BOARD'S OVERVIEW

EXECUTIVE OVERVIEW AND SUMMARY OF ACHIEVEMENTS

2005-6 has seen the completion of the first year of the AMP4 period and one of consolidation for the Company operationally. The Company refinanced its index-linked bond in the year, which follows the demerger and acquisition activities of recent years.

The Company is able to report another satisfactory year in terms of outputs to maintain future service and performance and overall satisfaction. The year has seen the maintenance of the Company's continued long term high performance of service standards to its customers. The average household bill has continued to be the second lowest in the industry in spite of the prices increases following the 2004 Periodic Review.

Whilst ahead of the expectations of the first year of the 2004 Final Determination, operating costs during the year have risen in several unfunded areas, particularly power, which were beyond the Company's control. It is notable that it is becoming increasingly difficult to absorb these costs when efficiency levels are already high.

There has been a slow start for the year in the delivery of the capital investment but the Company remains committed to achieving its key outputs and levels of expenditure as defined in the 2004 Final Determination. Expenditure planned for 2006/7 has been increased to match the Determination for the first two years of AMP4.

The Company remains firmly committed to ensuring our customers receive the best value for money of any water company in England and Wales. We also intend to remain at the leading edge of the industry, holding strong values of excellence, credibility, price and delivery. To this end, an enhanced level of governance has been implemented for the 2006 June Return process.

The Company has already commenced its preparations for the 2009 Periodic Review and looks forward to working with Ofwat in defining the key outputs and processes for the review over the coming year.

Achievements

The Company is able to report a number of key notable achievements over 2005-6. These include: -

- Another good year of performance in the levels of service given to customers. The Company was again placed in third position across the industry for 2004-5, based on Ofwat's Overall Performance Assessment (OPA) with a score of 286 points out of 288. This has confirmed a top three place for each of the last six years. The Company estimates that this level of performance will be maintained for 2005-6.

- Achievement of the 2005-6 leakage target of 75Ml/d, although the mild winter played a major role in this performance. The number of bursts increased slightly as a result of a relatively short cold snap in that mild winter. Consequently the overall number of bursts remains at high levels. Both leakage and burst mains performance is believed to be tending towards stability and therefore should support achievement of the future regulatory targets.

- An overall water quality Mean Zonal Compliance of 99.992%, the Company's best water quality performance ever.

- Ofwat ranking the Company as the second most efficient in terms of operating costs for 2004-5. In addition the Company has been included, along with three other water only companies, as Ofwat's defined industry frontier for operating cost performance. The Company is now ranked Band A for both operating cost and capital investment performance; one of only four companies to receive this banding for both categories of expenditure. Whilst the Company expects to remain within Band A, the need to cater for significant unfunded costs and to ensure delivery of outputs, may erode existing differences at the efficiency frontier.

Large user tariffs

In addition to having the second lowest household annual charge in the industry, the Company has now introduced two new tariffs applying to large industrial clients. The first, a premium user tariff, which offers a cost reflective discount to those using greater than 500 Ml/year, and the second, changes to the large user tariff, which offers an incentive to customers who move production away from high output summer months when costs are at their highest due to peak demand profiles.

Water Resources and Customer Expectations

The Company obtains its water resources from three main sources: Blithfield Reservoir (20%), the River Severn (35%) and 26 groundwater sites (45%) across the Company's area of supply.

Groundwater is abstracted from the Triassic Sandstone aquifer and because of the nature of the strata does not tend to react rapidly to periods of low rainfall. Since January 2005 there have been only five months where rainfall has exceeded the ten year average and in spite of this the groundwater position remains healthy.

The River Severn is a regulated river with flows in the river being augmented by inputs from both groundwater and reservoirs at its head. The sources used to augment flows in the River Severn have been at levels normally expected during the year and therefore there were no concerns over availability of resource from Hampton Loade.

The Company uses the level in Blithfield Reservoir as the indicator of resource availability and through careful management of it resources a level of 100% was achieved by 1st April 2006.

The Company resource situation remains very healthy for the time of the year following a very wet month of May, which was the wettest for twenty years.

The Company has no concerns over the supply situation for the forthcoming summer and regards the need for a hosepipe ban as highly unlikely

To the future

Looking ahead to the future, the Company has a number of issues that are emerging for the current AMP period and will also be issues for PR09.

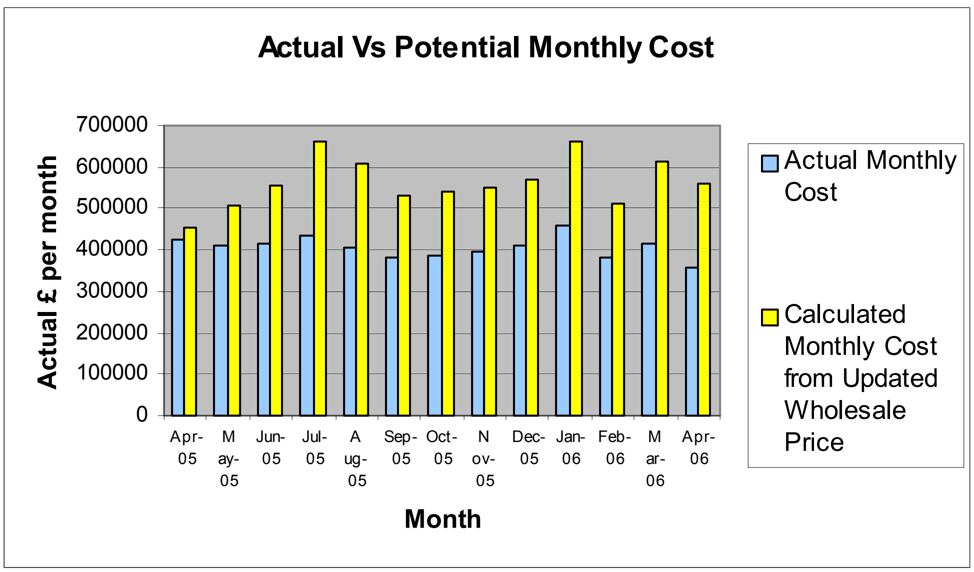
Energy prices

It is well established that electricity prices have risen significantly, in the market, over the past 3-4 years. In December 2004, the Company was successful in signing a supply agreement when the electricity market price was around £28-29 MW/hr, which was in fact a low point from the high prices of October 2004 but higher than the contract secured in January 2003. Unfortunately the prices of the December 2004 contract could only be secured for 2 ½ years due to the volatility and uncertainty of the market.

Wholesale prices have continued to increase and now range between £52-58 MW/hr. Despite securing a competitive agreement for the supply of electricity, achievement of the energy budget allowed for in the 2004 Final Determination will not be possible for the first half of AMP4. The current and forecast market rates also indicate an under funding for the latter half of AMP4.

The Company will continue to use electricity as efficiently as possible and seek new savings, for which it has a significant track record. It is to be reconfirmed that power costs are a higher percentage of the overall operating cost base for the Company, than for others, due to our individual highest level of pumping head requirements.

Assuming the market prices stabilise at £55 MW/hr, a further £3m would be added to the Company's annual energy expenditure beyond 2007.



It is extremely difficult to predict whether prices will remain around £55 MW/hr, fall, or even rise above £70 MW/hr. Close monitoring of global influences and contracting at the optimal time may enable the Company to mitigate future peaks that may hit prices in the latter half of 2007-8.

Pension contributions

In 2005/6, the employer contribution rate for the Company's defined benefit pension scheme was increased from 16.3% to 20.6%. In addition, the funding in the Final Determination in relation to the pension deficit was also charged and paid to the pension scheme in the year. As a result, pension contributions increased from £1.004m in 2004/5 to £1.954m in 2005/6. During the year, employee contributions were also increased from 6% to 7% and from the 1st April 2006 they have increased to 8%.

2009 Periodic Review

Although the first year of the AMP4 period has only just ended, the Company has commenced its preparations for the 2009 Periodic Review and notes the following in particular: -

Assessment of maintenance requirements for overground assets

Following assessment of the Company's submission for maintenance requirements for overground assets, a significantly greater emphasis has been placed on this key area going forward. A dedicated team, championing overground maintenance issues has made good progress in developing an overground asset register and developing systems / policies, to support analysis of the Company's non-infrastructure assets. The work of this team will ensure that the Company's approach to asset management planning is closely aligned to the Common Framework Methodology principles.

More comprehensive data sets and Company specific serviceability indicators for the range of non-infrastructure assets are in the process of being developed. In addition the use of the methodology is becoming more established in the Company's day to day business and justifications for expenditure in the AMP4 period.

Work to mitigate impacts of the TMA

Although the detail of the full Traffic Management Act is not known, and the extent to which restrictions will apply remain uncertain, the Company is commencing detailed preparations to ensure that processes, terms and external contracts in the distribution area are appropriately defined to mitigate the effects of the Act and minimise future costs incurred. Amongst the initiatives in progress are:

- Reviewing the option of extending use of field systems and other technology advances to enable activity on the network to be planned and conducted in an efficient manner. The ability to complete work on the highway promptly is critical;

- Commencing negotiations with staff to review future working pattern arrangements, including hours worked, overtime and standby arrangements and cover for weekend working, which is the time when more and more activity is programmed due to local authority restrictions. The challenge to negotiate changes to the working patterns and terms and conditions of the Company's network operatives should not be under-estimated.

Chapter 1 Key Outputs and Service Delivery – (Table A)

Operational measures

DG2 (low pressure)

DG2 performance continues to be excellent. For a considerable number of years the Company has been able to minimise low pressure disruption such that the percentage of properties receiving low pressure has not risen above 0.05%. The performance of 0.00% for 2005-6 matched the Company's performance for 2004-5. In fact at the year end only 3 properties out of a customer base of 560,104 properties suffered from DG2 problems.

DG3 (supply interruptions)

DG3 performance continues to be very good with an overall score of 0.09, improving on the 2004-5 score of 0.10.

DG4 (water restrictions)

DG4 water restrictions were once again avoided. The Company has not imposed a hose pipe ban in its area for 30 years.

Customer Services measures

DG6 (billing contact)

DG6 remained well above 99%. Although the percentage of enquiries actioned within 5 days fell slightly from 99.5% to 99.4%, an additional circa. 70,000 contacts were dealt with within this window compared with the previous year. An improved level of performance is already being seen, with 99.9% achieved in the final month of the year, which is attributable to the organisation and focus of the Company on improving customer service based on rising expectations.

DG7 (response to written complaints)

The performance of DG7, percentage of written complaints dealt with within 10 working days remained at 100%.

DG8 (meter reading)

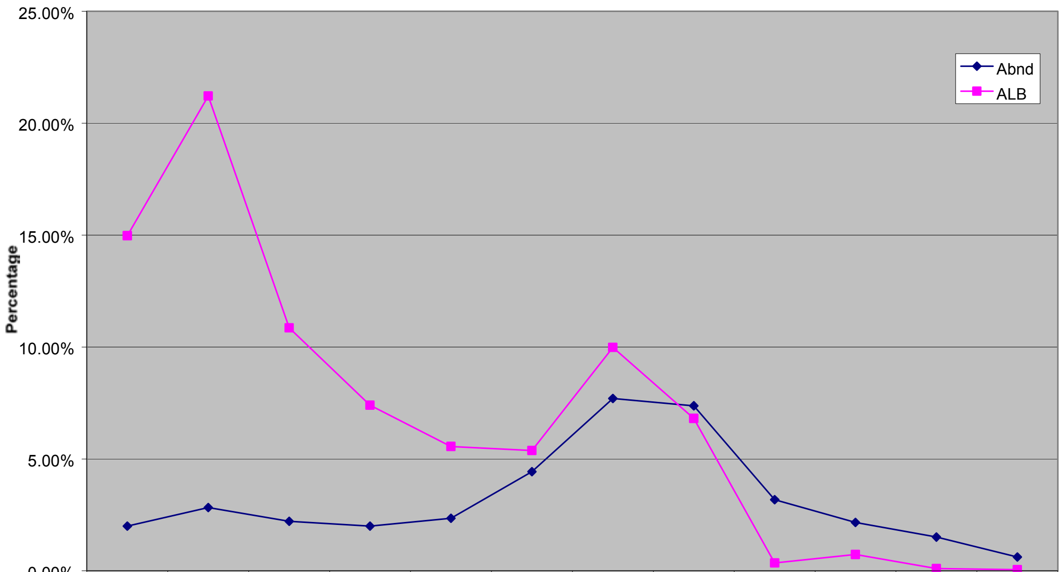
DG8 meter reading performance has further improved to 99.9% for the year with an additional 9858 accounts also being added to the metered customer file.

DG9 (telephone contact)

Overall there was a slight deterioration in DG9 performance both in terms of calls abandoned (3.2%) and calls receiving the engaged tone (7.7%), predominantly due to a poor start to the year. It is to be noted that the level of contacts increased by 21% over figures for 2004/5.

Since that time a very significant effort has been made to improve performance, efforts which have proved to be successful in the final quarter of the year and are continuing in these early months of 2006-7 critical for main billing season. The performance for the last quarter of 2005/6, in terms of calls abandoned and calls receiving the engaged tone, was 1.3% and 0.3% respectively.

Abandoned Calls & All Lines Busy 2005/06



	April	May	June	July	August	September	October	November	December	January	February	March
Abnd	1.99%	2.83%	2.21%	2.00%	2.35%	4.43%	7.70%	7.38%	3.18%	2.17%	1.51%	0.62%
ALB	14.98%	21.22%	10.85%	7.40%	5.55%	5.38%	9.98%	6.81%	0.35%	0.73%	0.10%	0.05%

Month

[As notified by Ofwat, there is an error in the ICS for Table A line 9 – DG9, percentage calls receiving the engaged tone. The figure should read 7.7% as calculated from ‘table 5 line 14 divided by (line 14 plus line 13) all multiplied by 100’]

Drinking water quality measures and outputs

The water quality compliance rate, the Mean Zonal Compliance, for the calendar year 2005 was 99.992%, maintaining the Company’s very high level of performance over recent years. (The compliance rate has always been at or above 99.7% since 1993).

For the Operational Performance Index (OPI) the Company’s performance was 99.945%, an increase from 99.935% in 2004.

During the year there have been no enforcement actions placed on the Company.

There is no large water quality improvement programme required for the Company in AMP4 and therefore no associated treatment works improvements for quality. For plumbosolvency control, phosphate dosing is included rather than a strategic lead communication pipe (cp) replacement programme. A review will be undertaken to assess the extent to which lead cp replacements are required in AMP5 to meet the 10ug/l standard for 2013.

There have been no lead communication pipe replacements required to comply with the 25ug/l lead standard.

The only other scheme of significance in the quality enhancement schedule is the mains duplication scheme from Hampton Loade to Sedgley Reservoir, which was completed in the report year.

Monitoring for the potential groundwater sustainability scheme at Checkhill Bogs has continued during the year. There is no allowance in the 2004 Determination for any subsequent appraisals or sustainability reductions that may need to be pursued and therefore if any are required, a mechanism for funding will be needed other than in price limits.

Serviceability – Underground assets

During the first year of AMP4 both leakage and burst mains performance is believed to be tending towards stability, and as such should support achievement of the future regulatory targets.

The Company has seen the following asset serviceability performance during 2005/06:

- Burst mains - reasonably stable (1.5% above the average for last 6 years)
- Underlying operational leakage - reasonably stable level over last 4 years
- Achievement of the 2005/06 regulatory leakage target
- DG2 levels of service - improvement on an already high level of service
- DG3 level of service - maintained an already high level of service
- Water quality - maintained a high level of performance

Although it may be too early to confirm achievement of stable asset serviceability, it is believed that this current performance indicates it is tending towards stability, while recognising this is at a higher burst level as a result of the step change in performance since 2000.

However, it is clear that the condition of the pipe network is such that it still remains vulnerable to weather impacts that can lead to an apparently disproportionate impact on performance. A recent example of this was the impact of a sudden short cold spell in November 2005, which had a significant impact on both the leakage and burst main rates. Targeted mains replacement over the longer term, in line with the current strategy, is expected to reduce the risk of this vulnerability. Although recent weather events have had an affect on asset performance these do not appear to have had a continuing impact as with the 2000 step change.

It is important to note that even as a consequence of the poor asset condition and the resulting weather impacts to asset performance, service to customers remains extremely high. On this basis it could be argued that serviceability to customers increased over the last year.

Integrated Strategy

As part of the AMP4 business plan the Company proposed a move towards a more integrated network management strategy to support improved investment targeting, to achieve stable asset serviceability, while maintaining excellent levels of customer service.

Overall, it is considered that delivery of the integrated strategy is on target. Some parts are ahead, including the earlier start on delivering addition leakage management infrastructure (DMAs/PRVs), whereas provision of network hydraulic models is behind due to difficulties with specialist staff recruitment.

Increased levels of mains rehabilitation are now in progress, which when coupled with the more integrated targeting activities taking place will lead to both mains burst reduction and support the existing operational leakage strategy to maintain leakage levels within target. Although it is still too early to see the impact of this move to a more integrated approach, initial benefits indicate this approach will be effective.

Serviceability – Overground Assets

During the year there have been no water quality failures where the Drinking Water Inspectorate has considered any enforcement actions. It is also worth noting that there have been no nitrate failures within the WQ Zones, which confirms the correct operation of all the formal blending schemes. With regard to microbiological failures at Treatment Works there were only two failures, which the DWI consider trivial.

As a consequence of continuing good operational practice, including distribution and treatment hygiene and the low level of microbiological failures, it is considered that the non-infrastructure serviceability assessment will be identified as ‘stable’.

H&S overview

Overview of Health and Safety Activities in 2005/6

South Staffordshire Water remains committed to maintaining high standards of health and safety across all of its business activities, in the belief that strong leadership at Board level and the active involvement of employees in health and safety brings positive business benefits.

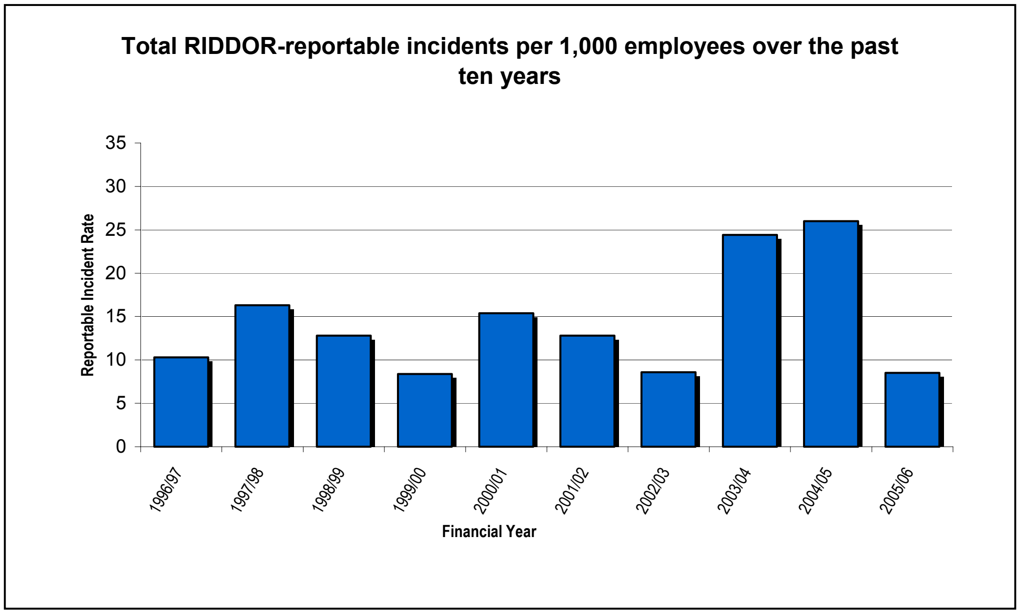
The Company has a Board member to act as champion for health and safety at Board level. Major schemes approved by the Board are reviewed for health and safety implications. The Company also has arrangements for the effective co-ordination and implementation of consistent practices, which meet or exceed minimum statutory requirements.

The Company has in place an active Health and Safety Committee, which meets quarterly at which both management and employees are equally represented. Members of the committee continue to undertake specific health and safety initiatives, which in the past year have included stress, workplace transport, underground cable avoidance and accident reporting.

The Company works very closely with *Water UK* in dealing with industry wide health and safety issues and initiatives. Consequently the Company is supportive of the *Water UK's* 'Water Ahead' occupational health reduction initiative.

During the year initiatives aimed at improving awareness to health and safety issues at all levels of the business have continued. Health and safety awareness training for managers and supervisors in particular includes the Institution of Occupational Safety & Health (IOSH) Managing Safely training.

The Company continues to demonstrate a commendable health and safety record. Trends in accident statistics and near miss data are monitored to provide early warning of areas of concern, which can then focussed on and a suitable response strategy developed. Indeed the policy and procedures in place for accident reporting and investigation have been reviewed and revised. The data below includes incidence of industrial diseases reported under RIDDOR, in 2005/06 there were no industrial diseases to report.



Health and safety is fundamental to the success of the Company's business activities, and the continued development and promotion of good working practices consistent with cost effective measures to ensure compliance with statutory requirements will continue to be promoted and implemented at all levels in the Company.

Chapter 2 Expenditure and Financial Performance Measures - (Table C)

Profitability

The current cost operating profit of £16.444m, including exceptional profit on disposal of £1.34m, compares to £13.374m in the Final Determination. Pre tax return on capital before exceptional items is 8.45% compared to a determination of 7.48%.

Financing of investment

During the year the Company exchanged its £85.0m index-linked bond (book value £94m) to an index-linked loan with a principal value of £84.7m resulting in an exceptional non-cash loss of £27.7m. This loan was then increased by a further £26.7m. As a result, the principal value of index-linked debt increased from £85.0m to £111.4m with the maturity date moving from 2025 to 2045. The bond is recorded in the balance sheet at its amortised cost including the premium and costs of issue of £155.2m. For covenant purposes the premium of £43m is excluded from debt and therefore the net debt for covenant purposes is £104m, being 57% of Regulated Asset Value (RAV) rather than £147m of debt as recorded in the balance sheet and a debt to RAV of 80%.

The Company loaned £15m in the year to its immediate parent undertaking, South Staffordshire Plc. In accordance with the Company's licence, this loan was approved by Ofwat. Interest is payable at 5.3% per annum.

CCD and IRC

Current Cost Depreciation (CCD) has shown a year on year reduction of £0.694m reflecting the MEA revaluation included in the Company's Final Business Plan. The charge is £0.211m lower than the Final Determination.

The Infrastructure Renewals Charge (IRC) for the year is £7.872m compared to £7.276m in the Final Determination and represents a 40% uplift on the 2004-05 charge. The charge represents the Company's view on the medium to long term maintenance needs of its infrastructure assets. The Company believes that a replacement rate of 70km per annum is sufficient for the next 15 years as submitted in its Final Business Plan.

Dividends

The total dividend for the year was £6.020m including £0.897m originally declared and disclosed in 2004/05. The Company policy is to pay dividends that maintain the level of debt to Regulated Asset Value (RAV) at 65%. However, in 2005/06 the exceptional loss on financing with respect to the index-linked bond restricted the dividend payment that could be paid out by £6.7m planned for the second half of the year and hence the actual debt to RAV was only 57%. It is intended that this amount will be distributed in 2006/07 in addition to the dividend in that year.

This dividend policy is designed to reward the efficient management of the Company's operations and the management of economic risk. Furthermore, it meets our licence condition by ensuring that our dividends do not impair our ability to finance our functions as a water undertaker.

By adopting a dividend policy based on 65% of our regulatory asset value, the Company ensures that there is appropriate headroom maintained against the covenants in our bond and bank borrowings. There are also incentives to improve our efficiency, to control debt levels and to generate cash. These incentives ultimately benefit customers and contribute to the Company's profitability.

Chapter 3 Key Supporting Information - (Table D)

Capital Expenditure

The level of capital expenditure was lower than expected during the year, partly as a result of the introduction of new contracting frameworks, but also because a substantial investment approved by Ofwat for expenditure in 2005/6 was actually carried out in 2004/5, due to the urgency of the scheme to mitigate risk to customer supplies. The profile of expenditure for 2006/7 has been increased to match the Determination for the first two years of AMP4. In addition, the Company's expenditure on underground mains has increased significantly over the previous year. Although good progress has been made there have been difficulties with recruiting the necessary expanded workforce. Again, this will be brought fully on track within the next 12 months.

Capital Works Activity

One of the Company's most significant capital projects (circa. £2m) for the first two years of the AMP4 period is the replacement of the bulk chlorine installation at Hampton Loade Treatment Works. This entails the removal of a 60 tonne storage bulk liquid chlorine installation and replacement with a disinfection chemical, which is far less of a health and safety risk in its storage and use. The project is well advanced and due for completion later in 2006.

Mains rehabilitation

A total of 55.70km of mains were renewed / relined during 2005-6. This is a significant increase on the levels for 2004-5 and is consistent with the AMP4 Determination, which incorporates the 40% uplift in the renewal of mains infrastructure.

Water Balance (inc. leakage)

During the year the Company experienced no water supply or water resource difficulties. Whilst the winter of 2005/6 has seen generally lower levels of rainfall, the Company has a variety of water resources available and the current position is healthy for the time of year with no water resource problems expected for the summer months. The Company will continue, however, to promote the wise use of water, particularly the need to secure greater understanding within our customer base that the use of sprinklers requires the installation of a meter.

Metering

As anticipated the levels of meter optants increased significantly during the year. 5,224 meters were installed over the period, ahead of the 3,242 predicted in the AMP4 profile. The high level of applications and installations is continuing for the start of 2006-7.

Sustainable procurement

SSW are fully committed to achieving a sustainable and efficient supply chain by the adoption of good practices by all parties in the supply chain to ensure that purchasers obtain value for money and suppliers are able to maintain a fair and profitable trading position.

Procurement is now involved in all expenditure throughout the Company (opex and capex) and the structure realigned to support this. Contract Management training has been delivered throughout the Company to raise awareness of staff involved directly with suppliers and contractors.

Many of the key points within the 'Guide to Sustainable Procurement' are already in place, examples of which are: -

- SSW has subscribed to the Achilles UVDB supplier database since November 2001 to facilitate supplier sourcing and to utilise the system as an EU compliant qualification system under the EU Utilities Procurement Directives.
- Partnering arrangements are negotiated, wherever practicable, with shared objectives to drive efficiency and innovation throughout the process.

Contract leakage reached an average level of 21% over the 12-month period 1 April 2005 to 31 March 2006, slightly increased from 2004/5. The overall efficiency of the requisitioning process has been enhanced with a greater degree of control on expenditure by elimination of maverick purchasers. Much of this expenditure is one-off or bespoke requirements and requires a high level of technical knowledge.

Reverse auctions have been undertaken in the past with Achilles and Oracle, which have been very successful on standard products such as paper and telephones. It is possible that further auctions might take place providing the projected savings can justify the cost of the auction.

SSW head up a consortium with Dee Valley Water and Isle of Man Water. It is hoped that Guernsey Water will also join the consortium later this year.

The Achilles Steering Group meets on a quarterly basis and as the predominance of subscribing Utilities are water companies; this facilitates an open and transparent exchange on best procurement practices and market intelligence, which supports sustainable procurement.

All suppliers are monitored for delivery performance where poor performance is identified meetings are held with these suppliers to ensure they make the necessary improvements to their service.

Operating costs in 2005/6 were £36.560m compared with a determination of £37.422m. However, this favourable position has been due to the efficiencies achieved in 2004-05 of 5.8% or £2.0m. In 2005/6 operating costs have increased year on year by £3.6m (2005/6 prices). Although the Company was allowed additional operating costs of £1.9m in the Final Determination, there have been a number of unfunded cost increases. The most significant one has been power costs that have increased from £3.3m in 2004/5 to £4.7m in 2005/6, an increase of £1.4m. The Company was only funded for a £1.0m increase in the Final Determination. Other cost increases seen during the year include an increase in the bad debt charge following the 14% increase in bills in 2005/6, increases in the unit costs of chemicals, increases in leakage detection activity and additional reactive and planned maintenance spend. Despite this, the Company is still committed to achieve further cost reductions over the next four years and to remain one of the most efficient companies in the industry.

Despite there being a slow start for the year in the delivery of capital investment, the Company is committed to achieving its key outputs and levels of expenditure as defined in the 2004 Final Determination, including the challenging capital efficiency targets.

Chapter 5 Competition

From the 1st December 2005, the scope for competition in the water industry opened up considerably with the introduction of the Water Supply Licensing (WSL) regime. From this date commercial customers who use in excess of 50Ml/annum can apply to an Ofwat approved Water Supply Licensee for transfer of their custom from the existing Water Supply Undertaker.

The Company has up to 35 customers who may be eligible to take up the option of transfer under the WSL regime.

During 2005 the Company prepared and published its Access Code and Indicative Access Prices as required by the new regime.

To date the Company has been approached by one new licensee and is in the process of negotiating a Master Wholesale Agreement under the auspices of their retail licence. A confidentiality agreement has also been signed between the two parties.

Board Governance for the provision of regulatory information

The Company takes its obligations for the provision of regulatory information very seriously and has in place processes to ensure the information it provides is reliable, accurate and complete.

With regard to the June Return, the Executive Directors of the Board are personally involved in the signing off of the Return itself.

A Board member is allocated to every June Return table and commentary and has, through a process of audit, signed off the tables and commentaries. This is in addition to the established process of the Reporter and Auditor audits. The Board members will also sign off any subsequent queries from Ofwat, post June return submission. In addition a special Executive Board meeting was held to sign off the process as a whole and the Board Overview.

The Board is of the view that it has sufficient processes and internal systems of control, to fully meet its obligations for the provision of information to Ofwat.

Board Approval

This Board Overview to the 2006 June Return has been reviewed and approved by the Executive Board of South Staffordshire Water Plc.

Dr Jack Carnell
Managing Director
South Staffordshire Water plc

16 June 2006