

GROUP CHIEF EXECUTIVE OFFICER'S OVERVIEW



CHRIS LOUGHLIN, GROUP CHIEF EXECUTIVE OFFICER

The year 2015/16 has been transformative for Pennon Group. While continuing to deliver market-leading performance in many areas of our businesses, we have been fine-tuning our strategic focus to meet the changing demands of our sector, evolving our governance and internal structures and beginning to draw new synergistic benefits from the closer alignment of our subsidiaries.

As the new Group Chief Executive Officer I am pleased to report that Pennon has performed very well in 2015/16.

South West Water is outperforming its regulatory contract having begun the K6 (2015-2020) period in a position of confidence following a successful Price Review, which saw its business plan deemed best-in-class. The drive towards further efficiency and improved performance has been complemented by the successful acquisition and merger with Bournemouth Water. Integration is substantially complete and the bringing together of these two good companies is allowing for substantial efficiency savings, the sharing of best practice and operational synergies. The combined water business is well placed for the regulatory changes ahead, including the opening of the non-household retail market in 2017, and there is a 94% probability it will set the efficiency frontier at the 2019 Price Review⁽¹⁾.

In waste management, Viridor has also performed well. The company has made a clear transition from landfill to a greater focus on recycling and the recovery of energy from waste. Eight of the 11 committed Energy Recovery Facilities (ERFs) are now on stream with the remainder under construction (at Glasgow, Dunbar and Beddington).

The ERF portfolio is being progressively de-risked with demand expected to exceed capacity over the long term. Approximately 80% of the total ERF portfolio volumes have been secured under long-term, index-linked contracts with short and medium-term contracts in place for the remaining 20%.

As Viridor completes its move from the investment phase to the delivery phase with the completion of the ERF portfolio, we are moving towards a more homogeneous risk profile across the Group. We are increasing the predictability and visibility of our revenues over the long term and putting Pennon in the strongest position possible to capitalise on future growth opportunities.

STRONG OPERATIONAL PERFORMANCE

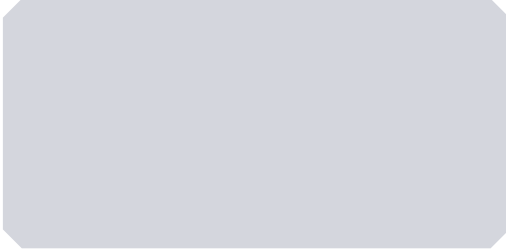
Both South West Water and Bournemouth Water have made considerable progress on their K6 business plan commitments.

At South West Water, drinking water quality remains high (99.97% compliance⁽²⁾), customer service continues to increase, and accelerated investment in bathing water improvements has helped the region perform very well against the revised EU standards, which came into force in 2015. Of the 145 bathing waters tested, 141 met the required standard. The failure of the other four was unrelated to the performance of any South West Water asset.

Bournemouth Water achieved 100% compliance with drinking water quality standards and continued to deliver customer service improvements, building on its already impressive track record of customer service excellence. In both the South West Water and Bournemouth Water service areas leakage rates were kept within target levels and there were no water restrictions placed on customers.

(1) Oxera modelling for South West Water and Bournemouth Water submission to the Competition and Markets Authority. This estimate provides the probability of the merged company, with synergy savings, being within the UQ (the efficiency benchmark as used by Ofwat in PR14) at PR19.

(2) As measured by mean zonal compliance.



In the waste management sector, Viridor has been a consistent leader and is well on track to increase Pennon's future earnings growth. This is being achieved through the delivery and ramp-up of ERFs, which are expected to contribute c.£100 million to Viridor's EBITDA in 2016/17.

In landfill energy, Viridor continues to maximise value from its assets, managing the ongoing reduction in inputs and moving from the 14 remaining operational sites to a smaller number of strategic sites by 2020. Landfill gas will remain a significant earnings stream after the sites have closed to waste inputs, and the company is maximising opportunities to use existing grid connections.

AREAS OF FOCUS

South West Water delivered a step change in customer service performance during K5 (2010-2015) through a combination of operational improvements and initiatives to improve the customer service experience, including a more proactive approach to communications.

In 2015/16 the company's customer service score⁽¹⁾ continued to increase, and further improvements are anticipated as best practice is shared with Bournemouth Water (which consistently delivers SIM performance in the upper quartile of the industry).

In wastewater services, areas for operational improvement remain, particularly with regards to reducing the risk of flooding and pollution. South West Water is working resolutely towards its 2020 targets, making the most of new techniques in activities such as forecasting and monitoring, and working closely alongside its supply chain partners to deliver the necessary enhancements.

In recycling, Viridor is accelerating the optimisation and rationalisation of its assets and contracts through the Input, Throughput and Output Optimisation (ITOO) programme (see page 33). By moving towards a more efficient cost base and more profitable activity, this is designed to overcome lower commodity prices. The programme is targeting a substantial enhancement in the company's EBITDA margin through restructuring and improvements in source material quality (including contract renegotiation where required), asset efficiency, productivity and yield, and specific quality control of outputs.

A number of input contracts have been successfully renegotiated to enhance value and the quality of inputs. New recycling contracts reflect the sharing of recycle price risks with customers through better gate fees and a better specified quality of inputs.

DRIVING VALUE THROUGH EFFICIENCY

South West Water is striving for ever greater efficiency in K6, building on its strong track record from K5. Recognised by Ofwat as delivering industry-leading cost efficiency, it was awarded an enhanced business plan assessment with the largest element of potential operational outperformance over K6 coming from total expenditure (Totex) savings.

Plans to merge Bournemouth Water with South West Water were given unconditional clearance by the Competition and Markets Authority (CMA) in November 2015. The merger became official on 1 April 2016 and the integration process has been progressing well with a new management structure in place.

During K6 (2015-2020) c.£27 million of synergies (net of restructuring costs) is set to be achieved through a combination of:

- the merging of the two companies' wholesale and retail operations
- the creation of a single, centralised support function
- the sharing of best practice to form common systems and processes
- supply chain efficiencies.

A new single legally separate company, Pennon Water Services, has been created which will provide retail and water management services for our c.85,000 non-household customers, who will be eligible for the new water retail market in 2017. The new market will move into a period of shadow operation in October 2016 prior to formal opening in April 2017.

In addition to Viridor's operational delivery, overheads are being streamlined as part of the announced reorganisation and restructuring. This is expected to deliver c.£9 million a year of enduring financial benefits from 2018/19.

**A TRANSFORMATIVE
YEAR FOR
PENNON GROUP**

(1) As measured by service incentive mechanism (SIM).

GROUP CHIEF EXECUTIVE OFFICER'S OVERVIEW **CONTINUED**

GROUP-WIDE SYNERGY

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.

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 and household customers.

A more joined-up Group brings benefits in a variety of ways. Looking ahead to the opening of the non-household retail market for water services, a key differentiator for Pennon is the link that can be forged between Pennon Water Services and Viridor's customer base. By capitalising on Viridor's commercial relationships and culture we can add value and improve our service offering.

Furthermore, as part of the evolution in Pennon's structure, a shared services review is underway, assessing where we can unlock opportunities to create additional value through integrating back office functions.

SUSTAINABLE AND RESPONSIBLE BUSINESS

Through innovation, the use of new technologies and the application of best practice, we continue to focus on sustainability.

By improving the efficiency and effectiveness of our business activities we ensure sustainable value for both shareholders and customers while minimising our environmental impacts. This spans everything from our holistic approach to water and wastewater management at catchment level (see Upstream Thinking and Downstream Thinking on pages 29 and 31) to our strategic purpose of giving resources new life.

At a community level we do our best to be a 'good neighbour' through community engagement, high operational standards, support for education and the provision of access and recreation.

South West Water continues to offer an industry-leading range of affordability schemes to those customers who genuinely struggle to pay. We continue to provide a social tariff and expand our innovative work with housing providers to help reduce customer debt.

At Viridor, a network of active community liaison groups continues to ensure close dialogue with people living and working in areas close to our major operational sites, enabling focused community benefit programmes.

In 2015 both South West Water and Viridor were recognised as responsible businesses within Business in the Community's Corporate Responsibility (CR) Index. Pennon Group also retained its inclusion in the FTSE4Good Index following independent assessment in 2015 of its Environmental, Social and Governance (ESG) performance.

PROUD OF OUR PEOPLE

Pennon has more than 4,800 employees. Their health and safety remains our top priority and we continue to refine our policies and make enhancements where necessary in order to protect their wellbeing and comply with best practice. Further detail can be found on page 48.

Across the Group we are focused on attracting, nurturing and retaining a high calibre workforce. South West Water, a significant employer in the south west of England, is ranked as a top 100 apprenticeship employer nationally, and has recruited 85 apprentices since 2011.

Meanwhile at Viridor, there is a growing focus on apprenticeships with 23 apprentices in the business today and a commitment to expand this at each of the ERFs.

The efforts and achievements of our employees have made 2015/16 a successful year and I would like to take this opportunity to thank them for their ongoing professionalism and dedication.

**IN A CHANGING
SECTOR PENNON
IS EVOLVING WITH
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OUTLOOK

As an environmental infrastructure business, Pennon is continually looking to the future to anticipate, influence and manage regulatory change and the policy environment. This is crucial to our success.

Through Viridor, we are well positioned with services reflecting the waste hierarchy, leading with reduction and recycling, through to energy recovery and finally to disposal.

We expect demand for ERFs to continue to exceed capacity into the long term. The option to commit to an additional ERF at Avonmouth remains and would take the total portfolio to 12 plants nationwide.

We remain cautious about future recyclate price growth but are not relying on a near-term price recovery and are instead driving forward self-help measures through Viridor's ITOO programme, which is delivering margin improvement. We continue to target new long-term and medium-term commercial and industrial recycling and recovery contracts.

In the water industry we are well placed to capitalise on structural changes and resilience challenges, making the most of opportunities for future consolidation and growth while continuing to deliver our business plans effectively. As Bournemouth Water becomes fully integrated with South West Water, we anticipate further synergistic benefits together with performance improvements derived from the sharing of best practice.

At a wider industry level South West Water is fully engaged in Water 2020 as we prepare and position ourselves for PR19. The company is in an extremely good position to anticipate and influence future regulatory reforms and is working hard to ensure involvement in shaping the future of the industry.

In a changing sector Pennon is evolving with confidence and ambition. We continue to build on a strong platform, recognising areas for further improvement and efficiencies while remaining focused on delivering sustainable business value.

Chris Loughlin

Group Chief Executive Officer
Pennon Group Plc

