# REGULATORY ACCOUNTS 2012

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## OUR BUSINESS

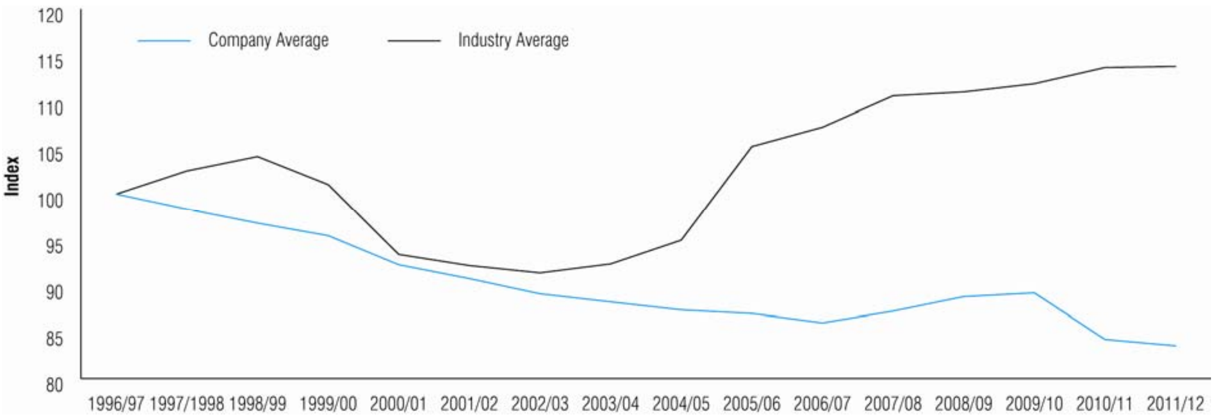
Portsmouth Water provides water to 305,000 homes and businesses in an area covering 868 square kilometres from the River Meon in Hampshire to the River Arun in West Sussex. The Company serves the cities and towns of Portsmouth, Chichester, Fareham, Gosport, Havant and Bognor Regis. On average, each day it supplies approximately 176 million litres of water through a network of over 3,275 kilometres of underground mains. Water supplied is derived from the chalk of the South Downs and is abstracted from wells, boreholes, springs and the River Itchen. The table below shows the major sources used by the Company during the year. The springs at Havant and Bedhampton, which provide 28% of the total supply, are thought to be the largest group of springs used for public supplies in Europe.

| Source | Actual 2011/12 Abstraction (Million Litres) | % of Supply 2011/12 | % of Supply 2010/11 |
|---|---|---|---|
| Springs at Havant & Bedhampton | 18,350 | 28 | 27 |
| River Itchen | 8,006 | 12 | 12 |
| Boreholes, Wells & Adits | 40,173 | 60 | 61 |
| **Totals** | **66,529** | **100** | **100** |

Water from the springs at Havant and Bedhampton is treated at the Farlington treatment works and there are also complex treatment works at the River Itchen, Lovedean, Soberton and Fishbourne. The last three works accounted for approximately 6% of supplies in 2011/12. Water from the remaining sources requires less sophisticated treatment.

Portsmouth Water's charges are the lowest in England and Wales, the average annual bill for water being £91 per household, the equivalent of 25p per day. In real terms, the price of water for household customers has fallen by 16.5% over the last 15 years. This compares with a real increase of 14% for the industry as a whole, as illustrated in the chart below, where the 1996/97 prices are indexed at 100:

**Comparison of Average Household Bills with Average Industry Tariffs**




The water industry is subject to a range of UK and EU legislation. Standards, particularly those relating to the environment, are being tightened on a regular basis and require increasing levels of investment. The standards of service provided by Portsmouth Water are monitored by three main regulators - the Water Services Regulation Authority (Ofwat) for setting prices and to ensure value for customers, the Environment Agency (EA) for environmental protection and the Drinking Water Inspectorate (DWI) for drinking water quality. Customers are represented by the Consumer Council for Water (CCW), which monitors the quality of service provided by the Company. Portsmouth Water works closely with these and other organisations interested in the services it provides.

Ofwat is the water industry's economic regulator, and its principal duties are exercised through the price-setting process. Ofwat sets price limits for Portsmouth Water every five years. The last determination of prices was in November 2009 for the period 2010 to 2015. The price setting process is known as the Periodic Review and involves a series of consultations between water companies, Ofwat and the other regulators over a two year period. The review examines all aspects of the business and requires the Company to submit a detailed Business Plan to Ofwat. Water companies are allowed to increase prices to customers annually by inflation (RPI) plus or minus the price limit set by Ofwat. The price limits reflect the revenue, which the regulator believes an efficient company needs in order to finance its operations and capital programme, after making an assessment of potential future efficiency gains.

The price limits set for the five year period to 2015 are as follows:

| | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 |
|---|---|---|---|---|---|
| % (reduction) in bills before inflation | **(4.8)** | **(2.1)** | **(1.7)** | **(1.4)** | **(0.6)** |

**Long Term Resource Planning**
Over the last twenty years, the Company has experienced falling demand for water, particularly from commercial customers. The future, however, is expected to see rising demand from domestic customers, with a significant house building programme planned in the Company's area of supply. The Company's strategy for ensuring there are sufficient water supplies to meet the demands of customers through to 2034/35 is set out in its Final Water Resources Management Plan, which was published in September 2011. The publication of the Plan follows a lengthy period involving two public consultations and the publication of numerous supporting documents.

The Final Plan sets out the key elements which will ensure that the Company is able to continue to maintain supplies to customers for the next 25 years.

The Final Planning Solution in the Final Plan includes the following elements:

– A compulsory metering programme utilising automatic meter reading (AMR) technology over a 15 year period from 2015-2030.
– A programme of leakage savings delivering a 3Ml/d leakage reduction between 2015 and 2020.
– The construction of a Washwater Recovery Plant at Farlington Water Treatment Works in 2017/18.
– The development of Havant Thicket Winter Storage Reservoir filled by surplus yield from the Company's Havant and Bedhampton Springs between 2025 and 2035.

The Company is committed to sustainable development. It must balance the provision of water supply with the needs of the environment and play a part in ensuring that the UK complies with European and National environmental legislation.

**Ownership**
The majority shareholder of South Downs Capital Limited, the ultimate holding company of Portsmouth Water Limited, is an Employee Benefit Trust. The employees and certain former employees are the beneficiaries of this Trust which is controlled by a Board of five Directors, of whom three are independent.

## BUSINESS STRATEGY

**Mission Statement**
*'We aim to supply drinking water of the highest quality, providing high levels of customer service and excellent value for money'*

The Company has a well developed, focused strategy which will meet the demands of all its stakeholders. The key objectives are:

– To ensure customers enjoy reliable and secure supplies meeting all water quality standards.
– To maintain our standards of customer service as one of the highest in the industry.
– To provide value for money by continuing to focus on operational efficiency.
– To minimise the impact on the environment to ensure we have a sustainable long term future.
– To grow the business where appropriate utilising a good resource position to provide bulk supplies and trade water.
– To achieve returns consistent with retaining investor confidence.

The strategy will be achieved by focusing on five key issues:

– Having a well developed and frequently updated long term water resources plan, which will meet the needs of the customer, through secure water supplies, whilst respecting the environment.
– Putting customers at the heart of everything we do, and ensuring that they continue to receive excellent value for money.
– Maintaining our asset base.
– Setting goals for efficiency which outperform regulatory targets.
– Maintaining a motivated workforce, whilst ensuring that the health and safety of employees is given the highest priority.

The progress of the Company is measured by a number of key performance indicators (KPI) and these are highlighted in the following section of the Review.

## CURRENT DEVELOPMENT AND PERFORMANCE

**Financial Performance**

The results for 2011/12 reflect the 2009 Price Determination, made by Ofwat which included a real reduction in charges for customers in the year of 2.1%. The Company has also experienced a 5% reduction in demand from commercial customers during the period. However these impacts have been offset by an increase in non water tariff income, mainly related to diversion of water mains.

**Profit before tax**

Turnover for the year increased by 3.2% to £36.7m. This reflected the 2009 Price Determination and an increase in income from mains diversion work of £0.8m and, largely as a result of these factors, operating profit increased to £6.4m from £6.0m in 2011 as analysed below:

| | 2011/12 £m | 2010/11 £m |
|---|---|---|
| Turnover | 36.7 | 35.5 |
| Operating costs excluding depreciation and FRS17 pension charge | 19.4 | 18.9 |
| Operating profit before depreciation and FRS17 pension charge | 17.4 | 16.7 |
| Depreciation (including renewals) | 8.6 | 8.3 |
| FRS17 Pension Charge | 2.3 | 2.3 |
| **Total Operating Profit** | **6.4** | **6.0** |

Operating costs, excluding depreciation and the FRS17 pension charge, increased by £0.5m (2.1%) in the year despite RPI at an average of about 5% and the introduction of the Carbon Reduction Commitment Levy of £0.2m which is effectively a tax on our energy usage.

Interest receivable at £1.3m (2011 - £1.2m) relates mainly to interest received from group companies and is based on Libor plus 1%. An increase in other finance income of £0.6m to £2.5m represents a decrease in interest on pension scheme liabilities.

Interest payable at £7.7m (2011 - £7.2m) includes £4.2m for indexation of the loan provided by Artesian Finance plc (2011 - £3.9m). The indexation of the loan for 2011 was based on RPI for July 2011 of 5%, whereas RPI for July 2010 was 4.8%. Interest on the capital sum amounted to £3.2m (2011 - £3.1m).

As a result of these factors, profit before tax increased to £2.7m (2011 - £0.9m). The profit before tax in 2011 included an exceptional charge of £1.1m in respect of an impairment loss on the asset value of the Havant Thicket Winter Storage Reservoir.

**Taxation**

The taxation credit of £1.0m was £1.2m lower than the previous year's charge of £0.2m due to the effects of higher reliefs against the taxable profits for the year and refunds received in respect of prior year charges. The deferred tax liability also reduced during the year as a result of the proposed 2% reduction to corporate tax rates resulting in a credit to the profit and loss account of £0.9m.

**Dividends**

The dividends paid during the year amounted to £2.496m (2011 - £3.385m). Dividends are paid up to the parent company and largely used to service debt held by the group.

**Cashflow and Balance Sheet**

Despite the increase in operating profit net cashflow from operations was £1.9m lower at £15.7m. (2011 - £17.6m). This was the result of the following movements in working capital:

- An increase in the debtor for unbilled measured income of £0.65m as a result of timing differences in the billing cycle.
- An increase in mains diversionary work in progress of £0.95m due to the very high level of activity in this area during the year.

Net debt (excluding deferred arrangement costs) at £88.3m (2011 - £88.3m) includes an index linked loan with a value of £89.5m. (2011 - £85.3m). The value is indexed each year by the previous July's recorded RPI. The increase in debt for the year is a result of this indexation. The level of gearing is an important ratio in the Company's loan covenants and is measured by the ratio of net debt to the Company's Regulatory Capital Value (RCV) which is determined by Ofwat at the 2009 Price Determination. The RCV is also indexed by RPI but at the March (year end) figure. The ratio is known as the Regulatory Asset Ratio. At the year end, the ratio was 76.2% (2011 - 76.7%).

**Accounting Policies**

The Historic Cost Accounts have been prepared in accordance with the accounting policies described in note 1 to the accounts on pages 18 to 20 and with UK GAAP.

Under its licence of appointment, Portsmouth Water Limited, a private company, is required to publish information about its annual results as if it were a Company covered by the Listing Rules of the Financial Services Authority. From April 2005, listed groups are required to prepare accounts in accordance with International Financial Reporting Standards (IFRS). It is the Company’s view that these standards are not appropriate for a regulated water business and it has been granted exemption, by Ofwat, such that it need only adopt IFRS when non-listed companies are required by statute to do so.

### Pensions

The Company takes account of the Brockhampton Pension Scheme, in which it is the principal employer, under the principles of FRS17. The latest actuarial valuation carried out for the purposes of FRS17 showed a surplus after deferred tax of £14.7m (2011 - £21.0m). The actual loss before deferred tax of £10.2m which is shown in the Statement of Total Recognised Gains and Losses (STRGL) on page 15 results primarily due to changes in assumptions underlying the FRS17 value of scheme liabilities.

In the most recent triennial actuarial valuation conducted at March 2011, the Scheme had a surplus of £21.2m. Until March 2010, the Company had not made contributions for a number of years. For the year ended 31 March 2012, the Company made contributions of £0.9m this being at a rate of 12.4% of earnings.

During the year the Company concluded a consultation with its employees regarding proposals to reduce the level of future benefits in the Scheme. Under the proposals, which were implemented in August 2011, new employees will receive a pension on a defined contribution basis although for existing employees their future benefit will remain on a defined benefit basis, although on a career average basis. The changes were made to reduce the long term cost of providing pensions and to reduce the risks to the Company associated with defined benefits pensions.

### Key Financial Performance Indicators

Gearing (net debt/regulatory capital value) and cash interest cover are recognised as key indicators for the Company. Performance in 2011/12 against the target ratios is shown in the table below.

| **KPI - 1**[1] | **Target** | **Performance 2011/12** | **Performance 2010/11** |
|---|---|---|---|
| Gearing - Debt/RCV[2] | <80% | 76.2% | 76.7% |
| Cash interest cover[2] | >1.6 | 1.89 | 1.64 |

[1] Each KPI is defined in the Appendix on page 46

[2] Definition of terms is contained in the Appendix on page 46

### Customer Service

Ofwat are now using the Service Incentive Mechanism (SIM) to measure the performance of companies in relation to customer service. This places greater emphasis on the quality of service received rather than the speed of response. Part of this is a qualitative assessment survey and the results of this are shown below.

| **KPI – 2 Customer Service Measures** | **Target** | **Performance 2011/12** | **Performance 2010/11** |
|---|---|---|---|
| Number of properties at risk of inadequate pressure | ≤ 120 | 66 | 66 |
| Properties affected by unplanned interruptions to supply >12 hours* | Nil | 332 | Nil |
| Population subject to hosepipe bans | Nil | Nil | Nil |
| Billing contacts - answered within 5 days | 100% | 100% | 100% |
| Written complaints - answered within 10 days ** | 100% | 99.6% | 99.5% |
| Bills for metered customers - number receiving bill based on meter reading | 100% | 100% | 100% |
| Telephone contact - number of calls abandoned | ≤ 2.5% | 3.3% | 3.5% |
| - all lines busy | ≤ 0.7% | 0.2% | 0.2% |
| Service Incentive Mechanism – qualitative survey element - position relates to 22 companies | <6th | 2nd | 2nd |
| Number of written complaints per 10,000 connections *** | <10 | 8 | 7 |

* 205 of these related to one incident.

** The Company had 248 written complaints, so the 99.6% represents one complaint taking longer than 10 days.

*** For 2010/11, the Industry average was 61 complaints per 10,000 connections.

### KPI - 3 Water Quality

The Company carries out an exhaustive programme of testing to ensure that water of the highest quality is supplied to customers. The table below shows the percentage number of samples which pass the strict standards set out in the Water Supply (Water Quality) Regulations.

| **Water Quality** | **Target** | **Performance 2011** | **Performance 2010** |
|---|---|---|---|
| Compliance samples passing standards (mean zonal compliance) | 99.95% | 99.95% | 99.96% |

The water quality performance indicator relates to the calendar year.

### Operating Efficiency

For many years Ofwat have published a report which included its assessment of the comparative operating efficiency of all water companies in England and Wales using econometric modelling. Portsmouth Water has always been ranked in Band A (mostly the highest or 2nd highest performing company). This benefited customers through relatively lower prices. Ofwat do not intend to publish this assessment in future, however they did use this relative performance to set efficiency targets for the 5 year period to 2015. As a result, Ofwat set an efficiency target of 0.25% per annum. The table below shows the outcome against this target.

### KPI - 4 Efficiency

| Target | Performance 2011/12 |
|---|---|
| To achieve the Ofwat efficiency target of 0.25% per annum | 4.32% |

### Capital Investment

Gross capital investment during the year was £8.1m (2011 - £9.6m) and included £3.9m (2011 - £5.0m) on infrastructure renewals. This was lower than usual as a major scheme to reduce the risk of quality and security issues at the River Itchen Treatment Works was delayed whilst planning permission for the work was obtained. After receiving capital contributions and infrastructure charges of £0.9m, net capital expenditure was £7.2m (2011 - £8.7m).

During the year the Company renewed 23.2km of mains (2011 – 18.3km) at a cost of £3.9m (2011 – £5.0m).

Gross expenditure on non infrastructure assets at £4.2m included £0.8m for installing domestic meter options, £0.2m on the implementation of a new billing system and a further £0.5m resulted from investment in vehicles and plant. The remainder was on relatively small projects. In the Final Determination the Company was given an allowance of 5,000 domestic meter options per year, however in 2011/12, 4,046 customers chose to switch to a measured supply. At March 2012, meter penetration for the Company was 21% of household customers.

### Water Resources - Outlook for 2012

As detailed on page 1, 88% of water supplied to customers is from groundwater springs, boreholes and wells which abstract from the underground chalk of the South Downs. Groundwater levels are therefore critical to maintaining supplies to customers. The Company has for many years monitored the groundwater level at Idsworth Well, Rowlands Castle, which is unaffected by abstraction and is representative of groundwater conditions in the South Downs chalk.

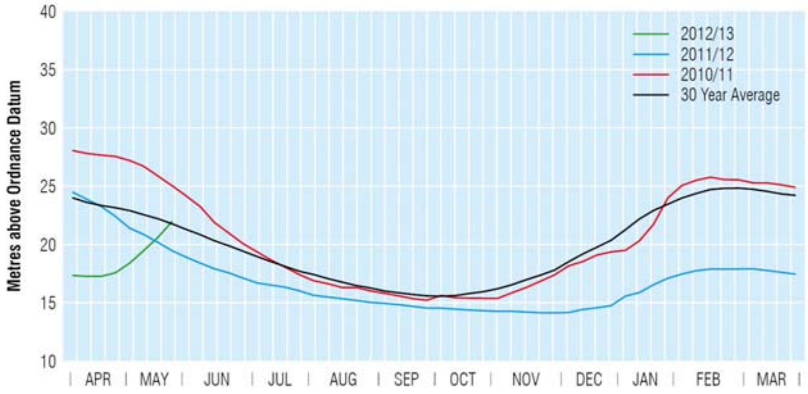
During the drought of 2012 no water restrictions were applied to Portsmouth Water customers.

Although seven water companies in the South East announced temporary bans in early April on non essential use, often referred to as hosepipe bans, Portsmouth Water’s area was not as severely affected and we appealed to customers to show voluntary restraint in their use of water. For Portsmouth Water’s area seven of the last twelve months have recorded below average rainfall, and whilst high rainfall in April, the wettest since 1886, has reduced demand and therefore has had some affect on restoring groundwater levels, we continue to ask customers to think about the way in which they use water and to use water wisely. However we do not believe for this year it will be necessary to impose further restrictions on water use in the Portsmouth Water area.

Whilst the South East of England has not experienced three consecutive dry winters Defra and the Environment Agency are encouraging all of us to consider the possibility. In the South East of England we on average use 160 litres of water per person every day, higher than other parts of the UK and considerably higher than our European neighbours. The combination of the recent wet weather and the strong response from customers with water use is already helping to keep water available for people and the environment.

At the end of May 2012, groundwater levels were in line with the long term average as outlined on the graph below, which includes the thirty year long term average.

### Idsworth Well



Metres above Ordnance Datum
40
35
30
25
20
15
10
2012/13
2011/12
2010/11
30 Year Average
APR
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
JAN
FEB
MAR

**Leakage**

Leakage for the year was recorded at an average of 29.9Ml/d. The leakage targets were set out in the Company's Business Plan for the last Periodic Review and agreed by Ofwat as part of the Final Determination in 2009.

**KPI - 5 Leakage**

| Target | Performance 2011/12 |
|---|---|
| Average leakage of < 30 Ml/d | Average leakage of 30 Mld |

**Employees**

The Company employs 234 people and believes it recruits and retains the right people to ensure the successful performance of the business. Employees share in the success of the Company through their interest in the Employee Benefit Trust.

The Company is firmly committed to the development of its employees and that they should all have opportunities to reach their full potential and, as a result, a number during the year have undertaken Degrees, HNC's, NVQ's along with associated professional qualifications.

In line with this objective the Company fully supports the principle of Modern Apprenticeships; for example, all new employees within the Customer Services department aged under 25 are employed through the Modern Apprenticeship scheme which leads to a minimum NVQ level 2 qualification with many going on to achieve level 3.

A key part of staff development is the Company involvement with the Institute of Water. The Institute of Water is a professional body whose purpose is to promote the advancement of knowledge within the water industry. To this end, Area and National Committees organise meetings, seminars, technical visits and conferences, as well as a variety of social events. These activities provide a shop window for the latest technological developments in the industry and a forum for the discussion of major topics. The Company encourages its staff to belong to the IoW and gain the benefit for both their personal and professional development by attending these events.

The Company celebrated winning an Employee Business Partnership (EBP) "Amazing People" Award in the category of "Offering Apprenticeships", sponsored by Havant Borough Council. The awards, which are held annually, are a celebration of the time and commitment businesses, schools, colleges and other partners invest in developing innovative programmes that support young people's preparation for adult life and work.

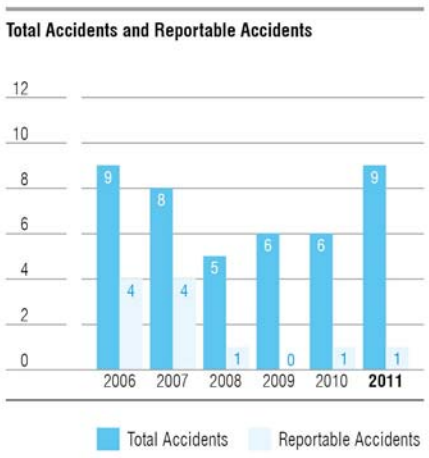
Total absence for 2011/12 (days per employee per year) was 4.3 (2011 - 3.9). This figure compares favourably with the average for private sector employers, which stands at 7.7 (Source: CIPD: Absence Survey Report 2011).

**Health and Safety**

Health and safety of employees is considered fundamental to the success of the business and the Company is committed to achieving high standards across the organisation. The Company has put health and safety at the top of the agenda and from the Board down has made it a high priority.

Considerable time and resources have continued to be directed into raising the awareness of Health and Safety and the statistical results for the year 2011 show very positive results from these efforts, with only one reportable accident (accident causing more than three days absence) being recorded.

It is pleasing to report that our efforts have again been recognised externally through the RoSPA Health and Safety Awards, by the Company being awarded the Gold Medal. This is in recognition of our Health and Safety record over the last seven years where we have received six Gold awards and an Industry sector award. This award is again recognition of the efforts of all employees who should feel proud of their achievements in making the Company a safer place.


Total Accidents and Reportable Accidents
12
10
8
6
4
2
0
9
8
5
6
6
9
4
4
1
0
1
1
2006
2007
2008
2009
2010
2011
Total Accidents
Reportable Accidents

## CORPORATE RESPONSIBILITY

### Water Efficiency

2010 saw Ofwat set the Company an annual target of achieving water savings, through water efficiency, of 0.29 mega litres per day (Ml/d). This equated to an overall five year target of 1.45 Ml/d. Last year saw the Company achieve 0.25 Ml/d a shortfall of 0.04 Ml/d against the target.

Pleasingly this year the Company has exceeded the target by claiming overall savings of 0.36 Ml/d. This includes clawing back the shortfall from last year and gives us going forward a surplus of 0.03 Ml/d.

This excellent result was achieved by initiatives such as supplying free water saving packs and subsidised water efficient devices such as shower heads to customers. This was in conjunction with a number of proactive water saving campaigns in the local media such as the “Water Saving Challenge” which is designed to encourage customers to change their behaviour when it comes to water use.

### Catchment Management

Portsmouth Water have established 'The Downs and Harbours Clean Water Partnership' with Natural England and the Environment Agency. The partnership's objective is to protect and improve drinking water quality and both river and coastal water quality.

A key issue for the Partnership is to try and ensure that there is no deterioration in the quality of our drinking water supplies which are taken from underground aquifers. This is achieved by advising land owners and farmers on the best practice for the use of fertilisers and overall land management. This will prevent us in the future having to use expensive treatment processes to remove chemicals such as nitrate (found in fertilisers) from drinking water.

### Work in the Community

2011/12 has seen the Company continue to play a valuable role in supporting the local community such as supporting the Hampshire Water Festival held in Havant and the continued sponsorship of the Portsmouth in Bloom competition with the 2012 theme based on sustainable gardening.

The Company’s successful education partnership with Staunton Country Park continues to grow and this year saw the opening of the “World of Water” within the park. WOW is an exhibit consisting of 10 large wall mounted boards in a covered outdoor area displaying information about saving water in a fun and interactive way. The exhibit is aimed at families and has a mix of information suitable for children of primary school age.

As part of our ‘Water for Health’ initiative, which promotes the benefits to children of drinking water, we again made available drinking water bottles at the subsidised cost of 30p per bottle to every child in a local primary, infant and junior school. This initiative remains very popular with 30,000 bottles delivered last year and which has seen nearly 300,000 water bottles delivered to local school children over a number of years.

The Company continues to offer community talks to local schools, colleges, clubs and groups such as Age Concern, Rotary and the Women’s Institute as well as supporting local schools in activities such as Science Days.

### WaterAid

The Company continues to support and promote the charity WaterAid to customers and staff. Over the last 30 years donations from our customers, together with fundraising efforts of our employees have raised a staggering £420,000 for WaterAid. It is estimated the average cost is only £15 per person for supplying a safe water supply to a village, combined with sanitation and hygiene education for life.

### Environmental Performance

The Company recognises its impact on the environment and seeks to carry out its activities in a sustainable manner, which is highlighted by the initiatives shown below.

*Conservation*

The Company’s total licensed area of supply covers an attractive part of Southern England between the South Downs and the coastal areas of Hampshire and West Sussex. It includes the historic cities of Portsmouth and Chichester, and the popular holiday resorts of Bognor Regis, Selsey and Hayling Island. The harbours of Portsmouth, Langstone, Chichester and Pagham have a number of important environmental designations under the EU Habitats Directive and are popular water activity venues.

Following the implementation of abstraction licence reductions at Havant and Bedhampton Springs and several sources in Sussex in order to protect habitats, the Company has agreed in principle a licence reduction for its Gaters Mill abstraction with the Environment Agency to preserve the River Itchen.

*Biodiversity Action Plan*

The Company's policy is to conserve and enhance the natural environment of its land and to preserve historic buildings and equipment, so far as is consistent with the primary duty of providing a sufficient supply of wholesome water at reasonable cost.

*Sustainable Procurement*

In procuring goods and services, the Company has a policy which seeks to ensure that its impact on the environment is minimised. This includes the use of low sulphur content diesel fuel, timber from replanted forests and predominantly recycled material for reinstatement.

## RISKS AND UNCERTAINTIES

### Risk Management

The Company identifies risks under six main headings - Operational, Water Quality, Financial, Environmental, Regulatory and Health and Safety of Employees. Individual risks facing the Company are identified and recorded in a risk register. For each risk the consequences, impact and likelihood of failure are identified, together with the management controls in place. The register also clearly allocates management responsibility and whether any further actions are required to control the risks.

The Board reviews the risk register and the controls established to mitigate these risks on an annual basis. It also receives regular reports on operational matters, including a monthly review of water quality matters directly with the Water Quality Manager and a quarterly review of health and safety matters with the Human Resources Manager. The Directors also receive reports from independent regulatory bodies, which comment on the performance of the core water business.

The Audit Committee meets at least three times a year, monitors the effectiveness of the systems which are in place and reports to the Board as a whole.

### Operational Risk

The key operational risks facing the Company are the loss of a treatment works or part of the mains network, which would result in a failure to supply water to customers. To mitigate this risk, the supply network has been enhanced over several years to connect different supply areas, such that in most situations water can be transferred to compensate for a failure at a treatment works. The Company also has a fully documented Emergency Plan which is initiated in the event of an incident, impacting either its ability to supply water to the public or resulting in a water quality issue.

### Water Quality Risk

To ensure water quality standards are maintained, the Company has a fully documented Drinking Water Safety Plan which identifies the potential risks throughout the supply process. Water quality is also monitored by a comprehensive sampling regime in accordance with statutory legislation. Furthermore, a telemetry system linked to all treatment works provides an alarm to our 24 hour Operations Centre if there is a failure of equipment. The Company also maintains two days' storage of treated water in service reservoirs to provide sufficient time for any water quality issues at treatment works to be rectified before supply to customers. In addition, it has membrane filtration at five treatment works considered most at risk from cryptosporidium being present in the raw water.

### Financial Risk

**Interest Rate, Liquidity, Capital and Credit Risk**

The major financial risks faced by the Company are interest rate, liquidity, capital and credit risks. The Company assesses these risks on an ongoing basis and its policies for managing them remain unchanged from previous periods.

The Company's exposure to interest rate fluctuations is now limited by the fixed interest rate applicable to the index-linked loan drawn in 2002, with inflation risks on the cost of the loan being effectively hedged against regulated revenues which are also linked to the RPI. Interest is charged at a fixed rate of 3.635% on the indexed amount of the loan. The indexed value of the loan at 31 March 2012 was £89.5m (2011 - £85.3m).

The Company seeks to manage financial risk, to ensure sufficient liquidity is available to meet foreseeable needs through an appropriate borrowing structure and to invest cash assets safely and profitably on the short term market. In 2011/12 all of the short term cash was deposited with the Company's Bankers, RBS. Short term liquidity is achieved through a £10m working capital facility and an overdraft arrangement. At the end of the year, £1.0m of this facility had been drawn (2011 - £4.5m), while the overdraft arrangement remained unutilised. The £10m facility, which terminates in August 2013, was arranged in August 2010 and replaced a £15m facility that was due for renewal.

The Company's objectives when managing capital are to safeguard the entity's ability to continue as a going concern, so it can provide returns for shareholders and benefit to customers.

The Company's exposure to credit risk results from the continuing impact of bad debt on its ability to collect water revenues. It seeks to minimise this risk by utilising all available means, including the use of a dedicated debt recovery section, agencies for collecting outstanding debt and the following of best practice guidelines.

**Financial Loss**

The risk of financial loss is addressed through comprehensive insurance cover for a range of risks, including damage to property, public and employee liability, fraud and terrorism. A system of internal controls is in place to manage the risks. In early 2007, the Auditors conducted a special review of the Company's internal control systems. The review did not reveal any significant weaknesses and it has recently been updated to reflect system changes. A disaster recovery plan is also in place to enable the Company to operate in the event of an incident disrupting its computer systems. At a remote site ten miles from its Head Office, the Company has an additional mainframe computer, which is 'backed up' every evening, and several workstations for employees to operate.

Energy now represents around 10% of total operating costs and fluctuating prices can have a material impact on profitability. To mitigate against the impact of price movements we fixed the wholesale price of energy in October 2011 until December 2014 at a price considerably lower than we paid in 2010/11.

**Environmental Risk**

The major environmental risk faced by the Company at the present time is a potential loss of abstraction licence resulting from measures that may be required by the EA to allow the UK to comply with the Water Framework Directive. Over the next few years the Company is undertaking a study to identify the impact of its abstraction at key points and to identify solutions where required.

The flooding in various parts of the UK during the summer of 2007 has prompted several national reports. Whilst the Company was not affected in 2007, it has conducted an assessment of the risks at each of its sites and included a small amount of expenditure which was allowed in the Final Determination of prices to remedy those sites where there is a risk of damage as a result of flooding.

**Regulatory Risk**

Regulatory risk relates to decisions taken by Ofwat at the five yearly price review and the potential failure to meet the level of service and capital programme agreed with Ofwat for the AMP 5 period, which could result in Ofwat taking action, including financial penalties. The price review is conducted in an open and transparent manner and the Company actively participates in the process. The performance against the regulatory targets is reviewed on a monthly basis by the Board or the Executive Directors. The annual performance against the targets is discussed on pages 4 to 6.

In the last 18 months, Ofwat have been reviewing their approach to Regulation and Future Price setting in their Programme 'Sustainable Water' and in October 2011 they published their consultation document on "Regulatory Compliance". A key objective of this review is to reduce the regulatory burden and we support their efforts in this. We also support their proposals to focus on overall outcomes rather than continue with the intensive requirement for information and increasingly complex price reviews. For future price reviews Ofwat are proposing to include separate price limits for retail and wholesale elements. We are concerned that this will increase complexity and add to the burden for smaller companies.

In December 2011 Ofwat published its paper on the "Water Industry Act 1991, Section 13 proposals by Ofwat to modify the conditions of appointment of all water only and water and sewerage companies". The Company responded to this consultation in February 2012 and, in common with all the other water companies in the industry, rejected its proposals.

The Company feels a deep sense of disquiet about the changes proposed. The licence provides it with important protections that cannot be adequately replicated for a small company by the chance to influence price review methodologies or the potential to refer our determinations to the Competition Commission. The Company accepts the need for some changes to the licence but these should be no more than is strictly needed to carry out the 2014 price review. The Company does not consider that Ofwat's section 2 duties under the Water Industry Act 1991 or the legitimate expectations Ofwat have created, through statements about the protection of the RCV and the link to RPI for wholesale controls for example, provide sufficient assurance for it to accept the type of licence modifications Ofwat set out in their December consultation, particularly as the statements only apply up to 2020. As a way forward the Company believes Ofwat should examine proposed licence modifications after they have published the methodology statement for the 2014 price review. The Company is particularly concerned about possible changes after the 2015-20 period, where under Ofwat's current licence modifications, the Company feels it would lose all control over proposals that could have a detrimental impact on its business.

**Competition in the Water Industry**

In 2008, the Secretary of State for Defra announced an independent review of competition and innovation in water markets. The review was to be led by Professor Martin Cave of Warwick University. The Final Report of this review was published in 2009, which concluded that the careful introduction of competition would help the Industry to meet the challenges it faced in the future.

The report proposed that competition should be introduced initially in retail for business customers and in water abstraction and then over time into upstream activity including treatment. A step by step approach was recommended to examine the benefit at each stage. The report also suggested that to obtain the full benefits of competition the whole retail element (household and business customers) should be separated from the vertically integrated water company as a separate business, even though only business customers would be the subject of competition.

The Water White Paper, "Water for Life" was published in December 2011. Subsequently the EFRA Select Committee launched an enquiry into the White Paper and the Company responded to this in January 2012. The Company is broadly supportive of the proposals in the White Paper (especially the decision not to require the legal separation of the retail business) although it does leave many questions unanswered. We await the publication of the Draft Water Bill, in due course.

Ofwat have been extremely active in considering how competition will work in the industry and have prepared a number of discussion papers and has continued to work on its accounting separation project which seeks to analyse cost into several business activities, including retail.

For its part the Company has participated in the discussions on the issues involved in market reform and is considering how it will respond to any changes. The Company is supportive of wider water trading and believes this can be achieved by offering greater incentive to companies to utilise bulk supplies. We also recognise that the introduction of retail competition for a greater number of business customers may well yield overall benefits, however it believes that wider market reform should only be pursued where the net benefit can be clearly demonstrated.

**Health and Safety**

The health and safety of employees is taken very seriously and a number of initiatives have been introduced over several years to reduce the number of accidents and the impact of injury.
These include:

- A Health and Safety Committee comprising Management and the Trade Unions
- A risk assessment programme that has seen over 500 assessments produced
- A system of workplace inspection ensuring that all manned premises are inspected at least twice per year
- Specific training for those at high risk of injury
- A limited free physiotherapy service for employees to deal with injuries

| | |
|---|---|
| **N Smith** | **N Sheeran** |
| Managing Director | Finance and Regulation Director |

28 June 2012

This report has been prepared in accordance with the requirements of the Companies Act 2006 and the Listing Rules of the Financial Services Authority.

## INFORMATION NOT SUBJECT TO AUDIT

### Remuneration Committee

The Remuneration Committee met on five occasions during the year to consider and approve, on behalf of the Board, the conditions of service of the executive Directors of the Company. It comprises the three independent non-executive Directors, Mr. R. L. Sullivan (Chairman of the Remuneration Committee), Mr. T. M. Lazenby MBE and Mr. R. J. Tennant.

### The Level and Make-up of Remuneration

The objective is to attract, retain and motivate high calibre senior executives through pay arrangements which are competitive and fair and reasonable for the responsibilities involved. In addition to individual performance, reference is made to pay levels in companies of similar size and within the same industry.

The remuneration package of the executive Directors, as reported in the accounts, includes a performance related element. The performance related element is based upon the achievement of agreed financial, customer service and personal targets for the whole of the previous year.

### Calculation of Increase for the year

There is a formula used to calculate the performance related element of the remuneration. Each of the above criteria is given a weighting, being 0.3 for the business objectives and customer service objectives and 0.4 for the personal objectives. These are multiplied by a score which is dependent on whether the objectives within the criteria have either not been met at all, have been partially achieved or have been met in full. The score ranges from 0 in the instance where objectives are not met, 0.1 to 0.9 where objectives are partially met, to 1.5 where objectives have been exceeded.

Therefore approximately one-third of the assessment of any increase awarded relates to the achievement of customer service measures, these mainly being:

- DG Indicators with regard to pressure, supply interruptions, billing queries and complaints, meter reading and telephone response
- Water quality
- Leakage targets
- Operating expenditure efficiency targets

The overall result of the above calculation is then applied to the ‘base’ increase for the year which is determined by prevailing market factors at the time and is designed to maintain a competitive position in the market place. The base increase determined for the year 2011/12 was 2.5%. It should be noted that the application of the above factor can give a negative result leading to a reduction being applied to the base increase already determined.

A.R. Neve received an additional 2.5% to reflect increased responsibility.
N. Smith was promoted to Managing Director during the year and his salary was increased as indicated below.
N.J. Roadnight retired in December 2011 and therefore only received salary to this point. This is reflected in the table below.
N.J. Sheeran joined the company on November 2011 and therefore in the year did not receive any performance increase.

### Results for the year 2011/12

The effect of the application of the above remuneration policy on each individual Director’s pay for 2011/12, based on their performance in the year 2010/11, was as follows:

| | Salary before Increase | Performance Assessed Increase | | Promotion/ Retirement | New Salary |
|---|---|---|---|---|---|
| A R Neve | £104,376 | £5,010 | (4.8%) | - | £109,386 |
| N Smith | £110,649 | £2,434 | (2.2%) | £7,307 | £120,390 |
| N J Roadnight | £147,066 | £3,235 | (2.2%) | (£43,162) | £107,139 |

### Service Contracts

The executive Directors have one year service contracts with the Company, which are in accordance with the UK Corporate Governance Code (the 'Code'). None of the executive Directors serves as a non-executive Director for another company. The non-executive Directors do not have service contracts.

The service contracts of the executive Directors include notice periods of one year, both by the Company and by the Director. There are no provisions for termination payments, other than payments for the period of notice.

Fees payable to the non-executive Directors are determined by the Board as a whole and reflect the time, commitment and responsibilities of the role.

No Director is involved in deciding his own remuneration.

### INFORMATION SUBJECT TO AUDIT

| **Directors' remuneration:** | **2012** | 2011 |
|---|---|---|
| | **£000** | £000 |
| Total remuneration | **515** | 485 |
| Highest paid Director | **137** | 166 |

| Remuneration is analysed by Director below: | Salary/Fees | Benefits | **Total 2012** | Total 2011 |
|---|---|---|---|---|
| | £000 | £000 | **£000** | £000 |
| **Executive:** | | | | |
| A R Neve | 109 | 15 | **124** | 118 |
| N J Roadnight (Retired 16 December 2011) | 107 | 28 | **135** | 166 |
| N J Sheeran (Appointed 9 December 2011) | 36 | 5 | **41** | - |
| N Smith | 120 | 17 | **137** | 126 |
| **Non-executive:** | | | | |
| T M Lazenby MBE (Chairman) | 34 | - | **34** | 33 |
| R L Sullivan | 22 | - | **22** | 21 |
| R J Tennant | 22 | - | **22** | 21 |
| | **450** | 65 | **515** | **485** |

Fees paid in respect of Mr T M Lazenby MBE are paid to Seamab Consultancy Limited.
Benefits comprise company cars and medical insurance.

### Long-term incentive schemes

The Company does not operate any long-term performance linked bonus scheme.

### Share options

The Company does not operate an Executive Share Option Scheme.
The Directors' beneficial holdings of shares in South Downs Capital Limited, the ultimate parent undertaking, are detailed below and, in total, represent 24% of the issued share capital of that Company. They have no interests in the shares of Portsmouth Water Limited.

| | **'C' Ordinary Shares** |
|---|---|
| A R Neve | 300 |
| N Smith | 450 |

Mr N J Roadnight left service on the 16 December 2011 but continues to have a beneficial holding of 550 shares in South Downs Capital Limited.

### Pensions

The Company participates in the Brockhampton Pension Scheme to provide defined benefits for its employees, including the executive Directors.

Benefits in kind relating to company cars are considered to be part of pensionable pay for all employees under the Scheme.

The executive Directors have accrued pension benefits under the Brockhampton Pension Scheme, which is a defined benefits scheme, during the year as detailed below:

| | Increase in Accrued Pension During Year to 31 March 2012 £000 | Transfer Value of Increase £000 | Accumulated Accrued Pension at 31 March 2012 £000 | Accumulated Accrued Pension at 31 March 2011 £000 |
|---|---|---|---|---|
| A R Neve[1] | 1 | 21 | 82 | 77 |
| N J Roadnight[2] | 1 | 7 | 109 | 103 |
| N Smith[3] | 2 | 41 | 69 | 64 |

The accumulated accrued pension is the leaving service benefit to which the Director would be entitled to if he were to leave service at the end of the year. It includes any benefits earned as an employee prior to becoming a Director, as well as those earned for qualifying services after becoming a Director.

The increase in accrued pension excludes any increase for inflation, as measured by the Consumer Price Index.

The transfer value has been calculated on the basis of actuarial advice in accordance with the basis adopted by the Trustees of the Scheme for calculating cash equivalent transfer values (which was agreed by the Trustees on 22 December 2011). The transfer value of the increase is then reduced by the amount of each member's contribution paid during the year.

[1]In accordance with the rules, Mr A R Neve's pension has been capped at two-thirds of his pensionable earnings.

[2]Mr N J Roadnight left service on 16 December 2011 therefore his leaving service benefit is his entitled benefit using his actual date of leaving revalued to 1 April 2012.

[3]The pensionable salary used to calculate Mr. N. Smith's accrued pension excludes £2,000 of non-pensionable salary.

By order of the Board

**T. M. Lazenby MBE**
Chairman
Havant
28 June 2012

**For the year ended 31 March 2012**

| | Notes | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|---|
| **TURNOVER** | 2 | 36,610 | 55 | 36,665 | 35,450 | 65 | 35,515 |
| Operating costs | 3 | (26,530) | (49) | (26,579) | (25,917) | (52) | (25,969) |
| Historical cost depreciation | | (3,621) | - | (3,621) | (3,511) | - | (3,511) |
| Operating income | 4 | (21) | - | (21) | (8) | - | (8) |
| **OPERATING PROFIT** | | 6,438 | 6 | 6,444 | 6,014 | 13 | 6,027 |
| Other income | 5 | - | 49 | 49 | - | 73 | 73 |
| Interest receivable | 6 | 1,317 | - | 1,317 | 1,178 | - | 1,178 |
| Other finance income | 20 | 2,492 | - | 2,492 | 1,897 | - | 1,897 |
| Interest payable and similar charges | 7 | (7,652) | - | (7,652) | (7,221) | - | (7,221) |
| Exceptional item | 10 | - | - | - | (1,086) | - | (1,086) |
| **PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION** | | 2,595 | 55 | 2,650 | 782 | 86 | 868 |
| Taxation | 8 | | | | | | |
| - Current Tax | | 93 | (14) | 79 | (305) | (24) | (329) |
| - Deferred Tax | | 937 | - | 937 | 149 | - | 149 |
| **PROFIT FOR THE FINANCIAL YEAR** | | 3,625 | 41 | 3,666 | 626 | 62 | 688 |
| Dividends | 9 | (2,455) | (41) | (2,496) | (2,860) | (62) | (2,922) |
| **RETAINED PROFIT/(LOSS) FOR THE FINANCIAL YEAR** | | 1,170 | - | 1,170 | (2,234) | - | (2,234) |

## STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES

**For the year ended 31 March 2012**

| | Notes | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|---|
| Profit for the financial year | | 3,625 | 41 | 3,666 | 626 | 62 | 688 |
| Actuarial (loss)/gain on pension scheme | 20 | (10,245) | - | (10,245) | 14,904 | - | 14,904 |
| Deferred tax relating to actuarial loss/(gain) on pension scheme | 18 | 2,561 | - | 2,561 | (4,024) | - | (4,024) |
| Effect of change to corporation tax rate on pension asset | | (155) | - | (155) | (226) | - | (226) |
| **Total recognised gains and losses relating to the year** | | (4,214) | 41 | (4,173) | 11,280 | 62 | 11,342 |
| Prior year adjustment | | - | - | - | 389 | - | 389 |
| **Total gains and losses recognised since last financial statements** | | (4,214) | 41 | (4,173) | 11,669 | 62 | 11,731 |

As at 31 March 2012

| | Notes | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|---|
| **FIXED ASSETS** | | | | | | | |
| Tangible | 10 | 90,292 | - | 90,292 | 90,657 | - | 90,657 |
| Investments | | | | | | | |
| - Loan to group company | 11 | 59,468 | - | 59,468 | 59,468 | - | 59,468 |
| - Other | 13 | 4 | - | 4 | 4 | - | 4 |
| | | 149,764 | - | 149,764 | 150,129 | - | 150,129 |
| **CURRENT ASSETS** | | | | | | | |
| Stores | | 596 | - | 596 | 520 | - | 520 |
| Debtors | 12 | 6,516 | - | 6,516 | 4,698 | - | 4,698 |
| Cash and short-term deposits | 14 | 2,563 | - | 2,563 | 1,746 | - | 1,746 |
| Infrastructure renewals prepayment | | 2,705 | - | 2,705 | 3,747 | - | 3,747 |
| | | 12,380 | - | 12,380 | 10,711 | - | 10,711 |
| **CREDITORS: AMOUNTS FALLING DUE WITHIN ONE YEAR** | | | | | | | |
| Borrowings | 15 | (1,284) | - | (1,284) | (4,784) | - | (4,784) |
| Corporation tax payable | | - | - | - | (189) | - | (189) |
| Unpaid dividend | | (1,412) | - | (1,412) | (1,412) | - | (1,412) |
| Creditors | 16 | (12,850) | - | (12,850) | (10,858) | - | (10,858) |
| **NET CURRENT LIABILITIES** | | (3,166) | - | (3,166) | (6,532) | - | (6,532) |
| **TOTAL ASSETS LESS CURRENT LIABILITIES** | | 146,598 | - | 146,598 | 143,597 | - | 143,597 |
| **CREDITORS: AMOUNTS FALLING DUE AFTER ONE YEAR** | | | | | | | |
| Borrowings | 17 | (88,924) | - | (88,924) | (85,070) | - | (85,070) |
| **PROVISIONS FOR LIABILITIES** | | | | | | | |
| Deferred Taxation | 18 | (9,940) | - | (9,940) | (10,419) | - | (10,419) |
| **NET ASSETS EXCLUDING PENSION ASSET** | | 47,734 | - | 47,734 | 48,108 | - | 48,108 |
| Pension asset | 20 | 14,674 | - | 14,674 | 20,969 | - | 20,969 |
| **NET ASSETS INCLUDING PENSION ASSET** | | 62,408 | - | 62,408 | 69,077 | - | 69,077 |
| **CAPITAL AND RESERVES** | | | | | | | |
| Called up share capital | | 1,078 | - | 1,078 | 1,078 | - | 1,078 |
| Share premium account | 19 | 1,539 | - | 1,539 | 1,539 | - | 1,539 |
| Capital redemption reserve | 19 | 3,250 | - | 3,250 | 3,250 | - | 3,250 |
| Profit and loss account | 19 | 56,541 | - | 56,541 | 63,210 | - | 63,210 |
| | | 62,408 | - | 62,408 | 69,077 | - | 69,077 |

**For the year ended 31 March 2012**

| | Statutory UK GAAP £m | Regulatory £m | Commentaries |
|---|---|---|---|
| **PROFIT AND LOSS ACCOUNT** | | | |
| Operating profit | 6,514 | 6,444 | See a) below |
| **BALANCE SHEET** | | | |
| Tangible fixed assets (net book value) | 94,469 | 90,292 | See b) below |

a) The difference relates to the way these figures have been presented in both sets of accounts. In the Statutory Accounts, this figure excludes the (£0.021m) for loss on sale of fixed assets as it is reported below the operating profit line in the profit and loss account, but includes other income of £0.049m. In the Regulatory Accounts the amount shown includes the (£0.021m) for loss on sale of fixed assets but reports the other income below the operating profit line.

b) The difference relates to the different accounting treatments for infrastructure renewals accounting in each set of accounts. In the Statutory Accounts the Company has followed common industry practice and adopted the infrastructure renewals accounting policy as set out in FRS 15. This has not been applied in the Regulatory Accounts, at the request of Ofwat.

## 1 ACCOUNTING POLICIES

The accounts have been prepared under the historical cost convention and in accordance with applicable United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) and with the provisions of the Companies Act 2006, except for the treatment of capital contributions as detailed in note 1.(c), and the non-application of FRS 15 for infrastructure renewals accounting, as required by Ofwat for the purposes of producing the regulatory accounts.

In view of the licence conditions under which the Company operates as a water supplier, it has to publish information about its annual results as if it were a company covered by the Listing Rules of the Financial Services Authority, except where it is considered inappropriate to do so. Earnings per share disclosures required by FRS 22 are not presented as the Company is a wholly owned subsidiary.

The principal accounting policies which have been applied consistently are as follows:

### (a) Turnover

Turnover, which excludes value added tax, represents the income receivable for goods and services provided to external customers in the ordinary course of business. It comprises the value of water supplied and other related charges. Turnover from the regulated water business includes amounts billed for the year, together with an estimation of amounts unbilled at the year end, for measured water customers. Unmeasured income bills are based on the rateable value of properties. Measured income arises from customers who have meters fitted at their premises and amounts billed, therefore, are based on actual water consumption. The estimation of the amounts unbilled at the year end uses a defined methodology based upon a measure of unbilled water consumed, which is calculated from historical customer data.

The Company does not make any provision for revenue recognition in accordance with Note G of FRS5, therefore the revenues reported in these regulatory accounts are identical with those reported in the statutory accounts. Irrecoverable amounts are not provided for, but are written off on an ongoing basis over the course of the year as they are identified.

All properties on the customer database are billed at the commencement of the billing year. Properties which are unoccupied or unfurnished are then written off during the year, following either contact from the customer and/or an inspection of the property carried out by the Company. Normal charges apply to furnished unmetered vacant properties.

A metered customer can request their supply to be temporarily turned off, after which they will not be charged until their supply is restored. Disconnected properties are not charged.

A property which is believed to be occupied, but the occupier's details are not known, is charged once the occupier's details are established.

Cash received from 'charges on income' is not treated as revenue, but is applied to reduce the outstanding debt derived from the turnover recognition policy. When the income was invoiced or accrued, it was recognised in line with the accounting policy.

Revenue from new properties is recognised from the date the meter is installed and the customer details have been obtained. Properties are only added to the billing system, once sufficient details have been obtained.

### (b) Fixed assets

#### *(i) Infrastructure assets - mains*

Infrastructure assets comprise a network of systems. Expenditure on infrastructure assets relating to increases in capacity or enhancement of the network is treated as an addition and included in tangible fixed assets at cost. Expenditure on maintaining the operating capability of the network is classified as infrastructure renewals expenditure and charged as an operating cost. The cost of infrastructure assets is their purchase cost together with incidental expenses of acquisition and directly attributable labour costs which are incremental to the Company.

No depreciation is charged on infrastructure assets because the network is required to be maintained in perpetuity and therefore has no finite economic life.

#### *(ii) Other assets*

Other assets comprise buildings and reservoirs, pumping plant, vehicles, mobile plant and office equipment. The cost of other assets is their purchase cost together with incidental expenses of acquisition and directly attributable labour costs which are incremental to the Company. Depreciation is provided on all other fixed assets with the exception of freehold land. It is calculated to write off the cost of assets less estimated residual values over their estimated useful economic lives using the straight line method. Those lives are estimated as follows:

| | |
|---|---|
| Buildings and Reservoirs | 100 years |
| Pumping Plant | 15-25 years |
| Vehicles and Mobile Plant | 5-7 years |
| Office Equipment | 7 years |

**(c) Capital contributions**

***(i) Mains contributions***

In certain circumstances third parties make non-returnable contributions towards the cost of specific infrastructure assets. They are treated as capital contributions and the Directors consider it appropriate that, in order to present a true and fair view, they should be deducted from fixed assets, as shown in note 10 to the accounts on page 24. In accordance with the Companies Act 2006 requirement to include fixed assets at cost, such contributions would normally be treated as deferred income and released to the profit and loss account over the useful life of the corresponding assets. However, the assets to which they relate do not have determinable finite lives and, accordingly, no basis exists on which to recognise those contributions as deferred income.

***(ii) Infrastructure charges***

Infrastructure charges are made in respect of new connections in accordance with Condition 'C' of the Instrument of Appointment. These charges are treated as capital contributions and deducted from fixed assets, as more fully explained in note 1.(c)(i) above.

**(d) Investments**

Investments are stated at the lower of cost or net realisable value.

**(e) Stocks**

Stocks of raw materials are valued at the lower of cost or net realisable value. In accordance with established practice in the water industry, no value is placed upon the water in reservoirs, mains or in the course of treatment.

**(f) Deferred taxation**

Deferred tax is recognised on all timing differences where the transactions or events that give the Company an obligation to pay more tax in the future, or the right to pay less tax in the future, have occurred by the balance sheet date. Deferred tax assets are recognised when it is more likely than not that they will be recovered. Deferred tax is measured using rates of tax that have been enacted or substantively enacted by the balance sheet date.

The deferred tax balances have been discounted using a post-tax yield to maturity that could be obtained at the balance sheet date on government bonds with maturity dates similar to when the timing differences are expected to reverse.

**(g) Leases**

All leases are regarded as operating leases. Operating lease payments are charged to the profit and loss account on a straight line basis over the period of the lease.

**(h) Pension costs and other post retirement benefits**

Portsmouth Water Limited is the principal employer and its parent company, Brockhampton Holdings Limited, is the participating employer in the Brockhampton Pension Scheme. This scheme is a defined benefit scheme. The assets of the scheme are held in a separate trustee administered fund.

The current service costs are charged to the profit and loss account and included as staff employment costs. The interest cost and expected return on assets are shown as a net amount within other finance income. Actuarial gains and losses are recognised immediately in the Statement of Recognised Gains and Losses.

Pension scheme liabilities are measured on an actuarial basis using the projected unit method and are discounted to their present value using the AA corporate bond rate.

Pension scheme assets are valued at market value at the balance sheet date. The pension scheme surplus is recognised in full on the balance sheet.

The deferred tax relating to a defined benefit asset is offset against the defined benefit asset and not included with other deferred tax liabilities.

Detailed information regarding the surplus and actuarial position of the scheme is given in note 20 to the accounts on pages 29 to 31.

The Company also operates a defined contribution pension scheme. The charge to the profit and loss account amounts to the contributions payable to the scheme in respect of the accounting period.

**(i) Financial instruments**

When a financial asset or liability is recognised initially it is measured at its fair value plus or minus transaction costs. The Company subsequently categorises financial instruments as follows:

Fixed asset investments consist of loans to Group undertakings, which earn interest based on London Interbank rates and are classified as loans and receivables. They are measured at amortised cost.

Other financial assets consist of short term bank deposits and debtors and are classified as loans and receivables. They are measured at amortised cost.

The Company’s financial liabilities consist of fixed rate borrowings in the form of perpetual debentures and an index linked loan. These instruments are classified as other liabilities and are measured at amortised cost.

| | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|
| **2. TURNOVER** | | | | | | |
| Unmeasured supplies | 21,290 | - | 21,290 | 21,201 | - | 21,201 |
| Measured supplies | 11,010 | - | 11,010 | 10,427 | - | 10,427 |
| Measured large users | 1,862 | - | 1,862 | 2,115 | - | 2,115 |
| SWS Bulk Supply | 517 | - | 517 | 561 | - | 561 |
| Third party services | 1,836 | 55 | 1,891 | 1,052 | 65 | 1,117 |
| Other sources | 95 | - | 95 | 94 | - | 94 |
| | 36,610 | 55 | 36,665 | 35,450 | 65 | 35,515 |

## 3. ANALYSIS OF OPERATING COSTS

This note has been prepared in accordance with Condition 'F' of the Company's Instrument of Appointment.

| | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|
| Manpower costs | 8,713 | 19 | 8,732 | 8,606 | 5 | 8,611 |
| Other costs of employment | 247 | - | 247 | 171 | - | 171 |
| Power | 2,148 | - | 2,148 | 2,328 | - | 2,328 |
| Rates | 2,285 | - | 2,285 | 2,438 | - | 2,338 |
| Hired and contracted services | 3,946 | 17 | 3,963 | 3,570 | 35 | 3,605 |
| Materials and consumables | 1,662 | 13 | 1,675 | 1,344 | 12 | 1,356 |
| Service charges | 1,785 | - | 1,785 | 1,953 | - | 1,953 |
| Infrastructure renewals charge | 4,955 | - | 4,955 | 4,747 | - | 4,747 |
| Provision for bad and doubtful debts | 535 | - | 535 | 519 | - | 519 |
| Other operating costs | 254 | - | 254 | 189 | - | 189 |
| | 26,530 | 49 | 26,579 | 25,917 | 52 | 25,969 |

| | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|
| **4. OPERATING INCOME** | | | | | | |
| (Loss) arising on disposal of fixed assets | (21) | - | (21) | (8) | - | (8) |
| **5. OTHER INCOME** | | | | | | |
| Rents | - | 46 | 46 | - | 69 | 69 |
| Home Assistance Service | - | 3 | 3 | - | 4 | 4 |
| | - | 49 | 49 | - | 73 | 73 |

| 6. INTEREST RECEIVABLE | 2012 £000 | 2011 £000 |
|---|---|---|
| Loan to Group Company | 1,298 | 1,161 |
| Repayment interest | - | 3 |
| Interest on short term deposits | 16 | 12 |
| Other interest receivable | 3 | 2 |
| | 1,317 | 1,178 |

## 7. INTEREST PAYABLE AND SIMILAR CHARGES

| | | 2012 £000 | 2011 £000 |
|---|---|---|---|
| £66.5m loan | - interest | 3,215 | 3,062 |
| | - indexation | 4,236 | 3,890 |
| | - amortisation of fees | 57 | 57 |
| | - administration expenses | 24 | 25 |
| | | 7,532 | 7,034 |
| Other bank loans and overdraft | | 104 | 170 |
| Debenture stocks | | 10 | 10 |
| Other interest payable | | 6 | 7 |
| | | 7,652 | 7,221 |

## 8. TAXATION

| | 2012 £000 | 2011 £000 |
|---|---|---|
| **Current tax** | | |
| United Kingdom corporation tax at 26% (2011 - 28%) | 98 | 334 |
| Adjustment in respect of prior periods | (177) | (5) |
| | (79) | 329 |
| **Deferred tax** | | |
| Origination and reversal of timing differences | 133 | 486 |
| Decrease in discount | 96 | 28 |
| Effect of change to corporation tax rate | (770) | (367) |
| Effect of change to capital allowance pool rates | 62 | - |
| Difference between pension cost charge and pension cost relief | 271 | 66 |
| Effect of change to corporation tax rate on pension asset | (729) | (362) |
| | (937) | (149) |
| **Tax on profit on ordinary activities** | (1,016) | 180 |

The tax charge for the year is higher (2011 - lower) than the standard rate of corporation tax in the UK of 26% (2011 - 28%). The difference is explained as follows:

| | 2012 | 2011 |
|---|---|---|
| Profit on ordinary activities before tax | 2,650 | 868 |
| Profit on ordinary activities multiplied by standard rate of corporation tax in the UK of 26% (2011 - 28%) | 689 | 243 |
| Effect of: | | |
| Expenses not deductible for tax purposes 17 | 316 | |
| Capital allowances for the period in excess depreciation | (229) | (343) |
| Revenue items charged to capital | (7) | 186 |
| Pension Contributions unrelieved from 2010/11 | (90) | - |
| Difference between pension cost charge and pension cost relief | (282) | (68) |
| Adjustments to tax charge in respect of prior periods | (177) | (5) |
| **Current tax charge for year** | (79) | 329 |

## 9. DIVIDENDS

| | 2012 £000 | 2011 £000 |
|---|---|---|
| **Equity: Ordinary/'A' Ordinary** | | |
| - interim paid | 1,304 | 1,037 |
| - final paid | 1,192 | 1,885 |
| | 2,496 | 2,922 |

The Directors have approved the payment of a final dividend of £0.848m for the year ended 31 March 2012, paid in June 2012. This dividend has not been accounted for within the current year financial statements, as it was not approved at the balance sheet date.

**Dividend Policy**

The Company's dividend policy is to maintain operational dividends in line with a payment which is based on 5% of the equity value of the opening Regulatory Capital Value for the year in question. The second part of the dividend is the recirculation of the inter-company interest received by Portsmouth Water on its loan to South Downs Limited. This payment is made net of any group tax relief surrendered.

## 10. TANGIBLE FIXED ASSETS

| | Operational Assets £000 | Infrastructure Assets £000 | Other Tangible Assets £000 | Total £000 |
|---|---|---|---|---|
| **HISTORICAL COST** | | | | |
| At 1 April 2011 | 82,765 | 47,234 | 14,269 | 144,268 |
| Additions | 1,757 | 923 | 1,534 | 4,214 |
| Disposals | - | - | (359) | 359) |
| At 31 March 2012 | 84,522 | 48,157 | 15,444 | 148,123 |
| **DEPRECIATION** | | | | |
| At 1 April 2011 | 24,147 | - | 9,257 | 33,404 |
| Charge for year | 2,291 | - | 1,330 | 3,621 |
| Disposals during year | - | - | (318) | (318) |
| At 31 March 2012 | 26,438 | - | 10,269 | 36,707 |
| **NET BOOK VALUE** | | | | |
| At 31 March 2012 | 58,084 | 48,157 | 5,175 | 111,416 |
| At 1 April 2011 | 58,618 | 47,234 | 5,012 | 110,864 |
| **CAPITAL CONTRIBUTIONS** | | | | |
| At 1 April 2011 | - | 20,207 | - | 20,207 |
| Received during year | - | 917 | - | 917 |
| At 31 March 2012 | - | 21,124 | - | 21,124 |
| **NET BOOK VALUE AFTER DEDUCTING CAPITAL CONTRIBUTIONS** | | | | |
| At 31 March 2012 | 58,084 | 27,033 | 5,175 | 90,292 |
| At 1 April 2011 | 58,618 | 27,027 | 5,012 | 90,657 |

In the preparation of its Statutory Accounts, the Company has followed common industry practice and adopted the infrastructure renewals accounting basis as set out in FRS 15 : Tangible Fixed Assets. However, for the purposes of the Regulatory Accounts, Ofwat has requested that FRS 15 is not applied for infrastructure renewals accounting, thereby providing a basis consistent with prior years. There has been no change to this policy in 2011/12. A reconciliation to the balance sheet shown in the Statutory Accounts is provided below:

| | Infrastructure Assets £000 |
|---|---|
| **COST** | |
| Cost at 31 March 2012 per Regulatory Accounts | 48,157 |
| Adjustment to opening balance | 31,136 |
| Infrastructure renewals expenditure capitalised since 1 April 1999 | 52,448 |
| Disposals since 1 April 1999 | (2,962) |
| Cost at 31 March 2012 per Statutory Accounts | 128,779 |
| **DEPRECIATION** | |
| At 31 March 2012 per Regulatory Accounts | - |
| Adjustment to opening balance | 31,136 |
| Depreciation charge for infrastructure renewals since 1 April 1999 | 48,271 |
| Disposals | (2,962) |
| At 31 March 2012 per Statutory Accounts | 76,445 |
| **NET BOOK VALUE** | |
| At 31 March 2012 per Regulatory Accounts | 48,157 |
| Adjustments for infrastructure renewals accounting since 1 April 1999 | 4,177 |
| At 31 March 2012 per Statutory Accounts | 52,334 |

## 11. FIXED ASSET INVESTMENT

| | Loan to Group Undertakings £000 |
|---|---|
| At 1 April 2011 and 31 March 2012 | 59,468 |

## 12. DEBTORS

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Trade debtors | 2,874 | 1,878 |
| Amounts owed by Group companies | 37 | 28 |
| Prepayments and accrued income | 3,118 | 2,420 |
| Other debtors | 487 | 372 |
| | 6,516 | 4,698 |

All of the above amounts fall due within one year

As at 31 March 2012, trade debtors had a carrying value of £5.352m (2011 - £4.126m) before provision for bad debt. Trade debtors in arrears are provided for in full, but only an element of current debt is provided for. The amount of the provision was £2.478m as at 31 March 2012 (2011 - £2.248m).

The ageing of these debtors was as follows:

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Up to 12 months | 3,146 | 2,120 |
| Over 12 months | 2,206 | 2,006 |
| | 5,352 | 4,126 |

The debtors provided for are mainly in respect of water charges for household customers where experience in the water industry has shown over time that it is likely that there will be difficulties in recovering the water charges for the periods concerned.

Movement on the provision for bad debt are as follows:

| | 2012 £000 | 2011 £000 |
|---|---|---|
| As at 1 April 2011 | 2,248 | 2,188 |
| Provision for bad debt required in the year | 535 | 519 |
| Debt written off in the year as uncollectable | (305) | (459) |
| As at 31 March 2012 | 2,478 | 2,248 |

The other classes within debtors do not contain balances that may be irrecoverable. The maximum exposure to credit risk at the reporting date is the fair value of each class of debtor mentioned above. The Company does not hold any collateral as security.

## 13. INVESTMENTS

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Unlisted investments | 4 | 4 |

## 14. CASH AT BANK AND IN HAND

Of the total amount shown of £2.563m, £1.655m (2011 - £1.591m) is held specifically for the payment of the next half yearly loan interest charges.

## 15. BORROWINGS: DUE WITHIN ONE YEAR

| | 2012 £000 | 2011 £000 |
|---|---|---|
| 3% Perpetual debenture stock | 60 | 60 |
| 3½% Perpetual debenture stock | 185 | 185 |
| 4% Perpetual debenture stock | 39 | 39 |
| Bank loan | 1,000 | 4,500 |
| | 1,284 | 4,784 |

The £1.0m bank loan is part of a three year £10m working capital facility, which is secured upon the assets of the Company and bears interest at London Interbank rates.

| 16. OTHER CREDITORS | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|
| Payments received on account | 2,474 | - | 2,474 | 2,060 | - | 2,060 |
| Trade creditors | 1,392 | - | 1,392 | 1,132 | - | 1,132 |
| Amounts owed to Group companies | 143 | - | 143 | 223 | - | 223 |
| Social security and other taxation | 229 | - | 229 | 211 | - | 211 |
| Other creditors | 3,003 | - | 3,003 | 1,949 | - | 1,949 |
| Accruals | 557 | - | 557 | 418 | - | 418 |
| Water rates in advance | 5,052 | - | 5,052 | 4,865 | - | 4,865 |
| | 12,850 | - | 12,850 | 10,858 | - | 10,858 |

| 17. CREDITORS: DUE AFTER ONE YEAR | 2012 £000 | 2011 £000 |
|---|---|---|
| Due within one to two years: | | |
| Payments on account | 548 | 439 |
| Due within two to five years: | | |
| Payments on account | - | 548 |
| In five years or more: | | |
| Bank loan | 89,542 | 85,306 |
| Less: deferred arrangement costs | 1,166 | 1,223 |
| | 88,376 | 84,083 |
| | 88,924 | 85,070 |

The thirty year £66.5m index-linked loan was issued on 26 June 2002, is repayable on 30 September 2032, and is secured upon the assets of the Company. The capital value of the loan is adjusted by the change in the Retail Prices Index from year to year. The fees associated with the loan issue of £1.722m are amortised over the life of the loan. The amount owing on the loan is stated net of the unamortised issue fees.

The loan interest is calculated by adjusting the value of the loan by the Retail Prices Index and then charging interest on this inflated amount at 3.635% per annum.

| 18. PROVISIONS FOR LIABILITIES | 2012 £000 | 2011 £000 |
|---|---|---|
| **DEFERRED TAXATION:** | | |
| At 1 April 2011 | 10,419 | 10,272 |
| Provided during the year in profit and loss account | (479) | 147 |
| At 31 March 2012 | 9,940 | 10,419 |

The total deferred tax balance before the effect of discounting is £10.640m (2011 - £11.345m). The amount provided for deferred taxation represents timing differences caused by the excess of tax allowances over depreciation.

| | 2012<br>£000 | 2011<br>£000 |
|---|---|---|
| **Deferred tax excluding that relating to pension asset:** | | |
| Accelerated capital allowances | 9,940 | 10,419 |
| Pension asset (note 20) | 4,891 | 7,755 |
| Total provision for deferred tax | 14,831 | 18,174 |
| At 1 April 2011 | 18,174 | 14,073 |
| Deferred tax charge in profit and loss account (note 8) | (937) | (149) |
| Deferred tax charged to the statement of total recognised gains and losses | (2,406) | 4,250 |
| At 31 March 2012 | 14,831 | 18,174 |

A reduction in the UK corporation tax rate from 26% to 25% with effect from 1 April 2012 was enacted during the period. As a consequence the deferred tax charge includes a decrease in the deferred tax liability of £0.770m. The recent announcement to further reduce the rate to 24% with effect from 1 April 2012 has not been enacted at the balance sheet date therefore has not been taken into account.

In addition to the reduction in the rates of corporation tax mentioned above, the UK Government has announced its intention to further reduce the rate of corporation tax to 22% by 2014. If this reduction to 22% had been enacted by 31 March 2012 the deferred tax liability would have been reduced by a further £1.192m to £8.748m.

Legislation to reduce the main rate of capital allowances from 20% to 18% with effect from 1 April 2012, together with a reduction in the special/long life pool rate from 10% to 8%, was expected during the period. As a consequence the deferred tax charge includes an increase in the deferred tax liabilities of £0.062m

If the tax rate changes had been enacted at the balance sheet date the deferred tax liability of £9.940m (see note 18) would have been reduced by £1.192m to £8.748m and the deferred tax liability relating to the pension asset of £4.891m (see note 20) would have been reduced by £0.587m to £4.304m. The reduction in the deferred tax liability would have been dealt with in the profit and loss account. The reduction in the deferred tax liability relating to the pension asset would have been dealt with in the statement of total recognised gains and losses. The reductions in deferred tax are expected to be implemented over the period to 2014 in line with legislative changes.

No provision has been made for deferred tax on gains recognised on the sale of properties where potentially taxable gains have been rolled over into replacement assets. Such tax would become payable only if the property were sold without it being possible to claim rollover relief. The total amount unprovided for is £0.619m. (2011 - £0.669m.). At present it is not envisaged that any tax will become payable in the foreseeable future.

## 19. RESERVES

| | Share Premium<br>£000 | Capital Redemption<br>£000 | Profit and Loss<br>£000 |
|---|---|---|---|
| At 1 April 2011 | 1,539 | 3,250 | 63,210 |
| Profit for financial year | - | - | 3,666 |
| Dividends | - | - | (2,496) |
| Actuarial (loss) on pension scheme | - | - | (10,245) |
| Movement on deferred tax relating to pension scheme | - | - | 2,561 |
| Effect of change to corporation tax rate on pension asset | - | - | (155) |
| As 31 March 2012 | 1,539 | 3,250 | 56,541 |

## 20. PENSIONS

Portsmouth Water Limited is the principal employer and its parent company, Brockhampton Holdings Limited, is the participating employer in the Brockhampton Pension Scheme. This scheme provides defined benefits based primarily on pensionable earnings. The assets of the scheme are held in a separate trustee administered fund.

The formal actuarial valuation as at 31 March 2011 was updated to the accounting date by an independent qualified actuary in accordance with FRS 17. As required by FRS 17, the value of the defined benefit liabilities has been measured using the projected unit method.

The estimated Company contributions expected to be paid to the Scheme for the year commencing 1 April 2012 is £1.0m (2011 actual: £0.9m).

The key FRS 17 assumptions used for the scheme were as follows:

| | **2012 % per annum** | **2011 % per annum** | **2010 % per annum** |
|---|---|---|---|
| RPI inflation | 3.4 | 3.5 | 3.7 |
| CPI inflation | 2.5 | 2.8 | n/a |
| Discount rate | 4.6 | 5.5 | 5.5 |
| Pension increases | 2.5 | 2.8 | 3.7 |
| Salary growth | 5.65 | 5.75 | 5.95 |

On the basis of the assumptions used for life expectancy, a male pensioner currently aged 60 would be expected to live for a further 28.3 years (2011 - 28.9 years). Allowance is made for future improvements in life expectancy.

The fair value of assets in the scheme, a breakdown of the assets into the main asset classes, the present value of the FRS 17 liabilities and the surplus of assets over the FRS 17 liabilities (which equals the gross pension asset) are set out below:

| | **2012 Expected Return % per annum** | **2012 Fair Value £000** | **2011 Expected Return % per annum** | **2011 Fair Value £000** | **2010 Expected Return % per annum** | **2010 Fair Value £000** |
|---|---|---|---|---|---|---|
| Equities | 7.2 | 74,294 | 7.6 | 77,654 | 7.8 | 74,538 |
| Bonds | 3.2 | 44,154 | 4.1 | 40,353 | 4.3 | 37,784 |
| Other | 0.7 | 5,214 | 2.1 | 2,030 | 2.0 | 1,521 |
| | 5.5 | 123,662 | 6.3 | 120,037 | 6.6 | 113,843 |

The total expected return on assets is derived by taking the weighted average of the long-term expected return on each of the asset classes.

| | **2012 £000** | **2011 £000** |
|---|---|---|
| Total fair value of scheme assets | 123,662 | 120,037 |
| FRS 17 value of scheme liabilities | 104,097 | 91,313 |
| Gross pension asset | 19,565 | 28,724 |
| Related deferred tax liability | 4,891 | 7,755 |
| Net pension asset | 14,674 | 20,969 |

Under FRS 17, the scheme is represented on the balance sheet at 31 March 2012 as an asset of £19.565m (2011 - £28.724m), which amounts to £14.674m net of deferred tax (2011 - £20.969m).

The Company paid contributions at a rate of 12.4% of earnings. Members pay contributions at a rate of 5% of earnings. The Company also operates a defined contribution pension scheme. The contributions payable by the Company for the year in respect of the defined contribution scheme amounted to £2,454 (2011 - £nil).

The FRS 17 value of scheme liabilities moved over the period as follows:

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Opening scheme liabilities | 91,313 | 100,268 |
| Employer's part of current service cost | 2,297 | 2,345 |
| Interest cost | 4,992 | 5,495 |
| Contributions by scheme participants | 96 | 279 |
| Benefits paid | (3,520) | (3,351) |
| Actuarial loss/(gain) | 8,919 | (13,723) |
| Closing scheme liabilities | 104,097 | 91,313 |

The FRS 17 value of scheme assets moved over the period as follows:

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Opening fair value of scheme assets | 120,037 | 113,843 |
| Expected return on assets | 7,484 | 7,392 |
| Contributions by scheme participants | 96 | 279 |
| Contributions by the Company | 891 | 693 |
| Benefits paid | (3,520) | (3,351) |
| Actuarial (loss)/gain | (1,326) | 1,181 |
| Closing fair value of scheme assets | 123,662 | 120,037 |

The following amounts have been included within operating profit under FRS 17:

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Current service cost (employer's part only) | 2,297 | 2,345 |
| Past service credit | - | - |
| Total operating charge | 2,297 | 2,345 |

The following amounts have been included as other finance income under FRS 17:

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Expected return on pension scheme assets | 7,484 | 7,392 |
| Interest on post retirement liabilities | (4,992) | (5,495) |
| Net return | 2,492 | 1,897 |
| Total return/(expense) recognised in the profit and loss account | 195 | (448) |

The following amounts have been recognised within the statement of total recognised gains and losses (STRGL) under FRS 17:

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Actual return less expected return on scheme assets | (1,326) | 1,181 |
| Experience gains arising on scheme liabilities | 1,783 | - |
| (Loss)/gain due to changes in assumptions underlying the FRS 17 value of scheme liabilities | (10,702) | 13,723 |
| Actuarial (loss)/gain recognised in the STRGL | (10,245) | 14,904 |

The actual return on plan assets was an increase of £6.158m in the year to 31 March 2012 (2011 - increase of £8.573m).

The history of experience gains and losses is:

| | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Present value of scheme liabilities (£000) | (104,097) | (91,313) | (100,268) | (69,808) | (77,718) |
| Total fair value of scheme assets (£000) | 123,662 | 120,037 | 113,843 | 86,724 | 107,696 |
| Gross pension asset (£000) | 19,565 | 28,724 | 13,575 | 16,916 | 29,978 |
| Actual return less expected return on scheme assets (£000) | (1,326) | 1,181 | 24,665 | (25,132) | (5,382) |
| Percentage of scheme's assets | (1%) | 1% | 22% | (29)% | (5)% |
| Experience gains arising on scheme's liabilities (£000) | 1,783 | - | - | 4,722 | - |
| Percentage of the FRS 17 value of the scheme's liabilities | 1% | 0% | 0% | 7% | 0% |
| Total amount recognised in the STRGL (£000) | (10,245) | 14,904 | (2,636) | (13,020) | 7,602 |
| Percentage of the FRS 17 value of the scheme's liabilities | (10%) | 16% | (3%) | (19%) | 10% |

The cumulative amount recognised in the STRGL as at 31 March 2012 was a loss of £17.974m (2011 - loss of £7.729m).

The Accounting Standards Board have published guidance relating to best practice for disclosure of pensions information. The Company has decided not to follow the guidance at this time.

## CURRENT COST PROFIT AND LOSS ACCOUNT
## FOR THE APPOINTED BUSINESS

**For the year ended 31 March 2012**

| | Notes | 2012 £000 | 2011 £000 |
|---|---|---|---|
| **TURNOVER** | 2 | 36,610 | 35,450 |
| Current cost operating costs | 3 | (31,860) | (31,094) |
| Operating income | 2 | (34) | 9 |
| | | 4,716 | 4,365 |
| Working capital adjustment | 4 | 195 | 321 |
| **CURRENT COST OPERATING PROFIT** | | 4,911 | 4,686 |
| Exceptional item | 5 | - | (1,216) |
| Interest receivable | | 1,317 | 1,178 |
| Other finance income | | 2,492 | 1,897 |
| Interest payable and similar charges | | (7,652) | (7,221) |
| Financing adjustment | 4 | 12 | 104 |
| **CURRENT COST PROFIT/(LOSS) BEFORE TAXATION** | | 1,080 | (572) |
| Taxation | | | |
| - Current Tax | | 93 | (305) |
| - Deferred Tax | | 937 | 149 |
| **CURRENT COST PROFIT/(LOSS) FOR THE FINANCIAL YEAR** | | 2,110 | (728) |
| Dividends | | (2,455) | (2,860) |
| **CURRENT COST (LOSS) RETAINED** | | (345) | (3,588) |

## CURRENT COST BALANCE SHEET
## FOR THE APPOINTED BUSINESS

**As at 31 March 2012**

| | Notes | 2012 £000 | 2011 £000 |
|---|---|---|---|
| **FIXED ASSETS** | | | |
| Tangible fixed assets | 5 | 1,063,152 | 1,027,639 |
| Third party contributions since 1989/90 | | (25,451) | (23,688) |
| | | 1,037,701 | 1,003,951 |
| Working capital | 6 | (5,655) | (5,456) |
| Cash | | 908 | 156 |
| Short term deposits | | 1,655 | 1,590 |
| Infrastructure renewals prepayment | | 2,705 | 3,747 |
| **NET OPERATING ASSETS** | | 1,037,314 | 1,003,988 |
| **NON OPERATING ASSETS AND LIABILITIES** | | | |
| Borrowings | | (1,284) | (4,784) |
| Non-trade debtors | | 15 | 10 |
| Non-trade creditors: amounts falling due within one year | | (98) | (195) |
| Investment - loan to group company | | 59,468 | 59,468 |
| - other | | 4 | 4 |
| Corporation tax payable | | - | (189) |
| Dividends | | (1,412) | (1,412) |
| **TOTAL NON OPERATING ASSETS AND LIABILITIES** | | 56,693 | 52,902 |
| **CREDITORS: AMOUNTS FALLING DUE AFTER ONE YEAR** | | | |
| Borrowings | | (88,924) | (85,070) |
| **PROVISIONS FOR LIABILITIES AND CHARGES** | | 1,005,083 | 971,820 |
| Deferred tax provision | | (9,940) | (10,419) |
| **NET ASSETS EXCLUDING PENSION ASSET** | | 995,143 | 961,401 |
| Pension asset | | 14,674 | 20,969 |
| **NET ASSETS INCLUDING PENSION ASSET** | | 1,009,817 | 982,370 |
| **CAPITAL AND RESERVES** | | | |
| Called up share capital | | 1,078 | 1,078 |
| Share premium account | | 1,539 | 1,539 |
| Capital redemption reserve | | 3,250 | 3,250 |
| Profit and loss account | 7 | 17,645 | 25,829 |
| Current cost reserve | 8 | 986,305 | 950,674 |
| | | 1,009,817 | 982,370 |

## CURRENT COST CASH FLOW STATEMENT

**For the year ended 31 March 2012**

| | Notes | Appointed 2012 £000 | Non Appointed 2012 £000 | Total 2012 £000 | Appointed 2011 £000 | Non Appointed 2011 £000 | Total 2011 £000 |
|---|---|---|---|---|---|---|---|
| **NET CASH INFLOW FROM OPERATING ACTIVITIES** | 9 | 15,663 | 55 | 15,718 | 17,470 | 86 | 17,556 |
| **RETURNS ON INVESTMENTS AND SERVICING OF FINANCE** | | | | | | | |
| Interest received | | 1,312 | - | 1,312 | 1,177 | - | 1,177 |
| Interest paid | | (3,354) | - | (3,354) | (3,283) | - | (3,283) |
| **NET CASHFLOW FROM RETURNS ON INVESTMENT AND SERVICING OF FINANCE** | | (2,042) | - | (2,042) | (2,106) | - | (2,106) |
| **TAXATION** | | | | | | | |
| UK corporation tax paid | | (179) | (14) | (193) | (998) | (24) | (1,022) |
| **CAPITAL EXPENDITURE AND FINANCIAL INVESTMENT** | | | | | | | |
| Purchase of tangible fixed assets | | (3,680) | - | (3,680) | (5,612) | - | (5,612) |
| Receipt of contributions | | 917 | - | 917 | 877 | - | 877 |
| Infrastructure renewals expenditure | | (3,913) | - | (3,913) | (5,014) | - | (5,014) |
| Sale of tangible fixed assets | | 6 | - | 6 | 21 | - | 21 |
| **NET CASH OUTFLOW FROM INVESTING ACTIVITIES** | | (6,670) | - | (6,670) | (9,728) | - | (9,728) |
| **EQUITY DIVIDENDS PAID** | | (2,455) | (41) | (2,496) | (3,323) | (62) | (3,385) |
| **CASH INFLOW/(OUTFLOW) BEFORE MANAGEMENT OF LIQUID RESOURCES AND FINANCING** | | 4,317 | - | 4,317 | 1,315 | - | 1,315 |
| **MANAGEMENT OF LIQUID RESOURCES** | | | | | | | |
| (Purchase) of short term deposits | | (65) | - | (65) | (75) | - | (75) |
| **NET CASHFLOW BEFORE FINANCING** | | 4,252 | - | 4,252 | 1,240 | - | 1,240 |
| **FINANCING** | | | | | | | |
| Repayment of loans | | (3,500) | - | (3,500) | (1,500) | - | (1,500) |
| **INCREASE/(DECREASE) IN CASH IN THE YEAR** | 10 | 752 | - | 752 | (260) | - | (260) |

## 1. ACCOUNTING POLICIES

The current cost accounts have been prepared for the appointed business of Portsmouth Water Limited in accordance with guidance issued by the Director General of Water Services for modified real terms financial statements suitable for regulation in the water industry. They measure profitability on the basis of real financial capital maintenance, in the context of assets which are valued at their current cost value to the business with the exception of assets acquired prior to 31 March 1990.

The accounting policies used are the same as those adopted in the historical cost accounts as shown on pages 18 to 20, except as set out below:

### Tangible Fixed Assets

Assets acquired prior to 31 March 1990 and in operational use are valued at the replacement cost of their operating capability. To the extent that the regulatory regime does not allow such assets to earn a return high enough to justify that value, this represents a modification of the value to the business principle. Also, no provision is made for possible funding of future replacements of pre 31 March 1990 assets by contributions from third parties and, to the extent that some of those assets would on replacement be so funded, replacement cost again differs from value to the business. Redundant assets are valued at their recoverable amounts.

### Modern Equivalent Asset (MEA) Valuation

A review of the MEA valuation and asset stock is undertaken as part of the periodic review. The revised values arising from this review provide the basis for calculating the MEA in the current cost financial statements. The process of continuing refinement of asset records has produced adjustments to existing values. The current cost depreciation figures included in the current cost operating costs are based on the revised MEA values.

#### Land and buildings

Non-specialised operational properties are valued on the basis of open market value for existing use at 31 March 1993 and have been expressed in real terms by adjusting for inflation as measured by the changes in the Retail Price Index (RPI) since that date.

Specialised operational properties acquired since 31 March 1990 are valued at the lower of depreciated replacement cost and recoverable amount, restated annually between periodic Asset Management Plan (AMP) reviews by adjusting for inflation, as measured by changes in the RPI.

#### Infrastructure assets

Mains are valued at replacement cost, determined principally on the basis of data provided by the AMP.

A process of continuing refinement of asset records is expected to produce adjustments to existing values when periodic review of the AMP takes place. In the intervening years, values are restated to take account of changes in the general level of inflation as measured by changes in the RPI over the year.

#### Other operational fixed assets

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

#### Surplus land

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

#### Third party contributions

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

### Real Financial Capital Maintenance Adjustments

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

Working capital adjustment - this is calculated by applying the change in the RPI over the year to the opening working capital balance.

Financing adjustment - this is calculated by applying the change in the RPI over the year to the opening balance of net finance, which comprises all monetary assets and liabilities in the balance sheet, apart from those included in working capital, deferred tax, dividends payable and index linked debt.

### Other Current Cost Adjustments

Depreciation adjustment - this is the difference between depreciation based on the current cost value of assets in these accounts and depreciation charged in arriving at historical cost profit.

Disposal of fixed assets adjustment - this is the difference between the values of realised assets in these current cost financial statements and the historical cost financial statements.

There has been no change in the year to the current cost depreciation policy.

| | 2012 £000 | 2011 £000 |
|---|---|---|
| **2. TURNOVER** | | |
| Unmeasured supplies | 21,290 | 21,201 |
| Measured supplies | 11,010 | 10,427 |
| Measured large users | 1,862 | 2,115 |
| SWS bulk supply | 517 | 561 |
| Third party services | 1,836 | 1,052 |
| Other sources | 95 | 94 |
| | 36,610 | 35,450 |
| **OPERATING INCOME** | | |
| Current cost (loss)/profit on disposal of fixed assets | (34) | 9 |
| Working capital adjustment | 195 | 321 |

| **3. CURRENT COST OPERATING COSTS** | 2012 £000 | 2011 £000 |
|---|---|---|
| Operating costs per historical cost accounts | 30,151 | 29,428 |
| Current cost depreciation adjustment (note 1) | 1,709 | 1,666 |
| | 31,860 | 31,094 |

## 4. WORKING CAPITAL AND FINANCING ADJUSTMENTS

These are the real financial capital maintenance adjustments for working capital and net finance, as described in note 1.

## 5. TANGIBLE FIXED ASSETS

| | Operational Assets £000 | Infrastructure Assets £000 | Other Tangible Assets £000 | Total £000 |
|---|---|---|---|---|
| **GROSS CURRENT REPLACEMENT COST** | | | | |
| At 1 April 2011 | 196,335 | 905,886 | 17,541 | 1,119,762 |
| RPI adjustment | 7,009 | 32,339 | 608 | 39,956 |
| Disposals | - | - | (520) | (520) |
| Additions | 1,757 | 923 | 1,534 | 4,214 |
| At 31 March 2012 | 205,101 | 939,148 | 19,163 | 1,163,412 |
| **DEPRECIATION** | | | | |
| At 1 April 2011 | 80,085 | - | 12,038 | 92,123 |
| RPI adjustment | 2,859 | - | 413 | 3,272 |
| Disposals during year | - | - | (465) | (465) |
| Charge for year | 3,833 | - | 1,497 | 5,330 |
| At 31 March 2012 | 86,777 | - | 13,483 | 100,260 |
| **NET BOOK VALUE** | | | | |
| At 31 March 2012 | 118,324 | 939,148 | 5,680 | 1,063,152 |
| At 1 April 2011 | 116,250 | 905,886 | 5,503 | 1,027,639 |

The RPI adjustment relates to the increase of the current cost valuations in line with inflation.

## 6. WORKING CAPITAL

| | | 2012 £000 | 2011 £000 |
|---|---|---|---|
| Stores | | 596 | 520 |
| Trade debtors | - measured household | 100 | 193 |
| | - unmeasured household | 1,268 | 1,104 |
| | - measured non-household | 225 | 353 |
| | - unmeasured non-household | 9 | 7 |
| | - other | 1,756 | 640 |
| Measured income accrual | | 2,866 | 2,208 |
| Prepayments and other debtors | | 251 | 212 |
| Trade creditors | | (990) | (553) |
| Deferred income - customer advance receipts | | (2,957) | (2,479) |
| Capital creditors | | (2,626) | (2,092) |
| Accruals and other creditors | | (6,153) | (5,569) |
| **TOTAL WORKING CAPITAL** | | (5,655) | (5,456) |

**7. PROFIT AND LOSS ACCOUNT**

| | £000 |
|---|---|
| As at 1 April 2011 | 25,829 |
| Loss for the financial year | 2,110 |
| Dividend | (2,455) |
| Actuarial loss on pension scheme | (10,245) |
| Movement on deferred tax relating to pension scheme | 2,561 |
| Effect of change to corporation tax rate on pension asset | (155) |
| As 31 March 2012 | 17,645 |

**8. CURRENT COST RESERVE**

| | £000 |
|---|---|
| As 1 April 2011 | 950,674 |
| RPI adjustments:- | |
| Fixed assets | 36,684 |
| Working capital adjustment | (195) |
| Net finance adjustment | (12) |
| Third party contributions | (846) |
| At 31 March 2012 | 986,305 |

**9. RECONCILIATION OF OPERATING PROFIT TO NET CASH INFLOW FROM OPERATING ACTIVITIES**

| | 2012 £000 | 2011 £000 |
|---|---|---|
| Current cost operating profit | 4,911 | 4,686 |
| Working capital adjustment | (195) | (321) |
| Increase/(decrease) in working capital | (1,014) | 1,473 |
| Loss on disposal of asset | 14 | - |
| Other finance charges | 1,406 | 1,652 |
| Current cost depreciation | 5,330 | 5,177 |
| Current cost loss/(profit) on sale of fixed assets | 34 | (9) |
| Infrastructure renewals charge | 4,955 | 4,747 |
| Movement in provisions | 222 | 65 |
| **NET CASHFLOW FROM OPERATING ACTIVITIES** | 15,663 | 17,470 |

## 10. ANALYSIS OF NET DEBT

| | As at 1 April 2011 £000 | Cash Flow £000 | Non Cash Movements £000 | As at 31 March 2012 £000 |
|---|---|---|---|---|
| Cash at bank and in hand | 156 | 752 | - | 908 |
| Loans due after one year | (84,083) | - | (4,293) | (88,376) |
| Loans due within one year | (4,784) | 3,500 | - | (1,284) |
| | (88,867) | 3,500 | (4,293) | (89,660) |
| Short term deposits | 1,590 | 65 | - | 1,655 |
| Current asset equity investments | 4 | - | - | 4 |
| | 1,594 | 65 | - | 1,659 |
| | (87,117) | 4,317 | (4,293) | (87,093) |

**INTEREST RATE RISK PROFILE**

| | Fixed rate £000 | Floating Rate £000 | Index linked £000 | Total £000 |
|---|---|---|---|---|
| **MATURITY PROFILE** | | | | |
| Less than one year | (284) | (1,000) | - | (1,284) |
| Between one and two years | - | - | - | - |
| Between two and five years | - | - | - | - |
| Between five and twenty years | - | - | - | - |
| In more than twenty years | - | - | (88,376) | (88,376) |
| **TOTAL BORROWINGS** | (284) | (1,000) | (88,376) | (89,660) |
| Cash and investments | | | | 912 |
| Short term deposits | | | | 1,655 |
| **NET DEBT** | | | | (87,093) |

## CURRENT COST ACTIVITY COST TABLE

| | Resources & Treatment £000 | Distribution £000 | Water Supply Subtotal £000 |
|---|---|---|---|
| **Direct Costs** | | | |
| Employment costs | 335 | 1,938 | 2,273 |
| Power | 994 | 1,018 | 2,012 |
| Hired and contracted services | 7 | 595 | 602 |
| Materials and consumables | 273 | 387 | 660 |
| Service charges | 1,785 | - | 1,785 |
| Other direct costs | 33 | 48 | 81 |
| Total direct costs | 3,427 | 3,986 | 7,413 |
| General and support expenditure | 2,611 | 2,771 | 5,382 |
| Total functional expenditure | 6,038 | 6,757 | 12,795 |
| **Business Activities** | | | |
| Customer services | | | 3,422 |
| Scientific services | | | 733 |
| Other business activities | | | 536 |
| Business activities subtotal | | | 4,691 |
| Local authority rates | | | 2,285 |
| Doubtful debts | | | 535 |
| Total opex less third party services | | | 20,306 |
| Third party services - opex | | | 1,269 |
| Total operating expenditure | | | 21,575 |
| **Capital Maintenance** | | | |
| Infrastructure renewals charge | - | 4,955 | 4,955 |
| Current cost depreciation | | | |
| - service activities | 2,808 | 1,356 | 4,164 |
| - business activities | | | 1,166 |
| Total capital maintenance | | | 10,285 |
| **Total operating costs** | | | 31,860 |
| **CCA (MEA) Values** | | | |
| Service activities | | | 1,056,838 |
| Business activities | | | 6,314 |
| Service totals | | | 1,063,152 |
| Services for the third parties | | | - |
| **Total** | | | 1,063,152 |

**Explanatory Note:** For the purpose of activity costing analysis, costs are allocated between service areas using the Company's management information reports. These reports allow costs to be identified for each cost centre in the Company and therefore the costs of each service area (e.g. Resources/Treatment) can be built up using the reports and by following the RAG guidance on cost centre areas to be included for each service.

**Regulatory Capital Value at 2011/12 prices**

| | £000 |
|---|---|
| Opening Regulatory Capital Value as at 1 April 2011 | 119,389 |
| Capital Expenditure (excluding infrastructure renewals) | 4,058 |
| Infrastructure renewals expenditure | 5,346 |
| Infrastructure renewals charge | (5,077) |
| Capital contributions | (1,239) |
| Current cost depreciation | (4,850) |
| Outperformance of regulatory assumptions (5 years in arrears) | (1,842) |
| Closing Regulatory Capital Value as at 31 March 2012 | 115,785 |
| **Average Regulatory Capital Value for the year** | 115,898 |

**Explanatory Note**

The Table shown above gives the build up of the Regulatory Capital Value for the financial year ended 31 March 2012 that was used by the Office of Water Services in setting price limits for the AMP5 period in the 2009 Final Determination of price limits.

The Regulatory Capital Value is the capital base for the Company on which it is allowed to earn a rate of return at the given cost of capital.

The opening Regulatory Capital Value for the year, after indexation by year end RPI, is adjusted to take account of net new investment (being new capital expenditure less capital contributions received) and the current cost depreciation charge for the year, as allowed in the 2009 Final Determination of price limits.

There is also a further adjustment made to reflect past outperformance of regulatory assumptions for the previous price setting period. This relates to capital expenditure efficiencies which were achieved in that period and which have been retained by the Company for five years, under the Office of Water Services' approach to Regulatory Capital Values.

Any differences in actual capital expenditure and depreciation charges from those allowed in the 2009 Final Determination do not affect price limits in the current period. These differences, including any capital efficiencies achieved, will be taken into account in the calculation of the Regulatory Capital Value for the next price review period from 2015 onwards.

For the purposes of the KPI indicator reported in the Operating and Financial Review on page 4, we have used this opening value as at 1 April 2012 for the Debt to Regulatory Capital Value Ratio, following the price determination.

The Directors are responsible, under Condition F of the Instrument of Appointment by the Secretary of State for the Environment, Food and Rural Affairs (Defra) and as a water undertaker under the Water Industry Act 1991, for preparing the financial statements for each financial year that give a true and fair view of the state of affairs of the Company at the end of the financial year and of the profit or loss of the Company for that period. In preparing those financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for:

- keeping proper accounting records, which disclose with reasonable accuracy at any time the financial position of the Company and which enable them to ensure that the financial statements comply with the Companies Act 2006;
- safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities; and
- the maintenance and integrity of the corporate and financial information included on the Company’s website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

In so far as the Directors are aware:

- there is no relevant audit information of which the Company’s auditors are unaware; and
- the Directors have taken all steps that they ought to have taken to make themselves aware of any relevant audit information and to establish that the auditors are aware of that information.

**Certificate of Compliance with Licence Condition F6A**

In arriving at the certificate provided below, the Board met on 28 June 2012 to consider the Appointee's financial and management requirements over the next 12 months and the available resources. The Directors reviewed the following information:

- the latest financial position of the Company through its latest Report and Accounts
- the Management Accounts for May 2012
- the current level of gearing
- the projected level of gearing through to 2013, based on its own internal budget projections
- the Company's available bank and overdraft facilities through to 2013
- the headroom between the projected key operating ratios (gearing and interest cover) and its loan covenants through to 2013 under a number of scenarios.

The Board were satisfied that sufficient resources existed and that they could provide the necessary assurance. In addition, compliance with the relevant sections of RAG 5.04 was also reviewed.

As required by the Water Services Regulation Authority the Board hereby certifies:

- that, in the opinion of the Directors, Portsmouth Water Limited will have available to it sufficient financial resources and facilities to enable it to carry out, for at least the next 12 months, the Regulated Activities (including the investment programme necessary to fulfil the Appointee’s obligations under the Appointment); and
- that, in the opinion of the Directors, the Appointee will, for at least the next 12 months, have available to it management resources which are sufficient to enable it to carry out those functions; and
- that, in the opinion of the Directors, all contracts entered into with any Associated Company include all necessary provisions and requirements concerning the standard of service to be supplied to the Appointee, to ensure that it is able to meet all its obligations as a water undertaker; and
- in accordance with its Instrument of Appointment under the Water Industry Act 1991, the Directors are of the opinion that the Company is in compliance with paragraph 3.1 of Condition 'K' of that Instrument.

**Signed by:**

T M Lazenby M.B.E. ..................................................

N Smith .......................................................................

N J Sheeran ................................................................

R C Porteous .............................................................

R L Sullivan ................................................................

R J Tennant ................................................................

The transactions required to be disclosed under Condition F of the Company's Instrument of Appointment are set out below:

**Borrowings or Sums Lent**

There is a loan outstanding made to a Group Company, South Downs Limited, in June 2002. The balance of the loan, consisting of the principal amount and accrued interest to date, amounts to £59.468m. This loan was made as a part of the refinancing package which was carried out in the financial year 2002/03. The interest rate for the loan is based on LIBOR plus a margin.

**Dividends paid to Associated Undertakings**

The dividends paid to the holding company, Portsmouth Water Holdings Limited, are shown in note 9 on page 23 of these Regulatory Accounts. The dividend policy is also covered within this note.

**Payments for Tax Losses**

Payments relating to the surrender of tax losses to Portsmouth Water Limited, from Group Companies, made to South Downs Limited amounting to £178,776.

**Supply of Services**

Details of services supplied to the Appointee by associates during the year are disclosed below.

| Service | Associate Company | Turnover of Associate (£000's) | Terms of Supply | Value (£000's) |
|---|---|---|---|---|
| Rent of operational sites | Brockhampton Holdings Limited | 186 | Market Tested | 84 |
| Management Charge | South Downs Limited | - | Turnover | 41 |

**Directors Remuneration**

There is a recharge of Directors salaries amounting to £20,975 paid to Portsmouth Water Limited by Brockhampton Holdings Limited, which represents the time spent by Portsmouth Water Executive Directors on Group matters.

**Capital Investment and Regulation Staff Salaries**

There is a recharge of capital investment and regulation department salaries amounting to £28,715 paid to Portsmouth Water Limited by Brockhampton Holdings Limited, in respect of staff time spent by Portsmouth Water staff on a solar panel capital scheme for the associated company.

**Statement by Board of Directors**

To the best of their knowledge, the Directors of the Company declare that all appropriate transactions with associated companies have been disclosed.

## REPORT OF THE INDEPENDENT AUDITOR TO THE WATER SERVICES REGULATION AUTHORITY AND DIRECTORS OF PORTSMOUTH WATER LIMITED

We have audited the Regulatory Accounts of Portsmouth Water Limited for the year ended 31 March 2012 on pages 14 to 40 which comprise:

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

These Regulatory Accounts have been prepared in accordance with the basis of preparation and accounting policies set out in the Statement of Accounting Policies.

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

### Respective responsibilities of the WSRA, the Directors and Auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 42, the Directors are responsible for the preparation of the Regulatory Accounts and for their fair presentation in accordance with the basis of preparation and accounting policies. Our responsibility is to audit and express an opinion on the Regulatory Accounts in accordance with International Standards on Auditing (UK and Ireland), except as stated in the 'Scope of the audit of the Regulatory Accounts' below, and having regard to the guidance contained in Audit 05/03 'Reporting to Regulators of Regulated Entities' issued by the Institute of Chartered Accountants in England and Wales. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### Scope of the audit of the Regulatory Accounts

An audit involves obtaining evidence about the amounts and disclosures in the Regulatory Accounts sufficient to give reasonable assurance that the Regulatory Accounts are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the Directors, and the overall presentation of the Regulatory Accounts. In addition, we read all the financial and non-financial information in the Regulatory Accounts to identify material inconsistencies with the audited Regulatory Accounts. If we become aware of any apparent misstatements or inconsistencies, we consider the implications for our report.

We have not assessed whether the accounting policies are appropriate to the circumstances of the Company where these are laid down by Condition F. Where Condition F does not give specific guidance on the accounting policies to be followed, our audit includes an assessment of whether the accounting policies adopted in respect of the transactions and balances required to be included in the Regulatory Accounts are consistent with those used in the preparation of the statutory financial statements of the company. Furthermore, as the nature, form and content of Regulatory Accounts are determined by the WSRA, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit option under International Standards on Auditing (UK & Ireland).

### Opinion on Regulatory Accounts

In our opinion, the Regulatory Accounts:

- fairly present in accordance with Condition F, the Regulatory Accounting Guidelines issued by the WSRA and the accounting policies set out on page 18 to 20 and page 35, the state of the Company's affairs at 31 March 2012 on an historical cost and current cost basis, and its historical cost and current cost profit and its current cost cash flow for the year then ended; and
- have been properly prepared in accordance with Condition F, the Regulatory Accounting Guidelines and the accounting policies.

### Basis of preparation

Without modifying our opinion, we draw attention to the fact that the Regulatory Accounts have been prepared in accordance with Condition F of the Appointment and the Regulatory Accounting Guidelines, the accounting policies set out in the statement of accounting policies and, in the case of the regulatory historical cost accounting statements, under the historical cost convention.

The Regulatory Accounts are separate from the statutory financial statements of the Company and have not been prepared under the basis of United Kingdom Generally Accepted Accounting Practice ('UK GAAP'). Financial information other than that prepared on the basis of UK GAAP does not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in statutory financial statements prepared in accordance with the Companies Act 2006. Furthermore, the regulatory historical cost accounting statements on pages 14 to 31 have been drawn up in accordance with Regulatory Accounting Guideline 3.06, in that infrastructure renewals accounting as applied in previous years should continue to be applied and accordingly, that the relevant sections of Financial Reporting Standards 12 and 15 be disapplied. The effect of this departure from Generally Accepted Accounting Practice and a reconciliation of the balance sheet drawn up on this basis to the balance sheet drawn up under the Companies Act 2006 is given on page 25.

### Opinion on other matters prescribed by Condition F

Under the terms of our contract, we have assumed responsibility to provide those additional opinions required by Condition F in relation to the accounting records. In our opinion:

- proper accounting records have been kept by the appointee as required by paragraph 3 of Condition F; and
- the Regulatory Accounts are in agreement with the accounting records and returns retained for the purpose of preparing the Regulatory Accounts.

### Other matters

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

Our opinion on the Regulatory Accounts is separate from our opinion on the statutory financial statements of the Company for the year ended 31 March 2012 on which we report, which are prepared for a different purpose. Our audit report in relation to the statutory financial statements of the Company (our 'statutory audit') was made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our statutory audit work was undertaken so that we might state to the Company's members those matters we are required to state to them in a statutory audit report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume responsibility for any other purpose or to any other person to whom our statutory audit report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

**NICHOLAS KELSEY**
Senior Statutory Auditor
For and on behalf of
**SAFFERY CHAMPNESS**
CHARTERED ACCOUNTANTS
REGISTERED AUDITORS
LION HOUSE RED LION STREET
LONDON
**6 JULY 2012**

| | | 2012 £000 | 2011 £000 |
|---|---|---|---|
| **KPI - 1** | | | |
| **a)** | **Gearing - Debt/RCV** | | |
| (i) | Debt | | |
| | Bank loan (note 17, page 27) | 89,542 | 85,306 |
| | Bank loan (note 15, page 26) | 1,000 | 4,500 |
| | Debenture stock (note 15, page 26) | 284 | 284 |
| | Cash at bank and in hand | (2,563) | (1,746) |
| | | 88,263 | 88,344 |

For the purposes of this ratio, debt excludes the deferred arrangement costs of £1.166m (note 17, on page 27) and the current asset investment of £0.004m (note 13, on page 26).

(ii) Regulatory Capital Value (RCV)

Value established by Ofwat in Final Determination in 2009

One of the elements considered by Ofwat in assessing revenues required by the Company is a return on the capital investment in the business. The value of the capital base of each company for the purposes of setting price limits is the RCV. The RCV is widely used by the investment community as a proxy for the market value of the regulated business. For Portsmouth Water the RCV is a key element of its bond covenants.

| | | 2012 £000 | 2011 £000 |
|---|---|---|---|
| | Regulatory capital value indexed to 31 March | 115,785 | 115,197 |
| (iii) | Gearing - Debt/RCV ratio (i) ÷ (ii) | 76.2% | 76.7% |

**b) Cash interest cover**

This ratio represents the number of times cashflow of the business covers interest payments.

(i) Cashflow before interest paid is derived from the cashflow statement on page 34 and is calculated as follows:

| | | 2012 £000 | 2011 £000 |
|---|---|---|---|
| | Operating Profit | 6,514 | 6,108 |
| | Notional Pension Costs | 1,406 | 1,652 |
| | Depreciation Charges | 8,576 | 8,258 |
| | Other items | 14 | 1,425 |
| | Interest received, excluding amounts for inter-company loan | 19 | 17 |
| | Taxation, excluding payments for group relief | (14) | (858) |
| | Capital expenditure | (6,670) | (9,728) |
| | (Repayment of loans)/new borrowings | (3,500) | (1,500) |
| | | 6,345 | 5,374 |
| (ii) | Interest paid | 3,354 | 3,283 |
| (iii) | Cash interest cover ratio (i) ÷ (ii) | 1.89 | 1.64 |

**KPI - 2 Customer Service Measures**

Indicators are based on information supplied to Ofwat and confirmed in the Ofwat publication ‘Levels of Service for the Water Industry in England and Wales Report’

**KPI - 3 Water Quality**

This indicator is based on figures reported to the DWI.

**KPI - 4 Efficiency**

The results for this indicator are provided by Ofwat in its publication ‘Water and Sewerage Unit Costs and Efficiency’.

**KPI - 5 Leakage**

This indicator is based on figures supplied to Ofwat and confirmed in its report ‘Security of Supply, Leakage and the Efficient Use of Water’. The figures for 2011/12 have been supplied to Ofwat, but will not be confirmed in the Ofwat document until later in 2012.