South West Water

2018

South West Water
Annual Report and
Financial Statements

SOUTH WEST WATER LIMITED
ANNUAL REPORT AND
FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 2018

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CHAIRMAN'S STATEMENT

The Company is, once again, reporting a strong year with strong operational and financial performance underpinning our sector-leading Return on Regulated Equity (RoRE).

South West Water achieved overall outperformance against its Outcome Delivery Incentives (ODIs), resulting in a net reward of £2.6 million for the year. Regretfully, we failed to meet our targets for pollution control however a dedicated improvement programme is underway. This has already resulted in a 19% reduction since the start of the five year period (2015-20) and we are confident in our ability to reduce the number of incidents further during 2018/19.

We delivered high levels of service to our customers, improving our Service Incentive Mechanism (SIM) score. We also significantly enhanced the quality of our communication and engagement with our workforce. I welcome the way we have tackled improvements in safety and environmental incident management over the past year. Our new Vision and Values emphasise to employees and external stakeholders that we strive to be a trusted and responsible company delivering high-quality, resilient services in a safe, reliable and sustainable manner.

SAFETY

The Company treats the issue of safety very seriously and has taken steps to enhance its performance in this crucial area with the injection of fresh expertise at both Board and executive level. Safety continues to be the first item for discussion on the agenda of all Board meetings.

Jon Butterworth was appointed as a new independent Non-Executive Director of South West Water in September 2017. In the role of independent scrutineer of health and safety processes across the Group, he is giving us the benefit of his years of operational and safety experience gained in the electricity and gas industry.

During the year our Pennon Group Director of Health, Safety, Security and Assurance continued to lead the development of our HomeSafe programme, which is designed to deliver the highest standards of health and safety performance across the Group. The Board has given its whole-hearted support to HomeSafe and, following the successful completion of pilot schemes, the full roll-out throughout South West Water started in April 2018.

It is our ambition to deliver sector-leading performance in this area and South West Water continues to seek out and implement new technologies and ways of working that will protect our staff.

EMPLOYEES AND CULTURE

I firmly believe organisations that embody a clear sense of vision and purpose deliver significant, measurable results. Such organisations acquire and retain the best employees, deliver the most for customers and increase returns for shareholders.

Following last year's appointment of a Pennon Group Director of HR, we are seeing a refreshed dialogue with our workforce through a variety of initiatives. Our first Group-wide integrated employee survey has given us a tool for benchmarking our workplace culture against other companies. The most successful workplace cultures are built on trust and this is a key driver of engagement. Our corporate value of 'trusted' has particular resonance for all our stakeholders.

In addition to employing graduates, we have retained our emphasis on offering apprenticeships and have now employed our 149th apprentice, while recognising the need to continually train and develop our people in line with best practice. I would like to take the opportunity to thank all our employees for their dedication and hard work in serving our customers, communities and other stakeholders during 2017/18.

SUSTAINABILITY

As one of England and Wales' ten regional water and wastewater undertakers, we take our responsibilities to the environment and communities we operate very seriously. We are trusted to deliver clean drinking water and reliable removal and disposal of wastewater in an area with more than one-third of the UK's beaches. Performing all this to the benefit of the communities we serve and providing the consistent investment that underwrites this activity amounts to a significant social contribution.

As a sustainable business, we seek continuous improvement in our water and wastewater services, including in our ability to manage environmental incidents. Our Operations Director (Wastewater Services), who was appointed to this position on a permanent basis during the year and who is also the Pennon Group Environmental and Sustainability Director, is helping us to address environmental issues. There has been significant investment already in mitigating the risk of flooding and pollution and I am confident the Company will maintain this momentum.

Our record demonstrates that the Board is behaving in a responsible way towards all our stakeholders including our customers, our workforce, our suppliers and our other stakeholders. We are maintaining high levels of investment to ensure customers receive the best possible service, while controlling bills to households and providing support and assistance to those customers in vulnerable circumstances. We look to attract, develop and retain a highly skilled and customer-focused workforce, supported by our award winning apprenticeship programme. Our employees are trained to a high standard and we are investing in them to develop and enhance their careers within the Company and Group.

BOARD CHANGES

During the year, the Company appointed Jon Butterworth as a new independent Non-Executive Director and Matthew Taylor as Senior Independent Director. Under Pennon's governance structure, Jon and Matthew, alongside our other Non-Executive Directors, attend the Pennon Group plc board and are encouraged to contribute to a range of issues from a South West Water perspective.

GOVERNANCE

Our new governance structure has bedded in well and we have continued to refine Board processes. We have further enhanced the descriptions of our governance structure within both this Annual Report and our Annual Performance Report (published in July 2018).

The executive team has also shown dedication, drive and enthusiasm, and their transparency with the Board has been a highlight.

DIVERSITY

The Board and Company strongly support equality and diversity in the workplace and we have adopted the Pennon Group diversity and inclusion policy. We are committed to the search for Board candidates being conducted (and appointments made) on merit and with due regard for the benefits of gender and ethnic diversity. Following the single Board appointment during the year, the proportion of female Directors has decreased slightly to 20%.

More information on the Board's diversity policy can be found within the Nomination Committee's report, on page 72.

OUTLOOK: BUILDING ON SUCCESS, EARNING TRUST

Customer needs and priorities will continue to be the primary focus of our operations. We will continue to share with customers the rewards we receive for outperformance while working to maintain high standards of customer service.

South West Water remains on track to meet all its business plan commitments for the K6 period by 2020. Our Annual Performance Report (published in July 2018) will report in detail on the progress we have made against these targets and further plans for improvement. We have also ensured we are well prepared both operationally and in terms of cost effectiveness for the Price Review 2019 (PR19).

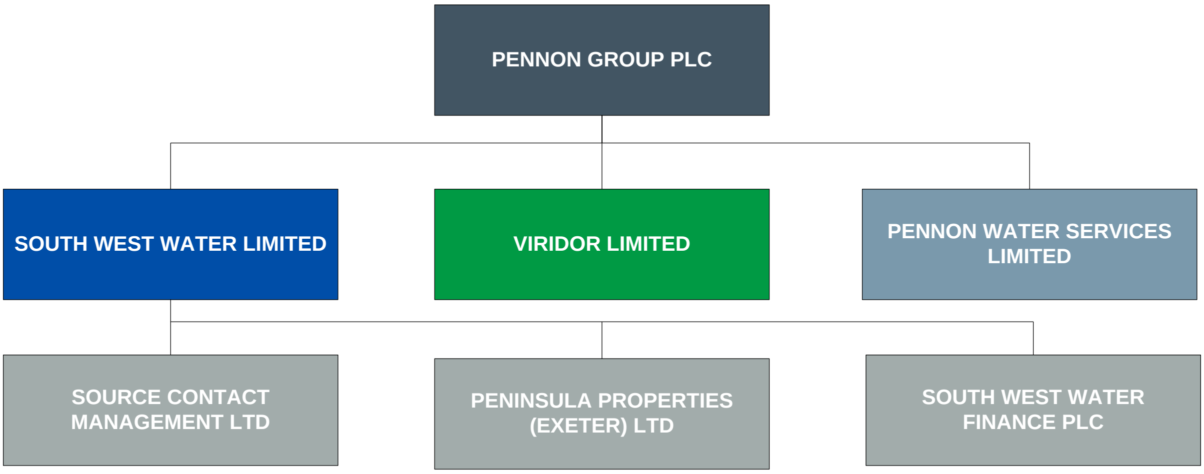
The successful merger of Bournemouth Water into South West Water has strengthened our operations. We are also currently in talks regarding extending our operational area to cover the Isles of Scilly.

South West Water continues to lead the sector in many areas, delivering RoRE outperformance through totex savings, financing with the lowest effective rates in the industry and achieving net ODI rewards. We are determined to sustain our outperformance momentum over the remaining K6 regulatory period, remain at the forefront of cost efficiency for the water sector and continue to share these benefits with our customers. This is a strong platform as we prepare for PR19 and develop our business plan for the next regulatory period 2020-2025. We are demonstrating a real commitment to engaging our customers and other stakeholders in this regard. While we expect PR19 to be challenging, South West Water is well placed to respond and to continue delivering truly outstanding services to customers.

We collaborate closely with our customers and have enhanced the way we engage with our workforce. We believe our strong organisational culture will give us a competitive advantage, deliver a high level of service to our customers and ultimately lead to outstanding business performance. Looking ahead, we have many successes upon which we can build as we apply our Pennon Group Vision of 'Bringing Resources to Life'. I am confident the Board, working together with the executive team and workforce, can ensure we continue to be not just a successful company, but a responsible and trusted one too.

SOUTH WEST WATER'S GROUP CONTEXT

South West Water Limited is a subsidiary of Pennon Group plc (which is South West Water's immediate and ultimate parent company), a FTSE 250 company, whose principal significant trading subsidiaries are shown below:



Note: this is a summary structure and excludes smaller, non-externally trading subsidiaries. South West Water's subsidiaries are described in note 16 (page 130).

SOUTH WEST WATER

South West Water provides regulated water and wastewater services across Cornwall, Devon and parts of Dorset and Somerset, water only services in areas of Dorset, Hampshire and Wiltshire (the Bournemouth Water area) and a small amount of non-appointed services. It is responsible for delivering the 2015-20 business plans in both the original South West Water area of operation and the Bournemouth Water area of operation.

South West Water provides retail services to residential (household) customers, however from 1 April 2017 no longer provides retail services to business (non-household) customers.

VIRIDOR

Viridor provides waste management services to UK residential and commercial customers including recycling, composting and energy recovery facilities.

PENNON WATER SERVICES

Pennon Water Services has provided retail services to non-household customers following the sale of South West Water's non-household customers and related assets on 1 April 2017.

Whilst part of the wider Pennon Group, South West Water has in place robust policies and practises to ensure full competition compliance with the market codes for the non-household retail market.

SOUTH WEST WATER'S SUBSIDIARIES

Source Contact Management manages South West Water's billing, collections and customer contact activities.

Peninsula Properties (Exeter) advises South West Water on property development opportunities.

South West Water Finance acts as a financing company for raising borrowings for South West Water.

SOUTH WEST WATER'S BUSINESS MODEL

OUR VISION

Bringing resources to life. Our vision is to lead the water industry. It is our job as a Company to live up to our values consistently with integrity and transparency.

OUR VALUES

TRUSTED

Trusted by our customers and stakeholders to deliver the services that households and businesses depend on in a fair, responsible and sustainable way.

COLLABORATIVE

Working collaboratively with customers, regional organisations and agencies, suppliers and other stakeholders to identify and implement new and improved ways of working.

RESPONSIBLE

Responsible leadership, governance and decision-making processes support the delivery of high quality services which bring positive social, economic and environmental benefits to the regions we serve.

PROGRESSIVE

To continually improve services we support a culture of innovation, utilising new technologies where appropriate in order to better meet our customers' needs and priorities.

OUR STRATEGIC FOCUS AREAS

In line with our vision to provide leadership in the UK water sector we focus on five strategic focus areas:

People and community	Finance and Economy	Water	Service	Environment
Supporting our people and local communities	Resilient business and service	Reliable, clean and safe supplies	Responsive to our customers' needs and priorities	Environmentally sustainable actions and initiatives

THE VALUE WE DELIVER – FOR THE BENEFIT OF OUR STAKEHOLDERS

Customers – Our high quality services support households and businesses in the regions we serve.

Shareholders and investors – Our strong business model ensures shareholders and investors get a fair return.

Regulators and other stakeholders – Our strong engagement with regulators and key stakeholders ensures clear visibility of our business approach.

Employees – Our employees are highly valued and are key to our success. Their safety is paramount.

Suppliers and contractors – The relationships we have with our suppliers and contractors are fair and deliver many regional economic benefits.

OUR PEOPLE

During the year a new people strategy and a new vision ‘Bringing resources to life,’ as well as the HomeSafe programme, were introduced.

PEOPLE STRATEGY

This was the first year of a new our people strategy **’talented people doing great things for our customers and each other’**. This Group-wide strategy has six threads: leadership; culture; people processes; compliance; training and talent which are helping us to focus more than ever on being a place where people enjoy working.

As part of our commitment to improve two-way communications with our workforce, we asked our people across the Company what they feel makes us unique as a business and what motivates them. We complemented this with sessions involving the leadership team, our employee survey data and external benchmarking. The results showed we had much in common across the Company and Group in terms of what we value and a shared sense of purpose in the work we do. This insight allowed us to develop a new Vision Statement: ‘Bringing resources to life’ with its associated values of ‘trusted, collaborative, responsible and progressive’. Work to embed our new Vision and Values and engage employees, customers and other stakeholders is underway.

WORKFORCE ENGAGEMENT

Involving our staff in the decisions we make helps us deliver the right business solutions. A company can only be as good as its people and the HR team is finding new ways to enhance employees’ voice so that our people feel empowered.

South West Water employees again participated in an employee survey, which was carried out on a Group-wide basis for the first time. We were pleased to see a high response rate within the Company of 85% with a Trust Index© score of 63% and an Engagement Score of 74%. Our Trust Index© is above the UK national average, but below the 70% threshold for being considered a ‘Best Workplace’. The survey identified clear strengths in communication and involvement, trust, diversity, empowerment and accountability. It also revealed areas requiring further work. These include continuing to ensure our people understand our strategy and direction, as well as maintaining focus on embedding our values into everything we do, while recognising the contribution made by our employees.

Other initiatives include ‘The Big Chat’, a Pennon Group-wide quarterly event which gives employees the chance to put questions to the Pennon Executive, which includes South West Water Directors, and the well established staff council, which includes representatives from across the business. An open, transparent and safe working environment, where workers feel able to speak up and are supported if they do so, is encouraged by ‘Speak Up,’ our whistleblowing policy.

HEALTH AND SAFETY

As well as launching HomeSafe in 2017, we continue to look to strengthen other areas of our health and safety (H&S) approach. New training for supervisory staff and safety behavioural training for our front line employees have been undertaken. We also created a broader set of H&S indicators to improve management information and insights, and safety performance. We have introduced a new measure of safety performance, the lost time injury frequency rate (LTIFR). In addition to recording RIDDOR injuries and ill health cases, we now also record lost time injuries (a lost time injury is defined as any work related injury that results in a person being unfit for work on any day beyond the day of the incident). This broader data set allows for a better understanding of injury causes and allows us to benchmark against other companies across many sectors. We recorded 25 lost time injuries in 2017, a 34.2% reduction compared with 2016.

For 2018, we will review the current safety performance measures to ensure they remain the most appropriate.

Further enhancement to the way we record and report H&S events include introducing a new Incident Management System and associated standards and processes to provide better, more accessible, real-time data, allowing further insights and actions to aid learning and prevention.

South West Water is implementing a programme aimed at becoming certified to the new ISO45001:2018 Occupational Health and Safety standard in 2019.

EMPLOYEE TRAINING AND DEVEOLPMENT

We remain committed to investing in the development of our staff and want to recognise talent across the Company. We support employees at all levels through training and development, helping to increase productivity, job satisfaction and safety, as well as developing our next generation of leaders by encouraging people to develop their knowledge, skills and competencies. The government’s apprenticeship reforms and introduction of the apprenticeship levy are helping us prioritise development for new and existing employees to address key skills shortages.

CODE OF CONDUCT

In June 2017, the new Pennon Code of Conduct was introduced and adopted across South West Water. To ensure everybody has the same understanding of what the new Code means, all employees were required to complete an e-learning module. This was followed by ancillary training on anti-bribery and anti-corruption, and the acceptance of gifts and hospitality to ensure we have strong compliance across the Group. Training on the Code and our legal compliance policies is compulsory for all our workers.

OPERATIONAL TRAINING

Many front-line operational roles are regulated and supported by high-quality training standards. Training is accredited and reviewed periodically to ensure high standards are maintained and we keep a register of personal training and skills undertaken.

DIVERSITY AND EQUAL OPPORTUNITIES

The Board continues to promote equality of opportunity and diversity across the Company in all areas, including gender and ethnicity. This remains a key area of focus – see the Nomination Committee report page 72 for further details. In line with all companies with 250 or more employees, we published details of our gender pay gap for the first time, with the mean average pay gap of 4.0%, which is more favourable than the national average.

GENDER DIVERSITY

Female membership %		
	2017/18	2016/17
The Board	20	22
Executive Management Team	25	33
Senior Management	18	20
Company	22	23

Note: Senior Management includes members of the Executive Management.

As at 31 March 2018 and as disclosed with the Directors' biographies on page 41 to 44, two of South West Water's Directors are female and therefore South West Water had 20% female representation at Board level, a decrease from the 22% female representation at 31 March 2017 following the appointment of an additional Non-Executive Director.

While circumstances on occasion will result in changes in Board composition and a lower than targeted female representation percentage, the Board is committed to moving towards a minimum of 25% female representation.

The proportion of female members at Senior Management level has decreased from 20% to 18% and female representation in the Company as a whole has decreased from 23% to 22%. We do not consider these reductions as representative of a long term trend and we are committed to improving diversity with a particular focus in areas of under-representation.

OUR OPERATIONS

We are focused on providing services in the most efficient and sustainable way possible. Innovation, new technologies and the adoption of an holistic approach underpins our commitment to delivering service improvement and long-term value.

KEY FACTS

- 2.2m total population served
- 1.0m customers served
- 23 raw water reservoirs
- 34 water treatment works
- 18,233km of drinking water mains network
- 651 wastewater treatment works
- 17,439km wastewater mains network
- 144 bathing waters (assessments carried out at 143) and 24 shellfish waters

We continued to deliver strong performance in 2017/18, providing high-quality drinking water, beating our leakage targets, driving improvements in our environmental standards and delivering improvements in customer service. We are confident in our preparations for the 2019 Price Review (PR19).

SECTOR-LEADING OUTPERFORMANCE

We continued to deliver sector-leading performance in 2017/18, with a cumulative return on regulated equity (RoRE) of 11.8%. This industry-leading performance comprises 6.0% as the base return, 2.6% total expenditure (totex) savings and efficiencies, 0.3% as a net reward on Outcome Delivery Incentives (ODIs). The remaining 2.9% reflects the difference between actual and assumed financing costs using a cumulative forecast retail price index (RPI) inflation over K6 of 2.8%, consistent with the way we calculate our innovative WaterShare mechanism. For 2017/18 the in-year RoRE performance was 11.1%, reflecting performance above 11% in each year of K6 to date.

TOTAL EXPENDITURE SAVINGS

During 2017/18, we continued to deliver further efficiencies and cost savings with £177 million of cumulative totex savings in the first three years of K6 (2015-2020). We expect to remain at the forefront of cost efficiency in the water sector.

We use new technology, innovative processes, training and equipment to deliver both water and wastewater improvements. Savings are driven by continuing advantages from our strategic alliances including a new water distribution framework and the H5O capital alliance. We are ensuring efficient capital investment through the use of data analytics, optimising capital and operating solutions while promoting efficient off-site build techniques.

The integration of Bournemouth Water continues to drive efficiencies, including delivery of key capital schemes in the region.

ODI REWARDS

Overall, our operational performance is ahead of our committed performance levels, resulting in continued net reward in ODI despite challenges from the cold weather in March 2018.

Operational performance for the full-year resulted in a net ODI reward of £2.6 million (£8.1 million cumulatively over three years of K6), reflecting annual equivalent RoRE outperformance of 0.3% to date.

We maintained good asset reliability and stable serviceability across all water and wastewater areas and received rewards for bathing water quality and water restrictions. Following improvements in external sewer flooding from last year, we received a reward for performance this year.

The cumulative net reward of £8.1 million comprises £10.4 million of rewards recognised at the end of the regulatory period and £2.3 million of net penalty which may be reflected during the regulatory period. Pollution events in wastewater, while improving, continue to be higher than the levels to which we have committed and we are targeting further improvements over the remaining regulatory period.

DELIVERING EXCELLENT CUSTOMER SERVICE

We aim to deliver the highest levels of customer service. South West Water's overall customer satisfaction score remains strong at 91% (2% higher than 2016/17), along with value-for-money satisfaction which also increased.

South West Water achieved its highest ever Service Incentive Mechanism (SIM) score of 85 while Bournemouth Water's SIM score of 88 remains one of the best in the UK. The SIM score is calculated using a qualitative element (based on customer surveys) and a quantitative element including the number of complaints received in writing or by phone. Complaints have halved since 2011 with written complaints down again in 2017/18 following the c.30% reduction in 2016/17.

During 2017/18 we introduced a number of proactive customer service improvements. These included the in-house development of our 'voice of the customer'(VoC) technologies, designed for use as a transactional (retail) survey and customer engagement tool innovatively adapted to fit with the unique needs of the wholesale area of our business. The technology has helped us increase the speed and quality of our responses through a more proactive, tailored approach. In conjunction with a wide-ranging number of process, people, technology and customer service improvement initiatives implemented during the year, this has seen South West Water achieve a larger in-year increase in its Customer Experience Survey score (which is an industry comparison of customer service) than any other water company.

In April 2018, South West Water received accreditation from the Institute of Customer Service (ICS). ServiceMark is a national standard recognising an organisation's achievement in customer service and its commitment to upholding those standards. This is a key development because the next generation of Ofwat's SIM mechanism – its customer experience measure known as CMeX (customer measure of excellence) – is likely to be based on the ICS metrics and principles.

A cornerstone of our customer service strategy is to ensure affordable bills and help customers in vulnerable circumstances. We introduced a new social tariff into the Bournemouth region during the year and now assist approximately 51,000 customers through a variety of support schemes across both regions.

WATERSHARE

Our unique WaterShare scheme identified £6.1 million of customer benefits during the year, in addition to the £4.0 million identified in 2016/17. The independent WaterShare customer panel scrutinises our performance against the current business plan and reviews and challenges our recommendations on how any benefits should be shared with customers. It recommended that the £4.0 million should be deferred to facilitate investments planned later in the regulatory period. The WaterShare panel will consider how to apply the 2017/18 benefit following customer research later in the year.

Net ODI penalties (for the first two years of K6) valued at £2.1 million, which apply in the current regulatory period, have been passed back to customers through a reduction to their bills in 2018/19.

WATER

We continued to maintain the high standards of drinking water quality achieved last year. South West Water's leakage performance at 83 megalitres per day was ahead of our target and resulted in a reward for the year. Bournemouth Water's leakage performance of 19 megalitres per day was also better than its target. These results reflect our continued investment in real-time pressure management and additional network monitoring and effective repairs.

South West Water achieved its 21st consecutive year of unrestricted water supplies, while the Bournemouth Water region has had no water restrictions since privatisation. This is a result of prudent water resource management, keeping leakage under control and high levels of water meter adoption, which helps customers to manage their consumption. Our long-term draft water resource management plan, published in 2017, includes a stress-tested forecast surplus of supply over demand.

The average duration of supply interruptions per property for South West Water was higher than last year as a result of the extreme cold weather in early March 2018. This resulted in a penalty of £0.9 million.

INVESTMENT IN INFRASTRUCTURE

Investment into key drinking water projects continued during the year to assist in maintaining water quality and reducing supply interruptions. This work includes improving water mains in the Plymouth area as well as our £60 million investment in the innovative Mayflower Water Treatment Works at North Plymouth, which is due to become operational in Autumn 2018. We also completed improvements at three water treatment plants in Devon:

- a £6 million programme at Tottiford Water Treatment Works
- a £6.3 million project at Northcombe Water Treatment Works
- a £5.7 million upgrade of Tamar Lakes Water Treatment Works.

All three use Granular Activated Carbon filtration and UV disinfection. We continued to invest in real-time pressure management and network modelling technology to reduce supply interruptions.

WASTEWATER

We aim to ensure the safe and efficient removal and disposal of wastewater, while minimising the likelihood of sewer flooding or pollution affecting homes, businesses or the environment.

Wastewater treatment improvements were again a focus this year along with increased monitoring to improve our ability to prevent potential failures. A good example is our £5 million investment in wastewater treatment in Fluxton, East Devon, which was completed in January 2018.

Although our numeric compliance was slightly down on the previous year's 98.4%, the underlying performance shown by lead indicators and our internal monitoring results continue to improve.

PROTECTING THE ENVIRONMENT

Investment to continue improving environmental performance saw a reduction in overall pollution incidents during the year. While performance still needs to improve, and we incurred a penalty this year, we made good progress and anticipate further improvements in 2018/19.

During the year, a thorough analysis of our historical performance regarding pollution incidents and their root causes was undertaken. New predictive computer models anticipate where blockages might arise and locates them before they become an issue. South West Water is investing in improvements at wastewater treatment works and pumping stations. New capabilities for assessing and clearing sewage network blockages are being introduced in addition to training aimed at increasing understanding among employees of the causes and impacts of pollution incidents.

We also continue to promote responsible sewer usage with our customers through initiatives such as 'Think Sink' and 'Love your Loo.'

In April 2018, South West Water was longlisted for the Environmental Sustainability Award as part of Business in the Community's Responsible Business Awards 2018.

INVESTMENT IN WASTEWATER INFRASTRUCTURE

Wastewater activity during the year included a £20 million investment in Plymouth to improve the already high level of bathing water quality. We created extra storm storage in the sewage network helping to reduce the risk of spills into Plymouth Sound, while protecting the already excellent water quality against extreme rainfall events in the future. The project includes construction of our largest ever ultra-violet disinfection facility for storm water and represents the largest single wastewater investment in the current K6 programme.

We improved water quality at eight shellfish harvesting areas on major estuaries in Devon and Cornwall and investment in providing higher capacity and better resilience at our wastewater treatment works, including Hayle in Cornwall is ongoing, while monitoring of our network during weather events has been enhanced.

Our positive results for the 2017 bathing water season, assessed under EU standards, reflect a sustained programme of major investments to protect bathing waters. Of the 143 bathing waters assessed in the South West Water region, 140 (98%) were classified as 'sufficient' or better, with 75% qualifying as 'excellent'. None of the three bathing waters rated as 'poor' were attributed to any failure of South West Water's assets.

We continue to reduce the risk of flooding to customers through numerous improvements to our sewage system in a range of locations, including Totnes and Paignton.

CUSTOMER ENGAGEMENT FOR PR19

In September 2018 South West Water will submit its business plan for the 2020-25 period to Ofwat as part of PR19.

In support of PR19 business planning, the company has carried out its largest programme of customer research and engagement to date, including inviting all customers to 'have their say' on business proposals published for consultation in March 2018 through traditional and digital channels, including social media. Feedback has been received from over 22,000 customers.

WHOLESALE SERVICES

South West Water successfully entered the Non-household Market on 1 April 2017 and now works with more than 16 different retailers (including Pennon Water Services (PWS)), and our wholesale service desk has been operating effectively. As a wholesaler in this new market, we welcome the opportunity to facilitate competition.

OUR COMMUNITY

As one of the largest companies in the region, South West Water provides services that are essential for the area's economic sustainability, supporting the employment of some 5,000 people either directly or indirectly through our supply chain. We engage with local communities through a range of activities including our own events, support for events run by our partners and fundraising for charities. Our community outreach also includes public information campaigns including 'Think Sink!' and 'Love Your Loo', and customer consultations such as our 'Get Into Water' programme as part of our PR19 work.

SPONSORSHIP AND CHARITABLE PARTNERSHIPS

In 2017/18, South West Water provided £97,000 of community sponsorship and supported a number of charities. Sponsorships included BeachCare with Keep Britain Tidy, Cornwall Wildlife Trust, Devon Wildlife Trust, South West Coast Path Association, Surf Life Saving GB and Beach Schools South West. Our charity activity was on behalf of Age UK Cornwall, Age UK Devon, Cornwall Air Ambulance Trust, Devon Air Ambulance Trust, Devon and Cornwall Food Action and the RNLI.

ACCESS AND RECREATION

Our partnership with South West Lakes Trust ensures that our reservoirs and landholdings are managed for environmental improvements and for the benefit of our customers and communities. During the year we welcomed over two million visitors to our recreational estate. There was a big focus on health and wellbeing with 70,000 people benefitting from health enhancing outdoor activities at the lakes and 5,000 people learning new skills as the Trust delivered training workshops in watersports, environmental and heritage education.

REPORT OF THE FINANCE DIRECTOR – FINANCIAL REVIEW

OVERVIEW

South West Water had another year of strong financial performance in 2017/18 reflecting continuing outperformance against our 2015-20 business plan.

The Company, including the merged Bournemouth Water, continues to deliver and outperform the sector leading business plan targets for the current K6 regulatory period and achieved a Return on Regulated Equity (RoRE) of 11.1% for the year (11.8% cumulatively). This result is achieved through outperformance spread across total expenditure (totex) savings, financing with the lowest effective rates in the industry and delivery of net ODI rewards; and through the unique 'Watershare' mechanism the benefits of outperformance are being shared with our water customers. £79 million has been identified for sharing with customers to date.

Within the context of totex outperformance of £177 million to date in K6, South West Water is also delivering on its targeted capital expenditure programme with a major investment in the innovative new water treatment works 'Mayflower' for Plymouth now nearing completion, investment in Plymouth Bathing Waters where specific improvements are maintaining the high level of bathing water quality in that area and improvements at three other water treatment works including the installation of Granular Activated Carbon 'GAC' filtration technology.

With Ofwat's PR19 Price Review widely anticipated to be challenging to the industry (with the Final Methodology signalling reduced allowed returns, but with strong operational and customer service incentives for good performing companies) South West Water is making good progress with its 2020-2025 (K7) business plan. During the year the WaterFuture 2050 plan was published setting out our vision and strategy over the long term. The Company's multi-channel customer engagement campaign 'Get into Water' is well underway and a formal customer consultation was launched on 1 March 2018. In developing its detailed plans the business is confident in its ability to remain at the frontier of cost efficiency for the water sector and is focused on maintaining the momentum on cost savings and financing outperformance that it has already built up.

South West Water has benefitted from a Group-wide focus on driving greater efficiencies and savings across the group, sharing best practice and ensuring it is well placed to capitalise on emerging opportunities. For example as a net user of electricity, South West Water takes advantage of the natural hedging opportunity for some of Virdor's energy generation. The Group's Shared Services Review is also on track and is delivering savings to South West Water.

We see consolidation as a sustainable way to deliver greater efficiency, lower bills and deliver benefits for customers. This has been demonstrated through the merger of Bournemouth Water operations into South West Water with c.£27 million of cumulative synergies targeted by 2020, of which c.£16 million has already been delivered through a 25% reduction in back office costs and sharing best practise improving performance.

Balancing operational risk and reward remains a key component of our financial and business strategy. Across our operations, we are successfully reducing risk by overlaying our long-term assets with continuing commercial arrangements and supporting these with long-term financing including in respect of new investments.

During the year our interest rate on average net debt remained low at 3.5% and at 31 March 2018 South West Water continued to have a strong funding position with £590m of cash and committed facilities.

STATUTORY FINANCIAL PERFORMANCE

NON-HOUSEHOLD RETAIL MARKET

On 1 April 2017 following the opening of the non-household retail market, South West Water exited this activity with Pennon Water Services, a fellow Group subsidiary, purchasing the non-household debtor book and related assets together totalling £31.9m for equal consideration of £31.9m. The revenue for 2016/17 was £5.7m with an EBITDA and profit before tax of £1.5m.

South West Water's statutory results show growth in profit before tax to £179.8 million (2016/17: £172.9 million) reflecting sector leading efficiencies. For 2017/18 there were no underlying items to disclose. In 2016/17 the statutory results included the impact of a £0.5m charge to operating costs and a tax credit of £14.4m for the reduction in future headline corporation tax rates.

REVENUE

Total revenue has increased by 1.8% to £572.8m primarily due to net tariff increases of 2.5%[1] and a small increase in customer demand of 0.2% from drier weather and increased developer activity. This increase in revenue is above the regulatory tolerance levels and will result in a penalty of £0.8 million.

82% of our household customers in the South West area are now benefitting from a metered supply, with 6,756 customers opting for a meter in 2017/18 (2016/17: 7,700). 71% of households in the Bournemouth Water region are metered with 903 switching in the year (2016/17: 2,100).

EBITDA

Underlying earnings before interest, tax, depreciation and amortisation (EBITDA) were 3.4% ahead of 2016/17 at £360.5 million (2016/17: £348.6 million). Underlying operating profit increased by 5.2% to £247.1 million (2016/17 £234.8 million) and underlying profit before tax increased by 3.7% to £179.8 million (2016/17: £173.4 million).

As described above, net tariff rises and increased customer demand net of meter switchers has driven an increase in revenue. Operating costs decreased slightly following South West Water no longer providing non-household retail services (2016/17 non-household retail operating costs: £4.7m). The underlying increase in operating costs is less than the 3.7% inflation for the year following targeted efficiencies and other savings as well as further efficiencies following the merger of Bournemouth Water. In addition, South West Water's bad debt performance remains strong with a charge of 0.8% of revenue (2016/17: 1.1%), reduced from 1.7% at March 2015. This continues to be driven by efficient collections as we work with our customers to manage their debt and strive to support those customers in vulnerable situations with affordability challenges.

South West Water has continued to record strong performances against the K6 regulatory contracts, outperforming regulatory assumptions resulting in a cumulative RoRE of 11.8%.

We continue to look to efficiently manage and optimise value from our estates portfolio, recognising a profit on sale of assets in the year of £2.4 million (2016/17: £2.1 million).

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[1] Tariff increase reflects the net position post wholesale revenue forecast incentive mechanism (WRFIM) pass back of £10.9 million.

OPERATING COSTS (BEFORE NON-UNDERLYING ITEMS)

Operating costs for the year totalled £325.7 million. The most significant areas of expenditure were:

Expenditure	**£m**
Employment costs	45.3
Depreciation	112.9
Business rates	28.5
Raw materials and consumables (excluding transport costs)	16.6
Trade receivables impairment	4.7

NET FINANCE COSTS

Underlying net finance costs of £67.3 million were £5.9 million higher than last year (2016/17: £61.4 million). This is primarily due to higher RPI (3.3% at March 2018) and higher net debt from continuing capital investments.

We have secured funding at a cost that is efficient and effective. RPI funding represents approximately 25% of borrowing resulting in higher interest costs as inflation rates have risen, but at 3.5% the Company interest rate on average net debt for 2017/18 remains sector leading (2016/17: 3.3%).

PROFIT BEFORE TAX

South West Water's underlying profit before tax was £179.8 million, an increase of 3.7%, compared with the prior year (2016/17: £173.4 million). On a statutory basis, profit before tax was £179.8 million (2016/17: £172.9 million) reflecting a net non-underlying charge before tax of £0.5 million in 2016/17.

TAXATION

The Company's mainstream UK corporation current tax charge for the year (including prior year adjustments) was £25.8 million (2016/17: £31.6 million), reflective of an effective tax rate of 14.3% (2016/17: 18.2%). The lower effective rate of taxation reflects the level of capital allowances claims on its increased capital expenditure.

The Company had a current tax asset of £0.7 million at 31 March 2018. Tax is payable in four quarterly instalments, two are payable in the financial year and two payable in the subsequent year. We paid £38.7 million in tax in 2017/18 relating to 2016/17 and 2017/18.

Underlying deferred tax for the year (including prior year adjustments) was a charge of £5.6 million (2016/17: £5.5 million). The charge for 2017/18 primarily reflects capital allowances in excess of depreciation charge. In the prior year there was a non-underlying £14.4 million deferred tax credit relating to the enacted reduction in the UK rate of corporation tax to 17% in 2020.

Overall the total tax charge for the year was £31.4 million (2016/17: £22.7 million).

DIVIDENDS AND RETAINED EARNINGS

The statutory net profit attributable to ordinary shareholders of £148.4 million has been transferred to reserves.

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

- a sustainable level of base dividend growth, determined by a number of factors including the shareholder's investment and the cost of capital
- a further level of growth funded by efficiency outperformance
- comparison with the assumptions made by Ofwat in setting prices for the regulatory period.

Dividend payments are designed to ensure that key financial ratios are not prejudiced, whilst also taking into account balance sheet considerations.

Payments are also designed to ensure that the ability of the Appointee to finance its Appointed Business is not impaired. Dividends of £120.3m were paid to the parent undertaking (2016/17: £213.1m), representing a base dividend of £55.2m and £65.1m of outperformance dividend based on cumulative performance for 2016/17.

The dividend was calculated with reference to the projections in the Ofwat 2014 Final Determination and the assumptions for 2017/18 included within the 2015-20 Business Plan.

CAPITAL INVESTMENT

Capital investment was £184.0 million in 2017/18 compared to £190.9 million in 2016/17. The key areas of focus remain:

- improved drinking water quality
- ensuring a high level of bathing water
- delivering environmental improvements (including a targeted strategy to reduce pollution incidents)

Key large schemes during the year included:

- the innovative Mayflower Water Treatment Works at North Plymouth with c. £28 million of expenditure in 2017/18 (2016/17 c.£27 million) and total cumulative expenditure of £60m.
- investment in Plymouth Bathing Waters, delivering targeted improvement to maintain the high level of bathing water quality in that area
- improvements at three water treatment works including the installation of Granular Activated Carbon 'GAC' filtration improving water quality

South West Water continues to deliver capital projects in line with Ofwat, Drinking Water Inspectorate and Environment Agency expectations.

CASH FLOW

South West Water's operational cash inflows in 2017/18 at £267.2 million were £15.1 million higher than last year (2016/17: £252.1 million). These funds have been put to use in efficiently financing the Company's capital structure and investing in future growth, through our substantial continuing capital investment programme. This investment has resulted in higher net debt.

On 1 April 2017, following the opening of the market, South West Water sold its non-household retail net customer book and related assets together totalling £31.9m to Pennon Water Services for consideration of £31.9m.

Corporation tax payments were £38.7 million. Total tax payments reflecting all taxes borne by the Group in 2017/18 are described in more detail in the section on 'Tax Contribution–borne/collected' on page 21.

LIQUIDITY AND DEBT PROFILE

South West Water has a strong liquidity and funding position with £586.9 million of cash and undrawn facilities at 31 March 2018. This consists of cash and deposits of £226.9 million (including £180.4 million of restricted funds representing deposits with lessors against lease obligations) and undrawn facilities of £360 million. At 31 March

2018 the Company's borrowings totalled £2,295.0 million. After the £226.9 million held in cash, this gives a net debt figure of £2,068.1 million, an increase of £34.3 million during the year (2016/17: £2,033.8 million).

South West Water has a diversified funding mix of 60% fixed, 15% floating and 25% index-linked borrowings. The Company's debt has a maturity of up to 40 years with a weighted average maturity of 23 years matching the asset base. Some of the Company's debt is floating rate, with derivatives being used to fix the rate on that debt. The Company has fixed, or put swaps in place to fix, the interest rate on a substantial portion of the existing debt for the entire K6 period, in line with the policy to have at least 50% of funding fixed before the start of a regulatory period.

£505.8 million of South West Water's debt is index-linked at an overall real rate of under 2.0%. As a result of the aforementioned initiatives, South West Water's cost of finance is among the lowest in the industry. Around two thirds of the net debt is from finance leases, providing a long maturity profile to its debt. Interest payable on them benefits from the fixed credit margins, which were secured at the inception of each lease. A quarter of the net funding for the water business is RPI linked, a level below Ofwat's notional level of 33% leaving headroom for RPI to CPIH transition.

At 31 March 2018 the fair value of the Company's non-current borrowings was £35.3 million more than its book value (2017 more than £54.5 million) as detailed in note 22 to the financial statements. This reflects the benefit of securing interest rates below the current market rate, offset by volatility in inflation markets.

CAPITAL STRUCTURE – OVERALL POSITION

The Company's net debt has increased by £34.3 million to £2,068.1 million. Cash inflow from operations was a strong £264.6 million. Cash outflows relating to the capital programme totalled £195.2 million, with 2016/17 and 2017/18 representing peak years for the Company's capital expenditure during the K6 regulatory period. The gearing ratio at 31 March 2018, being the ratio of net debt to (equity plus net debt) was 76.9% (31 March 2017 78.3%).

The combined South West Water and Bournemouth Water debt to RCV ratio is 60.3% (31 March 2017 61.8%), which aligns with Ofwat's K6 target for efficient gearing of 62.5%.

	2014	**2015**	**2016**	**2017**	**2018**
Regulatory capital value as at 31 March (£m)	2,959	2,928	3,150	3,291	3,431

The increase in RCV reflects planned capital investment during the year and the increase in the Retail Prices Index (RPI) during the year.

South West Water utilises the role of the Pennon Group's treasury function to ensure it has the funding to meet foreseeable needs, to maintain reasonable headroom for future contingencies and to manage interest rate risk. 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 following 12 months. These are intended to be met for the coming year from existing cash balances, loan facilities and operating cash flows.

The Pennon 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 it are not available as long-term funding for other areas of the Pennon Group.

TAXATION STRATEGY

South Water has adopted the Pennon Group plc tax strategy. This means that we will:

- At all times consider the Company's corporate and social responsibilities in relation to its tax affairs
- Operate appropriate tax risk governance processes to ensure that the policies are applied
- Comply with our legal requirements; file all appropriate returns on time and make all tax payments by the due date
- Consider all taxes as part of ongoing business decisions
- Not enter into artificial tax arrangements or take an aggressive stance in the interpretation of tax legislation
- Not undertake transactions which are outside the Company's low risk appetite for tax or not in line with the Pennon Group's Code of Conduct
- Engage with HMRC in a proactive and transparent way and discuss our interpretation of tax laws in real-time, such interpretations following both the letter and spirit of the laws.

The Company's approach to tax planning, risk management and governance is in line with the Finance Act 2016 requirements; the Company does not expect its tax strategy to change significantly year on year, however it is reviewed and updated annually.

Further details are given in the Group's Tax Strategy document which is available on the Pennon Group website.

TAXATION CONTRIBUTION (BORNE/COLLECTED)

The Company's total tax contribution extends significantly beyond the UK corporation tax payments.

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

- Value Added Tax (VAT) of £40.8 million recovered (2016/17: £44.3 million) by South West Water from HMRC. VAT has no material impact on profit before tax.
- Business rates of £28.5 million (2016/17: £26.4 million) paid to local authorities. This is a direct cost to the Company and reduces profit before tax.
- Employment taxes of £14.3 million (2016/17: £13.7 million) including employees' Pay As You Earn (PAYE) and total National Insurance Contributions (NICs). This is a direct cost to the Company and reduces profit before tax.
- Fuel Excise Duty of £0.9 million (2016/17: £0.7 million) related to transport costs. This reduces profit before tax.
- Payments to Environment Agency and other regulatory bodies total £9.8 million (2016/17: £9.7 million). This reduces profit before tax.
- Carbon Reduction Commitment (CRC) payment for the Company of £2.2 million (2016/17: £2.1 million). This reduces profit before tax.

The corporation tax rate for 2017/18 used to calculate the current year's tax is 19% and will reduce to 17% for the year ending 31 March 2021.

PENSIONS

The Company is a member of the Pennon Group's defined benefit pension schemes for certain employees of South West Water. The main defined benefit schemes were closed to new entrants on or before 1 April 2008.

At 31 March 2018 the Company's share of the pension schemes showed an aggregate deficit (before deferred tax) of £22.6m (2016/17: £32.3m). This decrease is primarily due to the remeasurements in financial assumptions during the year.

INSURANCE

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

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

- self-insurance – pay a moderate excess on most claims
- cover by the Pennon 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.

RISK REPORT

RISK MANAGEMENT AND INTERNAL CONTROL FRAMEWORK

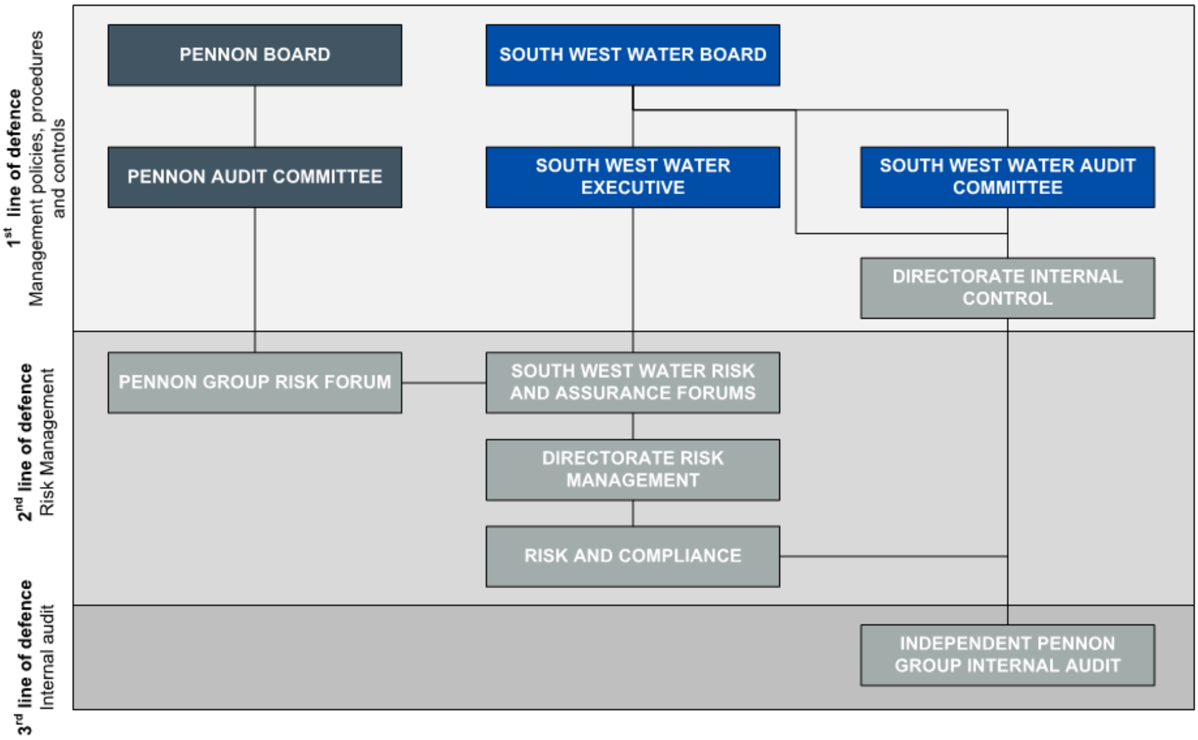
South West Water faces a variety of risks which, should they arise, could materially impact our ability to achieve our strategic objectives. Effective management of these existing and emerging risks is, therefore, essential to the long term success of the Company.

Pennon has a mature Group-wide integrated risk management framework (as described on the following page) which is fully embedded into our governance structures and culture and helps us to live up to our values of 'trusted' and 'responsible' in the way we carry out our business. Our risk management approach incorporates both 'top down' and 'bottom up' processes, ensuring a common understanding of the risks and opportunities that the Company is exposed to and how they may impact upon the achievement of our strategic priorities.

A consistent methodology is applied to the identification, evaluation and management of the Company's principal risks which considers both the likelihood of the risk occurring over a five year period and the potential impact from a customer and other stakeholder, financial, management effort and reputational perspective. Principal and other risks are captured in risk registers which are regularly reviewed and challenged, including at the Company's quarterly Risk and Assurance Forums.

South West Water seeks to reduce its risk exposure, in line with the desired risk appetite and tolerance levels, through the operation of a robust internal control environment which is aligned to the "three lines of defence" model, shown below. The Board, via the Audit Committee, obtains comfort over the effectiveness of the internal control environment through the reporting of outcomes from a variety of internal and external assurance providers, including an independent internal audit function.

RISK MANAGEMENT FRAMEWORK



The key elements of the Group’s risk management process include:

		Key Risk Management Responsibilities	Key Assurance Activities
FIRST LINE OF DEFENCE	**Board**	• Sets the Company’s strategic objectives • Establish the Company’s risk appetite • Determine the Company’s principal risks • Ensure an effective internal control framework	• Quarterly reviews of the Company’s principal risks against the determined risk appetite
	Audit Committee	• Review the effectiveness of the risk management framework • Review the adequacy of the internal control framework	• Performing quarterly ‘deep dive’ reviews on principal risks • Reviewing the Group Internal Audit Plan in respect of South West Water • Receive reports on the outcomes of key assurance activities
	Executive Management	• Day to day management of the principal and operational risks • Establish the relevant risk management processes and procedures • Maintain the internal control framework	• Perform a thorough quarterly appraisal of the Company’s risk profile • Monitor the Company’s performance against ODI/performance commitments and other KPIs • Establishing and reviewing policies, procedures and delegated authorities
SECOND LINE OF DEFENCE	**Group Risk Forum**	• Provide review and challenge over subsidiary / functional principal risks and mitigation strategies • Alignment of the ‘top down’ and ‘bottom up’ risk management process • Horizon scanning on emerging risks and opportunities	• Review of principal risks on a quarterly basis • ‘Deep dive’ reviews of specific risks. Topics include: Cyber Security, Renationalisation, Health and Safety and Financial Markets and Liquidity
	South West Water Risk and Assurance Forum	• Horizon scanning providing a forward looking view on South West Water specific emerging risks and opportunities • Reporting of updated risk statuses in respect of key Company projects • Review of Group-wide shared service risk registers focusing on risks relevant to South West Water	• Cyclical review of principal risks over an annual cycle • Quarterly review of assurance processes and by exception the effectiveness of controls in mitigating risks
	South West Water directorate functions	• Identification and assessment of risks • Implementation and execution of appropriate risk mitigation strategies, aligned with the agreed risk appetite • Monitor compliance with internal control framework	• Risk and Compliance functions undertake compliance activities over ISO standards and other key business processes • Self-certification of compliance with internal control framework
THIRD LINE OF DEFENCE	**Group Internal Audit**	• Provide independent, risk based assurance on the effectiveness of the internal control framework • Coordination of independent assurance activities	• Regular reporting to Audit Committee and Pennon Executive on the effectiveness of internal controls and • the outcomes from other third line assurance activity

CONTINUOUS IMPROVEMENT TO RISK MANAGEMENT

South West Water and the Pennon Group as a whole seek to continually improve our approach to risk management. During the year there have been a number of developments which have further enhanced the risk management process. These include:

- A Pennon Group Director of Risk and Assurance being appointed with responsibility for the Group Internal Audit and Risk Management functions and the co-ordination of assurance activities
- The Group wide Health and Safety programme, Homesafe, has been implemented across a number of sites and is being rolled out across South West Water
- A Health, Safety, Security, Assurance (HSSA) function being established providing second line assurance over the application of Health, Safety and Security processes and controls
- South West Water's internal second line assurance programme in respect of quality, environment, energy and information security being reviewed and expanded
- The update of several key corporate policies and procedures, including aligning across the Group where relevant
- The review and challenge of risks relating to Group corporate functions that have been established during the year by the Group Risk Forum and South West Water's Risk and Assurance Forums
- A programme of compliance training being rolled out to staff, with a focus on individuals in operational roles.

RISK APPETITE

The UK Corporate Governance Code requires companies to determine their risk appetite with respect to the level of risk it is considered appropriate to accept in achieving strategic objectives. Striking an appropriate balance between risk and reward is key to the success of the Company's strategy. The Board has established their risk appetite for each of the Principal Risks which allows the business to pursue value enhancing opportunities, whilst maintaining an overall level of risk exposure which the Board considers to be appropriate. The Board's evaluation of the effectiveness of internal control is considered in the context of the stated risk appetite.

OFWAT'S PRINCIPLES FOR HOLDING COMPANIES – BOARD LEADERSHIP, TRANSPARENCY AND GOVERNANCE

Ofwat requires that holding companies manage their risks in such a way that the regulated company is protected from risk elsewhere in the Group. Pennon Group's principal risks and uncertainties include those Group-level risks which could materially impact on South West Water.

Pennon's risk management and internal control frameworks ensure that it does not take any action that would cause South West Water to breach its licence obligations. Further, the Group's governance and management structures mean that there is full understanding and consideration of South West Water's duties and obligations under its licence, as well as an appropriate level of information sharing and disclosure to give South West Water assurance that it is not exposed as a result of activities elsewhere within the Group.

Further details of Group-wide principal risks and application of the Group's risk management framework across the Group are provided in the Pennon Group plc Annual Report (pages 52 – 61).

PRINCIPAL RISKS AND UNCERTAINTIES

South West Water's business model exposes the business to a variety of external and internal risks. The assessment of the Company's Principal Risks is informed by the potential impact of macro level political, economic and environmental factors. Whilst the ability of the Company to influence these macro level risks is limited, they continue to be regularly monitored and the potential implications for the Company are considered as part of the on-going risk assessment process. This includes undertaking scenario planning and analysis to understand the potential risk exposure of one, or a number, of these events occurring and taking appropriate steps to reduce the impact on the Company.

Over the past year there has been a significant increase in the level of uncertainty within the water sector as a result of evolving political views on the future of the water industry and changes in the priorities and focus of Ofwat. Specific risks have been included within the statement of principal risks below, which reflect the associated risk exposure to the Company arising from this uncertainty.

Additionally, South West Water has added a risk relating to 'Tax compliance and contribution'. This reflects both the finalisation of tax returns for older periods with HMRC and the increased external focus on the tax contribution of companies in the sector and other large corporate organisations.

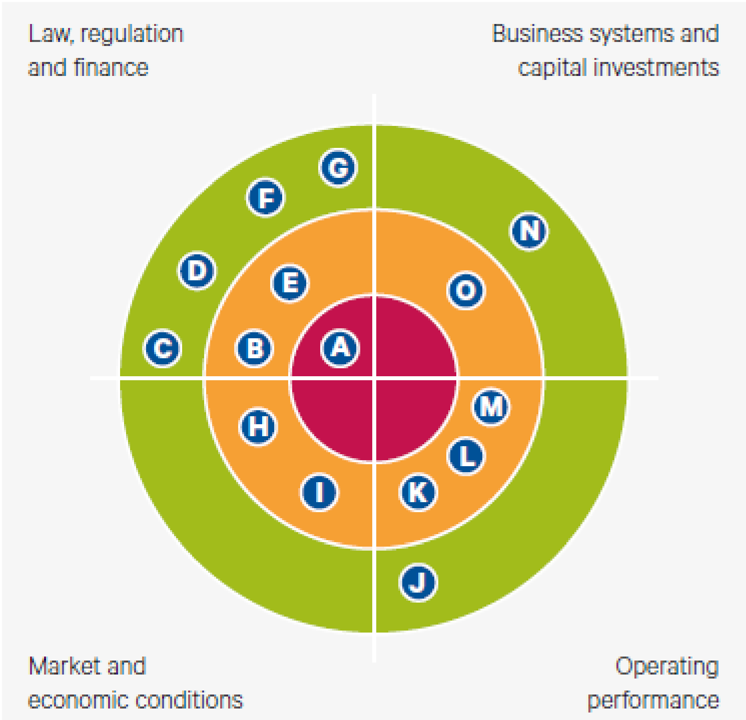
THE UNITED KINGDOM'S EXIT FROM THE EUROPEAN UNION

South West Water continues to regularly monitor the potential risks and implications arising from the United Kingdom's decision to trigger Article 50 and exit the European Union. Whilst a significant amount of uncertainty remains, the following issues have been identified which impact South West Water's principal risks and may be influenced by any agreement between the UK and the EU:

- **Changes in environmental legislation, such as drinking and bathing water quality.** At present the Company does not anticipate any significant deviation in existing environmental legislation or regulations when existing EU legislation is transferred to domestic UK law (principal risk C)
- **Exposure to exchange rate and interest rate fluctuations.** There is limited exposure to exchange rate fluctuations which is further mitigated through forward contracts providing certainty over future foreign currency risk. Interest rate risks are mitigated through having a long term maturity of debt and finance leases with a significant proportion of interest-bearing liabilities at fixed rates (principal risk D)
- **Inability to access the same levels of funding from the European Investment Bank.** Whilst South West Water has a variety of funding opportunities available to it, it continues to call for an appropriate UK replacement (principal risk D)
- **Impact on the domestic economy and the ability of our customers to pay their bills.** South West Water has a mature process to proactively monitor debt levels and operates a number of initiatives to support customers who are unable to pay their bills (principal risk H)
- **The ability to attract and employ EU nationals with the necessary skills and experience.** Although there is increased uncertainty over the movement of labour following the UK leaving the EU, South West Water has not historically employed a significant number of non-UK EU nationals and exposure to this risk is limited (principal risk M)

The Directors confirm that during 2017/18 they have carried out a robust assessment of risks facing the Company, including assessing the impacts on its business model, future performance, solvency and liquidity. These principal risks have been considered in preparing the viability statement on pages 35 and 36.

REPORTING AN OVERVIEW OF THE PRINCIPAL RISK PROFILE



STRATEGIC IMPACT AND RISK RANKING

Our principal risks link to the strategic focus areas as described on page 7, and risks have been assessed on the following scale:

Key	Risk level		
	Low	Medium	High
The red, amber and green risk level is our estimate of the net risk to the Company after mitigation. It is important to note that risk is difficult to estimate with accuracy and therefore the actual risk may be greater or less than our estimate indicates.	GREEN	AMBER	RED
Current assessment of direction of travel of risk level	Increasing	Stable	Decreasing

Principal risks	Ref	Strategic priorities	Risk description	Net risk level	Trend
Law, regulation and finance	**A**	Finance and economy	Change in Government policy/ renationalisation	RED	↑
	B	Environment Finance and economy	Regulatory reform	AMBER	↑
	C	Environment Finance and economy	Compliance with laws and regulation	GREEN	↔
	D	Finance and economy	Maintaining sufficient finance and funding to meet ongoing commitments	GREEN	↔
	E	People and community	Non-compliance or occurrence of avoidable health and safety incident	AMBER	↔
	F	People and community Finance and economy	Tax compliance and contribution	GREEN	↔
	G	Finance and economy	Increase in defined benefit pension scheme deficit	GREEN	↔
Market and economic conditions	**H**	Finance and economy	Non-recovery of customer debt	AMBER	↓
	I	Finance and economy	Macro-economic risks impacting commodity and power prices	AMBER	↑
Operating performance	**J**	Water Environment	Poor operating performance due to extreme weather or climate change	GREEN	↑
	K	Service	Poor customer service / increased competition leading to loss of customer base	AMBER	↔
	L	Water Service Environment	Business interruption or significant operational failure/incidents	AMBER	↑
	M	People and community	Difficulty in recruitment, retention and development of skills	AMBER	↑
Business systems and capital investments	**N**	Finance and economy	Failure or increased cost of capital projects/exposure to contract failures	GREEN	↔
	O	Water Service	Failure of IT systems, management and protection including cyber risks	AMBER	↑

LAW REGULATION AND FINANCE

Strategic impact	Mitigation and commentary	Risk appetite
Principal Risk A: Changes in Government policy/renationalisation		
2018 Net risk and direction: RED, INCREASING	**2017 Net risk and direction: GREEN, STABLE[1]**	
Finance and economy Changes in Government policy may fundamentally impact our ability to deliver our strategic priorities, impacting shareholder value.	The renationalisation of the water industry continues to be a central policy of the Opposition and remains a possibility in the event of a change of Government. We recognise however, that the current Government is supportive of the existing regulatory model. We engage regularly with all political parties as well as customers and stakeholders demonstrating the value they receive based on our operational performance and continued investment in the network infrastructure.	We recognise that Government policy evolves and seek to minimise potential risk and maximise opportunities through regular communication and robust scenario planning.
Principal Risk B: Regulatory Reform		
2018 Net risk and direction: AMBER, INCREASING	**2017 Net risk and direction: GREEN, STABLE[1]**	
Environment **Finance and economy** Reform of the regulatory framework may result in changes to our priorities and the service we provide to our customers. It may have a significant impact on our performance which can impact value.	During the year Ofwat finalised their price review methodology for 2020-25. In addition there has also been a focus on the corporate governance of companies in the sector. We are broadly supportive of the proposed changes and engage fully with Ofwat during each consultation. Action has already been taken to address a number of Ofwat's concerns. We are well positioned for the new regulatory period with a dedicated, experienced PR19 project team, supported by external consultants, which is monitored through a robust governance framework.	We accept that regulatory reform occurs and seek to leverage the opportunities this creates whilst mitigating the associated risk.
Principal Risk C: Compliance with laws and regulations		
2018 Net risk and direction: GREEN, STABLE	**2017 Net risk and direction: GREEN, STABLE[1]**	
Environment **Finance and economy** South West Water is required to comply with an ever increasing range of regulated and non-regulated laws and regulation. Non-compliance with one or a number of these may result in financial penalties, a negative impact on our ability to operate effectively and reputational damage which could affect shareholder value.	Our robust regulatory framework ensures compliance with Ofwat, Environment Agency and other relevant requirements. Employees, contractors and partners receive a rolling programme of training and guidance. Additionally, during the year we have launched our 'Speak Up' whistleblowing policy. We have been pro-active in reviewing our policies and processes in preparation for the introduction of GDPR and have appointed a dedicated Data Protection Officer, who acts across the Pennon Group.	South West Water maintains the highest standards of compliance and has no appetite for legal or regulatory breaches. We aim to minimise the impact of regulatory reform by targeting changes which are net present value neutral over the longer term to protect customer affordability and shareholder value.

(1) When included as a combined legal compliance/reform risk

LAW REGULATION AND FINANCE (continued)

<table>
<tr><th>Strategic impact</th><th colspan="2">Mitigation and commentary</th><th>Risk appetite</th></tr>
<tr><td colspan="4">Principal Risk D: Maintaining sufficient finance and funding, within our debt covenants, to meet ongoing commitments</td></tr>
<tr><td colspan="2">2018 Net risk and direction: GREEN, STABLE</td><td colspan="2">2017 Net risk and direction: GREEN, STABLE</td></tr>
<tr><td>Finance and economy

Failure to maintain funding requirements could lead to additional finance costs and put our growth agenda at risk.

Breach of covenants could result in the requirement to repay certain debt.</td><td colspan="2">South West Water and the entire Pennon Group have mature treasury, funding and cashflow policies in place. We regularly consider how political, economic and regulatory risks may impact on the Company's financing commitments and cashflow.

The Group operates with a strong liquidity position and a diversified funding mix. South West Water is funded to March 2020.

Funding is in place at effective average interest rates below many in the sector, with prefunding and headroom, including revolving credit facilities, to meet future funding requirements.

South West Water currently has a strong liquidity and funding position, being pre-funded until the end of the current regulatory period in 2020 and beyond.

Borrowing continues to be successfully raised by the Group Treasury team. This included refinancing of the Group £300m hybrid in September 2017.</td><td>We operate a prudent approach to our financing strategy in order to ensure our funding requirements are fully met.</td></tr>
<tr><td colspan="4">Principal Risk E: Non-compliance or occurrence of an avoidable health and safety incident.</td></tr>
<tr><td colspan="2">2018 Net risk and direction: AMBER, STABLE</td><td colspan="2">2017 Net risk and direction: AMBER, STABLE</td></tr>
<tr><td>People and community

A breach of health and safety law could impact upon our people (including contractors) as well as leading to financial penalties, significant legal costs and damage to South West Water's reputation.</td><td colspan="2">The effective management of health and safety related risks continues to be a priority for the Board and Executive Management.

The Group-wide HomeSafe programme is now being rolled out across South West Water. It is supported by a programme of capital investment for existing assets.

The Group has also invested in people, processes and systems within its Health, Safety, Security and Assurance (HSSA) function during the year which will assist in driving consistency and monitoring compliance with health and safety standards, including within South West Water.

The number of accidents reportable under RIDDOR (Reporting for Injuries, Diseases and Dangerous Occurrences Regulations) for the 2017 was nine across both our operational areas (2016: nine).

Ever higher standards are expected both internally and externally and therefore the underlying risk of not achieving these higher standards is considered to be rising.

South West Water aim to become certified to the new ISO45001:2018 (Health and Safety) standard in 2019.</td><td>The Board has no appetite for health and safety related incidents and has the highest standards of compliance within the Company and third parties.</td></tr>
</table>

LAW REGULATION AND FINANCE (continued)

Strategic impact	Mitigation and commentary	Risk appetite
Principal Risk F: Taxation compliance and contribution		
2018 Net risk and direction: GREEN, STABLE	**2017 Net risk and direction: n/a – not assessed**	
People and community **Finance and economy** Non-compliance may result in financial penalties, legal costs and reputational damage. Furthermore, the perception that South West Water's overall tax contribution is inadequate could have a detrimental impact on the reputation of the Company.	The Group has an experienced and professionally qualified in-house tax team, supported, where necessary, by external specialists. Significant progress has, and continues, to be made to agree outstanding items with HMRC. The agreement of uncertain tax items relating to past periods has facilitated the finalisation of tax returns for older periods. Furthermore, during 2017, the Group published its approach to tax and the tax contribution made by the Group. This was informed by the outcomes of extensive stakeholder research which was conducted via focus groups and qualitative surveys.	We ensure full compliance with HMRC requirements and will not enter into artificial tax arrangements or take an aggressive stance in the interpretation of tax legislation.
Principal Risk G: Increase in defined benefit pension deficit.		
2018 Net risk and direction: GREEN, STABLE	**2017 Net risk and direction: GREEN, STABLE**	
Finance and economy The Company could be called upon to increase funding to reduce the deficit, impacting our cost base.	We use professional advisors to manage the pension scheme's investment strategy to ensure the scheme can pay its obligations as they fall due. The last triennial evaluation, which demonstrated the recovery plan from 2013 is still on track.	The Board expectation is that pension benefits can be paid in full without increased costs to the Company.

MARKET AND ECONOMIC CONDITIONS

Strategic impact	Mitigation and commentary	Risk appetite
Principal Risk H: Non-recovery of customer debt and affordability		
2018 Net risk and direction: AMBER, DECREASING	**2017 Net risk and direction: AMBER, STABLE**	
Finance and economy There is a potential impact on revenue as a result of reduced customer debt collection, particularly with regards to vulnerable customers and affordability.	Following South West Water's exit from the Non-household retail market, this risk now reflects household consumers and non-household retailers. In line with market codes, robust procedures have been established to protect South West Water from largescale exposure to retailer default. Mature and embedded debt collection strategies are in place for the recovery of domestic customer debt. This is supplemented by social tariffs, now in place across both our operating areas and affordability schemes (such as Restart, WaterCare and Freshstart) to help reduce our bad debt exposure for those customers who are struggling to pay. South West Water's performance has improved in the last two years in respect of household debt collection. A lack of significant increases in household charges for 2018/19 should also contribute to further strong performance.	Whilst seeking to minimise non-recoverable debt, we recognise customer affordability challenges and given the inability to disconnect domestic customers, some risk of uncollectable debt remains.

MARKET AND ECONOMIC CONDITIONS (continued)

Strategic impact	Mitigation and commentary	Risk appetite
Principal Risk I: Macro-economic risks arising from a downturn in the global and UK economy and commodity and power prices.		
2018 Net risk and direction: AMBER, INCREASING	**2017 Net risk and direction: AMBER, STABLE**	
Finance and economy The economic climate as well as commodity and energy process have a direct impact upon the costs we pay for goods and services.	South West Water has established procurement procedures to source its goods and services through the most appropriate sources, ensuring quality of provision and price. The Procurement Steering Group (PSG) oversees strategies and policies to promote effective working practices for strategic contracting relationships. Energy usage is minimised (including minimisation during periods of increased cost) and where possible on-site renewable energy generation is undertaken to reduce the requirement to purchase electricity from the grid.	We seek to take well-judged and informed decisions whilst ensuring plans are in place to mitigate the potential impact of macro-economic risks.

OPERATING PERFORMANCE

Strategic impact	Mitigation and commentary	Risk appetite
Principal Risk J: Poor operating performance due to extreme weather or climate change.		
2018 Net risk and direction: GREEN, INCREASING	**2017 Net risk and direction: GREEN, INCREASING**	
Water **Environment** Failure of our assets to cope with extreme weather conditions may lead to an inability to meet our customers' needs, environmental damage, additional costs being incurred and reputational damage.	Contingency plans, emergency resources and investment through a planned capital programme assist in mitigating this risk. Extreme weather conditions, such as those experienced in early 2018, are expected to test the resilience of South West Water's assets, whilst the expectations of both customers and Ofwat during such an event have increased. We prepare drought plans every three years which are reviewed annually for a range of climate change and demand scenarios. The recently published Water Resources Management Plan has not identified an overall significant increase in the risk to water resources, however ongoing climate change will continue to challenge this.	We seek to reduce both the likelihood and impact of climate change through long term planning to ensure sufficient measures are in place to mitigate this risk.
Principal Risk K: Poor customer service / increased competition leading to loss of customer base.		
2018 Net risk and direction: AMBER, STABLE	**2017 Net risk and direction: AMBER, STABLE**	
Service Poor customer service has a direct impact on South West Water's delivery of the PR14 business plan.	Targeted improvements to continually improve customer service within South West Water have contributed to the achievement of the ServiceMark accreditation during the year. We continue to secure high Service Incentive Mechanism (SIM) scores, which have improved in both our operating areas this year. There has been a significant focus on our customer experience during the year and the reorganisation of the marketing and sales, service delivery and customer service functions has improved this further, alongside the launch of the annual customer survey.	We continually seek to increase customer satisfaction.

OPERATING PERFORMANCE (continued)

<table>
<tr><th>Strategic impact</th><th>Mitigation and commentary</th><th>Risk appetite</th></tr>
<tr><td colspan="3">Principal Risk L: Business Interruption or significant operational failure / incidents.</td></tr>
<tr><td colspan="3">2018 Net risk and direction: AMBER, INCREASING | 2017 Net risk and direction: AMBER, INCREASING</td></tr>
<tr><td>Water

Service

Environment

Operational failure could mean that we are not able to supply clean water to our customers or provide safe wastewater services.

This has a direct impact on the successful delivery of the PR14 business plan.</td><td>Due to the nature of South West Water's business there are risks which arise during the normal course of business, including risk of failure of assets, processes or systems. These could include:
• water quality deterioration
• contamination of water supplies
• pollution and flooding events
• water resource restrictions.

South West Water again experienced pollution incidents outside of target performance commitment levels, although the number of incidents has reduced. A continued reduction in the number of pollution events (especially wastewater events) is a priority and a programme of targeted action is currently underway to address these risks.

South West Water maintains detailed contingency plans and incident management procedures which are regularly reviewed.

Equipment failure is managed through a programme of sophisticated planned and preventive maintenance regime and effective management of stores.

Comprehensive insurance is also maintained across the asset base in the event of an incident occurring.</td><td>We operate a low tolerance for significant operational failure or incidents. We seek to mitigate these risks where possible and accelerate the recovery from any incident.</td></tr>
<tr><td colspan="3">Principal Risk M: Difficulty in recruitment, retention and development of appropriate skills, which are required to deliver the Company's strategy.</td></tr>
<tr><td colspan="3">2018 Net risk and direction: AMBER, INCREASING | 2017 Net risk and direction: AMBER, STABLE</td></tr>
<tr><td>People and community

Failure to have a workforce of skilled and motivated individuals will detrimentally impact all of our strategic priorities.

We need the right people in the right places to share best practice, deliver on our customers' priorities and generate synergies (including through the Group's 'shared services' structure).</td><td>The Group's people strategy has been rolled out and is designed to ensure we have the workforce necessary to deliver our strategic priorities. This has included refreshed Group-wide Vision and Values, increased workforce engagement, continued commitment to training and development and the introduction of a Pennon Code of Conduct.

South West Water's apprenticeship programme also spans all areas of the business and has now employed its 149th apprentice.

Succession plans remain in place for senior and other key positions. Challenges remain, however, in sourcing skills and expertise externally for specific senior and operational roles (particularly in the engineering, finance and scientific areas).</td><td>Whilst turnover does occur, we ensure the appropriate skills and experience are in place with succession plans to provide resilience in mitigating the impact of this.</td></tr>
</table>

BUSINESS SYSTEMS AND CAPITAL INVESTMENT

Strategic impact	Mitigation and commentary	Risk appetite
Principal Risk N: Failure or increased cost of capital projects / exposure to contract failures.		
2018 Net risk and direction: GREEN, STABLE	**2017 Net risk and direction: GREEN, STABLE**	
Finance and economy Failure of our assets to cope with extreme weather conditions may lead to an inability to meet our customers' needs, environmental damage, additional costs being incurred and reputational damage.	All capital projects are subject to a robust business case process and skilled project management resource and senior oversight is utilised to provide additional rigour in the delivery of major projects. Robust due diligence is undertaken on key suppliers, technologies and acquisitions. Back to back agreements and supplier guarantees also provide additional protection. The Mayflower Water Treatment Works in Plymouth remains on schedule for completion in late 2018. The site will use new technology to provide high quality drinking water to customers in Plymouth in as efficient manner as possible. The project is a major investment for South West Water and forms part of the capital programme in the 2015-20 business plan.	South West Water's investment activities are taken on an informed basis with risks weighed against appropriate returns.
Principal Risk O: Failure of information technology systems, management and protection including Cyber Risks.		
2018 Net risk and direction: AMBER, INCREASING	**2017 Net risk and direction: AMBER, STABLE**	
Water **Service** Failure of our information technology systems, due to inadequate internal processes or external cyber threats could result in the business being unable to operate effectively and the corruption or loss of data. This would have a detrimental impact on our customers and result in financial penalties and reputational damage.	South West Water and the wider Group operate a mature and embedded governance framework over the business as usual IT environment and major project implementations. This is aligned to the ISO27001 standards which South West Water has been certified under for several years and regular internal and external assessments are undertaken to maintain this accreditation. Disaster recovery plans are in place for corporate and operational technology and these are regularly reviewed and tested. Cyber risks are mitigated by a strong information security framework. This is aligned with guidance issued by the National Cyber Security Centre (NCSC). Awareness campaigns have been undertaken during the year aligned with preparations for the General Data Protection Regulation (GDPR). A variety of internal and external assessments are also undertaken, including annual penetration testing, to check the robustness of our controls.	We seek to minimise the risk of information technology failure and cyber security threats without detrimentally impacting on business operations.

VIABILITY STATEMENT

The Board has assessed the Company's financial viability and confirms that it has a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over a five-year period. The assessment has been made with reference to the Company's current position and prospects, its longer-term strategy, the Board's risk appetite and the Company's principal risks and how these are managed, as detailed on pages 26 to 34 of the Risk Report. South West Water is a long term business characterised by a multi-year investment programme, with the associated revenue stream.

The Company's strategic business plan and associated principal risks are a foundation of the scenario testing. This assessment has considered the potential impact of arising risks on the business model, future performance, solvency and liquidity over the period in question. In making their assessment, the Directors reviewed the principal risks and considered which risks might threaten viability.

Over the course of the year the Audit Committee has considered a deep-dive review of the following principal risks to enable a thorough assessment of the impact of these risks on ongoing viability:

Principal risk	Matters considered by the Audit Committee
Cyber security	Review of the cyber security framework in place
Financial resilience	Ability to manage external shocks or potential market dislocations that could impact on financing strategy
Recruitment and retention	Review of people risks including the ability to attract and retain the right skills to deliver the Company's strategy
Water resources and resilience	Consider the impact of climate change and drought risks on water resources and ongoing flood-related resilience

In stress testing the Company's business plan it was determined that none of the individual risks would in isolation compromise the Company's viability. In performing this stress testing all risks have been monetised with reference to risk weighting, factoring in the likelihood of occurrence and financial impact. In addition, further factors were considered to reverse engineer a scenario that could possibly compromise South West Water's viability, these included:

- all the principal risks occurring in all of the five years
- lower retail price index (RPI) projections in each of the five years
- significant one-off costs
- a deterioration in the credit quality of amounts owed to the Company

The three factors above, which are in addition to the principal risks, have been monetised as absolute financial costs and are not risk weighted on the likelihood of occurrence.

The Board considered the monetary impact of these scenarios on the Company's viability over a five-year period, concluding the reversed engineering scenario remote. The five-year period was chosen given the longer term nature of South West Water's business, for consistency with the length of the business's regulatory contract and the associated business planning cycle.

As part of the Board's considerations additional scenarios concerning viability were reviewed. This additional assessment considered South West Water's regulatory financial ring fence through the following scenarios that are recommended to be tested by Ofwat as part of the business planning process:

- totex underperformance (15% of totex)
- ODI penalty (3% of RoRE) in one year
- inflation sensitivities (+/-3%)
- increase in the level of bad debt (20%)
- new debt financed at 2% above forward projections
- financial penalty – equivalent to 3% of turnover
- any relevant inter-company financing scenarios.

These scenarios were considered in isolation and in the following combination:

- 10% totex underperformance in each of the five years
- ODI penalty of 1.5% in each of the five years
- One-off financial penalty of 1% of revenue.

The Directors concluded these scenarios in isolation and the combination noted above did not compromise the viability of South West Water over the five-year assessment period.

In making the assessment, the Directors have taken account of the Company's robust capital solvency position, its ability to raise new finance and a key potential mitigating action of restricting any non-contractual payments.

In assessing the prospects of the Company, the Directors note that as the Company operates in a regulated industry which potentially can be subject to non-market influences, such assessment is subject to uncertainty, the level of which depends on the proximity of the time horizon. Accordingly the future outcomes cannot be guaranteed or predicted with certainty.

As set out in the Audit Committee's report on pages 58 to 65, the Directors reviewed and discussed the process undertaken by management, and also reviewed the results of the stress testing performed.

FORWARD-LOOKING STATEMENTS

This strategic report, consisting of pages 3 to 37, 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 South West Water, wherever they occur in this strategic report, are necessarily based on assumptions reflecting the views of South West Water 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.

The strategic report consisting of pages 3 to 37 was approved by the Board on 30 May 2018.

By Order of the Board

S Bird
Managing Director
30 May 2018

GOVERNANCE AND REMUNERATION

CONTENTS

CHAIRMAN'S LETTER

I am pleased to introduce the corporate governance report for 2018 on behalf of the Board. This is the principal method of reporting on the Board's governance policies and the practical application of the principles of good corporate governance.

We consider that strong governance is central to our successful management of South West Water. It provides the framework for effective delivery of our strategy, the creation of shareholder value and the ongoing development of our sustainable business. In my third year as Chairman I remain committed to ensuring that we continue to operate to the highest standards of corporate governance.

South West Water is a subsidiary of Pennon Group plc, however as a regulated water and waste water business, South West Water complies with the requirements of Ofwat, and has its own independent board of directors and operates as if it is a publicly listed company in its own right.

The South West Water Board, which includes all of the Pennon Non-Executive Directors as well as three South West Water only Non-Executive Directors convenes before each Pennon Group Board meeting and considers South West Water strategy, performance and regulatory planning.

During the year we appointed Matthew Lord Taylor to the position of Senior Independent Director of South West Water. Matthew has been a Non-Executive Director of South West Water since 2010 and is well placed to provide a sounding board to me as Chairman and other Directors. He is not a Director of Pennon Group plc and is available to South West Water's stakeholders to discuss any concerns raised.

ROLE OF THE BOARD AND ITS EFFECTIVENESS

My primary role as Chairman is to provide leadership to the Board and to provide the right environment to enable each of the Directors and the Board as a whole to perform effectively to promote the success of the Company for the benefit of its stakeholders.

It is my view that the Board is highly effective with a good understanding of the Company's opportunities as well as the threats facing the business. This view is supported by the results of this year's Board and Committee performance evaluations. Further details are provided on page 54.

STAKEHOLDER ENGAGEMENT

The Board understands the part South West Water can play in bringing resources to life and creating a more sustainable UK. We are committed to carrying out our business in a responsible way and remain focused at improving the provision of water and wastewater services for benefit of all of our stakeholders.

We actively engage with our customers, our communities, our people and our suppliers, our regulators and other stakeholders and maintain appropriate and regular dialogue with those stakeholders to ensure that the rationale for our strategy and our performance objectives reflects their expectations. It also allows stakeholders to provide feedback on the matters they consider to be important and any issues which require addressing.

COMPLIANCE WITH THE UK CORPORATE GOVERNANCE CODE AND OTHER REQUIREMENTS

South West Water aims to comply with the UK Code as fully as possible, within the context of being a subsidiary of a listed company, Pennon Group plc, which itself fully complies with the UK Code. The UK Code is published on the Financial Reporting Council (FRC) website, www.frc.org.uk. In accordance with the FRC's requirements, we have reported against the April 2016 version of the Code, which is effective for reporting periods commencing on or after 17 June 2016.

Given the Group structure there are a limited number of areas in which South West Water does not comply with specific Code provisions. These areas are described on page 57 alongside any additional mitigations deemed necessary.

In addition, South West Water has complied with Ofwat's principles in respect of Board leadership, transparency and governance and our parent company, Pennon Group plc, has complied with Ofwat's principles for holding companies.

My introduction to this corporate governance report and the following sections are made in compliance with the UK Code 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, our confirmation of the Company as a going concern and Directors' responsibility statements. Finally, in accordance with reporting requirements, on pages 100 and 101 the Board confirms to shareholders that the Annual Report and Accounts taken as a whole is fair, balanced and understandable and provides the information necessary to assess the Company's performance, business model and strategy.

SOUTH WEST WATER LIMITED BOARD OF DIRECTORS

The South West Water Board of Directors at the end of the 2017/18 financial year comprised the Chairman (a Non-Executive Director), our Senior Independent Director (a Non-Executive Director), two Executive Directors, and five further Non-Executive Directors and the Pennon Group Chief Executive as a Non-Independent Non-Executive Director. In addition Susan Davy, Pennon Group Chief Financial Officer and Helen Barrett-Hague, Group General Counsel and Company Secretary also attend the South West Water Board. The Board considers the Non-Executive Directors (with the exception of Chris Loughlin who is Chief Executive Officer of Pennon Group plc) to be independent in accordance with the UK Corporate Governance Code. The Board believes its Directors have an appropriate range of skills and experience to oversee the business of the Company.

Sir John Parker Chairman
Appointment Sir John was appointed to the South West Water Board on 31 July 2015. He became Chairman of South West Water on 1 August 2015 and is also Chairman of Pennon Group plc. He is chairman of the Nomination Committee.
Skills and experience Sir John is a highly experienced and independent chairman and brings a wealth of leadership experience across a range of industries. He is widely recognised for his policy work on the value of diversity in the boardroom, having chaired the Government's review on Ethnic Diversity on UK Boards in 2017. Prior to that, he was a member of the Davies Committee – Women on Boards. He has chaired five FTSE 100 companies and was previously the chairman of Anglo American plc (until October 2017) and National Grid plc, senior non-executive director and chair of the Court of the Bank of England, deputy chairman of DP World, joint chair of Mondi and chair of BVT and P&O plc. He was also president of the Royal Academy of Engineering from 2011 to 2014 and is a Visiting Fellow of the University of Oxford.
External appointments Sir John is the chairman of construction and engineering company Laing O'Rourke and of Advanced Plasma Power Limited. He is also a non-executive director of Carnival Corporation and Airbus Group. He is a senior adviser to Spencer Stuart and is the senior nonexecutive director on the Cabinet Office board.

Dr Stephen Bird Managing Director
Appointment Stephen was appointed to the Board on 1 March 2000 and was appointed to the position of Managing Director of South West Water on 1 January 2016.
Skills and experience Prior to joining South West Water, Stephen held posts in the Welsh Water Authority, National Rivers Authority and Wallace Evans Consultants as an environmental consultant. He is a Fellow of the Chartered Institute of Environmental Managers, fellow of the Institute of Directors and holds an MBA.
External appointments Stephen is Director of the Heart of the South West Local Enterprise Partnership and a member of Water UK Council.

Louise Rowe Finance Director
Appointment Louise was appointed South West Water Finance Director on 1 February 2015.
Skills and experience Louise has been with South West Water for over eight years, holding a range of managerial roles in the Finance Directorate prior to her appointment as Finance Director. She is physics graduate and qualified as a chartered accountant with KPMG.
External appointments Louise is a member of the Water UK Finance Directors Forum and the Prince of Wales' Accounting for Sustainability's Finance Culture Project. She is also a Non-Executive Director for the Cornwall and Isles of Scilly Local Enterprise Partnership.

Lord Matthew Taylor of Goss Moor Senior Independent Director (Non-Executive Director)
Appointment Matthew was appointed to the South West Water Board on 1 March 2010 and appointed as Senior Independent Director on 28 March 2018.
Skills and experience Matthew was MP for Truro and St Austell for 23 years from 1987, until he stood down at the 2010 general election. He has expertise in planning for sustainable communities.
External appointments Lord Taylor of Goss Moor Chairs the St Austell Eco-Community Strategic Partnership Board. Matthew is also Non-Executive Director of Mayfield Market Towns Ltd., and Chair and Non-Executive Director of Bridgehall Real Estate Limited and Kensa Heat Pumps Limited.

Jon Butterworth MBE Non-Executive Director
Appointment Jon was appointed to the Board on 28 September 2017. He is a member of the Sustainability Committee and is also independent scrutineer of health and safety processes across the Group (including within South West Water) to help ensure that these are robust and effective.
Skills and experience Jon has over 38 years' experience in the utility industry. He started his career in British Gas and subsequently became the Managing Director of North West Transco in 1999 having worked in many Construction, Asset and Operational roles as well as running the UK Gas Emergency service. He has a wealth of knowledge in Utilities and has held numerous senior positions within the industry including National Operations Director and Global Director of Safety, Sustainability & Resilience within National Grid plc and currently leads its Global Transmission Businesses. Jon was awarded an MBE in 2009 for services to Britain's Gas Industry and is passionate about social responsibility. He was instrumental in the Governments Rehabilitation of Young Offenders programme and has dedicated over ten years to Special Olympics Great Britain (SOGB).
External appointments Jon is also the Chairman of CORGI, Ambassador of the HM Young Offenders Programme, Associate Member of Brooke/Woodlands Multi Academy Trust, Ambassador of Special Olympics Great Britain, Director & Chairman of the Finance Committee for the Gas Safety Trust and a Trustee of the National Gas Museums Trust.

Martin Hagen Non-Executive Director
Appointment Martin was appointed to the Board on 1 September 2010
Skills and experience Martin was previously Deputy Chairman of the Financial Conduct Authority's Regulatory Decisions Committee, a board member and President of the Institute of Chartered Accountants in England and Wales and senior partner of Deloitte's West of England practice.
External appointments Martin is an independent member of the Audit and Risk Assurance Committee of the Department for Work and Pensions (DWP), Governor and Audit Committee Chair of UWE Bristol and a Board member and Audit Committee. He is also Chair of Companies House.

Martin Angle Non-Executive Director
Appointment Martin was appointed to the Board on 1 April 2016, having been appointed to the Pennon Group plc board on 1 December 2008. He is Chairman of the Remuneration Committee and a member of the Audit, Nomination and Sustainability Committees.
Skills and experience Martin is an experienced Non-Executive Director, bringing a wide range of knowledge and experience from a career in investment banking, private equity and industry. Over a 20-year executive career in investment banking, Martin held senior roles with SG Warburg & Co. Ltd, Morgan Stanley and Dresdner Kleinwort Benson, before becoming the Group Finance Director of TI Group plc, then a FTSE 100 company. He subsequently joined Terra Firma Capital Partners where he held various senior roles in its portfolio companies, including the executive chairmanship of the Waste Recycling Group Limited, then a major participant in the UK waste sector, and Le Meridien Hotel Group where he was executive deputy chairman. Martin has also served as a Non-Executive Director on a number of boards including Savills plc, where he was the senior independent director; National Exhibition Group, where he was Chairman; Severstal; and Dubai International Capital. As chairman of the Remuneration Committee, Martin has steered the approach on executive remuneration, ensuring that it is aligned with and supports strategy.
External appointments During the year Martin was Vice Chairman and Non-Executive Director of the FIA Foundation, adviser to the Board of the Commercial Bank of Dubai and adviser to NGP, a private group based in the USA, which is building out a major platform in renewable energy in emerging markets.

Neil Cooper Non-Executive Director
Appointment Neil was appointed to the Board on 1 April 2016, having joined the Pennon Group plc Board on 1 September 2014. He is chairman of the Audit Committee and a member of the Remuneration and Nomination Committees.
Skills and experience Neil brings to the Board extensive experience in a wide variety of corporate and financial matters. He is currently the Chief Financial Officer of Currencies Direct, a foreign exchange broker and international payment provider. Previously he was Group Finance Director of Barratt Developments plc and, before that, Group Finance Director of William Hill plc and Bovis Homes plc. He also held senior finance positions at Whitbread plc, worked for PricewaterhouseCoopers as a management consultant and held a number of roles with Reckitt & Colman plc. As Chairman of the Audit Committee, Neil has been influential in directing the approach on a number of significant matters including internal control, governance and financial reporting.
External appointments Neil is an Executive Director of Currencies Direct.

Chris Loughlin Pennon Group Chief Executive Officer – Non-Independent Non-Executive Director
Appointment Chris was appointed to the Board on 1 August 2006 as Chief Executive of South West Water. He became the Pennon Group Chief Executive Officer on 1 January 2016. Chris is a member of the Sustainability Committee.
Skills and experience Chris has extensive experience of the regulated business environment and the management of major engineering and infrastructure services. He started his career as a chartered engineer working in both the consulting and contracting sectors and, after holding a number of senior positions with British Nuclear Fuels plc, joined its board as an Executive Director. Prior to joining Pennon he was Chief Operating Officer with Lloyds Register and before that Executive Chairman of Magnox Electric plc. He was also a senior diplomat in the British Embassy, Tokyo. Chris has a comprehensive understanding of the water industry. He was previously a board member (and, for a period, president) of the Institute of Water, and between April 2008 and March 2012 was Chairman of Water UK.
External appointments Chris is currently Chairman of British Water, a director of Water UK and a trustee of the charity WaterAid. An enthusiastic advocate of local business, Chris is also Vice Chairman of the Cornwall Local Enterprise Partnership.

Gill Rider Non-Executive Director
Appointment Gill was appointed to the Board on 1 April 2016, having been appointed to the Pennon Group plc board on 1 September 2012. She is chairman of the Sustainability Committee and a member of the Audit, Remuneration and Nomination Committees.
Skills and experience Gill has a wealth of experience in leadership, governance and remuneration across a broad range of sectors including professional services, education and government. Formerly, she 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 LLP culminating in the post of chief leadership officer for the global firm. She was previously president of the Chartered Institute of Personnel and Development and a Non-Executive Director of De La Rue plc. As Chairman of the Sustainability Committee, Gill has encouraged and supported executive management in the development of a sustainability programme that underpins the delivery of strategy. At Accenture she chaired the global corporate responsibility and Foundation giving programme and was instrumental in building sustainability objectives into Accenture’s worldwide human capital strategies.
External appointments Gill currently holds Non-Executive Directorships with Charles Taylor plc, where she is senior independent director, and Intertek Group plc. She is Chairman of both their remuneration committees. She is also Chair of the council (board) of the University of Southampton.

IN ATTENDANCE AT THE BOARD

The following attend the Board alongside the Company's Directors:

Susan Davy Pennon Group Chief Financial Officer
Skills and experience Susan is a member of the Pennon Board. She is a graduate qualified chartered accountant with 20 years' experience in the utility sector. Prior to her current appointment within Pennon Group plc, Susan was Finance and Regulatory Director at South West Water between 2007 and 2015, during which time she was responsible for the company's Business Plan to 2020. She has also held a number of other senior finance roles in the water sector, including as Head of Regulation and Head of Finance (Wastewater) at Yorkshire Water. Susan's knowledge of the industry coupled with her financial and regulatory expertise has supported the development of the Group's strategy and her input has been invaluable to the Board in its deliberations.
External appointments Susan is Chair of the CBI South West council and a member of the A4S (Accounting for Sustainability) CFO leadership network.

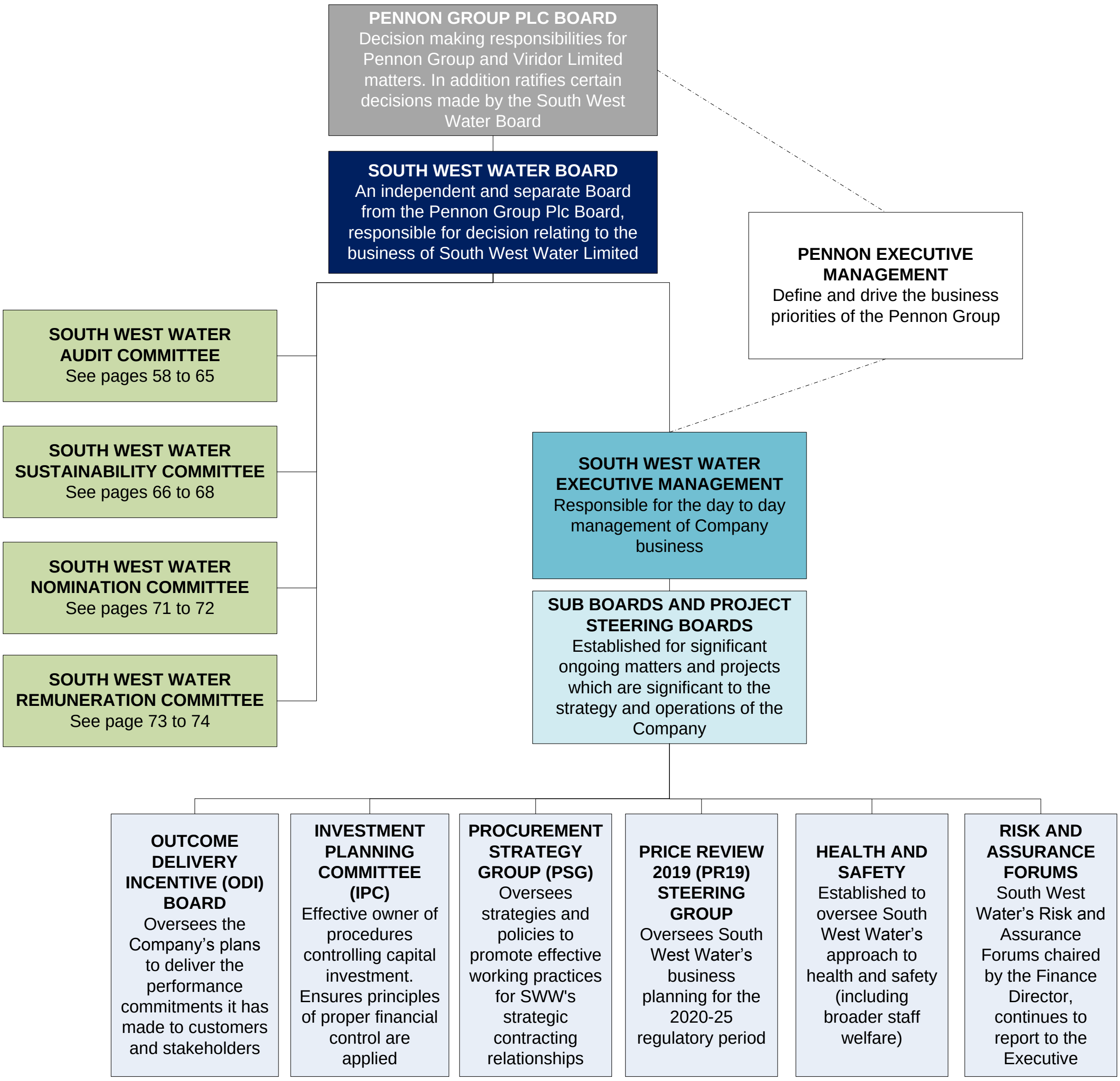
Helen Barrett-Hague Pennon Group General Counsel & Company Secretary
Skills and experience Helen has extensive corporate experience, including capital raisings, initial public offerings, corporate restructuring, mergers and acquisitions, both in the UK and overseas. She began her career in private practice before moving in-house in 1999 and holding positions of increasing responsibility with PA Consulting, Generics Group AG, Aveva Group plc and Alent plc. Helen is responsible for the provision of legal and company secretarial services to the Group, for statutory and regulatory compliance in terms of business conduct, and for supporting the Chairman and the Board in ensuring that Pennon's high standards of governance continue to be met. She is also chairman of the board of trustees of the Pennon Group Defined Contribution Pension Scheme.
External appointments None.

THE BOARD AND ITS GOVERNANCE FRAMEWORK

GOVERNANCE STRUCTURE

BOARD STRUCTURE SUMMARY

The following diagram summarises the context and structure within which the South West Water Board operates aligned with the revised governance approach of Pennon Group plc:



PENNON GROUP PLC BOARD

The Pennon Group Board concentrates on strategic matters for all parts of the Group. Its responsibilities include overall leadership of the Pennon Group, setting the Group's values, policies and standards, approving Pennon's strategy and objectives and providing oversight of the Group's operations and its performance. The Pennon Group board has also reserved to itself the requirement to ratify certain decisions taken by the South West Water Board, including:

- major capital projects and investments
- long-term objectives and commercial strategy
- the five-year regulatory business plan
- annual budgets
- certain decisions relating to financing.

This approach is compatible with Ofwat's principles for holding companies in respect of Board leadership, transparency and governance.

SOUTH WEST WATER BOARD

As a regulated water and sewerage company which is part of the listed Pennon Group, it is important that South West Water acts as a separate company and that the interests of customers and other stakeholders are protected. South West Water's 'Board, Leadership, Transparency and Governance Code' commits it to acting as if it is a separate Public Listed Company as far as is possible.

The South West Water Board continues to operate as a separate independent board in accordance with its own schedule of matters reserved to ensure compliance with Ofwat's principles on board leadership, transparency and governance. As described in more detail on pages 41 to 42, South West Water itself complies with the UK Corporate Governance Code as far as is possible within the context of the Group structure.

The South West Water board, which includes all of the Pennon Non-Executive Directors as well as three South West Water only Non-Executive Directors, convenes before each Pennon Board meeting and considers South West Water strategy, performance and regulatory planning.

Further information on the operations of the Board and committees are included on pages 41 to 77.

PENNON EXECUTIVE MANAGEMENT

The role of the Pennon Executive is to define and drive the business priorities that will achieve delivery of the strategy. It is responsible for ensuring, to the extent of the authority delegated by the Board, the proper and prudent management of Group resources to create and maximise shareholder value whilst protecting the interests of the wider stakeholder group.

Chaired by the Chief Executive Officer, the Pennon Executive meets formally on a monthly basis to review and refine recommendations to be presented to both the Pennon and where applicable the South West Water Boards. Members of the Pennon Executive are:

- Chris Loughlin, Pennon Group Chief Executive Officer
- Susan Davy, Pennon Group Chief Financial Officer
- Stephen Bird, South West Water Managing Director
- Phil Piddington, Viridor Managing Director
- Helen Barrett-Hague, Pennon Group General Counsel & Company Secretary
- Adele Barker, Pennon Group Director of Human Resources
- Steve Holmes, Pennon Group Director of Health, Safety, Security, Assurance (HSSA)
- Ed Mitchell, Pennon Group Director of Environment and South West Water Operations Director (Wastewater Services)
- Sarah Heald, Pennon Group Director of Corporate Affairs & Investor Relations
- Paul Ringham, Viridor Commercial Director
- Bob Taylor, South West Water Operations Director (Drinking Water Services) South West Water

THE SOUTH WEST WATER EXECUTIVE MANAGEMENT

Day to day management of South West Water's operations and activities is undertaken by South West Water's Executive Management. It includes Dr Stephen Bird (Managing Director) and Louise Rowe (Finance Director), who are also members of South West Water's Board and whose experience is described on page 41. There are six further members of the Executive Management, who have responsibilities for key areas of operations of South West Water:

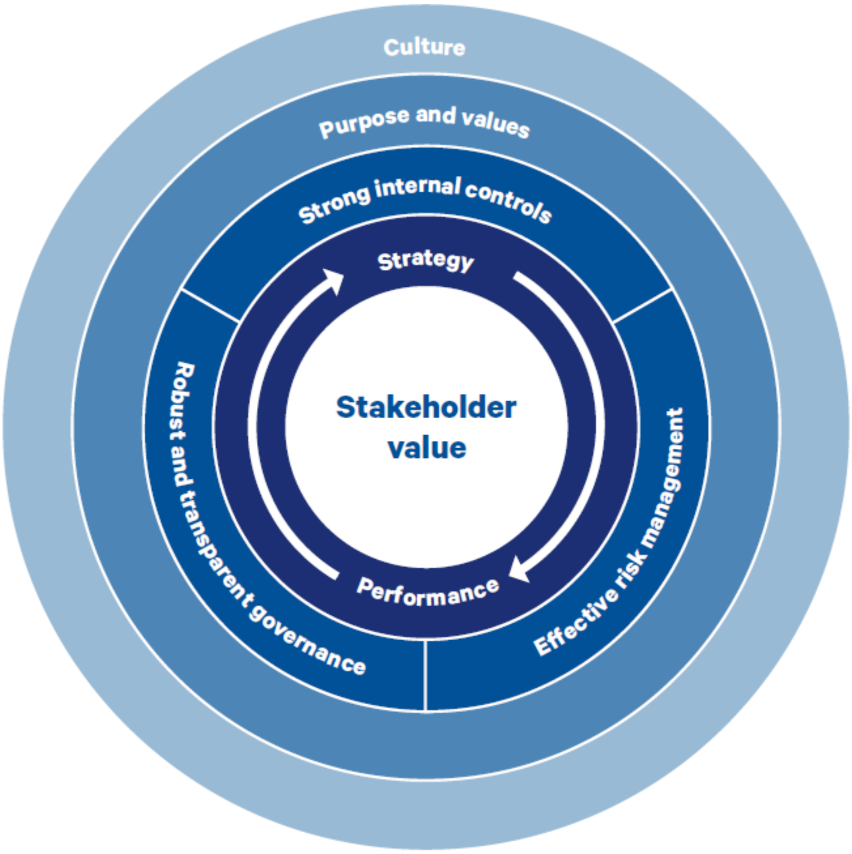
- Jo Ecroyd – Customer Services Director
- Ed Mitchell – Operations Director (Wastewater Services)
- Graham Murphy – Engineering Director
- Kevin Nankivell – Head of IT
- Bob Taylor – Operations Director (Drinking Water Services)
- Iain Vosper – Regulatory Director

Ed Mitchell, who had been acting as Interim Operations Director (Wastewater Services) was permanently appointed to the role this year.

In addition to the details provided on page 46 of this report, further information on the structure and operations of the South West Water Executive Management and the sub-committees which support the decision making of the business is included within the South West Water Annual Performance Report and Regulatory Reporting, published in July 2018 (www.southwestwater.co.uk/report2018).

APPROACH TO GOVERNANCE

The Board acts as the main governing body for the purpose of oversight for the Company. Our approach to governance is an integral part of our culture, guiding how we do business and create value for our stakeholders.



STAKEHOLDER VALUE

We deliver sustainable value for our stakeholders by providing high quality environmental infrastructure and customer services.

STRATEGY

Our strategy is to lead in the UK's water sector, investing for sustainable growth and drive value through efficiency.

PERFORMANCE

Our financial and operational performance is driven by our strategic sustainability objectives.

ROBUST AND TRANSPARENT GOVERNANCE

We are committed to operating to the highest standards of corporate governance.

EFFECTIVE RISK MANAGEMENT

We have a mature integrated risk management framework which is embedded into existing governance structures and ways of working.

STRONG INTERNAL CONTROLS

We keep the effectiveness of our control environment under regular review and seek to continually improve our approach.

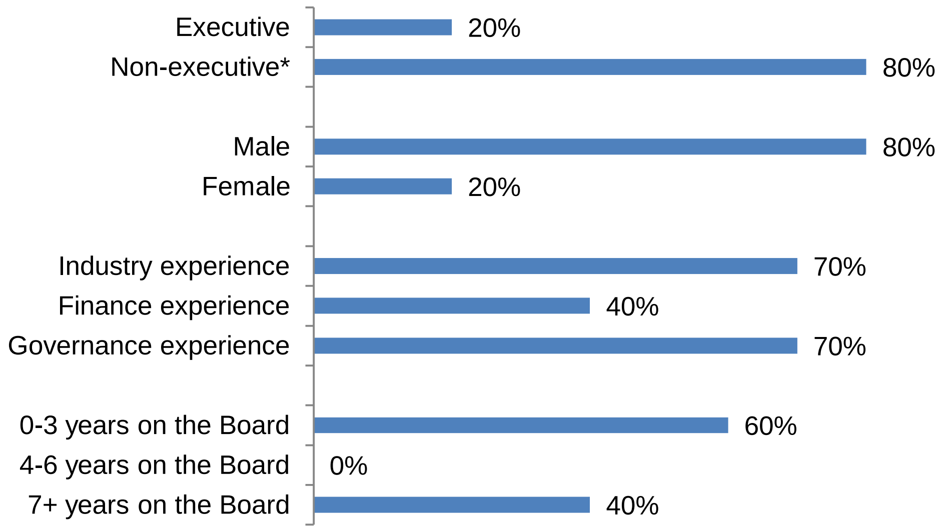
PURPOSE AND VALUES

Our purpose of 'Bringing Resources to Life' and supporting values of 'trusted, responsible, collaborative and progressive' will help drive our strategic priorities over the long term.

CULTURE

We are developing a culture that can be lived throughout the Group with integrity and transparency, ensuring we are trusted and valued by all our stakeholders.

BOARD COMPOSITION, INDEPENDENCE, EXPERIENCE AND TENURE (AS AT 31 MARCH 2018)



* including the Chairman and Pennon Group Chief Executive Officer

All of the Non-Executive Directors were considered by the Board to be independent throughout the year (except for Chris Loughlin who is the Chief Executive Officer of Pennon Group plc). None of the relationships or circumstances set out in provision B.1.1 of the UK Corporate Governance Code (the UK Code) applied to the Non-Executive Directors listed on page 96.

Notwithstanding their directorship of Pennon Group plc, Martin Angle, Neil Cooper and Gill Rider are considered to be independent in character and judgement given that they were appointed to the South West Water Board in order to facilitate the Group's revised governance framework, rather than to represent the interests of the shareholder.

In December 2017 Martin Angle reached the ninth anniversary of his appointment to the Pennon Group plc board. Martin will retire from the South West Water Board, Pennon Group plc and his role as chairman of both the Pennon Group and South West Water Remuneration Committees in December 2018.

The Board is satisfied that throughout the year Martin continued to demonstrate independence of character and judgement in the performance of his role as a Director and therefore has determined that he remains independent.

Sir John Parker was considered to be independent at the time of his appointment in accordance with provision A.3.1 of the UK Code. At that time, the Board concluded that none of the conditions set out in provision B.1.1 of the UK Code applied to Sir John; although he was appointed to the position of Pennon Group plc on the same date, he was not placed on the South West Water Board by Pennon in order to represent Pennon's interests but rather to help the flow of information and foster an understanding of the issues facing South West Water at Pennon board level. The operation of the Group's governance framework is underpinned by the dual South West Water/Pennon appointments held by Sir John and other Non-Executive Directors.

All Directors are subject to re-election each year in accordance with provision B.7.1 of the UK Code. At year end, the Board has 20% female representation, which is less than its 25% female representation target. Further details of gender diversity within the Company are described on page 10 and page 72.

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 41 to 44 and the experience chart on page 50 demonstrate collectively a broad range of business, financial and other relevant experience.

BOARD ROLES

There is a clear separation of responsibilities between the Chairman and the CEO, divided between managing the Board and the business, while they maintain a close working relationship.

Neil Cooper is chairman of the Audit Committee and in accordance with the UK Code he has recent and relevant financial experience (as set out in his biography on page 43).

All the Directors are equally accountable for the proper stewardship of the Group's affairs but they do have specific roles, which include those set out below:

Position	**Director**	**Role**
Chairman	Sir John Parker	• Leading the Board and setting its agenda • Promoting the highest standards of integrity and probity and ensuring good and effective governance • Managing Board composition, performance and succession planning • Providing advice, support and guidance to the Executive Directors • Representing the Company and being available to stakeholders • Discussing separately with the Non-Executive Directors performance and strategic issues
Managing Director	Dr Stephen Bird	• Managing South West Water and providing executive leadership • Leading the operation of the Company in accordance with the decisions of the Board • Co-ordinating with the Chairman on important and strategic issues of the Company and providing input to the Board's agenda • Contributing to succession planning and implementing the organisational structure • Managing stakeholder relations
Senior Independent Director[(1)]	Lord Matthew Taylor	• Assisting the Chairman with stakeholder communications and being available as an additional point of contact for stakeholders • Being available to other Non-Executive Directors if they have any concerns that are not satisfactorily resolved by the Chairman
Finance Director	Louise Rowe	• Supporting the Managing Director in providing executive leadership and developing strategy • Reporting to the Board on performance and developments across the business • Implementing decisions of the Board • Managing specific business responsibilities
Non-Independent Non-Executive Director	Chris Loughlin	• In conjunction with the Managing Director, propose and develop strategy and commercial objectives for consideration by the Board
Non-Executive Directors	Jon Butterworth Martin Hagen Martin Angle Neil Cooper Gill Rider	• Critically reviewing the strategies proposed for the Group • Critically examining the operational and financial performance of South West Water • Evaluating proposals from management and constructively challenging management's recommendations • Contributing to corporate accountability through being active members of the Committees of the Board

(1) Appointed as Senior Independent Director on 28 March 2018

BOARD MEMBERSHIP AND ATTENDANCE

The Directors and their attendance at the nine scheduled meetings of the Board during 2017/18 are as follows:

Board membership		**Attendance** [1]
Chairman		
Sir John Parker	Chairman	9/9
Executive Directors		
Dr Stephen Bird	Managing Director	9/9
Louise Rowe	Finance Director	9/9
Senior Independent Director		
Lord Matthew Taylor[1]	Independent Non-Executive Director	9/9
Non-executive Directors		
Jon Butterworth[2]	Independent Non-Executive Director	4/5
Martin Hagen	Independent Non-Executive Director	9/9
Martin Angle	Independent Non-Executive Director	8/9
Neil Cooper	Independent Non-Executive Director	9/9
Chris Loughlin	Non-Independent Non-Executive Director	9/9
Gill Rider	Independent Non-Executive Director	9/9
In attendance		
Susan Davy	Pennon Group Financial Officer	9/9
Helen Barrett-Hague	Pennon Group Counsel & Company Secretary	9/9

(1) Appointed as Senior Independent Director on 28 March 2018
(2) Attendance includes only meetings since his appointment on 28 September 2017

In addition to the nine Board meetings a Group-wide strategy day is held in September of each year.

MANAGING SOUTH WEST WATER

The South West Water board continues to operate as a separate independent board in accordance with its schedule of matters reserved (see below) to ensure compliance with Ofwat's principles on board leadership, transparency and governance.

The Pennon Group board's responsibilities include overall leadership of the Group, setting the Group's values, policies and standards, approving Pennon's strategy and objectives and providing oversight of the Group's operations and its performance.

The Pennon Group board also ratifies certain decisions taken by the South West Water Board, including major capital projects and investments, long-term objectives and commercial strategy, the five-year regulatory business plan, annual budgets and certain decisions relating to financing. This approach is compatible with Ofwat's principles for holding companies in respect of Board leadership, transparency and governance.

The Board delegates more detailed consideration of certain matters to the Board Committees, to the Executive Directors and to the Company Secretary. The matters reserved to the Board include:

- all acquisitions and disposals
- major items of capital expenditure
- authority levels for other expenditure
- risk management process and the monitoring of risks
- approval of the strategic plan and annual operating budgets
- Company policies, procedures and delegations
- appointments to the Board and its Committees
- approval of the Annual Reports and Financial Statements and the Annual Performance Report and Regulatory Reporting

OPERATION OF THE BOARD

The Board operates by receiving written reports circulated in advance of the meetings from the Executive Directors on matters within their respective business areas. The Board also receives presentations on key areas of the business and undertakes site visits to meet employees and gain a better understanding of the operation of business initiatives.

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

In arriving at decisions the Board takes into account the impact on stakeholder groups when considering what is in the best interests of shareholders as a whole.

The Chairman and Non-Executive Directors take particular care to ensure that the Board considers the interests of customers in all matters discussed by the Board, reflecting a very real understanding of the particular pressures on South West Water customers. In addition to a monthly review of customer contact and complaint analysis, the Board is regularly updated on customer satisfaction surveys.

South West Water has monitored customer satisfaction with service and value for money quarterly for over 20 years, and has also facilitated focus groups to discuss local and regional investment. Findings from all methods of customer consultation are fed back to the Board and incorporated into Company plans.

All Directors are equally accountable for the stewardship of the Company'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 examine the operational and financial performance of the Company and fulfil a key role in corporate accountability through their membership of the governance committees of the Board.

SOUTH WEST WATER EXECUTIVE MANAGEMENT

The role of the South West Water Executive is to define and drive the business priorities that will achieve delivery of the strategy. It is responsible for ensuring, to the extent of the authority delegated by the Board, the proper and prudent management of resources to create and maximise shareholder value whilst protecting the interests of the wider stakeholder group.

Chaired by the Chief Executive Officer, the Pennon Executive meets formally on a monthly basis to review and refine recommendations to be presented to the Board.

Further details concerning the Executive Management and its sub-groups are provided on pages 46 to 48 and within the South West Water Annual Performance Report and Regulatory Reporting, published in July 2018 (www.southwestwater.co.uk/report2018).

BOARD SUPPORT AND TRAINING

Directors have access to the advice and services of the Group 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.

Newly appointed Directors receive a formal induction which includes an explanation of the Group structure, regulatory and legal issues, the Group governance framework and policies, the Group's approach to risk management and its principal risks (financial and non-financial, including environmental, social and governance (ESG) risks), duties and obligations (including protocols around conflicts of interest and dealing in shares), and the current activities of the Board and its Committees. Directors also visit operating facilities and have meetings with staff to receive briefings on key processes and systems.

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 undertakes a formal and rigorous review of its performance and that of its Committees and Directors each year. Having carried out an externally facilitated evaluation last year, this year the evaluation of the Board's and the Committees' performance was carried out by means of a questionnaire created internally by the Pennon Group General Counsel & Company Secretary in consultation with the Chairman and Chairs of the various committees. As well as the Directors, the questionnaire was completed by various members of the senior executive team, the external audit partner and the advisor to the Remuneration Committee.

The questions were designed to assess the effectiveness of the Board during the year in setting the Group's strategy, promoting Pennon's culture and values, ensuring that the Group's obligations to its shareholders and other stakeholders were understood and met, overseeing the use of the Group's resources, managing the risks inherent in the strategy, plans and the operating environment, and ensuring that the executive team had managed all the activities of the Company well.

The Pennon Group Senior Independent Director (who is also a South West Water Non-Executive Director) separately conducted a review of the individual directors' performance and the Chairman's performance was evaluated separately by the Non-Executive Directors, led by the Pennon Group Senior Independent Director.

The review concluded that the Board, its Committees and its individual Directors had demonstrated a high degree of effectiveness and that the Board had a good understanding of opportunities for growth and the threats facing the business as well as its role in setting its value and standards so that its obligations to stakeholders are met. The Board's commitment to promoting a strong health and safety culture was noted. The Board and each committee considered the conclusions and recommendations arising from the evaluation process, which included areas specifically relating to diversity and succession planning as well as continuing to address the Directors' training and development needs.

BOARD COMMITTEES' TERMS OF REFERENCE

In accordance with Pennon Group policies, a range of key matters are delegated to the Board's Committees as set out on pages 58 to 74 of this governance report.

The terms of reference of each of the Board's Committees are set out on the Company's website www.southwestwater.co.uk and are also available from the Group Company Secretary upon request.

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. This has operated effectively during the year.

RISK MANAGEMENT AND INTERNAL CONTROL

The Board is responsible for maintaining the Company's system of internal control to safeguard shareholders' investment and the Company'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 2017/18 and up to the date of the approval of this annual report and accounts.

The Company's system of internal control is consistent with the FRC's 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' (FRC Internal Control Guidance).

The Board confirms that it applies procedures in accordance with the UK Code and the FRC Internal Control Guidance which brings together elements of best practice for risk management and internal control by companies. The Board's risk framework described on pages 23 to 26 in the strategic report provides for the identification of key risks including ESG risks in relation to the achievement of the business objectives of the Company, monitoring of such risks and ongoing and annual evaluation of the overall process.

As part of the review of the effectiveness of the system of risk management and internal control under the Group-wide risk management policy, 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 Company procedures.

The processes and policies serve to ensure that a culture of effective control and risk management is embedded throughout the Company and that the Company is in a position to react appropriately to new risks as they arise. Details of key risks affecting the Company are set out in the strategic report on pages 27 to 34.

CODE OF CONDUCT AND POLICIES

South West Water has adopted the Pennon Group's Code of Conduct and related policies which set out the commitment to promoting and maintaining the highest level of ethical standards.

The Code of Conduct and related policies set out our commitment to promoting and maintaining the highest level of ethical standards. Areas covered include our impact on the environment and our communities, our workplace and our business conduct.

The policy on anti-bribery and anti-corruption clearly prohibits any worker from offering or accepting bribes, facilitation payments and kickbacks and requires that due diligence checks be carried out before engaging a third party (including a corruption risk assessment including potential business partners of the third party and the nature of the proposed work and transaction). The policy also sets out the employment consequences for breach of the policy and potential legal sanctions under bribery laws. The policy places an obligation on workers to report any breach of the policy or any suspicions of fraud or other irregularities. The whistleblowing policy ('Speak Up') encourages workers to raise concerns and explains how this should be done.

Allegations of misconduct and irregularity are thoroughly investigated and follow-up action in respect of the Group's control environment is taken when appropriate. In the normal course of business, investigations into irregularities may be ongoing as of the date of the approval of the financial statements.

Our Code of Conduct and our policies are available on the Pennon Group website.

COMPANY AND GROUP COMPLIANCE WITH THE HIGHEST STANDARDS OF BOARD LEADERSHIP AND GOVERNANCE

South West Water Limited is a wholly-owned subsidiary of Pennon Group plc, a FTSE 250 company with a premium listing on the Official List, trading on the main market for listed securities of the London Stock Exchange.

South West Water and its parent company Pennon Group plc, remain committed to operating to the highest standards of board leadership and governance including transparency of reporting to investors, customers, regulators and other stakeholders. The full range of South West Water's corporate issues including strategy, performance, delivery, compliance and governance are covered within the governance structure shown above.

In response to, and in accordance with Ofwat's 'Board leadership, transparency and governance – principles' (January 2014) and the timetable for meeting those principles, South West Water adopted its own Board leadership, transparency and governance Code (31 March 2014) which sets out how South West Water complies with the Ofwat principles.

The South West Water Code states that the Company will comply with the UK Corporate Governance Code to the extent that it can be applied to South West Water within the context of the Pennon Group structure. The Company will continue to regularly review its governance structures, ensuring it continues to carry out its business in a transparent way, designed to secure the Company's long-term success and profitability.

INDEPENDENCE OF THE CHAIRMAN

Sir John Parker was considered to be independent at the time of his appointment, in accordance with provision A.3.1 of the Code. At that time, the Board concluded that none of the criteria set out in Provision B.1.1 of the Code applied to Sir John; although he was appointed to the position of Chairman of Pennon Group plc on the same date, he was not placed on the South West Water Board by Pennon in order to represent Pennon's interests but rather to help the flow of understanding of the issues facing South West Water at Pennon Board level.

In addition the operation of South West Water and the wider Group's governance framework is underpinned by the dual South West Water/Pennon Group plc appointments held by Sir John Parker and other Non-Executive Directors.

Notwithstanding Sir John's Chairmanship of Pennon Group plc, the South West Water Board believes he continues to demonstrate independence of character and judgement (of Pennon Group plc and its investors, and of management) when leading the Board in debate on South West Water matters.

SENIOR INDEPENDENT DIRECTOR

During the year, Lord Matthew Taylor has been appointed Senior Independent Director ('SID') for South West Water. Matthew has been a Non-Executive Director of South West Water since 2010 and as SID, provides a sounding board the Chairman and other Directors. He is not a Director of Pennon Group plc and is available to South West Water's stakeholders to discuss any concerns raised.

COMPLIANCE WITH THE UK CORPORATE GOVERNANCE CODE

Throughout the year, South West Water complied with its own Board leadership, transparency and governance Code. The South West Water Code states that the Company will comply with the current UK Corporate Governance Code to the extent it can be applied to the Company in the context of the Pennon Group structure.

The Company complied fully with the provisions and spirit of the Code during the year, subject to the exceptions as described below. Most of the exceptions relate to the Group structure, where certain responsibilities rest with Pennon Group plc (South West Water's parent company) which is fully compliant with the Code.

Provision A.4.1 of the Code states that the Board should appoint one independent Non-Executive Director to be the Senior Independent Director. South West Water did not have a Senior Independent Director in position for the whole year. Lord Matthew Taylor was appointed to the position on 28 March 2018. Prior to this appointment South West Water's Non-Executive Directors, including Pennon Group plc's Senior Independent Director, were available to deal with stakeholder concerns.

Provision B.6.3 – the performance evaluation of the Chairman is the responsibility of the Non-Executive Directors, led by the SID.

As the South West Water Chairman is also the Chairman of Pennon Group plc (South West Water's immediate and ultimate parent company), his performance evaluation is conducted separately by the Non-Executive Directors of Pennon Group plc, led by the Senior Independent Non-Executive Director of Pennon Group plc (who is also a Director of South West Water). Code provision B.6.3. states that the Non-Executive Directors (of South West Water) should be responsible for the performance evaluation of the Chairman, however as noted above due to the Group structure the South West Water Chairman's performance evaluation is conducted by the Non-Executive Directors of Pennon Group plc.

Provisions C.3.2, C.3.7 of the Code state that the Audit Committee should make recommendations to the Board in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor. Provision C.3.2 states that the Audit Committee should develop and implement policy on the engagement of the external auditor to supply non-audit services. As the auditor is appointed on a Group basis, the appointment, re-appointment and removal of South West Water's external auditor is (and has been throughout the year) a matter for the Pennon Group Audit Committee, as is the auditor's remuneration, terms of engagement and non-audit services.

Provision C.3.8. of the Code states that a separate section of the Annual Report should describe the work of the Committee in discharging its responsibilities, in particular an assessment of the effectiveness of the external audit process. Due to the Group structure, the overall assessment as to whether the external audit function is effective is (and has been throughout the year) the responsibility of the Pennon Group Audit Committee, which carries out its assessment in conjunction with the South West Water Audit Committee.

Provision D.2.2. of the Code states that the Remuneration Committee should have delegated responsibility for setting remuneration for all Executive Directors and the Chairman. However, the remuneration of the Chairman, who is also the Chairman of Pennon Group plc and the Pennon Group Chief Executive Officer, who is also a member of the Pennon Group plc Board is the responsibility of the Pennon Group Remuneration Committee.

During the year Pennon Group plc complied fully with the UK Corporate Governance Code. Full reports of the Pennon Group plc Board's Committees are contained within the Pennon Group plc Annual Report and Accounts.

THE AUDIT COMMITTEE

INTRODUCTION

As in previous years, the principal responsibilities of the Committee continue to be focused on a number of key areas. Firstly, on ensuring the appropriateness of the Company's financial reporting; an activity which includes the testing of accounting judgements made in preparing reporting and in assessing whether the presentation of the Company's activities is fair, balanced and understandable. Secondly, on reviewing and challenging the ongoing effectiveness of the internal control environment and thirdly, on the scope of risk management processes within South West Water and its subsidiaries, including monitoring the Company's risk appetite as well as acting as a forum in which to carry out more detailed reviews of higher risk areas of the operation.

Monitoring and reviewing the effectiveness of the external auditor and the internal audit function is a further important ongoing element of the Committee's assurance activities. These responsibilities are discharged throughout the year in accordance with the calendar of business of the Committee, which is designed to allow sufficient time for their consideration whilst also permitting time to be spent on related key financial matters.

South West Water's executive risk and assurance forums continues to assess risk appetite and monitor key risks and their mitigation alongside the Pennon Group Risk Forums, with the Committee subsequently reviewing detailed 'deep dive' presentations from senior management on individual principal risks. During the year this included cyber security, recruitment and retention and water resources and resilience risks. More detail on our risk management processes, principal risks and their associated mitigation can be found on pages 23 to 37.

Together with this we continue to assess the Company's viability over a period of five years, which we consider to be aligned with regulatory business cycle period, as well as being reasonable in terms of our ability to look forward with some certainty in the business and regulatory environment in which the Company operates. Our viability statement is reported on page 35 to 36.

As part of the half-year and year-end reporting review process, the Committee reviewed and challenged the key financial reporting judgements of management as set out on page 61. Significant matters considered by the Committee both during the year and in relation to the year-end financial statements are laid out in this report.

SOUTH WEST WATER AUDIT COMMITTEE COMPOSITION AND MEETINGS

Four meetings of the South West Water Audit Committee were held during the year. Membership of the South West Water Audit Committee and their attendance was as follows:

Membership	Role	Attendance
Neil Cooper	Chairman	4/4
Lord Matthew Taylor	Non-Executive Director	3/4
Martin Hagen	Non-Executive Director	4/4
Martin Angle	Non-Executive Director	4/4
Gill Rider	Non-Executive Director	4/4

Other regular attendees to South West Water Audit Committee meetings during the year included:

- Pennon Group Chief Executive Officer (a member of the South West Water Board)
- Pennon Group Chief Financial Officer
- South West Water Managing Director
- South West Water Finance Director
- Pennon Group Internal Audit Manager
- Pennon Group General Counsel & Company Secretary
- Statutory external financial auditor

In addition, the Chairman of the Board has had an open invitation to attend the Audit Committee meetings. In the last year he attended those meetings at which the Committee reviewed the half-year and full-year financial results of the Company.

In accordance with the UK Corporate Governance Code, the Board is satisfied that Neil Cooper, Martin Angle and Martin Hagen have recent and relevant financial experience. Details of each Director's significant and current experience are set out on pages 41 to 44.

All of the members of the South West Water Audit Committee were also members of the South West Water Remuneration Committee. This allowed them to provide input into both Committees on any performance matters and on the management of any risk factors relevant to remuneration matters.

SIGNIFICANT MATTERS CONSIDERED BY THE AUDIT COMMITTEE

The calendar of business of the Committee sets in place a framework for ensuing that it manages its affairs efficiently and effectively throughout the year and is able to concentrate on the key matters that affect the Company. The full terms of reference are available on our website (southwestwater.co.uk).

The most significant matters which the Committee considered and made decisions on during the year and where appropriate since the year end are set out below:

Financial reporting	• Monitored the integrity of the financial statements of the Company and the half year and full year results including reviewing and discussing significant financial reporting judgements contained in the statements • After a detailed review in accordance with its established process, advised the Board that the presentation of the Annual Report and Financial Statements is fair, balanced and understandable in accordance with the reporting requirements and recommend their approval for publication • Review of internal audit reports on core systems and processes within South West Water, for example purchase ledger and credit management • Monitored the effectiveness of key strategic projects including readiness for the new EU General Data Protection Regulations
External auditor	• Considered the statutory financial auditor's report on its review of the annual results focusing on key findings • Monitored the provision of non-audit services. • Considered and approved the audit plan for the statutory financial auditor • Considered the statutory financial auditor's report on control themes and observations for the year ended 31 March 2017, which did not identify any significant deficiencies Note: in line with the structure of the Group, certain activities such as recommending reappointment of the statutory financial auditor and assessment of effectiveness of the statutory financial auditor are performed by the Pennon Group Audit Committee. The responsibilities of the Pennon Group Audit Committee are described in the Pennon Group Annual Report (pages 73 to 76).
Risk management	• Reviewed the risk management framework and compliance with that framework during the year and after the year-end until the publication of the Company's Annual Report • Reviewed the assessment of the risks by the Executive Directors and considered risk appetite • Reviewed the Company's risk register and considered appropriate areas of focus and prioritisation for the audit work programme for the year • Received as part of the risk management review the annual report on any whistleblowing. • Carried out regular 'deep dives' at Committee meetings on principal risk areas
Governance	• Discussed the results of the performance evaluation of the Committee • Reviewed new annual report disclosure requirements including the audit report • Considered and approved accounting policies used in the preparation of the financial statements • Reviewed and updated Company policies • Confirmed compliance with South West Water's Code • Regularly held meetings with the external auditor and the Group Internal Audit Manager without members of management being present.

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 areas of judgement considered in relation to the financial statements for the year ended 31 March 2018 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 auditor have discussed the significant matters arising in respect of financial reporting during the year together with the areas of particular audit focus, as reported on in the independent auditor's report on pages 102 to 110. In addition to the significant matters set out in the table below, the Committee considered a range of other matters. These included including presentational matters, in particular relating to the non-underlying disclosure format and ensuring a fair presentation of statutory and non-statutory performance and financial measures.

Area of focus by the Committee: Revenue Recognition
How the matter was addressed by the Committee: There were a number of judgement areas in respect of revenue recognition relating to income from measured water services and estimates of timing of receipt of unmeasured revenue. The Committee relied on South West Water's track record of assessing an appropriate level of accrual at previous year ends given actual outturns. The Committee also closely considered the work in respect of these areas at year end by the statutory financial auditor as well as reviewing disclosures around revenue recognition accounting policies.

Area of focus by the Committee: Bad and doubtful debts
How the matter was addressed by the Committee: Regular updates on progress against debt collection targets and other contractual payments due are received by the Board. Performance is monitored regularly against South West Water's historical collection record and the track record of other companies in the sector. At the year end the statutory financial auditor reported on the work it had performed, which together with the detailed analysis reported enabled the Committee to conclude that the management's assessment of the year-end position was reasonable.

Area of focus by the Committee: Valuation of property, plant and equipment (PPE)
How the matter was addressed by the Committee: Regular updates on progress of the capital investment schemes are received by the Board. The valuation of PPE has been applied consistently and benchmarking of asset lives is considered annually. At the year end the statutory financial auditor reported on the work it had performed, which together with the detailed analysis reported enabled the Committee to conclude that the management's assessment of the year-end position was reasonable.

Area of focus by the Committee: Going concern basis for the preparation of the financial statements and viability statement
How the matter was addressed by the Committee: A report from the Pennon Group Chief Financial Officer on the financial performance of both the Pennon Group and South West Water separately, including forward-looking assessments of covenant compliance and funding levels under differing scenarios is provided to the Board on a periodic basis. Rolling five-year strategy projections and the resultant headroom relative to borrowings is also regularly reviewed by the Board, including scenarios to better enable the committee to understand the potential range of outcomes. At the end of each six month period the Pennon Group Chief Financial Officer prepares for consideration by the Committee a report focusing on the Company's liquidity over the 12-month period from the date of signing either the annual report or half-year results. This year the Committee has also considered a report from the Chief Financial Officer on the Company's financial viability over an appropriate period, which the Board considers to be five years, in connection with the new UK Corporate Governance Code requirement for a viability statement to be given by the Board. Consideration of these reports and constructive challenge on the findings of the reports, including the scenario testing carried out by management, has enabled the Committee to form its assessment and satisfy itself that it remains appropriate for the Group to continue to adopt the going concern basis of accounting in the preparation of the financial statements and in addition advise the Board on providing the viability statement set out on page 35 to 36.

EFFECTIVENESS OF THE EXTERNAL AUDIT PROCESS

Receiving high quality and effective audit services is of paramount importance to the Committee. We continue to monitor carefully the effectiveness of our external auditor as well as its independence, bearing in mind that it is recognised there is a need to use our external auditor's firm for certain non-audit services. We have full regard to the Financial Reporting Council's ('FRC') Ethical Standard and ensure that our procedures and safeguards meet these standards.

The current external statutory financial auditor, Ernst & Young LLP, was appointed following a comprehensive audit tender process undertaken by Pennon Group plc and approval by shareholders at the Pennon Group plc 2014 AGM. Their reappointment was approved at the 2017 Pennon Group plc Annual General Meeting. Debbie O'Hanlon is the audit partner and has been in that role since Ernst & Young's appointment.

The external auditor produced a detailed audit planning report in preparation for the year-end financial statements, which has assisted the auditor in delivering the timely audit of the Company's annual report and financial statements and which was shared with, and discussed by the Committee in advance.

The effectiveness review of the external auditor is undertaken as part of the Pennon Audit and South West Water Audit Committees' annual performance evaluation. Further details of the performance evaluation are provided on page 54. No issues were raised during that review and the Committees concluded that the auditor was effective during the year. The Pennon Group Audit Committee is responsible for matters relating to appointment and re-appointment of external auditor. It considered that it is appropriate that the external auditor be re-appointed and has made this recommendation to the Pennon Group Board.

The Committee Chairman has also met privately with the statutory financial auditor.

AUDITOR INDEPENDENCE

The Committee carefully reviews on an ongoing basis the relationship with the statutory financial auditor to ensure that the auditor's independence and objectivity is fully safeguarded.

The external statutory financial auditor reported on their independence in the year and since the year end and confirmed to the Committee that they have complied with the FRC's Ethical Standard and, based on their assessment, that they were independent of the Company.

PROVISION OF NON-AUDIT SERVICES

In line with the requirements of the EU Audit Directive and Regulation which came into force on 17 June 2016, the Committee continues to have a robust policy for the engagement of the statutory financial auditor's firm for non-audit work. The policy is for non-audit fees not to exceed 70% of the audit fee for statutory work.

The Committee receives a regular report covering the auditor's fees including details of non-audit fees incurred.

Recurrent fees relate to agreed procedures in relation to annual regulatory reporting obligations to Ofwat, work most efficiently and effectively performed by the statutory auditor. The policy is for non-audit fees not to exceed 70% of the audit fee for statutory work. The Committee carefully reviews non-audit work proposed for the statutory auditor, taking into consideration whether it is necessary for the auditor's firm to carry out such work and would only grant approval for the firm's appointment if it was satisfied that the auditor's independence and objectivity would be fully safeguarded. If there was another accounting firm that could provide the required level of experience and expertise in respect of the non-audit services, then such firm would be chosen in preference to the external auditor.

The level of non-audit fees payable to the external auditor for the past year is 17.3% of the audit fee, which is well within the Company's 70% non-audit fee limit.

The Pennon Group Chief Financial Officer regularly reports to the Committee on the extent of services provided to the Company by the external auditor and the level of fees paid. The fees paid to the external auditor's firm for non-audit services and for audit services are set out in note 6 to the financial statements on page 124.

Similar restrictions are applicable on a Group-wide basis and are summarised in the Pennon Group Audit Committee Report on page 76 of the Pennon Group plc Annual Report 2018.

INTERNAL AUDIT

The internal audit activities of the Company are a key part of the internal control and risk management framework of the Company. There is a long-standing and effective centralised internal audit service, at Pennon Group plc level which makes a significant contribution to the ability of the Committee to deliver its responsibilities.

A Company and Group internal audit plan was approved in January 2018 which will align the annual internal audit programme with the Company's financial year as well as the programmes of second line assurance functions within South West Water. It takes account of the principal risks, the activities to be undertaken by the statutory financial auditor, the Company's annual and ongoing risk management reviews and work performed by the Company's second line assurance functions. This approach seeks to ensure that there is a programme of internal and external audit reviews focused on identified key risk areas throughout the Company.

The Group Internal Audit Manager reports regularly to the Committee on audit reviews undertaken and their findings, and there are regular discussions, correspondence and private meetings between the Group Internal Audit Manager and the Committee chairman.

An external assessment of the internal function was performed by KPMG LLP in 2016, which concluded that the Company's internal audit function conforms to IIA standards issued by the Institute of Internal Auditors but identified some areas for improvement including the alignment of the internal audit programme with the financial year and refreshed reporting content. These have been auctioned.

FAIR, BALANCED AND UNDERSTANDABLE ASSESSMENT

To enable the Committee to advise the Board in making its statement that it considered that the Company's Annual Report and Financial Statements is fair, balanced and understandable (FBU) on pages 63 and 64, the Committee has applied a detailed FBU review framework that takes account of the Company's well-documented verification process, which includes external technical assurance upon certain key non-financial information, undertaken in conjunction with the preparation of the Annual Report and Financial Statements. This is in addition to the formal process carried out by the statutory financial auditor to enable the preparation of the independent auditor's report, which is set out on pages 102 to 110.

In preparing and finalising the 2018 Annual Report and Financial Statements, the Committee considered a report on the actions taken by management in accordance with the FBU process and an FBU assessment undertaken by the Executive Management. 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 Financial Statements 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.

INTEGRATED ASSURANCE FRAMEWORK

Throughout the year South West Water had in place an effective integrated assurance framework which identifies and monitors all types of assurance to enable a full evaluation of the conclusions drawn by all auditors, inspectors and reviewers from both internal and external providers.

The framework utilises a risk based approach to ensure an appropriate balance of varied providers of assurance dependent on the assessed risk and complexity of assurance requirements.

(i) Group independent internal audit

South West Water utilises the Pennon Group's independent Internal Audit function, to provide effective risk based coverage over the internal control environment. The Audit Committee's interactions and engagement into internal audit, including input into the annual plan is summarised above.

(ii) Annual assurance (financial and technical audit)

Alongside the statutory external auditor, South West Water also engages a Technical Auditor to provide assurance over key areas of regulatory performance reporting. This assurance considers our reported performance against key regulatory outputs and measures.

(iii) Quality assurance and ISO Internal Reviews

The South West Water Audit Committee also considers the resources for carrying out internal audits and reviews in key Company specific areas and endorses and acts on findings from these reviews carried out within the Company. There is a programme of internal audits coordinated by the Quality Assurance Department as part of the Company's ISO certifications.

South West Water has the following quality accreditations/certifications:

- ISO 9001: 2015 (quality management)
- ISO 14001: 2015 (environmental management)
- ISO 27001: 2013 (information security)
- ISO 17025: 2005 (laboratories and sampling)
- ISO 50001: 2011 (energy management)

These specific areas are also subject to periodic external reviews (such as ISO external reviews). South West Water achieved certification against the new updated quality and environmental standards for the first time during the year, well ahead of the required deadline to transfer to these new standards.

South West Water is implementing a programme of activity, including an internal audit programme which commenced in April 2018, aiming to achieve certification to the new ISO45001:2018 'Ocupational health and safety' standard in 2019.

OFWAT COMPANY MONITORING FRAMEWORK

The water industry regulator, Ofwat, introduced a 'company monitoring framework' as a tool to oversee that customers and other stakeholders an have confidence in the information that water companies report. The framework covers both data assurance activities and wider assurance that companies perform to demonstrate they are listening to customers and other stakeholders and delivering services customers want and can afford.

Companies are assessed in one of three categories, 'self assurance,' 'targeted assurance' or 'prescribed assurance,' which determine additional requirements that are required by companies to ensure trust and confidence is maintained for customers and other stakeholders.

In November 2017, following Ofwat's assessment of the 2016/17 reporting cycle, South West Water was classified within the 'targeted assurance' as it had been at the November 2016 assessment.

We were disappointed with this classification, having previously been classified within the 'self assurance' category in 2015, with discretion to deliver self assurance in relation to any additional assurance arrangements beyond base requirements.

The November 2017 assessment considered South West Water's performance against a number of specific areas. Ofwat did not identify any areas where is had 'serious' concerns in respect of South West Water's reporting of performance and we exceeded expectations in respect of the Assurance Plan (available at www.southwestwater.co.uk). In respect of the six other measures, including our 2016/17 assurance summary, South West Water was assessed as having met Ofwat's expectations.

South West Water met expectations in the two areas which Ofwat raised minor concerns over in its 2016 assessment (relating to 2015/16 outcome reporting in Bournemouth Water and the disclosure of our governance structures and processes). Improvements we made in respect of those concerns were summarised in the 2016/17 Summary Assurance Report.

SOUTH WEST WATER'S 2017/18 SUMMARY ASSURANCE REPORT

In July 2018, South West Water will publish its second annual 'Summary Assurance Report,' which will again detail assurance work which has been performed in areas which it has identified following consultation as significant areas for assurance, which includes annual reporting. This report will be available at www.southwestwater.co.uk/report2018.

THE SUSTAINABILITY COMMITTEE

INTRODUCTION

Sustainability remains an important and integral part of our strategy, and South West Water continues to take this responsibility seriously in all its business and operational practices. Our investment and our commitment to high levels of service and performance will contribute to meeting our communities' long-term needs – for water, wastewater and energy management.

The role of the Sustainability Committee is to set and oversee the delivery of sustainability objectives, which are set out on pages 69 and 70. We do this by bringing together and reviewing initiatives that drive sustainability, approving targets and monitoring the progress made in achieving them. Our sustainability objectives are truly "strategic" in that they are an essential part of our overall long-term strategy and create value for all our stakeholders. On pages 75 to 95 we explain the relationship between our strategy, sustainability objectives, the measurement of performance and how we reward our Executive Directors. All of this is underpinned by our corporate values, as we strive to be trusted, responsible, collaborative and progressive.

Through delivery of our sustainability objectives, we are able to uphold the highest standards of corporate responsibility for the benefit of all our stakeholders - our customers, our communities, our people and our suppliers, as well as our investors. The Committee has always played a central role in promoting and safeguarding stakeholder interests and is pleased to see that stakeholder engagement is now recognised as an essential aspect of corporate governance. South West Water has always taken a proactive and comprehensive approach to stakeholder engagement and we continue to monitor and refine the mechanisms we have in place to support ongoing dialogue. More information on our approach to stakeholder engagement is provided on page 39.

Throughout this annual report we demonstrate how a thorough approach to sustainability helps us to draw together the needs of society with the delivery of commercial success. We are pleased to note the results achieved which confirm sustainability is integrated in all we do.

SUSTAINABILITY COMMITTEE COMPOSITION AND MEETINGS

Four meetings of the South West Water Sustainability Committee were held during the year. Members of the Committee and their attendance were as follows:

Membership	Role	Attendance
Gill Rider	Chairman	4/4
Stephen Bird	Managing Director	4/4
Lord Matthew Taylor	Non-executive Director	3/4
Jon Butterworth[(1)]	Non-executive Director	3/3
Martin Angle	Non-executive Director	4/4
Chris Loughlin	Non-executive Director	4/4

(1) Attendance includes only meetings during appointment

The Sustainability Committee continues to provide oversight of South West Water's performance against its sustainability targets that are core to the successful delivery of South West Water's K6 Business Plan 2015-2020.

The Committee sets a range of targets for the Company as part of the business planning processes. Progress against these targets is reported to the Committee throughout the year. As at 31 March 2018 South West Water had achieved six of its 12 targets. Full details of the sustainability targets for South West Water are given on pages 69 to 70.

During the year the Committee continued to apply the best practice framework published by Business in the Community (BitC), a leading business-led charity that promotes responsible business. The structure provided through BitC's key areas of sustainability (marketplace, workplace, community and environment) is reflected in our sustainability objectives.

The Sustainability Committee balances the requirement to conduct business in a responsible manner (in relation to ESG matters) while at the same time delivering strong financial performance and lasting value for stakeholders. The Sustainability Committee reviews and approves as appropriate the strategies, policies, management, initiatives, targets and performance of South West Water in the areas of occupational health and safety and security, environment, workplace policies, responsible and ethical business practice, customer service and engagement, and the role of the Company in society.

Since last year's report, the Committee has considered a wide range of matters in the course of fulfilling its duties in accordance with its terms of reference:

- the Company's health and safety performance and the effectiveness of health and safety policies and procedures
- environmental strategy and performance
- performance in respect of customer service and engagement
- the Company's approach to community relations and investment
- performance against our workplace policy, including review of the South West Water's results in the first Group-wide employee engagement survey
- the new Pennon Group HR strategy, 'Talented people doing great things for our customers and each other'
- sustainable procurement and practices within the supply chain
- sustainability reporting for 2017 and the associated verifier's reports and recommendations
- progress against the sustainability targets for 2017/18 and sustainability targets for 2018/19.

In addition, the Committee considered:

- the results of the Company's gender pay gap analysis and proposed action plan
- the implementation of a Pennon Group-wide compliance and ethics training programme
- recommendations relating to South West Water arising from the first Pennon Group submission to BitC's Corporate Responsibility Index

VERIFICATION

South West Water's sustainability performance and reporting has been audited by Jacobs (a global provider of technical, professional and scientific services, including engineering, architecture, construction, operations and maintenance) as part of its audit of performance data contained within the Annual Performance Report. Jacobs utilise water industry specialists in the audit of our non-financial data.

South West Water considers that Jacobs's method of verification – which includes testing the assumptions, methods and procedures that are followed in the development of data and auditing that data to ensure accuracy and consistency – complements the best practice insight gained through South West Water's membership of Business in the Community.

Jacobs will provide a technical auditor's report within the Annual Performance Report and Regulatory Reporting outlining its opinion and key findings (published in July and available at southwestwater.co.uk/report2018).

BENCHMARKING

The Pennon Group (including South West Water) is a constituent of the FTSE4Good Index, an equity index series that is designed to facilitate investment in companies that meet globally recognised corporate responsibility standards. Companies in the FTSE4Good Index Series have met stringent environmental, social and governance criteria, and are positioned to capitalise on the benefits of responsible business practice.

SOUTH WEST WATER SUSTAINABILITY REPORT

South West Water's sustainability reporting is integrated throughout the strategic report and specifically in the following sections:

- Chairman's statement (pages 3 to 5)
- Business model (page 7)
- Our people (pages 8 to 10)
- Our operations (pages 11 to 15)
- Sustainability targets (pages 69 and 70)

Further details of our operational performance, including in respect of sustainability will be provided in our Annual Performance Report, available at www.southwestwater.co.uk/report2018, published in July.

SUSTAINABILITY TARGETS

A summary of South West Water's performance against sustainability targets for 2017/18 is outlined in the following report. South West Water is making good progress against its targets and it aims to meet all targets by the end of the regulatory reporting period (2015-2020).

ENVIRONMENTAL SUSTAINABILITY

The protection of the environment is an essential aspect of ensuring that we have high quality resources available now and in the future. By working alongside partner organisations and agencies and identifying how new technology and innovation can reduce our impact we aim to deliver water and wastewater services in harmony with the ecosystems and habitats of our region.

Target	**Status**
To ensure the average time taken to fix significant customer reported leaks is less than 2.1 days	NOT MET(1)
To achieve zero Category 1 and 2 pollution incidents which are our responsibility from waste water assets	NOT MET(2)
To increase the number of farms that have an agreed plan to benefit the environment and the acres of farmland under revised management plans and delivering environmental outcomes in line with our Business Plans	MET

(1) The average time taken to fix significant leaks can be significantly impacted by weather conditions and this measure has risen in the year as a result. We believe with the continued implementation of new technology, especially with a focus on leak detection in urban areas, South West Water remains on track to meet its 2020 regulatory target.

(2) Regrettably South West Water failed to meet its target for zero Category 1 or 2 pollutions from wastewater assets, although the number reduced year on year. South West Water has implemented a targeted strategy to reduce the number of pollutions from wastewater assets such as using additional vehicles and equipment for sewer monitoring and cleaning. We remain committed to reaching our 2020 targets in respect of pollution incidents.

COMMUNITY SUSTAINABILITY

As the providers of an essential service we have a responsibility and vested interest in understanding and meeting the needs of the various communities across the area we serve. It is our aim to be a 'good neighbour', having a positive effect on our local communities and the quality of life that they enjoy.

Target	**Status**
To minimise our supply interruptions to customers and ensure that they do not exceed 0.228 hours per property	NOT MET(1)
To increase the number of customers assisted through our water affordability initiatives in line with our Business Plans (to over 29,000)	MET
To invest at least £80k in the local community through sponsorship and charitable donations during the year and measure benefits this investment has delivered	MET

(1) The extreme weather in March 2018, especially rapid freeze and thaw conditions, has resulted in an increase in the average duration of supply interruptions. Had the extreme weather not occurred, South West Water was on track to meet this target. We continue to work with network alliance partners to improve the forecasting of workloads and effective utilisation of resources to ensure that the significant underlying improvement in results is maintained and targets are met.

WORKPLACE SUSTAINABILITY

Engaged staff are critical to the success of the Company. Colleagues who are more engaged feel safer, are involved in fewer accidents at work, take fewer days off sick and receive more positive feedback from customers. Put simply, working to improve engagement is a key part of working to improve overall performance and sustainability.

Target	Status
To achieve employee satisfaction of 78% as measured in our annual survey	NOT MET(1)
Our desire is to have no accidents at work and to achieve a reducing lost time accident frequency rate	MET
To have extended the recruitment of apprentices on our programme by the end of 2017/18 to over 110	MET

(1) Although employee satisfaction rose from 69% to 74% as measured by our annual employee survey, it did not reach the target of 78%. The survey identified clear strengths in communication and involvement, trust, diversity and empowerment and accountability. It also revealed areas requiring further work. These include continuing to ensure our people understand our strategy and direction, as well as maintaining focus on embedding our values into everything we do, while recognising the contribution made by our employees.

MARKETPLACE / CUSTOMER SUSTAINABILITY

Our ultimate goal is to provide our customers with the highest standards of service, ensuring that their requests, problems and queries are dealt with first time and that the service they receive represents value for money. In turn, this helps South West Water to build a solid reputation for high quality customer service, which contributes to the creation of shareholder value.

Target	Status
To achieve an average of 90% of our customers being satisfied or very satisfied with our overall services	MET
To achieve an average of 70% of our customers being satisfied with the value for money of our services	NOT MET(1)
To ensure our water and wastewater activities are emitting a reduced level of greenhouse gas compared to 2014/15 in line with our business plan	NOT MET(2)

(1) Although customer satisfaction with value for money improved in the year to 62%, it did not meet our challenging target of 70%. We continue to pledge to ensure that any rise in average household bills will remain less than inflation (as measured by the Retail Prices Index) over the 2015-20 period.

(2) Although we did not meet our target in respect of greenhouse gases produced in water activities, we met our target for wastewater activities and met the targets on a combined basis. We remain committed to our 2020 targets in respect of greenhouse gas emissions.

SOUTH WEST WATER'S ANNUAL PERFORMANCE REPORT AND REGULATORY REPORTING

Each of the above benchmarks chosen as our sustainability targets are also reported within our Annual Performance Report and Regulatory Reporting as either 'performance commitments' in respect of 'outcomes' specified in our 2015-20 regulatory business plan or as separate internal Key Performance Indicators.

South West Water's Annual Performance Report and Regulatory Reporting will be published in July 2018 and available at www.southwestwater.co.uk/report2018.

THE NOMINATION COMMITTEE

INTRODUCTION

The Nomination Committee met three times during the year to fulfil the duties set out in its terms of reference.

Matters considered by the Committee during the year included:

- A revised policy on Diversity, Inclusion and Respect
- The Company's performance against its diversity and equality policies
- The recruitment and appointment of Jon Butterworth as a Non-Executive Director, to fill the vacancy arising from the resignation of Steve Johnson in April 2016
- The appointment of Ed Mitchell as a Director of Operations (Wastewater Services)
- A review of succession plans, the leadership needs of the Company and the Company's approach to succession planning
- The structure, size and composition of the Board, including the skills knowledge, independence, diversity and experience of the Directors
- A review of the time spent by Non-Executive Directors in fulfilling their duties and the other directorships they hold.

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, Buchannan Harvey & Co, who have no other connection with the Company, were engaged to assist with the recruitment of a Non-Executive Director for the Board.

NOMINATION COMMITTEE COMPOSITION AND MEETINGS

Director	Role	Attendance
Sir John Parker	Chairman	3/3
Lord Matthew Taylor	Non-Executive Director	2/3
Martin Hagen	Non-Executive Director	3/3
Martin Angle	Non-Executive Director	3/3
Neil Cooper	Non-Executive Director	2/3
Gill Rider	Non-Executive Director	3/3

The Pennon Group Chief Executive (a member of the South West Water Board) also attends meetings when invited.

BOARD DIVERSITY POLICY

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 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 gender and ethnic diversity on the Board
- 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 Company 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 endeavours to achieve and maintain:
  - a minimum of 25% female representation on the Board
  - a minimum of 25% female representation on the Company's senior management team.

As disclosed on page 10, the percentage of female representation within the Board and the Company's senior management team is below the target set. Action is being taken to improve diversity across the workforce which will assist in increasing female representation at senior management level as described on page 10.

The Committee and the Board will continue to monitor and promote diversity across the Group with the aim of ensuring a diverse pipeline for succession to Board and senior management positions.

Our 2017 employee survey told us that 90% of our employees believe that people within the Company are treated fairly regardless of race or ethnic origin. Whilst we recognise this as good progress we plan to increase our focus on ethnic diversity in the coming year. We continue to strive to ensure people with disabilities are given all the encouragement and support necessary and that South West Water is seen as a welcoming and inclusive place to work in all respects.

Information regarding the gender breakdown of the workforce is provided on page 10.

THE REMUNERATION COMMITTEE

INTRODUCTION

The Committee is responsible for ensuring remuneration is aligned with and supports the Company and Group's strategy, reflects our values and optimises performance.

The Committee met four times during the year to fulfil the duties set out in its terms of reference. In particular, the Committee is responsible for:

- ensuring remuneration is aligned with and supports the Company's strategy, reflects our values as a Company and optimises performance
- maintaining and, in every third year, reviewing the remuneration policy and considering any changes necessary to ensure it remains appropriate and fulfils its purpose of attracting and retaining high calibre people who are able to contribute to the success of the Company
- advising the Board on the framework of executive remuneration for the Company
- determining the remuneration and terms of engagement of the Chairman, the Executive Directors and senior executives of the Company.

Remuneration of employees other than Executive Directors is considered by Executive Directors and Senior Management. Trade Unions recognised by the Company are consulted as part of annual pay review processes. All employees of South West Water are members of a bonus scheme which takes into account Company performance (both financial and non-financial) as well as personal performance.

THE COMMITTEE'S ACTIVITIES DURING THE FINANCIAL YEAR

The Committee engaged in the following activities during the year:

- Annual executive salary review
- Annual review of the Chairman's fee
- Determining performance targets in respect of the Annual Incentive Bonus Plan for 2017/18
- Reviewing drafts of the Directors' remuneration report for 2016/17 and recommending it to the Board for approval for inclusion in the 2017 annual report
- Determining bonuses and deferred bonus awards pursuant to the Company's Annual Incentive Bonus Plan in respect of the year 2017/18
- Noting the Long Term Incentive Plan (LTIP) awards for the year
- Noting the release of the 2014 deferred bonus share awards and the vesting of executive share options pursuant to the Annual Incentive Bonus Plan
- Noting the outcome of the 2014 Performance and Co-investment Plan awards
- Reviewing the results of the Committee's performance evaluation and instigating appropriate changes

THE COMMITTEE'S FOCUS FOR 2018/19

- Ensure that targets are stretching but also fair and achievable, so that they act to retain, motivate and incentivise management to deliver the Company's strategic goals and to create long-term value for shareholders
- Monitor on an ongoing basis the alignment of executive pay and benefits with the strategic direction of the Company and review workforce remuneration, incentives and policies to ensure these support the long-term success of the Company and promote its values
- Improve the process around, and disclosure of, personal bonus targets
- Undertake a review of the Committee's independent remuneration consultants
- Consider and respond to the remuneration related changes included in the new version of the UK Corporate Governance Code, due to be published in June 2018

REMUNERATION COMMITTEE COMPOSITION AND MEETINGS

There were four meetings of the South West Water Remuneration Committee during the year. Members of the Committee and their attendance were as follows:

Membership	Date of appointment		Attendance
Martin Angle	1 April 2016	Chairman of the Committee	4/4
Neil Cooper	1 April 2016	Non-Executive Director	3/4
Martin Hagen	1 September 2013	Non-Executive Director	4/4
Gill Rider	1 April 2016	Non-Executive Director	4/4

In accordance with the Code, all of the Committee members are independent Non-Executive Directors. The Chairman of the Board attends from time to time but is not a member of the Committee. The Pennon Group Chief Executive Officer (who is also a member of the South West Water Board) also attends meetings when invited except for such part of a meeting when matters concerning his own remuneration are to be discussed.

The Committee is advised by Deloitte, an independent remuneration consultant, to ensure remuneration is determined impartially. The Committee is also supported by the Group Director of Human Resources and the Group General Counsel and Company Secretary.

DIRECTORS' REMUNERATION AT A GLANCE

KEY COMPONENTS OF EXECUTIVE DIRECTORS' REMUNERATION

Base salary	Set at a competitive level to attract and retain high calibre candidates to meet Company's strategic objectives in an increasingly complex business environment.
Benefits	Benefits provided are consistent with the market and level of seniority and to aid retention of key skills to assist in meeting strategic objectives.
Annual bonus	Incentivises the achievement of key performance objectives aligned to the strategy of the Company.
Long-term incentive plan	Provides alignment to the achievement of the Company's strategic objectives and the delivery of sustainable long-term value to shareholders.
Shareholding guidelines	Create alignment between executives and shareholders and promote long-term stewardship.
Pension	Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.
All-employee share plans	Align the interests of all employees with Pennon Group plc's share performance.

SUMMARY OF DIRECTORS' REMUNERATION 2017/18

	Base salary/fees (£000)	Benefits (including sharesave) (£000)	Annual bonus (cash bonus and deferred shares) (£000)	Long term incentive plan (£000)	Pension (£000)	Total remuneration (£000)
Executive Directors						
Stephen Bird	244	21	155	-	74	493
Louise Rowe	160	15	104	-	24	303
Non-executive Directors						
Sir John Parker(1)	135	-	-	-	-	135
Lord Matthew Taylor	55	-	-	-	-	55
Jon Butterworth(2)	28	-	-	-	-	28
Martin Hagen	55	-	-	-	-	55
Martin Angle (1)	34	-	-	-	-	34
Neil Cooper(1)	33	-	-	-	-	33
Gill Rider(1)	37	-	-	-	-	37
Chris Loughlin(1)	259	15	225	-	78	577

(1) Also Directors of Pennon Group plc. The disclosures above reflect 50% of their full remuneration which is rechargeable to South West Water through group recharges. The full single total figure of remuneration tables are show on page 85.
(2) Jon Butterworth joined the South West Water Board on 28 September 2017.
See the full total figure of remuneration on page 85.

TOTAL REMUNERATION OPPORTUNITY AND OUTCOME 2017/18

Estimated zero vesting for LTIP which reduces actual remuneration outcome for the year.

	Fixed pay	Fixed pay £000	Annual Bonus £000	LTIP £000	Total £000
Stephen Bird	Actual Pay	339	155	-	**493**
	Maximum Pay	339	183	148	**670**
Louise Rowe	Actual Pay	199	104	-	**303**
	Maximum Pay	199	120	92	**411**

No adjustments have been made for share price movements or payment of dividends. Fixed pay includes salary, pension and benefits. LTIP maximum based on 2015 award.

ANNUAL STATEMENT FROM THE CHAIRMAN OF THE REMUNERATION COMMITTEE

Our remuneration arrangements ensure the commitment of our Executive Directors to our long-term strategic objectives.

INTRODUCTION

The revised Directors' Remuneration Policy outlined in last year's Directors' Remuneration Report has been implemented. The policy is in line with the Pennon Group policy. Rather than reproduce the policy in full in this report, it has been made available at www.pennon-group.co.uk/about-us/governance-and-remuneration. We are not proposing any changes to the policy this year.

A significant proportion of the Executive Directors' remuneration is provided as variable pay that rewards the achievement of stretching annual and long-term performance targets, which in turn are designed to ensure delivery of the Company and Group's strategy and create shareholder value. The relationship between our strategy, performance and the remuneration of our Executive Directors is summarised on the following page.

On pages 83 to 95 we set out our annual report on remuneration which contains the remuneration of the Directors for the year 2017/18 including the 'single remuneration figure' table providing a value for each element of remuneration for each Director. It also provides details of how our policy will be applied for 2018/19.

REVIEW OF THE YEAR

PERFORMANCE AGAINST BONUS TARGETS

The bonus outturns for the Executive Directors for 2017/18 reflect the Company's strong achievements against corporate, financial and operational targets and the Executive Directors' performance against personal targets. Half of the bonus is deferred and held as shares in Pennon Group plc.

Strong underlying earnings growth was maintained across the Pennon Group and South West Water and we continued to make good progress towards delivering our long-term strategic priorities. Pennon Group underlying profit before tax was £259 million, an increase of 3.5% compared with 2016/17. Pennon Group earnings per share (EPS) before deferred tax and non-underlying items was up 8% at 50.9p reflecting strong earnings from both South West Water and Viridor, supported by sector leading efficiencies in South West Water and a full year increase in Viridor's Energy Recovery Facility (ERF) operational capacity. South West Water's cumulative return on regulated equity (RoRE) at 11.8% continues to lead the sector and Viridor generated EBITDA of £150.2 million during the year.

Our operational metrics incentivise the Executives to focus on the issues that really matter to our customers and other stakeholders. South West Water's year-end outturn has been affected by the extreme cold weather in early March 2018, which caused an increase in supply interruptions, and while at 83 megalitres per day we met our Outcome Delivery Incentive (ODI) leakage of 84 megalitres per day, we did not achieve the stretch target of 82 megalitres per day.

While personal targets amount to only 15% to 20% of overall performance, the Executive Directors performed extremely well in 2017/18. Their leadership and drive has resulted in excellent progress towards delivery of our strategic priorities. There have been many challenges and successes during the year. Preparatory work on our PR19 business plan has produced the building blocks for a coherent and compelling submission, which will demonstrate our commitment to outstanding customer service and sharing reward.

The Committee recognises that positive steps have been taken during the year in relation to health and safety, with the development of HomeSafe and a 17% reduction in lost time the injury frequency rate (LTIFR). Environmental performance has also improved with a 6% reduction in wastewater pollution incidents. The Committee and the Executive expect these trends to continue as we strive towards a step change in performance in both areas.

Further details of bonus targets, measures and performance are set out on page 86.

LONG-TERM INCENTIVE PLAN (LTIP) OUTTURN

We are disappointed that the overall estimated outturn for awards vesting in 2018 under the old Performance and Co-investment plan is 0%. This reflects that Pennon's total shareholder return (TSR) for the three-year performance period is anticipated to be below the comparators index performance and the median of the FTSE 250, with Pennon's share price having been affected by external market and political considerations.

In 2017 a new long-term incentive plan was introduced, which has allowed us to move away from TSR and introduce a set of new performance measures that are aligned with our strategic objectives.

KEY REMUNERATION DECISIONS

For 2018/19, salaries for Executive Directors were increased by 2%, which will be lower than the pay increase awarded to the wider employee population.

Looking ahead to the annual bonus for 2018/19 we are maintaining our approach of setting measurable financial and customer-focused operational objectives. These objectives will support the delivery of our strategy and create value for our stakeholders.

LOOKING FORWARD

The Committee will continue to monitor the proposed changes to the UK Corporate Governance Code with interest, including proposals to strengthen the employee voice, as well as the Government's intention to introduce mandatory pay ration reporting.

We are constantly reviewing our remuneration arrangements and performance measures to ensure they are aligned with our strategy and provide shareholders with an appropriate level of transparency.

LINK BETWEEN STRATEGY, 2018 PERFORMANCE AND REMUNERATION

Strategic priority	Performance measures	Remuneration impacts
Leadership in UK Water and Waste	Pennon Group's TSR performance against comparator index (50% weighting) and FTSE 250 (50% weighting).	Performance and Co-Investment Plan outturn for awards granted in 2015 and 2016 (due to vest in 2018 and 2019 respectively)
	Pennon Group's EPS growth per annum (40% weighting), Pennon Group's dividend cover (40% weighting) and average return on capital employed (20% weighting)	LTIP outturn for awards granted in 2017 onwards
Leadership in cost base efficiency	Pennon Group's profit before tax (PBT) and South West Water's RoRE	Annual bonus outturn: SBird – 50% PBT/10% RoRE L Rowe - 37.5% PBT/7.5% RoRE
Driving sustainable growth	Performance against operational metrics and personal measures that are key to meeting the needs of our customers, communities, employees and other stakeholders	Annual bonus outturn: S Bird 20% operational/20% personal objectives L Rowe 15% operational/15% personal objectives

DIRECTORS' REMUNERATION POLICY

INTRODUCTION

The current Directors' remuneration policy was approved in July 2017.

The Committee's intention is to seek approval for the Company's remuneration policy at the end of the usual three-year cycle, in accordance with section 439A of the Companies Act 2006. Unless the Directors wish to amend the remuneration policy in the meantime, it will be submitted for approval in 2020, following a review to be carried out by the Committee in 2019/20.

The remuneration policy tables for Executive and Non-Executive Directors are set out below for information. The policy is displayed in its entirety on the South West Water website and is also available upon request from the Company Secretary.

POLICY TABLE – EXECUTIVE DIRECTORS

The table below sets out the elements of the total remuneration package for the Executive Directors which are comprised in the Directors' remuneration policy. Where it is intended that certain provision of the 2014 remuneration will continue to apply, this is indicated in the policy table below.

How the components support the strategic objectives of the Company	How the component operates (including provisions for recovery or withholding of payment)	Maximum potential value of the component	Description of framework used to assess performance
Base salary			
Set at a competitive level to attract and retain high calibre candidates to meet Company's strategic objectives in an increasingly complex business environment. Base salary reflects the scope and responsibility of the role as well as the skills and experience of the individual.	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. However, the Committee reserves the right to make increases above those made to general employees, for example in circumstances including (but not limited to) an increase in the scope of the role.	When reviewing salaries the Committee has regard to the following factors: • Salary increases generally for all employees in the Company • Market rates • Performance of individual and the Company • Other factors it considers relevant There is no overall maximum	None, although individual and Company performance are factors considered when reviewing salaries.

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 payment)	Maximum potential value of the component	Description of framework used to assess performance
Benefits			
Benefits provided are consistent with the market and level of seniority to 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.
Annual bonus			
Incentivises the achievement of key performance objectives aligned to the strategy of the Company.	Annual bonuses are calculated following finalisation of the financial results for the year to which they relate and are usually paid three months after the end of the financial year. 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. 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.	The maximum bonus potential for each Director is: • Stephen Bird 100% of base salary • Louise Rowe 75% of base salary	Performance targets relate to corporate and personal objectives which are reviewed each year. For 2018/19, in relation to the financial and operational measures of the annual bonus framework there will be a 60% overall weighting of which: • 50% (S Bird)/37.5% (L Rowe) will be profit before tax • 10% (S Bird)/7.5% (L Rowe) will be return on regulated equity • 20% (S Bird)/15% (L Rowe) will be operational measures. All of these measures will be subject to defined quantitative targets. The measures, weighting and threshold levels may be adjusted for future years. 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 in exceptional circumstances may exercise its discretion and adjust the bonus to reflect any specific factors.

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 payment)	Maximum potential value of the component	Description of framework used to assess performance
Long-term incentive plan (LTIP)			
Provides alignment to the achievement of the Company's strategic objectives and the delivery of sustainable long-term value to shareholders.	Annual grant of conditional shares (or equivalent). Share awards vest subject to the achievement of specific performance conditions measured over a performance period of no less than three years. Dividend equivalents (including dividend reinvestment) may be paid on vested awards. 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. For grants made in 2015 and 2016 onwards under the PCP, as well as all grants made from 2017 under the LTIP, malus and clawback provisions apply which permit shares to be forfeited, repaid or made subject to further conditions where the Committee considers it appropriate in certain circumstances. The circumstances in which malus may be applied include (but are not limited to) material misstatement, serious reputational damage, or the participant's misconduct. The circumstances in which clawback may be applied are material misstatement or serious misconduct. In addition a two year holding period will apply in respect of any shares which vest at the end of the three year performance period. Malus may be applied during the three year performance period and clawback may be applied up until the end of the holding period.	The maximum annual award is 100% for Stephen Bird and 80% for Louise Rowe.	The current performance measures for the LTIP are based on a combination of growth in earnings per share (EPS), sustainable dividend growth and dividend cover, and return on capital. For 2018/19 awards, performance measures will be weighted as follows: • 40% based on Pennon EPS growth • 40% based on a combination of Pennon dividend growth and a dividend cover metric • 20% based on Pennon return on capital employed The "underpin" evaluation includes consideration of environmental, social and governance (ESG) factors and safety performance as well as financial performance. No more than 25% of maximum vests for minimum performance. The Committee will keep the performance measures and weightings under review and may change the performance condition for future awards if this were considered to be aligned with the Pennon Group's interests and strategic objectives, as well as the impact of regulatory changes. However, the Committee would consult with major shareholders in advance of any proposed material change in performance measures.

Long term incentive plan (LTIP) commitments made under the 2014 policy

Performance conditions set under the previous remuneration policy (approved at the 2014 Pennon Group AGM) will continue to apply to awards granted in 2014, 2015 and 2016. These awards are due to vest in 2018 and 2019 respectively. Previous performance conditions were based on Pennon Group Plc total shareholder return (TSR) against the performance of a water/waste peer group index and constituents of the FTSE 250 index (excluding investment trusts). For awards granted under the 2014 remuneration policy, no more than 30% of the maximum vests for minimum performance.

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 payment)	Maximum potential value of the component	Description of framework used to assess performance
Shareholding requirements			
Create alignment between executives and shareholders and promote long-term stewardship.	100% of salary for both the Managing Director and Finance Director.		
Pension			
Provides funding for retirement and aids retention of key skills to assist in meeting the Company's strategic objectives.	Defined benefit pension arrangements are closed to new entrants. Defined contribution pension arrangements have been 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.	The maximum annual pension contribution or cash allowance is 21% for Stephen Bird and 15% for Louise Rowe. Legacy defined benefit pension arrangements will continue to be honoured. Whilst one Executive Director is a pension member there are no further prospective accruals in respect of defined benefit pension arrangements.	None.
All-employee share plans			
Align the interests of all employees with Pennon Group Plc 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.

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 and South West Water's strategy.	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. 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. 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.	Total fees paid to Non-executive Directors will remain within the limits stated in the Articles of Association.
Benefits		
The benefits provided for the Chairman are consistent with the market and level of seniority.	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). The Chairman's benefits include the provision of a driver and vehicle, when appropriate for the efficient carrying out of his duties.	None.

ANNUAL REPORT ON REMUNERATION

INTRODUCTION

This section sets out how the Company has applied its remuneration policy in the year, and details how the new policy will be implemented for the year 2018/19.

OPERATION OF THE REMUNERATION POLICY FOR 2018/19

A summary of the specific remuneration arrangements for Executive Directors in 2018/19 is described below:

<table>
<tr><td>Base salary 2018/19</td><td>2018/19 salaries are:
Stephen Bird: £248,472
Louise Rowe: £163,200

Salaries were increased by 2.0%, which is lower than increases for all employees.</td></tr>
<tr><td>Pension and benefits</td><td>No changes. Salary supplement cash allowance of 21% for Stephen Bird and 15% for Louise Rowe from which is deducted the employer’s contribution to the defined benefit or defined contribution pension schemes for the Directors.</td></tr>
<tr><td>Annual bonus</td><td>Maximum opportunity of 100% of salary for Stephen Bird and 75% of salary for Louise Rowe. No change to operation of deferral with 50% of the bonus to be deferred into shares for three years.

For 2018/19, the annual bonus will be based on the following performance measures:

<u>S Bird/L Rowe</u>
60%/45% based on Pennon Group financial metrics (50%/37.5% profit before taxation (PBT), 10%/7.5% Return on Regulatory Equity (RoRE)).

20%/15% based on operational metrics, weighted equally between the waste business and the water business. These measures will be quantitative and measurable, are key to meeting the needs of our customers, our regulator, and wider stakeholders:
• Water metrics:
○ Service Incentive Mechanism (SIM)
○ Bathing water quality
○ Leakage
○ Wastewater pollution incidents
○ Duration of interruptions to supply
○ Water and wastewater asset reliability

20%/15% based on personal strategic measures. These will be relevant to the individual, and will include health and safety and the development of the PR19 business plan, as well as the implementation of specific plans and initiatives.

For bonuses from 2014/15 both malus and clawback apply as described in the remuneration policy report.</td></tr>
</table>

OPERATION OF THE REMUNERATION POLICY FOR 2017/18 continued

Long-term incentive plan

Maximum award of 100% of base salary for the Managing Director and 80% for the Finance Director.

For 2018/19, performance measures will be EPS growth, a sustainable dividend measure, and ROCE, with targets set as follows:

Pennon Group EPS – 40% weighting

	EPS growth p.a.	Vesting
Threshold	6%	25%
Maximum	10%	100%

Straight line vesting between threshold and maximum

Sustainable dividend measure (dividend growth and dividend cover) – 40% weighting
The performance measure comprises two performance targets, both of which need to be achieved. There is a “gateway” dividend growth target of RPI+4% per annum. There is then an EBITDA dividend cover target which operates as follows:

	EBITDA dividend cover	Vesting
Threshold	2.6	25%
Maximum	3.6	100%

Straight line vesting between threshold and maximum

As an additional underpin the board must also be satisfied with the level of EPS dividend cover. EBITDA dividend cover will be based on adjusted EBITDA calculated as (underlying EBITDA + share of JV dividends & interest receivable + IFRIC12 interest receivable).

For the purpose of the calculation, dividend cover would be based on the policy of 4% p.a. above RPI.

Return on capital employed (ROCE)* – 20% weighting

	Average ROCE	Vesting
Threshold	8%	25%
Maximum	10%	100%

*ROCE is defined as (operating profit + JV profit after tax + interest receivable) divided by capital employed (debt + equity including hybrid).

Straight line vesting between threshold and maximum

The LTIP award will be subject to an ‘underpin’ relating to overall Group performance including consideration of environmental, social and governance factors and safety performance, as well as financial performance.

For awards from 2015/16 both malus and clawback apply and a holding period applies in respect of any shares which vest at the end of the three year performance period, as described in the remuneration policy report.

Performance is measured over three years and a two-year holding period applies.

Shareholding guidance

100% of salary for both the Managing Director and Finance Director (subject to building over five years for new appointments).

NON-EXECUTIVE DIRECTOR FEES

Non-Executive Director fees for 2018/19 are set out below. They include a 2% increase for the Non-Executive Directors and 11% for Lord Matthew Taylor reflecting increases in responsibility in the year following his appointment as Senior Independent Non-Executive Director, approved by the Board. The Chairman declined to accept an increase for 2018/19.

Director	Fees £000
Sir John Parker	135
Lord Matthew Taylor	61
Jon Butterworth	56
Martin Hagen	56
Martin Angle	34
Neil Cooper	34
Gill Rider	38
Chris Loughlin	264

The Chairman, Sir John Parker, and Martin Angle, Neil Cooper and Gill Rider's Director fees and Chris Loughlin's salary Director fees are set by Pennon Group plc and 50% of these fees are charged to South West Water through group recharges. The table above outlines the 50% fee/salary charges for 2018/19.

SINGLE TOTAL FIGURE OF REMUNERATION TABLES (AUDITED INFORMATION)

	Base salary/fees (£000)		Benefits[3] (including sharesave) (£000)		Annual bonus (cash bonus and deferred shares) (£000)		Performance and co-investment plan (£000)		Pension[5] (£000)		Total remuneration (£000)	
	2017/18	2016/17	2017/18	2016/17	2017/18	2016/17	2017/18[4]	2016/17	2017/18	2016/17	2017/18	2016/17
Executive Directors												
Stephen Bird	244	240	21	20	155	158	-	71	74	64	493	553
Louise Rowe	160	140	15	10	104	96	-	-	24	22	303	268
Non-Executive Directors												
Sir John Parker, Chairman[1]	135	133	-	-	-	-	-	-	-	-	135	133
Lord Matthew Taylor, Senior Independent Director	55	50	-	-	-	-	-	-	-	-	55	50
Jon Butterworth[2]	28	-	-	-	-	-	-	-	-	-	28	-
Martin Hagen	55	50	-	-	-	-	-	-	-	-	55	50
Martin Angle[1]	34	33	-	-	-	-	-	-	-	-	34	33
Neil Cooper[1]	33	33	-	-	-	-	-	-	-	-	33	33
Gill Rider[1]	37	36	-	-	-	-	-	-	-	-	37	36
Chris Loughlin[1]	259	255	15	13	225	215	-	100	78	77	577	660

(1) These directors are also Directors of Pennon Group plc. The disclosures above reflect 50% of their full remuneration which is rechargeable to South West Water through group recharges. The full single total figure of remuneration tables are show on page 93 of the Pennon Group plc Annual Report and Accounts 2018 .

(2) Jon Butterworth joined the South West Water Board on 28 September 2018.

(3) Benefits comprise a car allowance and medical insurance

(4) Based on an estimated 0% vesting as referred to on page 87

(5) See page 88 for further information.

ANNUAL BONUS OUTTURN FOR 2017/18 (AUDITED INFORMATION)

The performance targets set and the performance achieved in respect of the annual bonus for 2017/18 in respect of each Executive Director is set out below.

Stephen Bird

Measure	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Pennon Group EPS (37.5% weighting)					
Profit before tax	£242.7m	£247.7m	£260.1m	£258.8m	35.25%
South West Water return on regulated equity (RoRE) (7.5% weighting)					
	8.0%	9.0%	11.0%	11.8%	7.5%
Operational metrics (15% weighting) - Water/wastewater metrics*					
Service Incentive Mechanism - SWW		85	n/a	85	
Service Incentive Mechanism - BW		87	n/a	88	
Bathing water quality		<5 beach fails	n/a	0	
Leakage		82Ml/d	n/a	83Ml/d	3.75%
Wastewater pollution incidents (Cat 1-2)	No threshold	2	n/a	3	
Wastewater pollution incidents (Cat 3-4)		218	n/a	237	
Duration of interruptions to supply		0.228hr/prop	n/a	0.369hr/prop	
Wastewater and waste asset reliability		Stable	n/a	Stable	
Waste metrics*					
ERF availability		92%	n/a	92%	
Delivery against recycling action plan	No threshold	Fully met	n/a	Not fully met	5.25%
Growth in customer base		Growth target	n/a	Target met	
Personal strategic objectives* (15% weighting)					12%
Personal objectives for 2017/18 were aligned to the delivery of strategic objectives, including: • the personal leadership and embedding of the Group's health and safety programme HomeSafe • continued momentum around a number of Board priorities including the PR19 programme					**63.75%**

Louise Rowe

Measure	Threshold	Target	Maximum	Actual outturn	Bonus outturn
Pennon Group EPS (37.5%)					
Profit before tax	£242.7m	£247.7m	£260.1m	£258.8m	35.25%
South West Water return on regulated equity (RoRE) (7.5% weighting)					
	8.0%	9.0%	11.0%	11.8%	7.5%
Operational metrics (15%) - Water/wastewater metrics*					
Service Incentive Mechanism - SWW		85	n/a	85	
Service Incentive Mechanism - BW		87	n/a	88	
Bathing water quality		<5 beach fails	n/a	0	
Leakage	No threshold	82Ml/d	n/a	83Ml/d	3.75%
Wastewater pollution incidents (Cat 1-2)		2	n/a	3	
Wastewater pollution incidents (Cat 3-4)		218	n/a	237	
Duration of interruptions to supply		0.228hr/prop	n/a	0.369hr/prop	
Wastewater and waste asset reliability		Stable	n/a	Stable	
Waste metrics*					
ERF availability		92%	n/a	92%	
Delivery against recycling action plan	No threshold	Fully met	n/a	Not fully met	5.25%
Growth in customer base		Growth target	n/a	Target met	
Personal strategic objectives* (15%)					
Personal objectives for 2017/18 were aligned to the delivery of strategic objectives, including: • the personal leadership and embedding of the Group's health and safety programme HomeSafe • continued momentum around a number of Board priorities including the PR19 programme					13.0%
Total outturn					**64.75%**

PERFORMANCE & CO-INVESTMENT PLAN OUTTURN FOR 2017/18

The PCP awards made on 1 July 2015, which are due to vest on 1 July 2018, are the awards included in the single figure table.

The extent to which the awards will vest is subject to the satisfaction of the performance conditions that were in place at the time the awards were made:

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

• National Grid plc • Shanks Group	• Séché Environnement • Suez Environnement	• Severn Trent • United Utilities

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

The calculation of Pennon Group's TSR performance from the start of the performance period on 1 April 2015 to 31 March 2018 was undertaken by Deloitte LLP.

	Threshold (30% of maximum vests)	**Maximum (100% of maximum vests)**	**Achievement in the period to 1 April 2017***	**Vesting outturn***
Comparator Index (50% of award)	Equal to index	15% above the index	Below the index	0%
FTSE 250 (excluding investment trusts) (50% of award)	Above 50th percentile	At or above 75th percentile	31.9%	0%
TOTAL				0%
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 2018 to 30 June 2018) the achievement and the outturn is an estimate at the date of calculation 9 May 2018.

Vesting of an award is also subject to the 'underpin' described in the remuneration policy tables on page 80, which the Committee has determined to the date of this report would be satisfied if any award was to vest. The vested awards are subject to a two-year holding period during which clawback may be applied where the Committeee consideres it appropriate in certain circumstances. The circumstances in which clawback may be applied are material misstatement or serious misconduct. The holding period ends on 30 June 2020.

RETIREMENT BENEFITS AND ENTITLEMENTS (AUDITED INFORMATION)

Details of Directors pension entitlements and pension related benefits during the year are as follows:

	Value of defined benefit pension(i) (£000)	Contributions to defined contribution arrangements (£000)	Cash allowances in lieu of pension (£000)	Total value for the year	Normal retirement age and date (for pension purposes)	Accrued pension at 31 March 2018 (£000)
Stephen Bird	45	-	29	74	60 (14 May 2018)	105
Louise Rowe	-	14(ii)	10 (ii)	24	65 (15 January 2047)	-

(i) The value of the defined benefit pension accrued over the period comprises the total pension input amount (which has been calculated in line with regulatory requirements) less the pension contributions paid by the Director

(ii) **Louise Rowe** is a member of Pennon Group's defined contribution arrangement and received an overall pension benefit from the Company equivalent to 15% of her salary.

No additional benefits will become receivable by a Director in the event that the Director retires early.

DATE OF DIRECTORS' SERVICE CONTRACTS/LETTERS OF APPOINTMENT

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

Executive Directors	Date of service contract	Expiry date of service contract
Stephen Bird*	1 March 2000	At age 60# (14 May 2018)
Louise Rowe*	1 February 2015	At age 65 (15 January 2047)

* Each of the Executive Directors' service contracts is subject to 12 months' notice on either side.
\# Stephen Bird's service contract continues subject to the notice period on either side.

Non-executive Directors	Date of letter of appointment	Expiry date of appointment
Sir John Parker	19 March 2015	31 March 2021
Lord Matthew Taylor	1 March 2010	28 February 2019
Jon Butterworth	28 September 2017	28 September 2020
Martin Hagen	1 September 2010	31 August 2019
Martin Angle	1 April 2016	31 December 2018
Neil Cooper	1 April 2016	30 August 2020
Gill Rider	1 April 2016	30 August 2018
Chris Loughlin	1 January 2006	At age 67 (20 August 2019)

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 letters of appointment are for an initial three-year term.

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

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 Non-Executive Directors' fees were increased for 2017/18 by amounts ranging from 1.5% to 10%, to reflect principally changed responsibilities and additional commitments arising from the revised Board governance structure. The Chairman's increase was 1.5%.

The Chairman's benefits comprise provision of a driver and vehicle, when appropriate for the efficient carrying out of his duties. He is entitled to expenses on the same basis as for the other Non-Executive Directors.

ALL EMPLOYEE, PERFORMANCE AND OTHER CONTEXTUAL INFORMATION

Remuneration of the Managing Director

	2013/14	2014/15	2015/16	2016/17	2017/18
Managing Director single figure remuneration (£000)	408	378	461	553	493
Annual Bonus payout (% of maximum)	84.8%	89.6%	78.3%	65.8%	85%
LTIP (PCP) vesting (% of maximum)	30.2%	0.0%	34.5%	43.7%	0%[(1)]

1 The LTIP vesting percentage is an estimate as at 9 May 2018.

COMPARISON OF MANAGING DIRECTOR REMUNERATION TO EMPLOYEE REMUNERATION

The table below shows the percentage change between 2016/17 and 2017/18 in base salary, benefits and annual bonus for the average of the Managing Director and all employees.

The percentage increase in salary for employees reflects the annual award for staff in 2017/18 of 1.5%, analysed into the three components in the table below.

	Percentage change in salary	Percentage change in benefits	Percentage change in annual bonus
Managing Director remuneration	1.5%	5%	(1.9)%
All employees	1.5%	-	(3.6)%

RELATIVE IMPORTANCE OF SPEND ON PAY

	2017/18 £m	2016/17 £m	Percentage change (%)
Overall expenditure on pay[1]	52.8	54.1	2.5%
Distributions to Parent Company	120.3	213.1	(56.5%)
Net interest charges	67.3	61.9	8.7%
Purchase of property, plant and equipment (cash flow)	195.2	183.3	6.5%

1 Excludes employer's social security costs and non-underlying items.

The above table illustrates the relative importance of spend on pay compared with distributions to shareholders and other Company outgoings. The distributions to Parent Company, interest charges 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 2017/18

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
Stephen Bird	LTIP	100 % of salary	244	25% of maximum	31 March 2020
Louise Rowe		80% of salary	128		
Stephen Bird	Deferred bonus	50% of bonus awarded	79	n/a	29 August 2020
Louise Rowe			52		

LTIP awards were calculated using the Pennon Group plc share price of 802.7p (being the average closing price over the five dealing days preceding the date of grant, which was 25 August 2017. Deferred bonus awards were calculated using the share price at which shares were purchased on the market on 25 August 2017 and 29 August 2017 in order to satisfy the award, which was 808.691p.

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 Pennon Group plc shareholders.

To support this, the Committee operates shareholding guidelines. For 2017/18, this guideline was 100% of salary for Executive Directors. The Executive Directors are expected to build up a shareholding in the Company within the first five years of joining the Company.

The beneficial interests of the Executive Directors in the ordinary shares (40.7p each) of Pennon Group plc as at 31 March 2017 (or date of cessation, if earlier) and 31 March 2017 together with their shareholding guideline obligation (based on the 2017/18 guideline of 100% of salary) and interest are shown in the table below:

					Unvested awards			
	Share interests (including connected parties) at 31 March 2018	**Share interests (including connected parties) at 31 March 2017**	**Share-holding guideline (100% to be accrued over five years)**	**Share-holding guideline met?**	**Performance shares (subject to performance conditions)**	**SAYE**	**Deferred Bonus shares**	**ESOS**
Stephen Bird	29,528	25,500	100%	Yes	69,477	2,205	23,672	-
Louise Rowe	9,604	4,420	60%	Yes	39,470	-	11,476	1,553

Since 31 March 2018 44 additional ordinary shares in Pennon Group have been acquired by Louise Rowe as a result of participation in the Pennon Group's Share Incentive Plan.

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 Pennon Group, are shown in the table below:

Director	Shares held at 31 March 2018	Shares held at 31 March 2017
Sir John Parker, Chairman	27,027	10,000
Lord Matthew Taylor	-	-
Jon Butterworth	-	-
Martin Hagen	3,600	3,600
Martin Angle	-	-
Neil Cooper	-	-
Gill Rider	2,500	2,500
Chris Loughlin	324,935	290,323

Since 31 March 2018 Chris Loughlin has acquired 7,132 additional ordinary shares as part of the Pennon Group's Dividend Reinvestment Plan and Pennon Group's Share Incentive Plan. There is no formal shareholding guideline for the Non-executive Directors; however they are encouraged to purchase shares in Pennon Group plc. A shareholding guideline applies to Chris Loughlin in his capacity as Pennon Group Chief Executive Officer.

DETAILS OF SHARE AWARDS

(a) 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 Pennon Group plc 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 2017	Conditional awards made in year	Market price upon award in year	Vesting in year(i)	Value of shares upon vesting (before tax) £000	Conditional awards held at 31 March 2018	Date of end of period for qualifying conditions to be fulfilled	Expected date of release (ii)
Stephen Bird								
14/07/14	17,262	-	798.50p	4,073	28	-	13/07/17	-
01/07/15	18,260	-	810.50p	-	-	18,260	30/06/18	30/06/20
01/07/16	20,869	-	920.00p	-	-	20,869	30/06/19	24/08/22
25/08/17	-	30,348	802.70p	-	-	30,348	24/03/20	29/08/20
Louise Rowe								
01/07/15	11,351	-	810.50p	-	-	11,351	30/06/18	30/06/20
01/07/16	12,173	-	920.00p	-	-	12,173	30/06/19	24/08/22
25/08/17	-	15,946	802.70p	-	-	15,946	24/03/20	29/08/20

(i) 20.4% of the July 2014 award shares vested on 24 August 2017 at a market price of 806.84p 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.

(ii) Awards granted from 2015 onwards are subject to a two-year holding period following vesting.

PAYMENTS TO PAST DIRECTORS

No payments to past Directors were made during the year.

(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 Pennon Group plc 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 2017	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 2018	Date of end of period for qualifying conditions to be fulfilled
Stephen Bird							
27/08/14	6,509	-	821.50p	6,509	52	-	26/08/17
27/07/15	7,318	-	791.00p	-	-	7,318	26/07/18
04/07/16	6,589	-	950.14p	-	-	6,589	03/07/19
30/08/17	-	9,765	808.69p	-	-	9,765	29/08/20
Louise Rowe							
27/07/15[1]	1,553	-	791.00p	-	-	1,553	26/07/18
04/07/16	3,994	-	950.14p	-	-	3,994	03/07/19
30/08/17	-	5,929	808.69p	-	-	5,929	29/08/20

[1] In addition to the award made on 27 July 2015 to L Rowe, the Directors also received options pursuant to the Pennon Group's executive share option scheme (ESOS), details of which are set out below. These awards were made in conjunction with the operation of the bonus plan, details of which are set out on page 83.

During the year the Directors received dividends on the above shares in accordance with the conditions of the bonus plan as follows: Stephen Bird £7,342; Louise Rowe £1,995.

(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 Pennon Group pursuant to the Pennon Group's ESOS.

Director and date of Award	Options held at 1 April 2017	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 2018	Options held at 31 March 2018	Maturity date
L. Rowe 27/07/15	1,553	-	-	791.00p	-	643.40	1,553	27/07/18

(d) Sharesave scheme

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

Director and date of grant	**Options held at 1 April 2017**	**Granted in year**	**Exercised /lapsed in year**	**Exercise price per share**	**Market price of each share on exercising**	**Market value of each share at 31 March 2018**	**Options held at 31 March 2018**	**Exercise period/ maturity date**
S. Bird								
14/07/14	441	-	441	611.00p	805.00p	-	-	01/09/17-28/02/18
24/06/15	1,317	-	-	683.00p	-	643.40p	1.317	01/09/18-28/02/19
29/06/16	888	-	-	709.00p	-	643.40p	888	01/09/19 – 02/02/20
L. Rowe								
14/07/14	1,472	-	1,472	611.00p	-	-	-	01/09/17-28/02/18
24/06/15	1,317	-	1,317	683.00p	-	-	-	01/09/18-28/02/19

BOARD OF DIRECTORS AND COMPANY INFORMATION

CHAIRMAN	Sir John Parker
MANAGING DIRECTOR	Dr S C Bird
FINANCE DIRECTOR	L F Rowe
NON-EXECUTIVE DIRECTORS	Lord Taylor of Goss Moor M Angle J Butterworth MBE (appointed 28 September 2017) N Cooper M J Hagen G Rider C Loughlin (Pennon Group Chief Executive)
COMPANY SECRETARIES	H Barrett-Hague K Senior
REGISTERED OFFICE	Peninsula House Rydon Lane Exeter Devon EX2 7HR
INDEPENDENT AUDITOR	Ernst & Young LLP Apex Plaza Forbury Road Reading RG1 1YE
COMPANY'S REGISTERED NUMBER	02366665
PRINCIPAL ACTIVITIES	The principal activities of the Company are the provision of water and sewerage services. The Company holds the water and sewerage appointments for Cornwall and Devon and parts of Somerset and Dorset. It also provides water supply services to parts of Dorset, Hampshire and Wiltshire.

DIRECTORS' REPORT – OTHER STATUTORY DISCLOSURES

INTRODUCTION

This Directors' report is prepared in accordance with the provisions of the Companies Act 2006 and regulations made thereunder. It comprises pages 37 to 72 and 96 to 101 as well as the following matters which the Board considers are of strategic importance and, as permitted by legislation, has chosen to include in the strategic report rather than the Directors' report:

- risk management systems (page 23 to 26 of the strategic report)
- likely future developments of the Company (page 5 of the strategic report)
- certain employee matters (pages 8 to 10 of the strategic report), as well as the disclosures below.

In addition, there are a number of disclosures which are included in the Directors' report by reference, including:

- financial risk management (note 3 of the financial statements)
- financial instruments (pages 16 to 22 of the strategic report and notes 2o and 18 of the notes to the financial statements).

BOARD OF DIRECTORS

The Directors in office as at the date of this report (all of whom served during the year) are named on page 96.

FINANCIAL RESULTS AND DIVIDEND

A total dividend for the year of £120.3m was paid during the year (2016/17: £213.1m). The Report of the Finance Director on pages 16 to 22 analyses the Company'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.

EMPLOYMENT POLICIES AND EMPLOYEE INVOLVEMENT

South West Water has a culture of continuous improvement through investment in people at all levels within the Company. It 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 Company. Information regarding South West Water's workplace policies is provided on pages 8 to 10.

The Board has a diversity policy and encourages gender diversity in particular. Further details of the Board's diversity policy are set out in the report of the Nomination Committee on page 72, and information regarding the diversity of the workforce is provided on page 10.

South West Water respects the right to freedom of association and employees are consulted regularly about changes which may affect them either through their trade union-appointed representatives, through consultation groups or by means of the elected staff council. These forums, together with regular meetings with particular groups of employees, are used to ensure that employees are kept up to date with the business performance of their employer and the financial and economic factors affecting the performance of the Company. South West Water 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 Company is set out on pages 8 to 10 of the strategic report.

South West Water and the Pennon Group as a whole encourages share ownership among its employees in Pennon Group plc by operating an HM Revenue & Customs approved Sharesave scheme and Share Incentive Plan. Following Pennon shareholder approval at the 2014 AGM, these were amended to provide for the increased savings limits approved by government. At 31 March 2018 around two thirds of South West Water's employees were participating in these plans.

HUMAN RIGHTS AND ANTI-SLAVERY

South West Water is fully supportive of the principles set out in the UN Declaration of Human Rights, and the Pennon Group Code of Conduct outlines the high standards of employment practice with which everyone in the Company is expected to comply. The Company also supports the International Labour Organization's core conventions for the protection and safety of workforces wherever they may be throughout the Company.

The Company's commitment to ensuring the human rights of its employees are not infringed extends to those of its suppliers. Supplier codes of conduct are in place to ensure that people are treated fairly and with respect and dignity.

In addition, we have in place policies and procedures to assess, monitor and reduce the risk of modern slavery and human trafficking occurring in our businesses and supply chains. Risk assessments of any high risk supply partners have been completed to ensure compliance with the Modern Slavery Act across the Company and our anti-slavery and human trafficking web-based statement for the year, which is completed at a Group level, is available: www.southwestwater.co.uk.

RESEARCH AND DEVELOPMENT

The development and testing of innovative techniques and processes will continue to play a role in the further improvement and provision of cost effective services.

Research and development expenditure amounted to £0.1m during the year (2016/17: £0.2m)

OVERSEAS BRANCHES

The Company has no overseas branches.

DONATIONS

During 2017/18 the Company provided a total of £97,000 in charitable donations (2016/17: £75,000).

No political donations were made or political expenditure incurred and no contributions were made to a non-EU political party (2016/17: nil).

GOING CONCERN

Having considered the Company's funding position and financial projections the Directors have a reasonable expectation that the Company has adequate resources to continue its operational existence for the foreseeable future and considers the business model, strategy and operations are sustainable. They therefore have continued to adopt the going concern basis in preparing the financial statements.

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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 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 Company and of the profit or loss of the Company 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 that are reasonable and prudent
- state whether applicable International Financial Reporting Standards (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 Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of 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 page 96, confirms that, to the best of his or her knowledge:

i) The financial statements, which have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit of the Company.

ii) The strategic report (pages 3 to 37) and the Directors' report (pages 37 to 72 and 96 to 101) include a fair review of the development and performance of the business during the year and the position of the Company at the year end, together with a description of the principal risks and uncertainties they face.

iii) Following receipt of advice from the Audit Committee, that the annual report, taken as a whole, is fair, balanced and understandable, and provides the information necessary for the shareholders to assess the Company's performance, business model and strategy.

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

STATEMENT AS TO DISCLOSURE OF INFORMATION TO THE COMPANY'S AUDITOR

a) So far as each of the Directors in office at the date of signing of the report is aware, there is no relevant audit information of which the Company's auditor is unaware; and

b) each of the Directors has taken all the steps that each Director ought to have taken as a Director in order to make himself / herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

The Directors' report consisting of pages 37 to 72 and 96 to 101 was approved by the Board on 30 May 2018.

By Order of the Board

H BARRETT-HAGUE
Company Secretary

30 May 2018

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF SOUTH WEST WATER LIMITED

OPINION

We have audited the financial statements of South West Water Limited for the year ended 31 March 2018 which comprise the Income Statement, Statement of Comprehensive Income, Balance Sheet, Statement of Changes in Equity and Cash Flow Statement and the related notes1 to 36, including a summary of significant accounting policies. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

In our opinion, the financial statements:

- give a true and fair view of the company's affairs as at 31 March 2018 and of its profit for the year then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

BASIS FOR OPINION

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) and applicable law. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the financial statements section of our report below. We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

CONCLUSIONS RELATING TO PRINCIPAL RISKS, GOING CONCERN AND VIABILITY STATEMENT

We have nothing to report in respect of the following information in the annual report, in relation to which the ISAs(UK) require us to report to you whether we have anything material to add or draw attention to:

- the disclosures in the annual report set out on pages 26 to 34 that describe the principal risks and explain how they are being managed or mitigated;
- the directors' confirmation 26 in the annual report that they have carried out a robust assessment of the principal risks facing the entity, including those that would threaten its business model, future performance, solvency or liquidity;
- the directors' statement set out on page 99 in the financial statements about whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and their identification of any material uncertainties to the entity's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements
- whether the directors' statement in relation to going concern required under provisions C.1.3 and C.2.2 is materially inconsistent with our knowledge obtained in the audit; or

- the directors' explanation set out on page 35 to 36 in the annual report as to how they have assessed the prospects of the entity, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the entity will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions

OVERVIEW OF OUR AUDIT APPROACH

Key audit matters	• Revenue recognition • Valuation of the provision for doubtful debts • Valuation of plant, property and equipment
Materiality	• Overall materiality of £8.9m which represents 5% of profit before tax

KEY AUDIT MATTERS

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) that we identified. These matters included those which had the greatest effect on: the overall audit strategy, the allocation of resources in the audit; and directing the efforts of the engagement team. These matters were addressed in the context of our audit of the financial statements as a whole, and in our opinion thereon, and we do not provide a separate opinion on these matters.

Risk	Our response to the risk	Key observations communicated to the Audit Committee
Revenue recognition (£572.8, PY comparative £562.5million) *Refer to the Audit Committee Report (page 61); Accounting policies (page 116); and Note 4 of the Financial Statements (page 122)* Revenue relates to the provision of water and sewerage services. ISAs (UK & Ireland) presume there is a risk of fraud relating to revenue recognition. For the Company, given targets associated with financial performance and pressures to meet market expectations, there is an incentive to overstate revenue. This risk over revenue recognition specifically arises in the following judgemental areas, where there is opportunity to overstate revenue: Income from measured water services requires an estimation of the amount of unbilled charges at the year end. This is calculated using a combination of system	Our procedures include: • We obtained an understanding of the process for the supply of measured services, meter reading and related billing in order to assess the completeness of adjustments to reflect the accrual or deferral of revenue • We tested key controls linked to system generated information and around the estimation process for measured revenue • We compared the accrued income to bills raised post year end for a sample of customers, and compared management's history of estimating the accrued income balance to bills raised in the subsequent year to assess the accuracy of the accrued income balance • We corroborated the key assumptions and estimates made by management in recognising revenue, by	We concluded that the estimation process undertaken by management to calculate the measured income accrual reflects latest operational factors in the key assumptions and results in an acceptable income accrual.

generated information, based on previous customer volume usage, together with management judgements as to the likely impact on usage of factors such as recent weather patterns. The accrued income balance at 31 March 2018 is £61.5 million (2017: £72.2 million).	obtaining internal and external data on factors that influence demand from customers, such as weather patterns and leaks in infrastructure network • We tested whether contract terms and conditions were met and revenue recognised at the correct time in accordance with IFRS • We performed analytical procedures by comparing revenue balances for the year against expectation and obtaining support for significant variances • We tested a sample of transactions to underlying bills • In performing our journal testing, we paid increased attention to entries impacting revenue focusing on non-system postings and those raised in the last two weeks of the year.	
Valuation of the provision for doubtful debts (South West Water) (£89.7 million, PY comparative £91.4 million) *Refer to the Audit Committee Report (page 61); Accounting policies (page 118); and included within Note 18 of the Financial Statements (page 131)* The South West Water provision is calculated using a combination of system generated information on historic debt recovery rates and management's judgement of the future likely recovery rates. There is a risk that the assumptions used by management in calculating the bad debt provision may be susceptible to management bias and the valuation of the provision against trade receivables may be misstated. We have therefore focused on this key audit matter.	Our procedures include: • We performed a walkthrough of the process for calculating the bad debt provision and assessed the design effectiveness of key controls • We tested the operating effectiveness of key controls over the integrity of data and the report utilised to generate the ageing and categorisation of debt within South West Water's billing system • We tested historic data on collection rates and evaluated how this data was used in the preparation of the bad debt provision • We corroborated the assumptions used by management in determining the amounts provided against the different categories and age of debt, by comparing these assumptions to historic collection rates and by considering the impact of changes in the methods adopted operationally by management to collect debt, and in the external environment • We utilised collection information over the past three years, to determine a range of the likely ultimate collection of debts existing at the balance sheet date and compared this to the provision recorded by management,	We concluded that the doubtful debt provision is within an acceptable range (£80.7 million to £91.2 million) and reflects recent history of collection of outstanding debts.

	including assessing assumptions for evidence of management bias • We tested the appropriateness of journal entries and adjustments impacting the doubtful debt provision, particularly those raised close to the balance sheet date.	
Valuation of property, plant and equipment *Refer to the Audit Committee Report (page 61); Accounting policies (page 116 to 117); and Note 4 of the Financial Statements (page 123)* As shown in note 14, the carrying value of the Company's property, plant and equipment totals £2,970.5 million (2017: £2,899.8 million). Given targets associated to financial performance and also pressures to meet market expectations, there is a risk that expenditure might be improperly recognised as capital, rather than operating and that the depreciation charge may be understated if inappropriate useful economic lives are used.	• We tested the classification of expenditure between capital and operating, considering whether the expenditure recorded as property, plant and equipment meets the definitions set out in IAS 16 'Property, Plant and Equipment'. • We tested the asset lives utilised based on latest third party benchmarking. • We re-performed the calculation of depreciation. • We read the disclosures in the Annual Report and Financial Statements in respect of the change in asset lives and evaluated the adequacy of these.	We concluded that fixed assets have been correctly accounted for in the financial statements.

AN OVERVIEW OF THE SCOPE OF OUR AUDIT

Tailoring the scope

Our assessment of audit risk, our evaluation of materiality and our allocation of performance materiality determine our audit scope for the Company. This enables us to form an opinion on the financial statements. We take into account size, risk profile, the organisation of the Company and effectiveness of controls, including controls and changes in the business environment when assessing the level of work to be performed.

Changes from the prior year

No changes to the scope of the audit from the prior year.

OUR APPLICATION OF MATERIALITY

We apply the concept of materiality in planning and performing the audit, in evaluating the effect of identified misstatements on the audit and in forming our audit opinion.

Materiality

The magnitude of an omission or misstatement that, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users of the financial statements. Materiality provides a basis for determining the nature and extent of our audit procedures.

We determined materiality for the Company to be £8.9 million (2017: £8.7 million), which is 5% (2017: 5%) of profit before taxation before non-underlying items. We believe that profit before taxation before non-underlying items provides us with an appropriate measure of the underlying performance of the Company. We excluded non-underlying items on the basis that profit before taxation after non-underlying items is not indicative of the underlying performance of the Company. We also note that market and analyst commentary on the performance of the Company uses the same measure. We therefore, considered profit before taxation before non-underlying items to be the most relevant performance metric on which to base our materiality calculation.

Starting basis	• Reported profit before taxation £179.8m (2017: £172.9m)
Adjustments	• Non-underlying items - increase basis by £nil (2017: £0.5m)
Materiality	• Totals £179.8m (£173.4m) profit before taxation before non-underlying items • Materiality of £8.9m (5% of profit before taxation before non-underlying items)

Performance materiality

The application of materiality at the individual account or balance level. It is set at an amount to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality.

On the basis of our risk assessments, together with our assessment of the Company's overall control environment, our judgement was that performance materiality was 75% (2017: 75%) of our planning materiality, namely £6.7m (2017: £6.5m). We have set performance materiality at this percentage based on our assessment of the Company's internal control environment and the extent and nature of audit findings identified in the prior period. This basis is consistent with the prior year.

Reporting threshold

An amount below which identified misstatements are considered as being clearly trivial.

We agreed with the Audit Committee that we would report to them all uncorrected audit differences in excess of £0.4m (2017: £0.4m), which is set at 5% of planning materiality, as well as differences below that threshold that, in our view, warranted reporting on qualitative grounds.

We evaluate any uncorrected misstatements against both the quantitative measures of materiality discussed above and in light of other relevant qualitative considerations in forming our opinion.

OTHER INFORMATION

The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. The directors are responsible for the other information.

Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in this report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of the other information, we are required to report that fact.

We have nothing to report in this regard.

In this context, we also have nothing to report in regard to our responsibility to specifically address the following items in the other information and to report as uncorrected material misstatements of the other information where we conclude that those items meet the following conditions:

- **Fair, balanced and understandable set out on page 63 to 64 –** the statement given by the directors that they consider the annual report and financial statements 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, is materially inconsistent with our knowledge obtained in the audit; or
- **Audit committee reporting set out on pages 58 to 65 –** the section describing the work of the audit committee does not appropriately address matters communicated by us to the audit committee; or
- **Directors' statement of compliance with the UK Corporate Governance Code set out on page 40 –** the parts of the directors' statement relating to the Company's compliance with the UK Corporate Governance Code containing provisions specified for review by the auditor (specifically C.1.1, C.2.1 and C.2.3 and C3.1 to C.3.8) do not properly disclose a departure from a relevant provision of the UK Corporate Governance Code.

OPINIONS ON OTHER MATTERS PRESCRIBED BY THE COMPANIES ACT 2006

In our opinion, based on the work undertaken in the course of the audit:

- 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; and
- the strategic report and directors' report have been prepared in accordance with applicable legal requirements.

MATTERS ON WHICH WE ARE REQUIRED TO REPORT BY EXCEPTION

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or directors' report.

We have nothing to report in respect of the following matters in relation to which the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit

VOLUNTARY REPORTING MATTERS

Directors' remuneration report

The Company voluntarily prepares a Report of the directors on remuneration in accordance with the provisions of the Companies Act 2006. The directors have requested that we audit the part of the Report of the directors on remuneration specified by the Companies Act 2006 to be audited as if the Company were a quoted company.

In our opinion, the part of the directors' remuneration report to be audited has been properly prepared in accordance with the Companies Act 2006.

RESPONSIBILITIES OF DIRECTORS

As explained more fully in the directors' responsibilities statement set out on pages 100 to 101, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

AUDITOR'S RESPONSIBILITIES FOR THE AUDIT OF THE FINANCIAL STATEMENTS

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the

Financial Reporting Council's website at https://www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

USE OF OUR REPORT

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Debbie O'Hanlon (Senior statutory auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
Reading
30 May 2018

Notes:

1. The maintenance and integrity of the South West Water Limited web site is the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the web site.

2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

INCOME STATEMENT

FOR THE YEAR ENDED 31 MARCH 2018

	Notes	Before non-underlying items 2018 £m	Non-underlying items (note 5) 2018 £m	Total 2018 £m	Before non-underlying items 2017 £m	Non-underlying items (note 5) 2017 £m	Total 2017 £m
Revenue		572.8	-	572.8	562.5	-	562.5
Operating costs	6						
Employment costs		(45.3)	-	(45.3)	(46.7)	(0.5)	(47.2)
Raw materials and consumables used		(16.6)	-	(16.6)	(19.2)	-	(19.2)
Other operating expenses		(150.4)	-	(150.4)	(148.0)	-	(148.0)
Earnings before interest, tax, depreciation and amortisation		**360.5**	**-**	**360.5**	**348.6**	**(0.5)**	**348.1**
Depreciation and amortisation	6	(113.4)	-	(113.4)	(113.8)	-	(113.8)
Operating profit		**247.1**	**-**	**247.1**	**234.8**	**(0.5)**	**234.3**
Finance income	7	1.2	-	1.2	1.5	-	1.5
Finance costs	7	(68.5)	-	(68.5)	(62.9)	-	(62.9)
Net finance costs		**(67.3)**	**-**	**(67.3)**	**(61.4)**	**-**	**(61.4)**
Profit before tax		**179.8**	**-**	**179.8**	**173.4**	**(0.5)**	**172.9**
Taxation (charge)/credit	8	**(31.4)**	**-**	**(31.4)**	**(37.1)**	**14.4**	**(22.7)**
Profit for the year		**148.4**	**-**	**148.4**	**136.3**	**13.9**	**150.2**

STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 MARCH 2018

	Notes	Before non-underlying items 2018 £m	Non-underlying items (note 5) 2018 £m	Total 2018 £m	Before non-underlying items 2017 £m	Non-underlying items (note 5) 2017 £m	Total 2017 £m
Profit for the year		**148.4**	**-**	**148.4**	**136.3**	**13.9**	**150.2**
Other comprehensive (loss)/income							
Items which will not be reclassified to profit or loss							
Remeasurement of defined benefit obligations	24	12.2	-	12.2	(7.7)	-	(7.7)
Income tax on items that will not be reclassified	25	(2.0)	-	(2.0)	1.4	(0.4)	1.0
Total items that will not be reclassified to profit or loss		**10.2**	**-**	**10.2**	**(6.3)**	**(0.4)**	**(6.7)**
Items that may be reclassified subsequently to profit or loss							
Cash flow hedges		20.6	-	20.6	5.1	-	5.1
Income tax on items that may be reclassified	25	(3.5)	-	(3.5)	(0.5)	(0.4)	(0.9)
Total items that may be reclassified subsequently to profit or loss		**17.1**	**-**	**17.1**	**4.6**	**(0.4)**	**4.2**
Other comprehensive income/(loss) for the year net of tax		**27.3**	**-**	**27.3**	**(1.7)**	**(0.8)**	**(2.5)**
Total comprehensive income for the year		**175.7**	**-**	**175.7**	**134.6**	**13.1**	**147.7**

The notes on pages 112 to 142 form part of these financial statements.

BALANCE SHEET

AS AT 31 MARCH 2018

	Notes	2018 £m	2017 £m
Assets			
Non–current assets			
Goodwill	12	51.3	51.3
Other intangible assets	13	1.0	1.5
Property, plant and equipment	14	2,970.5	2,899.8
Investment in subsidiary undertakings	16	3.3	3.3
		3,026.1	**2,955.9**
Current assets			
Inventories	17	4.9	5.3
Trade and other receivables	18	117.6	142.2
Current tax asset		0.7	-
Cash and cash deposits	20	226.9	247.4
		350.1	**394.9**
Liabilities			
Current liabilities			
Borrowings	22	(48.1)	(158.3)
Derivative financial instruments	19	(8.4)	(15.2)
Trade and other payables	21	(77.9)	(93.5)
Current tax liabilities		-	(12.2)
Provisions	26	(2.7)	(4.9)
		(137.1)	**(284.1)**
Net current assets		**213.0**	**110.8**
Non–current liabilities			
Borrowings	22	(2,246.9)	(2,122.9)
Other non–current liabilities	23	(108.7)	(102.4)
Derivative financial instruments	19	(8.2)	(23.9)
Retirement benefit obligations	24	(22.6)	(32.3)
Deferred tax liabilities	25	(231.3)	(220.0)
		(2,617.7)	**(2,501.5)**
Net assets		**621.4**	**565.2**
Equity			
Called up share capital	27	250.9	250.9
Retained earnings and other reserves	29	370.5	314.3
Total Equity		**621.4**	**565.2**

The notes on pages 115 to 146 form part of these financial statements.

The financial statements on pages 111 to 146 were approved and authorised for issue by the Board of Directors on 30 May 2018 and were signed on its behalf by:

Dr S Bird
Managing Director

Registered office: Peninsula House, Rydon Lane, Exeter, Devon, England EX2 7HR
Registered Number: 02366665

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 MARCH 2018

	Called up share capital (note 27) £m	Retained earnings and other reserves (note 29) £m	Total Equity £m
At 31 March 2016	**150.9**	**379.5**	**530.4**
Called up Share Capital	100.0	-	100.0
Profit for the year	-	150.2	150.2
Other comprehensive loss for the year	-	(2.5)	(2.5)
Total comprehensive income for the year	-	147.7	147.7
Transactions with owners			
Dividends paid	-	(213.1)	(213.1)
Share based payments (net of tax)	-	0.2	0.2
Total transactions with owners	-	(212.9)	(212.9)
At 31 March 2017	**250.9**	**314.3**	**565.2**
Profit for the year	-	148.4	148.4
Other comprehensive loss for the year	-	27.3	27.3
Total comprehensive income for the year	-	175.7	175.7
Transactions with owners			
Dividends paid	-	(120.3)	(120.3)
Share based payments (net of tax)	-	0.8	0.8
Total transactions with owners	-	(119.5)	(119.5)
At 31 March 2018	**250.9**	**370.5**	**621.4**

The notes on pages 112 to 142 form part of these financial statements.

CASH FLOW STATEMENT

FOR THE YEAR ENDED 31 MARCH 2018

	Notes	2018 £m	2017 £m
Cash flows from operating activities			
Cash generated from operations	30	353.3	330.7
Interest paid		(47.4)	(47.0)
Tax paid		(38.7)	(31.6)
Net cash generated from operating activities		**267.2**	**252.1**
Cash flows from investing activities			
Interest received		0.2	0.6
Acquisition of subsidiaries (net of cash acquired)	16	-	8.3
Loss from sale of intangibles		-	(0.3)
Purchase of property, plant and equipment		(197.8)	(183.3)
Receipt of grants and contributions		2.3	1.9
Disposal of business assets to fellow subsidiary		31.9	-
Proceeds from sale of property, plant and equipment		2.8	2.4
Net cash used in investing activities		**(160.6)**	**(170.4)**
Cash flows from financing activities			
Deposit of restricted funds		42.4	(6.5)
Proceeds from new borrowing		50.0	130.0
Repayment of borrowings		(41.1)	(38.7)
Repayments/proceeds from intercompany borrowings		(100.0)	50.0
Finance lease sale and lease back		100.1	0.6
Finance lease principal repayments		(16.9)	(15.5)
Dividends paid		(120.3)	(213.1)
Net cash used in financing activities		**(85.8)**	**(93.2)**
Net increase/(decrease) in cash and cash equivalents		**20.8**	**(11.5)**
Cash and cash equivalents at beginning of the year		**25.7**	**37.2**
Cash and cash equivalents at end of the year	20	**46.5**	**25.7**

The notes on pages 112 to 142 form part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

1. GENERAL INFORMATION

South West Water Limited is a company registered in the United Kingdom under the Companies Act 2006. The address of the registered office, the nature of the Company's operations and its principal activities are set out on page 96.

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 transfers of assets from customers and certain financial instruments as described in accounting policy note (u) and (n) respectively) and in accordance with International Financial Reporting Standards (IFRS) and interpretations of the IFRS Interpretations Committee (IFRIC) 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 the financial statements as stated by the Directors on page 99.

The new standards or interpretations which were mandatory for the first time in the year beginning 1 April 2017 did not have a material impact on the net assets or results of the Company.

It is anticipated that adoption of the following standard could impact the Company's future results as set out below:

- IFRS 15 'Revenue from contracts with customers' relates to revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. The standard will replace IAS 18 'Revenue' and IAS 11 'Construction contracts' and related interpretations. The standard is effective for annual periods beginning on or after 1 January 2018.

  The Directors anticipate that the adoption of IFRS 15 on 1 April 2018 will not materially impact reported revenues or net assets.

- IFRS 16 'Leases' no longer distinguishes between an on the balance sheet finance lease and an off the balance sheet operating lease. Instead, for virtually all lease contracts, the lessee recognises a lease liability reflecting future lease payments and a 'right-of-use' asset. The standard is effective for annual periods beginning on or after 1 January 2019.

  The Directors anticipate that the adoption of IFRS 16 on 1 April 2019 will affect primarily the accounting for the Group's operating leases. As at the reporting date, the Company has non-cancellable operating lease commitments of £56m, see note 31. These predominantly relate to leases of properties occupied by the Company in the course of carrying out its business. If the standard had been adopted in the current year (assuming application of the modified retrospective transitional approach permitted by the standard) it is estimated this would have resulted in the Company recognising an asset in use and corresponding lease liability figure in the region of £35m. This would have resulted in a minimal impact on profit before tax but an estimated increase of around £2m EBITDA which would be replaced by increased charges for depreciation and finance costs. These impacts are not considered to be material to the Group's net assets or results. Existing borrowing covenants are not impacted by changes in accounting standards.

Other new standards or interpretations in issue, but not yet effective, including IFRS 9 'Financial instruments' are not expected to have a material impact on the Group's net assets or results.

(b) Exemption from consolidation

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

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

(c) Revenue recognition

Revenue represents the fair value of consideration receivable, excluding value added tax and trade discounts, in the ordinary course of business for services provided. Revenue is recognised once the services have been provided to the customer.

Revenue from main water and wastewater 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, estimated demand trends and current tariffs. Revenue for unmeasured charges is recognised on a time apportioned basis.

Revenue is recognised to the extent that it is probable that economic benefits will flow to the Company and revenue can be reliably measured.

(d) Segmental reporting

The Directors believe that the whole of the Company's activities constitute one single segment. Operating segments are reported in the manner consistent with internal reporting to the Chief Operating Decision Maker, which has been identified as the Board of Directors.

The Company's country of domicile is the United Kingdom and is the country in which it generates all of its revenue. The Company's non-current assets are all located within the United Kingdom.

(e) Goodwill

Goodwill arising on consolidation from the acquisition of subsidiary 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 (i).

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

(f) Other tangible assets

Other intangible assets include assets acquired in a business combination and 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 lives, with the expense charged to the income statement through operating costs.

(g) Property, plant and equipment

Cost includes the original purchase price of the asset and costs attributable to bringing the asset to its working condition for its intended use. The cost of assets includes directly attributable labour and overhead costs which are incremental to the Company.

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 at cost, less accumulated depreciation. Expenditure to increase capacity or enhance infrastructure assets is capitalised where it can be reliably measured and it is probable that incremental future economic benefits will flow to the Company. 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 estimated useful economic lives and are principally:

Dams and impounding reservoirs	200 years
Water mains	40 – 120 years
Sewers	40 – 120 years

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

ii) Other assets (including property, overground plant and equipment)

Other assets are included at cost less accumulated depreciation.

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

Freehold land is not depreciated. Other assets are depreciated evenly over their estimated useful economic lives to their residual value and are principally:

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

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

The cost of assets includes directly attributable labour and overhead costs which are incremental to the Company. 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 (u).

The assets residual value and useful lives are reviewed annually.

Gains or losses on disposals are determined by comparing the proceeds of sale with the carrying amount and are recognised within the income statement.

(h) 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 on a straight basis over the life of the lease.

(i) 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 value. 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.

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

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

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

(l) Inventories
Inventories are stated at the lower of cost and net realisable value. The cost of finished goods and work in progress includes raw materials and the cost of bringing stocks to their present location and condition. It excludes borrowing costs. Net realisable value is the estimated selling price less cost to sell.

(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 Company 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 Company has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

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 by applying expected recovery rates to debts outstanding at the end of the accounting period. The expected recovery rate takes into account age of the debt and payment history.

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) Derivative financial instruments and hedging activities
The Company uses derivative financial instruments, principally interest rate swaps, 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.

The Company 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 taken 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 Company is required to document in advance the relationship between the item being hedged and the hedging instrument. The Company is also required to document and demonstrate an assessment of the relationship between the hedged item and the hedging instrument which shows that the hedge will be highly effective on an ongoing basis. This effectiveness testing is reperformed at the end of each reporting period to ensure that the hedge remains highly effective.

The full fair value of a hedging derivative is apportioned on a straight line basis between non-current and current assets or liabilities based on the remaining maturity of the hedging derivative.

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.

(o) Taxation including deferred tax
The tax credit/(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 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 provisions on individual tax items where in the judgement of management, the position is uncertain.

The Company is part of the Pennon Group for tax purposes and accordingly may use the tax group relief provisions whereby current tax liabilities can be offset by current tax losses arising in other companies within the same tax group. Payments for group relief 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.

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

(q) Contingent liabilities

The Company is subject to litigation from time to time as a result of its activities. The Company 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.

There are contingent liabilities that arise in the normal course of business which, if realised, are not expected to result in a material liability to the Company.

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

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.

The movement in the fair value of scheme assets and the present value of scheme liabilities are shown in notional interest within finance income and cost. 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 to which they arise.

Defined contribution scheme

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

ii) Share-based payment

The Company participates in a number of equity-settled share-based payment plans for employees operated by its parent company Pennon Group plc. 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.

At each balance sheet date, the Company revises its estimates of the number of options that are expected to vest. It recognises the impact of the revision to original estimates, if any, in the income statement, with a corresponding adjustment to equity.

(t) Fair values

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

2. PRINCIPAL ACCOUNTING POLICIES CONTINUED

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 Company for similar financial instruments.

(u) 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.

(v) Non-underlying items

Non-underlying items are those that in the Directors' view are required to be separately disclosed by virtue of their size, nature or incidence to enable a full understanding of the Company's financial performance.

3. FINANCIAL RISK MANAGEMENT

(a) Financial risk factors

The Company's activities expose it to a variety of financial risks; market risk (interest rate risk), liquidity risk and credit risk. The Company receives treasury services from the treasury function of Pennon Group plc, the parent company, which 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 Company relate to interest rate and credit counterparty risk.

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

Financial instruments are used to raise finance, manage risk, optimise the use of surplus funds and manage overall interest rate performance. The company does not engage in speculative activity.

i) Market risk

The Company has both interest bearing assets and interest bearing liabilities. The Company has a policy of maintaining, after the effect of interest rate swaps, at least 50% of interest bearing liabilities at fixed rates. At the year end 60% (31 March 2017: 65%) of net borrowings were at fixed rates and 25% (31 March 2017: 24%) were index-linked. The Company 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. 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 Company. These instruments are analysed in more detail in note 19.

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.

The Company 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 Company's income and cash generated from operations (note 30) are independent of changes in market interest rates.

For 2018 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 increased/ decreased by £0.8m (2017: £0.2m), for the equity sensitivity fair value, derivative impacts are excluded.

For 2018 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 £2.0m (2017: £1.9m).

ii) Liquidity risk

The Company actively maintains a mixture of long-term and short-term committed facilities which are designed to ensure the Company 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 uncommitted facilities are provided in note 22.

3. FINANCIAL RISK MANAGEMENT (CONTINUED)

Contractual undiscounted cash flows including interest payments, at the balance sheet date were:

31 March 2018	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
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	32.0	35.0	115.8	776.8	959.6
Interest payments on borrowings	26.1	26.3	78.1	612.3	742.8
Finance lease liabilities including interest	36.8	73.4	188.5	1,954.9	2,253.6
Derivative financial liabilities					
Derivative contracts – net payments	7.9	6.9	1.2	0.4	16.4

31 March 2017	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
Non-derivative financial liabilities					
Borrowings excluding finance lease liabilities	141.1	32.0	110.4	753.4	1,036.9
Interest payments on borrowings	20.3	20.5	60.9	585.4	687.1
Finance lease liabilities including interest	31.5	31.4	175.7	1,893.4	2,132.0
Derivative financial liabilities					
Derivative contracts – net payments	12.5	11.1	10.4	0.8	34.8

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 18.

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 Company has no other significant concentration of credit risk. Surplus funds of the Company are usually placed in short-term fixed interest deposits or the overnight money markets. Deposit counterparties must meet a board approved minimum criteria based on their short term credit rating.

(b) Capital risk management
The Company's objectives when managing capital are to safeguard the Company'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 Company's policy is to have a minimum of 12 months pre-funding of projected capital expenditure. At 31 March 2018 the company had cash and committed facilities excluding restricted funds of almost £586.8m, meeting this objective.

The Company monitors capital on the basis of the gearing ratio, which is calculated as net borrowings divided by total capital. Net borrowings are analysed in note 31 and is calculated as total borrowings less cash and cash deposits. Total capital is calculated as equity plus net borrowings.

The gearing ratios at the balance sheet date were:

	2018 £m	2017 £m
Net Borrowings (note 31)	2,068.1	2,033.8
Total equity	621.4	565.2
Total capital	**2,689.5**	**2,599.0**
Gearing Ratio	**76.9%**	**78.3%**

Consistent with the industry peer group, the Company is also monitored on the basis of the ratio of its Debt to Regulated Capital Value (RCV). South West Water's net debt to RCV has decreased to 60.3%, which compares to Ofwat's K6 target for efficient gearing of 62.5%.

3. FINANCIAL RISK MANAGEMENT CONTINUED

	2018 £m	2017 £m
Regulatory Capital Value	3,431.2	3,290.6
Net borrowings (note 31)	2,068.1	2,033.8
Net borrowings / Regulatory Capital Value	**60.3%**	**61.8%**

The Company has entered into covenants with lenders and, whilst terms vary, these typically provide for limits on gearing and interest cover. The Company has been in compliance with its covenants during the year.

(c) Determination of fair values

The Company 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 Company's financial instruments are valued principally using level 2 measures as analysed in note 19.

The fair value of financial instruments traded in active markets (such as trading and available-for-sale securities) is based on quoted market prices at the balance sheet date. The quoted market price used for financial assets held by the Company is the current bid price.

The fair value of financial instruments that are 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 value less impairment provision of trade receivables and payables are assumed to approximate their fair values. The fair value of financial liabilities for disclosure purposes is estimated by discounting the future contractual cash flows at the current market interest rate that is available to the Company for similar financial instruments.

4. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES

The Company'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:

(a) Revenue recognition

The Company recognises revenue at the time of delivery of services. Payments received in advance of services delivered are recorded as a liability.

The Company 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; actual results could differ from these estimates which would result in operating revenue being adjusted in the period in which the revision of the estimates is determined. Revenue for unmeasured charges is recognised on a time apportioned basis.

(b) Provision for doubtful debts

At the balance sheet date the Company 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 2018 the Company's current amounts receivable from customers were £184.3m, against which £89.7m had been provided for impairment (note 18).

4. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES CONTINUED

(c) Retirement benefit obligations

The Company operates defined benefit pension schemes, through its parent company, 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 2016.

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 2015 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 24 of the financial statements.

(d) Taxation

The Company's current tax provision relates to management's judgement of the amount of tax payable.

(e) Property, plant and equipment

The Company's accounting policy for property, plant and equipment is detailed in note 2 (g) of the financial statements. The carrying value of property, plant and equipment as at 31 March 2018 was £2,970.5m. In the year ended 31 March 2018 additions to property, plant and equipment totalled £184.0m and the depreciation charge was £116.3m. Estimated useful economic lives of property, plant and equipment are based on management's judgement and experience.

Asset lives and residual values are reviewed annually and historically changes to remaining estimates of useful lives have not been material.

(f) Non-underlying items

In establishing which items are disclosed separately as non-underlying, to enable a full understanding of the Group's financial performance, the Directors exercise their judgement in assessing the size, nature or incidence of specific items. See note 5 for further details.

5. NON-UNDERLYING ITEMS

Non-underlying items are those that in the Directors' view are required to be separately disclosed by virtue of their size or incidence to enable full understanding of the Company's financial performance in the year and business trends over time.

	Notes	2018 £m	2017 £m
Restructuring costs	26	-	(0.5)
Net operating costs		**-**	**(0.5)**
Tax arising on non-underlying item:			
Tax credit / (charge) arising on non-underlying items	8	-	0.1
Deferred tax – change in rate	8	-	14.3
Net non-underlying credit		**-**	**13.9**

No items were recognised during the year as non-underlying.

During 2016/17 a one-off charge of £0.5m was made to the restructuring provision reflecting announced reorganisations across the Company. Following the enactment during 2016/17 of legislation to reduce the rate of corporation tax from 18% to 17% from April 2020, a 'one off' credit of £14.3m was recognised in the income statement. In addition, a charge of £0.8m was recognised in the Statement of Comprehensive Income and a credit of £0.1m was recognised, directly in equity.

6. OPERATING COSTS BEFORE NON-UNDERLYING ITEMS

	2018 £m	2017 £m
Employment costs before non-underlying items (note 10)	45.3	46.7
Raw materials and consumables	16.6	19.2
Other operating expenses include		
Profit on disposal of property, plant and equipment	(2.4)	(2.1)
Operating lease rentals payable:		
Plant and machinery	1.2	1.3
Property	1.7	1.5
Research and development expenditure	0.1	0.2
Trade receivables impairment (note 18)	4.7	6.4
Depreciation of property, plant and equipment:		
Owned assets	77.8	79.1
Under finance leases	35.1	34.2
	112.9	113.3
Amortisation of other intangible assets	0.5	0.5
Total Depreciation	113.4	113.8

Fees payable to the Company's auditor's in the year were:

	2018 £000	2017 £000
Fees payable to the Company's auditors and its associates for the audit of the financial statements	237	212
Fees payable to the Company's auditors and its associates for other services:		
All other services	41	73
Total fees	**278**	**285**

Expenses reimbursed to the auditors in relation to the audit of the Company were £16,000 (2016/17: £14,000).

A description of the work of the Audit Committee is set out in its report on page 58 to 65 which includes an explanation of how the auditor's objectivity and independence are safeguarded when non-audit services are provided by the auditor's firm.

7. NET FINANCE COSTS

	2018			2017		
	Finance cost £m	Finance income £m	Total £m	Finance cost £m	Finance income £m	Total £m
Cost of servicing debt						
Bank borrowings and overdrafts	(14.3)	-	(14.3)	(13.9)	-	(13.9)
Interest element of finance lease rentals	(31.0)	-	(31.0)	(29.5)	-	(29.5)
Other finance costs	(2.8)	-	(2.8)	(2.9)	-	(2.9)
Interest receivable	-	1.2	1.2	-	1.5	1.5
Intercompany interest to parent	-	-	-	(0.7)	-	(0.7)
Intercompany interest to subsidiaries	(19.6)	-	(19.6)	(15.2)	-	(15.2)
Working capital adjustment	**(67.7)**	**1.2**	**(66.5)**	**(62.2)**	**1.5**	**(60.7)**
Notional interest						
Retirement benefit obligations (note 24)	(0.8)	-	(0.8)	(0.7)	-	(0.7)
Finance (costs) /income	**(68.5)**	**1.2**	**(67.3)**	**(62.9)**	**1.5**	**(61.4)**

In addition to the above, finance costs of £4.0m (2016/17: £2.8m) have been capitalised on qualifying assets included in property, plant and equipment.

8. TAXATION

	Before non-underlying items 2018 £m	Non-underlying items (note 5) 2018 £m	Total 2018 £m	Before non-underlying items 2017 £m	Non-underlying items (note 5) 2017 £m	Total 2017 £m
Analysis of charge in year						
Current tax						
Current year tax charge	30.3	-	30.3	32.2	-	32.2
Prior year tax charge	(4.5)	-	(4.5)	(0.6)	-	(0.6)
Total current tax charge	**25.8**	**-**	**25.8**	**31.6**	**-**	**31.6**
Deferred tax						
Current year tax charge	4.9	-	4.9	3.6	(0.1)	3.5
Prior year tax charge	0.7	-	0.7	1.9		1.9
Deferred tax arising on change of rate of corporation tax (note 25)	-	-	-	-	(14.3)	(14.3)
Total deferred tax charge / (credit)	**5.6**	**-**	**5.6**	**5.5**	**(14.4)**	**(8.9)**
Total charge/ (credit) for the year	**31.4**	**-**	**31.4**	**37.1**	**(14.4)**	**22.7**

UK Corporation tax is calculated at 19% (2016/17: 20%) of the estimated assessable profit for the year.

The 2016/17 deferred tax credit included a credit of £14.3m reflecting a reduction in the rate of corporation tax. There has been no change in corporation tax rates enacted during 2017/18.

The tax for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK of 19% (2016/17: 20%). The differences are explained below:

	2018 £m	2017 £m
Profit before tax	179.8	172.9
Profit before tax multiplied by the standard rate of corporation tax in the UK of 19% (2016/17: 20%)	34.2	34.6
Effects of:		
Expenses not deductible for tax purposes	0.1	0.5
Depreciation charged on non qualifying assets	1.1	1.3
Profit on the disposal of non qualifying assets	(0.5)	(0.4)
Adjustments to tax charge in respect of prior year	(3.8)	1.3
Change in rate of corporation tax	-	(14.3)
Other	0.3	(0.3)
Tax charge for year	**31.4**	**22.7**

The adjustments to the tax charge in respect of prior years in 2017/18 results from the submission of the prior year tax returns resulting in lower tax charge being due than initially provided for.

The average effective tax rate excluding non-underlying items for the year was 17% (2016/17: 21%).

In addition to the amounts recognised in the income statement the following tax charges and credits were also recognised:

	2018 £m	2017 £m
Amounts recognised directly in other comprehensive income		
Deferred tax charge/(credit) on defined benefit pension schemes	2.0	(1.0)
Deferred tax charge on cash flow hedges	3.5	0.9
Amounts recognised directly in equity		
Deferred tax charge on share based payments	0.2	0.2

8. TAXATION CONTINUED

The current tax charge for the year differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK of 19% (2016/17: 20%). The differences are explained below:

	2018 £m	2017 £m
Profit before tax	179.8	172.9
Profit before tax multiplied by the standard rate of corporation tax in the UK of 19% (2016/17: 20%)	34.2	34.6
Effects of:		
Relief for capital allowances in place of depreciation	(22.0)	(16.4)
Depreciation charge in the financial statements	18.7	13.8
Other timing differences	-	0.2
Adjustments to the tax charge in respect of prior years	(4.5)	(0.6)
Expenses not deductible for tax purposes	0.1	0.5
Relief for capitalised interest	(0.7)	(0.5)
Tax charge / (credit) for year	**25.8**	**31.6**

South West Water's current tax charge is lower than the UK headline tax rate of 19%, primarily due to the availability of capital allowances. Capital allowances provide tax relief when a business incurs expenditure on qualifying capital items such as plant and machinery used by the business. As an infrastructure business, these allowances help the Group to plan major investment and consequentially to maintain lower customers bills, as corporation tax relief is given against the investments made.

Adjustments to the tax charge in prior periods results having submitted tax computations to HMRC and as a result ensuring the tax charge in the accounts reconciles with those submitted tax computations.

9. DIVIDENDS

	2018 £m	2017 £m
Amounts recognised as distributions to equity holders in the year:		
Base and enhanced dividend of 23.3p per ordinary share in respect of 2016/17 and 2015/16 paid 26 September 2016	-	58.4
Dividend of 21.8p per ordinary share in respect of outperformance 2015/16 paid 26 September 2016	-	54.7
Special dividend of 39.8p per ordinary share paid 26 September 2016	-	100.0
Base dividend of 22.0p per ordinary share in respect of 2016/17 and 2017/18 paid 29 September 2017	55.2	-
Special dividend of 25.9p per ordinary share paid 29 March 2018	65.1	-
	120.3	**213.1**

10. EMPLOYMENT COSTS

The average number of persons (including Executive Directors) employed by the Company was 1,433 (2017: 1,427).

	Note	2018 £m	2017 £m
Wages and salaries		44.3	46.1
Social security costs		4.6	4.7
Pension costs	24	7.5	7.1
Share-based payments		0.9	0.9
Non-underlying items (note 5)		-	0.5
Total employment costs		**57.4**	**59.3**
Charged as follows:			
Employee costs		45.3	46.7
Capital schemes		12.1	12.1
Non-underlying items (note 5)		-	0.5
Total employment costs		**57.4**	**59.3**

Details of Directors' emoluments are set out in note 11. There are no personnel other than Directors, who as key management exercise authority and responsibility for planning, directing and controlling the activities of the Company.

11. DIRECTORS' EMOLUMENTS

	2018 £000	2017 £000
Executive Directors:		
Salary	404	635
Performance-related bonus paid or payable	129	234
Share-based payments	209	182
Other emoluments, including payments in lieu of pension provision	133	206
Non-Executive Directors (including Chairman)	953	346
Total emoluments	**1,828**	**1,603**

More detailed information concerning Directors' emoluments (including pensions and the highest paid Director) and share interests is shown in the Annual Report on Remuneration on pages 83 to 95. This report also details arrangements with Pennon Group plc for the payment and recharging of emoluments relating to Directors who serve as Directors of both Pennon Group and South West Water. The cost of share-based payments represents the amount charged to the income statement, as described in note 28.

The aggregate gains on vesting of Directors' share-based awards amounted to a total of £80,000. Total gains made by Directors on the exercise of share options were £855 (2017: £4,145).

At 31 March 2018 there was one Director accruing retirement benefits under defined benefit pension schemes (2017: one Director). At 31 March 2018 there was one Director accruing retirement benefits under defined contribution pension schemes (2017: one Director) with contributions of £14,183 made during the year (2016/17: £12,810).

12. GOODWILL

	2017/18 £m	2016/17 £m
Cost		
At 1 April	51.3	-
Arising on acquisitions	-	51.3
At 31 March	**51.3**	**51.3**

The goodwill of £51.3m was recognised on acquisition of Bournemouth Water in 2016/17. It is attributable to synergies and outperformance arising from the merger of operating activities.

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, for which goodwill was recognised on acquisition of Bournemouth Water in 2016, is assessed using level 2 fair value hierarchy techniques, with reference to the market value of the merged water business, using a market based observable premium to Regulated Capital Value.

13. OTHER INTANGIBLE ASSETS

	2017/18 £m	2016/17 £m
Cost:		
At 1 April	2.0	**-**
Arising on acquisitions	-	2.0
At 31 March	**2.0**	**2.0**
Accumulated amortisation		
At 1 April	0.5	-
Charge for period	0.5	0.5
At 31 March	**1.0**	**0.5**
Net book value		
At 1 April	**1.5**	**-**
At 31 March	**1.0**	**1.5**
Weighted average useful economic life:		
At 1 April/on acquisition	**5 years**	**5 years**
At 31 March	**5 years**	**5 years**

Other acquired intangible assets relate to computer software and arose on the acquisition of Bournemouth Water.

14. PROPERTY, PLANT AND EQUIPMENT

	Freehold land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Total £m
Cost:						
At 31 March 2016	**35.5**	**1,688.6**	**673.1**	**1,490.2**	**93.4**	**3,980.8**
Arising on acquisitions	7.3	75.0	21.9	37.3	1.2	142.7
Additions	0.2	12.7	1.2	46.8	130.0	190.9
Assets adopted at fair value	-	5.4	14.0	5.1	-	24.5
Grants & contributions	-	(1.7)	-	-	-	(1.7)
Disposals	-	(1.2)	(0.2)	(2.4)		(3.8)
Transfers/reclassifications	2.8	16.3	3.5	39.6	(62.2)	-
At 31 March 2017	**45.8**	**1,795.1**	**713.5**	**1,616.6**	**162.4**	**4,333.4**
Additions	2.0	13.2	1.9	44.3	122.6	184.0
Assets adopted at fair value	-	8.1	-	-	-	8.1
Grants & contributions	-	(2.1)	-	-	-	(2.1)
Disposals	(0.2)	(1.2)	-	(2.1)	-	(3.5)
Disposal of business assets to fellow subsidiary	-	-	-	(2.6)	-	(2.6)
Transfers/reclassifications	3.7	21.9	11.1	73.4	(110.1)	-
At 31 March 2018	**51.3**	**1,835.0**	**726.5**	**1,729.6**	**174.9**	**4,517.3**
Accumulated depreciation:						
At 31 March 2016	**8.0**	**209.6**	**231.7**	**871.6**	**-**	**1,320.9**
Charge for year	1.6	23.8	13.1	77.8	-	116.3
Disposals	-	(1.2)	(0.2)	(2.2)		(3.6)
At 31 March 2017	**9.6**	**232.2**	**244.6**	**947.2**	**-**	**1,433.6**
Charge for year	1.7	22.4	13.7	78.5	-	116.3
Disposals	-	(1.2)	-	(1.9)	-	(3.1)
At 31 March 2018	**11.3**	**253.4**	**258.3**	**1,023.8**	**-**	**1,546.8**
Net book value:						
At 31 March 2016	**27.5**	**1,479.0**	**441.4**	**618.6**	**93.4**	**2,659.9**
At 31 March 2017	**36.2**	**1,562.9**	**468.9**	**669.4**	**162.4**	**2,899.8**
At 31 March 2018	**40.0**	**1,581.6**	**468.2**	**705.8**	**174.9**	**2,970.5**

Out of the total depreciation charge for the Company of £116.3m (2016/17: £116.3m), the sum of £1.5m (2016/17: £1.5m) has been charged to capital projects, £1.9m (2016/17: £1.5m) has been offset by deferred income and £112.9m (2016/17: £113.3m) against profits.

Asset lives and residual values are reviewed annually.

During the year borrowing costs of £4.0m (2016/17: £2.8m) have been capitalised on qualifying assets, at an average borrowing rate of 3.7% (2016/17: 3.7%).

On 1 April 2018, £2.6m of assets relating to the non-household retail business were acquired by Pennon Water Services Limited, a fellow Pennon Group plc subsidiary.

14. PROPERTY, PLANT AND EQUIPMENT CONTINUED

Assets held under finance leases were:

	Freehold land and buildings £m	Infrastructure assets £m	Operational properties £m	Fixed and mobile plant, vehicles and computers £m	Construction in progress £m	Total £m
Cost:						
At 31 March 2017	**-**	**409.0**	**436.7**	**424.8**	**0.2**	**1,270.7**
At 31 March 2018	**2.5**	**416.9**	**461.2**	**487.6**	**0.2**	**1,368.4**
Accumulated depreciation:						
At 31 March 2017	**-**	**58.3**	**111.5**	**224.8**	**-**	**394.6**
At 31 March 2018	**-**	**63.3**	**119.4**	**246.6**	**-**	**429.3**
Net book value:						
At 31 March 2017	**-**	**350.7**	**325.2**	**200.0**	**0.2**	**876.1**
At 31 March 2018	**2.5**	**353.6**	**341.8**	**241.0**	**0.2**	**939.1**

15. FINANCIAL INSTRUMENTS BY CATEGORY

The accounting policies for financial instruments have been applied to the line items as below:

		Fair value	Amortised cost		
	Note	Derivatives used for cash flow hedging £m	Loans and receivables £m	Trade receivables and trade payables £m	Total £m
31 March 2018					
Financial assets					
Trade and other receivables	18	-	16.4	94.6	111.0
Cash and cash deposits	20	-	227.0	-	227.0
		-	**243.4**	**94.6**	**338.0**
Financial liabilities					
Borrowings	22	-	(2,295.0)	-	(2,295.0)
Derivative financial instruments	19	(16.7)	-	-	(16.7)
Trade and other payables	21	-	(3.9)	(38.0)	(41.9)
		(16.7)	**(2,298.9)**	**(38.0)**	**(2,353.6)**

		Fair value	Amortised cost		
	Note	Derivatives used for cash flow hedging £m	Loans and receivables £m	Trade receivables and trade payables £m	Total £m
31 March 2017					
Financial assets					
Trade and other receivables	18	-	16.3	119.0	135.3
Cash and cash deposits	20	-	247.4	-	247.4
		-	**263.7**	**119.0**	**382.7**
Financial liabilities					
Borrowings	22	-	(2,281.2)	-	(2,281.2)
Derivative financial instruments	19	(39.1)	-	-	(39.1)
Trade and other payables	21	-	(3.3)	(56.7)	(60.0)
		(39.1)	**(2,284.5)**	**(56.7)**	**(2,380.3)**

16. INVESTMENTS

	2018 £m	2017 £m
At 31 March:		
Subsidiary undertakings	3.3	3.3

The Company has three wholly-owned trading subsidiaries, Peninsula Properties (Exeter) Limited, South West Water Finance plc and Source Contact Management Limited. The Company also has eight wholly-owned dormant subsidiaries, Bournemouth Water Investments Limited and its subsidiaries, BWH Enterprises Limited, Bournemouth Water Limited, Alderney Water Limited, West Hampshire Water Limited, Avon Valley Water Limited and Aquacare (BWH) Limited, and Source Collections Limited (a subsidiary of Source Contact Management Limited)

All of these subsidiaries are registered at Peninsula House, Rydon Lane, Exeter, Devon, England, EX2 7HR and are also incorporated and operate in England. The Company also has a minority shareholding in Landlord Tap Limited, which is incorporated, registered and operates in England.

Consolidated financial statements have not been prepared, as explained in note 2(b).

In the opinion of the Directors, the total value of the investments in subsidiaries is not less than the amount at which they are shown in the balance sheet.

17. INVENTORIES

	2018 £m	2017 £m
Raw materials and consumables	4.9	5.3

18. TRADE AND OTHER RECEIVABLES – CURRENT

	2018 £m	2017 £m
Amounts receivable from customers	184.3	210.4
Less: provision for impairment of receivables	(89.7)	(91.4)
Net trade receivables	**94.6**	**119.0**
Amounts owed by fellow subsidiary companies	13.3	1.3
Amounts owed by parent undertaking	-	-
Other receivables	3.2	15.0
Prepayments and accrued income	6.5	6.9
	117.6	**142.2**

Trade receivables include accrued income relating to customers with metered budget plans.

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

There is no concentration of credit risk in trade receivables. The Company 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 Company has created IAS 39 portfolio provisions, but cannot practicably identify which receivables specifically are the ones impaired. It is Company 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 gross trade receivables past due but not specifically impaired was:

	2018 £m	2017 £m
Past due 1 - 30 days	21.5	20.0
Past due 31 - 120 days	10.4	20.4
More than 120 days	143.6	148.3

The aged trade receivables above are taken directly from the Company's aged debt datamart and sales ledger records before the deduction of credit balances and other adjustments.

The Company has a duty under legislation to continue to provide domestic customers with services regardless of payment. The Company specifically reviews separate categories of debt to identify an appropriate provision for impairment.

The movement in the allowance for impairment in respect of trade receivables was:

	2018 £m	2017 £m
At 1 April	**91.4**	**88.7**
Acquisition provision for receivables impairment	-	0.8
Provision for receivables impairment	5.1	6.4
Disposal of business asset to fellow subsidiary company	(3.4)	-
Net Receivables written-off during the year as uncollectable	(3.4)	(4.5)
At 31 March	**89.7**	**91.4**

On 1 April 2017, following the opening of the market, South West Water's non-household retail net customer book and related assets together totalling £31.9m were acquired by Pennon Water Services (a fellow Pennon Group plc subsidiary) for consideration of £31.9m, being the consideration following finalised assessments of asset values. As a result, trade receivables from 2017/18 onwards now represent household retail receivables due from consumers and non-household wholesale receivables due from retailers of water and wastewater services.

Receivables in respect of wholesale water and wastewater services retailed by fellow group subsidiaries are included as amounts owed by fellow subsidiary companies.

19. DERIVATIVE FINANCIAL INSTRUMENTS

	2018 £m	2017 £m
Derivatives used for cash flow hedging:		
Current liabilities	(8.4)	(15.2)
Non-current liabilities	(8.2)	(23.9)

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 cash flow hedges was £nil (2016/17: £nil).

Interest rate swaps and fixed rate borrowings are used to manage the mix of fixed and floating rates to ensure at least 50%, after the effect of interest rate swaps, of net borrowings is at fixed rate. At 31 March 2018, 60% (31 March 2017: 65%) of net borrowings was at fixed rate.

At 31 March 2018 interest rate swaps to swap from floating to fixed rate and hedge financial liabilities with a notional value of £878.0m existed, with a weighted average maturity of 2.3 years (31 March 2017: £978.0m, with 3.0 years). The weighted average interest rate of the swaps was 1.96% (31 March 2017: 2.05%).

The periods for which cash flow hedges are expected to affect future profit or loss as follows:

	<1 year £m	1-2 years £m	2-5 years £m	Over 5 years £m	Total £m
31 March 2018					
Liabilities	(8.4)	(7.1)	(0.8)	(0.3)	(16.6)
31 March 2017					
Liabilities	(15.2)	(11.3)	(11.9)	(0.7)	(39.1)

Valuation hierarchy

The amounts of financial instruments carried at fair value by valuation method were:

	2018 £m	2017 £m
Level 2 inputs		
Liabilities		
Derivatives used for cash flow hedging	(16.6)	(39.1)

The amounts above are the fair value of financial instruments using level 2 inputs that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). The fair value of swaps is based on the market value of equivalent instruments at the balance sheet date.

20. CASH AND CASH DEPOSITS

	2018 £m	2017 £m
Cash at bank and in hand	46.5	25.7
Other deposits	180.4	221.7
Cash and cash deposits	**226.9**	**247.4**

Overnight deposits have an average maturity of one day. Other short-term bank deposits have an average maturity of 83 days.

Other deposits include £180.4m (31 March 2017: £221.7m) of restricted funds to settle long–term lease liabilities (note 22)

For the purposes of the cash flow statement, cash and cash equivalents comprise:

	2018 £m	2017 £m
Cash and cash deposits as above	226.9	247.4
Less: deposits with a maturity of three months or more (restricted funds)	(180.4)	(221.7)
Cash and cash equivalents	**46.5**	**25.7**

21. TRADE AND OTHER PAYABLES – CURRENT

	2018 £m	2017 £m
Trade payables	38.0	56.7
Amounts owed to subsidiary companies	3.9	3.3
Other tax and social security	3.5	1.6
Other payables	8.0	8.2
Accruals	22.6	21.5
Deferred income	1.9	2.2
	77.9	**93.5**

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

22. BORROWINGS

	2018 £m	2017 £m
Current		
Loan from parent company (note 35)	-	100.0
European Investment Bank	32.0	41.1
	32.0	**141.1**
Obligations under finance leases	16.1	17.2
Total current borrowings	**48.1**	**158.3**
Non-current		
European Investment Bank	291.4	323.4
Other external loans	224.9	171.6
Loan from subsidiary company (note 35)	411.3	400.8
	927.6	**895.8**
Obligations under finance leases	1,319.3	1,227.1
	2,246.9	**2,122.9**
Total borrowings	**2,295.0**	**2,281.2**

The loan from subsidiary company represents loans from South West Water Finance plc, a UK company whose purpose is to raise borrowings for South West Water Limited. The borrowings raised are lent to the Company on ‘back-to-back’ terms.

22. BORROWINGS CONTINUED

The fair value of the non-current borrowings were:

	2018 Book value £m	2018 Fair value £m	2017 Book value £m	2017 Fair value £m
European Investment Bank	291.4	251.5	323.4	282.3
Other external loans	224.9	270.2	171.6	277.0
Loan from subsidiary company	411.3	552.9	400.8	497.8
	927.6	**1,074.6**	**895.8**	**1,057.1**
Obligations under finance leases	1,319.3	1,207.7	1,227.1	1,120.3
	2,246.9	**2,282.3**	**2,122.9**	**2,177.4**

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:

	2018 £m	2017 £m
Between 1 and 2 years	85.5	48.0
Over 2 and less than 5 years	232.2	246.2
Over 5 years	1,929.2	1,828.7
	2,246.9	**2,122.9**

The weighted average maturity of non-current borrowings was 23.1 years (31 March 2017: 24.5 years).

Finance lease liabilities – minimum lease payments:

	2018 £m	2017 £m
Within 1 year	36.8	31.5
Over 1 year and less than 5 years	262.0	207.1
Over 5 years	1,954.8	1,893.4
	2,253.6	**2,132.0**
Less: future finance charges	(918.2)	(887.7)
Present value of finance lease liabilities	**1,335.4**	**1,244.3**

The maturity of finance lease liabilities was:

	2018 £m	2017 £m
Within 1 year	16.1	17.3
Over 1 year and less than 5 years	171.8	143.8
Over 5 years	1,147.5	1,083.2
	1,335.4	**1,244.3**

Included above are accrued finance charges arising on obligations under finance leases totalling £152.9m (2016/17: £144.9m), of which £0.6m (2016/17: £0.6m) is repayable within one year.

Included above is £0.5m (31 March 17: £0.8m) due to Peninsula Leasing Limited (a fellow Pennon Group subsidiary), under finance lease agreements of which £0.3m (31 March 2017: £0.4m) is repayable within one year.

The period for repayment of these leases was extended with an agreement to deposit with the lessor group amounts equal to the difference between the original and revised payments due. The accumulated deposits of £87.9m at 31 March 2018 (31 March 2017: £79.3m) 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 deposit at 31 March 2018 of £92.5m (31 March 2017: £142.4m) is being held to settle the lease liability at the end of the lease term, subject to rights to release by negotiation with the lessor.

22. BORROWINGS CONTINUED

Undrawn committed borrowing facilities at the balance sheet date were:

	2018 £m	2017 £m
Floating rate:		
Expiring within one year	80.0	-
Expiring after one year	279.9	510.0
	359.9	**510.0**

In addition, the Company has undrawn uncommitted short-term bank facilities of £nil (31 March 2017: £15.0m).

23. OTHER NON-CURRENT LIABILITIES

	2018 £m	2017 £m
Deferred income	108.7	102.4

Deferred income results from the adoption at fair value of assets transferred from customers.

24. RETIREMENT BENEFIT OBLIGATIONS

The Company's employees are eligible to participate in defined benefit pension schemes and also a defined contribution section within the main scheme, operated by the parent company, Pennon Group plc.

The assets of the Pennon 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 the schemes' trustees is determined by the schemes' trust documentation. The Pennon 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 £1.5m (2016/17: £1.3m).

Defined benefit schemes
The principal actuarial assumptions at 31 March 2018 were:

	2018 %	2017 %	2016 %
Rate of increase in pensionable pay	3.2	3.2	2.9
Rate of increase for current and future pensions	2.0	2.0	2.8
Rate used to discount schemes' liabilities and expected return on scheme assets	2.7	2.6	3.3
Inflation	3.2	3.2	2.9

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 2015 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 at:

	2018	2017	2016
Male	24.9	24.8	25.1
Female	27.3	27.2	27.3

The average life expectancy in years of a future pensioner retiring at age 62, 20 years after the balance sheet date, is projected as:

	2018	2017	2016
Male	26.3	26.2	26.5
Female	29.6	29.5	29.6

24. RETIREMENT BENEFIT OBLIGATIONS CONTINUED

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%	+/- 0.6%
Rate of increase in current and future pensions	+/- 0.5%	+/- 6.2%
Rate used to discount schemes' liabilities	+/- 0.5%	+/- 9.3%
Inflation	+/- 0.5%	+/- 6.4%
Life expectancy	+/- 1 year	+/- 4.5%

The sensitivity analysis shows the effect of changes in the principal assumptions used for the measurement of the pension liability. The method used to calculate the sensitivities is approximate and has been determined taking into account the duration of the liabilities and the overall profile of each scheme's membership. This is the same approach as has been adopted in previous years.

The amounts recognised in the balance sheet were:

	2018 £m	2017 £m
Present value of financial obligations	(639.7)	(658.6)
Fair value of plan assets	617.1	626.3
Net liability recognised in the balance sheet	**(22.6)**	**(32.3)**

The movement in the net defined benefit obligation over the accounting period is as follows:

			2018			2017
	Present value of obligation £m	Fair value of plan assets £m	Total £m	Present value of obligation £m	Fair value of plan assets £m	Total £m
At 1 April	**(658.6)**	**626.3**	**(32.3)**	**(500.8)**	**471.2**	**(29.6)**
Acquisition of subsidiary	**-**	**-**	**-**	**(79.5)**	**86.6**	**7.1**
Current service cost	(6.0)	-	(6.0)	(5.4)	-	(5.4)
Interest (expense)/income	(16.6)	15.8	(0.8)	(18.8)	18.1	(0.7)
Past service cost and gains and losses on settlements	(0.7)	-	(0.7)	(0.4)	-	(0.4)
	(23.3)	**15.8**	**(7.5)**	**(24.6)**	**18.1**	**(6.5)**
Remeasurements:						
Return/ (loss) on plan assets excluding amounts included in interest expense	-	(5.3)	(5.3)	-	71.8	71.8
Gain/(loss) from change in financial assumptions	17.5	-	17.5	(79.5)	-	(79.5)
Experience gains	-	-	-	-	-	-
	17.5	**(5.3)**	**12.2**	**(79.5)**	**71.8**	**(7.7)**
Contributions:						
Employers	-	5.0	5.0	-	4.4	4.4
Plan participants	-	-	-	(0.1)	0.1	-
Payments from plans:						
Benefit payments	24.7	(24.7)	-	25.9	(25.9)	-
	24.7	**(19.7)**	**5.0**	**25.8**	**(21.4)**	**4.4**
At 31 March	**(639.7)**	**617.1**	**(22.6)**	**(658.6)**	**626.3**	**(32.3)**

24. RETIREMENT BENEFIT OBLIGATIONS CONTINUED

Employer contributions are made into the scheme by South West Water and other companies within the Pennon Group based upon pensionable pay of employees in each section of the scheme. Full details of the scheme are included within the Pennon Group plc financial statements (see note 33).

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

			2018			2017
	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	121.2	-	20	148.1	-	23
Property	45.3	7.6	9	41.2	7.0	8
Bonds	305.7	-	50	275.3	-	44
Diversified Growth Fund	101.7	-	16	61.1	-	10
Insurance linked securities	33.0	-	5	37.3	-	6
Other	2.6	-	-	56.3	-	9
	609.5	**7.6**	**100**	**619.3**	**7.0**	**100**

Other assets principally represent cash contributions received from the Company towards the year-end which are invested during the subsequent financial year.

Through the Pennon Group defined benefit pension plan, the Company 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 holds a significant proportion of growth assets (equities, diversified growth funds and property) which are expected to outperform corporate bonds in the long-term while providing volatility and risk in the short-term. The allocation to growth assets is monitored such that it is aligned with the scheme's long-term objectives.

Changes in bond yields: A decrease in corporate bond yields will increase the scheme's liabilities, although this will be partially offset by an increase in the value of the scheme's bond holdings.

Inflation risk: The majority of the scheme's 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 scheme's obligations are to provide benefits for the life of the member, so increases in life expectancy will result in an increase in the liabilities.

In conjunction with its investment advisors, the trustees have structured the scheme's investments with the objectives of balancing investment returns and levels of risk. The asset allocation has three principal elements:

- holding of bonds which is expected to be less volatile than most other asset classes and reflects market movements in the scheme's 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 scheme's 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 scheme 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 2016. The Company did not make deficit recovery contribution to the main scheme during the year (2016/17: £nil). Pennon Group plc monitors funding levels on an annual basis and expects to pay total contributions of around £10.0m during the year ended 31 March 2019. This is in line with our K6 commitments.

25. DEFERRED TAX LIABILITIES

Deferred tax is provided in full on temporary differences under the liability method using the enacted tax rates.

The movements on deferred tax were:

	2018 £m	2017 £m
At 1 April	**220.0**	**211.8**
Arising on acquisitions	-	17.5
Impact of change of corporation tax rate credited to the income statement	-	(14.3)
Impact of change of corporation tax rate charged to other comprehensive income	-	0.8
Impact of change of corporation tax rate credited to equity	-	(0.1)
Other non underlying credits in the income statement	-	(0.1)
Other deferred tax charged to the income statement	5.6	5.4
Charged/(credited) to other comprehensive income / equity	5.7	(1.0)
At 31 March	**231.3**	**220.0**

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 Company's deferred tax liability is expected to be recovered over more than one year.

All deferred tax assets and liabilities within the same jurisdiction are offset.

The movements in deferred tax assets and liabilities were:

Deferred tax liabilities

	Accelerated tax depreciation £m
At 31 March 2016	**226.3**
Arising on acquisitions	16.3
Impact of change of rate	(14.1)
Charged to the income statement	6.1
At 31 March 2017	**234.6**
Charged to the income statement	5.9
At 31 March 2018	**240.5**

25. DEFERRED TAX LIABILITIES CONTINUED
Deferred tax assets

	Provisions £m	Retirement benefit obligations £m	Derivatives £m	Share based payments £m	Total £m
At 31 March 2016	**(1.2)**	**(5.3)**	**(7.4)**	**(0.6)**	**(14.5)**
Arising on acquisitions	(0.1)	1.3	-	-	1.2
Non-underlying charged/(credited) to the income statement	(0.4)	0.1	-	-	(0.3)
Credited to income statement	(0.3)	(0.4)	-	-	(0.7)
Charged/(credited) to other comprehensive income / equity	-	(1.4)	0.5	(0.1)	(1.0)
Non-underlying Charged/(credited) to equity/ other comprehensive income	-	0.4	0.4	(0.1)	0.7
At 31 March 2017	**(2.0)**	**(5.3)**	**(6.5)**	**(0.8)**	**(14.6)**
(Credit)/charge to income statement	-	(0.5)	-	0.2	(0.3)
Charge to other comprehensive income/equity	-	2.0	3.5	0.2	5.7
At 31 March 2018	**(2.0)**	**(3.8)**	**(3.0)**	**(0.4)**	**(9.2)**

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

	2018 £m	2017 £m
Actuarial gains on defined benefit schemes	2.0	(1.0)
Share-based payments	0.2	(0.2)
Cash-flow hedges	3.5	0.9
	5.7	**(0.3)**

26. PROVISIONS

	2018 £m	2017 £m
Restructuring		
At 1 April	**4.9**	**6.7**
Charged to the income statement	-	0.5
Utilised during year	(2.2)	(2.3)
At 31 March	**2.7**	**4.9**

The restructuring provision is expected to be utilised within one year.

27. CALLED UP SHARE CAPITAL

	2018 £m	2017 £m
Authorised		
500,000,000 Ordinary shares of £1 each	**500.0**	**500.0**
Allotted and fully paid		
250,923,000 Ordinary shares of £1 each	**250.9**	**250.9**

28. EMPLOYEE SHARE SCHEMES

The Company participates in a number of share plans for the benefit of employees operated by Pennon Group plc. Details of each plan are set out below.

i) Sharesave Scheme

An all-employee savings related plan is operated that enables employees to invest up to a maximum of £500 per month for three or five years. These savings can then be used to buy Ordinary shares, at a price set at a c.17% 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 Pennon Group before the option exercise period commences.

Outstanding options to subscribe for Pennon Group plc Ordinary shares of 40.7p each under the Sharesave scheme are:

			Thousands of shares in respect of which options outstanding at 31 March	
Date granted	**Subscription price fully paid**	**Period when options normally exercisable**	**2018**	**2017**
28 June 2010	431p	2013 – 2017	-	28
29 June 2011	536p	2014 – 2018	15	17
29 June 2012	588p	2015 – 2017	1	31
03 July 2013	538p	2016 – 2018	54	57
14 July 2014	611p	2017 – 2019	83	279
24 June 2015	683p	2018 – 2020	476	556
29 June 2016	709p	2019 – 2021	271	326
28 June 2017	766p	2020 – 2022	279	-
			1,179	**1,294**

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

		2018		2017
	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	1,294	658	1,324	617
Granted	316	767	342	709
Exercised	(258)	590	(290)	528
Expired	(173)	703	(82)	663
At 31 March	**1,179**	**695**	**1,294**	**658**

The weighted average price at the date of exercise of Sharesave options during the year was 798p (2016/17: 873p). The options outstanding at 31 March 2018 had a weighted average exercise price of 695p (31 March 2017: 658p) and a weighted average remaining contractual life of 1.5 years (31 March 2017: 1.9 years).

28. EMPLOYEE SHARE SCHEMES CONTINUED

The aggregate fair value of Sharesave options granted during the year was £0.9m (2016/17: £0.9m), determined using the Black-Scholes valuation model. The significant inputs into the valuation model, at the date of issue of the options, were:

	2018	2017
Weighted average share price	848p	854p
Weighted average exercise price	767p	709p
Expected volatility	19.0%	18.0%
Expected life	3.4 years	3.4 years
Risk-free rate	0.3%	0.3%
Expected dividend yield	4.5%	4.2%

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 Pennon Group plc, and are also required to hold a substantial personal share holding in Pennon Group plc. 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. From 2017/18, no further awards will be made under this plan as it has been superceded by a Long-Term Incentive Plan (see iii below).

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

		2018		2017
	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	183	847	366	749
Granted	-	-	68	920
Vested	(8)	799	(26)	653
Transferred to Pennon	-	-	(156)	-
Lapsed	(48)	799	(69)	653
At 31 March	**127**	**869**	**183**	**847**

The awards outstanding at 31 March 2018 had a weighted average exercise price of 869p (31 March 2017: 873p) and a weighted average remaining contractual life of 0.8 years (31 March 2017: 2.1 years).

No awards were granted during the year. The aggregate value of awards granted in 2017 was determined using a Monte-Carlo simulation model. The significant inputs into the valuation model at the date of the share awards were:

	2017
Weighted average share price	920p
Expected volatility	18.0%
Risk-free rate	0.3%

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

28. EMPLOYEE SHARE SCHEMES CONTINUED

iii) Long-Term Incentive Plan

Executive Directors and Senior Management receive a conditional award of Ordinary shares in Pennon Group plc. Share awards vest subject to the achievement of specific performance conditions measured over a performance period of not less than three years.

The number and price of shares in the LTIP are:

	2018 Number of Ordinary shares (thousands)	2018 Weighted average exercise price per share (p)
At 1 April	-	-
Granted	86	803
Vested	-	-
Transferred to Pennon	-	-
Lapsed	-	-
At 31 March	**86**	**803**

The awards outstanding at 31 March 2018 had a weighted average exercise price of 803p (31 March 2017: 873p) and a weighted average remaining contractual life of 2.4 years (31 March 2017: N/A).

The aggregate fair value of awards granted during the year was £0.4m (2016/17: N/A), determined from market value. No option pricing methodology is applied since the vesting of the shares depend on non-market performance vesting conditions.

iv) Annual Incentive Bonus Plan – Deferred Shares

Awards under the plan to Executive Directors and Senior Management involve the release of Ordinary shares in Pennon Group plc to participants. There is no performance condition since vesting is conditional upon continuous service with the Pennon Group for a period of three years from the award.

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

	2018 Number of Ordinary shares (thousands)	2018 Weighted average exercise price per share (p)	2017 Number of Ordinary shares (thousands)	2017 Weighted average exercise price per share (p)
At 1 April	143	845	160	768
Granted	57	809	44	950
Vested	(17)	821	(46)	693
Transferred to Pennon	(52)	-	-	-
Lapsed	(1)	843	(15)	798
At 31 March	**130**	**845**	**143**	**845**

The awards outstanding at 31 March 2018 had a weighted average price of 845p (31 March 2017: 845p) and a weighted average remaining contractual life of 1.6 years (31 March 2017: 2.4 years). The Group's share price at the date of the awards ranged from 791p to 950p.

The aggregate fair value of awards granted during the year was £0.5m (2016/17: £0.4m), determined from market value. No option pricing methodology is applied since dividends declared 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.

29. RETAINED EARNINGS AND OTHER RESERVES

	Hedging reserve £m	Retained earnings £m	Total £m
At 31 March 2016	**(33.8)**	**413.3**	**379.5**
Profit for the year	-	150.2	150.2
Other comprehensive income/(loss) for the year	4.2	(6.7)	(2.5)
Dividends paid	-	(213.1)	(213.1)
Share-based payments (including tax)	-	0.7	0.7
Pennon shares disposed on vesting of options	-	(0.5)	(0.5)
At 31 March 2017	**(29.6)**	**343.9**	**314.3**
Profit for the year	-	148.4	148.4
Other comprehensive income/(loss) for the year	17.1	10.2	27.3
Dividends paid	-	(120.3)	(120.3)
Share-based payments (including tax)	-	0.8	0.8
Pennon shares disposed on vesting of options	-	-	-
At 31 March 2018	**(12.5)**	**383.0**	**370.5**

The hedging reserve is used to record the portion of the gain or loss on a hedging instrument in a cash flow hedge that is determined to be an effective hedge.

30. CASH FLOW FROM OPERATING ACTIVITIES

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

	2018 £m	2017 £m
Continuing operations		
Profit for the year	148.4	150.2
Adjustments for:		
Share based payments	1.0	0.9
Deferred income released to profits	(0.3)	(0.2)
Profit on disposal of property, plant and equipment	(2.4)	(2.1)
Depreciation charge	112.9	113.3
Amortisation of intangible fixed assets	0.5	0.5
Finance income	(1.2)	(1.5)
Finance charge	68.5	62.9
Taxation	31.4	22.7
Non underlying provision charge	-	0.5
Changes in working capital:		
Decrease in inventories	0.4	0.2
Decrease/(increase) in trade and other receivables	(12.4)	(18.3)
(Decrease)/increase in trade and other payables	6.9	2.6
Increase in retirement benefit obligations	1.7	1.4
Decrease in provisions	(2.1)	(2.4)
Cash generated from operations	**353.3**	**330.7**

31. NET BORROWINGS

	2018 £m	2017 £m
Cash and cash deposits	**226.9**	**247.4**
Borrowings – current		
Loan from parent company	-	(100.0)
Other current borrowings	(32.0)	(41.1)
Finance lease obligations	(16.1)	(17.2)
Total current borrowings	**(48.1)**	**(158.3)**
Borrowings – non-current		
Other non-current borrowings	(927.6)	(895.8)
Finance lease obligations	(1,319.3)	(1,227.1)
Total non-current borrowings	**(2,246.9)**	**(2,122.9)**
Total net borrowings	**(2,068.1)**	**(2,033.8)**

32. OPERATING LEASE COMMITMENTS

The future aggregate minimum lease payments under non-cancellable operating leases are:

	2018 £m	2017 £m
Within 1 year	1.9	1.9
Over 1 year and less than 5 years	7.1	7.1
Over 5 years	46.8	46.5
	55.8	**55.5**

33. CONTINGENT LIABILITIES

	2018 £m	2017 £m
Guarantee of borrowings of subsidiary undertaking	401.7	391.4

Guarantees in respect of performance bonds, the last of which expire in 2057 and which will be reduced in line with repayments of the borrowings of the subsidiary undertaking, are entered into in the normal course of business. No liability is expected to arise in respect of the guarantees.

The Company is subject to litigation from time to time as a result of its activities. The Company 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.

34. CAPITAL COMMITMENTS

	2018 £m	2017 £m
Contracted but not provided	80.4	53.8

35. RELATED PARTY TRANSACTIONS

	2018 £m	2017 £m
Parent company		
Purchase of goods and services		
– Group expenses	5.6	5.3
Payment for provision of finance		
- Loan interest	0.1	0.6
Sale of goods and services		
– Administrative services	0.5	0.5
Dividends paid	120.3	213.1

	2018 £m	2017 £m
Subsidiaries of the Company		
Purchase of goods and services		
– Property consultancy	0.4	0.3
– Billing and collection services	9.7	9.9
Payment for provision of finance		
– Loan interest	19.4	15.2
Sale of goods and services (administrative services)	1.5	1.8

	2018 £m	2017 £m
Fellow subsidiaries of the Pennon Group		
Purchase of goods and services		
– Insurance premia	-	0.6
– Management charges	2.6	-
– Waste disposal	0.2	-
Sale of goods and services		
– Non-household services	126.0	-
– Tankered waste and trade effluent charges	0.3	-

35. RELATED PARTY TRANSACTIONS CONTINUED

	2018 £m	2017 £m
Year end balances		
Borrowings		
– Loan from parent	-	100.0
– Loan from subsidiary	411.3	400.8
– Finance lease balances with fellow subsidiary	0.7	0.8
Receivables		
– Parent company	-	0.5
– Subsidiaries	0.1	-
– Fellow subsidiaries	13.2	0.9
Payables		
– Subsidiaries	3.8	3.0
– Fellow subsidiaries	0.1	-

Details of the £100.0m loan from the parent Company, Pennon Group plc and the loan from the subsidiary, South West Water Finance are included in note 22.

36. PARENT COMPANY

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