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Dear Ms O'Sullivan

APB ETHICAL STANDARDS – CONSULTATION ON AUDIT FIRMS PROVIDING NON-AUDIT SERVICES TO LISTED COMPANIES THAT THEY AUDIT

Thank you for inviting comments on this consultation document. Pennon Group PLC's Audit Committee and management have considered the key issues raised in the document and we would comment as follows:

Do you think that the provision of non-audit services by accounting firms to their audit clients currently impacts confidence in the independence of auditors?

We believe that the sheer size and diversity of the large firms of auditors plus the annual specific review of independence undertaken by the Audit Committee gives sufficient assurance that independence is maintained.

The Group's Audit Committee oversees the appointment of the auditors for non-audit services with delegated authority to management for non-material assignments, subject to periodic reporting to the Committee.

For material assignments the Committee requires a report setting out the reasons for appointing the auditors to do the work. The Committee will only grant approval if it is satisfied that the auditors' independence and objectivity are safeguarded.

Are you aware of any instances where the provision of non-audit services by accounting firms to their audit clients has or may have adversely affected audit quality?

We are not aware of any such instances and believe that there are many situations where the use of the auditors' knowledge of the company's business activities and financial matters gives a key benefit to the company in commercial negotiations.

Continued

We believe the separation of the various non-audit activities within the larger firms gives adequate assurance that mainstream audit quality is maintained.

Do you think that there needs to be a change in the approach taken by APB to the setting of standards relating to the provision of non-audit services by auditors to the entities that they audit?

We believe that, whilst it is appropriate to periodically reassess the regulatory framework within which listed companies operate, the current approach provides adequate safeguards to maintain auditor independence and objectivity.

The consultation paper asks whether respondents would advocate "*More active corporate governance – e.g. so that non-audit service engagements were required to be pre-approved by the company's board of directors or audit committee*". As noted above Pennon has already adopted procedures which reflect this approach.

We believe that the current level of disclosure in financial statements, together with the report of the Audit Committee, gives investors and users of financial statements sufficient understanding of the approval processes and nature of the non-audit services undertaken by the auditors.

In setting the standards relating to auditor independence, do you believe regard should be had to the perceived benefits that are derived by companies from the provision of non-audit services by their auditors? If your answer is yes, please provide specific examples of these benefits and indicate the magnitude of any cost savings that arise.

We believe that the decision as to whether or not to appoint the auditor to provide a particular non-audit service is always taken with regard to the best interests of shareholders. Such appointments are only made where they are considered to be the best choice in terms of quality of service, advice and value for money.

In particular Pennon Group PLC derives benefit from using the auditors in the following key areas:

1. Regulatory financial reporting – the Group operates within a formalised regulatory framework in the water industry where use of the auditor is the only logical choice for providing independent assurance on financial reporting in annual regulatory returns and the quinquennial periodic review of customer price limits
2. Commercial bids and contracts – the Group's waste business is very active in bidding for Private Finance Initiative (PFI) and Public Private Partnership (PPP) contracts where specialist knowledge is required for the financial modelling and commercial negotiation of the bids and contracts.

The Group's audit firm has substantial experience in this area and there is only a limited number of other audit firms with appropriate PFI/ PPP project knowledge. On a number of occasions the Group has therefore used its audit firm for this work, particularly where alternative suppliers are engaged by other parties to the projects and are therefore unable to act for the Group due to conflicts of interest.

3. Corporate finance transactions benefit greatly from using the auditors' expertise and knowledge of the Group's business, especially for:

Acquisitions – where the auditors' knowledge of the existing business is a key element in performing due diligence on the acquisition target.

Bond financing – where issue and sponsor requirements are specifically addressed at the auditors to review documents and extract data from the audited financial statements.

Equity issues – where auditors are formally required to make statements to investors on the financial information presented in documents under the Listing Rules.

Existing auditors are acting in the above areas to protect shareholders' interests. The use of a different firm of auditors would, in our view, be detrimental to shareholders' interests in that it would incur greater cost, be disruptive to the development of the business and the timing of being able to act commercially.

We hope you will be able to reflect the above views in the outcome of your consultation.

Yours sincerely



pp G D Connell
Chairman Audit Committee



D J Dupont
Group Director of Finance