
Fees payable to the Company's auditors in respect of Pennon Group pension schemes:		
Audit	19	27

Expenses reimbursed to the auditors in relation to the audit of the Group were £45,000 (2013 £45,000).

In 2013 audit related fees of £65,000 were recognised directly in equity relating to the issuance cost of the perpetual capital securities.

A description of the work of the Audit Committee is set out in its report on pages 62 and 66 which includes an explanation of how the auditors' objectivity and independence are safeguarded when non-audit services are provided by the auditors' firm.

9. Net finance costs

	Notes	2014			2013 (Restated note 5)		
		Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt							
Bank borrowing and overdrafts		(32.5)	–	(32.5)	(40.0)	–	(40.0)
Interest element of finance lease rentals		(35.8)	–	(35.8)	(39.8)	–	(39.8)
Other finance costs		(4.9)	–	(4.9)	(5.4)	–	(5.4)
Interest receivable		–	5.3	5.3	–	5.8	5.8
Interest receivable on shareholder loans to joint ventures		–	9.8	9.8	–	9.3	9.3
		(73.2)	15.1	(58.1)	(85.2)	15.1	(70.1)
Other finance income							
Investment income received		–	11.3	11.3	–	66.8	66.8
Fair value losses on derivative financial instruments providing commercial hedges		(10.7)	–	(10.7)	(63.4)	–	(63.4)
		(10.7)	11.3	0.6	(63.4)	66.8	3.4
Notional interest							
Interest receivable on service concession arrangements		–	8.5	8.5	–	6.0	6.0
Retirement benefit obligations	31	(4.0)	–	(4.0)	(3.8)	–	(3.8)
Unwinding of discounts in liabilities		(9.3)	–	(9.3)	(4.3)	–	(4.3)
		(13.3)	8.5	(4.8)	(8.1)	6.0	(2.1)
Net gains on non-designated derivative financial instruments		–	8.4	8.4	–	7.4	7.4
		(97.2)	43.3	(53.9)	(156.7)	95.3	(61.4)
Exceptional items	7	–	–	–	(2.9)	15.4	12.5
		(97.2)	43.3	(53.9)	(159.6)	110.7	(48.9)

Other finance income represents enhanced yields from investment income received on short-term deposits held, partially offset by fair value losses on derivative financial instruments which provided commercial hedges against these short-term structured deposits. These transactions commenced and matured during the year.

In addition to the above, finance costs of £21.8 million (2013 £13.6 million) have been capitalised on qualifying assets included in property, plant and equipment.

10. Taxation

	Notes	Before exceptional items	Exceptional items	Total	Before exceptional items	Exceptional items	Total
		2014	(Note 7)		2013	(Note 7)	
		£m	2014	£m	(Restated note 5)	2013	(Restated note 5)
			£m		£m	£m	£m
Analysis of charge/(credit) in year							
Current tax charge/(credit)		35.3	–	35.3	43.3	(15.6)	27.7
Deferred tax – other		14.3	(10.2)	4.1	(0.5)	(21.5)	(22.0)
Deferred tax arising on change of rate of corporation tax		(40.1)	1.3	(38.8)	(13.6)	0.9	(12.7)
Total deferred tax credit	32	(25.8)	(8.9)	(34.7)	(14.1)	(20.6)	(34.7)
Tax charge/(credit) for year		9.5	(8.9)	0.6	29.2	(36.2)	(7.0)

Current tax is calculated at 23% (2013 24%) of the estimated assessable profit for the year.

Included in deferred tax is a non-recurring credit of £38.8 million (2013 £12.7 million) arising from a 3% reduction (2013 1%) in the rate of corporation tax from April 2014. From 1 April 2014 a 2% reduction will take place, followed by a further 1% reduction from 1 April 2015.

Notes to the financial statements

Continued

10. Taxation Continued

The tax for the year differs from the theoretical amount which would arise using the standard rate of corporation tax in the UK (23%) from:

	2014 £m	2013 (Restated note 5) £m
Profit before tax	158.7	13.6
Profit before tax multiplied by the standard rate of UK corporation tax of 23% (2013 24%)	36.5	3.3
Effects of:		
Expenses not deductible for tax purposes	7.5	8.5
Other	(0.2)	4.6
Change in rate of corporation tax	(38.8)	(12.7)
Adjustments to tax charge in respect of prior years	(4.4)	(10.7)
Tax charge/(credit) for year	0.6	(7.0)

Credit adjustments to the tax charge in respect of prior years include amounts released from the prior year current tax liability where a reassessment of a number of tax items indicates that a tax deduction is now expected.

The average applicable tax rate for the year before exceptional items was 5% (2013 15%).

In addition to the amounts recognised in the income statement the following tax charges and credits were also recognised:

	2014 £m	2013 (Restated note 5) £m
Amounts recognised directly in other comprehensive income		
Deferred tax charge on defined benefit pension schemes	10.2	–
Deferred tax charge on cash flow hedges	7.0	–
Amounts recognised directly in equity		
Deferred tax (credit)/charge on share based payments	(0.5)	0.5
Current tax credit on perpetual capital securities periodic return	(4.7)	–

11. Profit of the parent company

	2014 £m	2013 (Restated note 5) £m
Profit attributable to ordinary shareholders' equity dealt with in the accounts of the parent company	157.9	185.3

As permitted by Section 408 of the Companies Act 2006 no income statement or statement of comprehensive income is presented for the Company.

12. 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 37), 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 Performance and Co-investment Plan and the deferred shares element of the Annual Incentive Bonus Plan, to the extent that the performance criteria for vesting of the awards are expected to be met. The convertible bonds issued in August 2009 did not have a dilutive effect on statutory earnings per share during the year.

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

	2014	2013
Number of shares (millions)		
For basic earnings per share	367.4	363.6
Effect of dilutive potential Ordinary shares from share options	1.7	2.2
For diluted earnings per share	369.1	365.8

Basic and diluted earnings per share

Earnings per ordinary share before exceptional items and deferred tax are presented as the Directors believe that this measure provides a more useful comparison on business trends and performance, since deferred tax reflects distortive effects of changes in corporation tax rates and the level of long-term capital investment. Earnings per share have been calculated:

	2014			2013 (Restated note 5)		
	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
Statutory earnings	142.5	38.8	38.6	20.6	5.7	5.7
Deferred tax credit (before exceptional items)	(25.8)	(7.0)	(7.0)	(14.1)	(4.0)	(3.9)
Exceptional items (net of tax)	39.7	10.8	10.8	140.2	38.6	38.3
Earnings before exceptional items and deferred tax	156.4	42.6	42.4	146.7	40.3	40.1

13. Dividends

	2014 £m	2013 £m
Amounts recognised as distributions to ordinary equity holders in the year:		
Interim dividend paid for the year ended 31 March 2013: 8.76p (2012 8.22p) per share	31.9	29.7
Final dividend paid for the year ended 31 March 2013: 19.70p (2012 18.30p) per share	72.0	66.3
	103.9	96.0
Proposed dividends		
Proposed interim dividend for the year ended 31 March 2014: 9.39p (2013 8.76p) per share	34.8	31.9
Proposed final dividend for the year ended 31 March 2014: 20.92p (2013 19.70p) per share	77.9	72.0
	112.7	103.9

The proposed interim and final dividends have not been included as liabilities in these financial statements.

The proposed interim dividend for 2014 was paid on 3 April 2014 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting.

The amount of the proposed final dividend for the year ended 31 March 2014 excludes the impact of any conversions of the £125 million convertible bond, after the balance sheet date.

14. Employment costs

	Notes	2014 £m	2013 (Restated note 5) £m
Wages and salaries		134.3	134.3
Social security costs		13.1	13.1
Pension costs	31	20.2	17.6
Share-based payments	34	3.3	3.6
Total employment costs		170.9	168.6
Charged:			
Manpower costs – consolidated income statement		161.4	159.3
Capital schemes – property, plant and equipment		9.5	9.3
Total employment costs		170.9	168.6

Details of Directors' emoluments are set out in note 15. 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.

Notes to the financial statements

Continued

14. Employment costs Continued

	2014	2013
Employees (average number)		
The average monthly number of employees (including Executive Directors) was:		
Water and sewerage	1,356	1,354
Waste management	3,044	3,180
Other	51	50
Group totals	4,451	4,584

The total number of employees at 31 March 2014 was 4,498 (2013 4,511).

15. Directors' emoluments

	2014 £000	2013 £000
Executive Directors:		
Salary	1,121	1,110
Performance-related bonus paid or payable	400	261
Share-based payments	997	1,147
Other emoluments, including payments in lieu of pension provision	501	324
Non-executive Directors	480	477
	3,499	3,319

The cost of share-based payments represents the amount charged to the income statement, as described in note 34.

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £1,576,000 (2013 £1,644,000).

Total gains made by Directors on the exercise of share options were £1,000 (2013 £69,000).

Total emoluments include £1,594,000 (2013 £1,541,000) payable to Directors for services as directors of subsidiary undertakings.

At 31 March 2014 there were no Directors accruing retirement benefits under defined benefit pension schemes (2013 nil).

At 31 March 2014 one Director (2013 nil) is a member of the Group's defined contribution pension scheme. During the year three Directors received payments in lieu of pension provision (2013 three).

More detailed information concerning Directors' emoluments (including pensions and the highest paid Director) and share interests is shown in the Directors' remuneration report on pages 70 to 96.

16. Goodwill

	(Restated note 5) £m
Cost:	
At 1 April 2012	326.5
Recognised on acquisition of subsidiaries	12.8
At 31 March 2013	339.3
Recognised on acquisition of subsidiaries	–
At 31 March 2014	339.3
Carrying amount:	
At 1 April 2012	326.5
At 31 March 2013	339.3
At 31 March 2014	339.3

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 and this is the lowest level at which goodwill is monitored and tested.

Impairment testing of goodwill

The Group tests goodwill for impairment annually, or more frequently if there are any indications that impairment may have arisen. The recoverable amount of goodwill is determined based on value-in-use calculations which, under IAS 36 "Impairment of Assets", require the use of base cash flow projections that reflect reasonable and supportable assumptions with specific restrictions on the estimates to be used. These include limitations on reflecting cash flows to take account of future cost restructuring, or improvement or enhancement of asset performance. Uncommitted projects are excluded. Discount rates are required to be derived independently of the Group's capital structure and reflect management's prudent estimate of a rate that investors would require if they were to choose a similar investment.

The base cash flow projections have been derived by prudently adjusting key assumptions underlying the Group's detailed budget and strategic plan projections. These cover a period of 7 years and are prepared as part of the annual planning cycle. This period is believed to lead to a more realistic estimate of future cash flows than 5 years.

These plans are based on detailed market-by-market forecasts of projected volumes, prices and costs for each business activity. These forecasts reflect, on an individual operational site basis, numerous assumptions and estimates. The key assumptions include; anticipated changes in market size and volumes; recycle prices; energy selling prices; gate fees; the level of future landfill tax; and cost inflation. Management has determined the value assigned to each assumption based on historical experience, market surveys, industry analysis and current legislation. For business activities with an indefinite life a terminal growth rate has been used.

The key assumptions which management has applied to the cash flow projections include:

Assumption	Basis for assumption
Discount rate	
Pre-tax discount rates used range from 7.5% to 10% (across the segment's business activities).	Discount rates have been determined based on an estimate of the waste management segment's weighted average cost of capital adjusted for the different risk profiles of the segment's business activities to the extent that the cash flows have not already been adjusted. Investments in joint ventures reflect an expected equity return only.
Long-term growth rates	
0.5% applied to overheads beyond the period of the detailed projections.	Ongoing efficiencies and benefits from economies of scale.
2.5% applied to other cash flows beyond the period of the detailed projections	Based on forecasts of growth in waste management markets and the UK economy.

Using management's cash flow projections on the above basis, the value-in-use of the waste management business exceeds the carrying amount by £488 million ("headroom"). The headroom relative to the Company's investment in the waste management business (note 21) is £246 million. A reasonably possible change, with all other variables held constant, of a 0.5% increase in discount rates, a 1.5% increase in the long-term growth rate of overheads, a 0.5% reduction in the long-term growth rate of other cash flows or a 5.0% reduction in overall net cash flows, as a result of movements in key assumptions, would reduce "headroom" by £128 million, £59 million, £67 million and £83 million respectively.

Notes to the financial statements

Continued

17. Other intangible assets

	Service concession arrangements £m	Customer contracts (Restated note 5) £m	Patents £m	Total (Restated note 5) £m
Acquired intangible assets				
Cost:				
At 1 April 2012	–	31.5	0.2	31.7
Recognised on acquisition of subsidiaries	–	1.2	–	1.2
At 31 March 2013	–	32.7	0.2	32.9
Additions	19.6	–	–	19.6
At 31 March 2014	19.6	32.7	0.2	52.5
Accumulated amortisation:				
At 1 April 2012	–	9.6	0.1	9.7
Charge for year	–	3.7	–	3.7
Impairment charge for year	–	5.8	–	5.8
At 31 March 2013	–	19.1	0.1	19.2
Charge for year	–	2.7	–	2.7
At 31 March 2014	–	21.8	0.1	21.9
Carrying amount:				
At 1 April 2012	–	21.9	0.1	22.0
At 31 March 2013	–	13.6	0.1	13.7
At 31 March 2014	19.6	10.9	0.1	30.6

Service concession arrangements are amortised over the useful economic life of each contract. The average remaining life is 25 years.

Customer contracts are amortised over the useful economic life of each contract which at acquisition ranged between two and 15 years. The average remaining life is four years.

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

The carrying values of other intangible assets are reviewed annually or when events or changes in circumstance indicate that the carrying amounts may not be fully recoverable.

The principal assumptions used to assess impairment are set out in note 18 of the financial statements.

18. Property, plant and equipment

	Land and buildings (Restated note 5) £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers (Restated note 5) £m	Landfill restoration £m	Construction in progress £m	Total (Restated note 5) £m
Group							
Cost:							
At 1 April 2012	440.4	1,541.0	621.0	1,468.8	55.0	264.4	4,390.6
Arising on acquisitions	2.8	–	–	4.8	–	–	7.6
Additions	7.5	11.7	1.4	32.9	–	356.6	410.1
Assets adopted at fair value	–	3.3	–	–	–	–	3.3
Other	–	–	–	–	8.4	–	8.4
Grants and contributions	–	(1.0)	–	–	–	–	(1.0)
Disposals	–	(1.2)	–	(9.6)	–	–	(10.8)
Transfers/reclassifications	10.8	16.9	10.6	54.3	–	(92.6)	–
At 31 March 2013	461.5	1,570.7	633.0	1,551.2	63.4	528.4	4,808.2
Additions	16.8	13.8	1.2	30.8	–	298.2	360.8
Assets adopted at fair value	–	5.9	–	0.1	–	–	6.0
Grants and contributions	–	(1.6)	–	–	–	–	(1.6)
Disposals	–	(1.2)	(0.4)	(23.6)	–	–	(25.2)
Transfers/reclassifications	3.6	21.0	7.5	64.0	–	(96.1)	–
At 31 March 2014	481.9	1,608.6	641.3	1,622.5	63.4	730.5	5,148.2
Accumulated depreciation:							
At 1 April 2012	190.3	134.2	181.0	781.7	19.8	–	1,307.0
Charge for year	17.9	23.0	10.9	98.9	1.8	–	152.5
Impairment charge for the year	51.7	–	–	20.2	6.3	–	78.2
Disposals	–	(1.2)	–	(6.9)	–	–	(8.1)
At 31 March 2013	259.9	156.0	191.9	893.9	27.9	–	1,529.6
Charge for year	13.1	23.8	12.0	90.8	9.6	–	149.3
Impairment charge for the year	39.8	–	–	(2.0)	5.1	–	42.9
Disposals	–	(1.2)	(0.4)	(22.4)	–	–	(24.0)
At 31 March 2014	312.8	178.6	203.5	960.3	42.6	–	1,697.8
Net book value:							
At 1 April 2012	250.1	1,406.8	440.0	687.1	35.2	264.4	3,083.6
At 31 March 2013	201.6	1,414.7	441.1	657.3	35.5	528.4	3,278.6
At 31 March 2014	169.1	1,430.0	437.8	662.2	20.8	730.5	3,450.4

Notes to the financial statements

Continued

18. Property, plant and equipment Continued

Of the total depreciation charge of £149.3 million (2013 £152.5 million), £1.4 million (2013 £1.4 million) has been charged to capital projects, £0.8 million (2013 £0.8 million) has been offset by deferred income and £147.1 million (2013 £150.3 million) has been charged against profits.

Asset lives and residual values are reviewed annually.

During the year borrowing costs of £21.8 million (2013 £13.6 million) have been capitalised on qualifying assets, at an average borrowing rate of 4.3%.

Impairment testing for property, plant and equipment and other intangible assets

Property, plant and equipment and finite lived intangible assets are reviewed for impairment when any indicators of impairment are identified. Most of the individual assets do not generate independent cash flows and as a result, for the purposes of impairment reviews, the assets are grouped into cash generating units (CGUs). The CGUs of the waste management segment comprise individual sites which constitute the smallest identifiable group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or group of assets.

The carrying value of these individual sites is compared to the recoverable amount of the CGUs, which is based predominantly on value-in-use. Value-in-use calculations use the same base cash flow projections used for testing goodwill (note 16) and are derived by adjusting the Group's detailed budget and strategic plan which cover a period of 7 years and are approved by the Board annually. The key assumptions are the same as for the impairment testing of goodwill (note 16).

For certain CGUs the recoverable amount is determined by reference to the fair value less costs to sell of the underlying assets using external and internal valuations of property and equipment and management's estimate of disposal costs.

Impairment charges of £42.9 million (2013 £78.2 million) for property, plant and equipment and £nil (2013 £5.8 million) for intangible assets have been identified in the waste management segment relating to CGUs in landfill activities reflecting lower revenues and higher ongoing capital costs. For the purposes of disclosing the results of the impairment review the CGUs have been grouped together by business activity as each CGU within a business activity exhibits a similar risk profile. The key assumptions in the Group's detailed budget and strategic plan are the same as those used for testing goodwill (note 16). The assumptions applied to these cash flow projections are:

Assumption	Basis for assumption
Discount rate	
The pre-tax discount rate used for landfill is 8%.	Discount rates have been determined based on an estimate of the waste management segment's weighted average cost of capital adjusted for the different risk profiles of the segment's business activities to the extent that the cash flows have not already been adjusted.
Long-term growth rate	
0.5% applied to overheads beyond the period of the detailed projections.	Ongoing efficiencies and benefits from economies of scale.
2.5% applied to other cash flows beyond the strategic plan period up to the end of the life of the assets on projected volumes.	Based on forecasts of growth in waste management markets and the UK economy.

Using management cash flow projections a 1.5% increase in the long-term growth rate of overheads, with all other variables held constant, would increase the impairment charge by £6.5 million. A 0.5% increase in discount rate; or 0.5% reduction in the long-term growth rate of other cash flows; or a 5% reduction in overall net cash flows, with all other variables held constant, would not have a material impact on the impairment charge.

Assets held under finance leases included above were:

	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 31 March 2013	–	357.0	465.2	383.8	–	0.3	1,206.3
At 31 March 2014	–	357.0	465.2	421.3	–	0.2	1,243.7
Accumulated depreciation:							
At 31 March 2013	–	36.6	104.9	180.3	–	–	321.8
At 31 March 2014	–	41.9	112.8	200.9	–	–	355.6
Net book amount:							
At 31 March 2013	–	320.4	360.3	203.5	–	0.3	884.5
At 31 March 2014	–	315.1	352.4	220.4	–	0.2	888.1

	Fixed and mobile plant, vehicles and computers £m
Company	
Cost:	
At 1 April 2012	0.4
Additions	0.1
Disposals	(0.1)
At 31 March 2013	0.4
Additions	0.1
Disposals	(0.2)
At 31 March 2014	0.3
Accumulated depreciation:	
At 1 April 2012	0.2
Charge for year	0.1
Disposals	(0.1)
At 31 March 2013	0.2
Charge for year	0.1
Disposals	(0.2)
At 31 March 2014	0.1
Net book value:	
At 1 April 2012	0.2
At 31 March 2013	0.2
At 31 March 2014	0.2

Asset lives and residual values are reviewed annually.

Notes to the financial statements

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19. Financial instruments by category

The accounting policies for financial instruments have been applied to the line items:

	Notes	Fair value			Amortised cost		Total £m
		Derivatives used for fair value hedging £m	Derivatives used for cash flow hedging £m	Derivatives deemed held for trading £m	Loans and receivables £m	Trade receivables and trade payables £m	
Group							
31 March 2014							
Financial assets							
Trade receivables	23	–	–	–	–	120.3	120.3
Other receivables	20,23	–	–	–	233.7	–	233.7
Derivative financial instruments	24	20.0	8.5	–	–	–	28.5
Cash and cash deposits	26	–	–	–	613.1	–	613.1
Total		20.0	8.5	–	846.8	120.3	995.6
Financial liabilities							
Borrowings	29	–	–	–	(2,807.1)	–	(2,807.1)
Derivative financial instruments	24	(4.8)	(15.3)	(4.6)	–	–	(24.7)
Trade payables	27	–	–	–	–	(100.7)	(100.7)
Total		(4.8)	(15.3)	(4.6)	(2,807.1)	(100.7)	(2,932.5)
31 March 2013							
Financial assets							
Trade receivables	23	–	–	–	–	136.0	136.0
Other receivables	20,23	–	–	–	181.0	–	181.0
Derivative financial instruments	24	31.0	0.8	9.7	–	–	41.5
Cash and cash deposits	26	–	–	–	634.5	–	634.5
Total		31.0	0.8	9.7	815.5	136.0	993.0
Financial liabilities							
Borrowings	29	–	–	–	(2,643.2)	–	(2,643.2)
Derivative financial instruments	24	(9.2)	(41.1)	(2.9)	–	–	(53.2)
Trade payables	27	–	–	–	–	(86.9)	(86.9)
Total		(9.2)	(41.1)	(2.9)	(2,643.2)	(86.9)	(2,783.3)
Company							
31 March 2014							
Financial assets							
Amounts owed by subsidiaries	20,23	–	–	–	843.7	–	843.7
Derivative financial instruments	24	–	0.2	–	–	–	0.2
Cash and cash deposits	26	–	–	–	326.7	–	326.7
Total		–	0.2	–	1,170.4	–	1,170.6
Financial liabilities							
Borrowings	29	–	–	–	(1,098.8)	–	(1,098.8)
Derivative financial instruments	24	–	(0.1)	(2.4)	–	–	(2.5)
Trade payables	27	–	–	–	–	(0.1)	(0.1)
Total		–	(0.1)	(2.4)	(1,098.8)	(0.1)	(1,101.4)
31 March 2013							
Financial assets							
Amounts owed by subsidiaries	20,23	–	–	–	637.0	–	637.0
Derivative financial instruments	24	–	–	9.7	–	–	9.7
Cash and cash deposits	26	–	–	–	398.9	–	398.9
Total		–	–	9.7	1,035.9	–	1,045.6
Financial liabilities							
Borrowings	29	–	–	–	(1,049.8)	–	(1,049.8)
Trade payables	27	–	–	–	–	(0.4)	(0.4)
Total		–	–	–	(1,049.8)	(0.4)	(1,050.2)

20. Other non-current assets

Non-current receivables

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Amounts owed by subsidiary undertakings	-	-	833.5	502.0
Amounts owed by related parties (note 46)	87.9	79.9	-	-
Service concession arrangements	126.0	90.1	-	-
Other receivables	16.4	13.3	0.5	0.5
	230.3	183.3	834.0	502.5

Non-current receivables were due:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Between 1 and 2 years	23.1	21.0	166.8	126.2
Over 2 years and less than 5 years	22.8	24.4	500.2	376.3
Over 5 years	184.4	137.9	167.0	-
	230.3	183.3	834.0	502.5

The fair values of non-current receivables were:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Amounts owed by subsidiary undertakings	-	-	845.1	509.2
Amounts owed by related parties	165.2	161.6	-	-
Service concession arrangements	126.0	90.1	-	-
Other receivables	16.4	13.3	0.5	0.5
	307.6	265.0	845.6	509.7

The fair value of amounts owed by related parties is based on cash flows using a rate based on the borrowings rate of 2.5% (2013 2.5%).

The discount rate is equal to London Interbank Offered Rate plus an allowance to reflect an appropriate credit margin.

The effective interest rate on amounts owed by related parties was 13.0% (2013 13.0%).

Other receivables include site development and pre-contract costs of £15.9 million (2013 £12.8 million).

Notes to the financial statements

Continued

21. Investments

Subsidiary undertakings

	£m
Company	
At 1 April 2012	1,172.1
Additions	151.2
At 31 March 2013	1,323.3
At 31 March 2014	1,323.3

Joint ventures

	Shares £m
Group	
At 1 April 2012	0.1
Share of post-tax profit	5.8
Share of other comprehensive loss	2.7
Dividends received	(8.5)
At 31 March 2013	0.1
Share of post-tax profit	3.7
Share of other comprehensive profit	4.8
Dividends received	(8.5)
At 31 March 2014	0.1

The recoverable amount of investments is determined based on value-in-use calculations which are set out in note 16 of the financial statements.

Details of the Group's principal subsidiary and joint venture undertakings are set out in note 41.

The Group's share of the results, assets and liabilities in its principal joint ventures and associate, which are equity accounted in these financial statements, is:

	Assets		Liabilities		Income		Other comprehensive income/(loss) £m
	Non-current £m	Current £m	Non-current £m	Current £m	Revenue £m	Profit £m	
2014							
Lakeside Energy from Waste Holdings Limited	68.8	14.7	(81.4)	(2.0)	24.0	4.5	4.0
Viridor Laing (Greater Manchester) Holdings Limited	241.3	8.9	(197.2)	(53.0)	62.0	(0.5)	0.5
INEOS Runcorn (TPS) Holdings Limited	103.7	20.3	(120.1)	(3.9)	16.3	(0.3)	0.3
2013							
Lakeside Energy from Waste Holdings Limited	73.8	19.5	(86.1)	(7.2)	25.2	5.8	2.7
Viridor Laing (Greater Manchester) Holdings Limited	175.2	39.5	(188.9)	(25.8)	63.6	–	–
INEOS Runcorn (TPS) Holdings Limited	95.0	22.3	(117.1)	(0.2)	1.3	–	–

22. Inventories

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Raw materials and consumables	12.1	10.5	-	-

23. Trade and other receivables – current

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 £m
Trade receivables	206.4	212.4	-	-
Less: provision for impairment of receivables	(86.1)	(76.4)	-	-
Net trade receivables	120.3	136.0	-	-
Amounts owed by related parties (note 46)	19.3	11.0	-	-
Amounts owed by subsidiary undertakings	-	-	10.2	135.0
Other receivables	24.5	8.0	1.0	1.1
Prepayments and accrued income	114.1	112.6	0.2	0.2
	278.2	267.6	11.4	136.3

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

There is no concentration of credit risk in trade receivables. The Group has a large number of customers who are dispersed and there is no significant loss on trade receivables expected that has not been provided for. The Group has created IAS 39 portfolio provisions, but cannot practicably identify which receivables specifically are the ones impaired. It is Group policy to consider a receivable in a portfolio to which an impairment has been allocated on a collective basis as not being impaired for the purposes of IFRS 7 disclosures until the loss can be specifically identified with the receivable.

The ageing of trade receivables which are past due but not specifically impaired was:

	2014 £m	2013 £m
Group		
Past due 1 – 30 days	43.7	51.3
Past due 31 – 120 days	17.8	13.8
More than 120 days	130.5	115.6

The aged trade receivables above are taken directly from aged sales ledger records before deduction of credit balances and other adjustments.

The Group's two principal operating businesses specifically review separate categories of debt to identify an appropriate provision for impairment. South West Water Limited has a duty under legislation to continue to provide domestic customers with services regardless of payment.

The movement in the allowance for impairment in respect of trade receivables was:

	2014 £m	2013 £m
At 1 April	76.4	67.0
Provision for receivables impairment	10.2	9.9
Receivables written-off during the year as uncollectable	(8.4)	(9.5)
Cumulative amounts previously excluded from debt	7.9	9.0
At 31 March	86.1	76.4

Notes to the financial statements

Continued

24. Derivative financial instruments

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Derivatives used for cash flow hedging				
Non-current assets	6.7	0.2	0.2	–
Current assets	1.8	0.6	–	–
Current liabilities	(15.3)	(18.0)	–	–
Non-current liabilities	–	(23.1)	(0.1)	–
Derivatives used for fair value hedging				
Non-current assets	19.2	30.8	–	–
Current assets	0.8	0.2	–	–
Current liabilities	(1.2)	(2.3)	–	–
Non-current liabilities	(3.6)	(6.9)	–	–
Derivative deemed held for trading				
Current assets	–	9.7	–	9.7
Current liabilities	(4.3)	(1.4)	(2.4)	–
Non-current liabilities	(0.3)	(1.5)	–	–

The fair value of hedging derivatives is split between current and non-current assets or liabilities based on the maturity of the cash flows.

The ineffective portion recognised in the income statement arising from hedging relationships was £nil (2013 £nil).

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 are at fixed rate. At 31 March 2014 62% of Group net borrowings were at fixed rate (2013 54%).

At 31 March 2014 the Group had interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £1,563.0 million and a weighted average maturity of 3.7 years (2013 £1,135.0 million, with 4.0 years). The weighted average interest rate of the swaps for their nominal amount was 2.7% (2013 2.7%).

The derivative deemed held for trading does not qualify for hedge accounting under IAS 39, but is designed to improve the Group's overall interest rate performance. This derivative arises from a combination of non-derivative instruments entered into during the year that when combined result in a derivative instrument. Included in the derivative instrument is a £200 million floating interest rate-linked loan from Peninsula MB Limited to the Company and a fixed rate £200 million obligation due to the Company from Peninsula MB Limited. This derivative has an expected life of 13 years.

Valuation hierarchy

The Group uses the following hierarchy for determining the fair value of financial instruments by valuation technique:

- quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1)
- inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2)
- inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3).

The fair value of financial instruments not traded in an active market (level 2, for example over-the-counter derivatives) is determined by using valuation techniques. A variety of methods and assumptions are used based on market conditions existing at each balance sheet date. Quoted market prices or dealer quotes for similar instruments are used for long-term debt. Other techniques, such as estimated discounted cash flows, are used to determine fair value for the remaining financial instruments. The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows.

The Group's financial instruments are valued principally using level 2 measures:

Level 2 inputs	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Assets				
Derivatives used for cash flow hedging	8.5	0.8	0.2	-
Derivatives used for fair value hedging	20.0	31.0	-	-
Total assets	28.5	31.8	0.2	-
Liabilities				
Derivatives used for cash flow hedging	15.3	41.1	0.1	-
Derivatives used for fair value hedging	4.8	9.2	-	-
Derivative deemed held for trading	2.2	2.9	-	-
Total liabilities	22.3	53.2	0.1	-

Financial instruments valued using level 3 measures are valued by the counterparty using cash flows discounted at prevailing mid-market rates. The fair value of such financial instruments is not significantly sensitive to unobservable inputs.

Level 3 inputs	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Assets				
Derivative deemed held for trading	-	9.7	-	9.7
Liabilities				
Derivative deemed held for trading	2.4	-	2.4	-

The following table presents the changes in level 3 financial instruments for the year:

Level 3 inputs	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
At 1 April	9.7	2.3	9.7	2.3
Gains and losses recognised in net finance costs	8.4	7.4	8.4	7.4
Settlement of recognised gains	(20.5)	-	(20.5)	-
At 31 March	(2.4)	9.7	(2.4)	9.7

25. Financial instruments at fair value through profit

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Current assets	0.4	1.2	-	-
Non-current liabilities	(15.6)	(23.0)	-	-

Financial instruments at fair value through profit reflect the fair value movement of the hedged risk on a hedged item which has been designated in a fair value hedging relationship.

Notes to the financial statements

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26. Cash and cash deposits

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Cash at bank and in hand	90.1	86.6	85.5	58.4
Short-term bank deposits	145.0	159.0	90.0	159.0
Other deposits	378.0	388.9	151.2	181.5
Total cash and cash deposits (note 40)	613.1	634.5	326.7	398.9

Group short-term deposits have an average maturity of one day.

Group other deposits have an average maturity of 157 days.

Group other deposits include restricted funds of £164.1 million (2013 £135.9 million) to settle long-term lease liabilities (note 29) and £9.1 million (2013 £7.7 million) relating to letters of credit.

For the purposes of the cash flow statement cash and cash equivalents comprise:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Cash and cash deposits as above	613.1	634.5	326.7	398.9
Bank overdrafts (note 29)	-	(0.4)	-	-
	613.1	634.1	326.7	398.9
Less: deposits with a maturity of three months or more (restricted funds)	(173.2)	(143.6)	(1.4)	(1.4)
	439.9	490.5	325.3	397.5

27. Trade and other payables – current

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 £m
Trade payables	100.7	86.9	0.1	0.4
Amounts owed to subsidiary undertakings	-	-	0.1	0.1
Amounts owed to joint venture (note 46)	1.5	0.2	-	-
Other tax and social security	72.2	70.8	0.3	0.3
Accruals and other payables	124.4	118.8	6.9	6.9
	298.8	276.7	7.4	7.7

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

Included in accruals and other payables are amounts provided by the Group in relation to claims received which are considered by the Directors and the management of the Group to be the best estimate of the amounts that might be finally settled. Further disclosures have not been provided in accordance with IAS 37 paragraph 92.

28. Current tax liabilities

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 £m
Current tax liabilities	37.7	66.9	1.1	18.9

29. Borrowings

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Current				
Bank overdrafts	-	0.4	-	-
Short-term loans	0.9	75.9	0.9	75.9
Convertible bond	123.4	-	123.4	-
European Investment Bank	31.1	21.1	-	-
Amounts owed to subsidiary undertakings (note 46)	-	-	283.2	281.2
	155.4	97.4	407.5	357.1
Obligations under finance leases	118.5	41.2	-	-
Total current borrowings (note 40)	273.9	138.6	407.5	357.1
Non-current				
Bank and other loans	469.3	410.0	469.3	410.0
Private placements	222.0	162.3	222.0	162.3
Bond 2040	132.7	132.5	-	-
RPI index-linked bond	253.8	247.3	-	-
Convertible bond	-	120.4	-	120.4
European Investment Bank	304.3	210.4	-	-
	1,382.1	1,282.9	691.3	692.7
Obligations under finance leases	1,151.1	1,221.7	-	-
Total non-current borrowings (note 40)	2,533.2	2,504.6	691.3	692.7
Total borrowings	2,807.1	2,643.2	1,098.8	1,049.8

The Company issued a £100 million private placement in July 2007 maturing in 2022. Interest is payable at a fixed rate of 3.3%.

South West Water Finance Plc issued a £200 million RPI index-linked bond in July 2008 maturing in 2057 with a cash coupon of 1.99%.

The Company issued £125 million 4.625% convertible bonds in August 2009. The bonds mature five years from the issue date at their nominal value of £125 million or can be converted into shares, at the holders' option, at the conversion price of 597.81 pence per Ordinary share. The value of the equity conversion component was determined to be £10 million and has been recognised in shareholders' equity in retained earnings.

South West Water Finance Plc issued a £150 million bond in July 2010 maturing in 2040 with a cash coupon of 5.875%.

Notes to the financial statements

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29. Borrowings Continued

The fair values of non-current borrowings were:

	2014		2013	
	Book value £m	Fair value £m	Book value £m	Fair value £m
Group				
Bank and other loans	469.3	469.3	410.0	410.0
Private placements	222.0	215.9	162.3	156.5
Bond 2040	132.7	170.0	132.5	175.1
RPI index-linked bond	253.8	163.7	247.3	166.7
Convertible bond	-	-	120.4	145.9
European Investment Bank	304.3	260.1	210.4	189.5
	1,382.1	1,279.0	1,282.9	1,243.7
Obligations under finance leases	1,151.1	978.8	1,221.7	1,053.3
	2,533.2	2,257.8	2,504.6	2,297.0
Company				
Bank and other loans	469.3	469.3	410.0	410.0
Private placements	222.0	215.9	162.3	156.5
Convertible bond	-	-	120.4	145.9
	691.3	685.2	692.7	712.4

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

The maturity of non-current borrowings was:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Between 1 and 2 years	174.0	259.1	112.5	185.2
Over 2 years and less than 5 years	560.6	593.9	356.8	345.2
Over 5 years	1,798.6	1,651.6	222.0	162.3
	2,533.2	2,504.6	691.3	692.7

The weighted average maturity of non-current borrowings was 21 years (2013 22 years).

Finance lease liabilities – minimum lease payments were:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Within 1 year	62.5	56.6	-	-
Over 1 year and less than 5 years	297.8	291.0	-	-
Over 5 years	2,037.7	2,045.3	-	-
	2,398.0	2,392.9	-	-
Less: future finance charges	(1,128.4)	(1,130.0)	-	-
Present value of finance lease liabilities	1,269.6	1,262.9	-	-

The maturity of finance lease liabilities was:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Within 1 year	118.5	34.0	-	-
Over 1 year and less than 5 years	122.3	170.1	-	-
Over 5 years	1,028.8	1,058.8	-	-
	1,269.6	1,262.9	-	-

Included above are accrued finance charges arising on obligations under finance leases totalling £127.3 million (2013 £130.8 million), of which £6.9 million (2013 £14.4 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 property, plant and equipment which are secured by bank letters of credit issued by United Kingdom financial institutions. These letters of credit, covering the full period of the finance leases, are renewable between the financial institutions and South West Water Limited at five-yearly intervals, the next being March 2016.

The period for repayment of these leases includes an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The accumulated deposits, £60.1 million at 31 March 2014 (2013 £52.3 million) are being held to settle the lease liability over the period from the end of the original lease term. The deposits are subject to a registered charge given as security to the lessor for the balance outstanding.

The period for repayment of certain existing leases includes an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The accumulated deposits, £104.0 million at 31 March 2014 (2013 £83.6 million) are being held to settle the lease liability at the end of the lease term, subject to rights to release by negotiation with the lessor.

Undrawn committed borrowing facilities at the balance sheet date were:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Floating rate:				
Expiring within 1 year	30.0	190.0	-	25.0
Expiring after 1 year	660.0	325.0	415.0	220.0
	690.0	515.0	415.0	245.0

In addition the Group had, at 31 March 2014, undrawn uncommitted short-term bank facilities of £25.0 million (2013 £25.0 million) available to the Company or South West Water Limited.

30. Other non-current liabilities

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Amounts owed to subsidiary undertakings	-	-	8.7	8.7
Other payables	82.8	77.9	-	-
	82.8	77.9	8.7	8.7

Other payables include deferred income resulting from the adoption at fair value of assets transferred from customers in the water and sewerage segment.

Notes to the financial statements

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31. Retirement benefit obligations

The Group operates a number of defined benefit pension schemes and also a defined contribution section within the main scheme.

The assets of the Group's pension schemes are held in separate trustee administered funds. The trustees of the funds are required to act in the best interest of the funds' beneficiaries. The appointment of schemes' trustees is determined by the schemes' trust documentation. The Group has a policy for the main fund that one-half of all trustees, other than the Chairman, are nominated by members of the schemes, including pensioners.

Defined contribution schemes

Pension costs for defined contribution schemes were £4.5 million (2013 £2.8 million).

Defined benefit schemes

Assumptions

The principal actuarial assumptions at 31 March were:

	2014	2013	2012
	%	%	%
Rate of increase in pensionable pay	3.4	3.4	3.5
Rate of increase for current and future pensions	3.2	3.4	3.3
Rate used to discount schemes' liabilities and expected return on schemes' assets	4.30	4.35	4.73
Inflation	3.4	3.4	3.3

Mortality

Assumptions regarding future mortality experience are set based on actuarial advice in accordance with published statistics and experience. The mortality assumption uses a scheme-specific calculation based on CMI 2013 actuarial tables with an allowance for future longevity improvement.

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

	2014	2013	2012
Male	24.9	25.0	24.9
Female	27.1	27.0	27.0

The average life expectancy in years of a future pensioner retiring at age 62, 20 years after the balance sheet date, is projected as:

	2014	2013	2012
Male	26.3	25.9	25.8
Female	29.4	28.3	28.2

The sensitivities regarding the principal assumptions used to measure the schemes' liabilities are:

	Change in assumption	Impact on schemes' liabilities
Rate of increase in pensionable pay	+/- 0.5%	+/- 1.3%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.4%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 8.9%
Inflation	+/- 0.5%	+/- 6.9%
Life expectancy	+/- 1 year	+/- 3.5%

The amounts recognised in the balance sheet were:

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 (Restated note 5) £m
Present value of financial obligations	(677.4)	(671.9)	(47.2)	(47.3)
Fair value of plan assets	608.4	580.4	41.0	39.4
Deficit of funded plans	(69.0)	(91.5)	(6.2)	(7.9)
Impact of minimum funding asset ceiling	(10.3)	(8.1)	-	-
Net liability recognised in the balance sheet	(79.3)	(99.6)	(6.2)	(7.9)

The movement in the net defined benefit obligation over the accounting period is as follows:

	2014			2013		
	Present value of obligation £m	Fair value of plan assets £m	Total £m	Present value of obligation (Restated note 5) £m	Fair value of plan assets £m	Total (Restated note 5) £m
At 1 April	(680.0)	580.4	(99.6)	(606.6)	517.2	(89.4)
Current service cost	(15.5)	-	(15.5)	(14.4)	-	(14.4)
Interest (expense)/ income	(29.1)	25.1	(4.0)	(28.2)	24.4	(3.8)
Past service cost and gains and losses on settlements	(0.2)	-	(0.2)	(0.4)	-	(0.4)
	(44.8)	25.1	(19.7)	(43.0)	24.4	(18.6)
Remeasurements:						
Return on plan assets excluding amounts included in interest expense	-	8.0	8.0	-	44.6	44.6
Loss from change in demographic assumptions	(5.9)	-	(5.9)	-	-	-
Gain/(loss) from change in financial assumptions	9.9	-	9.9	(52.6)	-	(52.6)
Experience gains	15.1	-	15.1	1.3	-	1.3
Change in asset ceiling, excluding amounts included in interest expense	(0.9)	-	(0.9)	0.7	-	0.7
	18.2	8.0	26.2	(50.6)	44.6	(6.0)
Contributions:						
Employers	-	13.8	13.8	-	14.4	14.4
Plan participants	(1.1)	1.1	-	(1.2)	1.2	-
Payments from plans:						
Benefit payments	20.0	(20.0)	-	21.4	(21.4)	-
At 31 March	(687.7)	608.4	79.3	(680.0)	580.4	(99.6)

Notes to the financial statements

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31. Retirement benefit obligations Continued

The movement in the Company's net defined benefit obligation over the accounting period is as follows:

	2014			2013		
	Present value of obligation £m	Fair value of plan assets £m	Total £m	Present value of obligation (Restated note 5) £m	Fair value of plan assets £m	Total (Restated note 5) £m
1 April	(47.3)	39.4	(7.9)	(42.3)	35.4	(6.9)
Current service cost	(0.4)	–	(0.4)	(0.5)	–	(0.5)
Interest (expense)/income	(2.0)	1.7	(0.3)	(2.0)	1.7	(0.3)
	(2.4)	1.7	(0.7)	(2.5)	1.7	(0.8)
Remeasurements:						
Return on plan assets excluding amounts included in interest expense	–	0.3	0.3	–	2.8	2.8
Loss from change in demographic assumptions	(0.3)	–	(0.3)	–	–	–
Gain/(loss) from change in financial assumptions	0.9	–	0.9	(4.0)	–	(4.0)
Experience gains	0.4	–	0.4	–	–	–
	1.0	0.3	1.3	(4.0)	2.8	(1.2)
Contributions:						
Employers	–	1.1	1.1	–	1.0	1.0
Payments from plans:						
Benefit payments	1.5	(1.5)	–	1.5	(1.5)	–
At 31 March	(47.2)	41.0	(6.2)	(47.3)	39.4	(7.9)

Changes in the effect of the asset ceiling during the year were:

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 £m
Irrecoverable asset at start of the year	8.1	8.8	–	–
Interest on irrecoverable surplus	0.4	0.4	–	–
Actuarial gains/ (losses)	1.8	(1.1)	–	–

The Group has two minor pension schemes which are in surplus. However these surpluses are deemed irrecoverable assets in accordance with IFRIC 14 'The Limit on Defined Benefit Asset, Minimum Funding Requirements and their Interaction'.

The schemes' assets were:

	2014			2013		
	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %
Equities	288.4	-	47	314.0	-	54
Government bonds	84.2	-	14	89.6	-	15
Other bonds	115.3	-	19	96.0	-	6
Diversified growth	69.3	-	11	38.6	-	17
Property	38.0	1.4	7	34.0	1.3	6
Other	4.3	7.5	2	4.4	2.5	2
	599.5	8.9	100	576.6	3.8	100

Other assets at 31 March 2014 represented principally cash contributions received from the Group towards the year-end which were invested during the subsequent financial year.

The Company's share of the schemes' assets at the balance sheet date were:

	2014			2013		
	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %	Quoted prices in active market £m	Prices not quoted in active market £m	Fund %
Equities	19.8	-	48	20.3	-	51
Government bonds	5.5	-	14	3.1	-	8
Other bonds	6.7	-	16	6.9	-	18
Diversified growth	5.9	-	15	6.2	-	16
Property	3.0	-	7	2.7	-	7
Other	0.1	-	-	0.2	-	-
	41.0	-	100	39.4	-	100

Through its defined benefit pension plans, the Group is exposed to a number of risks, the most significant of which are detailed below:

Asset volatility	The liabilities are calculated using a discount rate set with reference to corporate bond yields; if assets underperform this yield, this will create a deficit. The schemes hold a significant proportion of growth assets (equities and diversified growth funds) which are expected to outperform corporate bonds in the long-term, but can give rise to volatility and risk in the short-term. The allocation to growth assets is monitored such that it is suitable with the schemes' long-term objectives.
Changes in bond yields	A decrease in corporate bond yields will increase the schemes' liabilities, although this will be partially offset by an increase in the value of the schemes' bond holdings.
Inflation risk	The majority of the schemes' benefit obligations are linked to inflation, and higher inflation will lead to higher liabilities (although, in most cases, caps on the level of inflationary increases are in place to protect against extreme inflation). The majority of the assets are either unaffected by or loosely correlated with inflation, meaning that an increase in inflation will also increase the deficit.
Life expectancy	The majority of the schemes' obligations are to provide benefits for the life of the member, so increases in life expectancy will result in an increase in the liabilities.

Notes to the financial statements

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31. Retirement benefit obligations Continued

In conjunction with its investment advisors, the trustees have structured the schemes' investments with the objective of balancing investment returns and levels of risk. The asset allocation for the main scheme has three principal elements:

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

The liabilities of the defined benefit schemes are measured by using the projected unit credit method which is an accrued benefits valuation method in which the schemes' liabilities make allowance for projected increases in pensionable pay.

The future cash flows arising from the payment of the defined benefits are expected to be settled primarily in the period between 15 and 40 years from the balance sheet date.

The last triennial actuarial valuation of the principal defined benefit scheme was at 31 March 2010. The Group paid no deficit recovery contributions to the main scheme during the year (2013 £nil million) since all payments up to 31 March 2015 under the existing schedule of contributions have been made. The schedule of contributions is due to be revised following the completion of the 31 March 2013 triennial actuarial valuation. The Group monitors funding levels on an annual basis and expects to pay total contributions of around £14 million during the year ended 31 March 2015.

32. Deferred tax

Deferred tax is provided in full on temporary differences under the liability method using a tax rate of 20% (2013 23%).

Movements on deferred tax were:

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 (Restated note 5) £m
Liabilities/(assets) at 1 April	245.1	279.5	(2.1)	(4.4)
(Credited)/charged to the income statement	(34.7)	(34.7)	0.1	2.5
Charged/(credited) to equity	16.7	0.5	0.7	(0.2)
Arising on acquisitions	–	(0.2)	–	–
Liabilities/(assets) at 31 March	227.1	245.1	(1.3)	(2.1)

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.

The majority of the Group's deferred tax liability is expected to be recovered over more than one year.

The majority of the Company's deferred tax asset is expected to be recovered over more than one year.

All deferred tax assets and liabilities within the same jurisdiction are offset.

The deferred tax balance has been reduced by a credit of £34.1 million to recognise the changes in the rate of corporation tax enacted on 17 July 2013 to reduce the rate from 1 April 2014 from 23% to 20%. From 1 April 2014 2% of the reduction will take place, followed by a further 1% reduction from 1 April 2015.

The movements in deferred tax assets and liabilities were:

Group

Deferred tax liabilities

	Accelerated tax depreciation			Total (Restated note 5) £m
	Owned assets (Restated note 5) £m	Leased assets £m	Other £m	
At 1 April 2012	293.9	15.8	21.2	330.9
(Credited)/ charged to the income statement	(37.6)	–	2.0	(35.6)
Arising on acquisitions	(0.1)	–	–	(0.1)
At 31 March 2013	256.2	15.8	23.2	295.2
(Credited)/charged to the income statement	(31.5)	(1.4)	5.4	(27.5)
At 31 March 2014	224.7	14.4	28.6	267.7

Deferred tax assets

	Provisions (Restated note 5) £m	Retirement benefit obligations (Restated note 5) £m	Other £m	Total (Restated note 5) £m
	At 1 April 2012	(8.1)	(21.4)	(21.9)
(Credited)/charged to the income statement	(0.6)	(1.5)	3.0	0.9
Charged to equity	–	–	0.5	0.5
Arising on acquisitions	(0.1)	–	–	(0.1)
At 31 March 2013	(8.8)	(22.9)	(18.4)	(50.1)
Credited to the income statement	(0.3)	(3.2)	(3.7)	(7.2)
Charged to equity	–	10.2	6.5	16.7
At 31 March 2014	(9.1)	(15.9)	(15.6)	(40.6)

Net liability:

At 31 March 2013	245.1
At 31 March 2014	227.1

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32. Deferred tax Continued

Company

Deferred tax assets

	Retirement benefit obligations (Restated note 5) £m	Other £m	Total (Restated note 5) £m
At 1 April 2012	(1.6)	(2.8)	(4.4)
Charged to the income statement	–	2.5	2.5
Credited to equity	(0.2)	–	(0.2)
At 31 March 2013	(1.8)	(0.3)	(2.1)
Charged to the income statement	–	0.1	0.1
Charged to equity	0.6	0.1	0.7
At 31 March 2014	(1.2)	(0.1)	(1.3)

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

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 (Restated note 5) £m
Actuarial (gains)/ losses on defined benefit schemes	(10.2)	–	(0.6)	0.2
Cash flow hedges	(7.0)	–	(0.1)	–
Deferred tax on other comprehensive (gain)/ loss	(17.2)	–	(0.7)	0.2
Share-based payments (note 34)	0.5	(0.5)	–	–
	(16.7)	(0.5)	(0.7)	0.2

33. Provisions

	Environmental and landfill restoration (Restated note 5) £m	Other provisions £m	Total (Restated note 5) £m
Group			
At 1 April 2013	185.5	27.1	212.6
Charged/(credited) to the income statement	10.2	(1.7)	8.5
Exceptional charges (note 7)	5.7	-	5.7
Utilised	(10.9)	(3.6)	(14.5)
At 31 March 2014	190.5	21.8	212.3

The amount charged to the income statement includes £9.3 million (2013 £3.8 million) charged to finance costs as the unwinding of discounts in provisions.

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

	2014 £m	2013 (Restated note 5) £m
Current	33.3	41.9
Non-current	179.0	170.7
	212.3	212.6

Environmental and landfill restoration provisions are incurred during the operational life of each landfill site and for a considerable period thereafter. The period of aftercare post-closure and the level of costs expected are uncertain and can vary significantly from site to site. Key factors are the type of waste, the speed at which it decomposes, the volume of leachate requiring treatment and regulatory requirements specific to the site. Environmental and landfill restoration provisions are expected to be substantially utilised throughout the operational life of a site and for landfill sites within 60 years of closure. The provisions have been established assuming current waste management technology based upon estimated costs at future prices which have been discounted to present value.

Other provisions comprise principally of onerous contracts and restructuring provisions. Onerous contracts are provided for at the net present value of the operating losses of the onerous contracts and are to be utilised over the remaining period of the contract to which they relate. The restructuring provision relates principally to severance costs and will be utilised within one year.

Notes to the financial statements

Continued

34. Share capital

Allotted, called-up and fully paid

	Number of shares		£m
	Treasury shares	Ordinary shares	
Group and Company			
At 1 April 2012 Ordinary shares of 40.7p each	3,632,705	360,588,466	148.2
Shares issued under the Scrip Dividend Alternative	–	2,542,187	1.0
Shares re-issued under the Company's Performance and Co-investment Plan	(493,217)	493,217	–
For consideration of £0.9 million, shares re-issued to the Pennon Employee Share Trust	(113,957)	113,957	–
For consideration of £0.4 million, shares re-issued under the Executive Share Option Scheme	(76,415)	76,415	–
For consideration of £3.3 million, shares re-issued under the Company's Sharesave Scheme	(843,280)	843,280	–
At 31 March 2013 Ordinary shares of 40.7p each	2,105,836	364,657,522	149.2
Shares issued under the Scrip Dividend Alternative	–	5,071,608	2.1
Shares re-issued under the Company's Performance and Co-investment Plan	(304,374)	304,374	–
For consideration of £0.4 million, shares re-issued to the Pennon Employee Share Trust	(69,336)	69,336	–
For consideration of £0.1 million, shares re-issued under the Executive Share Option Scheme	(11,134)	11,134	–
For consideration of £1.9 million, shares re-issued under the Company's Sharesave Scheme	(438,302)	438,302	–
At 31 March 2014 Ordinary shares of 40.7p each	1,282,690	370,552,276	151.3

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

Employee share schemes

The Group operates a number of equity-settled share plans for the benefit of employees. Details of each plan are:

i) Sharesave Scheme

An all-employee savings related plan is operated that 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 Ordinary 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 year 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 Ordinary shares of 40.7p each under the Company's share option schemes are:

	Date granted and subscription price fully paid	Period when options normally exercisable	Thousands of shares in respect of which options outstanding at 31 March	
			2014	2013
4 July 2006	358p	2009 – 2013	–	38
3 July 2007	522p	2010 – 2014	11	11
8 July 2008	517p	2011 – 2015	8	75
6 July 2009	386p	2012 – 2016	398	406
28 June 2010	431p	2013 – 2017	217	563
29 June 2011	536p	2014 – 2018	457	502
29 June 2012	588p	2015 – 2017	611	746
3 July 2013	538p	2016 – 2018	628	–
			2,330	2,341

i) Sharesave Scheme continued

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

	2014		2013	
	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	2,341	498	2,608	437
Granted	658	538	779	588
Forfeited	(199)	559	(157)	494
Exercised	(438)	436	(843)	394
Expired	(32)	517	(46)	496
At 31 March	2,330	515	2,341	498

The weighted average price of the Company's shares at the date of exercise of Sharesave options during the year was 703p (2013 731p). The options outstanding at 31 March 2014 had a weighted average exercise price of 515p (2013 498p) and a weighted average remaining contractual life of 1.7 years (2013 2.1 years).

The aggregate fair value of Sharesave options granted during the year was £0.9 million (2013 £0.8 million), determined using the Black-Scholes valuation model. The significant inputs into the valuation model at the date of issue of the options were:

	2014	2013
Weighted average share price	673p	735p
Weighted average exercise price	538p	588p
Expected volatility	18.0%	19.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.7%	0.4%
Expected dividend yield	4.2%	4.0%

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

ii) Performance and Co-investment Plan

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

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

	2014		2013	
	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	1,322	669	1,407	573
Granted	449	653	424	768
Vested	(276)	546	(493)	486
Lapsed	(295)	590	(16)	486
At 31 March	1,200	711	1,322	669

The awards outstanding at 31 March 2014 had a weighted exercise price of 711p (2013 669p) and a weighted average remaining contractual life of 1.3 years (2013 1.2 years).

Notes to the financial statements

Continued

34. Share capital Continued

The aggregate fair value of awards granted during the year was £1.6 million (2013 £1.9 million) determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2014	2013
Weighted average share price	653p	768p
Expected volatility	18.0%	19.0%
Risk-free rate	0.7%	0.4%

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

iii) Annual Incentive Bonus Plan – Deferred Shares

Awards under the plan to Executive Directors and senior management involve the release of Ordinary shares in the Company to participants. There is no performance condition since vesting is 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 Annual Incentive Bonus Plan are:

	2014		2013	
	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	429	680	427	602
Granted	99	693	120	754
Vested	(211)	616	(93)	473
Lapsed	(2)	573	(25)	473
At 31 March	315	727	429	680

The awards outstanding at 31 March 2014 had a weighted average exercise price of 727p (2013 680p) and a weighted average remaining contractual life of 1.2 years (2013 1.3 years). The Company's share price at the date of the awards ranged from 725p to 754p.

The aggregate fair value of awards granted during the year was £0.7 million (2013 £0.9 million), determined from market value. No option pricing methodology is applied since dividends paid on the shares are receivable by the participants in the scheme.

Further details of the plans and options granted to Directors, included above, are shown in the Directors' remuneration report.

35. Share premium account

	£m
Group and Company	
At 1 April 2012	8.0
Adjustment for shares issued under the Scrip Dividend Alternative	(1.0)
At 31 March 2013	7.0
Adjustment for shares issued under the Scrip Dividend Alternative	(2.1)
At 31 March 2014	4.9

36. Capital redemption reserve

The capital redemption reserve represents the redemption of B shares and cancellation of Deferred shares arising from a capital return to shareholders undertaken during 2006.

	£m
Group and Company	
At 1 April 2012	144.2
At 31 March 2013	144.2
At 31 March 2014	144.2

37. Retained earnings and other reserves

	Own shares £m	Hedging reserve £m	Retained earnings (Restated note 5) £m	Total (Restated note 5) £m
Group				
At 1 April 2012	(1.8)	(31.7)	562.2	528.7
Profit for the year	–	–	20.6	20.6
Other comprehensive loss for the year	–	(3.9)	(3.3)	(7.2)
Transfer from hedging reserve to income statement	–	2.9	–	2.9
Transfer from hedging reserve to property, plant and equipment	–	3.0	–	3.0
Dividends paid relating to 2012	–	–	(96.0)	(96.0)
Adjustment for shares issued under the Scrip Dividend Alternative	–	–	18.1	18.1
Credit to equity in respect of share-based payments	–	–	3.6	3.6
Deferred tax in respect of share-based payments	–	–	(0.5)	(0.5)
Charge in respect of share options vesting	0.4	–	(0.4)	–
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	(0.9)	–	–	(0.9)
Proceeds from treasury shares re-issued	–	–	4.6	4.6
At 31 March 2013	(2.3)	(29.7)	508.9	476.9
Profit for the year	–	–	142.5	142.5
Other comprehensive income for the year	–	25.2	20.8	46.0
Transfer from hedging reserve to property, plant and equipment	–	0.6	–	0.6
Dividends paid relating to 2013	–	–	(103.9)	(103.9)
Adjustment for shares issued under the Scrip Dividend Alternative	–	–	34.5	34.5
Credit to equity in respect of share-based payments	–	–	3.3	3.3
Deferred tax in respect of share-based payments	–	–	0.5	0.5
Charge in respect of share options vesting	1.0	–	(1.0)	–
Own shares acquired by the Pennon Employee Share Trust in respect of share options granted	(0.4)	–	–	(0.4)
Proceeds from treasury shares re-issued	–	–	2.4	2.4
At 31 March 2014	(1.7)	(3.9)	608.0	602.4

The own shares reserve represents the cost of Ordinary 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 Annual Incentive Bonus Plan.

The market value of the 331,000 Ordinary shares (2013 457,000 Ordinary shares) held by the trust at 31 March 2014 was £2.5 million (2013 £2.8 million).

Notes to the financial statements

Continued

37. Retained earnings and other reserves Continued

	Hedging reserve £m	Retained earnings (Restated note 5) £m	Total (Restated note 5) £m
Company			
At 1 April 2012	(0.3)	573.1	572.8
Profit for the year	–	185.3	185.3
Other comprehensive loss for the year	0.3	(1.1)	(0.8)
Dividends paid relating to 2012	–	(96.0)	(96.0)
Adjustment for shares issued under the Scrip Dividend Alternative	–	18.1	18.1
Credit to equity in respect of share-based payments	–	0.8	0.8
Proceeds from treasury shares re-issued	–	4.6	4.6
At 31 March 2013	–	684.8	684.8
Profit for the year	–	157.9	157.9
Other comprehensive income for the year	–	0.7	0.7
Dividends paid relating to 2013	–	(103.9)	(103.9)
Adjustment for shares issued under the Scrip Dividend Alternative	–	34.5	34.5
Credit to equity in respect of share-based payments	–	0.8	0.8
Proceeds from treasury shares re-issued	–	2.4	2.4
At 31 March 2014	–	777.2	777.2

38. Perpetual capital securities

	£m
Group and Company	
At 1 April 2012	–
Issue of GBP 300m 6.75% perpetual subordinated capital securities	294.8
At 31 March 2013	294.8
Distributions to perpetual capital security holders	(20.3)
Current tax relief on distributions to perpetual capital security holders	4.7
Profit for the year attributable to perpetual capital security holders	15.6
At 31 March 2014	294.8

On 8 March 2013 the Company issued £300 million perpetual capital securities. Costs directly associated with the issue of £5.2 million are set off against the value of the issuance. They have no fixed redemption date but the Company may, at its sole discretion, redeem all, but not part, of these securities at their principal amount on 8 March 2018 or any subsequent periodic return payment date after this.

The Company has the option to defer periodic returns on any relevant payment date, as long as a dividend on the Ordinary Shares has not been paid or declared in the previous 12 months. Deferred periodic returns shall be satisfied only on redemption or payment of dividend on Ordinary Shares, all of which only occur at the sole discretion of the Company.

As the Company paid a dividend in the 12 months prior to the periodic return date of 8 March, a periodic return of £20.3 million was paid during the year.

39. Analysis of cash flows given in the statement of cash flows

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

Cash generated from operations

	Group		Company	
	2014 £m	2013 (Restated note 5) £m	2014 £m	2013 (Restated note 5) £m
Continuing operations				
Profit for the year	158.1	20.6	173.5	185.3
Adjustments for:				
Share-based payments	3.3	3.6	0.8	0.8
Profit on disposal of property, plant and equipment	(4.2)	(1.8)	–	–
Depreciation charge	147.1	145.5	0.1	0.1
Amortisation of intangible assets	2.7	3.7	–	–
Exceptional impairment of property, plant and equipment	42.9	69.8	–	–
Exceptional provision charge	5.7	111.5	–	–
Other non cash exceptional charge	–	7.6	–	–
Share of post-tax profit from joint ventures	(3.7)	(5.8)	–	–
Finance income	(43.3)	(110.7)	(60.8)	(106.3)
Finance costs	97.2	159.6	44.0	97.5
Dividends receivable	–	–	(162.1)	(177.6)
Taxation charge/ (credit)	0.6	(7.0)	5.3	0.9
Changes in working capital (excluding the effect of acquisition of subsidiaries):				
Increase in inventories	(1.6)	(1.5)	–	–
Increase in trade and other receivables	(13.2)	(27.7)	(206.6)	(195.1)
Increase in service concession arrangements receivable	(47.5)	(31.3)	–	–
Increase/(decrease) in trade and other payables	7.3	11.8	(1.4)	(10.3)
Decrease/ (increase) in retirement benefit obligations from contributions	1.9	0.4	(0.8)	(0.5)
Decrease in provisions	(15.3)	(7.2)	–	–
Cash generated/(outflow) from operations	338.0	341.1	(208.0)	(205.2)

Reconciliation of total interest paid:

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Interest paid in operating activities	65.3	75.8	28.6	23.4
Interest paid in investing activities (purchase of property, plant and equipment)	21.8	13.6	–	–
Total interest paid	87.1	89.4	28.6	23.4

Notes to the financial statements

Continued

40. Net borrowings

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Cash and cash deposits	613.1	634.5	326.7	398.9
Borrowings – current				
Bank overdrafts	-	(0.4)	-	-
Other current borrowings	(155.4)	(97.0)	(124.3)	(75.9)
Finance lease obligations	(118.5)	(41.2)	-	-
Amounts owed to subsidiary undertakings	-	-	(283.2)	(281.2)
Total current borrowings	(273.9)	(138.6)	(407.5)	(357.1)
Borrowings – non-current				
Bank and other loans	(1,077.8)	(1,072.5)	(691.3)	(692.7)
Other non-current borrowings	(304.3)	(210.4)	-	-
Finance lease obligations	(1,151.1)	(1,221.7)	-	-
Total non-current borrowings	(2,533.2)	(2,504.6)	(691.3)	(692.7)
Total net borrowings	(2,194.0)	(2,008.7)	(772.1)	(650.9)

41. Principal subsidiary, joint venture and associate undertakings at 31 March 2014

	Country of incorporation, registration and principal operations
Water and sewerage	
South West Water Limited*	England
South West Water Finance Plc	England
Source Contact Management Limited	England
Waste management	
Viridor Limited*	England
Viridor Waste Limited	England
Viridor Waste Exeter Limited	England
Viridor Waste Suffolk Limited	England
Viridor Waste (West Sussex) Limited	England
Viridor Waste Management Limited	England
Viridor EnviroScot Limited	Scotland
Viridor Resource Management Limited	England
Viridor Waste Kent Limited	England
Viridor Oxfordshire Limited	England
Viridor EFW (Runcorn) Limited	England
Viridor Waste (Landfill Restoration) Limited	England
Viridor Waste (Atherton) Limited	England
Viridor Waste (Somerset) Limited	England
Viridor Waste (Thames) Limited	England
Viridor Waste (Greater Manchester) Limited	England
Viridor Polymer Recycling Limited	England
Viridor Trident Park Limited	England
Viridor (Glasgow) Limited	Scotland
Viridor (Lancashire) Limited	England
Viridor Peterborough Limited	England
Viridor South London Limited	England
Other	
Peninsula Insurance Limited*, ¹	Guernsey

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

¹ Captive insurance company established with the specific objective of financing risks emanating from within the Group

The subsidiary undertakings are wholly-owned and all shares in issue are Ordinary shares. All companies above are consolidated in the Group financial statements.

Notes to the financial statements

Continued

41. Principal subsidiary, joint venture and associate undertakings at 31 March 2014 Continued

Joint ventures and associate

All joint ventures, the associate and the subsidiary undertakings of Lakeside Energy from Waste Holdings Limited, Viridor Laing (Greater Manchester) Holdings Limited and INEOS Runcorn (TPS) Holdings Limited are incorporated and registered in England which is also their country of operation.

	Share capital in issue	Percentage held	Principal activity
Joint ventures			
Lakeside Energy from Waste Holdings Limited	1,000,000 A Ordinary shares	–	
	1,000,000 B Ordinary shares	100%	
Lakeside Energy from Waste Limited			Waste management
Shares in Lakeside Energy from Waste Holdings Limited are held by Viridor Waste Management Limited.			
Viridor Laing (Greater Manchester) Holdings Limited	2 Ordinary shares	50%	
Viridor Laing (Greater Manchester) Limited			Waste management
Shares in Viridor Laing (Greater Manchester) Holdings Limited are held by Viridor Waste Management Limited.			

Associates

INEOS Runcorn (TPS) Holdings Limited	1,000 A Ordinary shares	20%	
	186,750 B1 Ordinary shares	50%	
	62,250 B2 Ordinary shares	–	
INEOS Runcorn (TPS) Limited			Waste management

Shares in INEOS Runcorn (TPS) Holdings Limited are held by Viridor Waste Management Limited.

The Group's economic interest in INEOS Runcorn (TPS) Holdings Limited is 37.5%, as returns from the investment are based on holdings of B1 and B2 Ordinary shares.

42. Operating lease commitments

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
The future aggregate minimum lease payments under non-cancellable operating leases are:				
Within 1 year	10.3	9.4	–	–
Over 1 year and less than 5 years	30.9	28.3	–	–
Over 5 years	78.8	77.8	–	–
	120.0	115.5	–	–

The Group leases various offices, depots and workshops under non-cancellable operating lease agreements. The leases have various terms, escalation clauses and renewal rights. Property leases are negotiated for an average term of 25 years and rentals are reviewed on average at five-yearly intervals.

The Group also leases plant and machinery under non-cancellable operating lease agreements.

43. Contingent liabilities

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Guarantees:				
Borrowing facilities of subsidiary undertakings	-	-	438.6	297.1
Performance bonds	150.0	116.2	150.0	116.2
Other	6.9	6.9	6.9	6.9
	156.9	123.1	595.5	420.2

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.

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.

In connection with the application of the audit exemption under Section 479A of the Companies Act 2006 the Company has guaranteed all the outstanding liabilities as at 31 March 2014 of certain of its subsidiaries: Pennon Power Limited, Exe Continental and Viridor Waste 2 Limited since these companies qualify for the exemption.

The Group is subject to litigation from time to time as a result of its activities. The Group establishes provisions in connection with litigation where it has a present legal or constructive obligation as a result of past events and where it is more likely than not an outflow of resources will be required to settle the obligation and the amount can be reliably estimated.

44. Capital commitments

	Group		Company	
	2014 £m	2013 £m	2014 £m	2013 £m
Contracted but not provided	373.1	391.2	-	-

45. Post balance sheet events

In respect of the £125 million convertible bond due to mature in August 2014, between the year-end and 23 June 2014 notices of conversion for £61.3 million have been received requiring 10.3 million shares to be issued.

46. Related party transactions

During the year Group companies entered into the following transactions with joint ventures and associate related parties who are not members of the Group:

	2014 £m	2013 £m
Sales of goods and services		
Viridor Laing (Greater Manchester) Limited	104.6	83.0
Purchase of goods and services		
Lakeside Energy from Waste Limited	9.2	10.9
Dividends received		
Lakeside Energy from Waste Holdings Limited	8.5	8.5

Notes to the financial statements

Continued

46. Related party transactions Continued

Year-end balances

	2014 £m	2013 £m
Receivables due from related parties		
Viridor Laing (Greater Manchester) Holdings Limited (loan balance)	50.7	45.4
Lakeside Energy from Waste Holdings Limited (loan balance)	9.5	9.7
INEOS Runcorn (TPS) Holdings Limited (loan balance)	28.0	25.0
	88.2	80.1
Viridor Laing (Greater Manchester) Limited (trading balance)	18.1	9.6
Lakeside Energy from Waste Limited (trading balance)	0.9	1.2
	19.0	10.8
Payables due to related parties		
Lakeside Energy for Waste Limited (trading balance)	1.5	0.2

The £88.2 million (2013 £80.1 million) receivable relates to loans to related parties included within receivables and due for repayment in instalments between 2014 and 2033. Interest is charged at an average of 13.0% (2013 13.0%).

Company

The following transactions with subsidiary undertakings occurred in the year:

	2014 £m	2013 £m
Sales of goods and services (management fees)	9.7	9.3
Purchase of goods and services (support services)	0.5	0.5
Interest receivable	34.9	25.2
Interest payable	0.1	–
Dividends received	162.1	177.6

Sales of goods and services to subsidiary undertakings are at cost. Purchases of goods and services from subsidiary undertakings are under normal commercial terms and conditions which would also be available to unrelated third parties.

Year-end balances

	2014 £m	2013 £m
Receivables due from subsidiary undertakings		
Loans	834.1	628.2
Trading balances	9.6	8.8

Interest on £128.7 million of the loans has been charged at a fixed rate of 4.5% and on £288.4 million at a fixed rate of 6.0% (2013 £128.7 million, 4.5% and £199.4 million, 6.0%).

Interest on the balance of the loans is charged at 12 month LIBOR +1.5%. The loans are due for repayment in instalments over the period 2015 to 2019. During the year there were no provisions (2013 nil) in respect of loans to subsidiaries not expected to be repaid.

	2014 £m	2013 £m
Payables due to subsidiary undertakings		
Loans	283.2	281.2
Trading balances	14.4	14.4

The loans from subsidiary undertakings are unsecured and interest-free without any terms for repayment.

Five-year financial summary

	2014 £m	2013 (Restated note 5) £m	2012* £m	2011* £m	2010* £m
Income statement					
Revenue	1,321.2	1,201.1	1,233.1	1,159.2	1,068.9
Operating profit before exceptional items	257.5	245.6	268.8	260.9	266.3
Net finance costs before exceptional items	(53.9)	(61.4)	(72.3)	(76.7)	(81.6)
Share of profit in joint ventures	3.7	5.8	4.0	4.3	1.1
Profit before tax and exceptional items	207.3	190.0	200.5	188.5	185.8
Net exceptional items before tax	(48.6)	(176.4)	–	–	–
Taxation (charge)/credit	(0.6)	7.0	(28.1)	(16.9)	(44.3)
Profit for the year	158.1	20.6	172.4	171.6	141.5
Attributable to:					
Ordinary shareholders of the parent	142.5	20.6	172.4	171.6	141.5
Perpetual capital security holders	15.6	–	–	–	–
Dividends proposed	112.7	103.9	96.0	88.2	79.6
Earnings per ordinary share (basic):					
From continuing operations					
Earnings per share	38.8p	5.7p	48.1p	48.4p	40.4p
Deferred tax before exceptional items	(7.0)p	(4.0)p	(0.8)p	(6.1)p	0.4p
Exceptional items (net of tax)	10.8p	38.6p	–	–	–
Earnings per share before exceptional items and deferred tax	42.6p	40.3p	47.3p	42.3p	40.8p
Declared dividends per share	30.31p	28.46p	26.52p	24.65p	22.55p
	2014 £m	2013 (Restated note 5) £m	2012 (Restated note 5) £m	2011* £m	2010* £m
Capital expenditure					
Acquisitions	–	14.8	29.2	25.1	9.3
Property, plant and equipment	360.8	410.1	257.4	199.0	192.2
Balance sheet					
Non-current assets	4,076.6	3,846.0	3,592.5	3,347.6	3,189.4
Net current assets	241.9	378.5	11.8	335.7	162.1
Non-current liabilities	(3,120.9)	(3,152.4)	(2,775.2)	(2,903.8)	(2,688.6)
Net assets	1,197.6	1,072.1	829.1	779.5	662.9
Number of employees (average for year)					
Water and sewerage business	1,356	1,354	1,335	1,196	1,191
Waste management	3,044	3,180	3,148	3,012	2,853
Other businesses	51	50	46	44	43
	4,451	4,584	4,529	4,252	4,087

* Prior to the application of IAS 19 (Revised) 'Employee Benefits'.

Shareholder information

Financial Calendar

Financial year-end	31 March
Twenty-fifth Annual General Meeting	31 July 2014
Ex-dividend date for 2014 Final dividend	6 August 2014*
Record date for 2014 Final dividend	8 August 2014*
2014 Final dividend payable	3 October 2014*
2014/15 Half yearly financial report announcement	November 2015
2015 Interim dividend payable	April 2015
2015 Preliminary results announcement	May 2015
Twenty-sixth Annual General Meeting	July 2015
2015 Final dividend payable	October 2015

Scrip Dividend Alternative[#]

Ordinary shares quoted ex-dividend	6 August 2014
Record date for final cash dividend	8 August 2014
Posting of Scrip dividend offer	22 August 2014
Final date for receipt of Forms of Mandate	15 September 2014
Posting of dividend cheques and share certificates	2 October 2014
Final cash dividend payment date	3 October 2014
First day of dealing in the new Ordinary shares	3 October 2014

* These dates are subject to obtaining shareholder approval at the 2014 Annual General Meeting to the payment of a final dividend for the year ended 31 March 2014.

[#] The offer of the Scrip Dividend Alternative is subject to obtaining shareholder approval at the 2014 Annual General Meeting.

Shareholder Analysis at 31 March 2014

Range of shares held	Number of shareholders	% of total shareholders	% of Ordinary shares
Holding of Shares			
1 - 100	2,473	11.11	0.02
101 - 1,000	9,260	41.61	1.33
1,001 - 5,000	9,021	40.54	5.27
5,001 - 50,000	1,187	5.33	3.59
50,001 - 100,000	73	0.33	1.36
100,001 - Highest	239	1.08	88.43
	22,253	100	100

	Number of accounts	% of total accounts	% of total shares
Individuals	18,631	83.72	7.67
Companies	197	0.89	1.20
Trust companies (pension funds etc)	11	0.05	0.02
Banks and nominees	3,414	15.34	91.11
	22,253	100	100

Major Shareholdings

The net position on 31 March 2014 of investors who have notified interests in the issued share capital of the Company pursuant to the Financial Conduct Authority's Disclosure and Transparency Rules is as follows:

Ameriprise Financial Inc	9.53%
Pictet Asset Management SA	6.91%
Rare Infrastructure Limited	4.95%
AXA Investment Managers SA	4.88%
Invesco Ltd	4.65%
Legal & General Group Plc	3.63%
Norges Bank	3.04%

No changes to the above interests in the issued share capital of the Company have been disclosed to the Company between 31 March 2014 and 16 June 2014 (being a date not more than one month prior to the date of the Company's Notice of Annual General Meeting).

Registrar

All enquiries concerning shareholdings including notification of change of address, loss of a share certificate or dividend payments should be made to the Company's registrar. The Company's registrar, Capita Asset Services, can be contacted as follows:

Capita Asset Services
 Pennon Group Share Register,
 The Registry
 34 Beckenham Road, Beckenham
 Kent BR3 4TU

Telephone: **0871 664 9234** (calls cost 10p per minute plus network extras).
 Lines are open 8.30am – 5.30pm
 Monday-Friday.

Overseas telephone: **+44 800 141 2951**
 Email: **pennon@capita.co.uk**

Share dealing service

The telephone 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 **+44 (0) 131 240 0414** and quote: Pennon Group Dial & Deal Service. Commission is 0.5% (subject to a minimum charge of £17.50) 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 the Company's registrar, Capita Asset Services.

Individual Savings Accounts

By holding their shares in the Company in an Individual Savings Account (ISA), shareholders may gain tax advantages.

Scrip Dividend Alternative

Subject to obtaining shareholder approval at the 2014 Annual General Meeting both to the Company offering a Scrip Dividend Alternative and for the payment of a final dividend for the year ended 31 March 2014, full details of the Scrip Dividend Alternative, including how to join, will be sent out to shareholders on 22 August 2014. The full timetable for offering the Scrip Dividend Alternative is given on page 160. The Scrip Dividend Alternative provides shareholders with an opportunity to invest the cash dividend they receive on their Pennon Group Plc shares to buy further shares in the Company without incurring stamp duty or dealing expenses.

Online portfolio service

The online portfolio service provided by Capita Asset Services gives shareholders access to more information on their investments. Details of the portfolio service are available online at **www.capitashareportal.com**.

Electronic communications

The Company has passed a resolution which allows it to communicate with its shareholders by means of its website.

Shareholders currently receiving a printed copy of the Annual Report who now wish to sign up to receive all future shareholder communications electronically, can do so by registering with Capita Asset Services' share portal. Go to **www.capitashareportal.com** to register, select 'Account Registration' and then follow the on-screen instructions by inputting your surname, your Investor Code (which can be found on your Form of Proxy) and your postcode as well as entering an email address and selecting a password.

By registering to receive your shareholder communications electronically, you will also automatically receive your Dividend Tax Vouchers electronically.

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 via **www.capitashareportal.com**. Shareholders who register an email preference will not receive a paper proxy form. Instead they will receive an email alert advising them of general meetings of the Company, with links to the notices of meetings and annual and half yearly financial reports.

Pennon's website

www.pennon-group.co.uk provides news and details of the Company's activities plus links to its business websites.

The Investor information section contains up-to-date information for shareholders including comprehensive share price information; financial results; dividend payment dates and amounts; and RNS announcements. There is also a comprehensive share services section on the website which includes information on buying, selling and transferring shares; and on the action to be undertaken by shareholders in the event of a change in personal circumstances, for example, a change of address.

Beware of share fraud

The following is taken from the "Beware of share fraud" leaflet produced by the Financial Conduct Authority:

Fraudsters use persuasive and high-pressure tactics to lure investors into scams.

They may offer to sell shares that turn out to be worthless or non-existent, or to buy shares at an inflated price in return for an upfront payment.

While high profits are promised, if you buy or sell shares in this way you will probably lose your money.

How to avoid share fraud

1. Keep in mind that firms authorised by the Financial Conduct Authority (FCA) are unlikely to contact you out of the blue with an offer to buy or sell shares.
2. Do not get into a conversation, note the name of the person and firm contacting you and then end the call.
3. Check the Financial Services Register from **www.fca.org.uk** to see if the person and firm contacting you is authorised by the FCA.
4. Beware of fraudsters claiming to be from an authorised firm, copying its website or giving you false contact details.
5. Use the firm's contact details listed on the Register if you want to call it back.
6. Call the FCA on **0800 111 6768** if the firm does not have contact details on the Register or you are told they are out of date.
7. Search the list of unauthorised firms to avoid at **www.fca.org.uk/scams**
8. Consider that if you buy or sell shares from an unauthorised firm you will not have access to the Financial Ombudsman Service or Financial Services Compensation Scheme.
9. Think about getting independent financial and professional advice before you hand over any money.
10. Remember: if it sounds too good to be true, it probably is!

5,000 people contact the Financial Conduct Authority about share fraud each year, with victims losing an average of £20,000

Report a scam

If you are approached by fraudsters please tell the FCA using the share fraud reporting form at **www.fca.org.uk/scams** where you can find out more about investment scams.

You can also call the FCA Consumer Helpline on **0800 111 6768**.

If you have already paid money to share fraudsters you should contact Action Fraud on **0300 123 2040**.

Notes

Notes



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www.pennonannualreport.co.uk/2014

