**24 May 2017**

# Full Year Results 2016/17
# for the year ended 31 March 2017

## *Building momentum, driving growth*

**Chris Loughlin, Pennon Chief Executive said:**

"Pennon has delivered a strong performance in 2016/17 across its water and waste businesses. South West Water's Return on Regulated Equity continues to lead the sector while Viridor is growing through its Energy Recovery Facility portfolio, delivering EBITDA[(1)] of £107 million, ahead of our c.£100 million target.

Across the Group we are investing for growth while driving efficiency to keep costs low for the benefit of our customers. We have delivered savings of £129 million in total expenditure at South West Water since the beginning of the current regulatory period, cementing our commitment to reduce the real cost of water bills to 2020.

We believe Pennon is well positioned now and for the future and our performance underpins our long established sector-leading 10 year dividend policy of 4% growth per annum above RPI inflation out to 2020."

[1] Earnings before interest, tax, depreciation and amortisation

## Financial Highlights

| Underlying[2] | 2016/17 | 2015/16 | Change |
|---|---|---|---|
| Revenue | £1,353.1m | £1,352.3m | +0.1% |
| EBITDA | £486.0m | £448.4m | +8.4% |
| Adjusted EBITDA[3] | £546.2m | £508.4m | +7.4% |
| Operating Profit | £304.6m | £261.8m | +16.3% |
| Profit Before Tax (PBT) | £250.0m | £211.3m | +18.3% |
| Non-underlying items before tax[4] | (£39.5m) | (£5.0m) | |
| **Statutory Profit Before Tax** | **£210.5m** | **£206.3m** | **+2.0%** |
| Tax | (£30.0m) | (£38.0m) | +21.1% |
| **Statutory Profit After Tax (PAT)** | **£180.5m** | **£168.3m** | **+7.2%** |
| | | | |
| Earnings per share[5] | 47.0p | 39.5p | +19.0% |
| **Statutory Earnings per share** | **39.8p** | **37.0p** | **+7.6%** |
| Dividend per share[6] | 35.96p | 33.58p | +7.1% |
| | | | |
| PAT (attributable to holders of hybrid capital) | £16.2m | £16.2m | - |
| PAT (attributable to shareholders) | £164.3m | £152.1m | +8.0% |

- Underlying PBT up +18.3% following:
    - higher revenues driven by customer demand and cost savings at South West Water
    - growth at Viridor driven by the Energy Recovery Facilities (ERFs) which achieved EBITDA of £107 million, ahead of target
    - improved recycling margins through 'self-help' initiatives
    - continuing group efficiencies with £9 million p.a. of the c.£17 million p.a. expected from 2019 already secured
- Return on Regulated Equity (RORE) at 12.6%[7], unique WaterShare mechanism benefiting customers
- Sustainable, low cost funding position underpinning continuing capital investment
- Statutory earnings per share growth of +7.6%
- Dividend per share +7.1% to 35.96p

[2] Before non-underlying items. Underlying earnings are presented to provide a more useful comparison of business trends and performance
[3] Underlying EBITDA plus share of Joint Venture EBITDA and IFRIC 12 interest receivable
[4] Non-underlying items are adjusted for by virtue of their size, nature or incidence to enable a full understanding of the Group's financial performance
[5] Before deferred tax and non-underlying items
[6] The RPI rate used is 3.1% as of March 2017
[7] See page 23

## Operational Highlights

- Water business outperforming the regulatory contract with sector-leading RORE outperformance. Net ODI reward of £3.6 million[(8)] for 2016/17, and maintaining momentum from year one of the regulatory period
- ERF portfolio delivering growth with all eight operational sites performing well, with average availability at greater than 90% for 2016/17
- c.80%[9] of existing ERF portfolio volumes (and associated prices) contracted long-term
- Recycling margin improvement through 'self-help' measures, driving increased EBITDA
- Driving value through efficiency - integrating, sharing best practice, reducing costs through a Shared Service Review
- Negotiations with Greater Manchester Waste Disposal Authority (GMWDA) continue, seeking to ensure a well managed exit from the contract
- Secured further growth opportunities
    - Non-household Retail Market – Pennon Water Services operating successfully. One of only three incumbent companies growing, with net customer growth since market opening
    - Construction of four further ERFs are ongoing:
        - Dunbar and South London (Beddington) progressing to budget
        - Glasgow's Recycling and Renewable Energy Centre is receiving waste and generating energy. New construction contracts with Doosan Babcock are progressing well with ERF final commissioning expected in 2017
        - Avonmouth ERF investment now underway with key construction and operational contracts in place with completion expected in 2020/21

## Presentation of Results

A presentation for City audiences will be held today, Wednesday 24 May 2017, at 09.30am at the London Stock Exchange, 10 Paternoster Square, London, EC4M 7LS.

A live webcast of the presentation can also be accessed using the following link:

www.pennon-group.co.uk/investor-information


**For further information, please contact:**

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[8] £3.6m net reward reflecting £3.9m net reward which will be recognised at the end of the regulatory period and £0.3m net penalty which can be reflected during the regulatory period
[9] Excluding Avonmouth

## About Pennon Group

As one of the largest environmental infrastructure groups in the UK, Pennon is at the top end of the FTSE 250. Pennon has assets of around £5.9 billion and a workforce of around 5,000 people.

The merged water company of South West Water and Bournemouth Water provides water and wastewater services to a population of c.1.7 million in Cornwall, Devon and parts of Dorset and Somerset and water only services to c.0.5 million in parts of Dorset, Hampshire and Wiltshire. South West Water was awarded enhanced status for its 2015-2020 Business Plan, and has the highest potential returns in the water sector.

Viridor is a leading UK recycling, energy recovery and waste management company, providing services to more than 150 local authorities and major corporate clients as well as over 32,000 customers across the UK.

## Upcoming Events

| | |
|---|---|
| 6 July 2017 | Annual General Meeting |
| 25 September 2017 | Trading Statement |
| 29 November 2017 | Half Year Results 2017/18 |
| 26 March 2018 | Trading Statement |
| 25 May 2018 | Full Year Results 2017/18 |

## 10 year sector-leading dividend policy

Pennon's long established 10 year dividend policy of 4% year-on-year growth above RPI inflation to 2020 results in a doubling of dividend over 10 years (2010-2020)[10]. This policy reflects the Board's confidence in our long term strategy and is underpinned by the highest potential Return on Regulated Equity in the water sector over K6 (2015-2020) and the growth in earnings being delivered by Viridor's ERFs.

For 2016/17, the Board has recommended a final dividend of 24.87p, up 7.6%, subject to shareholder approval at the Annual General Meeting on 6 July 2017. The final dividend will be paid on 1 September 2017 to shareholders on the register on 7 July 2017. Together with the interim dividend of 11.09p, this will result in a total dividend for the year of 35.96p, an increase of 7.1%[(11)].

The Company will also offer a scrip dividend alternative. The final date for the receipt of Forms of Election/Mandate in respect of the scrip dividend alternative for the final dividend will be 14 August 2017.

**Full Year Dividend Payment Information*:**

| | |
|---|---|
| 6 July 2017 | Ex-dividend date |
| 7 July 2017 | Record date |
| 14 August 2017 | Scrip election date |
| 1 September 2017 | Payment date |

* These dates are provisional and, in the case of the final dividend, subject to obtaining shareholder approval at the 2017 Annual General Meeting.

[10] Future dividends growth based on policy of 4% + RPI forecast to 2020
[11] RPI as at 31 March 2017 was 3.1%

Pennon

# PENNON BUSINESS REVIEW

Pennon's priority continues to be the creation of shareholder value through its focus on UK environmental infrastructure across water and waste sectors.

The Group has performed strongly in 2016/17, in line with management expectations. Pennon generates significant operating cash flows, and has a strong liquidity and balance sheet position.

Pennon continues to seek and identify further growth opportunities within the UK, assessing the long-term viability of the market and achieving an appropriate risk/reward balance. Pennon has now committed to a further ERF at Avonmouth near Bristol, taking the portfolio to twelve ERFs, which is a significant infrastructure investment post-Brexit.

Incremental growth in the water business is being achieved through the successful merger of Bournemouth Water with combined licences and operations and a new retail venture for business customers with South Staffs/Cambridge Water which was launched on 1 April 2017.

**Strong operational and financial performance in water and waste businesses**

The merged water business of South West Water and Bournemouth Water continues to deliver and outperform the business plans with sector-leading RORE of 12.6% delivered in the year, and is expected to remain sector-leading through to 2020.

Viridor's ERF portfolio is performing well and has exceeded the EBITDA target of delivering c.£100 million EBITDA by delivering £106.9 million EBITDA in 2016/17. We expect market place demand for ERFs to continue to exceed capacity into the long term. With four ERFs now under construction we will generate significant growth in EBITDA over the next few years as the plants come on stream. The focus for the ERF portfolio remains on increasing the operational performance with average availability for the year above 90%.

Recycling 'self-help' measures implemented continue to support improved margins with EBITDA increasing by £9.6 million through;

- sharing commodity risk/opportunity with customers improving the dynamics of the contracts. Good progress has been made in contract renegotiations to date with further opportunities as negotiations continue
- focus on reducing costs and simplifying the organisation contributing to the improved performance
- further opportunities to increase returns through improving asset utilisation and rationalising the portfolio
- internalisation of haulage operations utilising our expertise within the collections business.

## Cost efficiency a continued focus

South West Water continues to strive for ever greater efficiency, with Totex outperformance resulting in cumulative savings of £129 million and financing outperformance of £67 million in the first two years of K6 (2015-2020) compared to the Final Determination allowances. South West Water is focused on maintaining this momentum over the K6 regulatory period and is confident in its ability to remain at the frontier of cost efficiency for the water sector. This continued focus on cost efficiency has enabled South West Water to deliver reductions in customer bills in real terms to 2020.

We have delivered the effective consolidation of Bournemouth Water with the c.£27 million of net synergies over K6 targeted from the integration on track, with the final wholesale and household retail operational functions being aligned across the regions.

Pennon has also focused on cost savings across the Group, with the c.£11 million p.a. of cost savings and synergy targets announced last year now increased to c.£17 million p.a. from 2019 following the successful conclusion of the Shared Services Review. As reported at the half year this review has resulted in a restructuring provision charge of £1.2 million and an asset value of £9.5 million per annum has been de-recognised, relating to a Viridor IT system which will no longer be used as the Group standardises its processes and systems. Of the c.£17 million p.a of cost savings expected in 2019, £9 million has been secured to date and Pennon is targeting further savings through a group-wide procurement approach.

## Driving growth

*New non-household retail venture with South Staffordshire Plc*

Pennon Water Services, the separate legal entity operated from Bournemouth providing retail services for our existing non-household retail brands, along with South West Water's wholesale operations successfully entered the retail market on 1 April 2017.

On the same day a new retail non-household venture arrangement with South Staffordshire Plc (incorporating South Staffs and Cambridge Water) began with Pennon retaining an 80% share. The activities will benefit from strong customer service and a common customer billing platform which will continue to be supported by the South Staffordshire Group.

The combined business is growing with over 1,500 net customers secured since market opening. In addition a programme targeting existing water-only customers with a dual water and wastewater service has been successful.

*Construction of four further ERFs progressing including Avonmouth ERF development now underway*

Following the commitment to build a further ERF at Avonmouth there are now four sites under construction. Dunbar and Beddington ERFs are progressing well and to budget. Glasgow's Recycling and Renewable Energy Centre began receiving waste and generating electricity through the Materials Recycling Facility (MRF) and Anaerobic Digestion Facility (AD) and the ROCs[12] application was submitted before the year end. New construction and commissioning contracts are in place with Doosan Babcock and work is now progressing well with commissioning expected in 2017. The client (Glasgow City Council) has been consulted throughout this period of change, and is supportive of Viridor's actions and the revised plan for completion.

In line with Pennon's growth ambitions, during the year the Board approved the investment of a further £252 million ERF at Avonmouth near Bristol to be completed in 2020/21, taking the portfolio to twelve plants. During the second half of the year, construction contracts with experienced construction and commissioning teams have been signed and c.£7 million of site preparation work has been completed. The contract with Somerset Waste Partnership which represents c.35% of total capacity has been secured for the life of the plant with 15% of capacity committed through further contracts, including our own collections fleet and strong regional commercial and industrial (C&I) demand.

In addition Viridor has recently secured a 3% increase in capacity at Cardiff (Trident Park) ERF with the possibility for further expansion at other facilities. Before capitalised interest, cumulative ERF investment to date is £1,058 million, excluding the £72 million spent on the Peterborough ERF, which was local authority financed. This leaves c.£400 million left to invest in the ERF construction programme; c.£180 million in 2017/18, c.£140 million in 2018/19 and c.£80 million in 2019/20.

**Prepared for the next regulatory review (PR19)**

South West Water has been fully engaged in Ofwat's Water 2020 forward programme as the methodology and mechanisms for PR19 are developed. Whilst lower base returns are expected in the next regulatory price review, we expect these to be balanced with greater incentives for outperformance for top performing companies. South West Water is in a good position to manage changes in the methodology[13].

[12] ROCs – Renewable Obligation Certificate
[13] Ofwat methodology due for publication on 11 July 2017

The debt consultation which Ofwat published in October 2016 confirmed a number of areas already expected and South West Water led the way at the last price review in adopting our pain/gain mechanism WaterShare which already shares benefits with customers. In addition, South West Water has always strived to remain efficiently financed and is comparable with the notional structures and gearing levels set by Ofwat.

The changes in approach to indexation along with the expected market reforms within the water resources and bio-resources (sludge) areas were previously signalled and the impact on South West Water's Regulatory Capital Value (RCV) is relatively low at c.4% and c.2% respectively of RCV currently included within these areas.

The methodology for indexation changes and the market reforms within the water resources and bio-resources (sludge) areas are being finalised alongside the development of the PR19 cost assessment models.

South West Water continues to deliver its operations and capital schemes effectively and with our strong strategic alliances and innovative planning and scoping techniques we see opportunities within the direct procurement proposals.

In addition, South West Water will be publishing its 25 year strategic plan later this year which will again focus on customer priorities through extensive customer engagement, its strong operational performance and longer term plans for resilience, reliability and responsiveness.

## PENNON FINANCIAL PERFORMANCE

### Pennon Group

| Underlying[14] | 2016/17 | 2015/16 | Change |
|---|---|---|---|
| Revenue | £1,353.1m | £1,352.3m | +0.1% |
| EBITDA | £486.0m | £448.4m | +8.4% |
| Adjusted EBITDA[15] | £546.2m | £508.4m | +7.4% |
| Operating Profit | £304.6m | £261.8m | +16.3% |
| Profit Before Tax | £250.0m | £211.3m | +18.3% |
| Non-underlying items before tax | (£39.5m) | (£5.0m) | |
| **Statutory Profit Before Tax** | **£210.5m** | **£206.3m** | **+2.0%** |
| Tax | (£30.0m) | (£38.0m) | +21.1% |
| **Statutory Profit After Tax** | **£180.5m** | **£168.3m** | **+7.2%** |
| Capital investment[16] | £384.7m | £316.9m | +21.4% |
| South West Water | £190.9m | £134.1m | +42.4% |
| Viridor | £193.8m | £182.8m | +6.0% |
| Earnings per share[17] | 47.0p | 39.5p | +19.0% |
| **Statutory Earnings per share** | **39.8p** | **37.0p** | **+7.6%** |
| Dividend per share[18] | 35.96p | 33.58p | +7.1% |

| | 31 March 2017 | 31 March 2016 | Change |
|---|---|---|---|
| Net debt | £2,664.9m | £2,484.4m | +7.3% |

### Non-underlying Items

Non-underlying items total £39.5 million before tax and net non-underlying items after tax is £11.1 million (2015/16 £29.1 million credit). The net charge is a result of:

- restructuring costs - £10.7 million charge relating to restructuring costs from the Group wide Shared Services Review and migration to a Group IT platform (including a £9.5m non-cash de-recognition of an existing IT asset)
- derivative movements - £28.8[19] million deferred tax charge reflecting non-cash movements as a result of the unwind of the 2011 Peninsula MB Limited (PMB) derivative and market movements on our long-dated floating rate vanilla swaps
- taxation - £28.4 million credit predominantly arising from the enacted reduction in the UK rate of corporation tax from 18% to 17% in 2020.

14 Before non-underlying items
15 Underlying EBITDA plus share of Joint Venture EBITDA and IFRIC 12 interest receivable
16 Including construction spend on service concession arrangements
17 Before deferred tax and non-underlying items
18 The RPI rate used is 3.1% as of March 2017
19 Two arrangements are accounted for in non-underlying derivative movements

The vanilla floating rate swaps are held over South West Water's long-term 2040 Bond and as market rates have fallen, the value of the derivative asset has increased.

Since 2011 the Group has received a fixed interest rate on a £200 million financial asset and paid an index-linked interest rate on a £200 million loan, designed to improve the Group's overall interest rate performance. The counterparty to both instruments was PMB. In combination, these instruments were accounted for as a derivative, with a net interest income of £8 million per annum cash settled (c.£7 million in 2016/17).

In periods of index underperformance, losses arose in PMB which were group relieved with the Group. Following a change in legislation, which saw the value of the derivative to the Group moving from a liability of £4 million to a liability of c.£40 million, the Group made the decision to exit the transaction.

On 10 February 2017 the Company unwound this transaction. The derivative had been due to end in 2027, however, following a change in the economic benefit of this derivative due to a change in legislation which impacted the derivative's future cash flows, the Company exercised its option to unwind the transaction early.

The process for unwinding the derivative resulted in the Group acquiring a financial asset for £283 million and a financial liability for £239 million from Nomura Structured Holdings plc. The counterparty to both these transactions was PMB. Simultaneously, the Company also acquired the remaining 25% of PMB's share capital from Nomura Structured Holdings plc, for a consideration of £36,000, with all PMB's liabilities being due to the Company from that point. The Company has since settled these liabilities through intercompany transactions with PMB. PMB has ceased all operating activities and will be liquidated in due course. The net consideration due to Nomura Structured Holdings plc in respect of these transactions is £44 million with an agreed payment date of June 2018. The impact for the Group is a net cost of £35 million post tax.

PMB is a private limited company, incorporated in England and Wales on 5 December 2011 as a subsidiary of Nomura Structured Holdings plc, part of the 'Nomura Group'. Prior to the transaction on 10 February 2017, PMB's share capital was 75% owned by the Company and 25% owned by Nomura Structured Holdings plc, who had control of PMB for accounting purposes.

The group relief claimed by the Group has been treated as an uncertain tax item and has been substantially provided for over recent years. Following the conclusion of discussions with HMRC, no further amounts are required to be recognised by the Group. A tax credit of £8 million relates to the overall cost to unwind this derivative transaction.

Post the unwind of the transaction the Group's interest income will no longer include the finance income of c.£8 million per annum (c.£7 million in 2016/17). and the underlying tax charge will reduce by a similar amount.

**Viridor**

| | 2016/17 | 2015/16 | Change |
|---|---|---|---|
| Revenue[20] | £793.5m | £806.2m | (1.6%) |
| EBITDA[21] | £138.3m | £116.5m | +18.7% |
| ERFs | £106.9m | £89.7m | +19.2% |
| Landfill | £6.5m | £6.3m | +3.2% |
| Landfill Gas | £27.6m | £31.5m | (12.4%) |
| Recycling | £22.7m | £13.1m | +73.3% |
| Contracts, Collections & Other | £34.1m | £36.5m | (6.6%) |
| Indirect Costs | (£59.5m) | (£60.6m) | +1.8% |
| Share of JV EBITDA | £44.1m | £43.3m | +1.8% |
| IFRIC 12 Interest Receivable | £16.1m | £16.7m | (3.6%) |
| Adjusted EBITDA[22] | £198.5m | £176.5m | +12.5% |
| Profit Before Tax[19] | £60.4m | £30.7m | +96.7% |

**South West Water**

| | 2016/17 | 2015/16 | Change |
|---|---|---|---|
| Revenue | £561.0m | £547.0m | +2.6% |
| Operating costs[19] | (£211.9m) | (£211.8m) | - |
| EBITDA[19] | £349.1m | £335.2m | +4.1% |
| Depreciation | (£113.7m) | (£110.7m) | (2.7%) |
| Operating Profit[19] | £235.4m | £224.5m | +4.9% |
| Interest | (£61.5m) | (£58.8m) | (4.6%) |
| Profit Before Tax[19] | £173.9m | £165.7m | +4.9% |

**Underlying performance ahead of last year reflecting a strong performance**

Group revenue was broadly in line with last year at £1,353.1 million. Viridor's revenue decreased by 1.6% to £793.5 million due to the expected decrease in construction spend on service concession arrangements as plants come on stream and lower landfill volumes, partly offset by the growing contribution of operational ERFs and increased revenues through contracts and collections. Excluding the change in construction revenue, Viridor's revenues would have increased from the prior year. Revenue from the water business was up by 2.6% to £561.0 million as a result of 2.5% higher demand on metered volumes, tariff increases of 1.4% (with RPI of 1.1%) 9,050 new connections offset by 9,800 customers switching to a measured supply and benefitting from lower bills. The increased demand from the drier weather resulted in revenue being above the regulatory tolerance levels and will result in a small penalty of £0.2 million.

[20] Including landfill tax and construction spend on service concession arrangements
[21] Before non-underlying items
[22] Underlying EBITDA plus share of Joint Venture EBITDA and IFRIC 12 interest receivable

At Viridor, the portfolio of operational ERFs continues to perform well delivering EBITDA ahead of the c.£100 million target with the six most recently delivered ERFs ramping up as Viridor optimises each plant. In addition there have been improvements from recycling 'self-help' measures, where significant progress has been made in reducing the cost base and improving the utilisation of assets, net of anticipated declines in landfill earnings primarily due to expected lower volumes. As a result, Viridor's EBITDA increased by 18.7% to £138.3 million (2015/16 £116.5 million).

Viridor's adjusted EBITDA increased 12.5% to £198.5 million (2015/16 £176.5 million). This measure includes the results from our joint ventures and IFRIC 12 interest receivable, capturing earnings across our ERF portfolio. Joint venture EBITDA increased slightly to £44.1 million (2015/16 £43.3 million) with IFRIC 12 interest receivable marginally down at £16.1 million (2015/16 £16.7 million).

Our ERF activities delivered EBITDA of £106.9 million (2015/16 £89.7 million) exceeding our target of c.£100 million of EBITDA from ERFs by 2016/17 (before IFRIC 12 interest receivable and our share of joint venture EBITDA). During the year ERF EBITDA included contractual compensation[23] of £12.7 million, a similar level to recent years. Viridor has four further ERFs under construction. Dunbar and Beddington (South London) are progressing well and to budget, steps have being taken to ensure construction of Glasgow ERF is completed successfully and development at Avonmouth has commenced.

Landfill EBITDA from waste disposal is up by £0.2 million this year whilst power generation is down by £3.9m million. The decrease in earnings is primarily due to expected lower volumes, which are in line with management expectations, and lower power prices.

Recycling and resources EBITDA, comprising recycling, collection and contracts and other, increased by 14.5% to £56.8 million (2015/16 £49.6 million). Recycling revenue at £90 per tonne has increased by £5 per tonne (2015/16 £85 per tonne) reflecting renegotiated input contracts and recyclate prices. Average operating costs fell by £2 per tonne to £72 per tonne (2015/16 £74 per tonne) as a result of 'self-help' efficiency measures offset by a £1 per tonne increase in shipping costs. As a result recycling EBITDA margin increased by £6 per tonne to £14 per tonne (2015/16 £8 per tonne). We remain cautious about future recyclate price growth and are not relying on a near term recovery. We are instead focusing on 'self-help' measures to drive margin improvement and to look to share commodity risk/ opportunity with our clients.

[23] Primarily relates to liquidated damages received/receivable when construction is completed post the original contractual completion date.

Following the merger of Bournemouth Water into South West Water the water business recorded strong performances against the K6 regulatory contracts, outperforming regulatory assumptions. The water business' profit before tax increased by 4.9% to £173.9 million (2015/16 £165.7 million) reflecting tariff increases, increased demand from the drier weather and stable operating costs of £211.9 million (2015/16 £211.8 million). With the highest potential returns in the sector for K6, South West Water is outperforming its business plan, resulting in a return on regulated equity of 12.6%[(24)] for the year.

South West Water's EBITDA increased during the year due to higher revenue and cost efficiencies. While average RPI has been increasing (3.1% at March 2017), total operating costs in 2016/17 were comparable to last year, with savings arising from operational maintenance synergies from the company mergers as well as targeted efficiencies contributing to cost performance. Operating costs also include a fine for £1.8 million issued in April 2017 relating to a HSE prosecution following the tragic fatality of an employee at a WasteWater Treatment Works in December 2013. In addition, South West Water's bad debt charge continues to fall, down by over a quarter since the end of K5 (2015), to 1.1% as a percentage of revenues (1.7% at the end of K5). This was driven by efficient collections as we work with our customers to manage their debt with the operations continually updating their approaches in targeting those customers with the means to pay whilst supporting those who have genuine affordability challenges.

**Net Finance Costs**

Underlying net finance costs of £58.8 million were £4.7 million higher than last year, predominantly reflecting higher RPI, higher net debt from continuing capital investments and lower finance income following the unwind of the 2011 PMB derivative. Net finance costs include c. £7 million of interest benefit from PMB, which has now ceased.

We have secured funding at a cost that is efficient and effective. The Group's interest rate on average net debt for the year to 31 March 2017 has increased slightly from 3.3% to 3.4% (after adjusting for capitalised interest of £12.9 million, notional interest items totalling £10.3 million and interest received from shareholder loans to joint ventures of £10.2 million). For South West Water this figure was 3.2% (2015/16 3.1%).

During the year underlying net finance costs (excluding pensions net interest of £1.2 million, discount unwind on provisions of £9.1 million and IFRIC 12 contract interest receivable of £16.1 million) were £64.6 million (2015/16 £59.6 million), covered 4.7 times (2015/16 4.4 times) by Group operating profit.

[24] Based on SWW's WaterShare approach to RORE calculation, see page 23

## Profit before tax

Group underlying profit before tax was £250.0 million, an increase of 18.3%, compared with the prior year (2015/16 £211.3 million). On a statutory basis, profit before tax was £210.5 million (2015/16 £206.3 million) reflecting non-underlying charges before tax of £39.5 million (2015/16 £5.0 million). Included in profit before tax is share of joint venture profit after tax of £4.2 million (2015/16 £3.6 million).

## Taxation

The Group's underlying mainstream UK corporation current tax charge for the year (before prior year) was £41.3 million, reflecting an effective tax rate of 16.5% (2015/16 £34.3 million, 16.2%) and higher profits. There was a prior year current tax credit of £1.8 million recognised for the year (2015/16 credit of £1.4 million). In addition there is a non-underlying £9.4 million current tax credit relating to non-underlying items.

Underlying deferred tax for the year (before prior year) was a charge of £17.8 million (2015/16 £23.3 million). The charge for 2016/17 primarily reflects capital allowances, including on ERFs, in excess of depreciation charge. There was a prior year deferred tax charge of £1.1 million recognised for the year (2015/16 £15.9 million charge). In addition there is a non-underlying £21.3 million deferred tax credit relating to the enacted reduction in the UK rate of corporation tax to 17% in 2020 and a £2.3 million deferred tax charge relating to other non-underlying items.

This resulted in a total tax charge for the year of £30.0 million (2015/16 £38.0 million).

During the year we have concluded discussions with HMRC resolving the treatment of certain uncertain tax items. Provisions for these uncertain tax items had been recognised in previous years, with no further amounts required in relation to these items.

## Earnings per share

Earnings per share on both a statutory and underlying basis before deferred tax were ahead of last year, up 7.6% at 39.8p (2015/16 37.0p) and up 19.0% at 47.0p (2015/16 39.5p) respectively, reflecting higher profits.

Net assets per share at book value at 31 March 2017 were 365p, up 1.1% on last year.

## Strong cash inflow from operations, continuing investment in future growth

The Group's operational cash inflows in 2016/17 were up £38 million to £456 million (2015/16 £418 million) including the benefit of higher earnings from ERFs. These funds have been put to use in efficiently financing the Group's capital structure and investing in future growth, through our substantial continuing capital investment programme with 2016/17 and 2017/18 peak years of investment. This investment has resulted in higher Group net debt.

Contributions into the defined benefit pension schemes were £11.2 million for the year. Payments of £36.4 million were made to meet our corporation tax obligations.

Other movements include £6.3 million of non-cash movement in the Euro loan due to exchange rates. Dividends from joint ventures amounted to £4.5 million with loan repayments of £0.3 million.

In addition, during the year the Company continued to benefit from offering a scrip dividend alternative. £6.9 million of potential cash dividend was retained in the business (2015/16 £6.3 million) and resulted in issuing 771,563 shares.

**Strong funding position underpinning capital investment**

The Group has a strong liquidity and funding position with £1,383 million cash and committed facilities at 31 March 2017 (March 2016 £1,707 million). This includes cash and deposits of £598 million (including £224 million of restricted funds representing deposits with lessors against lease obligations) and undrawn facilities of £785 million. At 31 March 2017 the Group's loans and finance lease obligations totalled £3,263 million.

During the year the Group drew down the South West Water EIB funding of £130 million signed in 2015/16.

The Group has also agreed a further £110 million of funding from the EIB into Pennon Group plc, in relation to the capital investment in Cardiff's Trident Park Energy Recovery Facility. This funding is anticipated to be signed later in 2017 when the EIB expects to have clarity over the implications of Article 50 being triggered. Negotiations are continuing with the EIB to secure additional funding for South West Water, so this can be delivered in a timely manner following the clarity noted above.

Since the year end the Group has signed £50 million of new and renewed revolving credit facilities to provide pre-funding for future cash flows.

The investment in Avonmouth ERF will be corporately financed and options are being considered, including a new hybrid, to continue the Group's diversified funding position.

**Efficient long-term financing strategy**

The Group has a diversified funding mix of fixed (£1,831 million, 69%), floating (£284 million, 11%) and index-linked borrowings (£550 million, 20%). The Group's debt has a maturity of up to 40 years with a weighted average maturity of 20 years matching the asset base. Much of the Group's debt is floating rate and derivatives are used to fix the rate on that debt. The Group has fixed, or put swaps in place to fix, the interest rate on a substantial portion of the existing water business debt for the entire K6 period, in line with the Group's policy to have at least 50% of funding fixed before the start of a regulatory period.

£492.8 million of South West Water's debt is index-linked at an overall real rate under 2.0%. As a result of the aforementioned initiatives, South West Water's cost of finance is among the lowest in the industry. Around two thirds of the water business net debt is from finance leases to provide a long maturity profile. Interest payable benefits from the fixed credit margins, which were secured at the inception of each lease. Bournemouth Water was successfully integrated into South West Water on 1 April 2016 and as a result a quarter of the net funding for the water business is RPI linked consistent with Ofwat's notional level.

**Net debt position**

The Group's net debt has increased by £181 million to £2,665 million. The Group's gearing ratio at 31 March 2017, being the ratio of net debt to (equity plus net debt) was 63.8% (31 March 2016 62.5%), reflecting the continuing capital investment during the year with 2016/17 and 2017/18 our peak years for capital expenditure.

Group net debt includes £1,132 million of investment in wholly-owned ERFs (Runcorn II, Oxford, Exeter, Cardiff, Glasgow, Dunbar and South London) and £87 million of funding for investments in joint ventures through shareholder loans (which together represents 45% of Group net debt). In addition the joint ventures have non-recourse net debt from third parties (excluding shareholder loans) of which Pennon's share is £194 million. c.85% of ERF funding (including joint ventures) is from corporate finance.

South West Water's debt to RCV[25] ratio is 61.8% (31 March 2016 59.7%), which aligns with Ofwat's K6 target for efficient gearing of 62.5%.

**Capital investment focused on regulatory expenditure and ERF build out**

Group capital investment[26] was £384.7 million in 2016/17 compared to £316.9 million in 2015/16.

Viridor's capital investment of £193.8 million was greater than in 2015/16 (£182.8 million). The majority of expenditure this year reflects the ongoing ERF programme, with significant expenditure at South London, Dunbar and Glasgow ERFs.

The infrastructure at Dunbar is nearing completion with a significant element of the process plant having been delivered to site prior to installation. The plant is expected to be operational in H2 2017/18. Construction at Beddington is progressing to plan with access routes to the site being improved and the core infrastructure under construction. Operations are expected to commence in H1 2018/19.

The completion of Glasgow with new contractor, Doosan Babcock, is progressing well and the site is receiving waste and generating electricity with ERF commissioning expected in 2017.

25 Based on RCV at March 2017 RPI of 3.1%

26 Including construction spend on service concession arrangements and £10.8 million of capitalised interest

For Avonmouth, during the second half of 2016/17, construction contracts with experienced construction and commissioning teams were signed and c.£7m of site preparation work completed.

South West Water's capital expenditure was £190.9 million compared to £134.1 million in 2015/16 and reflects the change in the nature and extent of capital activity with an increase in activity in year 2 of the regulatory programme.

As anticipated the largest single project for South West Water's spending is the development of the innovative Mayflower Water Treatment Works at North Plymouth. Construction works are well advanced and the formation of the process elements is underway with over 5km water pipeline and effluent pipes already installed. Advanced techniques have been used to limit the impact on the surrounding area including micro tunnelling under a major road into Plymouth. In addition investment has been targeted to improve wastewater compliance with process upgrades and improvements at 6 sites.

**Pensions**

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

At 31 March 2017 the Group's pension schemes showed an aggregate deficit (before deferred tax) of £68.0 million (March 2016 £40.9 million). Whilst the deficit has increased due to the post-Brexit fall in bond yields, increasing the valuation of liabilities over half of the increase in the valuation of liabilities has been offset by increases in asset values.

The net aggregate liabilities of £56 million (after deferred tax) represented around 2% of the Group's market capitalisation at 31 March 2017.

The 31 March 2016 actuarial valuation of the main scheme has been finalised and is in line with expectations at the 2013 valuation and contributions remain in line with Final Determination (FD) allowances.

# OPERATIONAL PERFORMANCE

**Pennon – evolving for the future**

*Driving benefits from a combined group*

Pennon is focused on driving greater synergies and savings across the Group, sharing best practice and ensuring it is well placed to capitalise on emerging opportunities.

As part of the evolution in Pennon's structure, we have successfully completed the Shared Services Review which has resulted in the centralisation of a number of corporate functions including corporate affairs and communications, human resources, finance, information services and SHEQ[(27)], as well as operational functions including procurement, logistics and facilities. The plans we have in place result in cost savings of c.£17 million per annum from 2019 with £9 million per annum of savings already secured. Pennon is also targeting further savings through a group-wide procurement approach.

Both Viridor and South West Water have a breadth and depth of experience in managing large asset bases and in using engineering excellence, technology and innovation to deliver efficiency and effectiveness. By sharing knowledge across the Group and harnessing our combined skills we can provide even better services to our extensive customer base of local authorities, major corporate clients, businesses and household customers.

For example, Pennon has adopted a group portfolio management approach to energy hedging, and has the ability to hedge its market position for periods up to five years ahead, further helping to protect revenues.

Over c.90% of energy (generation net of internal usage of electricity) is hedged for the coming year and over 60% is hedged out to 2019/20. In addition, the Group has a natural hedging opportunity which represents one third of Viridor's energy generation, as South West Water is a net user of electricity.

**Good operational and financial performance in Viridor**

| | **2016/17** | **2015/16** |
|---|---|---|
| Total Waste Inputs (million tonnes (MT)) | 7.6 | 7.8 |
| ERFs | 2.2 | 2.1 |
| Landfill | 1.7 | 2.0 |
| Recycling and Other | 3.7 | 3.7 |
| Recycling Volumes Traded | 1.6 | 1.8 |

[27] Safety, health, environment and quality

### ERFs Driving Growth

We are successfully establishing a significant asset base of ERFs, with eight plants now in operation. Viridor's ERF portfolio has delivered EBITDA of £106.9 million, reflecting a c.19% increase on last year and exceeds the milestone of c.£100 million targeted in 2016/17. Our focus is now on optimisation of the operational plants and increasing performance and average availability, which has been above 90% for 2016/17.

The operational ERFs have a design capacity of 2.1 million tonnes of waste inputs and 178 megawatts (MW) per annum including our joint ventures. This will extend to 3.2 million tonnes of waste, generating 276 MW by 2021. Approximately 80%[28] of the total ERF portfolio volumes (and associated price) have been secured under long-term, index-linked contracts with short and medium-term contracts in place for the remaining 20%.

Overall, Viridor has exported 1.5 Terawatt hours (TWh) of power to the national grid in 2016/17, and this is expected to continue to increase as the plants under construction come on stream.

### Maximising value from landfill gas

Our landfill energy business is being managed to maximise the value of landfill gas power generation, whilst exploring alternative commercial development and other energy opportunities.

At present, Viridor operates a network of landfill gas power generation sites, contributing 99MW of capacity in 2016/17. As the volume of gas declines over time with gas yields decreasing as expected by c.5-7% p.a over the long term, annual fluctuations will arise as sites close. The actual generation is below the capacity, giving rise to the alternative generation opportunities. In 2016/17 the landfill gas power generation output was down to 509 gigawatt hours (GWh) (2015/16 562 GWh).

Average revenue per Megawatt hour (MWh) was 3.9% lower at £87.16 (2015/16 £90.72) reflecting the lower market prices. The switch from legacy Non Fossil Fuel Obligation (NFFO) contracts to ROCs has been completed with all energy now sold under the higher value ROCs. Average operating costs decreased slightly to £33.02 per MWh (2015/16 £34.76).

[28] Excluding Avonmouth

***Landfill sites being managed for cash and alternative use***

Viridor continues its strategy of delivering cash flow from landfill sites and we anticipate the continued reduction of operational landfill capacity through closing or mothballing uneconomic sites. However, we believe that there will be an ongoing requirement for some landfill capacity for waste which cannot be recycled and is unsuitable for sending to ERFs.  Therefore, careful consideration is being given to selecting such suitable sites. Viridor closed four sites during the year, bringing the total number of operational sites to eleven, as part of a planned move to a forecasted retention of a handful of strategic sites by 2020.

While sites are being wound down to closure and aftercare, our emphasis is on reducing costs and we continue to review our approach, optimising the profile to closure as the market for waste arising for this area moves.

The landfill business continues to be cash generative. Viridor's average gate fees increased by 1.5% to £20.44 per tonne in 2016/17 (2015/16 £20.14 per tonne). Consented landfill capacity reduced from 47.4 million cubic metres (mcm) to 42.0 mcm, reflecting usage and site closures during the period. As previously provided for, c.31 mcm of Viridor's consented landfill capacity is not expected to be used.

Landfill tax continues to increase in line with inflation and rose to £86.10 per tonne on 1 April 2017.

**Recycling 'self-help' increasing EBITDA**

Whilst recycling volumes traded have reduced marginally from last year at 1.6 million tonnes (2015/16 1.8 million tonnes), revenue has increased by £5 per tonne.

Overall the basket of recyclate prices has been stable with a benefit in paper prices partially offset by other commodity fluctuations.

During the year we have focused on 'self-help' optimisation measures which have driven improved margins, in addition to an intensified focus on input quality including contract renegotiation where required. Viridor has continued to drive cost improvements from further organisational simplification, cost and overhead reduction, with operating costs reducing by £2 per tonne offset by a £1 per tonne increase in shipping costs which are reflected in sales prices. Further work is ongoing to improve asset utilisation and rationalise sites.

Overall margins have increased by £6 per tonne.

In line with our strategy of achieving a balanced risk profile we continue to work with stakeholders where we can share commodity risk and opportunity. There are further opportunities for risk sharing arrangements as contracts expire and are renegotiated.

With the most extensive Material Recycling Facility (MRF) capacity in the UK, focused on resource quality, established markets across the UK, Europe and Asia (including China), where it holds accreditations for export and continued regulatory and societal drivers, Viridor's outlook remains stable.

**Contracts and Collections securing waste inputs and ERF fuel**

Performance across our major local authority contracts around the UK (the more significant contracts include Greater Manchester, Glasgow, Lancashire, Somerset and West Sussex) and the Thames Water contract remains broadly in line with last year.

We have begun operating our 25-year contracted service for Tomorrow's Valley in Wales (where four local authorities have come together to create a £190 million residual waste contract for 90,000 tonnes per annum) securing fuel for Trident Park (Cardiff) ERF.

The performance of the collection business reflects the continued importance of the business in securing increased input tonnages for the business.

**Greater Manchester PFI**

As reported in Pennon's Trading Statement on 9 February 2017, the Greater Manchester Waste Disposal Authority (GMWDA) continues to face financial challenges and GMWDA has now confirmed it is seeking an exit and re-negotiation of the Recycling & Waste Management Private Finance Initiative (PFI) Contract. The contract with Viridor Laing (Greater Manchester) Limited was the UK's largest waste and energy project entered into in 2009.

Diversion of waste from landfill remains ahead of contractual commitments and Viridor and its partners are keen to ensure this progress is able to continue. Viridor and its joint venture partner John Laing have been actively engaging with GMWDA as they consider their options.

There are provisions in the PFI Contract for compensation to be paid to Viridor and John Laing on termination.

**Joint Ventures**

The joint venture at Lakeside ERF (a 50/50 joint venture with Grundon Waste Management) is in its seventh year of operation and continues to outperform its original power generation and waste processing targets.

**Good operational and financial performance in Water**

We are focused on providing water and wastewater services in the most efficient and sustainable way possible. Innovation, new technologies, and the pioneering of a holistic approach to water and wastewater management are playing a key role in delivering service improvements and long-term value.

**Outperforming our Final Determination Return on Regulated Equity (RORE) range**

South West Water has continued to deliver sector-leading outperformance and has confidence in its ability to deliver outperformance throughout the 2015-20 (K6) regulatory period. As a result of our targeted approach to efficiency South West Water has delivered Return on Regulated Equity (RORE)[29] of 12.6% (11.7% for 2015/16). Of the 12.6%, 6.0% is the base return, 3.2%[30] reflects Totex savings and efficiencies, 0.3% reflects a net reward on Outcome Delivery Incentives (ODIs) and 3.1%[31] reflects the difference between actual and assumed financing costs using a cumulative forecast RPI over K6 and is consistent with the approach adopted for calculating our innovative WaterShare mechanism.

During the year Ofwat issued additional guidance to companies which requires financing outperformance to be calculated using an in-year average RPI rate[32]. This approach reflects a financing outperformance of 2.4% and a total RORE of 11.9% for 2016/17 (2015/16 1.4% and 10.1% respectively). South West Water's RORE would remain sector-leading and by the end of K6 period overall performance will converge.

*Totex - securing outperformance*

South West Water is striving for ever greater efficiency and is confident in maintaining the momentum achieved in K6 to date with £129 million of cumulative Totex savings to 2016/17 (£73m delivered in the year) compared to the Final Determination allowances. These savings are being driven by:

- continuing advantages from our strategic alliances including a new water distribution framework and the $H_5O$ capital alliance in place since 2010, now delivering efficient schemes within the Bournemouth region
- ensuring efficient capital investment through the use of data analytics optimising the capital and operating solution and promoting efficient off-site build techniques

[29] RORE reflects Base RORE plus Outperformance. It is calculated using actual results before non-underlying items (deflated into 2012/13 prices) and compared against the Final Determination allowances and based on notional gearing, annual average RCV and reflecting the value of tax impacts at the actual annual effective tax rate for the year

[30] Includes integration synergies already delivered. Phasing of actual expenditure compared to the planned programme has been reflected. Outperformance includes a reduction in the RCV run-off for the RCV element of Totex outperformance calculated based on the Final Determination PAYG. Tax impacts reflect actual effective tax rates

[31] Interest outperformance is based on the outturn effective interest rate on net debt, translated into an effective real interest rate using cumulative K6 forecast RPI of 2.8%, notional debt gearing of 62.5%, and actual effective tax rates

[32] Average RPI of 2.1% for 2016/17 and 1.1% for 2015/16

- changing ways of working through our iOps programme including utilising new technology and equipment to increase the resources needed to deliver wastewater improvement, real-time pressure management targeting efficient interventions

- delivering Bournemouth Water synergies with c.£27 million of synergies targeted over K6 and further support function efficiencies.

*Delivering net ODI reward*

South West Water has 23 ODIs and Bournemouth Water 10 ODIs, including SIM, which have potential financial rewards or penalties. Incentives for performance are recognised in the year of delivery, whether the measure is recovered in period or as a regulatory true-up at the end of the period. Operational performance for the year has continued to improve and performance for the year results in the delivery of a net ODI reward of £3.6 million (£5.5 million cumulatively) reflecting RORE outperformance of 0.3% for the year. Good asset reliability with stable serviceability across all water and wastewater areas has been maintained. Rewards were delivered across bathing water quality, water restrictions with interruptions to supply and leakage showing a significant improvement from the 2015/16 position.

The cumulative net reward of £5.5 million comprises £7.5 million of net rewards recognised at the end of the regulatory period and £2.0 million of net penalty which could be adjusted during the regulatory period.

Whilst penalties have arisen on pollution events and external flooding ODIs wastewater continues to be an area of focus and performance to date has improved from last year.

*Financing investment efficiently*

Alongside strong operational outperformance, South West Water is confident that the efficient and effective financing strategy in place will continue to deliver cumulative K6 financing outperformance, with £67 million delivered in the K6 period to 31 March 2017. The effective interest rate in South West Water has remained broadly stable in the year with continued focus on maintaining efficient gearing levels, having a good balance of fixed and floating rate debt and continuing to implement cost efficient debt through finance leasing.

**Drinking water quality expected to be in upper quartile**

Drinking water quality remains a top priority for South West Water and we continue to maintain the high standards at 99.96% across the South West Water region and 99.98% in Bournemouth.

South West Water leakage has reduced to 82 megalitres per day resulting in an ODI reward. Investment in real-time pressure management and additional network monitoring has again ensured South West Water has met or exceeded its leakage target every year since inception.

Despite the significant increase in customer demand, water resources in the South West region remained unrestricted for a twentieth consecutive year and the Bournemouth water region maintained its position of having no water restrictions since privatisation.

The average duration of supply interruptions per property for South West Water has reduced significantly compared to 2015/16 and results in a small reward for the year (compared to the penalty incurred in 2015/16). Where an interruption does occur we aim to restore supplies as quickly as possible and keep customers informed of progress. In the Bournemouth region we are outperforming our target and have delivered improvements this year.

*Significant investment in drinking water*

Customers regard a clean and safe supply of drinking water as their top service priority and therefore maintaining water resources and reducing supply interruptions are essential to meeting customer expectations. Key areas of investment and activity during 2016/17 included:

- ongoing expenditure for a new £60 million state-of-the-art North Plymouth water treatment works
- improved water treatment processes with investment in Granular Activated Carbon (GAC) filters being installed at three water treatment works across the region
- real-time pressure management and network modelling technology targeting interventions efficiently
- continued investment in the 'Upstream Thinking' programme of catchment management working in partnership with a range of stakeholder groups including wildlife trusts and river authorities.

*SIM continuing to improve*

South West Water's overall customer satisfaction is broadly in line with the prior year at 89% with value for money satisfaction at an all time high for the second quarter of the year.

A key indicator of customer service performance for the water business is the service incentive mechanism (SIM), which Ofwat uses to compare the performance of water companies. The SIM score is calculated against a qualitative element (based on a customer survey) and a quantitative element that takes into account, among other things, the number of complaints received in writing or by phone. South West Water's SIM score for 2016/17 at 81.6 is our best yet and continues the improving trend of recent years. Bournemouth Water's SIM score at 86.3 remains at the frontier as one of the best in the industry for 2015/16 and is maintaining this trend for 2016/17.

Supporting this delivery is a c.30% reduction in written complaints across both the South West Water and Bournemouth Water regions. In addition the customer experience quality scores for the year have also improved across both regions. We are continuing to focus on delivering improvement in the customer experience through faster resolution of issues and lower call waiting times.

South West Water is also focused on providing support for customers and a new employee training and development programme has been implemented extending the support specifically for vulnerable customers. In addition, to further support those customers with affordability issues, a social tariff has been rolled out in the Bournemouth region for 2017/18.

**Wastewater improvements**

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

South West Water continues to focus on a targeted programme of wastewater treatment improvements while also working to prevent potential failure through increased monitoring. The targeted investment in high risk sites and change in operational approach has resulted in a significant improvement in numeric compliance (the percentage of wastewater treatment works deemed compliant) with current performance at 98.4% compared to the 95.8% in the previous year.

Whilst the number of significant pollution incidents (Category 1-2) continues to fall, disappointingly the number of minor incidents increased resulting in a penalty for the ODI this year. Improving performance in this area remains our top priority in the wastewater area.

Key areas of wastewater investment and activity during 2016/17 included:

- process improvements and upgrades at four key sites including increasing filters and additional treatments
- investing in supply demand schemes increasing capacity at our wastewater treatment works, specifically at Fluxton in Devon and Hayle in Cornwall
- improvements in the sewerage network reducing the impact of saline infiltration
- investment to improve bathing waters in Plymouth began during the year.

*Bathing water improvement, despite tougher EU standard*

Our legacy of major investment to protect bathing waters continues to be reflected in extremely positive results for the 2016 bathing water season, which was assessed under tougher new EU standards. Of the 143 bathing waters tested in the South West Water region, 141 (98.6%) were classified ‘sufficient’ or better, with more than 81% classified as ‘excellent’. Of the two bathing waters rated as ‘poor’ these were not attributed to any failure of South West Water’s assets.

*Targeting investment to reduce sewer flooding*

Whilst the number of external flooding incidents has reduced by c.5% from last year, a penalty is still expected to be incurred. South West Water continues to invest in improvement schemes, ongoing capital maintenance, and we are working to improve our response times to flooding incidents. In addition to the significant schemes completed last year at three key catchments, further investments in flooding improvements continued in 2016/17 across a number of smaller areas including St Columb in Cornwall.

Furthermore South West Water has also invested over £1 million supporting the Exeter Flood Defence Scheme at our Countess Wear wastewater treatment works.

## Board matters

Ian McAulay stepped down as the Chief Executive Officer of Viridor during the year and we thank him for his contribution and wish him well for the future. Phil Piddington was appointed to the new role of Managing Director of Viridor in September 2016. The change in management team and structure at Viridor, which mirrors the arrangements in place at South West Water, better reflects the objectives of the Group and will drive stronger accountability. Moreover, the appointment of Phil Piddington demonstrates that the Group is adding new skills and executing succession planning well.

Chris Loughlin
Group Chief Executive Officer
23 May 2017

Pennon

# Financial Timetable

**(YEAR ENDED 31 MARCH 2017 AND UPCOMING EVENTS)**

| | |
|---|---|
| 24 May 2017 | Full Year Results 2016/17 |
| Early June 2017 | Annual Report & Accounts published |
| 6 July 2017 | Annual General Meeting |
| 6 July 2017* | Ordinary shares quoted ex-dividend |
| 7 July 2017* | Record date for final dividend |
| 14 August 2017* | Scrip election date for final dividend |
| 1 September 2017* | Final cash dividend paid and Scrip shares issued |
| 25 September 2017 | Trading Statement |
| 29 November 2017 | Half Year Results 2017/18 |
| 26 March 2018 | Trading Statement |
| 25 May 2018 | Full Year Results 2017/18 |

* These dates are provisional and, in the case of the final dividend subject to obtaining shareholder approval at the 2017 Annual General Meeting.

## CAUTIONARY STATEMENT IN RESPECT OF FORWARD-LOOKING STATEMENTS

This Report contains forward-looking statements relating to the Pennon Group's operations, performance and financial position based on current expectations of, and assumptions and forecasts made by, Pennon Group management which may constitute “forward-looking statements” within the meaning of the U.S. Private Securities Litigation Reform Act of 1995. Forward-looking statements are identified in this Report by words such as "anticipate", "aim", "believe", "continue", "could", "due", "estimate", "expect", "forecast", "goal", "intend", "may", “outlook”, "plan", “probably”, "project", “remain”, "seek", "should", "target", "will", “would” and related and similar expressions, as well as statements in the future tense. All statements other than of historical fact may be forward-looking statements and represent the Group's belief regarding future events, many of which, by their nature, are inherently uncertain and outside the Group's control. Various known and unknown risks, uncertainties and other factors could lead to substantial differences between the actual future results, financial situation development or performance of the Group and the estimates and historical results given herein. Important risks, uncertainties and other factors that could cause actual results, performance or achievements of Pennon Group to differ materially from any outcomes or results expressed or implied by such forward-looking statements include, among other things, compliance with law, regulation or decisions by Government and regulators, including water industry reform; maintaining sufficient finance and funding to meet ongoing commitments; non-compliance or occurrence of avoidable Health and Safety incidents; uncertainty arising from open tax computations where liabilities remain to be agreed; non-recovery of customer debt; poor operating performance due to extreme weather and climate change; macro-economic risks arising from the Global and UK economic downturn impacting commodity and power prices; poor customer service/increased competition leading to loss of customer base; business interruption or significant operational failures/incidents; talent management and succession planning in place to meet business requirements; failure or increased cost of capital projects/exposure to contract failures and information technology systems, management and protection including cyber risks. These risks will be described in greater detail in the Pennon Group Annual Report published at the beginning of June 2017. Such forward looking statements should therefore be construed in light of such risks, uncertainties and other factors and undue reliance should not be placed on them. Nothing in this report should be construed as a profit forecast.

Any forward-looking statements are made only as of the date of this document and no representation, assurance, guarantee or warranty is given in relation to them including as to their accuracy, completeness, or the basis on which they are made. The Group accepts no obligation to revise or update publicly these forward-looking statements or adjust them as a result of new information or for future events or developments, except to the extent legally required.

## UNSOLICITED COMMUNICATIONS WITH SHAREHOLDERS

A number of companies, including Pennon Group plc, continue to be aware that their shareholders have received unsolicited telephone calls or correspondence concerning investment matters which imply a connection to the company concerned. If shareholders have any concerns about any contact they have received then please refer to the Financial Conduct Authority's website www.fca.org.uk/scamsmart. Details of any share dealing facilities that the Company endorses will be included in Company mailings.

**PENNON GROUP PLC**

## Consolidated income statement for the year ended 31 March 2017

| | Notes | Before non-underlying items 2017 £m | Non-underlying items (note 5) 2017 £m | Total 2017 £m | Before non-underlying items 2016 £m | Non-underlying items (note 5) 2016 £m | Total 2016 £m |
|---|---|---|---|---|---|---|---|
| **Revenue** | 4 | **1,353.1** | **-** | **1,353.1** | 1,352.3 | - | 1,352.3 |
| **Operating costs** | | | | | | | |
| Employment costs | | **(179.7)** | **(1.1)** | **(180.8)** | (180.0) | (8.6) | (188.6) |
| Raw materials and consumables used | | **(115.8)** | **-** | **(115.8)** | (114.7) | - | (114.7) |
| Other operating expenses | | **(571.6)** | **(9.6)** | **(581.2)** | (609.2) | (1.6) | (610.8) |
| **Earnings before interest, tax, depreciation and amortisation** | 4 | **486.0** | **(10.7)** | **475.3** | 448.4 | (10.2) | 438.2 |
| Depreciation and amortisation | | **(181.4)** | **-** | **(181.4)** | (186.6) | - | (186.6) |
| **Operating profit** | 4 | **304.6** | **(10.7)** | **293.9** | 261.8 | (10.2) | 251.6 |
| Finance income | 6 | **36.3** | **16.0** | **52.3** | 42.1 | 5.2 | 47.3 |
| Finance costs | 6 | **(95.1)** | **(44.8)** | **(139.9)** | (96.2) | - | (96.2) |
| Net finance costs | 6 | **(58.8)** | **(28.8)** | **(87.6)** | (54.1) | 5.2 | (48.9) |
| Share of post-tax profit from joint ventures | | **4.2** | **-** | **4.2** | 3.6 | - | 3.6 |
| **Profit before tax** | 4 | **250.0** | **(39.5)** | **210.5** | 211.3 | (5.0) | 206.3 |
| Taxation | 7 | **(58.4)** | **28.4** | **(30.0)** | (72.1) | 34.1 | (38.0) |
| **Profit for the year** | | **191.6** | **(11.1)** | **180.5** | 139.2 | 29.1 | 168.3 |
| **Attributable to:** | | | | | | | |
| Ordinary shareholders of the parent | | **175.4** | **(11.1)** | **164.3** | 123.0 | 29.1 | 152.1 |
| Perpetual capital security holders | | **16.2** | **-** | **16.2** | 16.2 | - | 16.2 |
| **Earnings per ordinary share** (pence per share) | 8 | | | | | | |
| - Basic | | | | **39.8** | | | 37.0 |
| - Diluted | | | | **39.6** | | | 36.9 |

**PENNON GROUP PLC**

**Consolidated statement of comprehensive income for the year ended 31 March 2017**

| | **Before non-underlying items 2017 £m** | **Non-underlying items (note 5) 2017 £m** | **Total 2017 £m** | Before non-underlying items 2016 £m | Non-underlying items (note 5) 2016 £m | Total 2016 £m |
|---|---|---|---|---|---|---|
| **Profit for the year** | **191.6** | **(11.1)** | **180.5** | 139.2 | 29.1 | 168.3 |
| **Other comprehensive (loss) / income** | | | | | | |
| *Items that will not be reclassified to profit or loss* | | | | | | |
| Remeasurement of defined benefit obligations | **(23.6)** | **-** | **(23.6)** | (2.6) | - | (2.6) |
| Income tax on items that will not be reclassified | **4.7** | **(1.4)** | **3.3** | 0.6 | (3.0) | (2.4) |
| Total items that will not be reclassified to profit or loss | **(18.9)** | **(1.4)** | **(20.3)** | (2.0) | (3.0) | (5.0) |
| *Items that may be reclassified subsequently to profit or loss* | | | | | | |
| Share of other comprehensive income from joint ventures | **0.3** | **-** | **0.3** | 2.4 | - | 2.4 |
| Cash flow hedges | **4.9** | **-** | **4.9** | 5.0 | - | 5.0 |
| Income tax on items that may be reclassified | **(1.0)** | **(0.3)** | **(1.3)** | (1.0) | (0.8) | (1.8) |
| Total items that may be reclassified subsequently to profit or loss | **4.2** | **(0.3)** | **3.9** | 6.4 | (0.8) | 5.6 |
| **Other comprehensive (loss) / income for the year net of tax** | **(14.7)** | **(1.7)** | **(16.4)** | 4.4 | (3.8) | 0.6 |
| **Total comprehensive income for the year** | **176.9** | **(12.8)** | **164.1** | 143.6 | 25.3 | 168.9 |
| Total comprehensive income attributable to: | | | | | | |
| Ordinary shareholders of the parent | **160.7** | **(12.8)** | **147.9** | 127.4 | 25.3 | 152.7 |
| Perpetual capital security holders | **16.2** | **-** | **16.2** | 16.2 | - | 16.2 |

**PENNON GROUP PLC**

**Consolidated balance sheet at 31 March 2017**

| | Notes | 2017 £m | 2016 £m |
|---|---|---|---|
| **ASSETS** | | | |
| **Non-current assets** | | | |
| Goodwill | | **385.0** | 385.0 |
| Other intangible assets | | **67.1** | 63.8 |
| Property, plant and equipment | | **4,103.2** | 3,897.3 |
| Other non-current assets | | **308.0** | 267.8 |
| Derivative financial instruments | | **73.6** | 62.7 |
| Investments in joint ventures | | **0.1** | 0.1 |
| | | **4,937.0** | 4,676.7 |
| **Current assets** | | | |
| Inventories | | **21.3** | 20.6 |
| Trade and other receivables | | **340.8** | 323.5 |
| Derivative financial instruments | | **14.1** | 9.5 |
| Cash and cash deposits | 13 | **598.1** | 632.2 |
| | | **974.3** | 985.8 |
| **LIABILITIES** | | | |
| **Current liabilities** | | | |
| Borrowings | 13 | **(146.5)** | (65.0) |
| Financial liabilities at fair value through profit | | **(2.4)** | (2.2) |
| Derivative financial instruments | | **(17.3)** | (17.4) |
| Trade and other payables | | **(286.5)** | (264.6) |
| Current tax liabilities | | **(26.8)** | (37.1) |
| Provisions | | **(40.4)** | (50.4) |
| | | **(519.9)** | (436.7) |
| **Net current assets** | | **454.4** | 549.1 |
| **Non-current liabilities** | | | |
| Borrowings | 13 | **(3,116.5)** | (3,051.6) |
| Other non-current liabilities | | **(180.7)** | (113.2) |
| Financial liabilities at fair value through profit | | **(48.4)** | (51.0) |
| Derivative financial instruments | | **(25.2)** | (38.5) |
| Retirement benefit obligations | | **(68.0)** | (40.9) |
| Deferred tax liabilities | | **(269.6)** | (272.0) |
| Provisions | | **(173.8)** | (171.0) |
| | | **(3,882.2)** | (3,738.2) |
| **Net assets** | | **1,509.2** | 1,487.6 |
| **Shareholders' Equity** | | | |
| Share capital | 10 | **168.4** | 167.8 |
| Share premium account | | **217.4** | 213.3 |
| Capital redemption reserve | | **144.2** | 144.2 |
| Retained earnings and other reserves | | **684.4** | 667.5 |
| **Total shareholders' equity** | | **1,214.4** | 1,192.8 |
| Perpetual capital securities | 11 | **294.8** | 294.8 |
| **Total equity** | | **1,509.2** | 1,487.6 |

PENNON GROUP PLC

**Consolidated statement of changes in equity for the year ended 31 March 2017**

| | Share capital (note 10) £m | Share premium account £m | Capital redemption reserve £m | Retained earnings and other reserves £m | Perpetual capital securities (note 11) £m | Total Equity £m |
|---|---|---|---|---|---|---|
| At 1 April 2015 | 162.4 | 118.6 | 144.2 | 634.1 | 294.8 | 1,354.1 |
| Profit for the year | - | - | - | 152.1 | 16.2 | 168.3 |
| Other comprehensive income for the year | - | - | - | 0.6 | - | 0.6 |
| Total comprehensive income for the year | - | - | - | 152.7 | 16.2 | 168.9 |
| *Transactions with equity shareholders:* | | | | | | |
| Dividends paid | - | - | - | (129.5) | - | (129.5) |
| Adjustment for shares issued under the Scrip Dividend Alternative | 0.3 | (0.3) | - | 6.3 | - | 6.3 |
| Equity issuance | 4.9 | 95.4 | - | - | - | 100.3 |
| Equity issuance related costs | - | (2.3) | - | - | - | (2.3) |
| Adjustment in respect of share-based payments (net of tax) | - | - | - | 2.5 | - | 2.5 |
| Distributions due to perpetual capital security holders | - | - | - | - | (20.3) | (20.3) |
| Current tax relief on distributions to perpetual capital security holders | - | - | - | - | 4.1 | 4.1 |
| Own shares acquired by the Pennon Employee Share Trust in respect of share options granted | - | - | - | (1.1) | - | (1.1) |
| Proceeds from treasury shares re-issued | - | - | - | 2.5 | - | 2.5 |
| Proceeds from shares issued under the Sharesave Scheme | 0.2 | 1.9 | - | - | - | 2.1 |
| | 5.4 | 94.7 | - | (119.3) | (16.2) | (35.4) |
| At 31 March 2016 | 167.8 | 213.3 | 144.2 | 667.5 | 294.8 | 1,487.6 |
| Profit for the year | - | - | - | 164.3 | 16.2 | 180.5 |
| Other comprehensive loss for the year | - | - | - | (16.4) | - | (16.4) |
| Total comprehensive income for the year | - | - | - | 147.9 | 16.2 | 164.1 |
| *Transactions with equity shareholders:* | | | | | | |
| Dividends paid | - | - | - | (138.5) | - | (138.5) |
| Adjustment for shares issued under the Scrip Dividend Alternative | 0.3 | (0.3) | - | 6.9 | - | 6.9 |
| Adjustment in respect of share-based payments (net of tax) | - | - | - | 3.2 | - | 3.2 |
| Distributions due to perpetual capital security holders | - | - | - | - | (20.3) | (20.3) |
| Current tax relief on distributions to perpetual capital security holders | - | - | - | - | 4.1 | 4.1 |
| Own shares acquired by the Pennon Employee Share Trust in respect of share options granted | 0.1 | 1.2 | - | (2.6) | - | (1.3) |
| Proceeds from shares issued under the Executive Share Option Scheme | - | 0.2 | - | - | - | 0.2 |
| Proceeds from shares issued under the Sharesave Scheme | 0.2 | 3.0 | - | - | - | 3.2 |
| | 0.6 | 4.1 | - | (131.0) | (16.2) | (142.5) |
| **At 31 March 2017** | **168.4** | **217.4** | **144.2** | **684.4** | **294.8** | **1,509.2** |

PENNON GROUP PLC

## Consolidated statement of cash flows for the year ended 31 March 2017

| | Notes | 2017 £m | 2016 £m |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Cash generated from operations | 12 | **431.5** | 371.3 |
| Interest paid | | **(76.4)** | (79.1) |
| Tax paid | | **(36.4)** | (45.0) |
| Net cash generated from operating activities | | **318.7** | 247.2 |
| **Cash flows from investing activities** | | | |
| Interest received | | **14.5** | 14.9 |
| Loan repayments received from joint ventures | | **0.3** | 27.5 |
| Dividends received from joint ventures | | **4.5** | 6.0 |
| Acquisitions, net of cash acquired | | **-** | (91.0) |
| Purchase of property, plant and equipment | | **(354.1)** | (283.7) |
| Proceeds from sale of property, plant and equipment | | **4.1** | 6.8 |
| Net cash used in investing activities | | **(330.7)** | (319.5) |
| **Cash flows from financing activities** | | | |
| Proceeds from treasury shares re-issued | 10 | **-** | 2.5 |
| Proceeds from issuance of ordinary shares | | **4.7** | 100.1 |
| Return/ (deposit) of restricted funds | | **2.7** | (30.3) |
| Purchase of ordinary shares by the Pennon Employee Share Trust | | **(2.6)** | (1.1) |
| Proceeds from new borrowing | | **130.0** | 80.0 |
| Repayment of borrowings | | **(39.0)** | (96.5) |
| Finance lease sale and leaseback | | **60.7** | 30.4 |
| Finance lease principal repayments | | **(24.0)** | (38.4) |
| Dividends paid | | **(131.6)** | (123.2) |
| Perpetual capital securities periodic return | | **(20.3)** | (20.3) |
| Net cash used in financing activities | | **(19.4)** | (96.8) |
| **Net decrease in cash and cash equivalents** | | **(31.4)** | (169.1) |
| Cash and cash equivalents at beginning of year | 13 | **405.7** | 574.8 |
| **Cash and cash equivalents at end of year** | 13 | **374.3** | 405.7 |

PENNON GROUP PLC

**Notes**

1. **General information**

Pennon Group plc is a company registered in the United Kingdom under the Companies Act 2006. The address of the registered office is given on page 48. During 2016/17 Pennon Group's business was operated through two main subsidiaries. South West Water Limited includes the merged water companies of South West Water and Bournemouth Water, providing water and wastewater services in Devon, Cornwall and parts of Dorset and Somerset and water only services in parts of Dorset, Hampshire and Wiltshire. Viridor Limited's business is recycling, energy recovery and waste management.

The financial information for the years ended 31 March 2017 and 31 March 2016 does not constitute statutory accounts within the meaning of section 434 of the Companies Act 2006. The Annual Report and Accounts for the year ended 31 March 2017, including the financial statements from which this financial information is derived, will be delivered to the Registrar of Companies following the Company's Annual General Meeting on 6 July 2017. The auditor's report on the 2017 financial statements was unqualified and did not contain a statement under section 498 of the Companies Act 2006.

The full financial statements for the year ended 31 March 2016 were approved by the Board of Directors on 24 May 2016 and have been delivered to the Registrar of Companies. The independent auditor's report on those financial statements was unqualified and did not contain a statement under section 498 of the Companies Act 2006. This final results announcement and the results for the year ended 31 March 2017 were approved by the Board of Directors on 23 May 2017.

2. **Basis of preparation**

The financial information in this announcement has been prepared on the historical cost accounting basis (except for fair value items as set out in the 2016 Annual Report and Accounts) and in accordance with International Financial Reporting Standards (IFRS) and interpretations of the IFRS Interpretations Committee as adopted by the European Union, and with those parts of the Companies Act 2006 applicable to companies reporting under IFRS. The accounting policies adopted are consistent with those followed in the preparation of the Group's 2017 Annual Report and Accounts which have not changed significantly from those adopted in the Group's 2016 Annual Report and Accounts (which are available on the Company website www.pennon-group.co.uk), except as described in note 3.

3. **Accounting policies**

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

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

  The Directors anticipate that the adoption of IFRS 16 on 1 April 2019 will affect primarily the accounting for the Group's operating leases. As at the reporting date, the group has non-cancellable operating lease commitments of £143m. The Group is assessing these commitments which will result in the recognition of an asset and a liability for future payments and how this will affect the Group's profit and classification of cash flows. Existing borrowing covenants are not impacted by changes in accounting standards.

Other new standards or interpretations in issue, but not yet effective, including IFRS 15 'Revenue from contracts with customers' and IFRS 9 'Financial instruments' are not expected to have a material impact on the Group's net assets or results.

PENNON GROUP PLC

**Notes (continued)**

4. **Segmental information**

Operating segments are reported in a manner consistent with internal reporting provided to the Chief Operating Decision-Maker, which has been identified as the Pennon Group plc Board.

The water business comprises the regulated water and wastewater services undertaken by South West Water. The waste management business is the recycling, energy recovery and waste management services provided by Viridor.

| | **2017** | 2016 |
|---|---|---|
| | **£m** | £m |
| **Revenue** | | |
| Water | **561.0** | 547.0 |
| Waste management | **793.5** | 806.2 |
| Other | **12.8** | 12.0 |
| Less intra-segment trading * | **(14.2)** | (12.9) |
| | **1,353.1** | 1,352.3 |
| **Segment result** | | |
| **Operating profit before depreciation, amortisation and non-underlying items (EBITDA)** | | |
| Water | **349.1** | 335.2 |
| Waste management | **138.3** | 116.5 |
| Other | **(1.4)** | (3.3) |
| | **486.0** | 448.4 |
| **Operating profit before non-underlying items** | | |
| Water | **235.4** | 224.5 |
| Waste management | **71.1** | 40.9 |
| Other | **(1.9)** | (3.6) |
| | **304.6** | 261.8 |
| **Profit before tax and non-underlying items** | | |
| Water | **173.9** | 165.7 |
| Waste management | **60.4** | 30.7 |
| Other | **15.7** | 14.9 |
| | **250.0** | 211.3 |
| **Profit before tax** | | |
| Water | **187.4** | 160.5 |
| Waste management | **50.2** | 25.7 |
| Other | **(27.1)** | 20.1 |
| | **210.5** | 206.3 |

* Intra-segment trading between and to different segments is under normal market based commercial terms and conditions. Intra-segment revenue of the other segment is at cost.

**Geographic analysis of revenue based on location of customers**

| | **2017** | 2016 |
|---|---|---|
| | **£m** | £m |
| UK | **1,287.6** | 1,296.1 |
| Rest of European Union | **10.3** | 10.5 |
| China | **45.1** | 38.8 |
| Rest of World | **10.1** | 6.9 |
| | **1,353.1** | 1,352.3 |

The UK is the Group's country of domicile and generates the majority of its revenue from external customers in the UK. The Group's non-current assets are all located in the UK.

## 5. Non-underlying items

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

| | **2017** **£m** | 2016 £m |
|---|---|---|
| **Operating costs** | | |
| Restructuring costs (a) | **(10.7)** | (10.2) |
| **Total operating costs** | **(10.7)** | (10.2) |
| Remeasurement of fair value movement in derivatives (b) | **16.0** | 5.2 |
| Unwind of synthetic derivative (c) | **(44.8)** | - |
| Deferred tax change in rate (d) | **21.3** | 33.1 |
| Tax credit arising on non-underlying items | **7.1** | 1.0 |
| **Net non-underlying (charge) / credit** | **(11.1)** | 29.1 |

(a) During the year a one-off charge of £10.7m was made relating to restructuring costs associated with the Group-wide Shared Services Review. The £10.7m charge consists of a £9.5m non-cash charge to other operating expenses relating to a rationalisation of systems leading to an asset de-recognition, and a £1.1m charge to manpower costs and a £0.1m charge to other operating costs in relation to restructuring provisions. The charge is considered non-underlying due to its size and non-recurring nature.

Last year a one-off charge of £10.2m was made to the restructuring provision reflecting announced reorganisations across the Group.

(b) In the year a credit of £16.0m was recognised relating to non-cash derivative fair value movements associated with derivatives that are not designated as being party to an accounting hedge relationship. These movements are non-underlying due to the nature of the item being market dependant and potentially can be significant in value (size).

(c) Since 2011 the Group has received a fixed interest rate on a £200m financial asset and paid an index-linked interest rate on a £200m loan, designed to improve the Group's overall interest rate performance. The counterparty to both instruments was Peninsula MB Limited (PMB). In combination, these instruments were accounted for as a derivative, with a net interest income of £8m p.a. cash settled (c.£7m in 2016/17).

In periods of index underperformance, losses arose in PMB which were group relieved with the Group. Following a change in legislation, which saw the value of the derivative to the Group moving from a liability of £4m to a liability of c.£40m, the Group made the decision to exit the transaction.

On 10 February 2017 the Company unwound this transaction. The derivative had been due to end in 2027, however, following a change in the economic benefit of this derivative due to a change in legislation which impacted the derivative's future cash flows, the Company exercised its option to unwind the transaction early.

The process for unwinding the derivative resulted in the Group acquiring a financial asset for £283m and a financial liability for £239m from Nomura Structured Holdings plc. The counterparty to both these transactions was PMB. Simultaneously, the Company also acquired the remaining 25% of PMB's share capital from Nomura Structured Holdings plc, for a consideration of £36,000, with all PMB's liabilities being due to the Company from that point. The Company has since settled these liabilities through intercompany transactions with PMB. PMB has ceased all operating activities and will be liquidated in due course. The net consideration due to Nomura Structured Holdings plc in respect of these transactions is £44m with an agreed payment date of June 2018. The impact for the Group is a net cost of £35m post tax.

5. **Non-underlying items (continued)**

PMB is a private limited company, incorporated in England and Wales on 5 December 2011 as a subsidiary of Nomura Structured Holdings plc, part of the 'Nomura Group'. Prior to the transaction on 10 February 2017, PMB's share capital was 75% owned by the Company and 25% owned by Nomura Structured Holdings plc, who had control of PMB for accounting purposes.

The group relief claimed by the Group has been treated as an uncertain tax item and has been substantially provided for over recent years. Following the conclusion of discussions with HMRC, no further amounts are required to be recognised by the Group. A tax credit of £8m relates to the overall cost to unwind this derivative transaction.

Post the unwind of the transaction the Group's interest will no longer include the finance income of c.£8m p.a. (c.£7m in 2016/17) and the underlying tax charge will reduce by a similar amount.

The liability recognised is non-underlying by its size and nature.

(d) Following the enactment during the year the rate of corporation tax reduced from 18% to 17% from April 2020, resulting in a one-off credit of £21.3m being recognised in the income statement. In addition a charge of £1.7m has been recognised in the statement of comprehensive income and a credit of £0.1m was recognised directly in equity.

Last year the rate of corporation tax reduced from 20% to 19% from April 2017, reducing further to 18% from April 2020, resulting in a one-off credit of £33.1m recognised in the income statement. In addition, a charge of £3.8m was recognised in the statement of comprehensive income and a charge of £0.1m was recognised directly in equity.

These movements are non-underlying as are dependent on changes in UK tax law and are non-underlying due to their size.

## 6. Net finance costs

| | **2017** | | | 2016 | | |
|---|---|---|---|---|---|---|
| | **Finance cost £m** | **Finance income £m** | **Total £m** | Finance cost £m | Finance income £m | Total £m |
| **Cost of servicing debt** | | | | | | |
| Bank borrowings and overdrafts | **(49.4)** | **-** | **(49.4)** | (48.7) | - | (48.7) |
| Interest element of finance lease rentals | **(31.9)** | **-** | **(31.9)** | (33.5) | - | (33.5) |
| Other finance costs | **(3.5)** | **-** | **(3.5)** | (2.8) | - | (2.8) |
| Interest receivable | **-** | **3.2** | **3.2** | - | 6.3 | 6.3 |
| Interest receivable on shareholder loans to joint ventures | **-** | **10.2** | **10.2** | - | 10.7 | 10.7 |
| | **(84.8)** | **13.4** | **(71.4)** | (85.0) | 17.0 | (68.0) |
| **Notional interest** | | | | | | |
| Interest receivable on service concession arrangements | **-** | **16.1** | **16.1** | - | 16.7 | 16.7 |
| Retirement benefit obligations | **(1.2)** | **-** | **(1.2)** | (1.8) | - | (1.8) |
| Unwinding of discounts on provisions | **(9.1)** | **-** | **(9.1)** | (9.4) | - | (9.4) |
| | **(10.3)** | **16.1** | **5.8** | (11.2) | 16.7 | 5.5 |
| Net gains on derivative financial instruments arising from the combination of non-derivative instruments | **-** | **6.8** | **6.8** | - | 8.4 | 8.4 |
| **Net finance costs before non-underlying items** | **(95.1)** | **36.3** | **(58.8)** | (96.2) | 42.1 | (54.1) |
| **Non-underlying items (note 5)** | | | | | | |
| Fair value remeasurement of non-designated derivative financial instruments, providing commercial hedges | **-** | **16.0** | **16.0** | - | 5.2 | 5.2 |
| Unwind of synthetic derivative | **(44.8)** | **-** | **(44.8)** | - | - | - |
| **Net finance costs after non-underlying items** | **(139.9)** | **52.3** | **(87.6)** | (96.2) | 47.3 | (48.9) |

In addition to the above, finance costs of £12.9m (2016 £9.4m) have been capitalised on qualifying assets included in property, plant and equipment, and other intangible assets.

## 7. Taxation

| | Before non-underlying items 2017 £m | Non-underlying items (note 5) 2017 £m | Total 2017 £m | Before non-underlying items 2016 £m | Non-underlying items (note 5) 2016 £m | Total 2016 £m |
|---|---|---|---|---|---|---|
| **Analysis of charge** | | | | | | |
| Current tax charge | **39.5** | **(9.4)** | **30.1** | 32.9 | (1.7) | 31.2 |
| Deferred tax - other | **18.9** | **2.3** | **21.2** | 39.2 | 0.7 | 39.9 |
| Deferred tax – arising on change of rate of corporation tax | **-** | **(21.3)** | **(21.3)** | - | (33.1) | (33.1) |
| Tax charge for the year | **58.4** | **(28.4)** | **30.0** | 72.1 | (34.1) | 38.0 |

UK corporation tax is calculated at 20% (2016 20%) of the estimated assessable profit for the year.

The tax charge is stated after release of prior year current tax credits of £1.8m (2016 credit of £1.4m) and a prior year deferred tax charge of £1.1m (2016 charge of £15.9m).

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

The 2017 deferred tax credit includes a credit of £21.3m (2016 charge included a credit of £33.1m) reflecting a reduction in the rate of UK corporation tax.

**Notes (continued)**

8. **Earnings per share**

Basic earnings per share are calculated by dividing the earnings attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the year, excluding those held in the employee share trust which are treated as cancelled.

For diluted earnings per share, the weighted average number of ordinary shares in issue is adjusted to include all dilutive potential ordinary shares.

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

| | **2017** | 2016 |
|---|---|---|
| **Number of shares** (millions) | | |
| **For basic earnings per share** | **413.0** | 410.9 |
| Effect of dilutive potential ordinary shares from share options | **1.9** | 1.8 |
| **For diluted earnings per share** | **414.9** | 412.7 |

*Basic and diluted earnings per ordinary share before non-underlying items and deferred tax*

Earnings per ordinary share before non-underlying items and deferred tax are presented as the Directors believe that this measure provides a more useful comparison of business trends and performance, since deferred tax reflects distortive effects of changes in corporation tax rates and the level of long-term investment. Earnings per share have been calculated:

| | **2017** | | | 2016 | | |
|---|---|---|---|---|---|---|
| | **Profit after tax £m** | **Earnings per share Basic p** | **Earnings per share Diluted p** | Profit after tax £m | Earnings per share Basic p | Earnings per share Diluted p |
| Statutory earnings | **164.3** | **39.8** | **39.6** | 152.1 | 37.0 | 36.9 |
| Deferred tax before non-underlying items | **18.9** | **4.5** | **4.6** | 39.2 | 9.5 | 9.5 |
| Non-underlying items (net of tax) | **11.1** | **2.7** | **2.6** | (29.1) | (7.0) | (7.1) |
| Earnings before non-underlying items and deferred tax | **194.3** | **47.0** | **46.8** | 162.2 | 39.5 | 39.3 |

**Notes (continued)**

9. **Dividends**

**Amounts recognised as distributions to ordinary equity holders in the year:**

| | **2017 £m** | 2016 £m |
|---|---|---|
| Interim dividend paid for the year ended 31 March 2016 : 10.46p (2015 9.98p) per share | **43.1** | 39.8 |
| Final dividend paid for the year ended 31 March 2016 : 23.12p (2015 21.82p) per share | **95.4** | 89.7 |
| | **138.5** | 129.5 |

**Proposed dividends**

| | |
|---|---|
| Proposed interim dividend for the year ended 31 March 2017 : 11.09p per share | **45.9** |
| Proposed final dividend for the year ended 31 March 2017 : 24.87p per share | **103.6** |
| | **149.5** |

The proposed interim and final dividends have not been included as liabilities in these financial statements.

The proposed interim dividend for 2017 was paid on 4 April 2017 and the proposed final dividend is subject to approval by shareholders at the Annual General Meeting on 6 July 2017.

If approved at the Annual General Meeting the final dividend of 24.87p per share will be paid on 1 September 2017 to shareholders on the register on 7 July 2017.

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**Notes (continued)**

10. **Share capital**

**Allotted, called up and fully paid**

| | Number of shares | | |
|---|---|---|---|
| | Treasury shares | Ordinary shares | £m |
| At 1 April 2015 Ordinary shares of 40.7p each | 389,515 | 398,720,708 | 162.4 |
| Shares issued in respect of the equity issuance | - | 12,084,337 | 4.9 |
| Shares issued under the Scrip Dividend Alternative | - | 760,626 | 0.3 |
| For consideration of £1.1m, shares re-issued to the Pennon Employee Share Trust | (143,538) | 143,538 | - |
| For consideration of £1.3m, shares re-issued under the Company's Sharesave Scheme | (227,316) | 227,316 | - |
| For consideration of £0.1m, shares re-issued under the Executive Share Option Scheme | (8,305) | 8,305 | - |
| For consideration of £2.1m, shares issued under the Company's Sharesave Scheme | - | 395,767 | 0.2 |
| At 31 March 2016 ordinary shares of 40.7p each | 10,356 | 412,340,597 | 167.8 |
| Shares issued under the Scrip Dividend Alternative | - | 771,563 | 0.3 |
| For consideration of £0.0m, shares re-issued under the Company's Executive Share Option Scheme | (1,913) | 1,913 | - |
| For consideration of £1.4m, shares issued to the Pennon Employee Share Trust | - | 143,479 | 0.1 |
| For consideration of £0.1m, shares issued under the Company's Executive Share Option Scheme | - | 24,457 | - |
| For consideration of £3.2m, shares issued in respect of the Company's Sharesave Scheme | - | 611,284 | 0.2 |
| **At 31 March 2017 ordinary shares of 40.7p each** | **8,443** | **413,893,293** | **168.4** |

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

**PENNON GROUP PLC**

**Notes (continued)**

| | | 2017 £m | 2016 £m |
|---|---|---|---|
| 11. | **Perpetual capital securities** | | |
| | GBP 300m 6.75% perpetual subordinated capital securities | **294.8** | 294.8 |

On 8 March 2013 the Company issued £300m perpetual capital securities. Costs directly associated with the issue of £5.2m are set off against the value of the issuance. They have no fixed redemption date but the Company may, at its sole discretion, redeem all, but not part, of these securities at their principal amount on 8 March 2018 or any subsequent periodic return payment date after this.

The Company has the option to defer periodic returns on any relevant payment date, as long as a dividend on the Ordinary Shares has not been paid or declared in the previous 12 months. Deferred periodic returns shall be satisfied only on redemption or payment of dividend on Ordinary Shares, all of which only occur at the sole discretion of the Company.

As the Company paid a dividend in the 12 months prior to the periodic return date of 8 March 2017, a periodic return of £20.3m was paid during the year.

PENNON GROUP PLC

**Notes (continued)**

## 12. Cash flow from operating activities

Reconciliation of profit for the year to net cash inflow from operations:

| | 2017 £m | 2016 £m |
|---|---|---|
| **Cash generated from operations** | | |
| Profit for the year | **180.5** | 168.3 |
| Adjustments for: | | |
| Share-based payments | **2.9** | 2.8 |
| Profit on disposal of property, plant and equipment | **(7.5)** | (4.3) |
| Depreciation charge | **178.2** | 182.9 |
| Amortisation of intangible assets | **3.2** | 3.7 |
| Non-underlying remeasurement of fair value movement in derivatives | **(16.0)** | (5.2) |
| Non-underlying unwind of synthetic derivative | **44.8** | - |
| Non-underlying provision charge | **10.7** | 10.2 |
| Share of post-tax profit from joint ventures | **(4.2)** | (3.6) |
| Finance income (before non-underlying items) | **(36.3)** | (42.1) |
| Finance costs (before non-underlying items) | **95.1** | 96.2 |
| Taxation charge | **30.0** | 38.0 |
| Changes in working capital: | | |
| Increase in inventories | **(0.7)** | (5.5) |
| (Increase) / decrease in trade and other receivables | **(13.1)** | 10.5 |
| Increase in service concession arrangements receivable | **(22.2)** | (15.6) |
| Increase / (decrease) in trade and other payables | **8.5** | (27.0) |
| Increase / (decrease) in retirement benefit obligations | **2.3** | (21.2) |
| Decrease in provisions | **(24.7)** | (16.8) |
| Cash generated from operations | **431.5** | 371.3 |

| | 2017 £m | 2016 £m |
|---|---|---|
| **Total interest paid** | | |
| Interest paid in operating activities | **76.4** | 79.1 |
| Interest paid in investing activities | **12.9** | 9.4 |
| Total interest paid | **89.3** | 88.5 |

**PENNON GROUP PLC**

**Notes (continued)**

13. **Net borrowings**

| | 2017 £m | 2016 £m |
|---|---|---|
| **Cash and cash deposits** | **598.1** | 632.2 |
| *Borrowings – current* | | |
| Bank and other loans | **(74.9)** | - |
| Other current borrowings | **(41.1)** | (39.0) |
| Finance lease obligations | **(30.5)** | (26.0) |
| **Total current borrowings** | **(146.5)** | (65.0) |
| *Borrowings – non-current* | | |
| Bank and other loans | **(1,439.3)** | (1,502.5) |
| Other non-current borrowings | **(323.4)** | (234.5) |
| Finance lease obligations | **(1,353.8)** | (1,314.6) |
| **Total non-current borrowings** | **(3,116.5)** | (3,051.6) |
| **Total net borrowings** | **(2,664.9)** | (2,484.4) |

For the purposes of the cash flow statement cash and cash equivalents comprise:

| | 2017 £m | 2016 £m |
|---|---|---|
| Cash and cash deposits as above | **598.1** | 632.2 |
| Less : deposits with a maturity of three months or more (restricted funds) | **(223.8)** | (226.5) |
| | **374.3** | 405.7 |

**PENNON GROUP PLC**

**Notes (continued)**

14. **Contingent liabilities**

| | **2017** **£m** | 2016 £m |
|---|---|---|
| Performance bonds | **187.5** | 159.7 |
| Other | **-** | 4.0 |
| | **187.5** | 163.7 |

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

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

*Other contractual and litigation uncertainties*

The Group establishes provisions in connection with contracts and litigation where it has a present legal or constructive obligation as a result of past events and where it is more likely than not an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Matters where it is uncertain that these conditions are met are:

- The Group's joint venture Viridor Laing (Greater Manchester) Ltd is party to a PFI contract with the Greater Manchester Waste Disposal Authority (the Authority). The authority has announced its intention to terminate this contract. The Group is in negotiation with the Authority with the aim of delivering an orderly exit from the contract.

- The Group is subject to litigation from time to time as a result of its activities, including a prosecution from the Health and Safety Executive in relation to the fatality of a Viridor employee at Derriford, Plymouth in 2015.

*Uncertain tax items*

Management judgement is required to estimate the tax provisions relating to uncertain tax items that remain to be agreed with HMRC.

In 2015/16 the Group reported significant judgement around uncertain tax items related to the interpretation of tax legislation regarding financial arrangements entered into in the normal course of business, which could have resulted in range of outcomes of additional liabilities of c£20m, to a reduction in liabilities of £52m. Following engagement and subsequently resolution with HMRC across a number of areas, achieved through a process designed to expedite outstanding tax matters, these items are no longer an area of significant judgement and there is no such range related to ongoing uncertain tax items. The Group has a small number of ongoing uncertain tax items related to capital allowances for expenditure incurred in the normal course of business, where the Group has paid in full the tax HMRC interpret as due, and therefore would receive up to £20m (2015/16 £70m) should these tax items be concluded in the Group's favour.

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