



PENNON GROUP PLC

(incorporated in England and Wales with limited liability under registration number 2366640)

£300,000,000 Perpetual Capital Securities

Issue price: 99.957 per cent.

The £300,000,000 Perpetual Capital Securities (the “**Capital Securities**”) will be issued by Pennon Group plc (the “**Issuer**”) on 22 September 2017 (the “**Issue Date**”) subject to the terms and conditions set out herein under “*Terms and Conditions of the Capital Securities*” (the “**Conditions**”, and references herein to a numbered Condition shall be construed accordingly).

The Capital Securities will constitute direct, unsecured and subordinated obligations of the Issuer, ranking *pari passu* and without any preference amongst themselves, and on a winding-up of the Issuer will rank in priority only to holders of Junior Share Capital (as defined in Condition 18), as further described in Condition 2.

Periodic returns will accrue on the principal amount of the Capital Securities from (and including) the Issue Date to (but excluding) 22 May 2020 (the “**First Call Date**”) at a fixed rate of 2.875 per cent. per annum, payable (subject to deferral as described below) annually in arrear (with a short first returns accrual period) on 22 May in each year, commencing 22 May 2018. Thereafter, periodic returns will accrue on the principal amount of the Capital Securities at a floating rate of return equal to 3-month LIBOR plus 7.018 per cent. per annum (representing a 5.00 per cent. step-up), payable (subject to deferral as described below) quarterly in arrear on 22 February, 22 May, 22 August and 22 November in each year, commencing 22 August 2020. If a change of control of the Issuer occurs or if South West Water Limited ceases to be a subsidiary of the Issuer, the applicable annual rate of return will increase by 5.00 per cent. and the Issuer will be entitled to redeem the Capital Securities in such circumstances, all as more particularly set out in Condition 5.5.

The Issuer may, at its discretion, elect to defer any payment of periodic returns, in whole or in part, unless during the 12 month period preceding the relevant returns payment date it has elected (in its discretion) to declare or pay a dividend or distribution on, or repay or purchase, any of its Junior Share Capital or Parity Securities (as defined in Condition 18). Periodic returns shall accrue on deferred periodic returns at the rate of return prevailing on the Capital Securities from time to time and, so long as the same remains unpaid, such deferred periodic returns and such periodic returns thereon shall constitute “**Arrears of Returns**”. The Issuer may, at its discretion, elect to pay Arrears of Returns in whole or in part at any time upon notice, and such Arrears of Returns shall in any event become due and payable in full in the circumstances described in Condition 3.9(c).

The Capital Securities are perpetual securities in respect of which there is no final maturity date and the Issuer is under no obligation to redeem the Capital Securities at any time. The holders of the Capital Securities (the “Holders”) have no right to call for their redemption. Prospective investors should be aware that they may be required to bear the financial risks of an investment in the Capital Securities for an indefinite period of time.

The Capital Securities will be redeemable at the option of the Issuer, subject to certain conditions, in whole but not in part on the First Call Date or on any returns payment date thereafter at their principal amount. In addition, the Issuer may at its option redeem all (but not some only) of the Capital Securities at any time prior to the First Call Date (i) at their principal amount if the Capital Securities become subject to withholding tax and the Issuer is required to gross-up payments on the Capital Securities; and (ii) at 101 per cent. of their principal amount if the proceeds of issue of the Capital Securities cease to be accounted for as equity in the Issuer’s consolidated accounts prepared in accordance with International Financial Reporting Standards. Alternatively, in such circumstances, the Issuer may elect to substitute, or vary the terms of, the Capital Securities to address such tax or accounting consequences, subject to certain restrictions. Further, the Issuer may elect to redeem all (but not some only) of the Capital Securities at any time at (a) 101 per cent. of their principal amount if there is a change of control of the Issuer or if South West Water Limited ceases to be a subsidiary of the Issuer; and (b) at their principal amount if at any time the Issuer and its group have purchased 80 per cent. or more of the Capital Securities originally issued. In connection with any redemption of the Capital Securities, there shall also be paid Arrears of Returns (if any) then outstanding and any other periodic returns accrued to (but excluding) the relevant redemption date.

Application has been made to the Financial Conduct Authority under Part VI of the Financial Services and Markets Act 2000 (the “**UK Listing Authority**”) for the Capital Securities to be admitted to the official list of the UK Listing Authority (the “**Official List**”) and to the London Stock Exchange plc (the “**London Stock Exchange**”) for the Capital Securities to be admitted to trading on the London Stock Exchange’s regulated market. References in this Prospectus to the Capital Securities being “**listed**” (and all related references) shall mean that the Capital Securities have been admitted to trading on the London Stock Exchange’s regulated market and have been admitted to the Official List. The London Stock Exchange’s regulated market is a regulated market for the purposes of the Markets in Financial Instruments Directive (Directive 2004/39/EC).

None of the Capital Securities have been or will be registered under the U.S. Securities Act of 1933 (the “**Securities Act**”) or any U.S. State securities laws, and the Capital Securities may not be offered or sold in the United States or to, or for the account or benefit of, any U.S. person (as defined in Regulation S under the Securities Act), absent registration or an applicable exemption from registration under the Securities Act and in accordance with all applicable securities laws of any state of the United States and any other jurisdiction. In addition, the Capital Securities are subject to U.S. tax law requirements. For a description of certain further restrictions on the offering and sale of Capital Securities and on the distribution of this document see “*Subscription and Sale*”.

The Capital Securities will be issued in bearer form in denominations of £100,000 and integral multiples of £1,000 in excess thereof up to and including £199,000 and will initially be represented by a temporary global security, exchangeable for a permanent global security not earlier than 40 days after the Issue Date upon certification of non-U.S. beneficial ownership. The global securities will be deposited on or about the Issue Date with a common depository for Euroclear Bank SA/NV and Clearstream Banking S.A., Definitive Capital Securities will be issued only in certain limited circumstances – see “*Overview of Provisions Relating to the Capital Securities Whilst in Global Form*”.

An investment in the Capital Securities involves certain risks. Prospective investors should read this Prospectus and, in particular, have regard to the factors described under the heading “*Risk Factors*” commencing on page 14.

Global Co-ordinators, Structuring Advisers and Joint Lead Managers

Barclays

Morgan Stanley

Joint Lead Managers

Goldman Sachs International

HSBC

NatWest Markets

IMPORTANT NOTICES

This Prospectus (the “**Prospectus**”) comprises a prospectus for the purposes of Article 5.3 of Directive 2003/71/EC as amended, including by Directive 2010/73/EU (the “**Prospectus Directive**”).

The Issuer accepts responsibility for the information contained in this Prospectus. To the best of the knowledge of the Issuer (having taken all reasonable care to ensure that such is the case) the information contained in this Prospectus is in accordance with the facts and does not omit anything likely to affect the import of such information.

This Prospectus is to be read in conjunction with all documents which are deemed to be incorporated herein by reference (see “*Documents Incorporated by Reference*”). This Prospectus should be read and construed on the basis that those documents are incorporated in and form part of this Prospectus.

Neither the Joint Lead Managers nor the Trustee (each as defined herein) have independently verified the information contained herein. Accordingly, no representation, warranty or undertaking, express or implied, is made and no responsibility or liability is accepted by any of the Joint Lead Managers or the Trustee as to the accuracy or completeness of the information contained or incorporated in this Prospectus or any other information provided by the Issuer in connection with the offering of the Capital Securities. No Joint Lead Manager or the Trustee accepts any liability in relation to the information contained or incorporated by reference in this Prospectus.

No person is or has been authorised by the Issuer, the Joint Lead Managers or the Trustee to give any information or to make any representation not contained in or not consistent with this Prospectus or any other information supplied in connection with the offering of the Capital Securities and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer, any of the Joint Lead Managers or the Trustee.

Neither this Prospectus nor any other information supplied in connection with the offering of the Capital Securities (a) is intended to provide the basis of any credit or other evaluation or (b) should be considered as a recommendation by the Issuer, any of the Joint Lead Managers or the Trustee that any recipient of this Prospectus or any other information supplied in connection with the offering of the Capital Securities should purchase any Capital Securities. Each investor contemplating purchasing any Capital Securities should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness, of the Issuer. Neither this Prospectus nor any other information supplied in connection with the offering of the Capital Securities constitutes an offer or invitation by or on behalf of the Issuer, any of the Joint Lead Managers or the Trustee to any person to subscribe for or to purchase any Capital Securities.

Neither the delivery of this Prospectus nor the offering, sale or delivery of the Capital Securities shall in any circumstances imply that the information contained or incorporated herein concerning the Issuer is correct at any time subsequent to the date hereof or that any other information supplied in connection with the offering of the Capital Securities is correct as of any time subsequent to the date indicated in the document containing the same. The Joint Lead Managers and the Trustee expressly do not undertake to review the financial condition or affairs of the Issuer during the life of the Capital Securities or to advise any investor in the Capital Securities of any information coming to their attention.

In making an investment decision, each investor must rely on their own examination, analysis and enquiry of the Issuer and the terms of the offering of the Capital Securities, including the merits and risks involved.

This Prospectus does not constitute an offer to sell or the solicitation of an offer to buy the Capital Securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The distribution of this Prospectus and the offer or sale of Capital Securities may be restricted by law in certain jurisdictions. None of the Issuer, the Joint Lead Managers or the Trustee represent that this Prospectus may be lawfully distributed, or that the Capital Securities may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer, the Joint Lead Managers or the Trustee which is intended to permit a public offering of the Capital Securities or the distribution of this Prospectus in any jurisdiction where action for that purpose is required. Accordingly, no Capital Securities may be offered or sold, directly or indirectly, and neither this

Prospectus nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Prospectus or any Capital Securities may come must inform themselves about, and observe, any such restrictions on the distribution of this Prospectus and the offering and sale of Capital Securities. In particular, there are restrictions on the distribution of this Prospectus and the offer or sale of Capital Securities in the United States and the United Kingdom (see “*Subscription and Sale*”).

SUITABILITY OF INVESTMENT

The Capital Securities are securities which, because of their nature, are normally bought and traded by a limited number of investors who are particularly knowledgeable in investment matters, and may not be a suitable investment for all investors. Each potential investor in the Capital Securities must determine the suitability of that investment in light of its own circumstances. In particular, each potential investor may wish to consider, either on its own or with the help of its financial and other professional advisers, whether it:

- (i) has sufficient knowledge and experience to make a meaningful evaluation of the Capital Securities, the merits and risks of investing in the Capital Securities and the information contained or incorporated by reference in this Prospectus;
- (ii) has access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Capital Securities and the impact the Capital Securities will have on its overall investment portfolio;
- (iii) has sufficient financial resources and liquidity to bear all of the risks of an investment in the Capital Securities;
- (iv) understands thoroughly the terms of the Capital Securities and is familiar with the behaviour of financial markets; and
- (v) is able to evaluate possible scenarios for economic, periodic returns rate and other factors that may affect its investment and its ability to bear the applicable risks.

Legal investment considerations may restrict certain investments. The investment activities of certain investors are subject to investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisers to determine whether and to what extent (1) Capital Securities are legal investments for it, (2) Capital Securities can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of any Capital Securities. Financial institutions should consult their legal advisers or the appropriate regulators to determine the appropriate treatment of Capital Securities under any applicable risk-based capital or similar rules.

PROHIBITION OF SALES TO EEA RETAIL INVESTORS

The Capital Securities are not intended, from 1 January 2018, to be offered, sold or otherwise made available to and, with effect from such date, should not be offered, sold or otherwise made available to any Retail Investor in the European Economic Area (“**EEA**”). For these purposes, a “Retail Investor” means a person who is one (or both) of: (i) a retail client as defined in point (11) of Article 4(1) of Directive 2014/65/EU (“**MiFID II**”); or (ii) a customer within the meaning of Directive 2002/92/EC, where that customer would not qualify as a professional client as defined in point (10) of Article 4(1) of MiFID II. Consequently no key information document required by Regulation (EU) No. 1286/2014 (the “**PRIIPs Regulation**”) for offering or selling the Capital Securities, or otherwise making them available, to Retail Investors in the EEA has been prepared and therefore offering or selling the Capital Securities or otherwise making them available to any Retail Investor in the EEA may be unlawful under the PRIIPs Regulation (once in force).

STABILISATION

In connection with the issue of the Capital Securities, Barclays Bank PLC as stabilisation manager (the “Stabilisation Manager”) (or any person acting on behalf of the Stabilisation Manager) may over-allot Capital Securities or effect transactions with a view to supporting the market price of the Capital Securities at a level higher than that which might otherwise prevail. However, stabilisation may not necessarily occur. Any stabilisation action may begin on or after the date on which adequate public disclosure of the terms of the offer of the Capital Securities is made and, if begun, may cease at any time, but it must end no later than the earlier of 30 days after the issue date of the Capital Securities and 60 days after the allotment of the Capital Securities. Any stabilisation action or over-allotment must be conducted by the Stabilisation Manager (or persons acting on behalf of the Stabilisation Manager) in accordance with all applicable laws and rules.

FORWARD-LOOKING STATEMENTS

This Prospectus includes certain “forward-looking statements”. Statements that are not historical facts, including statements about the beliefs and expectations of the Issuer, the Group (as defined below) and the Issuer’s Directors or management, are forward-looking statements. Words such as “believes”, “anticipates”, “estimates”, “expects”, “intends”, “plans”, “aims”, “potential”, “will”, “would”, “could”, “considered”, “likely”, “estimate” and variations of these words and similar future or conditional expressions, are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. By their nature, forward-looking statements involve risk and uncertainty because they relate to events and depend upon future circumstances that may or may not occur, many of which are beyond the control of the Issuer or the Group and all of which are based on the Issuer’s current beliefs and expectations about future events. Such forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause the actual results, performance or achievements of the Issuer or the Group, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such forward-looking statements are based on numerous assumptions regarding the present and future business strategies of the Issuer and the Group and the environment in which the Issuer and the Group will operate in the future. These forward-looking statements speak only as at the date of this Prospectus.

Except as required by applicable law or regulation or the rules of the London Stock Exchange, the Issuer expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained in this Prospectus to reflect any change in the Issuer’s expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

CERTAIN DEFINITIONS AND ROUNDING

References in this Prospectus to the “**Group**” are to the Issuer and its subsidiaries taken as a whole.

All references in this Prospectus to “**sterling**” and “**£**” are to the lawful currency of the United Kingdom. All references to “**U.S. Dollar**”, “**U.S.\$**” and “**\$**” refer to United States dollars.

Certain figures included in this Prospectus (including in information incorporated by reference) have been subject to rounding adjustments; accordingly, figures shown for the same category presented in different tables may vary slightly and figures shown as totals in certain tables may not be an arithmetic aggregation of the figures which precede them.

WEBSITES

References in this Prospectus to any website are for information only and, unless otherwise expressly provided herein, neither any website nor any information contained on any website will be incorporated by reference in, or otherwise form part of, this Prospectus.

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DOCUMENTS INCORPORATED BY REFERENCE

The following documents, which have previously been published and have been filed with the Financial Conduct Authority, shall be incorporated in, and form part of, this Prospectus:

- (a) the auditors' report and audited consolidated annual financial statements of the Issuer for the financial year ended 31 March 2017, comprising the information set out at the following pages of the Annual Report 2017:

	Annual Report 2017 page(s)
Auditors' Report.....	106 to 113
Consolidated Income Statement	114
Consolidated Statement of Comprehensive Income.....	114
Consolidated Balance Sheet	115
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- (b) the auditors' report and audited consolidated annual financial statements of the Issuer for the financial year ended 31 March 2016, comprising the information set out at the following pages of the Annual Report 2016:

	Annual Report 2016 page(s)
Auditors' Report.....	104 to 113
Consolidated Income Statement	114
Consolidated Statement of Comprehensive Income.....	114
Consolidated Balance Sheet	115
Consolidated Statement of Changes in Equity	116
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Such documents shall be incorporated in, and form part of, this Prospectus provided, however, that any statement contained in any of the documents incorporated by reference in, and forming part of, this Prospectus shall be deemed to be modified or superseded for the purpose of this Prospectus to the extent that a statement contained in this Prospectus or in a more recently published document incorporated by reference modifies or supersedes such earlier statement (whether expressly, by implication or otherwise).

Any documents or information that are themselves incorporated by reference into the documents incorporated by reference in this Prospectus are not incorporated in, and do not form part of, this Prospectus.

Any non-incorporated parts of a document referred to herein do not form part of this Prospectus and are either not relevant for investors or are covered elsewhere in this Prospectus. Any information contained on any website referred to in any of the documents specified above does not form part of this Prospectus.

Following the publication of this Prospectus, a supplement may be prepared by the Issuer and approved by the UK Listing Authority in accordance with Article 16 of the Prospectus Directive. Statements contained in any such supplement (or contained in any document incorporated by reference therein) shall, to the extent applicable (whether expressly, by implication or otherwise), be deemed to modify or supersede statements contained in this

Prospectus or in a document which is incorporated by reference in this Prospectus. Any statement so modified or superseded shall not, except as so modified or superseded, constitute a part of this Prospectus.

Copies of documents incorporated by reference in this Prospectus may be obtained (without charge) from the registered office of the Issuer and will be available for viewing on the investor relations website of the Issuer at <http://www.pennon-group.co.uk/investor-information/financial-reports-and-presentations>.

OVERVIEW OF THE CAPITAL SECURITIES

The following overview does not purport to be complete and is qualified in its entirety by the remainder of this Prospectus. Capitalised terms used and not otherwise defined in this overview have the meanings given in “*Terms and Conditions of the Capital Securities*”.

Words and expressions defined in “*Terms and Conditions of the Capital Securities*” shall have the same meanings in this Overview.

Issuer	Pennon Group plc
Description of Capital Securities	£300,000,000 Perpetual Capital Securities
Risk factors	An investment in the Capital Securities involves risks. There are certain factors that may affect the Issuer’s ability to fulfil its obligations under the Capital Securities. In addition, there are certain factors which are material for the purpose of assessing the market risks associated with Capital Securities and risks relating to the particular features structure of the Capital Securities. Prospective investors should carefully consider the information under “ <i>Risk Factors</i> ” in conjunction with the other information contained or incorporated by reference in this document.
Global Co-ordinators and Structuring Advisers	Barclays Bank PLC Morgan Stanley & Co. International plc
Joint Lead Managers	Barclays Bank PLC Goldman Sachs International HSBC Bank plc Morgan Stanley & Co. International plc The Royal Bank of Scotland plc (trading as NatWest Markets)
Trustee	The Law Debenture Trust Corporation p.l.c.
Principal Paying Agent	Citibank, N.A., London Branch
Issue Date	22 September 2017
Status	The Capital Securities will constitute direct, unsecured obligations of the Issuer, subordinated as described below, and will rank <i>pari passu</i> without any preference among themselves. The obligations of the Issuer in respect of the Capital Securities will rank: (a) in priority only to the rights and claims against the Issuer of the holders of Junior Share Capital; (b) <i>pari passu</i> with the rights and claims against the Issuer of the holders of any Parity Securities; and (c) junior to the rights and claims of all Creditors. For these purposes: “Creditors” means all creditors of the Issuer (including subordinated creditors) other than creditors whose claims are in respect of the Capital Securities, the Tokens or any Parity Securities or Junior Share Capital;

“**Junior Share Capital**” means the ordinary shares in the capital of the Issuer and any other shares of any class of the Issuer ranking *pari passu* therewith (if any); and

“**Parity Securities**” means any securities or other instruments either (i) issued directly by the Issuer and which rank or are expressed to rank *pari passu* with the Issuer’s obligations under the Capital Securities (including, for so long as any of the same remain outstanding, the £300,000,000 Perpetual Capital Securities issued by the Issuer on 8 March 2013 with ISIN: XS0899989213); or (ii) issued by any subsidiary of the Issuer and benefiting from a guarantee or support agreement entered into by the Issuer which ranks or is expressed to rank *pari passu* with the Issuer’s obligations under the Capital Securities.

Periodic returns

Periodic returns shall accrue on the principal amount of the Capital Securities from (and including) the Issue Date to (but excluding) the First Call Date at a fixed rate of 2.875 per cent. per annum (subject as provided under “*Redemption upon the occurrence of a Change of Control Event or a Significant Disposal Event*” below) (the “**Fixed Rate of Return**”), payable (subject to deferral as described below) annually in arrear on 22 May in each year, commencing 22 May 2018, save that the initial periodic returns payment scheduled for 22 May 2018 shall (subject to deferral as described below) be in respect of the period from (and including) the Issue Date to (but excluding) 22 May 2018.

From (and including) the First Call Date, periodic returns shall accrue on the principal amount of the Capital Securities at a floating rate of return equal to 3-month LIBOR plus a margin of (subject as provided under “*Redemption upon the occurrence of a Change of Control Event or a Significant Disposal Event*” below) 7.018 per cent. per annum (representing a 5.00 per cent. step-up) (the “**Floating Rate of Return**”), and together with the Fixed Rate of Return, the “**Rate of Return**”), payable (subject to deferral as described below) quarterly in arrear on 22 February, 22 May, 22 August and 22 November in each year, commencing 22 August 2020.

Deferral of periodic returns

On each Optional Returns Payment Date there shall be paid the periodic returns accrued in the returns accrual period to (but excluding) such Optional Returns Payment Date unless the Issuer elects to defer payment of such periodic returns in whole or in part.

On each Compulsory Returns Payment Date there shall be paid the periodic returns accrued in the returns accrual period to (but excluding) such Compulsory Returns Payment Date (and, for the avoidance of doubt, the Issuer shall have no discretion to elect to defer payment of periodic returns in whole or in part on any Compulsory Returns Payment Date).

Any periodic returns so deferred shall not fall due for payment on the relevant Returns Payment Date on which (but for such deferral) the same would otherwise have become due and payable, and such deferral shall not constitute a default under the Capital Securities for any purpose.

Periodic returns shall accrue on deferred periodic returns at the prevailing rate of return on the Capital Securities from time to time and, for so long as such deferred periodic returns and such periodic returns

thereon remain unpaid, the same shall constitute “**Arrears of Returns**”.

For these purposes:

“**Compulsory Returns Payment Date**” means any Returns Payment Date as of which, during the 12 month period ending on such Returns Payment Date, the Issuer has:

- (a) declared or paid a distribution on any class of Junior Share Capital or on any Parity Securities, except where such declaration or payment is mandatory under the terms of the relevant instrument; and/or
- (b) redeemed, repaid or otherwise acquired any Junior Share Capital or Parity Securities, except where such redemption, repayment or acquisition is mandatory under the terms of the relevant instrument; and

“**Optional Returns Payment Date**” means any Returns Payment Date which is not a Compulsory Returns Payment Date.

Payment of Arrears of Returns

Arrears of Returns may, at the option of the Issuer, be paid in whole or in part at any time upon notice to the Holders, the Trustee and the Principal Paying Agent.

In addition, all outstanding Arrears of Returns shall become due in full on the earliest to occur of:

- (i) the date upon which a dividend or distribution is next declared or paid on any class of Junior Share Capital or on any Parity Securities, except where such declaration or payment is mandatory under the terms of the relevant instrument;
- (ii) the date upon which any Junior Share Capital or Parity Securities are redeemed, repaid or otherwise acquired by the Issuer, except where such redemption, repayment or acquisition is mandatory under the terms of the relevant instrument;
- (iii) the due date for redemption of the Capital Securities;
- (iv) the date upon which any substitution or variation of the Capital Securities in accordance with Condition 6 takes effect; and
- (v) an order being made, or an effective resolution being passed, for the winding-up, liquidation or dissolution of the Issuer (except in the case of an Approved Winding-up).

No maturity

The Capital Securities have no final maturity date and are only redeemable at the option of the Issuer in the circumstances set out below.

Redemption at the option of the Issuer

The Issuer may, upon giving notice to the Holders, the Trustee and the Principal Paying Agent and subject to certain conditions set out in the Conditions, redeem all (but not some only) of the Capital Securities on the First Call Date or on any Returns Payment Date thereafter at their principal amount together with any Arrears of Returns and any other accrued and unpaid periodic returns.

Redemption upon the occurrence of a Tax Event

If the Issuer satisfies the Trustee that, as a result of any change in, or amendment to, the laws or regulations of the United Kingdom or any political subdivision or any authority thereof or therein, or any change in the application or official interpretation of such laws or regulations, which change or amendment becomes effective after 20 September 2017, on the next Returns Payment Date the Issuer would be required to pay additional amounts as provided or referred to in Condition 7 and such consequence cannot be avoided by the Issuer taking reasonable measures available to it (a “**Tax Event**”), the Issuer may, at any time prior to the First Call Date, at its option and upon giving notice to the Holders, the Trustee and the Principal Paying Agent but subject to certain conditions, redeem all (but not some only) of the Capital Securities at their principal amount together with any Arrears of Returns and any other accrued and unpaid periodic returns.

Redemption upon the occurrence of an Accounting Event

If the Issuer satisfies the Trustee that an Accounting Event has occurred, the Issuer may, at any time prior to the First Call Date, at its option and upon giving notice to the Holders, the Trustee and the Principal Paying Agent but subject to certain conditions, redeem all (but not some only) of the Capital Securities at 101 per cent. of their principal amount together with any Arrears of Returns and any other accrued and unpaid periodic returns.

An “**Accounting Event**” shall occur if as a result of a change in accounting practices or principles (or the application thereof) which become effective after 20 September 2017, the funds raised by the Issuer in respect of the Capital Securities may not, or may no longer, be recorded as equity in the next consolidated financial statements of the Issuer and a recognised accountancy firm, acting upon instructions of the Issuer, has delivered a letter or report addressed to the Issuer to that effect.

Redemption upon the occurrence of a Change of Control Event or a Significant Disposal Event

If a Change of Control Event or a Significant Disposal Event occurs, the Issuer may, at any time, at its option and upon giving notice to the Holders, the Trustee and the Principal Paying Agent but subject to certain conditions, redeem all (but not some only) of the Capital Securities at 101 per cent. of their principal amount together with any Arrears of Returns and any other accrued and unpaid periodic returns.

Increase in Rate of Return

If a Change of Control Event or a Significant Disposal Event occurs, the annual Rate of Return from time to time applicable to the Capital Securities shall increase by 5.00 per cent. with effect from (and including) the date of the occurrence of the Change of Control Event or, as the case may be, Significant Disposal Event.

Additional restrictions following a Significant Disposal Event

If a Significant Disposal Event occurs, the Issuer shall not, until such time as it redeems the Capital Securities:

- (a) declare or pay a dividend or distribution upon any class of Junior Share Capital or on any Parity Securities, except where such declaration or payment is mandatory under the terms of the relevant instrument; or
- (b) redeem, repay or otherwise acquire any Junior Share Capital or Parity Securities, except where such redemption, repayment

or acquisition is mandatory under the terms of the relevant instrument.

Definitions

A “**Change of Control Event**” has the meaning given to it in Condition 5.5(d); and

A “**Significant Disposal Event**” shall occur if, and at the time that, South West Water Limited ceases to be a (direct or indirect) subsidiary of the Issuer within the meaning of section 1159 of the Companies Act 2006.

Issuer right to redeem following the purchase of 80 per cent. of the Capital Securities

In the event that the Issuer and/or any subsidiary(ies) and/or affiliate(s) of the Issuer has or have, severally or jointly, purchased 80 per cent. or more of the initial aggregate principal amount of the Capital Securities, the Issuer may, upon giving notice to the Holders, the Trustee and the Principal Paying Agent but subject to certain conditions, at any time redeem all (but not some only) of the remaining Capital Securities at their principal amount together with any Arrears of Returns and any other accrued and unpaid periodic returns.

Substitution and variation

If a Tax Event or an Accounting Event has occurred and is continuing, then the Issuer may, upon giving notice to the Holders, the Trustee and the Principal Paying Agent and subject to certain conditions set out in the Conditions (without any requirement for the consent or approval of the Holders), at any time either: (i) substitute all, but not some only, of the Capital Securities for; or (ii) vary the terms of the Capital Securities so that they remain or become (as the case may be), Qualifying Securities (as defined in the Conditions, including that such Qualifying Securities must have terms that the Issuer has certified to the Trustee as being not materially less favourable to holders than the terms of the Capital Securities).

Events of Default

The Events of Default (as defined in Condition 9.1) in respect of the Capital Securities are limited to (a) non-payment of any amount of periodic returns or principal when due (subject to a specified grace period) and (b) a winding-up, liquidation or dissolution of the Issuer (except an Approved Winding-up).

Upon the occurrence of an Event of Default, the rights of enforcement of the Trustee are limited to (i) initiating steps for the winding-up, liquidation or dissolution of the Issuer in England and/or (ii) claiming in the winding-up, liquidation or dissolution of the Issuer, as the case may be.

On a winding-up, liquidation or dissolution of the Issuer (except an Approved Winding-up), the claim of the Trustee in respect of each Capital Security shall be for an amount equal to the principal amount of such Capital Security together with any Arrears of Returns (if any) and any other accrued and unpaid periodic returns thereon, and such claim shall be subordinated as provided under “*Status*” above and in Condition 2.3.

Meetings of Holders

The Trust Deed contains provisions for convening meetings of Holders to consider any matter affecting their interests, and for passing resolutions at such meetings or by way of written resolution or electronic consents. These provisions permit defined majorities to bind all Holders including Holders who did not attend and vote at the relevant meeting (or, as the case may be, sign the relevant written

resolution or deliver electronic consents) and Holders who voted in a manner contrary to the majority.

Taxation

All payments in respect of the Capital Securities will be made without deduction for or on account of taxes imposed by the United Kingdom, unless the withholding or deduction of Taxes is required by law. In the event that such withholding or deduction is required by law, the Issuer will, subject to customary exceptions provided in Condition 7, pay such additional amounts as may be necessary to cover the amounts so withheld or deducted.

Form and denomination

The Capital Securities will be issued in bearer form in specified denominations consisting of a minimum denomination of £100,000 and integral multiples of £1,000 in excess thereof up to and including £199,000. No Capital Securities will be issued in a principal amount exceeding £199,000.

Listing and admission to trading

Application has been made for the Capital Securities to be admitted to the Official List and to trading on the regulated market of the London Stock Exchange.

Governing law

The Capital Securities and any non-contractual obligations arising out of or in connection with the Capital Securities will be governed by, and construed in accordance with, English law.

Use of proceeds

The net proceeds of the issue of the Capital Securities will be applied by the Issuer for general corporate purposes, including (without limitation) to fund the purchase of any or all of the £300,000,000 Perpetual Capital Securities issued by the Issuer on 8 March 2013 pursuant to a cash tender offer announced by the Issuer on 11 September 2017.

Selling restrictions

There are restrictions on the offer, sale and transfer of the Capital Securities in the United States and the United Kingdom. See “*Subscription and Sale*”.

United States selling restrictions

Regulation S, Category 2. TEFRA D.

RISK FACTORS

In purchasing Capital Securities, investors assume the risk that the Issuer may become insolvent or otherwise be unable to make all payments due in respect of the Capital Securities. There is a wide range of factors which individually or together could result in the Issuer becoming unable to make all payments due in respect of the Capital Securities. It is not possible to identify all such factors or to determine which factors are most likely to occur, as the Issuer may not be aware of all relevant factors and certain factors which it currently deem not to be material may become material as a result of the occurrence of events outside the Issuer's control. The Issuer has identified in this Prospectus a number of factors which could materially adversely affect its business and ability to make payments due under the Capital Securities.

In addition, factors which are material for the purpose of assessing the market risks associated with the Capital Securities are also described below.

Prospective investors should also read the detailed information set out elsewhere in this Prospectus and reach their own views prior to making any investment decision.

Unless otherwise defined, capitalised terms used herein have the meaning given to them in "Terms and Conditions of the Capital Securities".

FACTORS THAT MAY AFFECT THE ISSUER'S ABILITY TO FULFIL ITS OBLIGATIONS UNDER THE CAPITAL SECURITIES

The Issuer's ability to fulfil its obligations under the Capital Securities may be affected by certain factors as set out below which may affect the Issuer and its subsidiaries. To the extent that any of the factors described below affects its subsidiaries, the Issuer will also be affected as it is a holding company and its financial position and results of operations are substantially dependent on those of its subsidiaries.

The Issuer is the holding company for two principal trading subsidiaries:

- South West Water Limited (the merged businesses of South West Water and Bournemouth Water), which provides water and sewerage services to a population of around 1.7 million in Devon, Cornwall and parts of Dorset and Somerset; and water only services to around 0.5 million in parts of Dorset, Hampshire and Wiltshire. South West Water Limited, together with its subsidiaries, is referred to in this Prospectus as "**South West Water**" and, unless otherwise indicated, such a reference is to the merged businesses of South West Water and Bournemouth Water.
- Viridor Limited, which is one of the UK's leading energy recovery, recycling and waste management businesses, providing services to more than 150 local authorities and major corporate clients as well as over 32,000 customers across the UK. Viridor Limited, together with its subsidiaries, is referred to in this Prospectus as "**Viridor**".

Additionally, in preparation for the opening of the English non-household retail water market on 1 April 2017, a joint venture company was set up, named Pennon Water Services Limited. 80 per cent. of the share capital is owned by the Issuer with 20 per cent. owned by the joint venture partner, South Staffordshire Plc, owner of South Staffordshire Water and Cambridge Water. Operations of Pennon Water Services Limited are ringfenced from South West Water's business. Pennon Water Services Limited entered the deregulated market as one of the top six largest retailers by customer base, and now provides billing, collections and account management services to around 170,000 customers. Pennon Water Services Limited, together with its subsidiaries, is referred to in this Prospectus as "**Pennon Water Services**" or "**PWS**".

Law and Regulation

South West Water operates in a heavily regulated industry and is, accordingly, exposed to a wide range of regulatory risks, including the risk of the loss of or a material adverse modification to its licence or geographical area of appointment, material changes in applicable regulation which adversely affect South West Water and the risk of failure to comply with applicable regulation.

Changes in government and government policy could lead to a changed regulatory environment which may materially adversely impact the business of the Group.

South West Water's businesses are subject to various laws and regulations in the UK, including environmental laws and regulations (as to which, see "*—South West Water is subject to stringent environmental regulations*").

and quality standards and changes in these standards could materially increase South West Water's costs and adversely affect profitability. In addition, any failure to comply with applicable environmental regulations could result in severe financial penalties and/or criminal prosecution"). Regulatory decisions in relation to South West Water's businesses, for example on the structure of the water industry, on whether licences, appointments, approvals or permits to operate are renewed or modified, whether market developments have been implemented satisfactorily, on the level of permitted charges or revenues for South West Water's businesses or whether there has been any breach of the terms of a licence, appointment, approval, permit or other obligation, could have an adverse impact on the results of South West Water's operations, cashflows, financial condition and the ability to develop its businesses in the future.

South West Water's licence was originally granted in 1989 and now covers the original South West Water and Bournemouth Water regulated businesses under a single licence. The licence is subject to modification in certain circumstances and was last modified on 6 April 2017. If, at any time, the Water Services Regulatory Authority ("Ofwat") were to announce a modification to the licence which South West Water did not accept, a reference could be made by Ofwat to the Competition and Markets Authority who would, following the consideration of representations from interested parties including South West Water, ultimately decide whether a licence modification should be made. In such circumstances, South West Water's licence could be modified without its consent.

A failure by South West Water to comply with the conditions of its licence or certain statutory duties, as modified from time to time, may lead to a fine or the making of an enforcement order by Ofwat or the Secretary of State for the Environment, Food and Rural Affairs (the "**Secretary of State**"), which could have an adverse impact on South West Water. Ofwat also has the power to fine South West Water up to 10 per cent. of its turnover in the preceding 12 months if it fails to comply with its statutory duties or the terms of its licence or fails to meet required standards of performance. The Secretary of State also has powers to impose a penalty under certain circumstances. Regulatory authorities may, from time to time, make enquiries of companies within their jurisdiction regarding compliance with laws or regulations governing their operations. In addition to regulatory compliance proceedings, South West Water's businesses could become involved in a range of third party proceedings relating to, for example, land use, environmental protection and water quality. Amongst others, these may include civil actions by third parties for infringement of rights, nuisance claims or other matters.

Furthermore, the impact of future changes in laws or regulations or the introduction of new laws or regulations that affect the business cannot always be predicted and, from time to time, interpretation of existing laws or regulations may also change or the approach to their enforcement may become more rigorous.

If South West Water fails to comply with applicable laws or regulations, or the terms of its licence, or does not successfully undertake corrective action, regulatory action could be taken that could include the imposition of a financial penalty (of up to 10 per cent. of relevant turnover for each infringement), prosecution or the imposition of an enforcement order requiring South West Water to incur additional expenditure to remedy its non-compliance. In the most extreme cases, non-compliance may lead to revocation of South West Water's licence or the appointment of a special administrator in relation to South West Water, see "*In certain circumstances (such as a serious breach of its duties under the Water Industry Act 1991 or inability to pay its debts), South West Water could be placed under special administration which could limit the ability of its creditors to recover amounts due to them*".

In certain circumstances (such as a serious breach of its duties under the Water Industry Act 1991 or inability to pay its debts), South West Water could be placed under special administration which could limit the ability of its creditors to recover amounts due to them.

The Water Industry Act 1991 contains provisions enabling the Secretary of State or Ofwat (with the permission of the Secretary of State) to secure the general continuity of water supply and sewerage services by petitioning the High Court for the appointment of a special administrator in certain circumstances (for example, where a water company is in breach of its principal duties under that Act or of the provisions of a final or confirmed provisional enforcement order (and in either case the breach is serious enough to make it inappropriate for the relevant water company to continue to hold its licence) or is unable, or is likely to be unable, to pay its debts). In addition, a petition by a creditor of a water company to the High Court for the winding up of the water company might result in the appointment of a special administrator where the court is satisfied that it would be appropriate to make such a winding-up order if the water company were not a company holding a licence under the Water Industry Act 1991. The duties and functions of a special administrator differ in certain important respects from those of an administrator of a company which is not a water company.

If a special administration order is made in respect of South West Water, during the period of the special administration order South West Water would have to be managed by the special administrator for the purposes of the order and in a manner which protected the interests of its shareholders and creditors. While the order is in force, no steps may be taken to enforce any security over the property of South West Water except with the consent of the special administrator or the leave of the court. As a result, if a special administration order is made in respect of South West Water, there can be no assurance that South West Water's creditors will be able to recover amounts due to them in full.

South West Water is subject to stringent environmental regulations and quality standards and changes in these standards could materially increase South West Water's costs and adversely affect profitability. In addition, any failure to comply with applicable environmental regulations could result in severe financial penalties and/or criminal prosecution.

Various environmental, consumer protection and health and safety laws and regulations govern South West Water's waste water and water distribution businesses. These laws and regulations establish, amongst other things, quality standards for drinking water, effluent treatment (including sewage sludge disposal) and discharges into the environment. All of these affect South West Water's operations. Although South West Water believes that it is currently in material compliance with all such laws and regulations, it cannot guarantee that it will be in full compliance with them at all times. In addition, South West Water is required to obtain various environmental permissions from regulatory agencies for its operations. Any inability to obtain or renew any such permission could restrict certain aspects of South West Water's business and result in increased costs and/or reduced profitability.

Environmental laws are complex and change frequently. These laws and their enforcement have tended to become more stringent over time. South West Water budgets for future expenditure to achieve compliance with current and known future changes in environmental law and regulation. However, it is possible that new or stricter standards could be imposed that would raise South West Water's expenditure by requiring modifications to its assets or operations. It is also possible that future legislation will impose constraints on existing water abstractions requiring South West Water to source alternative water supplies. These costs may be recoverable in part or in whole through the regulatory process of setting appropriate future revenue limits. In the event of these costs being significant, South West Water could apply (in certain circumstances) to Ofwat for a revision of its revenue limits through an interim determination ("**Interim Determination**") (as described under "*Description of the Issuer and the Group –Price regulation*"), although there is no assurance that in any such case South West Water would be able to recover its costs in full or at all or on a timely basis.

As environmental laws are becoming more stringent, South West Water may also be unable to comply with all new regulatory and environmental performance standards. Such non-compliance could result in the potential for fines or other sanctions imposed by either Ofwat or the courts, including ultimately the loss of South West Water's licence.

South West Water is subject to five yearly determinations on the prices which it is permitted to charge its customers. These price controls applicable to South West Water's regulated business are performance related and could adversely affect its profitability in a variety of ways.

Every five years, Ofwat sets limits on the revenue water companies in England and Wales can recover through customers' charges by issuing price determinations. The most recent price control review was set out by Ofwat in a Final Determination dated 12 December 2014 and applies to the period 1 April 2015 to 31 March 2020 ("**AMP6**"). That price review implemented separate price controls for the retail and wholesale parts of the value chain enabling more targeted regulation and support for the opening of the non-household retail market to competition.

The price control framework for AMP6 is based on a revenue cap formula which permits revenue to be recovered based on the percentage change of the Retail Prices Index ("**RPI**") plus an adjustment factor ("**K factor**") which incorporates efficiency targets and the delivery of outcomes that drive improvements to service levels.

The Return on Regulated Equity ("**RoRE**") which can be earned by South West Water's regulated business is defined through a package of rewards and penalties. It is calculated using actual results before non-underlying items and compared against the final determination allowances (based on notional gearing (at 62.5 per cent.), annual average regulatory capital value ("**RCV**") and taking into account tax impacts of outperformance.

The base return / equity cost of capital for South West Water for AMP6 was set at 6 per cent. with an overall weighted average cost of capital of 3.7 per cent. real after tax (i.e. the post-tax, pre-inflation rate set by Ofwat)

for the wholesale business with a further 0.2 per cent. from retail margins. RoRE actually earned can be higher or lower than this level through the operation of a number of regulatory mechanisms in place to assess and incentivise performance, including:

- Total expenditure savings and efficiencies, taking into account the phasing of actual expenditure within the business plan.
- The delivery of outcomes to customers compared to South West Water's committed performance levels through Outcome Delivery Incentives ("ODIs"). The ODIs cover a full range of business activities and were agreed after extensive consultation with customers and stakeholders. Actual performance against these commitments will increase or decrease revenues where commitments have financial penalties associated with underperformance or rewards for outperformance. The ODIs in the AMP6 period mean that South West Water faces material risk of penalties from operational underperformance as well as opportunities for rewards for outperformance. Payments can take the form of a penalty paid by a company to compensate customers for performance below its committed performance level or a reward received by a company to reflect a level of performance that exceeded its committed performance level.
- The difference between actual and allowed financing costs.

In addition, the service incentive mechanism ("SIM") rewards or penalises companies' service performance by comparing performance of companies in the sector in terms of the quality of service that is delivered to customers. It comprises both a quantitative measure of complaints and unwanted contacts, and a qualitative measure, based on survey evidence, that looks at how satisfied customers are with the quality of service that they receive. Depending upon South West Water's relative performance under the SIM it could receive a reduced or increased revenue allowance when price limits are next reset in the 2019 determination.

Further details of the operation of price control mechanisms is set out in "Description of the Issuer and the Group-Price Regulation".

On 11 July 2017 Ofwat published 'Delivering Water 2020: Consulting on our methodology for the 2019 price review' ("PR19") setting out its proposed approach for the price control review that will be applied to PR19, with the final methodology for PR19 planned to be issued in December 2017. This new framework signifies Ofwat's objective to pass on the benefit to customers from lower financing costs in setting the cost of capital, while ensuring that efficient companies will be remunerated appropriately so they can finance their programmes.

Ofwat states that in achieving an appropriate package of risk and return it plans to set the allowed return based on the prevailing market evidence which it believes points to a lower cost of capital at PR19.

There is no assurance that current or future price limits will not restrict South West Water's ability to generate sufficient revenue to carry on its business in a manner that is sufficiently profitable for its shareholders and investors. The conditions of South West Water's licence, including any condition relating to the prices South West Water can charge its customers, can be modified by Ofwat either with South West Water's agreement or following reference to the Competition and Markets Authority on public interest grounds.

Viridor is required under its permits to undertake significant expenditure on site restoration and aftercare following the closure of each landfill site. Permits cannot be surrendered during this period and Viridor is exposed to both the risk of liability from contamination and potential cost increases, which could be significant, in relation to each closed site for which it is responsible.

Landfills (and other industrial processes) in the UK are subject to a statutory permitting regime. Under Viridor's environmental permits, landfill sites require expenditure on restoration when the site is closed and subsequently on aftercare (maintenance, supervision, monitoring and management of gas and leachate levels) long after the landfilling activities have ceased. Viridor currently manages a number of closed landfill sites, including four sites that were closed in the year ended 31 March 2017. Landfill permits cannot be surrendered during the aftercare period and the Environment Agency and the Scottish Environment Protection Agency will only allow surrender of the permits in relation to these sites once it is satisfied that the landfill no longer poses any environmental risk.

The costs related to an environmental permit, both during and after the lifetime of a landfill site, can be substantial and have the potential to negatively impact on Viridor's profitability, particularly if they should increase significantly beyond the amounts originally provided by Viridor. In addition, Viridor remains subject to the risk of liability arising from any residual contamination at a site, even after the permit in respect of that site has been surrendered.

Breach of health and safety laws and regulations could lead to financial penalties, significant legal costs and damage to reputation.

It is Group policy to provide and maintain a safe working environment while preventing injury and ill health wherever possible. The Group continues to target improvement through training programmes focusing on behaviours and attitudes as well as risk awareness and risk control and the ability to learn from accidents or near misses.

Breach of health and safety laws and regulations could lead to financial penalties, significant legal costs and/or damage to the Group's reputation, which could have a material adverse impact on the business of the Group or its results of operations.

The Group has open tax computations and uncertain tax positions which could adversely affect the Group's profitability and cashflow.

The Group engages with HM Revenue and Customs ("HMRC") in an open and transparent way, identifying areas of uncertainty on a timely basis. Due to the complexity of tax legislation, the Group and tax authorities may sometimes have differing opinions on the treatment of certain tax items. The Group manages the risk and accrues for areas of tax uncertainty where appropriate, maintains an experienced and professionally qualified in-house tax team and is supported by external specialists as required. Nevertheless, were any material items to be resolved unfavourably this could adversely affect the Group's profitability and cashflows.

Proposed changes in tax law arising from the OECD's Base Erosion and Profit Shifting ("BEPS") project might have an adverse effect on the financial position of the Issuer and the Group.

The Finance Bill 2017-19 published on 8 September 2017 includes draft legislation restricting the tax deductibility of interest expense in response to the Organisation for Economic Co-operation and Development's ("OECD") final recommendations in relation to the tax deductibility of interest expenses arising from its BEPS project.

The draft legislation, if enacted in the form contained in the Finance Bill 2017-19, will introduce with effect from 1 April 2017 new restrictions on the tax deductibility of total net group interest expense for corporation tax purposes which included a cap on interest reductions by reference to a fixed ratio based on 30 per cent of a UK group's tax EBITDA (or an amount equal to the group's total net interest expense (if lower)). This was supplemented by a worldwide group ratio rule to enable groups which have a higher level of external gearing to deduct interest expense or debt owed to unrelated parties that would otherwise be disallowed under the fixed ratio rule, subject to certain conditions.

The enactment of the draft legislation in the form contained in the Finance Bill 2017-19, may limit the ability of the Issuer and its affiliates to claim deductions for all or part of its interest expenses, which may have an adverse effect on the financial position of the Issuer and the Group. However, it is not currently expected that any such restrictions on deductions for interest expense under the proposed rules will result in any additional cash tax liability for the Issuer and the Group.

Significant management discretion is involved in the preparation of the Group's consolidated financial statements for any period.

The preparation of the Group's consolidated financial statements requires management to make certain judgements and estimates, the most significant of which relate to:

- the value of environmental and landfill restoration provisions;
- the pension cost and liabilities associated with the Group's defined benefit pension schemes;
- in relation to its service concession arrangements, the split of contract receivables between profit on the construction of assets, operation of the service and provision of finance recognised as interest receivable;
- revenue recognition, including the amount of income accrued but not billed at the period end;
- the determination of provisions, including for doubtful debts, impairment of non-financial assets and valuation of non-current assets; and
- establishing which items are disclosed separately as non-underlying.

The Issuer is required to exercise significant judgement and make use of estimates and assumptions in the application of these matters. Estimates are based on factors including historical experience and expectations of

future events that management believe to be reasonable. However, given the nature of such estimates, actual results could be different from the assumptions used. In addition, there can be no assurance that any assumptions made by management will necessarily prove to have been accurate predictions of future events.

Financing

The Group is potentially exposed to interest rate variations which could affect its profitability and cashflow.

The Group's debt obligations are subject to both fixed and floating interest rate provisions. The Group has a policy of maintaining at least 50 per cent. of interest-bearing liabilities at fixed rates. The Group's exposure to interest rate movements on its floating-rate debt is managed by the use of interest rate derivatives. South West Water has fixed over 50 per cent. of its existing net debt for the entire AMP6 period and for the year ended March 2017 the Group had an average interest rate of 3.4 per cent (South West Water: 3.2 per cent.).

In addition, as at 31 March 2017, approximately 25 per cent. of South West Water's net debt was index-linked as part of the company's diverse portfolio of debt.

Despite South West Water and the Group having measures in place to counteract the effects of interest rate movements, substantial changes in market interest rates and/or incorrect hedging strategies could still result in greater liabilities for the Group in respect of its interest payment obligations which could, consequently, affect the Group's profitability and cashflow.

The Group may not be able to refinance existing financial facilities due for renewal or may only be able to refinance them at a significantly higher cost.

The Group's Treasury function operates only within policies approved by the Board and undertakes no speculative trading activity. The Board regularly monitors expected financing needs for at least the following 12 months. These are intended to be met for the coming year from existing cash balances, loan facilities and operating cashflows. As at 31 March 2017 the Group had cash and deposits of £598 million, and undrawn committed bank facilities of £785 million, giving access to total cash and committed facilities of £1,383 million whilst, at the same date, its debt repayments falling due by 31 March 2018 amounted to £146.5 million.

Notwithstanding its treasury policies, the Group is still subject to the risk of not being able to refinance material financial facilities or to meet other unanticipated material liabilities. This could result, for example, from a debt default (see "*The Group may breach its financial covenants which could result in increased costs of borrowing or a default and could result in material losses to Holders*"), which could consequently have an adverse impact on the cashflow of the Group. In addition, factors such as lenders' perception of the Group's creditworthiness and market volatility could result in the Group only being able to refinance maturing debt at a significantly higher cost which could adversely affect its profitability in future years.

The Group may be at risk of losing funds held by third parties (counterparty risk management).

Surplus funds of the Group are usually placed in short-term fixed interest deposits or the overnight money markets. The Group is thus potentially exposed to counterparty risk from holders of these surplus funds that could result in financial losses should such counterparties become unable to meet their obligations to the Group. Although the Issuer has agreed a policy for managing such counterparty risk, which includes controlling risk through credit limits, counterparty approvals and rigorous monitoring procedures including the use of external publicly available rating information ensuring that all deposits are held with counterparties which have an appropriate short-term credit rating. Should the Group's counterparties be unable to meet their obligations to the Group, its operating results, cashflow and financial condition could be materially and adversely affected.

The Group may breach its financial covenants which could result in increased costs of borrowing or a default and could result in material losses to Holders.

The Issuer and South West Water have entered into covenants with lenders. Whilst terms vary, the Group's terms typically provide for limits on gearing (primarily based on South West Water's regulatory capital value and non-regulated consolidated earnings before interest, tax and depreciation (EBITDA) plus interest receivable on service concession arrangements (also known as IFRIC 12)) and interest cover. If the Issuer or South West Water were to be in danger of breaching these covenants, it would need to negotiate a waiver or to renegotiate the relevant covenants with its lenders. There is no certainty that any such negotiation would be successful and, even if the covenants could be renegotiated or waived, there could be associated costs which would adversely impact the Group's profitability. If the relevant covenants could not be renegotiated or waived, the relevant borrower would either have to repay the relevant debt early (in which case redemption penalties could be

invoked which could have an adverse effect of the Group's cashflow and profitability) or could be placed in default. In addition, any failure by the Issuer or South West Water to comply with its covenants could impact other indebtedness of the Group, including the Capital Securities, through cross default provisions, and could result in material losses to holders of the Capital Securities.

The financial covenants offered by the Group include a term to re-test the covenants applying the accounting standards applicable on origination of the borrowing. This is to protect the Group from changes in accounting standards which may have a detrimental impact on the financial covenant testing methodology. To the extent that any covenants offered by the Group do not have such provisions, a change in accounting standards could result in a breach of financial covenants and an obligation on the Group to repay loan monies.

The Group's pension schemes may require additional contributions in future years which would reduce its profit in those years.

The Group operates defined benefit pension schemes for certain employees of the 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). The deficit has increased due to the post-Brexit fall in bond yields, increasing the valuation of liabilities. However, over half of the increase in the valuation of liabilities has been offset by increases in asset values.

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

The 31 March 2016 actuarial valuation of the main scheme has been finalised, the outcome is in line with the 2013 valuation and schedule of contributions, which is consistent with final determination allowances for the AMP6 period.

The assets of the pension schemes are held in trust funds independent of Group finances. Estimates of the amount and timing of future funding for the defined benefit schemes are based on various actuarial assumptions and other factors including, among other things, the actual and projected market performance of the scheme assets, future long-term bond yields, average life expectancies and relevant legal requirements. The impact of these assumptions and other factors may require the Group to make additional contributions to these pension schemes which, to the extent they are not recoverable under the regulatory price determination process, could materially adversely affect the Group's results of operations and financial condition.

South West Water revenues are linked to RPI and are therefore subject to inflation risk.

The tariffs for South West Water are linked to inflation (currently based on RPI but under a new methodology proposed by the regulator CPIH (the successor to the Consumer Prices Index ("CPI")) will be used to index customer bills) and, should there be any periods of deflation, tariffs and, consequently, revenues are at risk of reducing, which may adversely affect the financial position of South West Water.

Market and Economic Conditions

The Group's business may be adversely affected by poor global economic conditions.

The UK public vote in June 2016 to leave the European Union ("Brexit") has produced uncertainty in both the United Kingdom and in the European Union ("EU"). It is too early to know the implications of the vote to leave; this will only become clear when negotiations following the March 2017 triggering of Article 50 are complete. No assurance can be given that such matters would not adversely affect the business of the Group. In addition, the Group has historically accessed funding from EU-based investors and institutions including, by way of example, the European Investment Bank.

In the Viridor business, the continued drive by the UK Government to maintain austerity measures in the public sector has meant that a number of long term contracts with local authority counterparties are being scrutinised and reviewed. Viridor currently has eight operational Energy Recovery Facilities ("ERFs") and around 80 per cent. of the waste inputs for the ERF portfolio (excluding Avonmouth) are contracted. Were these contracts to be re-negotiated, this may adversely affect the profitability of Viridor and the Group.

Continued poor global conditions and competition within the market means there is a risk to supply sufficient waste volumes to drive future gate fees for the Viridor operations. This risk is on the shorter length contracts which are subject to greater pricing pressure. This could cause a reduction in revenues and have an adverse effect on Viridor's business, financial condition and results of operations.

Additionally, although South West Water's revenues are economically regulated through the regulatory price review mechanism, its revenues remain exposed to customer affordability issues and increased bad debts, see "*A significant proportion of South West Water's domestic customer base have metered water supplies which results in more volatile revenue streams than from customers who are not metered*" and "*- Non-recovery of a material amount of customer debt through the Group's subsidiaries could adversely affect the Group's profitability*".

Pennon Water Services is exposed to the impact of poor economic conditions and austerity on both SME and larger industrial customers by way of the risk of lower demand and increased bad debts.

As a result, any future deterioration of general economic conditions in the markets in which the Group operates as well as United States and international trading market conditions and/or related factors as well as changes in investment markets, including changes in interest rates, exchange rates and returns from equity, property and other investments, may also materially adversely affect the financial performance of the Group.

Non-recovery of a material amount of customer debt through the Group's subsidiaries could adversely affect the Group's profitability.

South West Water is restricted by statute in the measures it can take to recover debts owed by domestic customers. South West Water is responsible for the billing, cash collection and debt management activities for around 950,000 domestic water and wastewater customers. The Water Industry Act 1997 prohibits the disconnection of a domestic water supply for non-payment.

Non-recovery of debt is therefore a risk to South West Water and may cause its profitability and cash flow to suffer. Allowance is made by Ofwat in each price determination for its estimate of debt deemed to be irrecoverable, but there can be no assurance that the amount allowed by Ofwat is or will be adequate.

Pennon Water Services is contractually obliged to pay monthly wholesale charges, regardless of whether customer revenue has been recovered. As a result, the non-recovery of a material amount of customer debt could adversely affect Pennon Water Services' profitability.

A significant amount of the revenue received by Viridor is generated by the operational ERFs. This revenue is underpinned by long-term contracted volumes, the majority of which are from local authorities with good credit metrics. However, the remainder of contracts are of a shorter duration and may be with suppliers with a less established credit history. Customers with lower creditworthiness may pose an increased risk of debt collection delay or failure.

A significant proportion of South West Water's domestic customer base have metered water supplies which results in more volatile revenue streams than from customers who are not metered.

Approximately 80 per cent. of South West Water's domestic customer base make payment for their water based on volume of water used as measured by a meter. In part, this reflects the fact that higher than national average water and sewerage charges exist within the South West Water area. Revenues from customers who are metered is generally more volatile than revenue from other customers. This reflects the fact that changes in water usage by customers will vary based on abnormal weather impact, increased water efficiency (which metered customers are incentivised to adopt) and the effects of poor economic conditions impacting the Group's commercial customers.

The Viridor ERF fleet has long-term contracted waste volumes from a number of counterparties and is at risk of non-performance of their contracted business partners.

Viridor has waste volumes for the ERF fleet sourced on long-term contracts with multiple suppliers. Whilst the majority of these contracts are with Local Authority counterparties and have low risks of default, there remains the risk of a major supplier or contractor experiencing an insolvency event resulting in insufficient waste volumes being delivered to an ERF. This underperformance on a contractual basis could cause a reduction in revenues produced by the facility, which could have an adverse effect on Viridor's business, financial condition and results of operations.

Pennon Water Services operates in the non-household water and sewerage market, which is open to competition, and could be adversely affected by any material transfer of water customers.

In April 2017, Ofwat oversaw the opening of the English non-household retail market. Up to 1.2 million businesses, public sector and other English non-household customers across the UK are now able to choose who they buy water and wastewater services from. Wholesale services, providing water to premises and taking

wastewater away, are unaffected, but business customers are able to choose who provides their retail service. The reasons for this change are to deliver a resilient and sustainable water industry, to encourage innovation and efficiency and to attract long-term investment.

On 1 April 2017, the non-household (“NHH”) customers of South West Water, South Staffordshire Water and Cambridge Water were acquired by PWS, initially on deemed contracts. PWS entered the deregulated market as one of the top six largest retailers by customer base.

Pennon Water Services could be adversely affected by the material transfer of water customers to a competitor and a loss of market share which could adversely affect its results of operations, profitability or financial condition.

The Group’s net energy generation is subject to pricing and market volatility risks.

The Group 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.

As at 31 March 2017, over 90 per cent. of energy (generation net of internal usage of electricity) is hedged for the current financial year and over 60 per cent. is hedged until 31 March 2020. However, the Group remains exposed to an element of market price volatility on unhedged volumes.

The Group also has a natural hedging opportunity, representing one-third of Viridor’s energy generation, since South West Water is a net user of electricity.

South West Water is a large consumer of energy and is susceptible to market volatility in the price of electricity.

Since it has a large generation capacity, Viridor is able to provide an internal hedge through a ‘sleeving’ arrangement enabling South West Water to fix its energy requirements, optimise the Group’s energy position and reduce the Group’s exposure to volatility in the electricity market. If this natural hedge were to become unavailable and South West Water and/or Viridor were required to purchase electricity from the market, this would increase the Group’s exposure to the risk of volatile energy pricing in the market. Any bilateral external hedging by South West Water would also increase the Group’s overall exposure to the energy market.

Viridor’s energy generation business is subject to pricing and other risks, including changes in Government policy, a fall in the underlying energy price and reductions in the volumes of energy generation.

Viridor has a portfolio management approach to the sale of energy generation. Viridor is one of the largest independent power generators from waste in the UK. For the year ended 31 March 2017, Viridor exported 1.5 TWh of power.

The policy is to sell its generated energy forward on a seasonal basis. The Group is exposed to an element of market price volatility on unhedged volumes.

It is possible that a change in Government policy could result in additional onerous requirements for Viridor in future sales of its energy generation to the market.

Operational failure in Viridor’s ERF business could restrict the availability and optimisation of the ERF portfolio, which could result in a reduction in the volume of energy generation.

A fall in the underlying energy price, a negative change in Government policy or regulation or a reduction in volumes of energy produced by the ERF portfolio could have an adverse effect on Viridor’s business, financial condition and results of operations.

Viridor operates in competitive industries and increased competition affecting recycle and other prices or reduced demand for the services provided by Viridor could materially adversely impact its financial position.

Viridor is experiencing increased competition in a number of areas of its business. These include recycle trading (where competition from other operators can adversely impact both the volumes of recycle which it trades and the prices which it is able to achieve), the energy recovery market (gate fees and power prices) and in the landfill market (landfill gate fees).

Viridor’s ERF assets are subject to competition for contracts and waste volumes in addition to the power prices achieved in the market. Whilst the long-term gate fees are indexed and contractually sourced for around 80 per cent. of the volumes (excluding Avonmouth), there is greater risk on the shorter length contracts which are

subject to greater pricing pressure and in particular an increase in competition could cause a reduction in revenues which could have an adverse effect on Viridor's business, financial condition and results of operations.

Any consistent negative trends in recyclate market conditions or demand for Viridor's services could have an adverse effect on Viridor's business, financial condition and results of operations.

In addition to competition in the recyclate and ERF markets, Viridor experiences competition in relation to landfill gate fees, which are charges levied by Viridor upon a given quantity of waste received at a waste processing facility.

Viridor pays landfill tax based on the amount of waste accepted at the relevant site. Landfill tax has risen substantially in recent years and is subject to change based on UK Government policy and regulation. Landfill tax is currently increasing in line with inflation and, as at 1 April 2017, was £86.10 per tonne of waste. Viridor is required to charge the tax on materials received into its landfill sites and pay this amount to HMRC on a regular basis. Further increases to landfill tax may have an adverse impact on Viridor's cashflow.

Recyclate prices are volatile and driven by global economic conditions and supply and demand trends. In addition, Viridor is exposed to exchange rate risk in relation to its recyclate exports.

Viridor retains its position as one of the largest recycling businesses in the UK. Its recycling operations had a satisfactory year with recycling volumes traded in the year ended 31 March 2017 slightly lower than previous years at 1.6 million tonnes.

In the year ended 31 March 2017, recyclate prices were mainly flat but under pressure, with fluctuations across different commodities. Viridor is not relying on a near-term recovery and has implemented a number of 'self-help' measures. In addition, local authority austerity in the face of central Government cuts has made the market environment more difficult.

Notwithstanding Viridor's position in the UK market and the initiatives it has implemented, recyclate prices are volatile and driven by global economic conditions and supply and demand trends. In addition, Viridor is exposed to exchange rate risk in relation to its recyclate exports. Accordingly, any negative trends in global economic conditions or demand for Viridor's services, and any adverse movements in foreign currency exchange rates, could have a material adverse effect on Viridor's business, financial condition and results of operations.

Operating Performance

Failure of the Group's assets to cope with extreme weather conditions may lead to an inability to meet its customers' needs, to environmental damage, and to additional costs and loss of reputation.

The Group seeks to mitigate the risk of extreme weather incidents across the Group through contingency plans, emergency resources and investment through a planned capital programme.

However, there can be no assurance that such measures will be successful in mitigating the Group's risks, and failure of the Group's assets to cope with extreme weather conditions may lead to an inability to meet its customers' needs, environmental damage, additional costs and loss of reputation, all of which could have a material adverse effect on the Group's business, cashflows, financial condition and results of operations.

South West Water may be adversely affected by the long-term effects of climate change, which could impact its ability to deliver its services efficiently and could give rise to significant future costs which may not be fully recoverable and could therefore adversely affect its future profitability.

South West Water may be impacted by extreme weather conditions and the long-term effects of climate change. Extreme weather conditions (including drought and flooding), together with increased demand from customers resulting from, for example, hotter drier summers, could affect South West Water's resources, water quality and biodiversity. South West Water has established contingency plans, and will seek to adapt the way it conducts its business, to respond effectively to hotter, drier summers and wetter periods which are predicted. South West Water's assets and infrastructure could also increasingly be vulnerable to rising sea-levels, more intense storms and flooding. These conditions could affect South West Water's ability to provide water and wastewater services. Costs may be incurred in taking action to tackle vulnerable sites and infrastructure and, to the extent not fully recovered, this could have an adverse effect on the business, profitability and cashflow of South West Water.

Any contamination of South West Water's water supplies or pollution caused by South West Water could result in significant clean up costs and/or financial penalties which would be likely to adversely affect South West Water's future profitability.

Given the nature of South West Water's operations, there is a risk that drinking water quality and environmental pollution incidents may occur. These may emanate from naturally occurring compounds or man-made sources and, if South West Water is unable to substitute a water supply or to treat the contaminated water source adequately, or is otherwise unable to effectively mitigate the effects of the pollution, the possible consequences may be criminal prosecution leading to the imposition of fines on South West Water and/or civil liability in damages to third parties and/or a requirement to clean up any contamination and/or an operational requirement to upgrade plant and equipment. Such incidents could also give rise to prosecutions against the Directors of South West Water. The imposition of fines, civil liability, clean-up costs or upgrade costs may materially and adversely affect the financial position of South West Water.

Where South West Water incurs material remedial costs, some or all of the costs may be recoverable through future price reviews or through insurance policies maintained by South West Water, although there is no guarantee that all or any of the costs associated with these risks would be covered or that coverage will continue to be available in the future. South West Water could also be held liable for human exposure to hazardous substances in its water supplies or other environmental damage.

There is also a risk that South West Water may incur liability to clean up contamination caused by historical activities at its sites, whether or not South West Water caused the contamination in question. The costs of cleaning up contamination of land and/or water may be significant. Such contamination may also result in claims by third parties such as neighbouring landowners.

Interruptions to business or significant operational failures or incidents could have a significant impact on the profitability of Group businesses and also represent a reputational risk.

Operational failure in South West Water's business could result in not being able to supply clean water to customers or provide safe wastewater services. This could have a direct impact on the delivery of the AMP6 business plan and affect profitability by affecting expenditure efficiency and the delivery of ODIs.

South West Water controls and operates water and wastewater networks and maintains the associated assets with the objective of providing a continuous service. South West Water is also dependent on the ability to access, utilise and communicate remotely using electronic software applications mounted on corporate information technology hardware and communicating through internal and external networks which are not wholly under its control. South West Water's ability to maintain the required standards of operational performance may be adversely affected by any interruption in these networks. In addition, in exceptional circumstances, such as prolonged drought, system failure or catastrophic damage, a significant interruption of service provision could occur.

Such consequences may arise due to a number of circumstances, for example water shortages, the failure of an asset or an element of a network or supporting plant and equipment, human error, an individual's malicious intervention or unavoidable resource shortfalls.

In the event of a failure to meet the required standards of operational performance, South West Water could be fined for breaches of statutory obligations or be held liable to third parties, or be required to provide an alternative water supply of equivalent quality, which could increase costs. In addition, a significant interruption in service provision could result in significant harm to human health, environmental damage and/or economic and social disruption.

Operational failure in Viridor's businesses could particularly impact profitability of the Group by restricting the availability and optimisation of ERFs and recycling facilities.

Whilst the Group intends that adoption of effective business continuity and contingency plans should mitigate the risk and accelerate the recovery from an incident, and the Group has in place an insurance programme designed to cover residual risk, there can be no assurance that the measures adopted by the Group will be successful in all circumstances or that the insurance purchased by the Group will be adequate to cover its losses in full. Accordingly, any business interruptions could have a material adverse effect on the business of the group, its financial condition and its results of operations.

Poor customer service and/or increased competition could lead to a loss of the Group's customer base.

Poor customer service has a direct impact on (i) South West Water's delivery of the AMP6 business plan, with the SIM mechanism comparing its performance with other water companies, and (ii) Viridor's ability to retain and grow market share.

Growth for Pennon Water Services in the competitive non-household retail market is also dependent on understanding and meeting the needs of business customers.

South West Water, as part of the future direction for regulation, faces the possibility of competition in the household retail market.

During the ordinary course of business, Group companies may become subject to lawsuits which could materially and adversely affect the Group.

From time to time, Group companies may in the ordinary course of business be named as defendant in lawsuits, claims and other legal proceedings. These actions may seek, among other things, compensation for alleged losses, civil penalties or injunctive or declaratory relief. In the event that any such action is ultimately resolved unfavourably at amounts exceeding the Group's accrued liability, or at material amounts, the outcome could materially and adversely affect the Group's business, financial condition and results of operations.

Business Systems and Capital Investment

Failure of the Group's Information Technology systems, including as a result of a cyber-attack could lead to significant business interruption. Corruption or loss of data could result in detriment to the Group's customers, financial penalties and reputational damage.

Major systems implementation is supported by a formal programme governance framework, supplemented by specialist consultants. Viridor's systems are in the process of migrating to a Group shared service platform.

Cyber risks are mitigated by a strong information security framework, cyber security awareness campaigns, plus internal and external testing and formal ISO accreditation. Steps are taken to ensure all possible measures are in place, aligned to guidance issued by the National Cyber Security Centre, commensurate with the fast changing cyber risk landscape.

Notwithstanding the controls put in place, should cyber attacks develop, there is the risk that the Group's systems may be compromised, leading to business interruption and possible financial penalties and reputational damage.

Acquisitions made by the Group could prove to be costly in terms of time and resources and may impose post-acquisition integration or other risks.

In order to support its strategy, the Group has in past years made a number of acquisitions. These acquisitions expose the Group to numerous risks including:

- diversion of management attention and financial resources that would otherwise be available for the ongoing development or expansion of existing operations;
- unexpected losses of key employees, customers and suppliers of the acquired operations;
- difficulties in integrating the financial, technological and management standards (including health and safety and environmental risks), processes, procedures and controls of the acquired business with those of the Group's existing operations; and
- exposure to unanticipated liabilities and/or difficulties in mitigating contingent and/or assumed liabilities or paying more than the acquired business ultimately turns out to be worth.

In addition, general market conditions may change from those expected at the time of the acquisition which may significantly adversely affect results of operations in periods after the acquisition and may increase funding requirements. The Group undertakes detailed due diligence as part of its acquisition process and has considerable experience of successful acquisitions. If the Group is unable successfully to meet the challenges associated with any acquisitions it may make, this could have a material adverse effect on its business, financial condition and results of operations.

Viridor is currently completing the construction and commissioning of four ERFs to add to the operating portfolio of eight plants, each of which entails significant risks.

The ERF portfolio is a significant asset base comprising eight plants in operation with four under construction. This is the UK's largest network of modern low-carbon ERFs and produces much-needed energy. In the year ended 31 March 2017, Viridor's ERFs provided 178MW of generating capacity. Once the total committed ERF portfolio is completed in 2020/21 Viridor's ERFs alone will provide an estimated 276MW of energy generation capacity. Long-term waste contracts provide a secure fuel source for the ERFs and strategically agreed energy off-take contracts provide assured earnings from the energy generated.

Following the commitment to build a further ERF at Avonmouth, there are now four sites under construction:

- Dunbar and Beddington ERFs are progressing 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 Renewable Obligation Certificates application was submitted before 31 March 2017.

New construction and commissioning contracts are in place with Doosan Babcock and work is now progressing well with commissioning expected by the end of 2017.

The £252 million Avonmouth ERF is scheduled for completion in 2020/21. Construction contracts with experienced construction and commissioning teams have been signed and site preparation works have been completed. A contract with Somerset Waste Partnership, which represents around 35 per cent. of Avonmouth ERF's total capacity, has been secured for the life of the plant with 15 per cent. of capacity committed through further contracts, including Viridor's own collections fleet and strong regional commercial and industrial demand.

Viridor continues to build a strong operational team using power industry best practice. The company has demonstrated the ability to build these facilities safely, on time and to budget and during the year ended 31 March 2017, upper quartile availability and reliability was achieved. Maintaining this high level of performance in Viridor's ERFs contributed to fulfilling its commitment to achieve approximately £100 million EBITDA during the same year.

However, whilst Viridor considers that these projects are presently progressing well, each of these projects is significant, and any increase in the costs of delivery and/or any failure or delay in Viridor completing and commissioning any of these ERFs could have a material adverse effect on its business, financial condition and results of operations.

Viridor's risk assessment in relation to the long-term contracts it enters into may be inaccurate and the measures it takes to protect itself against the risks involved in such contracts may prove to be ineffective.

Any long-term integrated contract in which Viridor participates has a range of risks associated with it. The risks include waste volumes and mix, planning, technology, input costs, electricity costs and recycle prices. A careful assessment of the risks and apportionment of them between client, main contractor, technology and equipment suppliers, and sub-contractors is a key part of the process of bidding for and finalising a contract.

As part of these long term contracts, Viridor provides performance and financial guarantees to its clients. There is a risk that Viridor could fail to meet the terms of these guarantees which could result in additional costs to Viridor and/or termination of such contracts.

In the Viridor business, the continued drive by the UK Government to maintain austerity measures in the public sector has meant that a number of long-term contracts with local authority counterparties are being scrutinised and reviewed. Viridor currently has a fleet of eight operational ERFs, and around 80 per cent. of the waste inputs for the ERF portfolio (excluding Avonmouth) are contracted. Were these contracts to be re-negotiated this may adversely affect the profitability of the subsidiary and the Group.

Viridor seeks to protect itself against the risks in such contracts through due diligence, appropriate contractual documentation and appropriate pricing of the perceived risks. Nevertheless, there remains a risk that Viridor's commercial assessment of the risk involved in a particular long-term contract or that the measures it takes to protect itself against the risks will prove not to be effective. In such a case, the contracts will prove to be less profitable than originally anticipated and may prove to be unprofitable.

RISKS RELATED TO THE CAPITAL SECURITIES

Set out below is a description of certain material risks relating to the Capital Securities:

The Capital Securities are deeply subordinated obligations of the Issuer. On a winding-up, liquidation or dissolution of the Issuer investors in the Capital Securities may lose their entire investment in the Capital Securities.

The Capital Securities are the most junior-ranking investment in the Issuer other than ordinary shares. On a winding-up, liquidation or dissolution of the Issuer (other than an Approved Winding-up), claims in respect of the Capital Securities would rank behind the claims of all creditors of the Issuer, including subordinated creditors, other than claims in respect of instruments ranking *pari passu* with or junior to the Capital Securities (if any). Accordingly, the assets of the Issuer would be applied first in satisfying all senior-ranking claims in full, and payments would be made to holders of the Capital Securities, *pro rata* and proportionately with payments made to holders of any other *pari passu* instruments (if any), only if and to the extent that there are any assets remaining after satisfaction in full of all such senior-ranking claims. If the Issuer's assets are insufficient to meet all its obligations to senior-ranking creditors, the Holders will lose all of their investment in the Capital Securities. If the Issuer's assets are sufficient to meet all its obligations to senior-ranking creditors but insufficient to meet its obligations in full to the holders of the Capital Securities and any other obligations ranking *pari passu* therewith, the Holders will lose some (which may be substantially all) of their investment in the Capital Securities.

There is no restriction on the amount of securities or other instruments which the Issuer may issue or incur and which rank senior to, or *pari passu* with, the Capital Securities. The issue of any such securities or instruments may reduce the amount (if any) recoverable by Holders on a winding-up, liquidation or dissolution of the Issuer and/or may increase the likelihood of a deferral of payments under the Capital Securities.

If the Issuer's financial condition deteriorates such that there is an increased risk that the Issuer may be wound-up, such circumstances can be expected to have a material adverse effect on the market price of the Capital Securities. Investors in the Capital Securities may find it difficult to sell their Capital Securities in such circumstances, or may only be able to sell their Capital Securities at a price which may be significantly lower than the price at which they purchased their Capital Securities. In such event, investors may lose some or substantially all of their investment in the Capital Securities, whether or not the Issuer is wound up.

Payments of periodic returns may generally be deferred by the Issuer.

Unless the Issuer has, during the 12 month period preceding a scheduled periodic returns payment date, elected (in its discretion) to declare or pay dividends or distributions on, or otherwise redeem or purchase, any of its securities ranking junior to or *pari passu* with the Capital Securities, the Issuer shall have complete discretion to defer the payment of periodic returns which would otherwise become due on such scheduled periodic returns payment date. Any such deferral of periodic returns shall not constitute a default under the Capital Securities for any purpose.

Holders have no right to require payment of deferred periodic returns, and such arrears shall only be payable at the discretion of the Issuer or otherwise in certain circumstances specified in the Conditions, including upon redemption of the Capital Securities, discretionary payments on, or discretionary redemptions or repurchases of, junior or parity-ranking securities and the winding-up, liquidation or dissolution of the Issuer.

Deferral of periodic returns does not impose any restrictions on the Issuer in respect of payments on, or redemptions or repurchases of, any of its other obligations, and the holders of the Capital Securities are not entitled to claim immediate payment of the arrears if the Issuer makes payments on or in respect of senior-ranking obligations.

Any actual or anticipated deferral of periodic returns payments can be expected to have a material adverse effect on the market price of the Capital Securities. Investors in the Capital Securities may find it difficult to sell their Capital Securities in such circumstances, or may only be able to sell their Capital Securities at a price which may be significantly lower than the price at which they purchased their Capital Securities. In such event, investors may lose some or substantially all of their investment in the Capital Securities. In addition, as a result of the deferral provisions of the Capital Securities, the market price of the Capital Securities may be more volatile than the market prices of other securities or instruments that do not permit or require deferral of periodic returns, and may be more sensitive generally to adverse changes in the Issuer's financial condition.

The Capital Securities are perpetual securities and holders have no right to require their redemption.

The Capital Securities have no final maturity date and the Issuer is under no obligation to redeem the Capital Securities at any time. Holders have no right to require the redemption of the Capital Securities. Therefore, prospective investors should be aware that they may be required to bear the financial risks of an investment in the Capital Securities for an indefinite period of time.

Redemption of the Capital Securities is at all times at the discretion of the Issuer, and an investor may not be able to reinvest the redemption proceeds at an effective rate of return as high as that in respect of the Capital Securities.

The Capital Securities may only be redeemed at the option of the Issuer. There are a number of circumstances in which the Issuer shall have the right to redeem the Capital Securities, including at its option on 22 May 2020 or on any periodic returns payment date thereafter at their principal amount together with any Arrears of Returns and any other accrued and unpaid periodic returns.

In addition, the Issuer may (subject to certain conditions) redeem all outstanding Capital Securities:

- (i) at 101 per cent. of their principal amount if, as a result of a change in accounting practices or principles which become effective after 20 September 2017, the Issuer is no longer able to account for the proceeds of issue of the Capital Securities as equity in its accounts prepared in accordance with International Financial Reporting Standards (“IFRS”);
- (ii) at their principal amount if, as a result of a change in applicable law or regulation which becomes effective after 20 September 2017, payments in respect of the Capital Securities become subject to United Kingdom withholding tax and the Issuer is required to gross-up any such payments;
- (iii) at 101 per cent. of their principal amount in the event of a change of control of the Issuer or if South West Water Limited ceases to be a (direct or indirect) subsidiary of the Issuer (in each case, as more fully described in the Conditions); or
- (iv) at their principal amount if the Issuer and its Group have at any time acquired 80 per cent. or more of the principal amount of the Capital Securities originally issued,

in each case together with Arrears of Returns (if any) then outstanding and any other accrued and unpaid periodic returns up to (but excluding) the relevant redemption date.

During any period when the Issuer may elect to redeem the Capital Securities, the market value of the Capital Securities generally will not rise substantially above the price at which they can be redeemed. This also may be true prior to any redemption period.

An investor may not be able to reinvest the redemption proceeds at an effective rate of return as high as that in respect of the Capital Securities and may only be able to do so at a significantly lower rate of return. Potential investors should consider reinvestment risk in light of other investments which may be available at that time.

The Issuer may, without the consent of the holders, substitute or vary the terms of the Capital Securities in certain circumstances.

The Issuer shall be entitled, without the consent or approval of the Holders, to substitute the Capital Securities for, or vary the terms of the Capital Securities so that they become, or remain, Qualifying Securities (as defined in Condition 18) if:

- (i) as a result of a change in accounting practices or principles which become effective after 20 September 2017, the Issuer is no longer able to account for the proceeds of issue of the Capital Securities as equity in its IFRS accounts; or
- (ii) as a result of a change in applicable law or regulation which becomes effective after 20 September 2017, payments in respect of the Capital Securities become subject to United Kingdom withholding tax and the Issuer is required to gross up any such payments.

Whilst Qualifying Securities must have terms not materially less favourable to holders than the terms of the Capital Securities, there can be no assurance that, due to the particular circumstances of each Holder, such Qualifying Securities will be as favourable to each Holder in all respects.

The Capital Securities will be structurally subordinated to the claims of creditors of the Issuer's subsidiaries.

The Issuer's subsidiaries have incurred, and will continue to incur in the future, substantial amounts of debt in order to finance their operations. In the event of the insolvency of any of the Issuer's subsidiaries, claims of secured and unsecured creditors of such entity, including trade creditors, banks and other lenders, will have priority with respect to the assets of such entity over any claims that the Issuer or the creditors of the Issuer, as applicable, may have with respect to such assets. Accordingly, if the Issuer became insolvent at the same time, Holders' claims against the Issuer in respect of any Capital Securities would be structurally subordinated to the claims of all such creditors of the Issuer's subsidiaries. The Conditions do not restrict the amount of indebtedness which the Group may incur, including indebtedness of the Issuer's subsidiaries.

Periodic returns shall accrue on the Capital Securities at a fixed rate of return up to the First Call Date.

Periodic returns will accrue on the Capital Securities at a fixed rate of return up to the First Call Date. Investment in fixed rate instruments involves the risk that if market rates of return subsequently increase above the rate paid on the Capital Securities, this will adversely affect the market price of the Capital Securities.

After the First Call Date, periodic returns are intended to accrue on the Capital Securities at a rate determined by reference to the London Interbank Offered Rate ("LIBOR"), which is the subject of ongoing national and international regulatory reform.

After the First Call Date, periodic returns on the Capital Securities are intended to be determined by reference to LIBOR. LIBOR and other interest rates or other types of rates and indices which are deemed to be "benchmarks" are the subject of ongoing national and international regulatory reform. Some of these reforms are already effective whilst others are still to be implemented. Following the implementation of any potential reforms, the manner of administration of benchmarks (including LIBOR) may change, with the result that they may perform differently than in the past, or benchmarks could be eliminated entirely, or there could be other consequences which cannot be predicted.

For example, on 27 July 2017, the UK Financial Conduct Authority announced that it will no longer persuade or compel banks to submit rates for the calculation of the LIBOR benchmark after 2021 (the "**FCA Announcement**"). The FCA Announcement indicates that the continuation of LIBOR on the current basis cannot and will not be guaranteed after 2021. The potential elimination of the LIBOR benchmark or changes in the manner of administration of LIBOR, could require an adjustment to the Conditions, or otherwise require changes to the way in which periodic returns are calculated in respect of the Capital Securities. Any such consequence could have a material adverse effect on the value of and return on the Capital Securities.

If the Issuer does not redeem the Capital Securities on the First Call Date and any Floating Rate of Return is required to be determined by reference to Reuters LIBOR01 in circumstances where neither that page nor any direct successor or replacement is available due to LIBOR no longer being calculated or administered, the Conditions of the Capital Securities provide for use of an alternative page which has replaced LIBOR in customary market usage for the purposes of determining floating rates of interest in respect of sterling-denominated Eurobonds. However, if the Issuer determines, in good faith and following consultation with the Agent Bank, that there is no clear market consensus as to whether any page has replaced LIBOR in customary market usage, it will appoint an independent financial adviser chosen by the Issuer in its sole discretion (the "**IFA**") to determine an appropriate alternative page, and the decision of the IFA will be binding on the Issuer, the Trustee, the Agent Bank and the Holders.

Further, if such rate does not appear on Reuters LIBOR01 or any successor or replacement page, the relevant Floating Rate of Return is to be determined as if "GBP-LIBOR-Reference Banks" under the ISDA Definitions applied, the Conditions provide that the reference to "GBP-LIBOR-Reference Banks" should be construed as a reference to the term as defined in the ISDA Definitions or such alternative or replacement term in the ISDA Definitions which has replaced the use of "GBP-LIBOR-Reference Banks" in customary market usage for the purposes of determining floating rates of interest in respect of sterling-denominated Eurobonds. However, if the Issuer determines, in good faith and following consultation with the Agent Bank, that there is no clear market consensus as to whether there is any such alternative or replacement term in the ISDA Definitions, the IFA will make the final decision.

If any such alternative screen page or term is so specified (by the IFA or otherwise), there can be no assurance that such alternative rate will be directly equivalent to LIBOR, and such rate may be more or less favourable to an investor than a rate based on LIBOR.

Rights of enforcement in respect of the Capital Securities are limited.

Whilst the Trustee may at its discretion, and subject to it being indemnified and/or secured and/or pre-funded to its satisfaction, institute such steps, actions or proceedings against the Issuer as it may think fit to enforce any term or condition binding on the Issuer under the Trust Deed or the Capital Securities, in no event shall the Issuer, by virtue of the institution of any such steps, actions or proceedings, be obliged to pay any sum or sums sooner than the same would otherwise have been payable by it, except on a winding-up, liquidation or dissolution of the Issuer.

Further, no Holder shall be entitled to take any enforcement action against the Issuer in respect of its Capital Securities unless the Trustee, having become bound to take action in accordance with the Conditions, fails to do so within a reasonable period and such failure shall be continuing.

The terms of the Capital Securities contain provisions which permit their modification without the consent of all investors.

The Conditions contain provisions for convening meetings of Holders to consider matters relating to the Capital Securities. These provisions permit defined majorities to bind all Holders, including Holders who did not attend and vote at the relevant meeting and Holders who voted in a manner contrary to the majority. In addition, defined majorities of Holders are able to bind all other Holders through the passing of written resolutions or through delivery of electronic consents. The changes which such majorities may consent to include changes which may have a material adverse impact on, or abrogate, the rights attaching to the Capital Securities.

RISKS RELATED TO THE MARKET GENERALLY

Set out below is a description of material market risks, including liquidity risk and exchange rate risk:

An active secondary market in respect of the Capital Securities may never be established or may be illiquid and this would adversely affect the price at which an investor could sell the Capital Securities.

There is currently no active trading market in the Capital Securities. Although application has been made for the Capital Securities to be listed on the Official List and admitted to trading on the regulated market of the London Stock Exchange, there can be no guarantee that an active trading market in the Capital Securities will develop. Accordingly, there can be no assurance as to the development or liquidity of any trading market for the Capital Securities. Illiquidity may have a material adverse effect on the market value of the Capital Securities.

If the Capital Securities are traded after their initial issuance, they may trade at a discount to their issue price, depending upon prevailing market rates of return, the market for similar securities, general economic conditions and investors' general perception of the credit risk of the Issuer. In addition, any actual or anticipated deferral of payments under the Capital Securities, and/or any deterioration in the financial condition of the Issuer, can be expected to have a material adverse effect on the market price of the Capital Securities. Therefore, investors may not be able to sell the Capital Securities easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market, and will lose some of their investment if they sell their Capital Securities at a price that is lower than the price at which they purchased such Capital Securities.

If an investor's own currency is not pounds sterling, it will be exposed to movements in exchange rates adversely affecting the value of its holding of Capital Securities. In addition, the imposition of exchange controls in relation to any Capital Securities could result in an investor not receiving payments on those Capital Securities.

The Issuer will pay principal and periodic returns on the Capital Securities in pounds sterling. This presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the "**Investor's Currency**") other than pounds sterling. These include the risk that exchange rates may significantly change (including changes due to devaluation of pounds sterling or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to pounds sterling would decrease (1) the Investor's Currency-equivalent yield on the Capital Securities, (2) the Investor's Currency equivalent value of the principal payable on the Capital Securities and (3) the Investor's Currency equivalent market value of the Capital Securities.

Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate or the ability of the Issuer to make payments in respect of the

Capital Securities. As a result, investors may receive less periodic returns or principal than expected, or no periodic returns or principal.

As the Global Securities are held by or on behalf of Euroclear and Clearstream, Luxembourg, investors will have to rely on their procedures for transfer, payment and communication with the Issuer.

The Capital Securities will initially be represented by Global Securities and, except in certain limited circumstances described in the Permanent Global Security, investors will not be entitled to receive definitive Capital Securities. The Global Securities will be deposited with the common depositary for Euroclear and Clearstream, Luxembourg. Euroclear and Clearstream, Luxembourg will maintain records of the beneficial interests in the Global Securities. While the Capital Securities are represented by the Global Securities, investors will be able to trade their beneficial interests only through Euroclear and Clearstream, Luxembourg.

The Issuer will discharge its payment obligations under the Capital Securities by procuring that payments are made to Euroclear and Clearstream, Luxembourg for distribution to their account holders. A holder of a beneficial interest in a Global Security must rely on the procedures of Euroclear and Clearstream, Luxembourg to receive payments under the Capital Securities. The Issuer has no responsibility or liability for the records relating to, or payments made in respect of, beneficial interests in the Global Securities.

The value of the Capital Securities could be adversely affected by a change in English law or administrative practice.

The Conditions of the Capital Securities are based on English law, in effect as at the date of this Prospectus. No assurance can be given as to the impact of any possible judicial decision or change to English law or administrative practice after the date of this Prospectus and any such change could materially adversely impact the value of any Capital Securities affected by it.

Investors who hold a principal amount of Capital Securities that is less than the minimum specified denomination will be adversely affected if definitive Capital Securities are subsequently required to be issued.

The Capital Securities are issued in denominations of £100,000 and integral multiples of £1,000 in excess thereof, up to and including £199,000. If definitive Capital Securities were to be issued, a holder who, as a result of trading Capital Securities, holds less than £100,000 in principal amount of the Capital Securities in its account with a relevant clearing system would not be able to receive a definitive Capital Security, and would need to purchase additional Capital Securities such that it holds at least a principal amount of £100,000 in order to receive its Capital Securities in definitive form.

If Capital Securities in definitive form were to be issued, definitive Capital Securities having a denomination that is not an integral multiple of £100,000 may be illiquid and difficult to trade.

TERMS AND CONDITIONS OF THE CAPITAL SECURITIES

The following is the text of the Conditions of the Capital Securities which (subject to modification) will be endorsed on each Capital Security in definitive form (if issued):

The £300,000,000 Perpetual Capital Securities (the “**Capital Securities**”, which expression shall in these Conditions, unless the context otherwise requires, include any further capital securities issued pursuant to Condition 15 and forming a single series with the Capital Securities) of Pennon Group plc (the “**Issuer**”) are constituted by a Trust Deed dated 22 September 2017 (the “**Trust Deed**”) made between the Issuer and The Law Debenture Trust Corporation p.l.c. (the “**Trustee**”, which expression shall include its successor(s)) as trustee for the holders of the Capital Securities (the “**Holders**”) and the holders of the periodic returns tokens appertaining to the Capital Securities (the “**Tokenholders**” and the “**Tokens**” respectively, which expression shall, unless the context otherwise requires, include the talons for further tokens (the “**Talons**”) and the holders of the Talons).

The statements in these Conditions include summaries of, and are subject to, the detailed provisions of and definitions in the Trust Deed. Copies of the Trust Deed and the Agency Agreement dated 22 September 2017 (the “**Agency Agreement**”) made between the Issuer, the Trustee and Citibank, N.A., London Branch as principal paying agent (the “**Principal Paying Agent**” and, together with any other paying agent (if any) appointed by the Issuer from time to time, the “**Paying Agents**”) and as agent bank (the “**Agent Bank**”) are available for inspection during normal business hours by the Holders and the Tokenholders at the specified office of each of the Paying Agents. The Holders and the Tokenholders are entitled to the benefit of, are bound by, and are deemed to have notice of, all the provisions of the Trust Deed and are deemed to have notice of those provisions of the Agency Agreement applicable to them. In the event of any inconsistency between these Conditions and the terms of the Trust Deed, the Trust Deed shall prevail.

1. FORM, DENOMINATION AND TITLE

1.1 Form and denomination

The Capital Securities are in bearer form, serially numbered, in specified denominations consisting of a minimum denomination of £100,000 and integral multiples of £1,000 in excess thereof up to and including £199,000, with Tokens and one Talon attached on issue.

1.2 Title

Title to the Capital Securities and to the Tokens will pass by delivery.

1.3 Holder absolute owner

The Issuer, any Paying Agent and the Trustee may (to the fullest extent permitted by applicable laws) deem and treat the bearer of any Capital Security or Token as the absolute owner for all purposes (whether or not the Capital Security or Token shall be overdue and notwithstanding any notice of ownership or writing on the Capital Security or Token or any notice of previous loss or theft of the Capital Security or Token or of any trust or interest therein) and shall not be required to obtain any proof thereof or as to the identity of such bearer.

2. STATUS AND SUBORDINATION

2.1 Status

The Capital Securities and any relative Tokens are direct, unsecured obligations of the Issuer, subordinated as described below, and rank *pari passu* without any preference among themselves.

2.2 Subordination

The obligations of the Issuer in respect of the Capital Securities rank:

- (a) in priority only to the rights and claims against the Issuer of the holders of Junior Share Capital;
- (b) *pari passu* with the rights and claims against the Issuer of the holders of any Parity Securities; and
- (c) junior to the rights and claims of all Creditors.

2.3 Rights on a winding-up etc. of the Issuer

If at any time an order is made or an effective resolution is passed for the winding-up, liquidation or dissolution of the Issuer (except in the case of an Approved Winding-up), there shall be payable by the Issuer in respect of each Capital Security (in lieu of any other payment by the Issuer in respect of such Capital Security and any relative Token) such amount, if any, as would have been payable to the Holder if, on the day prior to the commencement of the winding-up, liquidation or dissolution and thereafter, such Holder were the holder of one of the lowest-ranking class of preference shares (whether or not issued) in the capital of the Issuer having a preferential right to a return of assets in the winding-up, liquidation or dissolution over the holders of Junior Share Capital on the assumption that such preference share was entitled to receive on a return of assets in such winding-up, liquidation or dissolution an amount equal to the principal amount of such Capital Security together with Arrears of Returns (if any) in respect thereof and any other accrued and unpaid periodic returns in respect thereof as provided in the Trust Deed together with, to the extent not otherwise included in the foregoing, any other damages awarded for breach of any obligations in respect thereof.

Such claim shall rank (i) in priority to the rights and claims in such winding-up, liquidation or dissolution of the holders of Junior Share Capital, (ii) *pari passu* with the rights and claims in such winding-up, liquidation or dissolution of the holders of any Parity Securities and (iii) junior to the rights and claims in such winding-up, liquidation or dissolution of all Creditors.

2.4 Set-off

Subject to applicable law, no Holder or Tokenholder may exercise, claim or plead any right of set-off, counter-claim or retention in respect of any amount owed to it by the Issuer arising under or in connection with the Capital Securities or the Tokens and each Holder and Tokenholder shall, by virtue of being the holder of any Capital Security or Token, be deemed to have waived all such rights of such set-off, counter-claim or retention to the fullest extent permitted by law.

Notwithstanding the provisions of the foregoing sentence, if any amounts owed to a Holder or Tokenholder by the Issuer arising under or in connection with any Capital Security or any Token relating thereto is discharged by set-off, compensation or retention, such Holder or Tokenholder will immediately pay an amount equal to the amount of such discharge to the Issuer or, in the event of the winding-up, liquidation or dissolution of the Issuer, the liquidator or (as the case may be) other insolvency official of the Issuer (and until such payment is made shall hold an amount equal thereto on trust for the Issuer or, as the case may be, the liquidator or other insolvency official) and accordingly such discharge will be deemed not to have taken place.

2.5 Application of this Condition

The provisions of this Condition 2 apply only to the payments of principal, periodic returns and Arrears of Returns in respect of the Capital Securities and any damages awarded in respect thereof, and nothing in this Condition 2 shall affect or prejudice the payment of the costs, charges, expenses, liabilities or remuneration of the Trustee or the rights and remedies of the Trustee in respect thereof.

3. PERIODIC RETURNS AND DEFERRAL OF PERIODIC RETURNS

3.1 Periodic returns prior to the First Call Date

Periodic returns shall accrue on the principal amount of the Capital Securities from (and including) the Issue Date to (but excluding) the First Call Date at a fixed rate of (subject to Condition 5.5(b)) 2.875 per cent. per annum (the “**Fixed Rate of Return**”) and, subject to Condition 3.9, such periodic returns will be payable annually in arrear on each Fixed Returns Payment Date (save that the initial periodic

returns payment scheduled (subject to Condition 3.9) for the Fixed Returns Payment Date falling on 22 May 2018 shall be in respect of the period from (and including) the Issue Date to (but excluding) 22 May 2018).

The amount of periodic returns payable (subject to Conditions 3.9 and 5.5(b)) on each Fixed Returns Payment Date shall be £28.75 in respect of each £1,000 in principal amount (the “**Calculation Amount**”) of the Capital Securities, save that the amount of periodic returns payable (subject to Conditions 3.9 and 5.5(b)) on the Fixed Returns Payment Date falling on 22 May 2018 shall be £19.06 per Calculation Amount.

The periodic returns payable (subject to Conditions 3.9 and 5.5(b)) on the relevant Fixed Returns Payment Date in respect of a Capital Security shall be calculated by multiplying the amount per Calculation Amount specified above by the specified denomination of such Capital Security and dividing the resulting figure by the Calculation Amount.

Where periodic returns are to be calculated in respect of any accrual period other than a full Returns Accrual Period prior to the First Call Date, they will be calculated on the basis of the actual number of days in the relevant accrual period from (and including) the date from which such periodic returns begin to accrue to (but excluding) the date on which such periodic returns fall due for payment divided by the number of days in the Returns Accrual Period in which the relevant period falls.

3.2 Periodic returns from the First Call Date

Periodic returns shall accrue on the principal amount of the Capital Securities from (and including) the First Call Date at the applicable Floating Rate of Return from time to time and, subject to Condition 3.9, such periodic returns will be payable quarterly in arrear on each Floating Returns Payment Date.

Each Floating Rate of Return will be determined by the Agent Bank on the basis of the Agent Bank’s determination on the first Business Day of each Returns Accrual Period commencing on or after the First Call Date (each a “**Returns Determination Date**”) of the rate of deposits in pounds sterling for a period of 3 months which appears on Reuters LIBOR01 (or any successor or replacement page including, where there is no direct successor or replacement page as a result of the London Interbank Offered Rate (“**LIBOR**”) no longer being calculated or administered as at the relevant Returns Determination Date, any alternative page which has replaced LIBOR in customary market usage for the purposes of determining floating rates of interest in respect of sterling-denominated Eurobonds, as notified by the Issuer to the Trustee, the Agent Bank and to the Holders in accordance with Condition 12) at 11.00 a.m. (London time), provided that if the Issuer determines, in good faith and following consultation with the Agent Bank, that there is no clear market consensus as to whether any page has replaced LIBOR in customary market usage, it will appoint an independent financial adviser chosen by the Issuer in its sole discretion (the “**IFA**”) to determine an appropriate alternative page, and the decision of the IFA will be binding on the Issuer, the Trustee, the Agent Bank and the Holders.

If such rate does not appear on Reuters LIBOR01 (or, if applicable, a successor or replacement page, as described above), the rate for that Returns Accrual Period will be determined as if the parties had specified “GBP-LIBOR-Reference Banks” (as such term is defined in the 2006 ISDA Definitions as published by the International Swaps and Derivatives Association, Inc. (the “**ISDA Definitions**”)) (or such alternative or replacement term in the ISDA Definitions (including as modified or replaced) which has replaced the use of “GBP-LIBOR-Reference Banks” in customary market usage for the purposes of determining floating rates of interest in respect of sterling-denominated Eurobonds, provided that if the Issuer determines, in good faith and following consultation with the Agent Bank, that there is no clear market consensus as to whether there is any such alternative or replacement term in the ISDA Definitions, this will be determined by the IFA, whose decision will be final) where the Reset Date is the first day of the relevant Returns Accrual Period, the Designated Maturity is 3 months, the Calculation Agent is the Agent Bank and the Reference Banks are to be selected by the Calculation Agent in consultation with the Issuer, and where the terms “**Reset Date**”, “**Designated Maturity**” and “**Calculation Agent**” have the meanings given to those terms in the ISDA Definitions (and, if an alternative term to “GBP-LIBOR-Reference Banks” is adopted as aforesaid, any similar or equivalent terms necessary for the determination of the relevant rate shall be construed accordingly, and any additional terms necessary for the determination of the relevant rate shall be construed by the Issuer in its sole discretion following consultation with the Agent Bank). The floating rate of return (the

“**Floating Rate of Return**”) for each such Returns Accrual Period shall be the sum of such rate determined as aforesaid for such Returns Accrual Period and the Margin.

Where periodic returns are to be calculated in respect of any accrual period commencing on or after the First Call Date, they will be calculated on the basis of the actual number of days in the relevant accrual period divided by 365 or, in the case of a periodic returns payment falling due in a leap year, 366.

3.3 Periodic returns accrual

Periodic returns will cease to accrue on each Capital Security from and including the due date for redemption thereof in accordance with Condition 5 unless, upon due presentation, payment of the principal in respect of the Capital Security is improperly withheld or refused or unless default is otherwise made in respect of the payment, in which event periodic returns shall continue to accrue as provided in the Trust Deed.

3.4 Determination of Floating Rate of Return and Periodic Returns Amount

The Agent Bank shall, as soon as practicable after 11.00 a.m. (London time) on each Returns Determination Date, but in no event later than the third Business Day thereafter, determine the Floating Rate of Return for the relevant Returns Accrual Period in accordance with Condition 3.2 and the amount of periodic returns in pounds sterling (the “**Periodic Returns Amount**”) that is, subject to Conditions 3.9 and 5.5(b), payable per Calculation Amount in respect of the Capital Securities for such Returns Accrual Period. The Periodic Returns Amount shall be determined by the Agent Bank by applying the applicable Floating Rate of Return to the Calculation Amount, multiplying the resulting figure by the actual number of days in the Returns Accrual Period concerned divided by 365 or, where the relevant Returns Payment Date falls in a leap year, 366 and rounding the resultant figure to the nearest penny (half a penny being rounded upwards).

The periodic returns payable (subject to Conditions 3.9 and 5.5(b)) on the relevant Floating Returns Payment Date in respect of a Capital Security shall be calculated by multiplying the Periodic Returns Amount per Calculation Amount determined above by the specified denomination of such Capital Security and dividing the resulting figure by the Calculation Amount, without any further rounding.

3.5 Publication of Floating Rate of Return and Periodic Returns Amount

The Agent Bank shall cause the Floating Rate of Return and the Periodic Returns Amount for each Returns Accrual Period starting on or after the First Call Date and the relative Returns Payment Date to be notified to the Issuer, the Trustee and, for so long as the Capital Securities are listed on any stock exchange, the relevant stock exchange or other relevant authority, and to be published in accordance with Condition 12 as soon as possible after their determination, and in no event later than the second Business Day thereafter. The Periodic Returns Amount and Returns Payment Date may subsequently be amended (or appropriate alternative arrangements made by way of adjustment) without notice in the event of an extension or shortening of the Returns Accrual Period.

3.6 Determination by the Trustee

The Trustee (or an expert appointed by the Trustee at the expense of the Issuer) shall, if the Agent Bank defaults at any time in its obligation to determine the Floating Rate of Return, Periodic Returns Amount and/or relative Returns Payment Date in accordance with the above provisions, determine the Floating Rate of Return, Periodic Returns Amount and relative Returns Payment Date in accordance with these Conditions and the determinations shall be deemed to be determinations by the Agent Bank.

3.7 Notifications, etc. to be final

All notifications, opinions, determinations, certificates, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions of this Condition, whether by the Agent Bank or the Trustee (or an expert as aforesaid), will (in the absence of wilful default, fraud or manifest error) be binding on the Issuer, the Trustee, the Agent Bank, the Paying Agents and all Holders and Tokenholders and (in the absence of wilful default and fraud) no liability to the Issuer, the Holders or the Tokenholders shall attach to the Agent Bank or, if applicable, the Trustee (or any such expert) in

connection with the exercise or non-exercise by any of them of their powers, duties and discretions under this Condition.

3.8 Agent Bank

The Issuer shall procure that, so long as any of the Capital Securities remains outstanding (as defined in the Trust Deed), there is at all times on and after the First Call Date an Agent Bank for the purposes of the Capital Securities and the Issuer may, subject to the prior written approval of the Trustee, terminate the appointment of the Agent Bank. In the event of the appointed office of any bank being unable or unwilling to continue to act as the Agent Bank or failing duly to determine the Floating Rate of Return and the Periodic Returns Amount for any Returns Accrual Period and/or the relative Returns Payment Date, the Issuer may, subject to the prior written approval of the Trustee, appoint the London office of another major bank engaged in the London interbank market to act in its place. The Agent Bank may not resign its duties or be removed without a successor having been appointed.

3.9 Periodic returns deferral and Arrears of Returns

(a) Deferral of periodic returns payments

On each Optional Returns Payment Date there shall be paid the periodic returns accrued in the Returns Accrual Period to (but excluding) such Optional Returns Payment Date unless the Issuer elects in its sole discretion to defer payment of such periodic returns in whole or in part.

On each Compulsory Returns Payment Date there shall be paid the periodic returns accrued in the Returns Accrual Period to (but excluding) such Compulsory Returns Payment Date (and, for the avoidance of doubt, the Issuer shall not have discretion to elect to defer payment of periodic returns in whole or in part on any Compulsory Returns Payment Date).

If the Issuer elects to defer any payment of periodic returns in whole or in part, it shall give notice to the Trustee and to the Holders in accordance with Condition 12 not more than 30 nor less than five days prior to the relevant Returns Payment Date (provided that any delay in giving such notice shall not affect the deferral of the relevant periodic returns payment or part thereof).

If the Issuer elects to defer any payment of periodic returns in whole or in part, the amount of periodic returns so deferred shall not fall due for payment on the relevant Returns Payment Date (and non-payment of such deferred periodic returns on such Returns Payment Date shall not constitute a default under the Capital Securities for any purpose) and periodic returns shall accrue on such deferred periodic returns, at the periodic returns rate from time to time prevailing on the Capital Securities, from (and including) the date on which such deferred periodic returns would (had they not been deferred) otherwise have been due to (but excluding) the date on which such deferred periodic returns are paid, in each case such periodic returns being compounded on each Returns Payment Date. For so long as the same remains unpaid, any deferred periodic returns and periodic returns thereon shall constitute “**Arrears of Returns**”.

(b) Payment of Arrears of Returns at the option of the Issuer

Arrears of Returns may, at the option of the Issuer, be paid in whole or in part (and, if in part, the earliest Arrears of Returns shall be deemed to be paid first) at any time upon the expiration of not less than seven days’ notice to such effect (which notice shall specify the due date for payment) given to the Trustee, the Principal Paying Agent and to the Holders in accordance with Condition 12.

Any such notice shall (subject as follows) be irrevocable and the Issuer shall be obliged to pay the relevant amount of Arrears of Returns on the due date specified in the notice.

(c) *Mandatory payment of Arrears of Returns*

All Arrears of Returns in respect of the Capital Securities outstanding shall become due in full on the earliest to occur of:

- (i) the date upon which a dividend or distribution is next declared or paid on any class of Junior Share Capital or on any Parity Securities, except where such declaration or payment is mandatory under the terms of the relevant instrument;
- (ii) the date upon which any Junior Share Capital or Parity Securities are redeemed, repaid or otherwise acquired by the Issuer, except where such redemption, repayment or acquisition is mandatory under the terms of the relevant instrument;
- (iii) the due date for redemption of the Capital Securities;
- (iv) the date upon which any substitution or variation of the Capital Securities in accordance with Condition 6 takes effect; and
- (v) an order being made, or an effective resolution being passed, for the winding-up, liquidation or dissolution of the Issuer (except in the case of an Approved Winding-up).

If Arrears of Returns become due in full in the circumstances described in (i) or (ii) above, the Issuer will, as soon as reasonably practicable, give notice to such effect (which notice shall specify the date upon which the relevant circumstances described in (i) or (ii), as the case may be, occurred) to the Trustee, the Principal Paying Agent and to the Holders in accordance with Condition 12.

4. PAYMENTS AND EXCHANGES OF TALONS

4.1 Payments in respect of Capital Securities

Payments of principal and periodic returns (including Arrears of Returns) in respect of each Capital Security will be made against presentation and surrender (or, in the case of part payment only, endorsement) of the Capital Security, except that payments of periodic returns due on a Returns Payment Date will be made against presentation and surrender (or, in the case of part payment only, endorsement) of the relevant Token, in each case at the specified office outside the United States of any of the Paying Agents.

4.2 Method of payment

Payments will be made in pounds sterling by credit or transfer to an account in pounds sterling maintained by the payee with or, at the option of the payee, by a cheque in pounds sterling drawn on, a bank in London.

4.3 Missing unmatured Tokens

Each Capital Security should be presented for payment together with all relative unmatured Tokens (which expression shall, for the avoidance of doubt, include Tokens falling to be issued on exchange of matured Talons). Upon the date on which any Capital Security becomes due and repayable, all unmatured Tokens appertaining to the Capital Security (whether or not attached) shall become void and no payment shall be made in respect of such Tokens.

4.4 Payments subject to applicable laws

Payments in respect of principal and periodic returns (including Arrears of Returns) on the Capital Securities are subject in all cases to (i) any fiscal or other laws and regulations applicable in the place of payment, but without prejudice to the provisions of Condition 7 and (ii) any withholding or deduction required pursuant to an agreement described in Section 1471(b) of the U.S. Internal Revenue

Code of 1986 (the “**Code**”) or otherwise imposed pursuant to Sections 1471 through 1474 of the Code, any regulations or agreements thereunder, any official interpretations thereof, or any law implementing an intergovernmental approach thereto.

4.5 Payment only on a presentation date

A holder shall be entitled to present a Capital Security or Token for payment only on a Presentation Date and shall not, except as referred to in Condition 3.3, be entitled to any further periodic returns or other payment if a Presentation Date is after the due date.

4.6 Exchange of Talons

On and after the Returns Payment Date on which the final Token comprised in any Token sheet matures, the Talon comprised in the Token sheet may be surrendered at the specified office of any Paying Agent in exchange for a further Token sheet (including any appropriate further Talon), subject to the provisions of Condition 8. Each Talon shall, for the purposes of these Conditions, be deemed to mature on the Returns Payment Date on which the final Token comprised in the relative Token sheet matures.

4.7 Paying Agents

The Issuer reserves the right, subject to the prior written approval of the Trustee, at any time to vary or terminate the appointment of any Paying Agent and to appoint additional or other Paying Agents, provided that:

- (a) there will at all times be a Principal Paying Agent;
- (b) so long as the Capital Securities are listed on any stock exchange and the rules of such stock exchange shall so require, there will at all times be at least one Paying Agent in such jurisdiction as the rules of such stock exchange shall require; and
- (c) there will be at all times on and after the First Call Date an Agent Bank.

Notice of any termination or appointment and of any changes in specified offices will be given to the Holders promptly by the Issuer in accordance with Condition 12.

5. REDEMPTION AND PURCHASE

5.1 No maturity

The Capital Securities have no final maturity date and are only redeemable or repayable in accordance with the following provisions of this Condition 5 or Condition 9.

5.2 Redemption at the option of the Issuer

The Issuer may, subject to Condition 5.9, upon giving not less than 15 nor more than 30 days’ notice to the Holders in accordance with Condition 12 (which notice shall, subject as provided in Condition 5.9, be irrevocable and shall specify the Redemption Date) and to the Trustee and the Principal Paying Agent, redeem all (but not some only) of the Capital Securities on the First Call Date or on any Returns Payment Date thereafter at their principal amount together with any Arrears of Returns and any other periodic returns accrued from (and including) the Returns Payment Date immediately preceding the Redemption Date to (but excluding) the Redemption Date.

5.3 Redemption upon the occurrence of a Tax Event

If the Issuer satisfies the Trustee, in accordance with Condition 5.9 below, immediately before the giving of the notice referred to below that, as a result of any change in, or amendment to, the laws or regulations of the United Kingdom or any political subdivision or any authority thereof or therein, or any change in the application or official interpretation of such laws or regulations, which change or

amendment becomes effective after 20 September 2017, on the next Returns Payment Date the Issuer would be required to pay additional amounts as provided or referred to in Condition 7 and the requirement to pay such additional amounts cannot be avoided by the Issuer taking reasonable measures available to it (a “**Tax Event**”), the Issuer may, at any time prior to the First Call Date, at its option but subject to Condition 5.9, upon giving not less than 15 nor more than 30 days’ notice to the Holders in accordance with Condition 12 (which notice shall, subject as provided in Condition 5.9, be irrevocable and shall specify the Redemption Date) and to the Trustee and the Principal Paying Agent, redeem all (but not some only) of the Capital Securities at their principal amount, together with any Arrears of Returns and any other periodic returns accrued from (and including) the Returns Payment Date immediately preceding the Redemption Date to (but excluding) the Redemption Date (provided that no such notice of redemption shall be given in respect of a Tax Event earlier than 90 days prior to the earliest date on which the Issuer would be required to pay such additional amounts, were a payment in respect of the Capital Securities then due).

5.4 Redemption upon the occurrence of an Accounting Event

If the Issuer satisfies the Trustee, in accordance with Condition 5.9 below, immediately before the giving of the notice referred to below that an Accounting Event has occurred, the Issuer may, at any time prior to the First Call Date, at its option but subject to Condition 5.9, upon giving not less than 15 nor more than 30 days’ notice to the Holders in accordance with Condition 12 (which notice shall, subject as provided in Condition 5.9, be irrevocable and shall specify the Redemption Date) and to the Trustee and the Principal Paying Agent, redeem all (but not some only) of the Capital Securities at 101 per cent. of their principal amount together with any Arrears of Returns and any other periodic returns accrued from (and including) the Returns Payment Date immediately preceding the Redemption Date to (but excluding) the Redemption Date.

An “**Accounting Event**” shall occur if as a result of a change in accounting practices or principles (or the application thereof) which become effective after 20 September 2017, the funds raised by the Issuer in respect of the Capital Securities may not, or may no longer, be recorded as equity in the next Consolidated Financial Statements and a recognised accountancy firm, acting upon instructions of the Issuer, has delivered a letter or report addressed to the Issuer to that effect.

5.5 Redemption upon the occurrence of a Change of Control Event or a Significant Disposal Event

(a) Issuer right to redeem

If a Change of Control Event and/or a Significant Disposal Event has occurred, the Issuer may, at any time, at its option but subject to Condition 5.9, upon giving not less than 15 nor more than 30 days’ notice to the Holders in accordance with Condition 12 (which notice shall, subject as provided in Condition 5.9, be irrevocable and shall specify the Redemption Date) and to the Trustee and the Principal Paying Agent, redeem all (but not some only) of the Capital Securities at 101 per cent. of their principal amount together with any Arrears of Returns and any other periodic returns accrued from (and including) the Returns Payment Date immediately preceding the Redemption Date to (but excluding) the Redemption Date.

(b) Increase in Rate of Return following a Change of Control Event and/or a Significant Disposal Event

If a Change of Control Event and/or a Significant Disposal Event occurs, the annual Rate of Return from time to time applicable to the Capital Securities shall increase by 5.00 per cent. in respect of each such event which has occurred with effect on (and from) the date of the Change of Control Event and/or, as the case may be, Significant Disposal Event and, accordingly, with effect from such date:

- (i) (if the Change of Control Event and/or, as the case may be, Significant Disposal Event occurs before the First Call Date) the Fixed Rate of Return shall increase to 7.875 per cent. per annum if one of such events occurs and to 12.875 per cent. per annum if both of such events occur; and

- (ii) the Margin component of the Floating Rate of Return shall increase to 12.018 per cent. per annum if one of such events occurs and to 17.018 per cent. per annum if both of such events occur.

(c) *Additional restrictions following a Significant Disposal Event*

If a Significant Disposal Event occurs, the Issuer shall not, until such time as it redeems the Capital Securities in accordance with Condition 5.5(a):

- (i) declare or pay a dividend or distribution upon any class of Junior Share Capital or on any Parity Securities, except where such declaration or payment is mandatory under the terms of the relevant instrument; or
- (ii) redeem, repay or otherwise acquire any Junior Share Capital or Parity Securities, except where such redemption, repayment or acquisition is mandatory under the terms of the relevant instrument.

(d) *Change of Control Event*

A “**Change of Control Event**” shall occur if a Change of Control occurs and either:

- (i) at the time of such Change of Control, the Issuer does not have a long-term debt rating by any Rating Agency and the Acquirer Rating Threshold is not satisfied; or
- (ii) at the time of such Change of Control, the Issuer has a long-term debt rating from any Rating Agency and, within the Change of Control Period, a Rating Downgrade occurs.

For these purposes:

The “**Acquirer Rating Threshold**” will be satisfied only if the person or persons becoming interested in the share capital of the Issuer, as referred to in the definition of Change of Control below, has or have, at the time of such Change of Control, a long-term debt rating of at least “A” from Standard & Poor’s Credit Market Services Europe Limited, “A” from Fitch Ratings Limited or “A2” from Moody’s Investors Service Limited (or, in each case, any successor or affiliate of any such rating agency);

A “**Change of Control**” shall occur if any person or any persons acting in concert (as defined in the City Code on Take-overs and Mergers), other than a holding company (as defined in Section 736 of the Companies Act 1985 (as amended)) whose shareholders are or are to be substantially similar to the pre-existing shareholders of the Issuer, shall become interested (within the meaning of Part 22 of the Companies Act 2006 (as amended)) in (i) more than 50 per cent. of the issued or allotted ordinary share capital of the Issuer or (ii) such number of shares in the capital of the Issuer carrying more than 50 per cent. of the total voting rights attached to the issued or allotted share capital of the Issuer that are normally exercisable at a general meeting of the Issuer;

The “**Change of Control Period**” shall commence on the date of the Change of Control (or, if earlier, the date of the first public announcement of the Change of Control) and shall end 45 days after the date of the Change of Control; provided that if, within that period, any Rating Agency publicly announces that it has put on review, for possible downgrade or withdrawal, any long-term debt rating assigned by it to the Issuer, the Change of Control Period shall be extended until the earlier to occur of (i) each such relevant credit rating being removed from review or (ii) the 45th day following the public announcement of the relevant credit rating(s) being put on review;

“**Rating Downgrade**” means any withdrawal or downgrading of a long-term debt rating which was assigned by any Rating Agency to the Issuer immediately prior to the Change of Control, in circumstances where the relevant Rating Agency publicly confirms or announces, or informs the Issuer or Trustee in writing upon request, that the relevant withdrawal or

downgrading of such credit rating was a result, in whole or in part, of such Change of Control or any event comprised in or arising as a result of, or in respect of, such Change of Control; and

“**Rating Agency**” means each of Standard & Poor’s Credit Market Services Europe Limited, Moody’s Investors Service Limited and Fitch Ratings Limited and their respective affiliates, successors and assigns.

(e) *Significant Disposal Event*

A “**Significant Disposal Event**” shall occur if, and at the time that, South West Water Limited ceases to be a (direct or indirect) subsidiary of the Issuer within the meaning of section 1159 of the Companies Act 2006.

(f) *Notification of Change of Control Event or Significant Disposal Event*

If a Change of Control Event or a Significant Disposal Event occurs, the Issuer shall, as soon as reasonably practicable (and in any event within 7 Business Days following the occurrence of the Change of Control Event or Significant Disposal Event (as applicable)), give notice that such Change of Control Event or Significant Disposal Event (as applicable) has occurred (which notice shall specify the date on which the Change of Control Event or Significant Disposal Event (as applicable) occurred) to the Holders in accordance with Condition 12 and to the Trustee and the Principal Paying Agent.

The Trustee shall be under no obligation to ascertain whether a Change of Control Event or a Significant Disposal Event, or any event which could lead to the occurrence of, or could constitute, a Change of Control Event or a Significant Disposal Event, has occurred and, until it shall have express notice in writing pursuant this Condition 5.5(f) or the Trust Deed to the contrary, the Trustee may assume that no Change of Control Event or Significant Disposal Event has occurred.

5.6 **Issuer right to redeem following the purchase of 80 per cent. of the Capital Securities**

In the event that the Issuer and/or any subsidiary(ies) and/or affiliate(s) of the Issuer has or have, severally or jointly, purchased 80 per cent. or more of the initial aggregate principal amount of the Capital Securities (being the aggregate principal amount of (i) the Capital Securities issued on the Issue Date and (ii) any further capital securities issued after the Issue Date which are consolidated and form a single series with the Capital Securities) the Issuer may, at its option but subject to Condition 5.9, upon giving not less than 15 nor more than 30 days’ notice to the Holders in accordance with Condition 12 (which notice shall, subject as provided in Condition 5.9, be irrevocable and shall specify the Redemption Date) and to the Trustee and the Principal Paying Agent, at any time redeem all (but not some only) of the remaining Capital Securities at their principal amount together with any Arrears of Returns and any other periodic returns accrued from (and including) the Returns Payment Date immediately preceding the Redemption Date to (but excluding) the Redemption Date.

5.7 **Purchases**

The Issuer and any of its subsidiaries and affiliates may at any time purchase Capital Securities (provided that all unmatured Tokens appertaining to the Capital Securities are purchased with the Capital Securities) in the open market or otherwise and in any manner and at any price. Any Capital Securities so purchased may, at the option of the Issuer, be held, re-issued, re-sold or surrendered to any Paying Agent for cancellation. Any Capital Securities so purchased, while held by or on behalf of the Issuer or any of its subsidiaries or affiliates, shall not entitle the holder to vote at any meetings of the Holders and shall not be deemed to be outstanding for the purposes of calculating quorums at meetings of the Holders or for the purposes of Condition 13.1.

5.8 Cancellation of Capital Securities

All Capital Securities which are (a) redeemed or substituted or (b) purchased by the Issuer or any of its subsidiaries or affiliates and surrendered for cancellation will forthwith be cancelled, together with all relative unmaturing Tokens attached to the Capital Securities or surrendered with the Capital Securities.

5.9 Conditions to redemption

The Issuer's right to redeem Capital Securities pursuant to any of Condition 5.2, 5.3, 5.4, 5.5 or 5.6 shall be conditional upon:

- (a) the relevant notice having been duly given pursuant to the relevant Condition;
- (b) in the case of redemption upon the occurrence of a Tax Event pursuant to Condition 5.3, the Issuer having delivered to the Trustee, not later than the time of giving the relevant notice of redemption to Holders, a certificate signed by a Director of the Issuer stating that a Tax Event has occurred as described in Condition 5.3, together with an opinion of independent tax or legal advisers of recognised standing to the effect that the circumstances described in Condition 5.3 apply (but, for the avoidance of doubt, such opinion shall not be required to comment on whether or not the requirement to pay additional amounts can be avoided by the Issuer taking reasonable measures available to it);
- (c) in the case of redemption upon the occurrence of an Accounting Event pursuant to Condition 5.4, the Issuer having delivered to the Trustee, not later than the time of giving the relevant notice of redemption to Holders:
 - (i) a certificate signed by a Director of the Issuer stating that an Accounting Event has occurred; and
 - (ii) a copy of the letter or report referred to in the definition of Accounting Event on which the Trustee shall be entitled to rely without enquiry and with no liability to any person for so doing;
- (d) in the case of redemption upon the occurrence of a Change of Control Event or a Significant Disposal Event pursuant to Condition 5.5, the Issuer having delivered to the Trustee, not later than the time of giving the relevant notice of redemption to Holders, a certificate signed by a Director of the Issuer stating that a Change of Control Event or, as the case may be, a Significant Disposal Event has occurred; and
- (e) in the case of redemption in the circumstances described in Condition 5.6, the Issuer having delivered to the Trustee, not later than the time of giving the relevant notice of redemption to Holders, a certificate signed by a Director of the Issuer stating that the Issuer and/or any subsidiary(ies) and/or affiliate(s) of the Issuer has or have, severally or jointly, purchased more than 80 per cent. of the initial aggregate principal amount of the Capital Securities.

Upon the expiry of any notice as is referred to in Condition 5.2, 5.3, 5.4, 5.5 or 5.6 above, the Issuer shall (subject as follows) be bound to redeem the Capital Securities to which the notice refers in accordance with the terms of such Condition, except that if any of the applicable conditions to such redemption as referred to in this Condition 5.9 has not been satisfied, then (unless otherwise agreed between the Issuer and the Trustee) any such notice shall be void and have no effect and the Capital Securities shall not fall due for redemption on the Redemption Date specified in the relevant notice. In such event, the Issuer will, as soon as practicable, give notice to the Holders in accordance with Condition 12.

5.10 Reliance by Trustee

The Trustee shall be entitled, without enquiry and without any liability to the Holders or Tokenholders, to accept any Director's certificate, together with any accompanying opinions and/or reports or letters, as referred to in Condition 5.9 as sufficient evidence of the occurrence of events, and/or the existence

of the circumstances, described in such Certificate, in which event the same shall be conclusive and binding on the Holders and the Tokenholders.

6. SUBSTITUTION AND VARIATION

6.1 Substitution and variation following the occurrence of a Tax Event or Accounting Event

If a Tax Event or an Accounting Event has occurred and is continuing, then the Issuer may, subject to Condition 6.2 (without any requirement for the consent or approval of the Holders), upon giving not less than 30 nor more than 60 days' notice to the Holders in accordance with Condition 12 (which notice shall be irrevocable) and to the Trustee and Principal Paying Agent, at any time either:

- (a) substitute all, but not some only, of the Capital Securities for; or
- (b) vary the terms of the Capital Securities so that they remain or become (as the case may be),

Qualifying Securities, and the Trustee shall (subject to the following provisions of this Condition 6 and subject to the receipt by it of the documents required to be delivered to it pursuant to Condition 6.2) agree to such substitution or variation, without further enquiry and without any liability or responsibility to any person on the part of the Trustee.

Upon expiry of such notice, the Issuer shall either vary the terms or, as the case may be, substitute the Capital Securities in accordance with this Condition 6, as the case may be.

6.2 Conditions to substitution and variation

The Issuer's right to substitute or, as the case may be, vary the terms of the Capital Securities pursuant to Condition 6.1 shall be conditional upon:

- (a) the relevant notice having been duly given pursuant to Condition 6.1;
- (b) in the case of a substitution or variation following the occurrence of a Tax Event, the Issuer having delivered to the Trustee, not later than the time of giving the notice referred to in (a) above, a certificate signed by a Director of the Issuer stating that a Tax Event has occurred as described in Condition 5.3, together with an opinion of independent tax or legal advisers of recognised standing to the effect that the circumstances described in Condition 5.3 apply (but, for the avoidance of doubt, such opinion shall not be required to comment on whether or not the requirement to pay additional amounts can be avoided by the Issuer taking reasonable measures available to it);
- (c) in the case of a substitution or variation following the occurrence of an Accounting Event, the Issuer having delivered to the Trustee, not later than the time of giving the notice referred to in (a) above:
 - (i) a certificate signed by a Director of the Issuer stating that an Accounting Event has occurred; and
 - (ii) a copy of the letter or report referred to in the definition of Accounting Event, on which the Trustee shall be entitled to rely without enquiry and with no liability to any person for so doing;
- (d) the certificate referred to in (b) or (c) above (as the case may be) containing further certifications to the effect that:
 - (i) the terms of the Qualifying Securities are not materially less favourable to Holders than the terms of the Capital Securities and that such determination was reached by the Issuer in consultation with an independent investment bank or counsel of recognised standing;

- (ii) the criteria specified in paragraphs (a) to (d) of the definition of Qualifying Securities will be satisfied by the Qualifying Securities upon issue; and
- (iii) such substitution or variation will not give rise to a Tax Event or an Accounting Event (with respect to either the Capital Securities or the Qualifying Securities); and
- (e) all outstanding Arrears of Returns (if any) being paid in full on or prior to the date on which such substitution or variation takes effect.

6.3 Role of Trustee

The Trustee shall be entitled, without enquiry and without any liability to the Holders or Tokenholders, to accept any Director's certificate, together with any accompanying opinions and/or reports or letters, as referred to in Condition 6.2 as sufficient evidence of the occurrence of events, and/or the existence of the circumstances, described in such Certificate, in which event the same shall be conclusive and binding on the Holders and the Tokenholders.

The Trustee shall (at the cost of the Issuer) enter into a trust deed or supplemental trust deed in form and substance satisfactory to the Trustee in relation to any such substitution of the Capital Securities for, or the variation of the terms of the Capital Securities so that they remain or become (as the case may be), Qualifying Securities, provided that the Trustee shall not be required to enter into any such trust deed or supplemental trust deed in connection therewith which imposes additional duties, liabilities or more onerous obligations upon the Trustee.

6.4 Compliance with stock exchange rules

In connection with any substitution or variation of the Capital Securities pursuant to this Condition 6, the Issuer shall comply with the rules of any stock exchange on which the Capital Securities are, for the time being, listed or admitted to trading.

7. TAXATION

7.1 Payment without withholding

All payments in respect of the Capital Securities and the Tokens by or on behalf of the Issuer shall be made without withholding or deduction for, or on account of, any present or future taxes, duties, assessments or governmental charges of whatever nature ("**Taxes**") imposed or levied by or on behalf of the United Kingdom or any political subdivision or any authority thereof or therein having power to tax, unless the withholding or deduction of the Taxes is required by law. In that event, the Issuer will pay such additional amounts as may be necessary in order that the net amounts received by the Holders and Tokenholders after the withholding or deduction shall equal the respective amounts which would have been receivable in respect of the Capital Securities or, as the case may be, Tokens in the absence of the withholding or deduction; except that no additional amounts shall be payable in relation to any payment in respect of any Capital Security or Token:

- (a) presented for payment by or on behalf of a holder who is liable to the Taxes in respect of the Capital Security or Token by reason of his having some connection with the United Kingdom other than the mere holding of the Capital Security or Token; or
- (b) presented for payment by or on behalf of a holder who would not be liable for or subject to the deduction or withholding or who would have been able to avoid such withholding or deduction by complying with any statutory requirement or making a declaration of non-residence or other similar claim for exemption or any filing; or
- (c) presented for payment more than 30 days after the Relevant Date except to the extent that a holder would have been entitled to additional amounts on presenting the same for payment on the last day of the period of 30 days assuming, whether or not such is in fact the case, that day to have been a Presentation Date.

Notwithstanding any other provision of these Conditions, in no event will the Issuer be required to pay any additional amounts in respect of the Capital Securities or Tokens for, or on account of, any withholding or deduction required pursuant to an agreement described in Section 1471(b) of the Code or otherwise imposed pursuant to Sections 1471 through 1474 of the Code, any regulations or agreements thereunder, or any official interpretations thereof, or any law implementing an intergovernmental approach thereto.

7.2 Additional amounts

Any reference in these Conditions to any amounts in respect of the Capital Securities shall be deemed also to refer to any additional amounts which may be payable under this Condition or under any undertakings given in addition to, or in substitution for, this Condition pursuant to the Trust Deed.

8. PRESCRIPTION

Capital Securities and Tokens (which for this purpose shall not include Talons) will become void unless presented for payment within periods of 10 years (in the case of principal) and five years (in the case of periodic returns) from the Relevant Date in respect of the Capital Securities or, as the case may be, the Tokens, subject to the provisions of Condition 4. There shall not be included in any Token sheet issued upon exchange of a Talon any Token which would be void upon issue under this Condition or Condition 4.

9. EVENTS OF DEFAULT AND ENFORCEMENT

9.1 Events of Default

If either of the following events (each an “**Event of Default**”) occurs:

- (a) *Non-payment when due*: any amount of periodic returns (including Arrears of Returns) or principal in respect of any Capital Security shall not be paid on the due date thereof and such non-payment shall not be remedied within a period of 14 days (in the case of a payment of periodic returns (including Arrears of Returns)) or 7 days (in the case of a payment of principal); or
- (b) *Winding-up*: an order is made or an effective resolution passed (and, where possible, not discharged or stayed within a period of seven days) for the winding-up, dissolution or liquidation of the Issuer (except in the case of an Approved Winding-up),

then the Trustee in its sole discretion (notwithstanding the provisions of Condition 9.2 but subject to Condition 9.3) may, or if so requested by an Extraordinary Resolution of the Holders or in writing by the Holders of at least one-quarter in principal amount of the Capital Securities then outstanding shall, subject in each case to its being indemnified and/or secured and/or pre-funded to its satisfaction:

- (x) in the case of paragraph (a) above, initiate steps, actions or proceedings for the winding-up, liquidation or dissolution in England of the Issuer and/or prove in the winding-up, liquidation or dissolution of the Issuer in respect of the Capital Securities, but may take no other action in respect of such non-payment; and
- (y) in the case of paragraph (b) above, prove in the winding-up, liquidation or dissolution of the Issuer in respect of the Capital Securities,

provided that, in either case, the claim of the Trustee in the winding-up, liquidation or dissolution of the Issuer in respect of each Capital Security shall be as described in Condition 2.3 and such claims shall be subordinated as described in Condition 2.2.

The Event of Default described in paragraph (a) above shall occur only in the event of non-payment of an amount which is due for payment. For the avoidance of doubt, if any payment of periodic returns in respect of the Capital Securities is deferred (in whole or in part) pursuant to Condition 3.9, the amount of periodic returns so deferred shall not be due on the date on which it would otherwise (in the absence of such deferral) have become due. Accordingly, non-payment of any deferred periodic returns on such

date shall not constitute an Event of Default. This italicised text is for information only and does not form part of the Conditions.

9.2 Enforcement

Without prejudice to Condition 9.1 above, the Trustee may at its discretion (subject to Condition 9.3) and without further notice institute such steps, actions or proceedings against the Issuer as it may think fit to enforce any term or condition binding on the Issuer under the Trust Deed, the Capital Securities or the Tokens (other than any payment obligation of the Issuer under or arising from the Capital Securities or the Trust Deed including, without limitation, payment of any damages awarded for breach of any obligations in respect of the Capital Securities) but in no event shall the Issuer, by virtue of the institution of any such steps, actions or proceedings, be obliged to pay any sum or sums sooner than the same would otherwise have been payable by it.

9.3 Entitlement of Trustee

The Trustee shall not be bound to take any of the actions referred to in Condition 9.1 or 9.2 above against the Issuer to enforce the terms of the Trust Deed, the Capital Securities or the Tokens or any other action or step under the Trust Deed (except as otherwise specifically provided herein) unless (i) it shall have been so requested by an Extraordinary Resolution of the Holders or in writing by the Holders of at least one-quarter in principal amount of the Capital Securities then outstanding and (ii) it shall have been indemnified and/or secured and/or prefunded to its satisfaction.

9.4 Right of Holders

No Holder or Tokenholder shall be entitled to proceed directly against the Issuer or to institute proceedings for the dissolution, liquidation or winding-up of the Issuer or to prove in such winding-up, liquidation or dissolution unless the Trustee, having become bound so to proceed or prove, fails to do so within a reasonable period and such failure shall be continuing, in which case the Holder or Tokenholder shall have, in respect of its Capital Securities, only such rights against the Issuer as those which the Trustee is entitled to exercise in respect of such Capital Securities as set out in this Condition 9.

9.5 Extent of Holders' remedy

No remedy against the Issuer, other than as referred to in this Condition 9, shall be available to the Trustee, the Holders or the Tokenholders, whether for the recovery of amounts owing in respect of the Capital Securities or Tokens or under the Trust Deed or in respect of any breach by the Issuer of any of its other obligations under or in respect of the Capital Securities, Tokens or under the Trust Deed.

10. REPLACEMENT OF CAPITAL SECURITIES AND TOKENS

Should any Capital Security or Token be lost, stolen, mutilated, defaced or destroyed, it may be replaced at the specified office of the Principal Paying Agent upon payment by the claimant of the expenses incurred in connection with the replacement and on such terms as to evidence and indemnity as the Issuer may reasonably require. Mutilated or defaced Capital Securities or Tokens must be surrendered before replacements will be issued.

11. SUBSTITUTION OF ISSUER

The Trustee may, without the consent of the Holders or Tokenholders, agree with the Issuer to the substitution in place of the Issuer (or of any previous substitute under this Condition) as the principal obligor under the Capital Securities, the Tokens and the Trust Deed (on a subordinated basis equivalent to that set out in Condition 2) of any other company being a subsidiary of the Issuer, subject to:

- (a) the Capital Securities being unconditionally and irrevocably guaranteed by the Issuer provided that the obligations of the Issuer under such guarantee shall be subordinated on a basis equivalent to that described in Condition 2; and
- (b) certain other conditions set out in the Trust Deed being complied with.

12. NOTICES

All notices to the Holders will be valid if published in a leading English language daily newspaper published in London (expected to be the *Financial Times*). The Issuer shall also ensure that notices are duly published in a manner which complies with the rules and regulations of any stock exchange on which the Capital Securities are, for the time being, listed or admitted to trading. Any such notice will be deemed to have been given on the date of the first publication or, where required to be published in more than one newspaper, on the date of the first publication in all required newspapers. If publication as provided above is not practicable, notice will be given in such other manner, and shall be deemed to have been given on such date, as the Trustee may approve. Tokenholders will be deemed for all purposes to have notice of the contents of any notice given to the Holders in accordance with this paragraph.

13. MEETINGS OF HOLDERS, MODIFICATION, WAIVER, AUTHORISATION AND DETERMINATION

13.1 Meetings of Holders

The Trust Deed contains provisions for convening meetings of the Holders to consider any matter affecting their interests, including the modification or abrogation by Extraordinary Resolution (which is defined in the Trust Deed as a resolution duly passed by a majority of not less than three-fourths of the votes cast thereon, a resolution in writing signed by or on behalf of the Holders of not less than 75 per cent. in principal amount of the Capital Securities then outstanding or consent given by way of electronic consents through the relevant clearing system(s) (in a form satisfactory to the Trustee) by or on behalf of the Holders of not less than 75 per cent. in principal amount of the Capital Securities then outstanding) of any of these Conditions or any of the provisions of the Trust Deed.

The quorum at any meeting for passing an Extraordinary Resolution will, subject to the following proviso, be one or more persons present holding or representing more than 50 per cent. in principal amount of the Capital Securities for the time being outstanding, or at any adjourned such meeting one or more persons present whatever the principal amount of the Capital Securities held or represented by him or them, provided that at any meeting the business of which includes the modification or abrogation of certain of the provisions of these Conditions and certain of the provisions of the Trust Deed (as specified in Schedule 3 to the Trust Deed), the necessary quorum for passing an Extraordinary Resolution will be one or more persons present holding or representing not less than two-thirds, or at any adjourned such meeting not less than one-third, of the principal amount of the Capital Securities for the time being outstanding. An Extraordinary Resolution passed at any meeting of the Holders or by way of a resolution in writing or by way of electronic consents will be binding on all Holders (whether or not they are present at the meeting and whether or not voting or, as the case may be, whether or not the written resolution is signed by them or on their behalf) and on all Tokenholders.

13.2 Modification, waiver, authorisation and determination

The Trustee may agree, without the consent of the Holders or Tokenholders, to any modification of, or to the waiver or authorisation of any breach or proposed breach of, any of these Conditions or any of the provisions of the Trust Deed, or determine, without any such consent as aforesaid, that any Event of Default or Potential Event of Default (as defined in the Trust Deed) shall not be treated as such (provided that, in any such case, it is not, in the opinion of the Trustee, materially prejudicial to the interests of the Holders) or may agree, without any such consent as aforesaid, to any modification which, in its opinion, is of a formal, minor or technical nature or to correct a manifest error.

13.3 Trustee to have regard to interests of Holders as a class

In connection with the exercise by it of any of its trusts, powers, authorities and discretions (including, without limitation, any modification, waiver, authorisation, determination or substitution), the Trustee shall have regard to the general interests of the Holders as a class but shall not have regard to any interests arising from circumstances particular to individual Holders or Tokenholders (whatever their number) and, in particular but without limitation, shall not have regard to the consequences of any such exercise for individual Holders or Tokenholders (whatever their number) resulting from their being for any purpose domiciled or resident in, or otherwise connected with, or subject to the jurisdiction of, any

particular territory or any political sub-division thereof and the Trustee shall not be entitled to require, nor shall any Holder or Tokenholder be entitled to claim, from the Issuer, the Trustee or any other person any indemnification or payment in respect of any tax consequence of any such exercise upon individual Holders or Tokenholders except to the extent already provided for in Condition 7 and/or any undertaking given in addition to, or in substitution for, Condition 7 pursuant to the Trust Deed.

13.4 Notification to the Holders

Any modification, abrogation, waiver, authorisation or determination made or agreed to by the Trustee pursuant to this Condition 13 and any substitution of the Issuer effected pursuant to Condition 11 shall be binding on the Holders and the Tokenholders and, unless the Trustee agrees otherwise, shall be notified by the Issuer to the Holders as soon as practicable thereafter in accordance with Condition 12.

14. INDEMNIFICATION OF THE TRUSTEE AND ITS CONTRACTING WITH THE ISSUER

14.1 Indemnification of the Trustee

The Trust Deed contains provisions for the indemnification of the Trustee and for its relief from responsibility, including provisions relieving it from taking action unless indemnified and/or secured and/or prefunded to its satisfaction.

14.2 Trustee contracting with the Issuer

The Trust Deed also contains provisions pursuant to which the Trustee is entitled, *inter alia*, (a) to enter into business transactions with the Issuer and/or any of the Issuer's subsidiaries and to act as trustee for the holders of any other securities issued or guaranteed by, or relating to, the Issuer and/ or any of the Issuer's subsidiaries, (b) to exercise and enforce its rights, comply with its obligations and perform its duties under or in relation to any such transactions or, as the case may be, any such trusteeship without regard to the interests of, or consequences for, the Holders or Tokenholders, and (c) to retain and not be liable to account for any profit made or any other amount or benefit received thereby or in connection therewith.

15. FURTHER ISSUES

The Issuer is at liberty from time to time, without the consent of the Holders or Tokenholders, to create and issue further capital securities, bonds and notes (whether in bearer or registered form) either:

- (a) ranking *pari passu* in all respects (or in all respects save for the first payment of periodic returns thereon) and so that the same shall be consolidated and form a single series with the outstanding Capital Securities; or
- (b) upon such terms as to ranking, distributions, redemption and otherwise as the Issuer may determine at the time of the issue.

Any further capital securities which are to form a single series with the outstanding Capital Securities shall, and any other further capital securities, bond or notes may (with the consent of the Trustee), be constituted by a deed supplemental to the Trust Deed. The Trust Deed contains provisions for convening a single meeting of the Holders and the holders of capital securities, bonds or notes of other series in certain circumstances where the Trustee so decides.

16. GOVERNING LAW

The Trust Deed, the Capital Securities and the Tokens, and any non-contractual obligations arising out of or in connection therewith, are governed by, and shall be construed in accordance with, English law.

17. RIGHTS OF THIRD PARTIES

No rights are conferred on any person under the Contracts (Rights of Third Parties) Act 1999 to enforce any term of the Capital Securities, but this does not affect any right or remedy of any person which exists or is available apart from that Act.

18. DEFINITIONS

Unless the context otherwise requires, the following terms shall have the following meanings in these Conditions:

“**Accounting Event**” has the meaning given in Condition 5.4.

“**Acquirer Rating Threshold**” has the meaning given to it in Condition 5.5(d).

“**Agency Agreement**” has the meaning given to it under the preamble of these Conditions.

“**Agent Bank**” means Citibank, N.A., London Branch (including any successor thereto).

“**Approved Winding-up**” means a liquidation, dissolution or winding-up of the Issuer in connection with a reconstruction, amalgamation, reorganisation, merger or consolidation on terms previously approved either (i) in writing by the Trustee or (ii) by an Extraordinary Resolution (as defined in the Trust Deed) of the Holders, and in either case, such terms do not provide that the Capital Securities shall thereby become redeemable or repayable in accordance with these Conditions.

“**Arrears of Returns**” has the meaning given to it under Condition 3.9.

“**Auditors**” means the auditors for the time being of the Issuer or, in the event of their being unable or unwilling promptly to carry out any action requested of them pursuant to the provisions of the Trust Deed, such other firm of accountants as may be nominated or approved by the Trustee after consultation with the Issuer.

“**Business Day**” means a day which is a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in London.

“**Calculation Amount**” has the meaning given to it under Condition 3.1.

“**Capital Securities**” has the meaning given to it under the preamble of these Conditions, and “**Capital Security**” shall be construed accordingly.

“**Change of Control**” has the meaning given to it in Condition 5.5(d).

“**Change of Control Event**” has the meaning given to it under Condition 5.5(d).

“**Change of Control Period**” has the meaning given to it in Condition 5.5(d).

“**Compulsory Returns Payment Date**” means any Returns Payment Date as of which, during the 12 month period ending on such Returns Payment Date, the Issuer has:

- (a) declared or paid a distribution on any class of Junior Share Capital or on any Parity Securities, except where such declaration or payment is mandatory under the terms of the relevant instrument; and/or
- (b) redeemed, repaid or otherwise acquired any Junior Share Capital or Parity Securities, except where such redemption, repayment or acquisition is mandatory under the terms of the relevant instrument.

“**Conditions**” means these terms and conditions of the Capital Securities, as the same may be amended from time to time.

“**Consolidated Financial Statements**” means either of:

- (a) audited annual consolidated financial statements of the Issuer; or
- (b) unaudited condensed consolidated half-year financial statements of the Issuer which are subject to a formal “review” from an independent auditor,

in each case prepared in accordance with IFRS.

“**Creditors**” means all creditors of the Issuer (including subordinated creditors) other than creditors whose claims are in respect of the Capital Securities, the Tokens or any Parity Securities or Junior Share Capital.

“**Event of Default**” has the meaning given to it under Condition 9.

“**First Call Date**” means 22 May 2020.

“**Fixed Rate of Return**” has the meaning given to it under Condition 3.1.

“**Fixed Returns Payment Date**” means 22 May in each year from (and including) 22 May 2018 to (and including) the First Call Date.

“**Floating Rate of Return**” has the meaning given to it under Condition 3.2.

“**Floating Returns Payment Date**” means 22 February, 22 May, 22 August and 22 November in each year from (and including) 22 August 2020, provided that if any such date would otherwise fall on a day which is not a Business Day, the relevant Floating Returns Payment Date shall be postponed to the next day which is a Business Day unless it would then fall into the next calendar month in which event the relevant Floating Returns Payment Date shall be brought forward to the immediately preceding Business Day.

“**Holders**” has the meaning given to it under the preamble of these Conditions.

“**IFRS**” means the International Financial Reporting Standards as adopted or applicable in England, as amended from time to time, or any other accounting standards that may replace IFRS for the purposes of preparing the Consolidated Financial Statements of the Issuer.

“**Issue Date**” means 22 September 2017.

“**Issuer**” means Pennon Group plc.

“**Junior Share Capital**” means the ordinary shares in the capital of the Issuer and any other shares of any class of the Issuer ranking *pari passu* therewith (if any).

“**Margin**” means (subject to Condition 5.5(b)) 7.018 per cent. per annum (being the initial credit spread plus 5.00 per cent. per annum).

“**Optional Returns Payment Date**” means any Returns Payment Date which is not a Compulsory Returns Payment Date.

“**Parity Securities**” means any securities or other instruments either (i) issued directly by the Issuer and which rank or are expressed to rank *pari passu* with the Issuer’s obligations under the Capital Securities (including, for so long as any of the same remain outstanding, the £300,000,000 Perpetual Capital Securities issued by the Issuer on 8 March 2013 with ISIN: XS0899989213); or (ii) issued by any subsidiary of the Issuer and benefiting from a guarantee or support agreement entered into by the

Issuer which ranks or is expressed to rank *pari passu* with the Issuer's obligations under the Capital Securities.

"Paying Agents" has the meaning given to it under the preamble of these Conditions.

"Periodic Returns Amount" has the meaning given to it under Condition 3.4.

"pounds sterling" or **"£"** means the lawful currency of the United Kingdom.

"Presentation Date" means a day which (subject to Condition 8):

- (a) is or falls after the relevant due date;
- (b) is a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the place of the specified office of the Paying Agent at which the Capital Security or Token is presented for payment; and
- (c) in the case of payment by credit or transfer to a pounds sterling account in London, is a Business Day.

"Principal Paying Agent" has the meaning given to it under the preamble of these Conditions.

"Qualifying Securities" means securities that:

- (a) are issued by the Issuer, or by a wholly-owned subsidiary of the Issuer with an unconditional and irrevocable guarantee of such obligations by the Issuer which guarantee is subordinated as specified in (b) below;
- (b) shall have the same ranking and be subordinated as described in Condition 2 (if issued by the Issuer) or shall benefit from a guarantee by the Issuer which shall have the same ranking and be subordinated as described in Condition 2 (if issued by a wholly-owned subsidiary of the Issuer);
- (c) contain terms not materially less favourable to Holders than the terms of the Capital Securities (as determined by the Issuer in consultation with an independent investment bank or counsel of recognised standing) and which:
 - (i) provide for the same or a more favourable periodic returns rate from time to time as applied to the Capital Securities and preserve the same Returns Payment Dates;
 - (ii) (A) preserve the obligations (including the obligations arising from the exercise of any right) of the Issuer as to redemption of the Capital Securities, including (without limitation) as to timing of, and amounts payable upon, such redemption, and (B) do not provide for additional Issuer rights of redemption beyond those rights which the Issuer has under the Capital Securities;
 - (iii) preserve any existing rights under these Conditions to any Arrears of Returns, any other periodic returns and any other amounts payable under the Capital Securities which, in each case, has accrued to Holders and not been paid; and
 - (iv) do not contain terms providing for the mandatory deferral or cancellation of payments of periodic returns and/or principal; and
- (d) (if the Capital Securities are listed or admitted to trading on any stock exchange immediately prior to the relevant substitution or variation) are listed or admitted to trading on the same stock exchange or are listed on the Official List maintained by the UK Listing Authority and admitted to trading on the regulated market of the London Stock Exchange plc.

“Rate of Return” means the Fixed Rate of Return and/or the Floating Rate of Return from time to time, as applicable.

“Rating Agency” has the meaning given to it in Condition 5.5(d).

“Rating Downgrade” has the meaning given to it in Condition 5.5(d).

“Redemption Date” means the day on which the Capital Securities become due for redemption in accordance with these Conditions.

“Relevant Date” means the date on which the payment first becomes due but, if the full amount of the money payable has not been received by the Principal Paying Agent or the Trustee on or before the due date, it means the date on which, the full amount of the money having been so received, notice to that effect has been duly given to the Holders by the Issuer in accordance with Condition 12.

“Returns Accrual Period” means the period from (and including) the Issue Date to (but excluding) the first Returns Payment Date, and each subsequent period from (and including) a Returns Payment Date to (but excluding) the immediately succeeding Returns Payment Date.

“Returns Determination Date” has the meaning given to it under Condition 3.2.

“Returns Payment Date” means each Fixed Returns Payment Date and each Floating Returns Payment Date.

“Significant Disposal Event” has the meaning given to it under Condition 5.5(e).

“Tax Event” has the meaning given to it under Condition 5.3.

“Tokens” has the meaning given to it under the preamble of these Conditions.

“Tokenholders” has the meaning given to it under the preamble of these Conditions.

“Trust Deed” has the meaning given to it under the preamble of these Conditions.

“Trustee” has the meaning given to it under the preamble of these Conditions.

OVERVIEW OF PROVISIONS RELATING TO THE CAPITAL SECURITIES WHILST IN GLOBAL FORM

The Temporary Global Security and the Permanent Global Security contain provisions which apply to the Capital Securities while they are in global form, some of which modify the effect of the Conditions set out in this Prospectus. The following is an overview of certain of those provisions:

1 Exchange

The Capital Securities will initially be represented by a temporary global capital security (the “**Temporary Global Security**”), without periodic return tokens, which will be deposited on or about the Issue Date with a common depositary for Euroclear Bank SA/NV (“**Euroclear**”) and Clearstream Banking S.A. (“**Clearstream, Luxembourg**”).

The Temporary Global Security will be exchangeable in whole or in part for interests in a permanent global capital security (the “**Permanent Global Security**” and, together with the Temporary Global Security, the “**Global Securities**”), without periodic return tokens, on or after a date which is expected to be 1 November 2017, upon certification as to non-U.S. beneficial ownership in the form set out in the Temporary Global Security. The Permanent Global Security will become exchangeable, in whole but not in part (free of charge to the Holder), for the definitive Capital Securities only if Euroclear or Clearstream, Luxembourg is closed for business for a continuous period of 14 days (other than by reason of holidays, statutory or otherwise) or announces an intention permanently to cease business or does in fact do so and no alternative clearing system satisfactory to the Trustee is available. Thereupon the holder of the Permanent Global Security may give notice to the Issuer of its intention to exchange the Permanent Global Security for definitive Capital Securities on a day (specified in the notice) falling not less than 60 days after that on which the notice requiring exchange is given and on which banks are open for business in the city in which the specified office of the Principal Paying Agent is located (the “**Definitives Exchange Date**”).

On or after the Definitives Exchange Date, the holder of the Permanent Global Security may surrender the Permanent Global Security to or to the order of the Principal Paying Agent. In exchange for the Permanent Global Security the Issuer will deliver, or procure the delivery of, definitive Capital Securities in bearer form, serially numbered, in the denomination of £100,000 and integral multiples of £1,000 in excess thereof up to and including £199,000 each with periodic returns Tokens and one Talon attached on issue in respect of periodic returns which have not already been paid on the permanent Global Security (in exchange for the whole of this permanent Global Security). On exchange in full of the Permanent Global Security, the Issuer will procure that it is cancelled.

2 Payments

No payment will be made on the Temporary Global Security unless exchange for the relevant interest in the Permanent Global Security is improperly withheld or refused. Payments of principal and periodic returns in respect of the Permanent Global Security will be made against presentation for endorsement and, if no further payment falls to be made on it, surrender of the Permanent Global Security to or to the order of the Principal Paying Agent. A record of each payment so made will be endorsed in the appropriate schedule to the Permanent Global Security, which endorsement will be *prima facie* evidence that such payment has been made in respect of the Capital Securities.

Payments due in respect of Capital Securities represented by the Global Securities shall be made by the Principal Paying Agent to or to the order of the common depositary for Euroclear and Clearstream, Luxembourg (as bearer of the Global Securities), and payment to or to the order of the common depositary (as bearer of the Global Securities) shall discharge the Issuer’s obligations in respect of the relevant payment. Each person holding beneficial interests in the Capital Securities in an account with Euroclear and Clearstream, Luxembourg must look solely to Euroclear or Clearstream, Luxembourg, as the case may be, for its share of each payment made to the common depositary.

3 Calculation of periodic returns

Notwithstanding the provisions of Condition 3, for so long as all the Capital Securities are represented by one or more Global Securities held on behalf of a clearing system, periodic returns shall be

calculated on the basis of the entire principal amount of Capital Securities represented by each Global Security, and not per Calculation Amount.

4 Notices

So long as all the Capital Securities are represented by one or more Global Securities held on behalf of one or more clearing systems, notices to holders may be given by delivery of the relevant notice to the relevant clearing system(s) for communication by such clearing system(s) to entitled accountholders in substitution for publication as required by the Conditions. Any such notice shall be deemed to have been given to the holders on the day on which such notice is delivered to Euroclear, Clearstream, Luxembourg and/or such other relevant clearing system (as the case may be). So long as the Capital Securities are admitted to listing or trading on any stock exchange, the Issuer shall also comply with the requirements of such stock exchange with respect to the giving of such notice.

5 Transfers

So long as Capital Securities are represented by one or more Global Securities held on behalf of Euroclear and Clearstream, Luxembourg, transfers of book-entry interests in the Capital Securities will be effected through the records of Euroclear and Clearstream, Luxembourg and their respective participants in accordance with the rules and procedures of Euroclear and Clearstream, Luxembourg and their respective direct and indirect participants.

6 Prescription

Claims against the Issuer in respect of principal or premium and periodic returns on the Capital Securities while the Capital Securities are represented by the Permanent Global Security will become void unless it is presented for payment within a period of 10 years (in the case of principal and premium) and five years (in the case of periodic returns) from the appropriate Relevant Date (as defined in Condition 18).

7 Meetings

The holder of a Global Security will be treated at a meeting of holders as having one vote in respect of each £1 in principal amount of Capital Securities represented by such Global Security. Persons holding beneficial interests in the Capital Securities in an account with Euroclear or Clearstream, Luxembourg shall be entitled to participate in, and/or vote at, meetings of the holders of the Capital Securities in accordance with the procedures set out in the Trust Deed and the normal procedures of Euroclear and Clearstream, Luxembourg.

8 Purchase and Cancellation

Cancellation of any security represented by the Temporary Global Security or the Permanent Global Security to be cancelled following its purchase will be effected by reduction in the principal amount of the Temporary Global Security or the Permanent Global Security (as the case may be).

9 Trustee's Powers

In considering the interests of holders while the Temporary Global Security or Permanent Global Security is held on behalf of a clearing system, the Trustee may have regard to any information provided to it by such clearing system or its operator or a participant in such system as to the identity (either individually or by category) of its accountholders with entitlements to the Temporary Global Security or the Permanent Global Security (as the case may be) and may consider such interests as if such accountholders were the Holder of the Temporary Global Security or the Permanent Global Security (as the case may be).

10 Euroclear and Clearstream, Luxembourg

References in the Global Securities and this overview to Euroclear and/or Clearstream, Luxembourg shall be deemed to be references to any other clearing system approved by the Trustee.

USE OF PROCEEDS

The net proceeds of the issue of the Capital Securities will be applied by the Issuer for general corporate purposes, including (without limitation) to fund the purchase of any or all of the £300,000,000 Perpetual Capital Securities issued by the Issuer on 8 March 2013 pursuant to a cash tender offer announced by the Issuer on 11 September 2017.

DESCRIPTION OF THE ISSUER AND THE GROUP

INTRODUCTION

The Issuer is one of the largest environmental infrastructure groups in the UK, it is at the top end of the FTSE 250, had total assets of £5.9 billion as at 31 March 2017 (2016: £5.7 billion) and a workforce of around 5,000 people. The Issuer's market capitalisation at 31 August 2017 was £3.4 billion. The Issuer has an experienced management team, committed to sustainable development, enhancing the environment and providing high quality customer services.

The Issuer is the holding company for two principal trading subsidiaries:

- South West Water Limited (the merged businesses of South West Water and Bournemouth Water), which provides water and sewerage services to a population of around 1.7 million in Devon, Cornwall and parts of Dorset and Somerset; and water only services to around 0.5 million in parts of Dorset, Hampshire and Wiltshire.
- Viridor Limited, which is one of the UK's leading energy recovery, recycling and waste management businesses, providing services to more than 150 local authorities and major corporate clients as well as over 32,000 customers across the UK.

Additionally, in preparation for the opening to competition of the English non-household retail water market on 1 April 2017, a joint venture company was set up, named Pennon Water Services Limited. 80 per cent. of the share capital is owned by the Issuer with 20 per cent. owned by the joint venture partner, South Staffordshire Plc, owner of South Staffordshire Water and Cambridge Water. Operations of Pennon Water Services Limited are ringfenced from South West Water's business. Pennon Water Services Limited entered the deregulated market as one of the top six largest retailers by customer base, and now provides billing, collections and account management services to around 170,000 customers.

For the year ended 31 March 2017, the Group's revenue and profit before tax were £1,353 million (year ended 31 March 2016: £1,352 million) and £211 million (year ended 31 March 2016: £206 million), respectively, and its capital investment, including construction spend on service concession arrangements, was £385 million (year ended 31 March 2016: £317 million). Adjusted EBITDA for the year ended 31 March 2017 increased by £37.8 million to £546.2 million. Approximately two-thirds of the Group's revenues are index-linked and long-term contracted.

The Issuer is a public limited company domiciled in the United Kingdom and was incorporated in England on 1 April 1989. The Issuer is registered in England and Wales under registration number 2366640. The principal legislation under which the Issuer operates is the Companies Act 1985 and the Companies Act 2006, together with regulations made under those Acts.

The Issuer's address is Peninsula House, Rydon Lane, Exeter EX2 7HR and its telephone number is +44 (0)1392 446677.

STRATEGY

The Issuer's strategy is to promote the success of the Group for the benefit of its shareholders, customers and communities through the provision of high quality environmental infrastructure and customer service. Its strategic aims are to lead in the UK's water and waste sectors, invest for sustainable growth and drive value through efficiency.

The long term priorities to deliver the strategy for the Group are:

- *Leadership in UK water and waste sectors.*

The Group is committed to delivering high quality services for the benefit of customers, proactively seeking to understand their needs and priorities and making the most of new technologies and innovation to deliver appropriate improvements.

In the year to 31 March 2017, South West Water's outperformance against the AMP6 regulatory contract (for the period from 1 April 2015 to 31 March 2020) achieved a sector-leading Watershare RoRE of 12.6 per cent. In the assessment of its delivery to customers of ODIs, South West Water secured a net cumulative award of £5.5 million for the period to 31 March 2017 and a net award of £3.6 million in the year to 31 March 2017.

In the waste business, Viridor continues to be a leader following its significant investment in its portfolio of ERFs which delivered £107 million EBITDA for the year ended 31 March 2017, in excess of the target of approximately £100 million. Viridor now has a clear track record of constructing and commissioning ERFs, and delivering strong operational and financial results. It also continues to drive returns from recycling through broader “self-help” measures that are reducing the cost base and improving utilisation of assets.

- *Leadership in cost base efficiency*, by focussing on driving down overheads and operating in the most efficient way to minimise costs.

South West Water maintained its strong momentum in controlling total expenditure (“**Totex**”) with cumulative savings of £129 million and financing outperformance of £67 million in the first two years of AMP6. South West Water is targeting to remain at the forefront of cost efficiency for the water sector.

The final determination allowed £1.9 billion of total expenditure over the AMP6 period (based on 2012/2013 prices) and South West Water is aiming to continue outperforming allowed Totex.

A Group-wide Shared Services Review is targeting estimated savings of £17 million per year by 2018 (of which around £9 million had been secured by 31 March 2017) by centralising key corporate services and operational functions, including the introduction of a shared IT platform.

The Group has secured funding at a cost that is efficient and effective. The Group’s average interest rate for the year ended 31 March 2017 was 3.4 per cent.

- *Driving sustainable growth*, by actively seeking opportunities to invest for growth, whether through investment to increase the asset portfolio, initiatives to expand the customer base or partnerships with other organisations.

The announcement in 2016 of a £252 million investment in an additional ERF at Avonmouth, near Bristol, to be delivered in 2020/21 expanded the Viridor ERF portfolio to 12 plants, with eight already in operation. Long-term waste contracts provide a secure fuel source for the ERFs and strategically agreed energy off-take contracts provide assured earnings from the energy generated. The Issuer’s assessment (supported by third party analysis from, amongst others, the Department for Environment, Food and Rural Affairs (Defra), the Scottish Environment Protection Agency (SEPA) and Natural Resources Wales (NRW)) of the residual waste market is that demand will exceed capacity in the period to 2030.

In preparation for the opening of the English non-household retail water market on 1 April 2017, an 80:20 joint venture company was set up called Pennon Water Services Limited. PWS entered the deregulated market as one of the top six largest retailers by customer base, and now provides billing, collections and account management services to approximately 170,000 customers.

- *Maximising shareholder returns.*

Dividend per share for the year ended 31 March 2017 was 36.0p, an increase of 7.1 per cent. compared to the year ended 31 March 2016.

The Issuer has a long-standing dividend policy of RPI plus 4 per cent. year-on-year growth through to 2020. This policy reflects the Issuer’s confidence in its long term strategy and is underpinned by the highest potential RoRE in the water sector over AMP6¹ and the growth in earnings being delivered by Viridor’s ERFs. The Issuer has provided an uninterrupted dividend stream since privatisation in 1989.

- *Strong governance.*

Strong governance is central to the successful management of the Group, and provides the framework for effective delivery of the strategy, creation of shareholder value and the ongoing development of sustainable business.

- *Strong focus on sustainability.*

In early 2017 the Issuer completed its first Group submission to Business in the Community’s Corporate Responsibility Index and received a score of 90 per cent. (a 3 star rating). The Issuer is also

¹ Ofwat, Final Determination, December 2014

included in the FTSE4Good Index. In addition, it achieved a score of B (Management) for the annual CDP submission (formerly the Carbon Disclosure Project) for Climate Change and Water, and continues to take steps to effectively reduce its impacts.

- *People.*

The Group aims to attract, develop and retain a highly skilled and customer-centric workforce. It has a culture of continuous improvement through investment in people at all levels within the Group and is committed to pursuing equality and diversity in all its employment activities. The Group's policy is to provide and maintain a safe working environment while preventing injury and ill health wherever possible.

The Group has established a fully embedded risk management framework to identify significant risks and determine whether they are being appropriately managed and mitigated in line with the Group's agreed risk appetite and mitigated.

SUSTAINABILITY

As one of the UK's largest environmental infrastructure businesses providing water, recycling and energy services, sustainability is an integral part of the Group's strategy. In order to create shareholder value, the Group endeavours to maximise the efficiency of its use of resources, reduce waste, increase levels of recycling and fully exploit opportunities for renewable energy generation. The Group's investors, customers, employees and the communities in which it operates expect the Group to operate to the highest levels of corporate responsibility.

The Group has a long track record in partnership and innovation across a range of sustainability issues. The Issuer's decision-making on capital investment integrates many sustainability factors, including social, community and environmental impacts, using a range of tools to ensure that decisions made involve more than purely economic or financial criteria.

The Board has appointed a Sustainability Committee whose role is to promote the highest standards of corporate responsibility by bringing together and reviewing initiatives that drive sustainability. The Sustainability Committee has defined the following strategic objectives, which cover the four key areas of customers, communities, people and environment:

- Managing the Group as a sustainable and successful business for the benefit of customers, shareholders and other stakeholders
- Engaging with customers and stakeholders to foster good relationships
- Aiming to ensure business activities have a positive impact on communities
- Striving for the highest standards of health and safety in the workplace
- Aspiring to leadership in minimising emissions and developing climate change adaption strategies
- Developing and motivating employees, treating them fairly, ensuring they are fully engaged in the Group's objectives and following the highest standards of business conduct
- Aspiring to leadership in all aspects of waste prevention and resource efficiency

These objectives drive the sustainability targets set by the Issuer's subsidiaries, performance against which is monitored by the Sustainability Committee.

PRINCIPAL ACTIVITIES

The Issuer operates and invests in the areas of water and sewerage services and energy recovery, recycling and waste management. The Issuer's three operating subsidiaries are South West Water, Viridor and Pennon Water Services (from 1 April 2017). The table below shows the revenue and profit before tax of each of the Group's operating segments for the financial years ended 31 March 2017 and 31 March 2016. The competitive market in water and sewerage service for non-household customers in which PWS operates did not open until 1 April 2017.

	Year ended 31 March 2017	Year ended 31 March 2016
	<i>(£million)</i>	<i>(£million)</i>
Revenue		
(1) Water and sewerage	561.0	547.0
(2) Waste management.....	793.5	806.2
Other	12.8	12.0
(3) Less intra-segment trading.....	(14.2)	(12.9)
Total revenue	1,353.1	1,352.3
Profit before tax before non-underlying items	250.0	211.3
Non-underlying items	(39.5)	(5.0)
Profit before tax	210.5	206.3
(1) Water and sewerage	187.4	160.5
(2) Waste management.....	50.2	25.7
Other	(27.1)	20.1
Total profit before tax	210.5	206.3

Notes

- (1) This comprises the regulated water and sewerage activities undertaken by South West Water.
- (2) This comprises the recycling, renewable energy and waste management services provided by Viridor.
- (3) Intra-segment trading between and to other segments is under normal market based commercial terms and conditions. Intra-segment revenue of the other segment is at cost.

South West Water Limited

South West Water is the licensed water and sewerage service provider for Devon, Cornwall and parts of Dorset and Somerset and since the acquisition of Bournemouth Water in April 2015 is also the water service provider in parts of Dorset, Hampshire and Wiltshire. It serves a region of 11,300 square kilometers with approximately 2.2 million residents, 1.2 million customers and around 10 million annual visitors. On average, each day South West Water distributes over 560 million litres of treated water across the two regions and disposes of around 514 million litres of wastewater through an asset base comprising approximately 18,100 kilometres of water distribution mains, 15,600 kilometres of sewers, 1,200 wastewater pumping stations, 23 raw water reservoirs, 36 water treatment works and 653 wastewater treatment works including 70 works with ultra-violet treatment.

Since privatisation in 1989, South West Water has successfully delivered the largest capital investment programme per capita of any of the water and sewerage companies in England and Wales with an initial focus on improving coastal wastewater treatment and disposal. The region currently has 144 EU designated bathing waters, more than a third of the total in England, and 24 shellfish waters. South West Water continues its programme of improving bathing waters recognising the importance to its regions' economy.

Ofwat is the economic regulator of the water sector in England and Wales. One of its responsibilities is to periodically determine the prices water companies are permitted to charge their customers.

Ofwat's price control framework for AMP6 is based on a revenue cap formula which permits revenue to be recovered based on the percentage change of RPI plus a K factor which incorporates efficiency targets and the delivery of outcomes that drive improvements to service levels.

The RoRE which can be earned by South West Water's regulated business is defined through a package of rewards and penalties. It is calculated using actual results before non-underlying items and compared against the Final Determination allowances (based on notional gearing (at 62.5 per cent.)), annual average RCV and taking into account tax impacts of outperformance.

For the current regulatory period (AMP6), the business plan for South West Water's original operating areas (there was a separate plan for the Bournemouth Water area) was recognised by Ofwat as a strong plan and

received ‘enhanced status’ which resulted in it being given the opportunities to earn higher returns and greater opportunities for outperformance than companies not awarded that status.

The base return / equity cost of capital for South West Water was set at 6.0 per cent. with an overall weighted average cost of capital of 3.7 per cent. real after tax for the wholesale business with a further 0.2 per cent. from retail margins. The base return for Bournemouth Water within the overall total is 5.8 per cent., but its smaller size results in a combined return of 6.0 per cent. RoRE actually earned can be higher or lower than this level through the operation of a number of regulatory mechanisms in place to assess and incentivise performance:

- Total expenditure savings and efficiencies, taking into account the phasing of actual expenditure within the business plan. £73 million of savings and efficiencies were delivered in the year ended 31 March 2017, giving a cumulative figure of £129 million for the first two years of AMP6. The final determination allowed £1.9 billion of total expenditure over the AMP6 period (based on 2012/2013 prices) and South West Water is aiming to continue outperforming allowed Totex.
- The delivery of outcomes to customers compared to South West Water’s committed performance levels through ODIs. The ODIs cover a full range of business activities and were agreed after extensive consultation with customers and stakeholders. ODI performance for the year ended 31 March 2017 resulted in a net reward of £3.6 million, giving a cumulative net reward of £5.5 million, comprising reward of £7.5 million and penalty of £2.0 million. Major performance areas producing reward include many clean water activities, and bathing water quality while penalty areas are currently waste water pollution incidents and external sewer flooding.
- The difference between actual and allowed financing costs. £34 million was delivered in the year ended 31 March 2017, giving a cumulative figure of £67 million for the first two years of AMP6.

In addition, the SIM rewards or penalises companies’ service performance by comparing performance of companies in the sector in terms of the quality of service that is delivered to customers. It comprises both a quantitative measure of complaints and unwanted contacts, and a qualitative measure, based on survey evidence, that looks at how satisfied customers are with the quality of service that they receive. Depending upon South West Water’s relative performance under the SIM it could receive a reduced or increased revenue allowance when price limits are next reset in 2019.

Ofwat’s determination allowed for further investment by South West Water to improve the quality of water and sewerage services. As a result, and due to anticipated RPI increases, South West Water’s RCV is expected to increase from £2.9 billion in March 2015 to approximately £3.6 billion in March 2020 (which also includes Bournemouth Water, which had an RCV in March 2015 of £0.1 billion), an increase of approximately 24 per cent. This will enlarge the base for the calculation of the rate of return allowed by Ofwat.

Volumes for the wholesale water business are fully regulated and, in the period to 2020, there is no volume risk.

For the year ended 31 March 2017, the Watershare RoRE performance was 12.6 per cent. (2016: 11.7 per cent.) with extra returns being earned in addition to the base return of 6.0 per cent. through total expenditure outperformance of 3.2 per cent. (2016: 2.5 per cent.), ODI performance of 0.3 per cent. (2016: 0.2 per cent.) and financing outperformance of 3.1 per cent. (2016: 3.0 per cent.).

At 31 March 2017 the ratio of South West Water’s net debt to RCV was 61.8 per cent. (2016: 59.7 per cent.) compared to the notional 62.5 per cent. used in Ofwat modeling. South West Water’s net debt at 31 March 2017 was £2,033.8 million (2016: £1,793.3 million) of which finance leasing, providing long maturities at secured margins, was £1,227.1 million (2016: £1,230.6 million), 60 per cent. (2016: 69 per cent.) of the total.

South West Water manages its regions’ drinking water and wastewater in an integrated way from source to sea, seeking to deliver high quality services in the most efficient and sustainable way possible.

For the year ended 31 March 2017, South West Water’s revenue was £561.0 million (2016: £547.0 million). The increase in the year reflected a tariff increase of 1.4 per cent., a demand increase of 2.5 per cent. on metered supplies and an increase in new connections. Operating costs at £211.9 million for the year ended 31 March 2017 were stable with the prior year figure of £211.8 million but reflected a lower bad debt charge at 1.1 per cent. of revenue and contributed to an overall Totex outperformance. While average RPI has been increasing (3.1 per cent. at 31 March 2017), total operating costs for the year ended 31 March 2017 were comparable to the previous year, with savings arising from operational maintenance synergies from the merger of South West Water and Bournemouth Water as well as targeted efficiencies contributing to cost performance. Profit before tax for the year ended 31 March 2017 was £187.4 million (2016: £160.5 million). Increases in interest cost and depreciation in the year were attributable to increases in net debt and the capital programme.

Major features of operation performance for the year ended 31 March 2017 were:

- Twentieth consecutive year without water restrictions
- Leakage target of 82ML per day outperformed
- High water quality standards maintained
- 98.6 per cent. of the 143 bathing waters tested in the South West Water region achieving ‘sufficient’ quality
- Customer service (written complaints reduced by approximately 30 per cent., value for money satisfaction at an all-time high and best ever customer service score for the Group)
- Best ever Group result for the percentage of wastewater treatment works deemed compliant at 98.4 per cent.
- Significant pollution incidents reduced

The number of less significant pollution incidents was above target, resulting in a penalty for the year. Further improvements in this area of wastewater operations are being prioritised.

Viridor

Viridor is a leading UK energy recovery, recycling and waste management company, providing services to more than 150 local authorities and major corporate clients as well as over 32,000 other customers across the UK. Viridor is at the forefront of the resource sector in the UK, transforming waste into energy, high quality recyclates and raw materials. It has a network of 300 recycling, energy recovery and waste management facilities and a fleet of some 650 waste collection vehicles which focus primarily on the industrial and commercial market. It managed 7.6 million tonnes of resources and recyclates in the year ended 31 March 2017, of which 1.6 million tonnes were recycled (including organics).

Viridor is a major developer of ERFs in the UK. It has built and operates one of the largest fleets of ERFs in the UK. Eight ERFs are already in operation – and generated EBITDA of £107 million in the year ended 31 March 2017 – with four more under construction and due to be operational by 2020. Dunbar and Beddington (South London) are progressing to budget, steps have been taken to ensure construction of Glasgow ERF is completed successfully and development at Avonmouth has commenced. Approximately 80 per cent. of ERF portfolio fuel supply volumes (and associated price) are contracted long-term. This excludes Avonmouth, where contracts are currently being negotiated due to the more recent investment decision for the project. The remaining 20 per cent. is under short and medium-term contracts. The main source of ERF revenue is in the form of waste fuel input (gate fees) making up about 70 per cent. of the total, but a further 25 per cent. arises from the power output. Energy risk management at a Group level acts as a natural hedge between South West Water and Viridor, offsetting any drop in power prices.

For the operational plants, the focus is on optimisation and, for the year ended 31 March 2017, average availability was in excess of 90 per cent.

All ERFs in the UK processed a combined 12 million tonnes of waste in 2016, with Viridor facilities processing 2 million tonnes of this total. The ERFs in construction are expected to raise Viridor’s capacity in 2020 to 3.2 million tonnes out of an estimated UK capacity of 15-16 million tonnes in that year.

Independent third party analysis indicates that the current under capacity in the UK combustible residual waste market is forecast to continue to 2030 and beyond. This means Viridor is well placed to receive combustible residual waste volumes in the market.

In pursuing its growth strategy for ERFs, in addition to self-build, Viridor has entered into public private partnership contracts and / or joint venture agreements where appropriate.

On the ERF portfolio, forecast project spend of £1,529 million compares to the original planned project spend of £1,551 million.

Viridor is a market leader in processing comingled waste streams (where recyclables are mixed in the same bin) collected by councils and their contractors. In 2016, Viridor processed approximately 0.7 million tonnes of mixed recyclable waste out of an estimated UK total of 4 million tonnes. Viridor is concentrating on ‘self-help’ optimisation measures and other efficiency initiatives (such as improved asset utilisation, cost and overhead reduction, organisation simplification and portfolio rationalisation) to improve margins by reducing costs against a background of recycle prices that are not expected to make a near-term recovery and a more difficult market environment resulting from local authority austerity in the face of central Government cuts.

Viridor's landfill market consists of municipal, commercial and industrial wastes, along with certain other special types of waste. The network of landfill gas power generation sites contributed 99MW of capacity in the year ended 31 March 2017. Viridor manages the landfill business to maximise the value of landfill gas power generation, and to optimise opportunities for waste disposal where it is not suitable for recycling or sending to ERFs, whilst exploring alternative commercial development opportunities and other energy uses. Four sites were closed in the year ended 31 March 2017, bringing the total number of operational sites to eleven.

For the year ended 31 March 2017, Viridor's revenue was £793.5 million (2016: £806.2 million). The reduction was due to the expected decrease in construction spend on service concession agreements as plants come into operation 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 due partly to a number of Viridor's long-term contracts being index-linked.

In the year ended 31 March 2017, Viridor's EBITDA before non-underlying items increased by 18.7 per cent. to £138.3 million (2016: £116.5 million). The portfolio of operational ERFs continued to perform well delivering EBITDA ahead of the target of approximately £100 million, with the six most recently delivered ERFs increasing performance as Viridor optimises each plant. In addition there were improvements from recycling 'self-help' measures, where significant progress was 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.

In the year ended 31 March 2017, Viridor's adjusted EBITDA increased 12.5 per cent. to £198.5 million (2016: £176.5 million). This measure includes the results from joint ventures and IFRIC 12 interest receivable under service concession arrangements, capturing earnings across the ERF portfolio. Joint venture EBITDA increased slightly to £44.1 million (2016: £43.3 million) with IFRIC 12 interest receivable under service concession arrangements marginally down at £16.1 million (2016: £16.7 million). Total ERF activities delivered EBITDA of £106.9 million (2016: £89.7 million) exceeding the internal target of approximately £100 million of EBITDA from ERFs by year ended 31 March 2017 (before IFRIC 12 interest receivable under service concession arrangements and Viridor's share of joint venture EBITDA).

Viridor landfill EBITDA from waste disposal was up by £0.2 million to £6.5 million in the year ended 31 March 2017, whilst power generation was down by £3.9 million to £27.6 million. The decrease in earnings was primarily due to lower volumes, which were in line with management expectations, and lower power prices.

Viridor recycling and resources EBITDA for the year ended 31 March 2017, comprising (amongst other things) recycling, collection and contracts, increased by 14.5 per cent. to £56.8 million (2016: £49.6 million). Recycling revenue at £90 per tonne increased by £5 per tonne (2016: £85 per tonne) reflecting renegotiated input contracts and recyclate prices. Average operating costs fell by £2 per tonne to £72 per tonne (2016: £74 per tonne) as a result of 'self-help' efficiency measures offset by a £1 per tonne increase in shipping costs. As a result, the recycling EBITDA margin increased by £6 per tonne to £14 per tonne (2016: £8 per tonne). Viridor remains cautious about future recyclate price growth and continues to focus on 'self-help' measures to drive margin improvement and to look to share commodity risk/ opportunity with customers.

Profit before tax for Viridor was £50.2 million for the year ended 31 March 2017 (2016: £25.7 million).

Pennon Water Services Limited

PWS is the NHH retail business of Pennon Group plc and South Staffordshire Plc, owner of South Staffordshire Water and Cambridge Water. 80 per cent. of the share capital is owned by the Issuer and the remaining 20 per cent. by South Staffordshire Plc. On 1 April 2017, the NHH customers of South West Water, South Staffordshire Water and Cambridge Water were transferred to PWS, initially on deemed contracts. The vast majority of business customers had not previously negotiated contracts with their water retailer upon the opening of the NHH retail market in April 2017, largely due to the regional monopolies in place for the water industry to that point. In order to protect customers, it was stipulated that customers transferring to a new or associated retailer on Market Opening, through the retail exit process, would do so on a deemed contract - meaning that, unless directly negotiated by the customers, the new retailers could not change the service offered, or charge these customers more on a like for like basis, than they would have been charged by their incumbent water company had the market not been opened. Pennon Water Services Limited entered the deregulated market as one of the top six largest retailers by customer base. It provides billing, collections and account management services to approximately 170,000 customers, predominantly to business customers in the existing South West Water and South Staffordshire Water wholesale regions. The annual margin allowed in Ofwat's 2014 price determination ("PR14") was approximately £4 million per annum.

CAPITAL INVESTMENT

Group capital investment was £384.7 million in the year ended 31 March 2017, compared to £316.9 million in the year ended 31 March 2016. A similarly high level of investment is expected to continue into 2017/2018, reflecting the profile of investment in Viridor's ERFs and the phasing of the expenditure in South West Water's AMP 6 (2015-2020) capital programme.

South West Water's capital expenditure for the year ended 31 March 2017 was £190.9 million (2016: £134.1 million). The largest single project in South West Water's spending that year was the development of the innovative Mayflower water treatment works at North Plymouth. In addition, investment was targeted to improve wastewater compliance with process upgrades and improvements at six sites.

Viridor's capital investment of £193.8 million was ahead of the year ended 31 March 2016 (£182.8 million). The majority of expenditure in the year ended 31 March 2017 reflected the ongoing ERF programme, with significant expenditure at South London, Dunbar and Glasgow ERFs.

LIQUIDITY AND FUNDING

One of the Group's key objectives is to maintain strong liquidity and retain access to efficient and effective funding. The Group is currently fully funded until March 2019.

The Group reported a strong liquidity and funding position with £1,383 million cash and committed facilities at 31 March 2017 (2016: £1,707 million). This included cash and cash deposits of £598 million (including £224 million of restricted funds representing deposits with lessors against lease obligations) and undrawn facilities of £785 million.

Since 31 March 2017, the Group has signed £50 million of new and renewed revolving credit facilities to provide pre-funding for future cash flows.

At 31 March 2017, the Group's loans and finance lease obligations totalled £3,263 million. After the £598 million held in cash, this gave a net debt figure of £2,665 million, an increase of £181 million during the year ended 31 March 2017.

At 31 March 2017, Group net debt included £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 per cent. 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. Around 85 per cent. of ERF funding (including joint ventures) is from corporate finance.

As at 31 March 2017, the Group had non-cancellable operating lease commitments of £143 million.

The Group's gearing ratio at 31 March 2017, being the ratio of net debt to equity plus net debt was 63.8 per cent. (2016: 62.5 per cent.). The Issuer's 2013 Securities (as defined below) are recognised in the Issuer's accounts as equity. For illustrative purposes only, if the 2013 Securities had instead been recognised as debt in the Issuer's accounts, the Group's gearing ratio would have remained broadly in line with gearing levels prior to the issuance of the 2013 Securities (2017: 70.4 per cent., 2016: 70.0 per cent.). The Issuer expects the accounting treatment for the Capital Securities to be the same as that applied to the 2013 Securities.

South West Water's debt to RCV ratio at 31 March 2017 was 61.8% (2016: 59.7%), which aligns with Ofwat's AMP6 target for efficient gearing of 62.5%.

Net finance cost before underlying items for the year ended 31 March 2017 was £58.8 million (2016: £54.1 million). The increase predominantly reflected higher RPI and higher net debt from continuing capital investments.

The Group has secured funding at a cost that is, in the Group's opinion, efficient and effective. The Group's interest rate on average net debt for the year ended 31 March 2017 increased slightly from 3.3 per cent. to 3.4 per cent. (after adjusting for capitalised interest of £12.9 million, notional interest items totalling £10.3 million, interest received from shareholder loans to joint ventures of £10.2 million and IFRIC 12 interest receivable under service concession arrangements of £16.1 million). For South West Water, this figure was 3.2 per cent (2016: 3.1 per cent.).

For the year ended 31 March 2017, net interest cover was 4.7 (2016: 4.4).

At 31 March 2017 the Group had a diversified funding mix of fixed (£1,831 million, 69 per cent.), floating (£284 million, 11 per cent.) and index-linked (£550 million, 20 per cent.) borrowings. The Group's debt had 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 issued as 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 AMP6 period, in line with the Group policy.

£492.8 million of South West Water's debt at 31 March 2017 was index-linked. 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 secured at the inception of each lease.

South West Water's funding is treated for regulatory purposes as ring-fenced. This means that funds raised by, or for, it are not available as long-term funding for other areas of the Group.

The Board regularly monitors expected financing needs for at least the following 12 months. These are intended to be met for the coming year from existing cash balances, loan facilities and operating cash flows.

The role of the Group's treasury function is to ensure that the Group has the funding to meet foreseeable needs, to maintain reasonable headroom for future contingencies and to manage interest rate risk. It operates only within policies approved by the Board and undertakes no speculative trading activity.

PERPETUAL CAPITAL SECURITIES

On 8 March 2013, the Issuer issued £300 million perpetual capital securities (the "2013 Securities") recognised in the Issuer's accounts as equity. The 2013 Securities have no fixed redemption date but the Issuer may, at its sole discretion, redeem all, but not part, of the 2013 Securities at the principal amount on 8 March 2018 or any subsequent periodic return payment date after this. The Issuer 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 and the Issuer has not made any other discretionary payment on, or repurchase or redemption of, any share capital or any other securities (if any) ranking *pari passu* with the 2013 Securities over that period. A periodic return of £20.3 million was paid during the year ended 31 March 2017 (as it has been in every year since the 2013 Securities were issued).

COMPETITION - WATER INDUSTRY

Since 1 April 2017, up to 1.2 million businesses and other non-household customers across England have been able to choose which retailer they buy water and wastewater services from. Wholesale services, providing water to premises and taking wastewater away, are unaffected, but business customers can choose who provides their retail service.

The English non-household market operates through a controlled portal operated by Market Operator Services Limited. It has required the separation of the wholesale and retail arms of water businesses.

In the year ended 31 March 2017, the Group established PWS (80 per cent. of the share capital is owned by the Issuer with 20 per cent. owned by the joint venture partner, South Staffordshire Plc, owner of South Staffordshire Water and Cambridge Water), which operates independently of South West Water and can secure services from any wholesaler in the United Kingdom. South West Water has an obligation to provide wholesale services to retailers operating in its area.

Following publication of 'Delivering Water 2020', Ofwat is consulting on its proposed approach for the price control review that will be applied to PR19. The proposals under consideration include:

- Separating water resources and bio-resources activities into separate revenue controls and developing competitive markets in those areas for the provision of those services.
- Introducing a system of inviting tenders to design, build and operate large investment schemes over £100 million (known as direct procurement).

COMPETITION - VIRIDOR

There is significant competition in the waste management and recycling market which varies geographically and by business activity/type of waste service. In general terms, there are seven leading companies (including Viridor) offering services throughout either the majority or significant parts of the UK and for the majority of the range of waste-related services. In addition, there are a large number of smaller companies who compete on a regional or local basis with a more limited range of services; such smaller companies are particularly active in the collection and recycling business where capital investment requirements are lower than for landfill and energy recovery.

The barriers to entry in some waste business activities are significant both in terms of regulation and capital investment requirements. The number of competitors in the least regulated and less capital intensive activities is consequentially greater. Viridor focuses particularly upon infrastructure related activities such as local authority contracts, ERFs, processing of recyclates and landfill (with associated landfill gas power generation) where its competitive advantage is strongest.

REGULATION - SOUTH WEST WATER

Appointments

In England and Wales, water companies operating the public water networks hold appointments as water undertakers, and those operating the public wastewater networks hold appointments as sewerage undertakers, for the purposes of the Water Industry Act 1991. They also supply water and wastewater services direct to household customers (and in some cases to non-household customers) who are connected to their networks.

South West Water holds a licence as regional water and sewerage undertaker (one of ten in England and Wales) for providing water and sewerage services in Devon, Cornwall and parts of Dorset and Somerset, and for providing water only services in parts of Dorset, Hampshire and Wiltshire, which together comprise approximately one million homes and businesses.

Since 1 April 2017, holders of new water supply and/or sewerage licences can provide water and sewerage retail services to eligible non-household premises. Pennon Water Services was granted such a licence on 3 October 2016 (one of 25 in England and Wales).

Licence conditions

South West Water's licences are subject to a range of conditions including (amongst other things):

- provisions relating to the operation of price control (see “*Price regulation*”);
- a prohibition on undue preference or undue discrimination in the setting of charges
- provisions to ensure that the financial affairs of the regulated business can be separately assessed and reported on
- obligations on the licensee to ensure that it has at its disposal sufficient financial and managerial resources to carry out the regulated activities
- restrictions in relation to transactions with owners and associated owners (the financial “ring fence”) – Ofwat's consent is required for certain transactions including transferring certain rights or assets, guaranteeing any liability, or lending any funds to an associated company, and all transactions with associated companies must be on an arm's length basis without cross-subsidy
- governing interactions with other appointees / licensees (for example, in relation to the transfer of customers)
- restrictions on the disposal of land
- a provision allowing the licence to be terminated on 25 years' notice
- provisions on the payment of licence fees to cover the operating costs of Ofwat and the Consumer Council for Water and for the supply of information to Ofwat
- provisions relating to water supply licence competition

Licence conditions can be modified by Ofwat, either with the licensee's agreement or following reference to the Competition and Markets Authority for a decision on public interest grounds. Licence modifications can also result, in certain circumstances, from a merger or market investigation reference to the Competition and Markets Authority.

Regulators and Legislation

South West Water operates within the water and sewerage sectors and is regulated by the Water Services Regulation Authority (Ofwat), the Secretary of State, the Environment Agency and the Drinking Water Inspectorate. It has to comply with several different Acts of Parliament and European Directives.

The legislation covers the following broad areas:

- economic regulation of the sector
- water supply
- sewerage services
- drinking water quality
- environmental standards
- customer service
- flood and drought protection and adaptation

Ofwat and the Secretary of State also have secondary duties that include obligations to promote efficiency and economy on the part of water companies in the carrying out of their functions as such and to contribute to the achievement of sustainable development.

Acts of Parliament

The *Water Industry Act 1991* sets out the main powers and duties of the water and sewerage companies. The Act also defines the powers and duties of Ofwat which must, amongst other things:

- protect the interests of consumers, wherever appropriate, by promoting effective competition;
- secure that water and sewerage undertakers properly carry out their statutory functions;
- secure that water companies can (in particular through securing reasonable returns on their capital) finance the proper carrying out of their statutory functions;
- secure that water supply licensees and sewerage licensees properly carry out their licensed activities and statutory functions; and
- further the resilience objective to secure the long-term resilience of water companies' water supply and wastewater systems; and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services.

The *Water Resources Act 1991* sets out the functions of the Environment Agency and introduced water quality classifications and objectives for the first time.

Subsequent Legislation

The most notable of the subsequent legislation which modifies the above framework includes:

The *Environment Act 1995* placed a duty on the water companies to promote the efficient use of water by customers. It created a new body, the Environment Agency (EA), which took over the functions of the National Rivers Authority and the waste regulation functions of local authorities. Today, the EA has statutory responsibility for enforcement of pollution control, water resources management, fisheries management, flood protection and alleviation and land drainage.

The *Competition Act 1998* prohibits any agreements between businesses that prevent, restrict or distort competition. It also prohibits any abuse of a dominant market position. Ofwat shares enforcement powers in relation to the water and sewerage sectors with the Competition and Markets Authority (CMA).

The *Water Industry Act 1999* made several important amendments to the WIA 91 including removing the water company's right to disconnect domestic customers for non-payment of bills and charges on metered and rateable value.

The *Water Act 2003* amended the framework for abstraction licensing and extended the scope for limited competition for large non-household users. Significantly, Section 48 of the 2003 Act gave Ofwat the power to impose financial penalties on a water company which contravenes any condition of its licence or any of certain statutory requirements or fails to meet performance standards prescribed pursuant to the Water Industry Act

1991. Ofwat must consider what level of penalty is reasonable in all the circumstances which can be up to 10 per cent of the water company's relevant regulated turnover for each breach for which a penalty is imposed.

In addition, where Ofwat is satisfied that a water company is in breach of a condition of its licence or certain of its statutory obligations, it has the power to secure compliance by means of an enforcement order. Failure to comply with an enforcement order can lead to court action by Ofwat for an injunction and claims for compensation by any person who suffers loss or damages as a result of the breach.

The *Enterprise Act 2002* amended the WIA 91 to update the regime for the compulsory reference of certain mergers between water companies to the Competition Commission (now the CMA).

The *Flood and Water Management Act 2010* encouraged the use of sustainable urban drainage systems (SUDs), amended the WIA 91 to modernise the list of activities that can be restricted by water companies in a drought, and made it easier for water companies to offer lower tariffs to certain groups.

The *Water Act 2014* set out a framework to restructure the water and sewerage businesses in England culminating in the new market opening in April 2017. The Act enabled greater industry competition and encourages efficiency and innovation by allowing non-household UK customers to select their water and sewerage retailer and encourages retailers to compete for customer business by providing better service, lower prices and/or extra water saving services.

The new market is regulated by the Market Arrangements Code and the Wholesale-Retail Code 2017 and is enforced by both Ofwat and Market Operator Services Limited (MOSL) to oversee and regulate the market and is responsible for the effective and efficient operation of the water retail market and plays a central role in its evolution.

The 2014 Act also gave Ofwat new powers to make rules about charges and charges schemes, as well as making provisions for flood insurance and drainage boards.

The *Water Industry Designated Codes (Appeals to the Competition and Markets Authority) Regulations 2017* set up a right of appeal to the Competition and Markets Authority (CMA) against a decision by Ofwat to revise or not to revise a code designated for the purposes of section 207A(2) of the Water Industry Act 1991. The codes currently designated are the new Market Arrangements Code and the Wholesale-Retail Code.

The Regulations set out the decisions that can be appealed and who can bring such an appeal and the procedures for doing so (including applying for permission to appeal). They also set out the powers of the CMA in determining such appeals and the procedures and time limits for doing so.

European Legislation

European environmental legislation usually takes the form of a 'directive'. Every member state must comply with European directives which take precedence over national legislation.

Some of the most important directives for the water and sewerage sectors are:

The Water Framework Directive creates a single system of water management, based around a natural river basin – which may form part of two or more member states, or local government areas. The directive sets objectives and deadlines for improving water quality. It looks overall at both the ecology of the water and its chemical characteristics.

The Urban Wastewater Treatment Directive aims to protect the water environment from being damaged by urban waste water and certain industrial discharges.

The Marine Strategy Framework Directive establishes marine regions on the basis of geographical and environmental criteria. Member states – cooperating with other member states and non-EU countries within a marine region – are required to develop strategies to protect their marine waters.

The Floods Directive requires member states to carry out flood risk assessments, create maps of flood risk and develop flood risk management plans.

The Drinking Water Directive sets quality standards for drinking water and requires drinking water quality to be monitored and reported.

The Bathing Water Directive aims to protect public health and the environment by keeping coastal and inland bathing waters free from pollution.

The Sewage Sludge Directive aims to encourage the use of sewage sludge in agriculture and to regulate its use in such a way as to prevent harmful effects on soil, vegetation, animals and man.

Price regulation

The most recent price control review was set out by Ofwat in a Final Determination dated 12 December 2014 and applies to the AMP6 period (2015-2020). That price review implemented separate price controls for the retail and wholesale parts of the value chain enabling more targeted regulation and support for the opening of the non-household retail market.

The price control framework for AMP6 is based on a revenue cap formula which permits revenue to be recovered based on the percentage change of the RPI plus a K factor which incorporates efficiency targets.

The RoRE which can be earned by South West Water's regulated business is defined through a package of rewards and penalties. It is calculated using actual results before non-underlying items and compared against the final determination allowances, based on notional gearing (at 62.5 per cent.), annual average RCV and taking into account tax impacts of outperformance.

The base return / equity cost of capital for South West Water was set at 6.0 per cent with an overall weighted average cost of capital of 3.7 per cent real after tax for the wholesale business with a further 0.2 per cent. from retail margins.

RoRE actually earned can be higher or lower than this level through the operation of a number of regulatory mechanisms in place to assess and incentivise performance:

- Total expenditure savings and efficiencies, taking into account the phasing of actual expenditure within the business plan. £73 million of savings and efficiencies were delivered in the year ended 31 March 2017, giving a cumulative figure of £129 million for the first two years of AMP6.
- The delivery of outcomes to customers compared to South West Water's committed performance levels through ODIs. The ODIs cover a full range of business activities and were agreed after extensive consultation with customers and stakeholders. ODI performance for the year ended 31 March 2017 resulted in a net reward of £3.6 million, giving a cumulative net reward of £5.5 million, comprising reward of £7.5 million and penalty of £2.0 million. Major performance areas producing reward include many clean water activities, and bathing water quality while penalty areas are currently waste water pollution incidents and external sewer flooding.
- The difference between actual and allowed financing costs. £34 million was delivered in the year ended 31 March 2017, giving a cumulative figure of £67 million for the first two years of AMP6.

In addition, the SIM rewards or penalises companies' service performance by comparing performance in terms of the quality of service that is delivered to customers. It comprises both a quantitative measure of complaints and unwanted contacts, and a qualitative measure, based on survey evidence, that looks at how satisfied customers are with the quality of service that they receive. Depending upon South West Water's relative performance under the SIM it could receive a reduced or increased revenue allowance when price limits are next reset in 2019.

South West Water has in place a WaterShare mechanism to share net benefits with customers through reinvestment options, future bill reductions and service improvements exceeding planned targets. WaterShare reflects the established mechanism for sharing Totex outperformance and also allows customers to share in financing outperformance from movements in the market rates for new debt instruments. In addition, specific items are also shared with customers – with differing rates depending on the company delivery. Cumulatively for the first two years of AMP6 £7.1 million of benefits to customers arose under this mechanism.

On 11 July 2017 Ofwat published 'Delivering Water 2020: Consulting on our methodology for the 2019 price review' setting out its proposed approach for the price control review that will be applied to PR19. The consultation period on the proposals closed on 30 August 2017, with the final methodology for PR19 planned to be issued in December 2017. It is proposed that companies submit their business plans in September 2018 with a draft determination following in July 2019 and a final determination in December 2019.

In its consultation paper, Ofwat proposes the continuation of the outcomes and Totex framework that was used for PR14 and states that it expects companies to step up levels of efficiency in PR19 and will challenge companies that fail to do so. It signifies Ofwat's objective to pass on the benefit to customers from lower financing costs in setting the cost of capital, while ensuring that efficient companies will be remunerated appropriately so they can finance their programmes. Its proposed methodology also promotes greater use of markets for water resources and bioresources ('sludge') to deliver improvements in efficiency and resilience.

The methodology proposes additional wholesale business price controls for water resources and bioresources, giving four in total:

- Water network plus (water treatment and distribution)
- Wastewater network plus (waste water collection and treatment)
- Water resources
- Bioresources

These are proposed to be controls on total revenues, except for bioresources which is proposed to be a control on average revenues.

Separate price controls for residential retail and business retail for companies who have not exited the market are also proposed, as at present.

Ofwat states that in achieving an appropriate package of risk and return it plans to set the allowed return based on the prevailing market evidence which it believes points to a lower cost of capital at PR19. The consultation document also proposes moving to using CPIH (the successor to the Consumer Prices Index) to index customer bills and transition towards CPIH indexation for the RCV. South West Water has been fully engaged in Ofwat's 2020 forward programme as the methodology and mechanisms for PR19 are developed and believes it is in a good position to manage changes in the methodology given its strong track record of outperformance.

On 6 April 2017, Ofwat made modifications to the licences of the 17 largest water companies (including South West Water) to come into effect on 15 April 2017. These changes (which were accepted by all the companies) provide the framework for the proposed price controls described above to be introduced and the phased indexation move from RPI to CPI or CPIH (as indicated in the Ofwat licence modification).

In the event of South West Water being materially affected by additional costs or lower revenues than originally anticipated at the time of the most recent Ofwat price determination, regulatory mechanisms permit South West Water to apply to Ofwat for price limits to be re-set through an Interim Determination. Interim Determinations may be granted either as a result of specific relevant changes in circumstances, such as a new legal obligation requiring additional capital investment, which are set out in South West Water's licence. Ofwat will examine the item and may adjust its price limits if the item is at least equal to 10 per cent. of the company's turnover.

It is also possible for South West Water to apply to Ofwat for a substantial effect determination if an unforeseen circumstance substantially increases costs or reduces revenues, where the total adverse impact on South West Water amounts to at least 20 per cent. of its revenue and where the impact on revenue and costs could not have been avoided by prudent action by the company.

South West Water can appeal to the Competition and Markets Authority with respect to any price limits which are set by Ofwat pursuant to a periodic review or Interim Determination. The Competition and Markets Authority will determine any such appeal in accordance with the same principles as apply to Ofwat in setting price limits.

Water efficiency

The Government has not yet decided to introduce universal water metering but has stated that the case for this may change.

Water affordability

Water companies are able to choose to use cross-subsidies in their charges schemes to reduce the bills of financially struggling customers. South West Water has a social tariff to help very low income customers (eligible for certain state benefits) by way of a bill reduction of up to 50 per cent.

Enforcement reform

The 2011 Water Act grants increases to the regulatory powers of the Secretary of State and Ofwat. These include new powers for the Secretary of State to issue orders in relation to the conduct of marketing activities (these provisions might be used to address issues around mis-selling of water supply contracts, for instance if a new arrangement makes a customer worse-off than if it had remained with the undertaker) and an extension of Ofwat's information gathering powers.

Special administration regime

The Water Industry Act 1991 contains provisions enabling the Secretary of State or Ofwat to secure the general continuity of water supply and sewerage services in England and Wales through the appointment of a special administrator, who would have extensive functions similar to those of an administrator under the Insolvency Act 1986, but with certain important differences. The person appointed as a special administrator would be appointed only for the purposes of transferring as a going concern to one or more different water companies so much of the business of the water company as was necessary for the proper carrying out of its functions (the “**transfer purpose**”) and pending the transfer, of carrying out those functions. Once the relevant provisions of the Flood and Water Management Act 2010 are brought into force, where a water company is placed in special administration on the grounds that it is, or is likely to be, unable to pay its debts, the special administrator will be required to seek to rescue the water company as a going concern (the “**rescue purpose**”) rather than to transfer its business in accordance with the transfer purpose. However, the special administrator must pursue the transfer purpose instead of the rescue purpose where he thinks that a rescue is unlikely to be possible or that the objectives of a special administration order would be better achieved through a transfer.

If a special administration order were made in respect of South West Water, it would be for the special administrator to agree the terms of the transfer of all or any of the business of South West Water on behalf of South West Water, subject to the provisions of the Water Industry Act 1991. Until another company has been appointed as an undertaker in its place and its appointment as a water undertaker or sewerage undertaker is terminated, a water company may not be wound-up, nor may an administrator under the Insolvency Act 1986 be appointed in respect of it.

During the period of a special administration order, a water company is managed in such a way as to achieve the purposes of such order and in a manner that seeks to protect the respective interests of members and creditors of the water company. However, the effect of other provisions of the Water Industry Act 1991 is ultimately to subordinate members’ and creditors’ rights in favour of the purposes of the special administration order. See also “*Risk Factors-Factors That May Affect The Issuer’s Ability To Fulfil Its Obligations Under The Capital Securities - In certain circumstances (such as a serious breach of its duties under the Water Industries Act 1991 or inability to pay its debts), South West Water could be placed under special administration which could limit the ability of its creditors to recover amounts due to them*”.

REGULATION – VIRIDOR

Viridor’s waste and recycling facilities in England and Wales are regulated by environmental permits and in Scotland by waste management licences or pollution prevention and control permits. Compliance with these permits or licences is monitored by the Environment Agency (“**EA**”) in England and Wales and by the Scottish Environmental Protection Agency (“**SEPA**”) in Scotland. These permits and licences are complex, designed to minimise uncontrolled emissions to land, water or air, to enhance the environment and to protect public health. Both the EA and SEPA have wide ranging and extensive powers.

All Viridor’s waste management facilities, including the development and expansion of landfill sites, are subject to planning permission from the relevant local authority. Major facilities such as Energy Recovery Facilities above 50 MW must receive consent from the relevant Secretary of State.

Viridor’s extensive transport operation is regulated by the Driver and Vehicles Standards Agency (“**DVSA**”), an executive agency sponsored by the Department of Transport. DVSA provides a range of licensing, testing and enforcement services with the aim of improving the standard of roadworthiness for large goods vehicles, ensuring the compliance of operators and drivers, and supporting the independent Traffic Commissioners. Each transport depot has in place an Operators (O) Licence which limits the number and type of vehicle that may operate from that location.

ENVIRONMENT

The water and waste water industry in the UK is subject to substantial domestic and EU regulation, placing significant statutory obligations on South West Water with regard to, amongst other factors, the quality of treated water supplied, waste water treatment and the effects of the South West Water’s activities on the environment, biodiversity and human health and safety.

The ongoing development of such regulation could lead to additional obligations and restrictions being imposed on South West Water which may adversely impact its operations and increase expenditure.

All water companies have general duties, in exercising their functions, to conserve and enhance biodiversity and natural beauty and to promote efficient use of water. Environmental and public health regulation in the water sector is primarily the responsibility of the Secretary of State together with:

- The Environment Agency, which is responsible for conserving and redistributing water resources and securing their proper use, including the licensing of water abstraction from, and the environmental permitting of discharges to, controlled waters, for pollution control generally and for drought control and flood defence measures. The Government has proposed extending the scope of the environmental permitting regime to cover water abstraction as well as water discharge.
- The Drinking Water Inspectorate (“DWI”), which enforces drinking water quality standards, being involved in ensuring that water companies fulfil their statutory duty to supply drinking water that is wholesome; and
- Natural England, which is responsible for the protection of designated sites for nature conservation, for example so-called Sites of Special Scientific Interest.

EU directives, including the Water Framework Directive, the Drinking Water Directive, the Bathing Water Directive, the Urban Wastewater Treatment Directive and the Industrial Emissions Directive, are implemented in the UK by primary and secondary legislation. Any pollution of controlled waters or other environmental harm caused by South West Water or failure to meet drinking water quality or fitness requirements may result in enforcement action (including prosecution) or in liability for remedial or compensatory works under a number of statutory liability regimes, including that implemented in the UK pursuant to the EU Environmental Liability Directive, or for damages or other compensation.

Energy use in water and waste water treatment and other activities carried out by South West Water results in indirect emissions of greenhouse gases. South West Water is principally subject to the CRC Energy Efficiency Scheme, a mandatory UK emissions trading scheme for significant consumers of energy (which resulted in an annual cost to it of £1.9 million in the financial year ended 31 March 2017). The Government has announced that the CRC Energy Efficiency Scheme will be terminated at the end of the current phase (ending in 2019) and replaced with an alternative tax but further details and possible cost implications are not yet known.

INSURANCE

The Group manages its property and third party liability risks through insurance policies that mainly cover property and business interruption, motor, public liability, environmental pollution and employers’ liability. The Group uses three tiers of insurance to cover operating risks:

- self-insurance – Group companies pay a moderate excess on most claims
- cover by the Group’s subsidiary (Peninsula Insurance Limited) of the layer of risk between the self-insurance and the cover provided by external insurers
- cover provided by the external insurance market, arranged by its brokers with insurance companies that have good credit ratings.

The Group’s insurance policies are subject to commercially negotiated deductibles, exclusions and limitations and the Group will only receive insurance proceeds in respect of a claim made by it to the extent that its insurers have the funds to make payment. Therefore insurance may not cover all losses incurred by the Group and no assurance is given that the Group will not suffer losses beyond the limits of, or outside the cover provided by, its insurance policies.

OTHER FINANCIAL INFORMATION

The financial measures presented by the Issuer in this section “*Other Financial Information*” are not defined in accordance with IFRS accounting standards. However, the Issuer believes that these measures provide useful supplementary information to both investors and the Issuer’s management, as they facilitate the evaluation of the Issuer’s performance. It is to be noted that since not all companies calculate financial measurements in the same manner, these are not always comparable to measurements used by other companies (even if similarly labelled). Accordingly, these financial measures should not be seen as a substitute for measures defined according to IFRS. The list below presents alternative performance measures, along with their reconciliation to the extent that such information is not defined according to IFRS and not included in the Issuer’s financial statements incorporated by reference into this Prospectus. For the avoidance of doubt, the Issuer does not consider operational performance measures prescribed by Ofwat to be alternative performance measures.

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion	
Watershare RoRE	12.6 per cent.	11.7 per cent.	Return on regulated equity as prescribed by Ofwat adjusted to reflect the difference between actual and assumed financing costs using a cumulative forecast RPI over AMP6. Ofwat’s methodology uses an in-year average RPI rate.	This measure is presented in addition to the Ofwat calculated RoRE as the measure was included in South West Water’s business plan to measure performance and share outperformance with customers.	
Reconciliation					
			<u>2017</u>	<u>2016</u>	
			<u>£m</u>	<u>£m</u>	
Ofwat RoRE (as defined by Ofwat methodology)			11.9%	10.1%	
Less Ofwat calculated financing performance			-2.4%	-1.4%	
Add Watershare calculated financing performance			3.1%	3.0%	
Watershare RoRE			12.6%	11.7%	
Net debt	£2,664.9 million	£2,484.4 million	A measure of indebtedness consisting of borrowings less cash and cash deposits.	This measure is presented to assess and monitor the level of net indebtedness in the Group.	
Reconciliation					
			<u>2017</u>	<u>2016</u>	<u>2015</u>
			<u>£m</u>	<u>£m</u>	<u>£m</u>
Cash and cash deposits			598.1	632.2	771.0
Current borrowings			(146.5)	(65.0)	(113.6)
Non-current borrowings			(3,116.5)	(3,051.6)	(2,854.5)
Net debt			(2,664.9)	(2,484.4)	(2,197.1)
South West Water Limited net debt	£2,033.8 million	£1,793.3 million	A measure of indebtedness of South West Water Limited consisting of borrowings less cash and cash deposits.	This measure is presented to assess and monitor the level of net indebtedness in South West Water Limited.	
Reconciliation					
			<u>2017</u>	<u>2016</u>	
			<u>£m</u>	<u>£m</u>	
Cash and cash deposits			247.4	251.2	
Current borrowings			(158.3)	(104.6)	
Non-current borrowings			(2,122.9)	(1,939.9)	
South West Water Limited net debt			(2,033.8)	(1,793.3)	

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
Joint venture non-recourse net debt	£194 million	-	A measure of the non-recourse net indebtedness of joint ventures excluding shareholder loans	This measure is presented to assess and monitor non-recourse net indebtedness of joint ventures excluding shareholder loans.
Reconciliation				
			<u>2017</u>	
			<u>£m</u>	
Cash and cash equivalents			53.4	
Borrowings			(333.6)	
Net debt			(280.2)	
Associated shareholder loans			86.5	
Joint venture non-recourse net debt (excluding shareholder loans)			(193.7)	
South West Water's net debt / Regulatory Capital Value (RCV)	61.8 per cent.	59.7 per cent.	A regulatory measure of gearing comparing the water business borrowings less cash and cash deposits (net debt) to regulatory capital value as prescribed under Ofwat's regulatory framework.	This measure is presented to assess the gearing level of the water business in relation to the regulatory capital value of the water business to monitor against Ofwat's notional gearing target of 62.5 per cent.
Reconciliation				
			<u>2017</u>	<u>2016</u>
			<u>£m</u>	<u>£m</u>
Regulated Capital Value			3,290.6	3,150.2
Water business net debt			2,033.8	1,880.0
Water business net debt / RCV			61.8%	59.7%
Average interest rate	3.4 per cent.	3.3 per cent.	A measure of the mean average interest rate payable on the Group's net debt, which excludes interest costs not directly associated with Group net debt.	This measure is presented to assess and monitor the relative cost of financing for the Group.
Reconciliation				
			<u>2017</u>	<u>2016</u>
			<u>£m</u>	<u>£m</u>
Net finance costs			87.6	48.9
Exclude:				
Non-underlying net finance costs			(28.8)	5.2
Interest receivable on shareholder loans to JVs			10.2	10.7

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
Net interest on retirement benefit obligations			(1.2)	(1.8)
Unwinding of discounts in provisions			(9.1)	(9.4)
Interest receivable on service concession arrangements			16.1	16.7
Add:				
Capitalised interest			12.9	9.4
Net interest for average interest rate calculation			87.7	79.7
Opening net debt			2,484.4	2,197.1
Add: net debt acquired at 15 April 2015			-	147.0
Opening net debt plus debt acquired at 15 April 2015			2,484.4	2,344.1
Closing net debt			2,664.9	2,484.4
Average net debt (opening net debt plus closing net debt plus debt acquired at 15 April 2015 / 2)			2,574.7	2,414.3
Average interest rate (net interest / average net debt)			3.4%	3.3%
Non-underlying net finance costs	£28.8 million	£5.2 million	A measure of recognised non-underlying finance costs of the Group, the reconciliation of this is included in note 6 on page 131 of the 2017 Annual Report and Accounts of the Group.	This measure is presented to assess the non-underlying finance costs of the Group.
Non-underlying employment costs	£1.1 million	£8.6 million	A measure of recognised non-underlying employment costs, the reconciliation of this is included in note 6 on page 131 of the 2017 Annual Report and Accounts of the Group.	This measure is presented to assess the non-underlying employment costs of the Group.
Non-underlying other operating expenses	£9.6 million	£1.6 million	A measure of recognised non-underlying other operating expenses, the reconciliation of this is included in note 6 on page 131 of the 2017 Annual Report and Accounts of the Group.	This measure is presented to assess the non-underlying other operating expenses of the Group.
South West Water average interest rate	3.2 per cent.	3.1 per cent.	A measure of the mean average interest rate payable on water business net debt which consists principally of South West Water's net debt and, from 2017, Bournemouth Water's net debt, and which excludes interest costs	This measure is presented to assess and monitor the relative cost of financing for the water business.

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
			not directly associated with water business net debt.	
Reconciliation				
				2017 2016
				£m £m
Net finance costs				61.4 55.3
Exclude:				
Net interest on retirement benefit obligations				(0.7) (1.4)
Add:				
Capitalised interest				2.8 1.4
Net interest for average interest rate calculation				63.5 55.3
Opening water net debt				1,878.9 1,816.9
Closing water net debt				2,033.2 1,792.6
Average net debt (opening water net debt plus closing water net debt / 2)				1,956.1 1,804.8
Average interest rate (net interest / average net debt)				3.2% 3.1%
Water business net debt	£2,033.2 million	£1,792.6 million	A measure of indebtedness of the water business consisting of borrowings less cash and cash deposits.	This measure is presented to assess and monitor the level of net indebtedness in the water business.
Reconciliation				
				2017 2016 2015
				£m £m £m
Cash and cash deposits				252.4 256.2 251.7
Current borrowings				(162.8) (108.9) (187.8)
Non-current borrowings				(2,122.8) (1,939.9) (1,880.8)
Water business net debt				(2,033.2) (1,792.6) (1,816.9)
				2016 £m
Closing net debt at 31 March 2016				1,792.6
Add: net debt acquired at 1 April 2016				86.3
Opening net debt at 1 April 2016				1,878.9
Non-regulated consolidated earnings before interest, tax, depreciation and amortisation, excluding non-underlying items (EBITDA)	£136.9 million	£113.2 million	A measure of earnings from operations excluding interest, tax, depreciation and amortisation.	This measure is presented to assess and monitor operational underlying performance.

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
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Reconciliation

	<u>2017</u>	<u>2016</u>
	<u>£m</u>	<u>£m</u>
Profit after tax	180.5	168.3
Excluding:		
Taxation	30.0	38.0
Share of post-tax profit from JVs	(4.2)	(3.6)
Net finance costs	87.6	48.9
Depreciation and amortisation	181.4	186.6
Non-underlying employment costs	1.1	8.6
Non-underlying other operating expenses	9.6	1.6
Water segment EBITDA	<u>(349.1)</u>	<u>(335.2)</u>
Non-regulated EBITDA	<u>136.9</u>	<u>113.2</u>

Adjusted EBITDA

£546.2 million

£508.4 million

Underlying earnings measure adjusting EBITDA as defined above to include the Group's share of EBITDA from its joint ventures and finance income on service concession arrangements.

This measure is presented to aggregate earnings from all the Group's ERFs which are accounted for differently depending upon the contractual relationships.

Reconciliation

	<u>2017</u>	<u>2016</u>
	<u>£m</u>	<u>£m</u>
Profit after tax	180.5	168.3
Excluding:		
Taxation	30.0	38.0
Share of post-tax profit from JVs	(4.2)	(3.6)
Net finance costs	87.6	48.9
Depreciation and amortisation	181.4	186.6
Non-underlying employment costs	1.1	8.6
Non-underlying other operating expenses	9.6	1.6
EBITDA	<u>486.0</u>	<u>448.4</u>
Add:		
Share of joint venture EBITDA (including share of interest receivable on service concession arrangements)	44.1	43.3
Interest receivable on service concession arrangements	16.1	16.7
Adjusted EBITDA	<u>546.2</u>	<u>508.4</u>

Viridor earnings before interest, tax, depreciation and amortisation,

£138.3 million

£116.5 million

A measure of earnings from operations excluding interest, tax, depreciation and

This measure is presented to assess and monitor operational underlying performance

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Financial measure	31 March 2017	31 March 2016	Definition		Rationale for inclusion		
Taxation		2.2	2.5	(1.9)	1.2	(1.1)	1.4
JV net finance costs		8.2	27.5	29.7	9.0	29.6	30.0
JV depreciation and amortisation		8.1	1.3	12.4	7.9	1.2	10.7
JV EBITDA (including interest receivable on service concession arrangements)		29.4	28.8	40.2	31.3	29.6	34.3
Viridor economic interest		50%	50%	37.5%	50%	50%	37.5%
Viridor share of joint venture EBITDA (including interest receivable on service concession arrangements)		14.7	14.4	15.0	15.6	14.8	12.9

Water segment EBITDA £349.1 million £335.2 million A measure of earnings from water segment operations excluding interest, tax, depreciation and amortisation. This measure is presented to assess and monitor operational underlying performance.

Reconciliation

	<u>2017</u>	<u>2016</u>
	<u>£m</u>	<u>£m</u>
Water segment profit before tax	187.4	160.5
Excluding:		
Water segment non-underlying profit before tax	(13.5)	5.2
Water segment net finance costs	61.5	58.8
Water segment depreciation and amortisation	113.7	110.7
Water segment EBITDA	349.1	335.2

Interest cover / net interest cover 4.7x 4.4x Underlying measure of net interest costs adjusted for notional interest items as a ratio to operating profits. This measure is presented to assess and monitor the ratio of underlying net interest costs to operating profit.

Reconciliation

	<u>2017</u>	<u>2016</u>
	<u>£m</u>	<u>£m</u>
Operating profit	293.9	251.6
Non-underlying operating profit	10.7	10.2
Underlying operating profit	304.6	261.8
Net interest for average interest rate calculation	87.7	79.7
Exclude:		
Capitalised interest	(12.9)	(9.4)
Add:		
Interest receivable on shareholder loans to JVs	(10.2)	(10.7)
Net interest for interest cover / net interest cover	64.6	59.6

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
Interest cover / net interest cover			4.7	4.4
Net finance cost before underlying items	£58.8 million	£54.1 million	Finance costs net of finance income and non-underlying items.	This measure is presented to assess and monitor the aggregate cost of the financing of the Group.
Reconciliation				
			<u>2017</u>	<u>2016</u>
			<u>£m</u>	<u>£m</u>
Finance income			52.3	47.3
Less: Finance income non-underlying items			(16.0)	(5.2)
Finance costs			(139.9)	(96.2)
Less: Finance costs non-underlying items			44.8	-
Net finance cost before underlying items			(58.8)	(54.1)
Earnings per share before non-underlying items and deferred tax	47.0p	39.5p	Profit after tax attributable to shareholders excluding non-underlying items and deferred tax, divided by the weighted average number of ordinary shares in issue during the year.	A measure of performance relative to individual shareholders.
Reconciliation				
			<u>2017</u>	<u>2016</u>
			<u>£m</u>	<u>£m</u>
Profit after tax			180.5	168.3
Excluding:				
Non-underlying profit after tax items			11.1	(29.1)
Deferred tax charges before non-underlying items			18.9	39.2
Less:				
Profit after tax attributable to perpetual capital security holders			(16.2)	(16.2)
Earnings before non-underlying items and deferred tax			194.3	162.2
Weighted average number of shares			413.0	410.9
Earnings per share before non-underlying items and deferred tax (p)			47.0	39.5
Profit before tax and non-underlying items	£250.0 million	£211.3 million	A measure of profit before tax and non-underlying items.	This measure is presented to assess and monitor underlying performance before tax.

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
Reconciliation				
			<u>2017</u>	<u>2016</u>
			<u>£m</u>	<u>£m</u>
Profit before tax			210.5	206.3
Excluding:				
Non-underlying employment costs			1.1	8.6
Non-underlying other operating expenses			9.6	1.6
Non-underlying net finance costs			<u>28.8</u>	<u>(5.2)</u>
Profit before tax and non underlying items			<u>250.0</u>	<u>211.3</u>
Dividend per share	35.96p	33.58p	The dividend amount per share that the issuer proposes to pay shareholders in an annual period, being the proposed dividend divided by the number of shares.	This measure is presented to show the return to shareholders on an individual share basis.
Reconciliation				
			<u>2017</u>	<u>2016</u>
Proposed interim dividend per share at 31 March			11.09	10.46
Proposed final dividend per share at 31 March			24.87	23.12
Dividend per share (pence)			<u>35.96</u>	<u>33.58</u>
Group gearing ratio	63.8 per cent.	62.5 per cent.	Net debt, as defined earlier, divided by total equity plus net debt.	This measure is presented to assess and monitor the group's capital structure.
Reconciliation				
			<u>2017</u>	<u>2016</u>
			<u>£m</u>	<u>£m</u>
Net debt			2,644.9	2,484.4
Total equity			<u>1,509.2</u>	<u>1,487.6</u>
Total capital			<u>4,174.1</u>	<u>3,972.0</u>
Group gearing ratio (net debt / total capital)			63.8%	62.5%
Group gearing ratio, reclassifying the perpetual capital as debt	70.4 per cent.	70.0 per cent.	Net debt, as defined above, plus the perpetual capital, divided by total capital.	This measure is presented to assess and monitor the group's capital structure reclassifying the

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
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perpetual capital to debt.

Reconciliation

	2017 £m	2016 £m
Net debt	2,644.9	2,484.4
Perpetual capital securities	294.8	294.8
	2,939.7	2,779.2
Total capital	4,174.1	3,972.0
Group gearing ratio excluding hybrid securities	70.4%	70.0%

Net aggregate pension liability

£56 million

Net retirement benefit obligation adjusted for deferred taxation.

This measure is presented to identify the net retirement benefit obligation adjusted for deferred taxation.

Reconciliation

	2017 £m
Present value of pension scheme obligations	971
Fair value of pension plan assets	903
Net retirement benefit obligation	68
Deferred tax	(12)
Net aggregate pension liability	56

Group Capital Investment

£384.7 million

£316.9 million

Total capital investment by the Group.

This measure is presented to assess and monitor the total capital investment by the Group.

Reconciliation

	2017 £m	2016 £m
Property, plant and equipment additions	377.5	284.2
Other expenditure including IFRIC 12 service concession expenditure and landfill restoration spend	7.2	32.7
Group Capital Investment	384.7	316.9

South West Water's Capital Expenditure

£190.9 million

£134.1 million

Total capital expenditure of South West Water.

This measure is presented to assess and monitor the total capital

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
				expenditure of South West Water.
Reconciliation				
			2017	2016
			£m	£m
South West Water Limited capital expenditure			190.9	126.3
Bournemouth Water Limited capital expenditure			-	7.8
Total South West Water capital expenditure			190.9	134.1
Viridor's Capital Investment	£193.8 million	£182.8 million	Total capital investment of Viridor.	This measure is presented to assess and monitor the total capital investment of Viridor.
Reconciliation				
			2017	2016
			£m	£m
Property, plant and equipment additions			186.5	150.1
Other expenditure including IFRIC 12 service concession expenditure and landfill restoration spend			7.3	32.7
Viridor Capital Investment			193.8	182.8
Recycling revenue per tonne	£90/tonne	£85/tonne	Recycling revenue, recognised in line with the Group's revenue accounting policy, divided by the volume of waste material recycled.	This measure is presented to assess and monitor revenues generated from recycling activities.
Recycling operating costs per tonne	£72/tonne	£74/tonne	Recycling operating costs before depreciation, recognised in line with the Group's accounting policy, divided by the volume of waste material recycled.	This measure is presented to assess and monitor operational costs incurred in recycling activities.
Recycling shipping costs per tonne	£4/tonne	£3/tonne	Recycling shipping costs divided by the volume of waste material recycled.	This measure is presented to assess and monitor shipping costs incurred in recycling activities.
Recycling EBITDA margin per tonne	£14/tonne	£8/tonne	Recycling revenue per tonne less recycling operating costs per tonne	This measure is presented to assess and monitor operational

Financial measure	31 March 2017	31 March 2016	Definition	Rationale for inclusion
			and shipping costs per tonne.	performance of our recycling activities.

RECENT DEVELOPMENTS

On 24 August 2017, the Issuer announced that principles had been agreed, and a heads of terms signed, between the Greater Manchester Waste Disposal Authority (“**GMWDA**”) and Viridor Laing (Greater Manchester) Limited (“**Viridor Laing**”) in relation to the exit of GMWDA from its 25-year Recycling & Waste Management Private Finance Initiative (PFI) Contract (the “**PFI Contract**”) with Viridor Laing.

As announced by the Issuer on 2 May 2017, GMWDA took the decision to seek an exit from the PFI Contract on 26 April 2017. The Issuer expects (subject to a number of conditions and approvals) that a final agreement on the termination of the PFI Contract will be signed by the end of September 2017.

The Issuer currently anticipates that there will be a net one-off non-material impact to the income statements of each of Viridor Laing and INEOS Runcorn (TPS) Holdings Limited, the joint venture entities, for the financial year ending 31 March 2018. This takes into account a reduction in the book value investment in joint ventures and an expected one-off gain on joint venture profit after tax.

MANAGEMENT AND EMPLOYEES

BOARD OF DIRECTORS

The responsibilities of the Board of Directors (the “**Board**”) include overall leadership of the Group, setting the Group’s values, policies and standards, approving the Group’s strategy and objectives and providing oversight of the Group’s operations and its performance. The Board makes decisions in relation to Group and Viridor business in accordance with its schedule of matters reserved. The South West Water board continues to operate as a separate independent board in accordance with its own schedule of matters reserved to ensure compliance with Ofwat’s principles on board leadership, transparency and governance.

Detailed consideration of certain matters is delegated to Board committees, to the Executive Directors and to the Group General Counsel & Company Secretary, as appropriate. In addition to the matters the Directors are required to decide by statute or regulation, the matters reserved to the Board in relation to the Issuer and Viridor Limited include: acquisitions and disposals; major items of capital expenditure; authority levels for other expenditure; risk management process and monitoring of risks; approval of the strategic plan and annual operating budgets, Group policies, procedures and delegations; and appointments to the Board and its committees.

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

The members of the Board of Directors of the Issuer, their functions and the principal activities performed by them outside the Issuer as of the date hereof are set forth in the following table and subsequent mini-biographies:

Name	Function
Sir John Parker	Chairman
Christopher Loughlin	Chief Executive Officer
Susan Davy	Chief Financial Officer
Gill Rider	Senior Independent Director (Non-Executive)
Martin Angle	Independent Non-executive Director
Neil Cooper	Independent Non-executive Director
Martin Hagen*	South West Water Non-executive Director (in attendance)
Matthew Taylor*	South West Water Non-executive Director (in attendance)

* The South West Water Non-executive Directors are not members of the Board but are in attendance at meetings of the Board. There is currently a vacancy for a third South West Water Non-executive Director.

Sir John Parker

Sir John was appointed to the Board as Deputy Chairman on 1 April 2015 and became Chairman on 1 August 2015. He is also chairman of the Nomination Committee.

Skills and experience

Sir John is a highly experienced and independent chairman and brings a wealth of leadership experience across a range of industries. He won the lifetime achievement award at The Sunday Times 2015 Non-Executive Director Awards and is widely recognised for his policy work on corporate governance, including the value of diversity in the boardroom.

He has chaired five FTSE100 companies and was previously the chairman of National Grid plc, senior non-executive director and chair of the Court of the Bank of England, deputy chairman of DP World, joint chair of Mondi and chair of BVT and P&O plc. He was also president of the Royal Academy of Engineering from 2011 to 2014.

Since his appointment as Chairman, Sir John has brought the Group together under a revised governance framework that features a new role of Group Chief Executive Officer and other senior positions. The new team is working together collaboratively to drive forward the Group's strategy.

External appointments

Sir John is the chairman of Anglo American plc and of Advanced Plasma Power Limited. He is also a non-executive director of Carnival Corporation and Airbus Group, and is a Visiting Fellow of the University of Oxford. Sir John's commitments are expected to reduce later in 2017, when he retires from the board of Anglo American plc.

Christopher Loughlin

Chris was appointed to the Board on 1 August 2006 upon joining the Issuer as Chief Executive of South West Water. He became the Group Chief Executive Officer on 1 January 2016. Chris is chairman of the Pennon Executive and a member of the Sustainability Committee.

Skills and experience

Chris has extensive experience of the regulated business environment and the management of major engineering and infrastructure services. He started his career as a chartered engineer working in both the consulting and contracting sectors and, after holding a number of senior positions with British Nuclear Fuels plc, joined its board as an executive director. Prior to joining Pennon he was chief operating officer with Lloyds Register and before that executive chairman of Magnox Electric plc. He was also a senior diplomat in the British Embassy, Tokyo.

Chris has a comprehensive understanding of the water industry. He was previously a board member (and, for a period, president) of the Institute of Water, and between April 2008 and March 2012 was chairman of Water UK.

Since his appointment as Group Chief Executive Officer, Chris has set the Group on a path of closer collaboration in pursuit of delivery of its strategy, with the constituent parts of the Group now working together to identify synergies, reduce costs and exploit opportunities for growth.

External appointments

Chris is currently chairman of British Water, a director of Water UK and a trustee of the charity WaterAid. An enthusiastic advocate of local business, Chris is also vice chairman of the Cornwall Local Enterprise Partnership.

Susan Davy

Susan joined the Board on 1 February 2015. She is a member of the Pennon Executive.

Skills and experience

Susan is a graduate qualified chartered accountant with 20 years' experience in the utility sector. Prior to her current appointment, Susan was Finance Director at South West Water between 2007 and 2015, during which time she was responsible for the company's Business Plan to 2020. She has also held a number of other senior finance roles in the water sector, including as Head of Regulation and Head of Finance (Wastewater) at Yorkshire Water.

Susan's knowledge of the industry coupled with her financial and regulatory expertise has supported the development of Pennon's strategy and her input has been invaluable to the Board in its deliberations. Susan is highly respected in the City and has been instrumental in building the Group's reputation.

External appointments

Susan is a member of the A4S (Accounting for Sustainability) CFO leadership network and a council member of CBI South West.

Gill Rider

Gill was appointed to the Board on 1 September 2012. She is chairman of the Sustainability Committee and a member of the Audit, Remuneration and Nomination Committees.

Skills and experience

Gill has a wealth of experience in leadership, governance and remuneration across a broad range of sectors including professional services, education and government. Formerly, she was head of the Civil Service Capability Group in the Cabinet Office, reporting to the Cabinet Secretary and prior to that held a number of senior positions with Accenture LLP culminating in the post of chief leadership officer for the global firm. She was previously president of the Chartered Institute of Personnel and Development and a non-executive director of De La Rue plc.

As chairman of the Sustainability Committee, Gill has encouraged and supported executive management in the development of a sustainability programme that underpins the delivery of the Group's strategy. At Accenture, she chaired the global corporate responsibility and Foundation giving programme and was instrumental in building sustainability objectives into Accenture's worldwide human capital strategies.

External appointments

Gill currently holds non-executive directorships with Charles Taylor plc, where she is senior independent director, and Intertek Group plc. She is chairman of both their remuneration committees. She is also chair of the council (board) of the University of Southampton.

Martin Angle

Martin was appointed to the Board on 1 December 2008. He is chairman of the Remuneration Committee and a member of the Audit, Nomination and Sustainability Committees.

Skills and experience

Martin is an experienced non-executive director, bringing a wide range of knowledge and experience from a career in investment banking, private equity and industry.

Over a 20-year executive career in investment banking, Martin held senior roles with SG Warburg & Co. Ltd, Morgan Stanley and Dresdner Kleinwort Benson, before becoming the group finance director of TI Group plc, then a FTSE 100 company. He subsequently joined Terra Firma Capital Partners where he held various senior roles in its portfolio companies, including the executive chairmanship of the Waste Recycling Group Limited, then a major participant in the UK waste sector, and Le Meridien Hotel Group where he was executive deputy chairman.

Martin has also served as a non-executive director on a number of boards including Savills plc, where he was the senior independent director; National Exhibition Group, where he was chairman; Severstal; and Dubai International Capital.

As chairman of the Remuneration Committee, Martin has steered the Issuer's approach on executive remuneration, ensuring that it is aligned with and supports the Group's strategy.

External appointments

Martin is currently vice chairman and non-executive director of the FIA Foundation, the adviser to the Board of the Commercial Bank of Dubai and the adviser to NGP, a private group based in the USA, which is building out a major platform in renewable energy in emerging markets.

Neil Cooper

Neil joined the Board on 1 September 2014. He is chairman of the Audit Committee and a member of the Remuneration and Nomination Committees.

Skills and experience

Neil brings to the Board extensive experience in a wide variety of corporate and financial matters. Most recently, he was group finance director of Barratt Developments plc and, before that, group finance director of William Hill plc and Bovis Homes plc. He also held senior finance positions at Whitbread plc, worked for PricewaterhouseCoopers as a management consultant and held a number of roles with Reckitt & Colman plc.

As chairman of the Audit Committee, Neil has been influential in directing the Issuer's approach on a number of significant matters including internal control, governance and financial reporting.

External appointments

Neil is currently Executive Director of Currencies Direct Limited.

Conflicts

The business address of each of the Directors listed above is Peninsula House, Rydon Lane, Exeter EX2 7HR. There are no potential conflicts of interest between the duties to the Issuer of any of the Directors listed above and their private interests and/or other duties.

BOARD COMMITTEES

Detailed consideration of certain matters is delegated to the following committees established by the Board of Directors:

- **Audit Committee:** This committee comprises three independent Non-Executive Directors and two South West Water non-executive Directors for South West Water matters. This committee ensures the appropriateness of the Group's financial reporting, monitors the performance of the external auditors and the internal audit function, and reviews and make recommendations in relation to the Group's internal systems and risk control policies.
- **Sustainability Committee:** This committee comprises two independent Non-Executive Directors, two South West Water non-executive Directors (of which one is a vacancy) for South West Water matters, and the Group CEO. The committee's duties are to review the strategies, policies, management, initiatives, targets and performance of the Group in the areas of occupational health and safety and security; environment; workplace policies; responsible and ethical business practice; customer service and engagement; and the role of the Group in society.
- **Nomination Committee:** This committee comprises the Chairman, three independent Non-Executive Directors and three South West Water Non-executive Directors (of which one is a vacancy) for South West Water matters. The committee's responsibilities include reviewing the structure, size and composition of the board, monitoring compliance with the Board's diversity policy, succession planning, and determining the nomination process for and selecting and recommending to the Board suitable candidates for appointment as Directors of the Issuer and of South West Water.
- **Remuneration Committee:** This committee comprises three independent Non-Executive Directors and two South West Water non-executive Directors (of which one is a vacancy) for South West Water matters. The committee advises the Board on the framework of executive remuneration for the Group and determines the remuneration and terms of engagement of the chairman, the executive Directors and senior management of the Group.

EMPLOYEES

The Group employs around 5,000 employees and its goal is to attract and retain talented people with the knowledge, skills, values and behaviours required to deliver the Group's long term goals and objectives. Underpinning this, and in line with human rights principles, the Group has a range of policies covering health and safety, equal opportunities, diversity, ethics and employee relations. All elements of the Group's workplace strategy apply to both permanent and temporary workers and the Group expects suppliers and contractors to comply with relevant legislation and to hold similar principles. Employee representation is facilitated through trade union membership and, for South West Water, by an elected Staff Council.

A Code of Conduct sets out the principles that the Group believes should guide its employees' actions. These principles apply equally to permanent and temporary employees and the Group expects suppliers and contractors to comply with equivalent guidance. Employee training courses have been developed around the Code of Conduct that focus on specific aspects relating to legal and ethical behaviour.

Group policy is to provide and maintain a safe working environment while preventing injury and ill health wherever possible. Improvement is targeted through training programmes focusing on behaviours and attitudes as well as risk awareness and risk control and the ability to learn from accidents or near misses. The Group has recently initiated a new Health and Safety programme 'HomeSafe': it represents a wide-ranging agenda of consolidation and improvements, which focuses on people, process and the physical environment.

The Group encourages share ownership amongst its employees by operating an HM Revenue & Customs approved Sharesave Scheme and Share Incentive Plan. At 31 March 2017 over 40 per cent. of the Group's employees participated in these plans.

TAXATION

UNITED KINGDOM TAXATION

The following applies only to persons who are the beneficial owners of Capital Securities and is a summary of the Issuer's understanding of current United Kingdom tax law as applied in England and Wales and published HM Revenue and Customs practice (which may not be binding on HM Revenue and Customs) relating to certain aspects of United Kingdom taxation and are not intended to be exhaustive. They do not necessarily apply where the income is deemed for tax purposes to be the income of any other person. Some aspects do not apply to certain classes of person (such as dealers and persons connected with the Issuer) to whom special rules may apply. The United Kingdom tax treatment of prospective Holders of Capital Securities depends on their individual circumstances and may be subject to change in the future. Prospective Holders who may be subject to tax in a jurisdiction other than the United Kingdom or who may be unsure as to their tax position should seek their own professional advice.

A. Periodic Returns on the Capital Securities

Payment of periodic returns on the Capital Securities

Payments of periodic returns on the Capital Securities may be made without deduction of or withholding on account of United Kingdom income tax provided that the Capital Securities continue to be listed on a "recognised stock exchange" within the meaning of section 1005 of the Income Tax Act 2007 (the "Act"). The London Stock Exchange is a recognised stock exchange. Securities will be treated as listed on the London Stock Exchange if they are included in the Official List and admitted to trading on the London Stock Exchange. Provided, therefore, that the Capital Securities remain so listed, periodic returns on the Capital Securities will be payable without withholding or deduction on account of United Kingdom tax.

Periodic returns on the Capital Securities may also be paid without withholding or deduction on account of United Kingdom tax where such amounts are paid by the Issuer and, at the time the payment is made, the Issuer reasonably believes that the beneficial owner is within the charge to United Kingdom corporation tax as regards such amounts, provided that HMRC has not given a direction (in circumstances where it has reasonable grounds to believe that it is likely that the above exemption is not available in respect of such payments of periodic returns at the time the payment is made) that such amount should be paid under deduction of tax.

In other cases, an amount must generally be withheld from payments of periodic returns on the Capital Securities on account of United Kingdom income tax at the basic rate (currently 20 per cent.), subject to any other available exemptions and reliefs. However, where an applicable double tax treaty provides for a lower rate of withholding tax (or for no tax to be withheld) in relation to a Holder who is not resident in the United Kingdom, HMRC can issue a notice to the Issuer to pay the periodic return to the Holder without deduction of tax (or for such amounts to be paid with tax deducted at the rate provided for in the relevant double tax treaty).

Further United Kingdom Income Tax Issues

Periodic returns on the Capital Securities constitutes United Kingdom source income for tax purposes and, as such, may be subject to income tax by direct assessment irrespective of the residence of the Holder, even where paid without withholding.

However, periodic returns with a United Kingdom source received without deduction or withholding on account of United Kingdom tax will not be chargeable to United Kingdom tax in the hands of a Holder (other than certain trustees) who is not resident for tax purposes in the United Kingdom unless that Holder carries on a trade, profession or vocation in the United Kingdom through a United Kingdom branch or agency in connection with which the periodic return is received or to which the Capital Securities are attributable (and where that Holder is a company, unless that Holder carries on a trade in the United Kingdom through a permanent establishment in connection with which the periodic return is received or to which the Capital Securities are attributable). There are exemptions for periodic

returns received by certain categories of agent (such as some brokers and investment managers). The provisions of an applicable double taxation treaty may also be relevant for such Holders.

B. United Kingdom Corporation Tax Payers

In general, Holders which are within the charge to United Kingdom corporation tax (including non-resident Holders within the charge to United Kingdom corporation tax whose Capital Securities are used, held or acquired for the purposes of a trade carried on in the United Kingdom through a permanent establishment) will be charged to tax as income on all returns, profits or gains on, and fluctuations in value of, the Capital Securities (whether attributable to currency fluctuations or otherwise) broadly in accordance with their statutory accounting treatment.

C. Other United Kingdom Tax Payers

Periodic returns

Holders who are either individuals or trustees and are resident or ordinarily resident for tax purposes in the United Kingdom or who carry on a trade, profession or vocation in the United Kingdom through a branch or agency to which the Capital Securities are attributable will generally be liable to United Kingdom tax on the amount of any periodic returns received in respect of the Capital Securities.

Taxation of Chargeable Gains

The Capital Securities will constitute “qualifying corporate bonds” within the meaning of section 117 of the Taxation of Chargeable Gains Act 1992. Accordingly, a disposal by a Holder of a Capital Securities will not give rise to a chargeable gain or an allowable loss for the purposes of the UK taxation of chargeable gains.

Accrued Income Scheme

On a disposal of Capital Securities by a Holder, any periodic returns which have accrued since the last returns payment date may be chargeable to tax as income under the rules of the accrued income scheme as set out in Part 12 of the Act, if that Holder is resident in the United Kingdom or carries on a trade in the United Kingdom through a branch or agency to which the Capital Securities are attributable.

The Capital Securities are likely to constitute variable rate securities for the purposes of the accrued income scheme. Under the accrued income scheme on a disposal of Capital Securities by a Holder who is resident or ordinarily resident in the United Kingdom or carries on a trade in the United Kingdom through a branch or agency to which the Capital Securities are attributable the Holder may be charged to income tax on an amount of income which is just and reasonable in the circumstances. The purchaser of such Capital Securities will not be entitled to any equivalent tax credit under the accrued income scheme to set against any actual amounts received as a periodic return by the purchaser in respect of the Capital Securities (which may therefore be taxable in full).

D. Stamp Duty and Stamp Duty Reserve Tax (“SDRT”)

No United Kingdom stamp duty or SDRT should be payable on the issue of the Capital Securities or on a transfer by delivery of the Capital Securities.

FOREIGN ACCOUNT TAX COMPLIANCE ACT

Pursuant to certain provisions of the U.S. Internal Revenue Code of 1986, commonly known as FATCA, a “**foreign financial institution**” (as defined by FATCA) may be required to withhold on certain payments it makes (“**foreign passthru payments**”) to persons that fail to meet certain certification, reporting or related requirements. The Issuer may be a foreign financial institution for these purposes. A number of jurisdictions (including the United Kingdom) have entered into, or have agreed in substance to, intergovernmental agreements with the United States to implement FATCA (“**IGAs**”), which modify the way in which FATCA applies in their jurisdictions. Under the provisions of IGAs as currently in effect, a foreign financial institution

in an IGA jurisdiction would generally not be required to withhold under FATCA or an IGA from payments that it makes.

Certain aspects of the application of the FATCA provisions and IGAs to instruments such as the Capital Securities, including whether withholding would ever be required pursuant to FATCA or an IGA with respect to payments on instruments such as the Capital Securities, are uncertain and may be subject to change. Even if withholding would be required pursuant to FATCA or an IGA with respect to payments on instruments such as the Capital Securities, such withholding would not apply prior to 1 January 2019.

Holders should consult their own tax advisers regarding how these rules may apply to their investment in Capital Securities. In the event any withholding would be required pursuant to FATCA or an IGA with respect to payments on the Capital Securities, no person will be required to pay additional amounts as a result of the withholding.

SUBSCRIPTION AND SALE

Barclays Bank PLC and Morgan Stanley & Co. International plc (the “**Global Co-ordinators and Structuring Advisers**”) and Goldman Sachs International, HSBC Bank plc and The Royal Bank of Scotland plc (trading as NatWest Markets) (together with the Global Co-ordinators and Structuring Advisers, the “**Joint Lead Managers**”) have, pursuant to a Subscription Agreement (the “**Subscription Agreement**”) dated 20 September 2017, agreed with the Issuer, subject to the satisfaction of certain conditions, to subscribe for the Capital Securities on a joint and several basis. The Issuer has agreed to pay to the Joint Lead Managers a combined management and selling commission in consideration of their agreement to act as Joint Lead Managers, and to reimburse the Joint Lead Managers for certain costs and expenses incurred in connection with the management of the issue of the Capital Securities. The Subscription Agreement may be terminated in certain circumstances prior to payment being made to the Issuer.

United States

The Capital Securities have not been and will not be registered under the Securities Act, as amended, or the securities laws of any state or other jurisdiction of the United States and may not be offered or sold within the United States or to, or for the account or benefit of, U.S. persons (as defined in Regulation S) except in accordance with Regulation S or pursuant to transactions exempt from or not subject to the registration requirements of the Securities Act. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

The Capital Securities are subject to U.S. tax law requirements and may not be offered, sold or delivered within the United States or its possessions or to a United States person, except in certain transactions permitted by U.S. tax regulations. Terms used in this paragraph have the meanings given to them by the U.S. Internal Revenue Code of 1986 and treasury regulations promulgated thereunder.

Each Joint Lead Manager has represented and agreed that it has not offered or sold, and will not offer or sell, any Capital Securities (a) as part of its distribution at any time and (b) otherwise until 40 days after the completion of the distribution of all Capital Securities, except in accordance with Regulation S under the Securities Act. Each Joint Lead Manager has further agreed that, at or prior to confirmation of a sale of Capital Securities, it will send to each distributor, dealer or person receiving a selling concession, fee or other remuneration that purchases Capital Securities from it during the 40-day distribution compliance period a confirmation or other notice setting forth the restrictions on offers and sales of the Capital Securities within the United States or to, or for the account or benefit of, U.S. persons. Terms used in this paragraph have the meanings given to them in Regulation S under the Securities Act.

United Kingdom

Each Joint Lead Manager has represented, warranted and agreed that:

- (a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act 2000, as amended (the “**FSMA**”)) received by it in connection with the issue or sale of any Capital Securities in circumstances in which Section 21(1) of the FSMA does not apply to the Issuer; and
- (b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to any Capital Securities in, from or otherwise involving the United Kingdom.

General

No action has been or will be taken in any jurisdiction by the Issuer or Joint Lead Managers that would permit a public offering of the Capital Securities, or possession or distribution of any offering material in relation thereto, in any country or jurisdiction where action for that purpose is required.

Persons into whose hands this Prospectus comes are required by the Issuer and the Joint Lead Managers to comply with all applicable laws and regulations in each country or jurisdiction in or from which they purchase,

offer, sell or deliver the Capital Securities or have in their possession or distribute such offering material, in all cases at their own expense.

Each Joint Lead Manager has agreed that it shall, to the best of its knowledge and belief, comply with all applicable securities laws and regulations in force in each jurisdiction in which it purchases, offers, sells or delivers Capital Securities or possesses or distributes this Prospectus or any other offering or publicity material, in all cases at its own expense and will obtain any consent, approval or permission required by it for the purchase, offer, sale or delivery by it of Capital Securities under the laws and regulations in force in any jurisdiction to which it is subject or in which it makes such purchases, offers, sales or deliveries.

GENERAL INFORMATION

1 Authorisation

The issue of the Capital Securities was duly authorised by resolutions of the Board of Directors of the Issuer passed on 28 July 2017.

2 Listing and admission to trading

Application has been made to the UK Listing Authority for the Capital Securities to be admitted to the Official List and to the London Stock Exchange for such Capital Securities to be admitted to trading on its regulated market. It is expected that such listing and admission to trading of the Capital Securities will be granted on or about 22 September 2017, subject only to the issue of the Temporary Global Security. It is expected that dealings in the Capital Securities will commence on 25 September 2017. The expenses in connection therewith are expected to be approximately £4,200.

3 Clearing Systems

The Capital Securities have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The ISIN for the Capital Securities is XS1646358728 and the Common Code is 164635872.

The address of Euroclear is Euroclear Bank SA/NV, 1 Boulevard du Roi Albert II, B-1210 Brussels and the address of Clearstream, Luxembourg is Clearstream Banking S.A. 42 Avenue JF Kennedy, L-1855 Luxembourg.

4 No significant or material adverse change

There has been no significant change in the financial or trading position of the Issuer or the Group since 31 March 2017 and there has been no material adverse change in the financial position or prospects of the Issuer or the Group since 31 March 2017.

5 Litigation

There have been no governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened) of which the Issuer is aware during the 12 months preceding the date of this document which may have, or have had in the recent past, significant effects on the financial position or profitability of the Issuer or the Group.

6 Auditors

The auditors of the Issuer are Ernst & Young LLP. Ernst & Young LLP is registered to carry out audit work by the Institute of Chartered Accountants in England and Wales. Ernst & Young LLP have audited the Issuer's consolidated financial statements in accordance with IFRS for each of the two financial years ended on 31 March 2016 and 31 March 2017 and reported thereon without qualification. The auditors of the Issuer have no material interest in the Issuer.

7 U.S. tax

The Capital Securities and any Tokens will contain the following legend: "*Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in Sections 165(j) and 1287(a) of the Internal Revenue Code.*"

8 Yield

During the period from (and including) the Issue Date to (but excluding) the First Call Date, the yield of the Capital Securities will (unless the Fixed Rate of Return is increased in accordance with Condition 5.5(b), and subject to any deferral of periodic returns in accordance with Condition 3.9) be 2.896 per cent. on an annual basis. This figure is calculated on the basis of the issue price and as at the date of this Prospectus, and is not an indication of future yield.

9 Documents available

For the period of 12 months starting on the date on which this Prospectus is made available to the public, copies of the following documents will, when published, be available, during usual business hours on any weekday (Saturdays and public holidays excepted), for inspection at the specified office of the Paying Agents:

- (a) the Trust Deed and the Agency Agreement;
- (b) the Articles of Association of the Issuer;
- (c) the published annual report and audited consolidated financial statements of the Issuer for the two financial years ended 31 March 2016 and 31 March 2017, including the audit reports in respect thereof;
- (d) the latest published audited consolidated annual financial statements and unaudited consolidated interim financial statements of the Issuer and any subsequent interim management statement published by the Issuer; and
- (e) a copy of this Prospectus.

In addition, this Prospectus will also be available on the website of the Regulatory News Service operated by the London Stock Exchange at www.londonstockexchange.com/exchange/news/market-news/market-news-home.html.

10 Joint Lead Managers transacting with the Issuer and its affiliates

The Joint Lead Managers and their affiliates may have engaged, and may in future engage, in investment banking and/or commercial banking transactions with, and may perform services to, the Issuer and/or members of its group and their respective affiliates in the ordinary course of business.

In addition, in the ordinary course of their business activities the Joint Lead Managers and their affiliates may make or hold a broad array of investments and actively trade securities (or related derivative securities) and financial instruments for their own account and for the accounts of their customers. Such investments and securities activities may involve securities and/or instruments of the Issuer or its affiliates. Joint Lead Managers or their affiliates that have a lending relationship with the Issuer routinely hedge their credit exposure to the Issuer consistent with their customary risk management policies. Typically, such persons would hedge such exposure by entering into transactions which consist of either the purchase of credit default swaps or the creation of short positions in securities, including potentially the Capital Securities. Any such short positions could adversely affect future trading prices of the Capital Securities. The Joint Lead Managers and their affiliates may also make investment recommendations and/or publish or express independent research views in respect of such securities or financial instruments and may hold or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

ISSUER

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