

## Financial review

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The past year has seen an unprecedented period of disruption to financial markets, the banking sector and other financial institutions. These events have combined to create the so called ‘credit crunch’ and a wider economic recession. The speed of these events has also presented its own challenge and we have witnessed first, a rapid rise in retail price inflation, followed by a rapid decline with annual RPI inflation at a negative 0.4% and declining by the March 2009 year end.

The group reacted quickly to events, meeting the challenges, sustaining a sound financial performance throughout the year and ending it in a strong liquidity position.

When it became apparent that credit was becoming more difficult to obtain, with some traditional funding sources and markets effectively closed, the board took the decision to ‘pre fund’ a major part of our investment and cash needs for up to the next two years. Following this decision, we took a number of steps including successfully issuing new bonds to the sterling market in January, raising £400 million repayable in January 2018. These decisions have, of course, a short term economic cost as we are now holding cash, deposited on lower rates than our current borrowing costs. However, it is the view of the board that, despite the cost, in these unprecedented times, we should secure the funding required to maintain our services to customers and sustain our investment programme, particularly at Severn Trent Water.

The rapid rise in the first half year and then fall in retail price inflation (RPI) has also presented a number of challenges. At Severn Trent Water, which operates under an RPI model as regulated by Ofwat, we faced rising costs in the first half year which we worked hard to contain, while seeking to obtain value from the falling rates in the latter half. In a business such as Severn Trent Water where lead times on procured items, particularly on the capital investment programme, are longer this challenge has been difficult.

We continue to watch carefully the evolution of both the credit markets and the general economic situation, so we may seek out the best options to manage the business in these volatile economic times, but we finished the year ended 31 March 2009 in a strong liquidity position.

**Group financial performance**

Group turnover from continuing operations was £1,642.2 million (£1,552.4 million), an increase of 5.8% over last year. The growth in turnover was mainly due to the price increases in Severn Trent Water, offset by the impact of lower consumption across our

measured commercial income base, which reduced year on year revenues by around £20 million.

As described in our preliminary results published in June 2008, Severn Trent Retail and Utility Services (previously reported in Severn Trent Water) is now reported within Severn Trent Services. All comparatives have been restated to reflect this change (see note 5).

**Financial highlights**

	2009	2008	% change
Turnover* (£m)	<b>1,642.2</b>	1,552.4	5.8
Profit* before interest, tax and exceptionals (£m)	<b>469.9</b>	469.5	0.1
Profit* before interest and tax (£m)	<b>451.0</b>	400.7	12.6
Profit* before tax, exceptionals and IAS 39 (£m)	<b>273.5</b>	292.2	(6.4)
Profit* before tax (£m)	<b>167.6</b>	192.4	(12.9)
Earnings* per share before exceptionals, IAS 39 and deferred tax (p)	<b>92.7</b>	97.8	(5.2)
Earnings* per share (p)	<b>(24.6)</b>	89.3	n/a
Final dividend (p)	<b>41.05</b>	41.29	(0.6)
Interim dividend (p)	<b>26.29</b>	24.34	8.0
Total dividend for the year (p)	<b>67.34</b>	65.63	2.6

\* from continuing operations

Group profit before interest, tax and exceptional items increased by 0.1% to £469.9 million (£469.5 million). Beyond the net increase in turnover, the main factors affecting profit before interest, tax and exceptional items were increased energy and commodity costs and an increase in infrastructure renewals expenditure and depreciation in Severn Trent Water and increased contribution to profit before interest, tax and exceptional items of £3.9 million from Severn Trent Services. There were net exceptional costs of £18.9 million (£68.8 million). Group profit before interest and tax was £451.0 million (£400.7 million).

**Severn Trent Water**

Turnover in Severn Trent Water increased by 4.7% in 2008/09, to £1,324.9 million. Sales prices increased by 5.07% (including inflation) from 1 April 2008, with the previously noted decline in commercial consumption reducing revenues by around £20 million.

Profit before interest, tax and exceptional items was flat on the previous year at £456.0 million. Beyond the increase in turnover, a number of factors impacted profit before interest, tax and exceptional items, principally: an increase in infrastructure renewals expenditure of £18.9 million, an increase in energy and commodity costs of £12.5 million, an increase in the bad debt charge of £6.6 million, increase in depreciation charges of £11.5 million and an increase of £5.0 million, net of efficiency savings, across the balance of our cost base.

During the financial year, Severn Trent Water invested £635.3 million (gross, UK GAAP) in fixed assets and maintaining and improving its



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infrastructure network. Included in this total was net infrastructure renewals expenditure of £130 million.

Adjusting for minor timing differences and modifications to the AMP4 capital programme (notified to Ofwat through the change control process) we continue to be in line to achieve this programme with capital expenditure, net of grants, contributions and other income (UK GAAP) of £2.6 billion.

### Severn Trent Services

Turnover in Severn Trent Services was £339.3 million in 2008/09, up 8.4% on 2007/08. Profit before interest, tax and exceptional items increased by 14.7% to £30.5 million.

As set out in the table below, adjusting for the effect of the sale of small businesses and removing the impact of changing exchange rates, like for like turnover was up around 0.5% and profit before interest, tax and exceptional items was up 17.4%.

	Turnover		PBIT*	
	2009 £m	2008 £m	2009 £m	2008 £m
As reported	<b>339.3</b>	313.0	<b>30.5</b>	26.6
STRUS	<b>(12.5)</b>	(15.7)	<b>(4.0)</b>	(5.9)
Excluding STRUS	<b>326.8</b>	297.3	<b>26.5</b>	20.7
Exchange rate impact	-	31.0	-	1.9
Sale of business	<b>(7.6)</b>	(10.8)	<b>1.2</b>	1.0
Adjusted 'like for like'	<b>319.2</b>	317.5	<b>27.7</b>	23.6

\* profit before interest, tax and exceptional items

Return on invested capital remained at around 15%.

### Corporate and other

Corporate and Other Businesses' turnover was down 9.6% to £4.7 million and is now mostly internal charges from our captive insurance company. This turnover is eliminated on consolidation as the captive exists to insure Severn Trent group risks only and does not write any external business. The finalisation of the insurance position in relation to the 2007 floods was the primary reason for an underwriting loss of around £2.0 million being recorded in the year, which forms part of the £3.7 million loss related to other businesses. Corporate overheads amounted to £12.7 million (£10.9 million). In total, Corporate and other incurred a loss before interest, tax and exceptional items of £16.4 million (loss of £11.2 million).

### Exceptional items

There was a net exceptional charge, in the year to 31 March 2009 of £18.9 million (£68.8 million) comprising:

- Restructuring costs of £14.6 million comprising: a charge of £13.7 million in Severn Trent Water arising from the programme to restructure and realign the business, a charge of £2.1 million in Severn Trent Services arising from the write down of the Smartmeter business to its expected recoverable amount and a credit of £1.2 million in Corporate arising from the release of provisions and adjustments to sale proceeds for businesses sold in previous periods;

- A net credit of £1.5 million arising from the flooding incidents that affected Severn Trent Water's water and sewerage networks during the summer of 2007. This includes insurance recoveries of £14.6 million less costs of £13.1 million;
- A charge of £7.2 million arising from Severn Trent Water's settlement and closure of the regulatory issues that arose in previous years. This includes a court imposed fine of £2.0 million and costs of £0.2 million from two offences relating to leakage data supplied to Ofwat in 2001 and 2002 and a provision of £5.0 million for additional contributions to the Severn Trent Charitable Trust as agreed with Ofwat; and
- In Severn Trent Services, a credit of £1.4 million arising from the release of the exceptional provision made in the prior year relating to third party legal costs.

### Net finance costs

The group's net finance costs were £196.4 million, compared to £177.4 million in the prior period. The increase was largely due to higher finance costs on pension obligations which increased as a result of a higher discount rate, whilst the expected return on assets was lower because the value of investments declined. This was partly offset by a reduction in the interest charge on index linked debt to £42 million (£55 million) due to the lower RPI in the latter part of the year. An increase in gross debt resulted in a higher interest cost and a cost of holding cash since short term investment rates fell during the year.

### Losses/gains on financial instruments

The group issues notes in foreign currency under its EMTN programme and uses cross currency swaps to convert the proceeds to sterling. The effect of these swaps is that interest and principal payments on the borrowings are denominated in sterling and hence the currency risk is eliminated. The foreign currency notes and swaps are recorded in the balance sheet at their fair values and the changes in fair values are taken to losses/gains on financial instruments in the profit and loss account. Since the terms of the swaps closely match those of the underlying notes, such changes tend to be broadly equal and opposite. The changes in fair value of debt are shown in the reconciliation of movements in net debt in note 36.

The group holds interest rate swaps with a net notional principal amount of £761 million under which it pays fixed rate interest and receives floating rate interest. These swaps are carried in the books at fair value and are revalued at each balance sheet date. The changes in fair value are taken to losses/gains on financial instruments in the profit and loss account. During the year there has been a decrease of £80.5 million in the fair value of these instruments because market interest rates were lower at 31 March 2009 than at 2008 and hence the difference between market rates and the rates payable in the fixed legs of the swaps has increased. This loss has been charged to losses/gains on financial instruments (see note 12).

It is important to note that we intend to and typically do hold these swaps to maturity. Further, this is not a cash movement and, over the life of the swaps, these charges will net out because the swaps will have a zero fair value when they mature.

### Profit from continuing operations

Group profit from continuing operations before tax, exceptional items and gains/losses on financial instruments decreased by 6.4% to £273.5 million (£292.2 million). Group profit from continuing operations before tax was £167.6 million (£192.4 million).

### Taxation

The total tax charge for the full year was £223.6 million (credit of £18.2 million), of which current tax represented a charge of £52.1 million (£56.2 million) and deferred tax was a charge of £171.5 million (credit of £74.4 million), including an exceptional charge of £185.6 million in relation to the phased withdrawal of Industrial Buildings Allowances.

The effective rate of current tax on continuing businesses, excluding prior year settlements and exceptional items, calculated on profit before tax, exceptional items and gains/losses on financial instruments was 24.7% (25.6%). The decrease in effective rate is as a result of the reduction in the corporation tax rate to 28%; higher year on year capital expenditure leading to a greater level of capital allowances and other adjustments.

Going forward, we expect the effective current tax rate for 2009/10 to be in the range of 24% to 26%.

### Loss for the period and earnings per share

Loss for the period (after tax) from continuing operations was £56.0 million (profit of £210.6 million).

Basic loss per share from continuing and discontinued operations was 24.6 pence (earnings per share 89.7 pence). Adjusted basic earnings per share from continuing operations (before exceptional items, gains/losses on financial instruments and deferred tax) were 92.7 pence (97.8 pence) (see note 16).

### Cash flow

	2009 £m	2008 £m
Cash generated from operations	643.5	645.9
Net capital expenditure	(465.0)	(439.6)
Net interest paid	(173.9)	(150.1)
Tax received/(paid)	1.1	(76.2)
Other cash flows	(1.3)	(1.2)
Free cash flow	4.4	(21.2)
Dividends	(158.8)	(147.3)
Net issue of shares	6.2	8.2
Change in net debt from cash flows	(148.2)	(160.3)
Non cash movements	(216.0)	(144.9)
Change in net debt	(364.2)	(305.2)
Net debt at 1 April	(3,432.8)	(3,127.6)
Net debt at 31 March	(3,797.0)	(3,432.8)

Cash generated from operations was £643.5 million (£645.9 million). Capital expenditure net of grants and proceeds of sales of fixed assets was £465.0 (£439.6 million). Net interest paid increased to £173.9 million (£150.1 million).

Net debt at 31 March 2009 was £3,797.0 million (£3,432.8 million). Balance sheet gearing (net debt/net debt plus equity) at the year end was 80% (74.0%). Net debt (excluding fair value adjustments), expressed as a percentage of Regulatory Capital Value (RCV) was 57.3% (57.2%), based on RCV at 31 March 2009 of £6,198 million (£5,922 million). The group's net interest charge, excluding gains/losses on financial instruments, was covered 3.7 times (3.7 times) by profit before interest, tax, depreciation and exceptional items, and 2.4 times (2.5 times) by profit before interest, tax and exceptional items.

### Treasury management and liquidity

The group's treasury affairs are managed centrally and in accordance with its Treasury Procedures Manual and Policy Statement. The treasury operation's primary role is to manage liquidity, funding, investment and the group's financial risk, including risk from volatility in interest and (to a lesser extent) currency rates and counterparty credit risk. Its activities are subject to a set of controls commensurate with the magnitude of the borrowings and investments under its management. The board determines matters of treasury policy and its approval is required for certain treasury transactions.

It is the group's strategy to access a broad range of sources of finance to obtain both the quantum required and lowest cost compatible with the need for continued availability.

The group's policy for the management of interest rate risk requires that no less than 45% of the group's borrowings should be at fixed interest rates, or hedged through the use of interest rate swaps or forward rate agreements. At 31 March 2009, interest rates for some 82% of the group's net debt of £3,797 million were so fixed, with a weighted average interest rate of 5.9% for a weighted average period of 12.1 years. This policy has been implemented by entering into a portfolio of long dated interest rate swaps that hedge the group's economic exposure to changes in interest rates. However, these swaps are not designated to particular liabilities and hence do not meet the criteria for hedge accounting under IAS 39. Consequently, the swaps are revalued at each balance sheet date and the change in fair value is taken to the income statement under gains/losses on financial instruments. In the year ended 31 March 2009 £80.5 million (£24.3 million) was charged to the income statement in respect of such fair value movements.

The group's principal operating activity, Severn Trent Water, is a long term business characterised by multi year investment programmes. The strategic funding objectives of the group must reflect this and the liquidity position and the availability of committed funding are essential to meeting its objectives and obligations. The group therefore seeks to attain a balance of long term funding or commitment of funds across a range of funding sources at the best possible economic cost.



The group is well funded for the investment demands of the remainder of the AMP4 period and for the demands that will come with the next Ofwat price review from April 2010.

In the context of the 'credit crunch', the group remains in a strong liquidity position today. In July 2008 the group renewed a £200 million bank facility for five years and in January 2009 it borrowed £400 million in a sterling bond issue. At 31 March 2009 it had in excess of £640 million in cash and cash equivalents and £500 million of undrawn five year committed bank facilities. In April 2009 the group obtained a further £150 million committed facility from the European Investment Bank. Average debt maturity is now approximately 19 years (20 years).

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The group uses financial derivatives solely for the purposes of managing risk associated with financing its normal business activities. The group does not hold or issue derivative financial instruments for financial trading purposes. The group uses a limited number of currency swaps and interest rate swaps to redenominate external borrowings into the currencies and interest rate coupon required for group purposes.

The group's business does not involve significant exposure to foreign exchange transactions. The group has investments in various assets denominated in foreign currencies, principally the US dollar and the euro. The group's current policy is to hedge an element of the currency translation risk associated with certain foreign currency denominated assets.

The long term credit ratings of Severn Trent Plc and Severn Trent Water Limited are:

Long term ratings	Severn Trent Plc	Severn Trent Water Limited
Moody's*	A3	A2
Standard & Poor's**	A-	A

\* on 20 May 2009, Moody's confirmed the ratings for the group and announced that they have placed the ratings under review for possible downgrade.

\*\* on 23 December 2008, Standard and Poor's confirmed the ratings for the group, and announced that they were subject to a 'negative outlook'.

Further details of the group's borrowings, investments and financial instruments are contained in note 22 to the accounts.

### Pensions

The group has two defined benefit pension schemes, of which the Severn Trent Pension Scheme (STPS) is by far the largest. Formal actuarial valuations were last undertaken for the STPS as at 31 March 2007.

On an IAS 19 basis, the estimated net position (before deferred tax) of the group's defined benefit pension schemes was a deficit of £233.0 million as at 31 March 2009. This compares to a deficit of £126.0 million as at 31 March 2008. See note 29 for details of the year on year movement in this net position.

Total cash contributions to the schemes in the year were £42.0 million (£55.6 million).

The key actuarial assumptions were:

	2009	2008
Price inflation	2.9%	3.4%
Salary increases	3.9%	4.9%
Discount rate	6.7%	6.4%
Pension increases in payment	3.0%	3.4%
Expected return on equities	8.0%	8.0%

Age to which current pensioners aged 65 are expected to live

Men	85.1	85.1
Women	88.2	88.2

Age to which future pensioners currently aged 45 are expected to live

Men	85.9	85.9
Women	88.9	88.9

The following table summarises the estimated impact on scheme liabilities resulting from changes to key actuarial assumptions whilst holding all other assumptions constant.

Assumption	Change in assumption	Impact on scheme liabilities
Discount rate	Increase/decrease by 0.1%	Decrease/increase by £21.0 million
Price inflation	Increase/decrease by 0.1%	Increase/decrease by £21.0 million
Mortality	Increase life expectancy by 1 year	Increase by £28.0 million

On an IAS 19 basis, the funding level at 31 March 2009 was 83% (91%). As at 31 March 2009 the group's defined benefit pension schemes had total assets of approximately £1,075 million and total liabilities of approximately £1,308 million.

### Exchange rates

The trading results of overseas subsidiaries are translated to sterling at the average rate of exchange ruling during the year and their net assets are translated at the closing rate on the balance sheet date.

### Accounting policies and presentation of the financial statements

The group's financial statements are prepared in accordance with International Financial Reporting Standards that have been ratified by the European Union.

### Supplementary information

For supplementary information including the group's preliminary results presentation, see the Severn Trent website ([www.severntrent.com](http://www.severntrent.com)).