



## PENNON GROUP PLC

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

### £300,000,000 Perpetual Capital Securities

Issue price: 99.531 per cent.

The £300,000,000 Perpetual Capital Securities (the “**Capital Securities**”) will be issued by Pennon Group plc (the “**Issuer**”) on 8 March 2013 (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) 8 March 2018 at a fixed rate of 6.75 per cent. per annum, payable (subject to deferral as described below) annually in arrear on 8 March. 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 10.745 per cent. per annum (representing a 5.00 per cent. step-up), payable (subject to deferral as described below) quarterly in arrear on 8 March, 8 June, 8 September and 8 December. 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 8 March 2018 and 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 8 March 2018 (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 periodic returns payments on the Capital Securities cease to be deductible for the purposes of the Issuer’s United Kingdom corporation tax obligations or if the proceeds of issue of the Capital Securities cease to be accounted for as equity in the Issuer’s IFRS accounts. 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 Services Authority in its capacity as competent authority (the “**UK Listing Authority**”) under the Financial Services and Markets Act 2000 (“**FSMA**”) 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, which is a regulated market for the purposes of European Directive 2004/39/EC on markets in financial instruments.

None of the Capital Securities have been or will be registered under the U.S. Securities Act of 1933 (the “**Securities Act**”), and the Capital Securities may not be offered or sold or delivered within the United States, absent registration or an applicable exemption from registration under the Securities Act. In addition, the Capital Securities are subject to U.S. tax law requirements and may not be sold to U.S. persons. 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 S.A./N.V. and Clearstream Banking, *société anonyme*. 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 11.**

### Joint Lead Managers

Barclays

BofA Merrill Lynch

HSBC

The Royal Bank of Scotland

This Prospectus (the “**Prospectus**”) comprises a prospectus for the purposes of Article 5.3 of Directive 2003/71/EC as amended 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 such 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.

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 legal 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.

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*”).

**IN CONNECTION WITH THE ISSUE OF THE CAPITAL SECURITIES, MERRILL LYNCH INTERNATIONAL AS STABILISING MANAGER (THE “STABILISING MANAGER”) (OR ANY PERSON ACTING ON BEHALF OF THE STABILISING 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, THERE IS NO ASSURANCE THAT THE STABILISING MANAGER (OR PERSONS ACTING ON BEHALF OF THE STABILISING MANAGER) WILL UNDERTAKE STABILISATION ACTION. 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 BE ENDED 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 STABILISING MANAGER (OR PERSONS ACTING ON BEHALF OF THE STABILISING MANAGER) IN ACCORDANCE WITH ALL APPLICABLE LAWS AND RULES.**

All references in this document 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.

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## DOCUMENT INCORPORATED BY REFERENCE

The following documents, which have previously been published and have been filed with the Financial Services 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 two financial years ended 31 March 2011 and 31 March 2012, comprising the information set out at the following pages of the Annual Report 2011 and 2012 respectively:

	<b>Annual Report 2011</b>	<b>Annual Report 2012</b>
Consolidated Balance Sheet .....	Page 60	Page 64
Consolidated Income Statement .....	Page 58	Page 62
Consolidated Statement of Comprehensive Income.....	Page 59	Page 63
Consolidated Statement of Changes in Equity.....	Page 61	Page 65
Consolidated Cashflow Statements.....	Page 62	Page 66
Accounting Principles and Notes.....	Pages 63 to 112	Pages 67 to 111
Audit Report.....	Page 57	Page 61

- (b) the unaudited interim consolidated financial statements for the six months ended 30 September 2012 of the Issuer, comprising the information set out at the following pages of the Half Year Report for such period:

	<b>Half Year Report 2012</b>
Condensed Consolidated Balance Sheet .....	Page 30
Condensed Consolidated Income Statement .....	Page 28
Condensed Consolidated Statement of Comprehensive Income.....	Page 29
Condensed Consolidated Statement of Changes in Equity.....	Page 31
Condensed Consolidated Statement of Cashflows.....	Page 32
Accounting Principles and Notes.....	Pages 33 to 42

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.

Copies of documents incorporated by reference in this Prospectus may be obtained (without charge) from the registered office of the Issuer.

## 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*”.

<b>Issuer</b>	Pennon Group plc.
<b>Description of Capital Securities</b>	£300,000,000 Perpetual Capital Securities.
<b>Risk factors</b>	An investment in the Capital Securities involves risks. 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.
<b>Joint Lead Managers</b>	Barclays Bank PLC HSBC Bank plc Merrill Lynch International The Royal Bank of Scotland plc
<b>Trustee</b>	The Law Debenture Trust Corporation p.l.c.
<b>Principal Paying Agent</b>	Citibank, N.A., London Branch
<b>Issue Date</b>	8 March 2013.
<b>Status</b>	<p>The Capital Securities are direct, unsecured obligations of the Issuer, subordinated as described below, and rank <i>pari passu</i> without any preference among themselves.</p> <p>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) <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.</p> <p>For these purposes:</p> <p>“<b>Creditors</b>” 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;</p> <p>“<b>Junior Share Capital</b>” means the ordinary shares in the capital of the Issuer and any other shares of any class of the Issuer ranking <i>pari passu</i> therewith (if any); and</p> <p>“<b>Parity Securities</b>” means any securities or other instruments either (i) issued directly by the Issuer and which rank or are expressed to rank <i>pari passu</i> with the Issuer’s obligations under the Capital Securities; 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 <i>pari passu</i> with the Issuer’s obligations under the Capital Securities.</p>
<b>Periodic returns</b>	<p>Periodic returns shall accrue on the principal amount of the Capital Securities from (and including) the Issue Date to (but excluding) 8 March 2018 (the “<b>First Call Date</b>”) at a fixed rate of 6.75 per cent. per annum (subject as provided under “<i>Redemption upon the occurrence of a Change of Control Event or a Significant Disposal Event</i>” below) (the “<b>Fixed Rate of Return</b>”), payable (subject to deferral as described below) annually in arrear on 8 March.</p> <p>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 “<i>Redemption upon the occurrence of a Change of Control Event or a Significant Disposal Event</i>” below)</p>

10.745 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 8 March, 8 June, 8 September and 8 December in each year.

#### **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 Periodic Returns 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 6 March 2013:

- (a) on the next Returns Payment Date the Issuer would be required to pay additional amounts as provided or referred to in Condition 7; or
- (b) payments by the Issuer on the Capital Securities are no longer, or would within the next 90 days (if any payment were made in such period) no longer be, fully deductible by the Issuer for United Kingdom corporation tax purposes,

and such consequence cannot be avoided by the Issuer taking reasonable measures available to it (each 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:

- (x) in the case of a Tax Event under (a) above, their principal amount; or
- (y) in the case of a Tax Event under (b) above, 101 per cent. of their principal amount,

together (in either case) 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 6 March 2013, 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, 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. 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) 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.

**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.

**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 either or both of its subsidiaries, South West Water Limited (which, together with its subsidiaries, is referred to in this Prospectus as "**South West Water**") and Viridor Limited (which, together with its subsidiaries, is referred to in this Prospectus as "**Viridor**"). To the extent that any of the factors described below affect either or both of South West Water and Viridor, 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 two major subsidiaries. The Issuer and its subsidiaries together are defined in this Prospectus as the "**Group**".

#### **South West Water**

***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 regulations***

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 prosecutions*"). 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, originally granted in 1989, is subject to modification in certain circumstances. For example, in December 2012, the Water Services Regulation Authority ("**Ofwat**") published proposals to modify the conditions of appointment (licences) of all appointed companies in the water and waste water industry (together referred to herein as "**water companies**"). The proposals provide for separate retail and wholesale price controls. In common with the other water companies, South West Water has notified Ofwat that it will accept these proposed changes. The impact of these changes will not be known until Ofwat issues its detailed price review methodology for wholesale and retail price controls later in 2013.

If, at any time, 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 Commission 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.

In addition, South West Water's area of appointment may also be modified as a result of inset appointments. An inset appointment is made when an existing water company is replaced by another as the supplier of water and/or sewerage services for one or more customers within its licensed area. As at the date of this Prospectus, no inset appointments have been granted in South West Water's area of appointment. There are proposals under consideration to reform the inset appointment regime.

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. In July 2012, the government published a draft Water Bill (the "**draft Water Bill**") which may result in new legislation, including in relation to competition and market reform, see "*Description of the Issuer and the Group—Regulation—South West Water*".

The draft Water Bill also proposes the introduction of a new water abstraction regime. Although this new regime is not intended to be fully in place until the mid to late 2020s, the draft Water Bill indicates that more immediate action will be taken by the Environment Agency to address unsustainable abstractions using existing regulatory powers. This may result in more or stricter future limitations on abstraction licences and/or increased abstraction charges payable by South West Water (see "*Description of the Issuer and the Group—Environment*").

In addition, the draft Water Bill also provides for the further reduction of the threshold from 5 megalitres a year to zero for non-household customers, (see "*Description of the Issuer and the Group—Competition—South West Water*" for further details) and contains provisions which would facilitate further competition and new entry in upstream activities. These proposals, which are currently undergoing pre-legislative scrutiny, include:

- extending the water supply licensing regime to sewerage services;
- introducing a new regulated approach to market entry;
- introducing a transparent access pricing regime and abolishing the statutory cost principle which currently governs the charges payable by water supply licensees to incumbent water undertakers;
- unbundling the combined supply licence so that a new entrant wishing to provide upstream water supply services will no longer be obliged to provide retail services to its customers;
- extending access rights to water companies' treatment and storage systems rather than just their mains and pipes; and
- introducing a new network licence to enable new entrants to own and operate their own infrastructure connected to the incumbent's network.

If South West Water fails to comply with applicable laws or regulations, or the terms of its licence, or does not successfully undertaken 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 capital or operating 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 prosecutions***

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 capital and operating expenditures 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 capital and operating expenditures 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 price limits. In the event of these costs being significant, South West Water could apply to Ofwat for a revision of its price limits through an Interim Determination (as described under “*Description of the Issuer and the Group—Regulation—South West Water—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.

***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.

***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 could adversely affect its profitability in a variety of ways***

Every five years, Ofwat sets limits on the prices that water companies in England and Wales can charge their customers by issuing price determinations. The price limits were last reviewed and reset during 2009 for the five year period from 1 April 2010. There are provisions for changes to the price limits between price reviews under certain circumstances, see "*Description of the Issuer and the Group—Regulation—South West Water—Price Regulation*". 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 Commission on public interest grounds. 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. In December 2012, Ofwat published proposals to modify the conditions of appointment (licences) of all water companies. The proposals provide for separate retail and wholesale price controls. In common with the other water companies, South West Water has notified Ofwat that it will accept these proposed changes. In January 2013, Ofwat published a consultation document on its proposed framework and approach to setting price controls for 2015-20 for the water companies. It sets out a methodology that Ofwat proposes to use to seek to improve on how future price limits are set, support the UK and Welsh Government's policies for the sector, enable companies to innovate and meet the challenges they face and protect the customers of today and tomorrow. At this stage, South West Water is not in a position to determine the likely effect of these anticipated changes in the price control conditions of its licence but there is a risk that some or all of the proposed changes, if implemented as proposed, could result in a material adverse effect on South West Water's business, revenue, profitability and financial condition.

Implicit within the most recent price limits (for the 2010 – 2015 period, known as the "**AMP5 period**") set by Ofwat are assumptions concerning South West Water's future operating expenditure and the achievement of operating cost savings. If these efficiencies are not achieved this may be reflected in less favourable outcomes in future profitability and cashflows or in Ofwat's future price determinations.

For the AMP5 period, Ofwat introduced a new comparative incentive mechanism (the service incentive mechanism or "**SIM**") to reward or penalise water and sewerage companies' service performance, replacing the previous overall performance assessment methodology. The SIM compares water companies' performance in terms of the quality of service that is delivered to customers. The SIM 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. The SIM will be measured over the period 2011/12 to 2013/14. 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 2014.

Earnings from South West Water's businesses will be affected by its ability to meet or better its regulatory targets set by Ofwat, the Environment Agency, the Drinking Water Inspectorate (the "DWI") and other regulators. To meet these targets, South West Water must continue to improve management systems, processes and operational performance. In addition, earnings from South West Water's regulated business also depend on meeting service quality standards set by regulators. To meet these standards South West Water must improve service reliability and customer service. If South West Water does not meet the targets and standards it has been set, both its results and its reputation may be adversely affected, and penalties could be imposed.

***South West Water undertakes significant capital expenditure, the costs of which are factored into its price determinations. Any failure by South West Water to deliver its capital investment programme could therefore adversely affect its profitability and could result in a failure of assets with potentially material consequences***

South West Water requires significant capital for additions to and replacement of plant and equipment for its operations. The price limits set by Ofwat every five years take into account the level of capital expenditure expected to be incurred during the relevant price determination period and the associated funding costs. If South West Water is unable to deliver its capital investment programme at expected expenditure levels, or is unable to secure the expected level of efficiency savings on its capital investment programme, or the programme falls behind schedule or contains incorrect assumptions by South West Water as to the capital investment required, South West Water's profitability might suffer because of a need for increased capital expenditure. Ofwat may also factor such failure into future five-yearly price reviews by seeking to recover amounts equivalent to the "allowed costs" of any parts of the programme that are not delivered. South West Water's ability to meet regulatory output targets and environmental performance standards could also be adversely affected by such failure, which may result in penalties imposed by Ofwat and the need for further increases in capital expenditure and operating expenditure by South West Water.

South West Water is also required to maintain the serviceability of its water and waste water assets ensuring they continue to deliver a level of service and performance that is at least as good as in the past. Where serviceability falls below required reference levels of performance, Ofwat deploys a staged approach to regulatory action to secure corrective actions and could make financial adjustments at the next price setting if these actions did not restore service performance. If performance was to continue to decline, South West Water may incur additional operating or capital expenditure to restore performance.

In addition, any failure by South West Water to deliver its capital investment programme for its businesses or to maintain the health of its systems could result in a major failure in any of its assets. Delivery of the capital investment programme may be adversely affected by a range of factors including a decline in operating cashflow, an inability to access sufficient external debt financing and other sources of capital either at all or at a cost similar to that assumed by Ofwat, and other factors, including adverse legacy effects of earlier capital investments (such as increased maintenance or enhancement costs) and failure to adequately deliver specified outputs. Any failure of any of its assets could cause South West Water to be in breach of the terms of a licence, appointment, approval, permit or other obligation and even incidents that do not amount to a breach could result in adverse regulatory action and financial consequences, as well as harming South West Water's reputation.

***Any failure by South West Water to deliver the operating cost savings assumed by Ofwat in making its price determinations for South West Water could adversely affect South West Water's future profitability***

Operating cost savings are set by Ofwat for each price determination period. Should operating cost savings not be achieved, South West Water's profitability could suffer. A significant proportion of South West Water's operating costs, including energy, bad debts, pensions and abstraction charges, are subject to fluctuation from external factors. This could result in South West Water having to achieve a greater level of operating efficiencies in other areas, which may not be achievable without impacting on regulatory targets and service levels and, if operational cost savings are not achieved in any period, this could result in less favourable outcomes in future price reviews which could adversely impact South West Water's profitability in future periods.

***Energy costs comprise a significant proportion of South West Water's total costs and any significant and unanticipated increase in these costs could adversely affect its future profitability***

Energy costs comprise approximately 13 per cent. of South West Water's operating costs excluding depreciation and restructuring costs. As a result, South West Water is exposed to the risk of increased energy costs. Wholesale energy prices continue to be volatile, reflecting global economic and political

conditions. Whilst Ofwat allows for energy costs in a price determination and although South West Water seeks to mitigate, in part, rising energy costs through careful system operation to reduce consumption, by maximising renewable energy generation and by purchasing more cost-effective or efficient energy, increases in energy costs beyond the level assumed by Ofwat would adversely affect South West Water's profitability.

***In circumstances where South West Water is materially affected by additional costs or lower revenues than anticipated at the time of a price determination, it may apply for an Interim Determination, although there is no certainty as to the outcome of any such Interim Determination***

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, or through a substantial effect clause, where the total adverse impact on South West Water amounts to at least 20 per cent. of its revenue or costs.

In October 2011, the ownership of private sewers and lateral drains in the UK was transferred to sewerage undertakers. At present, the condition of these assets is not fully known and therefore there is uncertainty surrounding the cost of maintaining and upgrading these assets. South West Water's price determination for the AMP5 period did not include any allowance for these costs. Since the transfer and up to 30 September 2012, South West Water has incurred operating and capital costs of £5.3 million resulting from the transfer. South West Water has announced that it intends in calendar 2013 to apply for an Interim Determination in relation to the additional costs incurred by it as a result of the transfer. There is, however, no guarantee that Ofwat will make an interim price adjustment or that any adjustment made will fully reimburse South West Water for its additional costs incurred. If no interim price adjustment is made, the additional costs may not be recovered until prices are readjusted for the period between 1 April 2015 and 31 March 2020, and even then not in full.

***South West Water is restricted by statute in the measures it can take to recover debts owed by domestic customers. As a result, the non-recovery of a material amount of customer debt could adversely affect South West Water's profitability***

South West Water is responsible for the billing, cash collection and debt management activities for around 795,000 domestic and business water and waste water 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 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. To achieve a re-setting of its price limits through an Interim Determination when changes in the regulatory assumptions as to the level of non-recoverable debt are material, South West Water would need to demonstrate that (a) the increase was due to a deterioration in the economy, and (b) South West Water has put in place appropriate procedures and measures to mitigate the increase in debt levels. South West Water may therefore suffer losses from its inability to recover its debts fully, which could adversely affect its business, results of operations, profitability or financial condition.

***Any material operational failure experienced, or poor operating performance delivered, by South West Water could result in material financial penalties and costs, which would adversely affect South West Water's future profitability***

South West Water controls and operates water and waste water 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.

Notwithstanding anything in this risk factor, this risk factor should not be taken as implying that either the Issuer or the Group will be unable to comply with its obligations as a company with securities admitted to the Official List.

***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 75 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 recession impacting the Group's commercial customers. For example, South West Water's customer demand for water in the six months to 30 September 2012 fell by 3.5 per cent. against the equivalent period of 2011, in part reflecting the wettest summer for 100 years.

***South West Water may be adversely affected by short-term variations in weather conditions and 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 adapt the way it conducts its business, to respond effectively to hotter, drier summers and wetter periods which are predicted. However, 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 waste water 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.

***Financial loss arising from the insolvency of a major supplier or contractor***

Although South West Water does not have material creditor exposure as it does not make payments before receipt of goods and services, and also uses a third party credit monitoring service for changes to suppliers' financial status and creditworthiness to supplement an annual risk review of key and strategic suppliers, it may nevertheless be vulnerable to financial loss in the event of one of its key suppliers or contracts becoming insolvent in circumstances previously unknown to South West Water.

***The water and waste water industry is competitive and Ofwat is seeking to increase competition. South West Water could be adversely affected by any material increase in competition in its area of appointment***

Ofwat has taken steps to introduce competition into the water supply and sewerage markets through inset appointments and the water supply licensing regime for non-household customers using in excess of 5 megalitres per annum. There have been 43 inset appointments as at the date of this Prospectus (although none is in South West Water's licence area) to serve new developments, and 10 new companies have been granted water supply licences (although two have subsequently been revoked).

In addition, the draft Water Bill contains significant proposals which, if implemented, should further increase competition in the water and sewerage markets, including as a result of customers switching to, or otherwise becoming served by, a new or different supplier (that is, one other than the incumbent). Any significant increase in competition could adversely affect South West Water's business, financial condition and results of operations.

## **Viridor**

***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***

Recycling is an important part of Viridor's business. Recyclate prices are driven by global supply and demand trends among manufacturing reprocessors. As with any global commodity, recyclate prices are sensitive to world economic conditions and, even though Viridor may mitigate some recyclate price risk by sharing downsides or upsides with its customers, there remains a risk that its profits in recycling may be adversely affected by downward movements in recyclate prices. As an illustration of the sensitivity, prices in the first half of the financial year ending 31 March 2012 were well above long-term trends for recyclate prices resulting in increased competition for supplies of recyclate – (see below); however reflecting weakness in Eurozone economies and slowing of growth in China and Asian markets among other factors, in the second half of that financial year and continuing into the financial year ending 31 March 2013, recyclate prices fell significantly. Although Viridor was able in the first half of 2012/13 to mitigate approximately 50 per cent. of the effect of the falling prices through contractual arrangements, the fall in recyclate prices was a significant contributing factor to the falls in revenue and profit before tax experienced by Viridor in the six months ended 30 September 2012 compared to the corresponding period of the previous year. As noted in the Issuer's half year results announcement in November 2012 and in its Interim Management Statement of February 2013, Viridor remains cautious about future prospects for recyclate prices.

In the financial year ended 31 March 2012, Viridor traded 1.84 million tonnes of recyclate, a significant proportion of which was exported to China and other non-European markets. As non-European export prices and freight costs for recyclate are generally set in U.S. dollars, these costs can vary with U.S. dollar exchange rate movements as well as with world economic conditions and the increasing cost of sourcing and processing raw materials. As a result, Viridor is also exposed to exchange rate risk in relation to its revenue from recyclate exports. In addition, shipping costs to the Far East are currently well above budgeted levels.

***Viridor's renewable energy business is subject to pricing and other risks, including changes in government policy, a fall in the value of renewables obligation certificates and reductions in the volumes of landfill gas***

Renewable energy prices under the current renewables obligation regime (the “**RO regime**”) are primarily a function of the underlying “brown energy” price (that is, energy arising from sources other than renewable resources) and the premium achieved from the sale of renewables obligation certificates (“**ROCs**”).

Viridor's policy is to sell its brown energy forward and currently has sold most of its energy generation through to the end of March 2014. Brown energy prices will continue to be determined by the world and UK energy markets and may go down as well as up. Any changes in underlying energy prices will directly affect Viridor's revenues when its sales contracts come up for renewal. In addition, residual values for landfill assets take account of expected future earnings from landfill gas generation post closure of the respective landfill. To the extent that energy prices or volumes (see below) are lower than modelled, landfill residual values will be adversely affected with a consequent increase in required depreciation rates.

Without a pricing mechanism such as the RO regime, further investment in renewable energy generation would not generally be economic. The UK government has made a strong commitment to renewable energy which is key to meeting the long-term carbon reduction strategy set out in the energy white paper and the UK's long-term legally binding carbon reduction targets. To date, the government has stressed its commitment to “grandfather” rights under current ROC schemes, which are not subject to retrospective changes. Renewable energy is also important in minimising the UK's increasing reliance on imported energy. Nevertheless, there remains a risk that the government may change the pricing mechanism for renewable energy, which could have an adverse effect on Viridor's profitability. The government's planned Electricity Market Reform is likely to have implications for future power generation projects; however at this point the details of the government plans are still unclear which is a material uncertainty affecting all future power projects.

The value of ROCs is increased by the sharing of the buy-out price monies (Renewable Obligation Buy Out Rate – “**ROBOR**”) among holders of ROCs. The value of ROBOR depends on the supply of renewable electricity relative to the UK's annual increasing targets. If large amounts of renewable energy

generating capacity gained planning permission and commenced operations there is a risk that the value of ROBOR would decline subject to a minimum headroom built into the system. ROBOR rates are currently depressed reflecting this factor. The value of a ROC is also dependent on the financial strength of those suppliers who opt to pay the buy-out price. There is a risk that the insolvency of a licensed electricity supplier could lead to a drop in the value of the ROCs which Viridor sells to licensed suppliers which would adversely affect Viridor's revenue and profitability.

A landfill gas project must be able to collect and burn sufficient gas to produce electricity. Ultimately, the volume of gas generated will depend on the amount and composition of the waste landfilled. For example, as the amount of biodegradable municipal waste diverted away from landfill is increased in the future in accordance with Council Directive 1999/31/EC of 26 April 1999 on the landfill of waste (the "**Landfill Directive**") obligations, the total biodegradable component of the waste going to landfill will reduce, affecting the volumes of landfill gas produced. It is therefore possible that, in the future, the gas obtained at one or more of Viridor's landfill gas plants will not be available either in the amounts or of the calorific value required to make a plant cost effective. In such a case, Viridor would need to close the plant, resulting in reduced revenue and the incurrence of decommissioning and other expenses associated with the closure of the plant. This would also have an adverse effect on landfill residual values as noted above.

***Viridor is currently undertaking a number of significant energy from waste projects, each of which entails significant risks***

Viridor is currently undertaking the construction of four energy from waste ("Efw") projects with a further three projects contractually committed and other potential Efw projects still in the bidding phase. When undertaking a new project, Viridor faces a number of risks, including:

- requirements to make significant capital expenditures without receiving cashflow from the project concerned until future periods;
- possible shortage of available cash to fund construction of the project and the related possibility that financing for such construction may not be available to Viridor on suitable terms or at all;
- a range of construction risks, including technological or design failures, contractor default, defects in or shortages of materials, labour disruptions and escalating construction costs;
- delays in obtaining, or a failure to obtain, all necessary planning permissions and other governmental and regulatory permits, approvals and authorisations;
- uncertainties as to market demand or a decline in market demand for waste inputs to the plants or the energy to be generated by the project after construction has begun, including as a result of market and economic conditions and competition from third parties (some of whom currently export waste derived "fuel" to continental Europe where there is spare capacity – see below), that may result in Viridor's investment not being profitable;
- an inability to complete projects on schedule or within budgeted amounts; and
- methodological errors or erroneous assumptions in the financial models used by the Group to make investment decisions.

There can be no assurance that any or all of Viridor's current or future Efw projects will be completed in the anticipated timeframe or at all, whether as a result of the factors specified above or for any other reason, and inability to complete a project in the anticipated timeframe or at all could have an adverse effect on Viridor's business, financial condition and results of operations.

***Acquisitions made by Viridor 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, Viridor has in past years made a significant number of acquisitions. These acquisitions expose Viridor 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 Viridor'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 Viridor's results of operations in periods after the acquisition and may increase Viridor's funding requirements. Whilst Viridor undertakes detailed due diligence as part of its acquisition process and has considerable experience of successful acquisitions over the past 20 years, market conditions in the recycling segment have deteriorated significantly in the past year as noted above. If Viridor 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'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.

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.

***Joint ventures entered into by Viridor could require additional financial support***

Viridor has entered into a number of joint ventures and may enter into joint ventures in the future. Whilst Viridor's immediate exposure is usually limited to its equity and loan investment, it may become commercially appropriate for Viridor to provide additional financial support in the event of performance or other contractual failures by such joint ventures. If Viridor should determine that it is appropriate to provide additional financial support, this may have an adverse effect on its financial condition.

***There is a risk that future increases in landfill costs may not be recoverable through price increases particularly given the current declining landfill market***

The raising of environmental standards in the United Kingdom is leading to a gradual increase in landfill costs in general. Particular areas of cost increase include:

- site engineering (which results in increased depreciation), restoration and aftercare costs (see below);
- leachate management;
- landfill gas management; and
- general site management.

Companies such as Viridor, with landfills engineered to modern standards and established environmental control systems, should incur lower than average increases in costs. However, there remains a risk that rising standards may generate higher treatment and disposal costs than are currently assumed. These costs are recovered on a per tonne rate against current and projected landfill volumes. To the extent that volumes are lower than expected the cost charged per tonne increases. This is a particular risk given current trends in the landfill market.

Landfill sites are divided into sections termed "cells" and are then filled and restored on a cell by cell basis. After site closure, final restoration and aftercare are undertaken in accordance with the planning permission for the site. Although aftercare costs are built into budgets for each landfill site, the costs can be extensive and are also expected to continue for around 30 years or more after the closure of the landfill site. These costs are best estimates based on Viridor's own experience and they are updated at each stage of the capital expenditure programme. Nevertheless, as with any estimate of future costs, there is a risk

that the estimate may prove over time to be inaccurate for a range of reasons and there is also a risk that circumstances may change which may result in significantly higher costs being incurred than estimated.

Municipal waste contracts typically last for up to seven years. They usually have provision for price increases under set formulae related to inflation as measured by the UK General Index of Retail Prices (“RPI”) and in some cases take into account specific legislative or technical changes. Prices for other types of waste depend more on local markets and competitive conditions. Viridor’s experience over a number of years is that prices, as a long-term trend, have risen fast enough at least to cover cost increases in the areas in which it operates, although, in individual years, price increases may have been less than cost increases. However with current declining landfill volumes there is an increasing risk that landfill prices may not recover cost increases.

***European directives and the UK government are seeking to reduce materially the amount of waste disposed to landfill which is likely to have an adverse effect on Viridor’s future revenue from its landfill operations***

The UK government’s waste strategy, stemming from the Landfill Directive, is expected to lead to a continuing reduction in volumes of waste being disposed to landfill. The UK is required under the Landfill Directive to reduce the amount of biodegradable waste going to landfill sites, compared to the 1995 level, by 25 per cent. by 2010, by 50 per cent. by 2015 and by 65 per cent. by 2020. Steeply rising landfill tax is making landfill increasingly uneconomic compared to other treatment and disposal routes such as recycling and energy from waste. In Scotland, a policy of zero waste to landfill by 2020 is being promoted together with a ban of organic material to landfill from 2014. Taking account of the above factors, Viridor projects that the total amount of waste (both municipal and industrial/commercial) which will be disposed to landfill from 2020 will only be 5 to 10 million tonnes per annum (depending on the speed of development of energy from waste facilities in the United Kingdom) and, accordingly, is likely have a negative impact on Viridor’s revenues and unit costs in its landfill operations.

***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. All of Viridor’s operational landfills have an environmental permit, though in some cases Viridor is appealing against certain of the conditions imposed, which might have cost or other implications for operating the landfills, such as limiting the types of waste that can be deposited in landfills, restricting the hours during which the landfill can be operated or otherwise resulting in higher standards for the business.

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 26 closed landfill sites. 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 assumed 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.

***Viridor operates in competitive industries and increased competition affecting recyclate 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 recyclate trading where there is an increasing number of companies seeking to establish themselves in the market and where, from time to time and including in the financial year ended 31 March 2012, Viridor has experienced and continues to experience aggressive price competition from other contractors which can adversely impact both the volumes of recyclate which it trades and the prices which it is able to achieve.

In addition, 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. This competition is driven in part by government policies which are reducing the amount of waste that can be disposed of to landfill,

see “—European directives and the UK government are seeking to reduce materially the amount of waste disposed to landfill which is likely to have an adverse effect on Viridor’s future revenue from its landfill operations”.

Further, Viridor naturally experiences significant competition in bidding for new long-term Public Private Partnership (“PPP”) contracts. These contracts generally require a number of bidders to go through a lengthy and expensive qualification and bidding process with no certainty that they will be successful.

The competition which Viridor experiences is adversely affecting the prices which it can realise for the goods and services supplied by it and any further increase in competition is likely to further adversely affect Viridor’s revenues and profitability.

***Viridor is dependent on its information technology systems and any material failure of these systems could seriously disrupt Viridor’s business and have an adverse effect on its reputation and financial position***

Viridor is dependent on its ability to access, utilise and communicate remotely using electronic software applications mounted on corporate information technology (“IT”) hardware and communicating through internal and external networks which are not wholly under its control. Some of Viridor’s IT systems require replacement, development or upgrading to meet the growing requirements of the business and to ensure that all acquired companies are fully integrated in terms of their systems.

The current state of development of Viridor’s IT systems increases the risk that interruption, failure or third party intervention could have a material adverse effect on its business and operations. In addition, there is a risk that any new or replacement systems introduced may not perform to the required specifications which could also adversely impact Viridor’s business and operations and lead to reputational damage if its ability to deliver services to its customers is materially disrupted.

Notwithstanding anything in this risk factor, this risk factor should not be taken as implying that either the Issuer or the Group will be unable to comply with its obligations as a company with securities admitted to the Official List.

***The Group may have to recognise additional provisions and/ or impairments to the carrying amount of its assets as a result of changing market conditions or other factors***

The Group tests the carrying amount of assets with an indefinite useful life and not subject to amortisation annually for impairment, or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

The Group tests the carrying amount of assets which are subject to amortisation or depreciation for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

For the preparation of the financial statements at 31 March 2013, Viridor is undertaking an assessment of asset impairment and environmental provisions to reflect market conditions, changes in estimation and other factors including projected future cash flows in its recycling operations and the continuing reduction in landfill volumes. The impact, if any, of any possible impairment cannot be currently quantified because the analysis is not complete. Any impairment or additional charges are not expected to result in a material immediate cash outflow and impairment may be reversible if future market conditions improve but nevertheless could adversely affect the Group’s financial condition.

## **The Group**

***It may not be possible to continue to sustain the same level of earnings and growth of the Group as in the past***

The Issuer’s ability to fulfil its obligations under the Capital Securities may be affected if the Group is not able to continue to grow its key businesses and produce sustainable earnings growth. In this connection, all the risks described under “—South West Water” and “—Viridor” are relevant to an assessment of the Group’s ability to grow. In addition, the growth of the Group is dependent upon correct strategies being pursued and successfully implemented by strong and able management within the Group, as well as on external factors.

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

Both the activities of South West Water and Viridor are, to an extent, affected by poor economic conditions.

In recent years, a number of countries in Europe, such as Greece, Italy, Ireland, Portugal and Spain, have been particularly negatively affected by adverse financial and economic conditions and are struggling with large public budget deficits. The public budget deficits, weak economies and the disruption in the capital markets necessitated rescue packages for Greece, Ireland, Portugal and Spain and perceived risk of default on the sovereign debt of those countries, particularly in relation to Greece, raised concerns about the contagion effect such a default would have on other European Union ("EU") economies as well as the ongoing viability of the euro currency and the European Monetary Union. In addition, other EU countries also face potential fiscal tightening and growth rates may remain weak in the near future and even major emerging market countries such as China have experienced weaker economic conditions.

The financial performance of the Group has at times been adversely affected by these trends. For example, although South West Water's revenues are economically regulated through the price review mechanism, its revenues remain exposed to customer affordability, increased bad debts and the effects of recession on its industrial customers, 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 "*—South West Water is restricted by statute in the measures it can take to recover debts owed by domestic customers. As a result, the non-recovery of a material amount of customer debt could adversely affect South West Water's profitability*".

In addition, Viridor has been affected by volatility in recyclate prices in part driven by changing economic conditions, see "*—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*". Also, Viridor faces the risk that volumes taken to landfill sites will decline due to a contraction in the economy and Viridor's revenues from collection activities are also subject to UK economic conditions, particularly among its industrial customers. Any worsening of economic conditions could also result in increased competition for Viridor, see "*—Viridor operates in competitive industries and increased competition affecting recyclate and other prices or reduced demand for the services provided by Viridor could materially adversely impact its financial position*".

As a result, any future deterioration of general economic conditions in the markets in which the Group operates as well as by 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.

***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 schemes for certain staff. Employer costs have been limited as a result of the introduction of defined contribution arrangements for the majority of new Viridor employees from 2003 and for all new South West Water employees from April 2008. As at 30 September 2012, 35 per cent. of employees in the Group were in defined benefit schemes and 30 per cent. in defined contribution schemes.

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.

As at 30 September 2012, the Group's defined benefit pension schemes had a deficit (net of deferred tax) under IAS 19 of £80 million.

***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 maintains a policy that, in any one year, at least 50 per cent. of net debt carries fixed rate interest payment obligations and 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 AMP5 period at an average interest rate of 3.4 per cent.

In addition South West Water has index-linked approximately 24 per cent. of its current net debt up to 2041 – 2057 at an overall real interest rate of 1.66 per cent.

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.

***Mis-allocation or incorrect categorisation of capital expenditure for tax purposes may affect the Group's taxes***

A material risk for the Group is the possibility that capital expenditure qualifying for capital allowances is mis-allocated or categorised incorrectly. This could result in under-claims or over-claims for corporation tax relief and result in unforeseen material liabilities of the Group arising at any particular time, which could adversely affect the Group's profitability and cashflows.

***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 policies aim to ensure that it has sufficient cash and committed loan facilities equivalent to at least one year's forecast requirements at all times and to ensure that no more than 20 per cent. of the Group's net debt is permitted to mature in any one financial year. For example, as at 30 September 2012 the Group had cash and deposits of £459 million, and undrawn committed bank facilities of £536 million, giving access to total cash resources of £995 million whilst, at the same date, its debt repayments falling due by 30 September 2013 amounted to £383 million. Notwithstanding its treasury policies and a reduction by 25 February 2013 of debt repayments falling due by 30 September 2013 to £173 million, 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 and have to repay loan monies*”), 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, rigorous monitoring procedures and ensuring that deposits are held with counterparties which have a short-term credit rating approved by the Board of Directors of the Issuer (Moody's P-1 and Standard and Poor's A-1), 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, these typically provide for limits on gearing (primarily based on South West Water's regulatory capital value and Viridor's earnings before interest, tax and depreciation) 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 would likely 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 affect 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.

***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.

***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 amount of environmental and landfill restoration provisions and the estimation of landfill reserves;
- 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;
- the appropriate treatment of site development costs for new projects pending all necessary planning permissions being obtained;
- the determination of tax, impairment and other provisions.

These judgements and estimates are described in more detail in note 4 to the Group's consolidated financial statements for the year ended 31 March 2012, which are incorporated by reference in this document.

The exercise of this discretion may have a material effect on the Group's results of operations as presented in its consolidated financial statements and the results of operations so presented could be materially different from those which would have been presented if different assumptions and/or estimates had been 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.

## **RISK RELATED TO CAPITAL SECURITIES**

Set out below is a description of 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, 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 creditors, the Holders will lose all or some 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 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 8 March 2018 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 6 March 2013, the Issuer is no longer able to account for the proceeds of issue of the Capital Securities as equity in its IFRS accounts;
- (ii) at 101 per cent. of their principal amount if, as a result of a change in applicable law or regulation which becomes effective after 6 March 2013, payments in respect of the Capital Securities cease to be fully deductible for United Kingdom corporation tax purposes;
- (iii) at their principal amount if, as a result of a change in applicable law or regulation which becomes effective after 6 March 2013, 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;
- (iv) 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; or
- (v) 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 6 March 2013, 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 6 March 2013, payments in respect of the Capital Securities cease to be fully deductible for United Kingdom corporation tax purposes, or 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.

***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 terms and conditions of the Capital Securities, 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. 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.

#### ***Withholding under the EU Savings Directive***

Under EC Council Directive 2003/48/EC on the taxation of savings income (the "**Directive**"), Member States are required to provide to the tax authorities of another Member State details of payments of interest (or similar income) paid by a person established within its jurisdiction to (or for the benefit of) an individual resident in that other Member State or to certain limited types of entities established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments.

The European Commission has proposed certain amendments to the Directive, which may, if implemented, amend or broaden the scope of the requirements described above.

If a payment were to be made or collected through a Member State which has opted for a withholding system and an amount of, or in respect of, tax were to be withheld from that payment pursuant to the Directive or any law implementing or complying with, or introduced in order to conform to, the Directive, neither the Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Capital Security as a result of the imposition of such withholding tax. The Issuer is required to maintain a Paying Agent in a Member State that is not obliged to withhold or deduct tax pursuant to the Directive or any law implementing or complying with, or introduced in order to conform to, the Directive.

***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 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.

## 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 8 March 2013 (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 “**Holder**s”) 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 8 March 2013 (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) and any other accrued and unpaid periodic returns 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. Such claim shall (i) rank 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.

### **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 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)) 6.75 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.

The amount of periodic returns payable (subject to Conditions 3.9 and 5.5(b)) on each Fixed Returns Payment Date shall be £67.50 in respect of each £1,000 in principal amount (the “**Calculation Amount**”) of the Capital Securities.

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) at 11.00 a.m. (London time). If such rate does not appear on Reuters LIBOR01 (or, if applicable, a successor or replacement page), 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**")) where the Reset Date is the first day of the relevant Returns Accrual Period, the Designated Maturity is 3 months and the Calculation Agent is the Agent Bank and where the terms "**Reset Date**", "**Designated Maturity**" and "**Calculation Agent**" have the meanings given to those terms in the ISDA Definitions. 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 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 (a “**Deferral 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 any fiscal or other laws and regulations applicable in the place of payment, but without prejudice to the provisions of Condition 7.

### **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;
- (c) there will at all times be a Paying Agent in a Member State of the European Union that is not obliged to withhold or deduct tax pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive; and
- (d) there will be at all times 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 6 March 2013:

- (a) on the next Returns Payment Date the Issuer would be required to pay additional amounts as provided or referred to in Condition 7; or
- (b) payments by the Issuer on the Capital Securities are no longer, or would within the next 90 days (if any payment were made in such period) no longer be, fully deductible by the Issuer for United Kingdom corporation tax purposes,

and the requirement to pay such additional amounts (in the case of (a)) or the loss of deductibility (in the case of (b)) cannot be avoided by the Issuer taking reasonable measures available to it (each 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:

- (x) in the case of a Tax Event under (a) above, their principal amount; or
- (y) in the case of a Tax Event under (b) above, 101 per cent. of their principal amount,

together (in either case) 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 described in paragraph (a) 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 6 March 2013, 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 11.75 per cent. per annum if one of such events occurs and to 16.75 per cent. per annum if both of such events occur; and
- (ii) the Margin component of the Floating Rate of Return shall increase to 15.745 per cent. per annum if one of such events occurs and to 20.745 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 unmatured 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(a) or (b) (as the case may be), together with an opinion of independent tax or legal advisers of recognised standing to the effect that the circumstances described in Condition 5.3(a) or (b) (as the case may be) apply;
- (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 Directors' 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(a) or (b) (as the case may be), together with an opinion of independent tax or legal advisers of recognised standing to the effect that the circumstances described in Condition 5.3(a) or (b) (as the case may be) apply;
- (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) and that 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 Directors' 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) where such withholding or deduction is imposed on a payment to an individual and is required to be made pursuant to European Council Directive 2003/48/EC or any law implementing or complying with, or introduced in order to conform to, such Directive; or
- (c) presented for payment by or on behalf of a holder who would have been able to avoid such withholding or deduction by presenting the relevant Capital Security or Token to another Paying Agent, if any, in a Member State of the European Union; or
- (d) 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.

## **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 8 March 2018.

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

“**Fixed Returns Payment Date**” means 8 March in each year from (and including) 8 March 2014 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 8 March, 8 June, 8 September and 8 December in each year from (and including) 8 June 2018, 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 in the European Union, 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 8 March 2013.

“**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)) 10.745 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; 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 depository for Euroclear Bank S.A./N.V. (“**Euroclear**”) and Clearstream Banking, *société anonyme* (“**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 (the “**Exchange Date**”) which is expected to be 17 April 2013, 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 depository for Euroclear and Clearstream, Luxembourg, and payment to or to the order of the common depository 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 depository.

### 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 a clearing system, notices to holders may be given by delivery of the relevant notice to that clearing system for communication by it 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 and/or Clearstream, Luxembourg (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 £1,000 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.

## DESCRIPTION OF THE ISSUER AND THE GROUP

### INTRODUCTION

The Issuer is a large FTSE 250 company which operates and invests in utility infrastructure businesses. The Issuer is the holding company for two principal subsidiaries:

- **South West Water**, which provides water and sewerage services in Devon, Cornwall and parts of Dorset and Somerset; and
- **Viridor**, which is one of the UK's leading recycling, renewable energy and waste management businesses.

The Group is committed to sustainable development, enhancing the environment and providing high quality customer services. As at 30 September 2012, the Group had total assets of £4.5 billion and employed approximately 4,530 employees. For the year ended 31 March 2012, the Group's revenue and profit before tax were £1,233 million and £200 million, respectively, and its capital expenditure, including construction spend on service concession arrangements, was £273 million.

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 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 other stakeholders through its focus on water and sewerage services, recycling, renewable energy and waste management. The Group aims to be a pre-eminent provider of customer services to high standards of quality, efficiency and reliability.

To achieve this strategy, the Group is focused on the following key areas:

- *Customer satisfaction:* Both South West Water and Viridor are committed to meeting the needs of their customers. For example, South West Water's customer service key performance indicator ("KPI") is its SIM (Service Incentive Mechanism) score which takes into account various customer service measures including the number of written complaints and the results of customer satisfaction surveys. South West Water achieved a 15 per cent. improvement in customer service between 2010/11 and 2011/12 based on SIM scores (and a 78 per cent. improvement over two years).
- *Financial performance:* The Group has set itself challenging financial targets in order to achieve sustainable performance over the short-, medium- and long-term. These include targets in relation to profit before tax, dividend per share, earnings per share before deferred tax and the interest rate on average net debt.
- *Maximising shareholder returns:* The Issuer's policy is to seek to grow its dividend by 4 per cent. above inflation per annum until at least the end of 2014/15.
- *Strong governance:* The Group takes a responsible and transparent approach to environmental, social and governance matters, with its sustainable practices not only benefitting communities but also enabling its businesses to be more successful.
- *Employee engagement:* The Group aims to be a responsible employer, focused on ensuring workforce well-being, continuity, efficiency and productivity.

The Group's operating framework also includes a comprehensive and fully embedded risk management process which assists it in managing its risks and opportunities to deliver the Group's strategy.

### PRINCIPAL ACTIVITIES

The Issuer operates and invests in the areas of water and sewerage services and recycling, renewable energy and waste management. The Issuer's two principal subsidiaries are South West Water and Viridor. The table below shows the revenue, operating profit and profit before tax of each of the Group's operating segments for the financial year ended 31 March 2012 and for the six months ended 30 September 2012.

	<b>Year ended 31 March 2012</b>	<b>Six months ended 30 September 2012</b>
	( <i>£ million</i> )	
<b>Revenue</b>		
(1) Water and sewerage .....	474.0	256.5
(2) Waste management.....	761.1	378.1
Other .....	9.8	5.3
(3) Less intra-segment trading.....	(11.8)	(6.2)
<b>Total revenue</b> .....	<b>1,233.1</b>	<b>633.7</b>
<b>Operating profit</b>		
(1) Water and sewerage .....	204.7	115.0
(2) Waste management.....	63.7	21.0
Other .....	0.4	0.3
<b>Total operating profit</b> .....	<b>268.8</b>	<b>136.3</b>
<b>Profit before tax</b>		
(1) Water and sewerage .....	141.5	83.8
(2) Waste management.....	57.6	22.5
Other .....	1.4	4.8
<b>Total profit before tax</b> .....	<b>200.5</b>	<b>111.1</b>

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 by the water and sewerage and waste management segments is under normal commercial terms and conditions that would also be available to third parties. 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. It serves a region of 10,300 square kilometres with approximately 1.68 million residents and 10 million annual visitors. On average, each day South West Water distributes over 415 million litres of treated water and disposes of around 481 million litres of waste water through an asset base comprising, as at 30 September 2012, approximately 15,100 kilometres of water distribution mains, 14,700 kilometres of sewers, 18 impounding reservoirs, 39 water treatment works, 645 waste water treatment works including 55 works with ultra-violet treatment and three with membrane filtration and 1,639 intermittent discharges, including 1,001 combined sewer overflows.

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 waste water treatment and disposal. The region currently has 146 EU designated bathing waters, over a quarter of the total in England and Wales, and a substantial majority of these have been improved since privatisation as a result of the company's marine investment programme.

In the current AMP5 period, the Water Services Regulatory Authority ("Ofwat") assumed that the equity cost of capital for all companies would be 7.1 per cent. real after tax with an overall weighted average cost of capital of 4.5 per cent. real after tax. 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 regulatory capital value ("RCV") is expected to increase from £2.55 billion in March 2010 to approximately £3.0 billion in March 2015, an increase of approximately 18 per cent. This will enlarge the base for the calculation of the rate of return allowed by Ofwat. Additional value may be created if South West Water outperforms Ofwat's assumptions by, for example, delivering service at lower operating and/or capital costs and/or financing its investment programme and operations at lower cost. By the end of the second year of the AMP5 period, South West Water was out-performing both its targeted operating cost reductions and its capital programme efficiencies.

South West Water is focused on delivering its vision of pure water (the provision of safe and reliable water supplies), pure service (the delivery of increased levels of customer satisfaction) and pure environment (protecting and enhancing the environment).

### **Viridor**

Viridor was the UK's largest operator of materials recycling facilities by overall processing capacity in 2011/12 (in the assessment of management based on publicly available information) and is a major developer of energy from waste ("Efw") plants in the UK. Viridor also has core competencies in the generation of electricity from landfill gas and landfill disposal.

Viridor operates 25 materials recycling facilities and traded 1.84 million tonnes of recyclate during 2011/12. It also operates 34 landfill gas power plants which generate renewable power by harnessing methane produced in landfill sites; three Efw plants which generate energy from the incineration of waste; and eight anaerobic and in-vessel composting plants. It has a further four Efw plants and four anaerobic digestion plants under construction and a further three Efw plants contractually committed. As at 30 September 2012, Viridor had a renewable power generation capacity of 133.5MW with a further 167MW under construction or contractually committed.

Viridor also has a waste collection fleet focusing primarily on the industrial and commercial market along with waste transfer stations, treatment plants, household waste recycling (civic amenity) sites ("HWRS") and composting facilities in a number of regions in the UK.

Viridor's strategy is to add value by:

- Growing its recycling capacity and services;
- Growing its Efw capacity and services;
- Selectively gaining more public private partnership ("PPP") contracts; and
- Capitalising on its long-term strong position in the landfill market.

The UK has an EU target of generating 15 per cent. of total energy from renewable sources by 2020, which is likely to require over 30 per cent. of electricity to be generated from renewable sources. The government's stated strategy is to increase the percentage of electricity generated from renewable sources from the current figure of 11.6 per cent. to a target of 15 per cent. in 2015. Historically, renewable energy projects were supported by the government through the Non Fossil Fuel Obligation ("NFFO") scheme. Fixed price RPI-linked contracts with terms of up to 15 years were awarded to the most competitive renewable projects in five tranches of bidding. In April 2002, the NFFO regime was replaced by the RO regime. The overall price for electricity supplied under the RO regime is currently substantially higher than that achieved under the most recent NFFO scheme. This has facilitated the increase of Viridor's total landfill gas power generation capacity to 105 MW at 30 September 2012, compared with 28 MW in March 2002. Of this power generation capacity, 26 per cent. is under NFFO and 74 per cent. is under the RO regime. Around 60 per cent. of Viridor's existing NFFO contracts end in financial year 2013/14 and the balance up to 2016/17, after which most of the capacity can transfer to ROCs.

To take advantage of opportunities presented by the government's developing waste strategy, Viridor is pursuing Efw (sometimes in combined heat and power (CHP) schemes) and a range of recycling or related treatment opportunities (including materials recycling facilities, mechanical-biological treatment, anaerobic digestion, composting and HWRS). These facilities may be combined in integrated waste management contracts.

Viridor's landfill market consists of municipal, commercial and industrial wastes, along with certain other special types of waste. Landfill is currently the United Kingdom's major final disposal route for these wastes. Viridor is a major landfill site operator within the UK with a total consented landfill capacity of approximately 65.4 million cubic metres as at 31 March 2012. During the financial year 2011/12, it used 3.6 million cubic metres.

### **CAPITAL INVESTMENT**

South West Water's regulatory capital investment (including infrastructure renewals expenditure) for the year to 31 March 2012 was £131 million, consistent with its planned investment programme of £705 million (in 2007/2008 prices) over the AMP5 period. The main focus of investment is on the maintenance of existing assets. Other key areas are increasing water resource availability and ensuring

the resilience of the network even in extreme weather conditions, improving drinking water quality, delivering environmental improvements and achieving high standards of bathing water quality.

Viridor has four EfW plants currently under construction. £252 million had been spent on these EfW plants as at 30 September 2012 out of a total budgeted cost of £690 million. These EfW plants are expected to be operational and generate significant cash on a phased basis commencing 2014/15 onwards. In addition a further three EfW plants are planned at a total capital cost of approximately £475 million.

## **LIQUIDITY AND FUNDING**

The Group has a strong liquidity and funding position with £995 million of cash balances and committed funding facilities at 30 September 2012. This includes cash and deposits of £459 million (including £126 million of restricted funds representing deposits with lessors against finance lease obligations) and undrawn facilities of £536 million. During the six months to 30 September 2012, £85 million of new and renewed facilities were secured with a further £272 million being secured between 30 September 2012 and the date of the Group's Interim Management Statement on 14 February 2013.

As at 30 September 2012, the Group's loans and finance lease obligations totalled £2,632 million. After deducting the cash balance of £459 million, this gives a net debt figure of £2,173 million at 30 September 2012.

The Group's debt is diversified including a convertible bond, other bonds (including long-term index-linked bonds), private placements, European Investment Bank and bank bilateral loans and finance leases. The Group utilises a mix of fixed, floating and index-linked rate borrowings and the finance leasing portfolio (which comprised 59 per cent. of the outstanding borrowing at 30 September 2012) provides a long maturity profile and secured credit margins.

The Group has entered into derivative contracts which fix the interest rate on over 50 per cent. of South West Water's net debt for the remainder of the AMP5 period at an average rate of around 3.4 per cent. In addition, £380 million of South West Water's debt is index-linked at an overall real rate of 1.7 per cent. The Group's average interest rate for the six months to 30 September 2012 was 3.2 per cent. The Group's average debt maturity at 30 September 2012 was 22 years.

## **COMPETITION – SOUTH WEST WATER**

At present, there are two main forms of competition in the water and waste water industry: inset appointments and water supply licensing. An inset appointment is made when an existing undertaker is replaced by another as the supplier of water and/or sewerage services for one or more customers within its licensed area. Since 1 December 2005, water supply licensees have been able to provide both retail supply (which is the supply by a licensee of water purchased from a water undertaker's supply system to an eligible customer) and combined supply (which is the introduction of water into an incumbent water company's existing network for retail by the licensee to an eligible customer) to non-household users with an annual consumption of not less than 50 megalitres. This threshold was reduced in December 2011, implementing a recommendation made in the Cave Review of competition and innovation in the water markets (the "**Cave review**"), and there is now competition for non-household customers with an annual consumption of 5 megalitres a year. This has increased, nationwide, the size of the competitive market for water supply services. A water undertaker is obliged to allow a licensed water supplier to use its network for the purpose of supplying eligible non-household customers subject to payment of charges and certain conditions and rights of refusal. See further information relating to the draft Water Bill under "*—Regulation—South West Water*" below.

## **COMPETITION – VIRIDOR**

There is significant competition in the waste management and recycling market which varies geographically and by business segment/type of waste service. In general terms, there are 7 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 segments where capital investment requirements are lower than for landfill and energy from waste.

The market is relatively fragmented with the top 7 companies estimated to account for around 60 per cent. of total industry turnover. The top 7 companies all offer slightly different geographic

presence and segmental splits. Viridor is principally active in the South West, South East and North West of England as well as in Scotland and Wales.

The barriers to entry in some business segments are significant both in terms of regulation and capital investment requirements. The number of competitors in the least regulated and less capital intensive segments is consequentially greater. Viridor focusses particularly upon infrastructure related segments such as local authority contracts, EfW, 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 almost all water and sewerage services are supplied by 10 water and sewerage companies and 11 water only companies. Licences were originally granted to each of these companies by the Secretary of State for the Environment or for Wales in 1989. These licences continue in force for an indefinite period, subject to potential termination rights as set out below. South West Water holds water and sewerage licences for areas of South West England which comprise approximately 0.8 million homes and businesses.

The statutory basis for the regulation of the activities of licensees is the Water Industry Act 1991, as amended in particular by the Water Act 2003. The fundamental statutory duty of a licensee in respect of its water business is to develop and maintain an efficient and economical system of water supply within its supply area. Similarly, sewerage companies are subject to an overriding duty to provide, maintain, improve and extend a system of public sewers so as to ensure that its supply area is effectively drained and to make provision for emptying those sewers when necessary and effectually dealing with the contents.

### **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 Control*”);
- a prohibition on undue discrimination or undue preference in setting charges for water supply or sewerage services;
- 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 on the disposal of land;
- provisions on the payment of fees and the supply of information to Ofwat;
- a provision allowing a licence to be terminated on 25 years' notice;
- provisions relating to water supply licensing competition; and
- restrictions on dealings with associated companies. 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.

Licence conditions can be modified by Ofwat, either with the licensee's agreement or following reference to the Competition Commission 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 Commission.

### **Regulators**

South West Water is regulated by Ofwat, the Secretary of State, the Environment Agency and the Drinking Water Inspectorate. The Water Industry Act 1991 requires Ofwat and the Secretary of State to exercise and perform their statutory powers and duties in a manner each considers best calculated to (among other things):



- protect the interests of consumers, wherever appropriate, by promoting effective competition between water companies;
- secure that the functions of water companies are properly carried out in respect of every area of England and Wales;
- secure that water companies are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of their functions.

Oftwat 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.

In addition to the Water Industry Act 1991, Oftwat also exercises powers under competition legislation concurrently with the Office of Fair Trading, most significantly the Competition Act 1998, the Enterprise Act 2002 and under Articles 101 and 102 of the Treaty on the Functioning of the European Union.

The Water Act 2003 gave Oftwat 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. Such penalties may be up to 10 per cent. of the water company's relevant regulated turnover. In addition, where Oftwat 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 Oftwat for an injunction and claims for compensation by any person who suffers loss or damages as a result of the breach. Alternatively, where actual or likely contravention of an enforcement order (or of one of a water company's principal statutory duties under the Water Industry Act 1991) is so serious as to make it inappropriate for the water company to continue to hold its licence, the Secretary of State or, with his or her consent, Oftwat, may apply to the High Court for the appointment of a special administrator. A special administrator may also be appointed in other circumstances such as where a water company is, or is likely to be, unable to pay its debts. A description of the special administration regime is provided below under "*—Special administration regime*".

Pollution control, water resources management, fisheries management, flood protection and alleviation, and land drainage all fall within the scope of the Environment Agency's statutory responsibility.

As a water undertaker, South West Water is required to comply with drinking water standards specified in regulations issued by the Secretary of State and administered by the DWI in respect of a number of substances. Where non-compliance by a water undertaker with such regulations has been material, the Secretary of State has accepted undertakings by the relevant entity to secure or facilitate compliance with such regulations.

As a sewerage undertaker, South West Water is required to obtain consents (environmental permits) from the Environment Agency for discharges of polluting substances into controlled waters from various sources (such as sewage treatment works). Failure by a sewerage undertaker to hold or comply with the terms of requisite discharge consents is an offence which may result in regulatory action, including prosecution, being taken against the relevant entity.

### **Price regulation**

The current price control framework is based on a price cap formula which permits maximum price increases based on the percentage change of the RPI plus an adjustment factor ("**K factor**") which incorporates efficiency targets, quality standards and enhancements to service levels and security of supply.

The most recent price control review was carried out by Oftwat in 2009 and provided for a K factor of 1.1 per cent. in 2010/2011, 3.4 per cent. in 2011/2012, 2.5 per cent. in 2012/2013, 1.3 per cent. in 2013/2014 and 1.1 per cent. in 2014/2015. This represents a total K factor of 9.4 per cent. over the five year period.

Price cap regulation is performance related. Water companies are incentivised to be efficient, both in terms of their operating costs and in the implementation of their capital expenditure programme. It is intended that the benefit of any efficiency savings achieved through effective management should be retained by the water companies for a period of up to five years, after which time the benefit should be passed to customers through the subsequent price setting process. In the current price review period, the cost of any under-performance in operating costs is borne by the water companies.

For the AMP5 period, Ofwat introduced a new capital expenditure incentive scheme (the “CIS”) under which water companies bear the cost of under-performance for five years, giving symmetry with treatment of efficiency savings. The CIS is designed to provide incentives for companies to put forward challenging and efficient business plans. The lower the CIS ratio of requested to allowed investment, the greater the proportion of requested capital expenditure funded through price limits in the AMP5 period. If a water company incurs more capital expenditure than included in price limit assumptions, the actual expenditure, if approved by Ofwat, will be reflected in the future RCV. The CIS ratios applicable to South West Water for the AMP5 period are 105 for the water service and 110 for the sewerage service.

In addition, for the AMP5 period, Ofwat introduced a new comparative service incentive mechanism to reward or penalise water companies’ service performance. This SIM replaced the overall performance assessment used since 1996. The SIM compares companies’ performance in terms of the quality of service that is delivered to customers. The SIM 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. The SIM will be measured over the period 2011/12 to 2013/14. Depending upon South West Water’s relative performance under the SIM it could receive a revenue penalty or reward when price limits are next reset in 2014 for the following five years.

Unexpected capital costs or savings arising from changes in certain regulatory assumptions during a review period are recorded and notified by South West Water to Ofwat. This process, known as ‘logging up and down’, allows for prices to be adjusted up or down at the next periodic review to compensate companies or customers respectively for the unexpected costs or savings, to the extent agreed by Ofwat.

In addition, there are certain circumstances where, provided a specified materiality threshold is exceeded, South West Water can request and/or Ofwat can instigate, a re-setting of the price cap between price reviews. This is known as an Interim Determination of K factor (“**Interim Determination**”). The circumstances in which an Interim Determination is available include changes in certain legal obligations including the transfer of private sewers and lateral drains (see below) and certain drinking water and environmental obligations, failure to take action to deliver required outputs, and changes in costs relating to certain issues specified at the time of the price review.

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

All water companies’ licences also include a ‘shipwreck’ or substantial effect clause, which allows companies’ price limits to be revised when events beyond their control have a significant effect (less than or equal to 20 per cent.) on their costs or revenues.

### **Developments in water industry regulation arising out of the Water White Paper and the draft Water Bill**

On 8 December 2011, DEFRA published a Water White Paper (the “**White Paper**”), which outlined Government policy in the sector following a number of reviews such as the Cave Review, the Gray Review and the Walker Review of charging for household water and sewerage services. The White Paper included proposals to reform the abstraction and use of water resources; encourage competition and new entry in the water industry; address water efficiency; address water affordability; and to reform the applicable enforcement regime.

As contemplated in the White Paper, the draft Water Bill was published on 10 July 2012 for pre-legislative scrutiny. The draft Water Bill takes forward the proposed package of reforms to water sector regulation that were set out in the White Paper. The government has not yet indicated when it expects to formally introduce the draft Water Bill, however it has stated that it will develop the legislative proposals during the period of pre-legislative scrutiny and that there are also further measures which may yet be included in the Bill. The government has also stated it will publish a new strategic policy statement for Ofwat that will set out the outcomes it wishes to see from economic regulation. A consultation on this strategic policy statement was published by the Government in December 2012.

#### ***The draft Water Bill – Encouraging competition and new entry in the water industry***

The draft Water Bill proposes to extend competition in the supply of water to non-household customers in the water sector through changes to the current water supply licensing regime and inset appointments. See “*Risk Factors—Factors that may affect the Issuer’s ability to fulfil its obligations under the Capital Securities—South West Water—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 regulations”* for a description of the principal proposals in the draft Water Bill that affect competition.

The draft Water Bill also includes proposals in relation to:

- Framework powers to allow abstraction and impoundment licensing to be brought within the environmental permitting regime in England and also to allocate water rights (and trading of those rights). The government plans to consult fully by the end of 2013 on abstraction reform; and
- Removing the requirement for automatic referral to the Competition Commission of water mergers over the specified thresholds in favour of a more standard two-tier referral system for water mergers, whereby, in lieu of the Office for Fair Trading (“OFT”) making a referral to the Competition Commission, companies could alternatively offer undertakings to the OFT.

Following on from Gray Review, the government is also working with Ofwat to explore the case for modernisation and standardisation of the licences of water companies, including the ability for changes to licences to be agreed to by a qualified majority of water companies.

### ***Water efficiency***

The government has not yet decided to introduce universal water metering but has stated that the case for this may change. It notes the potential of smart water meters to improve water company network management and encourage more sustainable water use by consumers, although no specific provision is made in the draft Water Bill.

### ***Water affordability***

The government has recently issued guidance to Ofwat and water companies on the introduction of company social tariffs. This means every water company is now able to choose to use cross-subsidies in its charges schemes to reduce the bills of financially struggling customers.

### ***Enforcement reform***

The draft Water Bill also 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. The draft Water Bill also proposes to allow Ofwat to apply financial penalties for infringements of licences or certain statutory requirements over a five year period as opposed to one year as is currently the case.

### **Transfer of private sewers and lateral drains into South West Water’s ownership**

A significant change during the AMP5 period is the transfer into South West Water’s ownership of approximately 5,400 kilometres of existing private sewers and lateral drains along with responsibility for repair and maintenance, which took place in October 2011.

At present, the condition of the assets transferred is not fully known and therefore there is uncertainty surrounding the future cost of maintaining and upgrading these assets. Since the transfer and up to 30 September 2012, South West Water had incurred operating and maintenance costs of £4.1 million and £1.2 million, respectively, in relation to the new network. Additionally, a further difficulty in accurately determining these future costs is that related privately owned pumping stations will also be transferred to South West Water on a phased basis up to 1 October 2016 and there will be a significant degree of discretion around investment levels in pumping stations during the AMP5 period, which will impact on actual reported capital expenditure costs.

South West Water’s price determination for the AMP5 period did not include any allowance for these costs. South West Water has announced that it intends to apply for an Interim Determination in 2013 to adjust prices to account for these additional costs. See *“Risk Factors—Factors that may affect the Issuer’s ability to fulfil its obligations under the Capital Securities—In circumstances where South West Water is materially affected by additional costs or lower revenues than anticipated at the time of a price determination, it may apply for an Interim Determination, although there is no certainty as to the outcome of any such Interim Determination”*.

### **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 (“**PPC**”) 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 EfW plants above 50 MW must receive consent from the relevant Secretary of State.

Viridor’s extensive transport operation is regulated by the Vehicle and Operator Services Agency (“**VOSA**”), an agency of the Department of Transport. VOSA 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 operating costs and/or capital expenditure. For instance, the implementation of the EU Industrial Emissions Directive

may result in additional environmental permitting requirements being imposed on South West Water in relation to water and waste water activities.

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 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 Sites of Special Scientific Interest.

The draft Water Bill has proposed the introduction of a reformed water abstraction regime intended to be in place by the mid to late 2020s. The government is concerned that too much water is currently being abstracted in certain areas and that current abstraction charges do not send the right price signals to reflect the relative scarcity or abundance of water. The government is expected to consult on more detailed proposals in 2013. The new regime may result in more or stricter future limitations on abstraction licences and/or increased abstraction charges payable by South West Water.

EU directives, including the Water Framework Directive, the Drinking Water Directive, the Bathing Water Directive and the Urban Wastewater Treatment Directive, are implemented in the UK by primary and secondary legislation. The requirements of the Water Framework Directive, including the requirement on EU Member States to ensure that their waters achieve at least “good status” by 2015, may result in more or stricter limitations on abstraction licences and more or stricter restrictions on discharge consents (or environmental permits). The White Paper proposes a new catchment area-based approach to water quality in order to meet the requirements of the Water Framework Directive. It notes that water companies can play an influential role in tackling pollution at catchment level, but that there is also a need to address pollution at source as opposed to water companies applying end of pipe treatment. 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 £1.6 million in the financial year ended 31 March 2012). The government has announced that it may consider replacing the CRC Energy Efficiency Scheme 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, motor, business interruption, public liability, environmental pollution and employer’s liability. The Group uses three tiers of insurance to cover operating risks:

- self insurance: Group companies pay a moderate excess on most claims;
- intra-Group insurance: cover by the Group’s subsidiary, Pennon Insurance Limited, of the layer of risk between the self insurance and the external cover; and
- external insurance: cover provided by the external insurance market, arranged by brokers with insurance companies with 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.

## **RECENT DEVELOPMENTS**

On 14 February 2013, the Issuer published an Interim Management Statement which included, *inter alia*, the following information with respect to the Issuer and the Group:

### *Issuer*

Since 1 October 2012, the Issuer has renewed £209 million of revolving credit facilities and term loans, put in place £63 million of new term loans and revolving credit facilities and drawn down a £40 million finance lease.

### *South West Water*

South West Water is continuing its strong performance against the 2010-2015 regulatory contract and management believes it is well placed to outperform its assumptions. South West Water continues to deliver robust operational performance and high standards of customer service, notwithstanding the extreme flooding experienced in recent months.

On 17 January 2013, South West Water announced that it had agreed to accept the proposed changes to its licence as a water and sewerage undertaker as published by Ofwat in December 2012. These licence proposals were prepared as a result of extensive constructive discussions between Ofwat and water companies following the previous Ofwat notice issued in October 2012.

### *Viridor*

Viridor has made further strong progress since the beginning of the year in developing its project pipeline. In particular:

- financial close was achieved for the Glasgow Design Build Finance Operate project (July 2012) and planning application for the Recycling and Renewable Energy Centre, which is part of the project, was approved (January 2013);
- financial close was achieved for the South London Waste Partnership PPP (November 2012);
- planning was approved (January 2013) and financial close was achieved (February 2013) for the Peterborough PPP; and
- provisional preferred bidder was achieved for the South East Wales residual waste project (Prosiect Gwrydd) (February 2013).

Trading in Viridor has been significantly below the level of last year, with recyclate prices falling back from their 2011 peak reflecting world economic and market conditions. Recyclate revenues per tonne have recovered a little from their lows of October and November 2012 but remain significantly below first half 2012/13 levels and management remains cautious about the prospects for further recovery. As a result of the weakness in recyclate prices and the continuing reduction in landfill volumes in Viridor, the Group is reviewing the carrying values of some of Viridor's assets and environmental provisions (any impairment or additional charges would be non-cash items) and expects to update the market in its preliminary results announcement expected to be published on or around 23 May 2013.

## MANAGEMENT AND EMPLOYEES

### BOARD OF DIRECTORS

In accordance with Group policies, the Board of Directors has a schedule of matters reserved for its decision and delegates more detailed consideration of certain matters to Board Committees; to the subsidiary boards of South West Water and Viridor; to the Executive Directors; and to the Group General Counsel & Company Secretary, as appropriate. The matters reserved to the Board include the approval of financial statements; acquisitions and disposals; major items of capital expenditure; authority levels for other expenditure; risk management; and approval of the strategic plan and annual operating budgets.

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:

<b>Name</b>	<b>Function</b>
Kenneth Harvey	Chairman
Colin Drummond	Chief Executive, Viridor
David Dupont	Group Director of Finance
Christopher Loughlin	Chief Executive, South West Water
Gerard Connell	Senior Independent Non-executive Director
Martin Angle	Non-executive Director
Dinah Nichols	Non-executive Director
Gill Rider	Non-executive Director

#### **Kenneth Harvey**

Appointed on 1 March 1997. Ken was formerly chairman and chief executive of Norweb Plc. He was chairman of National Grid Holdings in 1995 and was previously deputy chairman of London Electricity and earlier its engineering director. He has also been chairman of a number of limited and private equity funded companies. Currently he is the senior independent non-executive director of National Grid Plc.

#### **Colin Drummond**

Appointed on 1 April 1992. Prior to joining the Issuer Colin was a divisional chief executive of Coats Viyella, having previously been corporate development director of Renold plc, a strategy consultant with the Boston Consulting Group and an official of the Bank of England. He is chairman of the Government's Living with Environmental Change Business Advisory Board and of the Environmental Sustainability Knowledge Transfer Network. He is a senior visiting research fellow in Earth Sciences at Oxford University and a Past Master of the Worshipful Company of Water Conservators.

#### **David Dupont**

Appointed on 2 March 2002. David was formerly regulatory and finance director of South West Water Limited, having joined Pennon Group plc (then South West Water Plc) in 1992 as strategic planning manager. Previously he held business planning and development roles with Gateway Corporation. He is a member of the CBI Environmental Affairs Committee and the CBI South West Regional Council.

#### **Christopher Loughlin**

Appointed on 1 August 2006. Chris was previously chief operating officer with Lloyd's Register and earlier in his career was an executive director of British Nuclear Fuels Plc and executive chairman of Magnox Electric Plc. He was also a senior diplomat in the British Embassy, Tokyo, working in both the consulting and contracting sectors. Chris started his career as a chartered engineer and subsequently held a number of senior positions with British Nuclear Fuels. Between April 2008 and March 2012 he was chairman of Water UK and currently is vice chairman of the Cornwall Local Enterprise Partnership and a member of the audit committee of the charity, WaterAid.

#### **Gerard Connell**

Appointed on 1 October 2003. Gerard currently is also a non-executive director and chairman of the audit committee of the Defence Science and Technology Laboratory and the independent director, finance and investment, of the Nuclear Decommissioning Fund Company Limited. He was previously group finance director of Wincanton Plc. Before that he was a director of Hill Samuel and a managing director of Bankers Trust, having trained originally at Price Waterhouse. In addition he has held other

corporate finance and business development positions in the City and in industry. He is also a governor of King's College School, Wimbledon.

### **Martin Angle**

Appointed on 1 December 2008. Martin currently holds non-executive directorships with Savills plc, OAO Severstal, Shuaa Capital PSC and The National Exhibition Centre where he is Chairman. In addition he sits on the Board of the FIA Foundation where he is a vice-chairman. Formerly he held senior positions with Terra Firma Capital Partners and various of its portfolio companies, including the executive chairmanship of Waste Recycling Group Limited. Before that he was the group finance director of TI Group plc and held a number of senior investment banking positions with SG Warburg & Co Ltd, Morgan Stanley and Dresdner Kleinwort Benson.

### **Dinah Nichols**

Appointed on 12 June 2003. Dinah was formerly Director General Environment at the Department for Environment, Food and Rural Affairs and previously held various senior appointments within Government, including being head of the Water Directorate during the period of water privatisation. She is also a Crown Estate Counsellor, Chair of Keep Britain Tidy, a non-executive director of the Land Trust and, until recently, a director of Aberdeen Smaller Companies High Investment Trust.

### **Gill Rider**

Appointed on 1 September 2012. Gill currently holds non-executive directorships with Charles Taylor Consulting Plc, the Chartered Institute of Personnel & Development where she is president, and De La Rue Plc where she is Chairman of the Remuneration Committee. She is also Chair of the University of Southampton Council. As an executive, Gill's most recent senior position was with the Cabinet Office where she was head of the Civil Service Capability Group reporting to the Cabinet Secretary. Prior to that she held a number of senior positions with Accenture culminating in the post of Chief Leadership Officer for the global firm.

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**

The Board of Directors has established the following committees:

- **Audit Committee:** This committee comprises four Board members, Gerard Connell (Chairman), Martin Angle, Dinah Nichols and Gill Rider. This committee 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 six Board members, Dinah Nichols (Chairman), Gerard Connell, Martin Angle, Gill Rider, Colin Drummond and Christopher Loughlin. 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; non-financial regulatory compliance and the role of the Group in society.
- **Nomination Committee:** This committee comprises five Board members, Kenneth Harvey (Chairman), Gerard Connell, Martin Angle, Dinah Nichols and Gill Rider. The committee meets as and when required to select and recommend to the Board suitable candidates for appointment as executive and non-executive directors to the Board and as executive directors to the Viridor and South West Water boards, determine the nomination process and review succession plans.
- **Remuneration Committee:** This committee comprises four Board members, Martin Angle (Chairman), Gerard Connell, Dinah Nichols and Gill Rider. 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 4,530 employees (South West Water approximately 1,330 and Viridor approximately 3,150).



The Group aims for best practice in recruitment, training and development, talent management, health and well-being, retention and succession planning. The Group has a range of family friendly policies, equal opportunity policies and policies to ensure a healthy work-life balance. Employee representation is facilitated through trade union membership and, for South West Water, by an elected Staff Council.

Group companies' health and safety policies and procedures are delivered through programmes which integrate with other areas of the business including operations, compliance, human resources and quality. The Group has a range of training programmes aimed at different levels across the organisation.

The Group encourages share ownership amongst its employees by operating an HM Revenue & Customs approved Sharesave Scheme and Share Incentive Plan. At 31 March 2012 around one third of the Group's employees participated in these plans.

## 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 HM Revenue and Customs ("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.). If periodic returns were paid under deduction of United Kingdom income tax (e.g. if the Capital Securities lost their listing), Holders who are not resident in the United Kingdom may be able to recover all or part of the tax deducted if there is an appropriate provision in a double tax treaty. Additionally, 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).

Holders of Capital Securities may wish to note that, in certain circumstances and subject to certain exemptions (including one that may be applicable to Holders that are not individuals), HMRC has power to obtain information (including the name and address of the beneficial owner of the periodic return) from any person in the United Kingdom who either pays or credits certain payments, including a periodic return to a Holder. Information so obtained may, in certain circumstances, be exchanged by HMRC with the tax authorities of the jurisdiction in which the Holder is resident for tax purposes.

#### *EU Savings Directive*

Under EC Council Directive 2003/48/EC on the taxation of savings income, Member States are required to provide to the tax authorities of another Member State details of payments of certain types of income, including periodic returns, paid by a person within its jurisdiction to an individual resident in that other Member State or to certain limited types of entities established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments.

The European Commission has proposed certain amendments to the Directive, which may, if implemented, amend or broaden the scope of the requirements described above.

#### *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 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*

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.

## SUBSCRIPTION AND SALE

Barclays Bank PLC, HSBC Bank plc, Merrill Lynch International and The Royal Bank of Scotland plc (together, the “**Joint Lead Managers**”) have, pursuant to a Subscription Agreement (the “**Subscription Agreement**”) dated 6 March 2013, 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 underwriting 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.

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.

### **United States**

The Capital Securities have not been and will not be registered under the U.S. Securities Act 1933, as amended (the “**Securities Act**”) and may not be offered or sold within the United States except pursuant to an exemption from, or in a transaction 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 offered and sold, and will offer and sell, any Capital Securities (a) as part of their distribution at any time or (b) otherwise until 40 days after the completion of the distribution of all Capital Securities, only in accordance with Rule 903 of Regulation S under the Securities Act. Each Joint Lead Manager has further agreed that 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 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 by 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 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 18 February 2013.

### 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 8 March 2013, subject only to the issue of the Temporary Global Security. It is expected that dealings in the Capital Securities will commence on 11 March 2013. The expenses in connection therewith are expected to be approximately £7,175.

### 3 Clearing Systems

The Capital Securities have been accepted for clearance through Euroclear and Clearstream, Luxembourg. The ISIN for the Capital Securities is XS0899989213 and the Common Code is 089998921.

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

### 4 No significant or material adverse change

Save as disclosed in the last paragraph under “*Recent Developments – Viridor*” on page 62 of this Prospectus, there has been no significant change in the financial or trading position of the Issuer or the Group since 30 September 2012 and there has been no material adverse change in the financial position or prospects of the Issuer or the Group since 31 March 2012.

### 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 PricewaterhouseCoopers LLP, Chartered Accountants and Registered Auditors, who have audited the Issuer’s consolidated financial statements, without qualification, in accordance with IFRS for each of the two financial years ended on 31 March 2011 and 31 March 2012. 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)) be 6.864 per cent. per annum. 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 2011 and 31 March 2012, including the audit reports in respect thereof;
- (d) the unaudited consolidated interim financial statements of the Issuer in respect of the six months ended 30 September 2012;
- (e) the Issuer's Interim Management Statement published on 14 February 2013;
- (f) 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
- (g) 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](http://www.londonstockexchange.com/exchange/news/market-news/market-news-home.html).

**ISSUER**

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**Merrill Lynch International**  
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**The Royal Bank of Scotland plc**  
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**TRUSTEE**

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