



**Investor Report and Compliance Certificate**

**For the SWS Financing Group**

**For the period ended 31 March 2011**

**Confidential**

**Important Notice**

This report is being distributed in fulfilment of a finance document, the Common Terms Agreement. It is directed to, and intended for, existing investors in the company. No other persons should act or rely on it. The company makes no representation as to the accuracy of forecast information. This report should not be relied on as a guide to future performance and should not be relied on in deciding whether to undertake future investment in the company. It should be noted that the information in this report has not been reviewed by the company's auditors.

## **Investor Report**

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## **General overview and business update**

This Investor Report covers the financial year ended 31 March 2011. The Investor Report is a requirement of the Common Terms Agreement (CTA), which governs the company's obligations to its lenders and investors.

Capitalised terms used in this Investors Report/Compliance Certificate shall have the same definitions as in the CTA.

### **General levels of service**

From 2010/11, the Service Incentive Mechanism, a quantitative and qualitative customer service score, has replaced the overall performance assessment and scores from 2011/12 will be used to determine comparative performance for regulatory price setting. The financial year 2010/11 therefore provides an opportunity for companies to familiarise themselves with this new comparative performance mechanism prior to it being used for comparative performance from 2011/12.

### **Financial performance for the year to 31 March 2011**

Turnover decreased by 4.7% to £647.1m (2009/10: £679.1m) compared with an average tariff decrease of 1.9%. In addition to the tariff decrease, the accrual methodology for estimating the amount of unbilled income at the year end was revised, resulting in a further one-off reduction of £23m. Operating profit for 2010/11 decreased by 37% to £191.9m as a result of an exceptional bad debt charge of £38.6m following an accounting revision to timing of providing for bad debts, the turnover reduction and an increase in operating costs of 11%.

Net cash flow from operating activities increased to £472.5m (2009/10 £445.5m excluding 2009/10 exceptionals). This is in contrast to the reduction in operating profit, which has been adversely affected by one-off accounting changes which do not affect past, or future, cash generation of the business.

### **Financial ratios**

As required by the CTA, financial ratios are reported up to the end of the current five year regulatory period. In all cases, the financial ratios exceed the 'trigger levels' as defined in the CTA. The forecasts used to generate the financial ratios are derived from the SWS Business Financial Model and are in the format specified by the CTA.

Financial forecasts in this report fully reflect the projected shortfall in revenues against those assumed in the PR09 price determination (a shortfall in turnover over the AMP5 period of £162m), projected costs associated with the adoption of private sewers (£55m over the remainder of the AMP period), plus other cost pressures such as the carbon reduction commitment levy on energy costs.

Forecast RPI s used for this Investor Report are 5.3% at March 2011, 4.4% at March 2012 and 2.5% thereafter.

For investor reporting, interest paid is reported on an accruals basis in line with the requirements of the CTA.

Projected distributions comprise preference share dividends and group relief tax payments. Ordinary share dividends are not projected as these are subject to individual Board approval.

**Operational performance**

Drinking water compliance for the 2010 Calendar year was 99.90% (2009: 99.98%). This is a key measure of the quality of water received by customers. Maintaining compliance as close to 100% as practicable is a key target to ensure consistently high standards to customers.

Leakage for 2010/11, at 92 MI/d, is an improvement on 2009/10 performance of 95MI/d and maintains Southern Water's position of having a lower level of leakage than any of the water and sewerage companies. The 2010/11 leakage performance was, however, higher than the OFWAT target of 83MI/d (2009/10 target 92 MI/d).

Water resource levels continue to be managed at a sustainable level, with a maximum security of supply index of 100%.

There were seven of the more serious Category 1 and 2 pollution incidents in the 2010 Calendar year (nine in 2009).

Serviceability performance for Water non-infrastructure, Water infrastructure and Wastewater non-infrastructure has been assessed by the company as 'Stable' and Wastewater infrastructure has been assessed as 'Marginal'. The performance of Water non-infrastructure has improved from 'Deteriorating' in 2009/10 and the performance of Wastewater infrastructure has fallen from 'Stable' in 2009/10.

**Capital expenditure**

Capital expenditure for the year was in line with expectations at £408.5m. This is a significant increase over the previous year (£234.1m) and represents an excellent start to delivering the AMP5 capital investment programme, underpinning the company's five-year monitoring plan and including the ongoing construction of the Brighton & Hove wastewater project.

**Financing**

Since the previous Investor Report (covering the six months to September 2010), on 7 July 2011, Moody's downgraded the rating on the Class A debt from A3 to Baa1 (negative outlook), the Class B debt from Baa3 to Ba1 (negative outlook) and the corporate family rating from Baa1 to Baa2 (negative outlook). On 15 July 2011, Fitch also downgraded the rating on the Class A debt from A (negative outlook) to A- (stable outlook) and the Class B debt from BBB+ (negative outlook) to BBB (stable outlook).

**Board membership**

Les Dawson, CEO, resigned from the Board in May 2010. Howard Goodbourn (formerly Finance Director) was appointed as Interim CEO and resigned in March 2011. Matthew Wright was appointed to the Board as CEO on 28 February 2011. Mike Jones has been appointed as Finance Director but has not been appointed to the Board at the date of this report.

**Ultimate parent company**

The ultimate parent company is Greensands Holdings Ltd.

**Consolidated cashflow**

Ref.		31 Mar 2010 £m	31 Mar 2011 £m	31 Mar 2012 £m	31 Mar 2013 £m	31 Mar 2014 £m	31 Mar 2015 £m
	Revenue						
1	Appointed	669.0	684.0	711.3	752.6	808.8	842.7
2	Non Appointed	5.3	3.9	4.1	4.0	4.1	4.3
	Operating Costs						
3	Appointed	213.5	223.6	234.6	255.0	276.1	302.2
4	Non Appointed	2.7	1.9	2.0	2.3	2.5	2.7
	Exceptional operating cash outflow *	56.1	0.0	0.0	0.0	0.0	0.0
5	Net Capital Expenditure (inc Disposals of Assets)	212.5	375.9	469.1	406.0	357.1	253.3
	Annual Finance Charge	136.5	131.9	126.3	132.2	136.0	132.8
6	Taxation	0.0	0.0	0.0	0.0	0.0	0.0
	Payments on Subordinated Debt and Distributions	23.5	65.8	49.4	50.5	20.2	20.0
	Net cash reserves movement	29.5	-111.2	-166.0	-89.4	21.0	136.0

\* This relates to a one-off payment into the final benefit pension scheme

**Annual Finance Charge**

Ref.		31 Mar 2010 £m	31 Mar 2011 £m	31 Mar 2012 £m	31 Mar 2013 £m	31 Mar 2014 £m	31 Mar 2015 £m
	Class A Bonds interest	118.5	107.6	103	106	109.6	112.1
	Class B Bonds interest	19.7	19.7	19.7	19.7	19.7	22.7
	Interest income	4.9	2.2	1.9	1.5	1.9	4.2
	Class A Facilities commitment fees	1.3	4.7	2.2	2.2	2.2	2.2
7	Class A Debt Interest	114.9	110.1	103.3	106.7	109.9	110.1
8	Senior Debt Interest	136.5	131.9	126.3	132.2	136.0	132.8
	Annual Finance Charge	136.5	131.9	126.3	132.2	136	132.8
	Monthly Payment Amount *	12.0	11.2	10.7	11.1	11.5	11.4

\* Monthly payment amount is stated gross and reduced by interest received in the DSPA

<b>Cash accounts and reserves</b>							
<b>Ref.</b>		<b>31 Mar 2010 £m</b>	<b>31 Mar 2011 £m</b>	<b>31 Mar 2012 £m</b>	<b>31 Mar 2013 £m</b>	<b>31 Mar 2014 £m</b>	<b>31 Mar 2015 £m</b>
	<b>SWS O&amp;M Reserve account</b>						
	Opening balance	44.4	46.3	46.3	44.4	44.4	44.4
	Cash transferred	1.9	0.0	-1.9	0.0	0.0	0.0
	Closing balance	46.3	46.3	44.4	44.4	44.4	44.4
	<b>Capex Reserve account</b>						
	Opening balance	312.8	216	125.5	11.8	0.0	0.0
	Cash transferred	-96.8	-90.5	-113.7	-11.8	0.0	128.9
	Closing balance	216	125.5	11.8	0.0	0.0	128.9
	<b>Debt Service Payment account</b>						
	Opening balance	10.8	11.5	5.0	5.0	5.0	5.0
	Cash transferred	0.7	-6.5	0.0	0.0	0.0	0.0
	Closing balance	11.5	5.0	5.0	5.0	5.0	5.0
	<b>SWS Operating accounts</b>						
	Opening balance	0.9	30.6	0.8	0.0	0.0	0.0
	Cash transferred	29.7	-29.8	-0.8	0.0	0.0	0.0
	Closing balance	30.6	0.8	0.0	0.0	0.0	0.0
	<b>Total Cash Balances</b>						
	Opening balance	368.9	304.4	177.6	61.2	49.4	49.4
	Cash transferred	-64.5	-126.8	-116.4	-11.8	0.0	128.9
9	Closing balance	304.4	177.6	61.2	49.4	49.4	178.3



### Bonds, Authorised Loan Facilities and Leases

Ref.	31 Mar 2010 £m	31 Mar 2011 £m	31 Mar 2012 £m	31 Mar 2013 £m	31 Mar 2014 £m	31 Mar 2015 £m
* Senior £350m A1 6.192% Fixed Rate Bonds due 2029	350.0	350.0	350.0	350.0	350.0	350.0
* £150m A2a 3.706% Index Linked Bonds due 2034	179.6	188.2	198.7	206.1	211.2	216.5
* £35m A2b 3.706% Limited Index Bonds due 2034	41.9	43.9	46.4	48.1	49.3	50.5
£350m A4 6.64% Fixed Rate Bonds due 2026	350.0	350.0	350.0	350.0	350.0	350.0
£150m A5 3.816% Index Linked Bonds due 2023	179.6	188.2	198.7	206.1	211.2	216.5
* £350m A7 5.0% Fixed Rate Bonds due 2021	350.0	350.0	350.0	350.0	350.0	350.0
* £150m A8 5.0% Fixed Rate Bonds due 2041	150.0	150.0	150.0	150.0	150.0	150.0
* £200m A9 4.5% Fixed Rate Bonds due 2052	200.0	200.0	200.0	200.0	200.0	200.0
* £300m A10 5.125% Fixed Rate Bonds due 2056	300.0	300.0	300.0	300.0	300.0	300.0
£300m A11 6.125% Fixed Rate Bonds due 2019	300.0	300.0	300.0	300.0	300.0	300.0
RPI accretion on Index-Linked swaps	70.4	97.4	174.2	229.4	269.1	309.8
£250m B1 step-up Fixed/Floating rate Bonds due 2038	250.0	250.0	250.0	250.0	350.0	350.0
£50m Class B loan facility	50.0	50.0	100.0	100.0	0.0	0.0
* £165m Artesian 4.076% Index Linked Bonds due 2033	197.5	207.0	218.5	226.7	232.4	238.2
* £156m Artesian 3.635% Index Linked Bonds due 2032	182.7	191.5	202.1	209.7	214.9	220.3
** New cash required	0.0	0.0	0.0	50.0	50.0	50.0
Revolving Credit Facilities	0.0	0.0	0.0	28.1	7.1	0.0
DSR Liquidity Facility Drawings	0.0	0.0	0.0	0.0	0.0	0.0
O&M Liquidity Facility Drawings	0.0	0.0	0.0	0.0	0.0	0.0
Finance Leases	0.0	0.0	0.0	0.0	0.0	0.0
Class A Indebtedness	2851.7	2916.2	3038.6	3204.2	3245.2	3301.8
Senior Indebtedness	3151.7	3216.2	3388.6	3554.2	3595.2	3651.8
10 Class A Net Indebtedness	2547.3	2738.6	2977.4	3154.8	3195.8	3123.5
11 Senior Net Indebtedness	2847.3	3038.6	3327.4	3504.8	3545.8	3473.5
Nominal value of fixed rate debt swapped to Index Linked	877.0	877.0	1318.0	1318.0	1318.0	1318.0

\* Wrapped by MBIA or FSA

\*\* 'New cash required' is a notional class of debt included to forecast compliance ratios correctly. This is not an attempt to forecast the mix, cost and timing of future financing.

### Interest Cover Ratios

	Trigger	Default	31 Mar 2010 £m	31 Mar 2011 £m	31 Mar 2012 £m	31 Mar 2013 £m	31 Mar 2014 £m	31 Mar 2015 £m		
A			455.5	460.4	476.7	497.6	532.7	540.5		
B			458.1	462.4	478.8	499.3	534.3	542.1		
C			259.5	275.6	304.6	322.6	335.4	344.9		
D			114.9	110.1	103.3	106.7	109.9	110.1		
E			136.5	131.9	126.3	132.2	136.0	132.8		
F			4.4	7.0	7.6	7.1	6.3	4.8		
G			92.4	164.2	N/A	N/A	N/A	N/A		
Class A Adjusted ICR										
		Historic: (B-C+F)/D Projected: (A-C+F)/D	1.3	N/A	1.8	1.8	1.7	1.7	1.9	1.8
Class A Average ICR										
			1.4	N/A	1.7	1.8	1.8	1.8	1.8	1.8
Senior Adjusted ICR										
		Historic: (B-C+F)/E Projected: (A-C+F)/E	1.1	N/A	1.5	1.5	1.4	1.4	1.5	1.5
Senior Average Adjusted ICR										
			1.2	N/A	1.4	1.4	1.5	1.5	1.5	1.5
Class A ICR										
		Historic: B/D Projected: A/D	N/A	1.6	4.0	4.3	4.7	4.7	4.9	5.0
Class A Post Maintenance ICR										
		Historic: (B-G+F)/D	N/A	1.0	3.2	2.8	N/A	N/A	N/A	N/A

### Regulatory Asset Ratios

	Trigger	Default	31 Mar 2010 £m	31 Mar 2011 £m	31 Mar 2012 £m	31 Mar 2013 £m	31 Mar 2014 £m	31 Mar 2015 £m	
G	Class A Net Indebtedness (10)		2547.3	2738.6	2977.4	3154.8	3195.8	3123.5	
H	Senior Net Indebtedness (11)		2847.3	3038.6	3327.4	3504.8	3545.8	3473.5	
I	RCV		3566.9	3745.1	4092.8	4294	4400.1	4486.6	
Class A RAR									
	Projected: G/I	0.750	N/A	0.714	0.731	0.727	0.735	0.726	0.696
Senior RAR									
	Projected: H/I	0.900	0.950	0.798	0.811	0.813	0.816	0.806	0.774

The opening RCV on 1 April 2010 was 'logged down' by £99m, the most significant part of which was uncommitted expenditure on the Brighton & Hove scheme. The effect on the following AMP6 period opening RCV, from projected capital expenditure and projected changes to the notified index, is forecast to be a 'logging down' of £101m.

**Declaration**

We confirm that each of the above Ratios has been calculated in respect of each of the relevant periods for which it is required under the Common Terms Agreement and has not breached the Trigger Event Ratio Levels and has not caused Paragraph 20 (Ratios) of Part 2 (Event of Default (SWS and the Issuer)) of Schedule 7 of the Common Terms Agreement to be breached.

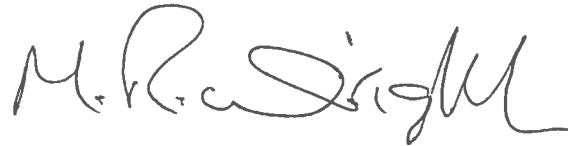
We confirm that the Annual Finance Charge is £126.3m for 2011/12 equating to a Monthly Payment Amount for this period of £10.7m.

We also confirm that no Default or Potential Trigger Event is outstanding and that SWS's insurances are being maintained in accordance with the Common Terms Agreement.

Matthew Wright  
Director



Matthew Wright  
Director



Mike Jones  
Finance Director



Mike Jones  
Finance Director



for and on behalf of Southern Water Services Limited

for and on behalf of Southern Water Services (Finance) Limited