

**SOUTHERN WATER SERVICES LIMITED**

**OPERATING AND FINANCIAL REVIEW,**

**ANNUAL REPORT**

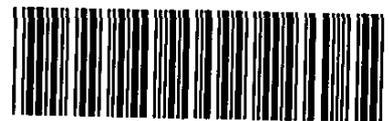
**AND**

**FINANCIAL STATEMENTS**

**FOR THE YEAR ENDED**

**31 MARCH 2012**

**TUESDAY**



**\*A1FS91OW\***

**A17**

**21/08/2012**

**#27**

**COMPANIES HOUSE**

SOUTHERN WATER SERVICES LIMITED

**OPERATING AND FINANCIAL REVIEW, ANNUAL REPORT AND FINANCIAL STATEMENTS  
FOR THE YEAR ENDED 31 MARCH 2012**

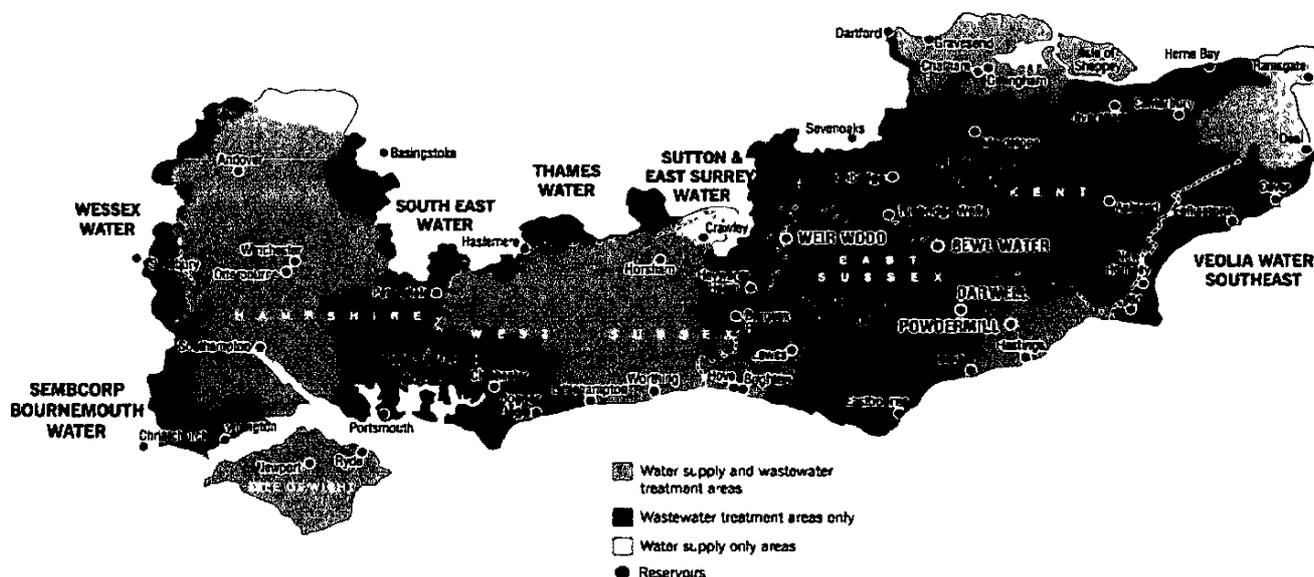
<b>Contents</b>	<b>Page</b>
At a glance	1
Chief Executive's summary	2
Operating and financial review	5
Report of the directors	27
Corporate governance	31
Profit and loss account	33
Statement of total recognised gains and losses	34
Balance sheet	35
Cash flow statement	36
Notes to the financial statements	37
Independent auditors' report	59

# SOUTHERN WATER SERVICES LIMITED

## ANNUAL REPORT

### At a glance

We provide high quality water services to more than 2.4 million people and wastewater services to 4.4 million people in the South East of England.



Our region stretches across the counties of Kent, East and West Sussex, Hampshire and the Isle of Wight.

### Our physical assets include:

- 13,715 km of water mains
- 94 water treatment works
- 21,959 km of sewers (excluding private sewers)
- Circa 17,000 km of private sewers adopted on 1 October 2011
- 370 sewage treatment works

### Drinking water supplied per day:

551 million litres  
1.0 million properties served

### Treated wastewater per day:

800 million litres  
1.9 million properties served

Employees: 1,898 at 31 March 2012

	2012	2011	Change
Turnover	£716.2m	£647.1m	10.7%
Operating profit (before exceptional item in 2011)	£271.6m	£230.1m	18.0%
Profit on ordinary activities after taxation	£79.9m	£32.0m	149.7%

## CHIEF EXECUTIVE'S SUMMARY

In a year of challenges and change, Southern Water recorded a number of notable successes in 2011-12 as well as laying the foundations for further improvements for the future

A new management team was brought together during the year with a new strategic direction and focus. Key to this is making improvements to our business processes to help us deliver excellent service to our customers while achieving our agreed outputs and obligations, to time and budget, between now and 2015

As part of this process the "Shaping the Future" change programme has been established to manage the initiatives and ensure delivery of the business improvements. We have also taken further steps in bringing our asset management capabilities back in-house to help improve our asset maintenance, investment and the delivery of our long term plans for our customers

During the year we achieved our best ever health and safety result in terms of reportable injuries (RIDDORs). While every accident is one too many, the figure of just seven RIDDORs improved on our previous lowest figure of eight in 2010-11. The welfare of our staff and contractors remains our number one priority and we were again awarded a Royal Society for the Prevention of Accidents President's Award for our ongoing health and safety performance

In terms of leakage, we recorded our lowest figure ever and beat the current target set by our regulator Ofwat by eleven million litres a day. We remain the water and sewerage company with the lowest leakage level and we are continuing to invest in order to further improve our leakage performance

We have made great strides with our industry leading five-year programme to install water meters in the majority of the homes in our region by 2015. So far we have fitted more than 150,000, each equipped with a state-of-the-art leak alarm. These meters enable us to help find leaks on the customer's side of the meter, and fix them promptly, a service provided free of charge to our customers. Further, we have also taken into account affordability issues for our customers by introducing a transitional and support tariff to help them as they move to a metered charge. We have also completed over 5,600 "Home Saver" checks to help customers identify ways of using water and energy more wisely

Developments in leakage detection and metering are particularly important when set against the backdrop of an exceptionally dry two years, which included the second driest 12 months on record, and the South East officially classed as being in drought. We joined six other water companies in introducing water restrictions – the first time we have done so since 2005-6 – in our Kent and Sussex supply areas. Subsequent rain in April and May had a considerable benefit to our river and reservoir sources, although it will still take some time for our underground sources, which provide the majority of our water supplies, to fully recover

Our ongoing investment in water resources is helping to ensure we maintain supplies to customers in the months and years ahead. This is typified by the early completion in 2011 of a new reservoir at Hardham, West Sussex which enables us to take up to 10 million litres of water a day from the River Arun. Moreover, the quality of our drinking water supplied to customers continued to be high

Elsewhere in the business, we made customer service improvements including a "Think Customer" initiative to promote putting the customer first with our staff and suppliers and achieved our target improvement for the Service Incentive Mechanism (SIM) – the means by which Ofwat measures levels of customer satisfaction. We recorded a 20 per cent improvement in our SIM score despite a challenging period in which we received higher levels of customer contact than expected

Our financial results reflect an increase in operating profit before exceptional items to £271.6m compared with £230.1m in 2010-11. Turnover increased reflecting the regulatory price increase and a one-off adjustment made in 2010-11 in relation to the estimation method used for calculating the value of unbilled income. Overall operating costs also increased. However, taking account of new obligations including private sewers and the carbon reduction commitment, together with inflation, underlying operating costs were lower than the previous year. These savings resulted from process reviews and tight budgetary control led by the new management team. Overall customer cash collections showed an improvement despite the difficult economic environment, with the bad debt charge as a percentage of revenue reducing from the previous year

Legislation to transfer ownership of private sewers to water companies from 1 October 2011 provided the opportunity to plan and implement new processes. Our approach achieved high levels of customer satisfaction, as recorded by the Consumer Council for Water survey, which found that 90 per cent of customers questioned said our communication of the changes was clear, or very clear. Overall, we successfully integrated the management of these new assets into our business and we will use this model to continue to improve customer service in future projects. As funding for the adoption of these assets has not been included within the Final Determination made by Ofwat for this regulatory period, we are continuing to review the case for making an application for an Interim Determination of K (IDoK) to reflect this additional obligation

**CHIEF EXECUTIVE'S SUMMARY (continued)**

During the year, a considerable amount of work took place to provide a better understanding of our assets and to improve maintenance and investment. Centres of excellence – working with suppliers to drive improved asset management planning – were a key feature in this. We will continue to seek innovative and cost-effective ways to build and maintain our water and wastewater sites while minimising the impact on our carbon footprint.

Ongoing partnerships with our multi-services framework suppliers and offshore providers have continued to deliver benefits.

We are on track to deliver our capital investment programme for 2010-15 of about £1.8 billion and will complete some of our planned work earlier than scheduled. This includes our £300 million scheme to bring cleaner seas to Sussex, where construction of a new wastewater treatment works at Peacehaven, along with associated infrastructure, will be compliant with the Environment Agency Discharge consent by 31 March 2013 and will be taken over by Southern Water from 1 July 2013. New schemes which started during the year included a £14 million investment at Chatham in Kent to replace almost 50km of old water mains and flush clean more than 100km of pipes. The water used to flush the mains is being recycled for Medway Council to use on its public areas in an initiative directly related to the water resources situation.

We have made significant investment during the year to maintain and improve serviceability, and across all four sub-service areas (wastewater infrastructure and non-infrastructure, water infrastructure and non-infrastructure), we are reporting stable serviceability.

As a result of our wastewater Below Ground Improvement Plan (BGIP), five out of six serviceability indicators for the wastewater infrastructure sub-service are within control limits for this reporting period, and most have improved against last period. We did not see an improvement in the sixth measure, pollution incidents in 2011-12 as we had hoped. However while the pollution measure would not indicate 'stable' serviceability, if considered in isolation, the improvement in other factors indicate an overall stable position. We are committed to continue to look for ways of reducing the number of pollutions from the wastewater network.

We also launched an employee engagement initiative to help make our company a better place to work. Staff were invited to complete our first Sunday Times "Best Companies to Work For" survey, which gave us a sound base from which to work.

We started to lay the foundations for our next business plan, for the 2015-2020 period, so that we can continue to meet and exceed the expectations of our customers and stakeholders. We support an outcomes-based approach, proposed by Ofwat, and we will engage with our customers and stakeholders more than ever to understand their needs.

Our newly-formed Customer Challenge Group will be important in ensuring that our business plan reflects the needs of our customers and stakeholders and we have made an early start by appointing an independent chair person, Anna Bradley, and recruiting all the Challenge Group members. Anna's previous roles include Chief Executive of the National Consumer Council and Chair of Ofcom's Communications Consumer Panel.

We recognise there will be greater competition in the water industry in the future. In addition, the consultation on future price limits represents a significant change for the water sector, offering new challenges and fresh opportunities. We are committed to working with Ofwat and other regulators to contribute to developments in the industry. To drive this agenda, we established a new team to concentrate on market reform and business effectiveness.

We remain committed to reducing the impact of our operations on the environment through our environmental management system, which achieved re-certification to ISO14001 in 2011. We were again awarded the Carbon Trust Standard in recognition of our steps to measure, manage and reduce carbon emissions over a three-year period.

Our work was recognised through a number of awards, including Utility Industry Achievement Awards for our River Arun (Hardham reservoir) abstraction scheme and the installation of 'intelligent' water meters through our metering programme. We also had success at the Water Industry Achievement Awards where our sympathetic approach to debt won the Customer Satisfaction Initiative of the Year.

We continued to support the community we serve, with more than £325,000 raised through charity events. Help was also given to local community organisations through a range of activities and partnerships, including Sporting Chance which works with professional sports clubs to promote sporting activity, water efficiency and drinking water for health, to young people.

Our award-winning Learn to Swim scheme reached a milestone in 2012, celebrating its 20<sup>th</sup> anniversary in this Olympic year. Since 1992, more than 600,000 children have learned to swim through the scheme. Our sponsorship of the South and South East in Bloom competition also reached its 10<sup>th</sup> year.

**CHIEF EXECUTIVE'S SUMMARY (continued)**

In summary, this has been a year of achievement and we have moved forward, although there are some areas that will need additional focus in 2012-13 in order to fully achieve our goal. I would like to take this opportunity to thank all the people working at Southern Water and our partner organisations for their hard work and efforts throughout the past year.

A handwritten signature in black ink, appearing to read 'M. R. Wright', written in a cursive style.

**Matthew Wright**  
**Chief Executive Officer**

**OPERATING AND FINANCIAL REVIEW**

*This section is prepared in accordance with the Accounting Standards Board's Reporting Statement: Operating and Financial Review, January 2006.*

**A. OUR BUSINESS**

Southern Water Services Limited (Southern Water) holds an appointment as a water and sewerage undertaker for the South East area of England. Drinking water supplies and wastewater services are provided in an area covering Kent, East and West Sussex, Hampshire and the Isle of Wight. These activities, which are referred to as the appointed business, account for over 99 per cent of turnover. There are also a number of minor activities which are not regulated under the appointment and which are described below as the non-appointed activities.

**Water services**

Southern Water supplies high quality drinking water to more than one million properties across the region, through a network of more than 13,700 kilometres of mains, 94 water treatment works and numerous pumping stations and service reservoirs.

The average daily volume supplied in 2011-12 was 551 million litres a day. Of the domestic properties served, 50 per cent have a meter and pay by reference to the amount of water supplied. 89 per cent of business customers are metered.

**Wastewater services**

Every day we treat 800 million litres of wastewater from 1.9 million domestic and business properties. Wastewater is transported through a network of more than 38,900 kilometres of sewers, including 17,000 kilometers of private sewers adopted on 1 October 2011, and 2,334 pumping stations to 370 wastewater treatment works where it undergoes a number of treatment processes. Once treated the water is recycled safely back to the environment. Recycled by-products from these processes are used to produce agricultural fertilisers / soil conditioners and to generate renewable electricity using anaerobic digestion and combined heat and power plants.

**Non-appointed activities**

Southern Water also carries out a small number of non-appointed activities associated with the core business. The largest of these is the provision of property search information for homebuyers. During the year over 66,000 (2010-11 58,000) residential searches were provided. The slight rise, year on year, is due to a small improvement in the general property market conditions.

**Regulation of the water industry**

The economic regulator for the water industry is the Water Services Regulation Authority (WSRA), more commonly known as 'Ofwat'. Ofwat's main duties are ensuring companies carry out and can finance their functions and protecting customers' interests. It is responsible for setting price limits every five years for all appointed water and sewerage undertakers. These price limits apply to the weighted average of water and wastewater charges.

Price limits were last set in 2009 for the period 2010-11 to 2014-15. The allowed increases are shown in Figure 1 below. Associated with these price limits are a set of required outputs and efficiency targets.

Figure 1 Price limits

	2010-11	2011-12	2012-13	2013-14	2014-15
Allowed real price increase ('K' factor)	-0.7%	0.0%	3.6%	3.3%	-0.1%

Charges can be increased by the Retail Prices Index (RPI) plus the 'K' factor.

In addition to the K factor, Ofwat has modified Southern Water's licence to allow it to increase charges by an additional 1.4 per cent in 2011-12. This additional adjustment relates to the provision of transitional tariffs to help customers moving to a water meter under the Company's Universal Metering Programme, which is described in further detail in section E.

## OPERATING AND FINANCIAL REVIEW (continued)

### A OUR BUSINESS (continued)

#### Competition

One of Ofwat's primary duties is to protect customers, and to do so wherever it is appropriate by promoting competition. There are currently two main sources of competition in the sector – Water Supply licencees and inset appointments.

The water supply licensing regime was introduced in December 2005, but to date only one customer (in another company's supply area) has switched supplier. The failure of the regime is widely attributed to the pricing mechanism, which is set out in legislation and is designed principally to ensure that customers not eligible to switch supplier are no worse off. In its recent Water White Paper, the Government announced its intention to remove the cost principle from legislation and replace it with regulated access prices, overseen by Ofwat.

It is clear that non-household customers, particularly those operating on a national scale, are keen to exercise choice over their water supplier and deal with a smaller number of providers. We support giving these customers a choice of supplier and will continue to work hard to ensure that we are meeting the needs of all of our current customers. But we are clear that such choice should not be at the expense of domestic customers who will remain unable to choose their supplier for the foreseeable future.

Competition is also possible through cross-border supplies and inset appointments, where the incumbent's licensed area of supply is altered. Since 2007, 26 new appointments have been made in England and Wales. There are currently three inset appointments in Southern Water's area. While we continue to work constructively with developers and new appointees, in the long-term we believe creating a patchwork of water companies, using parts of incumbent water company's networks, will simply add to confusion and provide little meaningful benefit for customers who remain unable to choose supplier.

The Water White Paper also included proposals aimed at facilitating greater competition in water resources provision and trading. The water companies operating in the South East, which is the most water-stressed part of the country, have for a number of years worked collaboratively to best manage the region's scarce water resources. Nonetheless, we agree that there is more that could be done and we are keen to see more trading, where it makes economic sense. We recently published the results of some research we carried out in this area, looking at the impact on trading of 'shadow prices', which aim to recognise the scarcity value of water, and the barriers to trading. We have also initiated a pilot scheme to look at creating a trading pool (whereby certain types of trade would be 'pre-approved' by the Environment Agency following an impact assessment) on the River Rother, which has a large number of abstractors upstream of our treatment works at Hardham. We will continue to develop our thinking in this area and work with our regulators and Government to put in place a pragmatic water trading regime.

#### Strategic goals

2011-12 marked the second year of the new regulatory period, following the price review in 2009. During this period we are committed to improving our key processes to deliver better services for customers, protecting the environment and providing safe and reliable services in the most efficient way. In particular we are focused on transforming our asset management capabilities. Our goal is to be recognised as the leading water company by 2015.

To drive the performance of the business towards this goal, the Executive Management Team has set 13 targets, covering the full range of our activities including customer service, leakage reduction, delivery of our capital programme, improving efficiency and most importantly, the health and safety of our staff, contractors and customers.

During the year we have begun that journey. Particular highlights during this first year are:

- Recording our best health and safety performance in terms of reportable injuries (RIDDORs). The figure of seven RIDDORs beat our previous best performance of eight in 2010-11. We believe this represents sector-leading performance.
- Achieving our lowest level of leakage, beating the current target set by regulator Ofwat by eleven million litres a day. We remain the water and sewerage company with the lowest leakage level.
- Installing more than 150,000 water meters with leak alarms as part of our programme to install meters in the majority of homes in our region by 2015.
- Achieving all of the regulatory outputs agreed for AMP5.
- Further improvements in customer services resulting in a 20 per cent improvement in our SIM score to achieve our internal target.

**OPERATING AND FINANCIAL REVIEW (continued)**

**A. OUR BUSINESS (continued)**

**Strategic goals (continued)**

- Continuing to provide high quality drinking water. Compliance with Drinking Water Inspectorate (DWI) standards was 99.88 per cent in the 2011 calendar year.
- Progress in re-building our internal asset management capability by bringing significant activities in-house.
- Laying the foundations for our next business plan so that we can continue to meet and exceed the expectations of our customers and stakeholders.

There remain a number of key challenges for this period to enable us to achieve our strategic goals.

In particular, we recognise that there is more to do in reshaping some of our key processes to deliver further operating efficiencies, and we will continue to focus our efforts to make these improvements during 2012-13 and beyond.

There are also significant challenges for us in managing our networks. During the year, we agreed revised leakage targets with Ofwat as, following the impacts of three harsh winters on the resilience of our water infrastructure network, we were unable to achieve the challenging leakage targets that we set for ourselves as part of the last price review. We have provided Ofwat with a formal undertaking that we will meet the new targets, as well as agreeing to return £5m to customers in recognition of the failure to meet our target in 2010-11. In 2011-12 we have significantly reduced our leakage to a level which is 11Ml/d below the new target. We continue to have the lowest leakage levels of any of the ten water and sewerage companies in England and Wales. Customers expect us to manage our resources effectively, and we remain committed to leading the industry on leakage.

On the sewer network, we continue to look for ways of reducing the number of pollution incidents to ensure we maintain serviceability, Ofwat's measure of the effectiveness of our maintenance activity in delivering services to customers. This follows increases in both pollution incidents and flooding in the previous reporting period. Whilst our action plan has had an impact on the underlying serviceability causes, and flooding incidents have reduced, we did not see a reduction in pollution incidents. The relative position of the five other indicators of serviceability would conclude an overall stable position as they either improved or remained as stable. The underlying causes of pollution incidents are constantly under review and we are committed to continue to look for ways of improving the performance.

Finally, revenues from customers continue to be significantly lower than assumed by Ofwat in setting price limits. In 2011-12, revenues were approximately £27m lower than the forecast revenues used to set prices. During the year we have put considerable effort in to analysing the underlying reasons for the shortfall and have identified a number of initiatives which will help mitigate the deficit. While this shortfall can be recovered under the Revenue Correction Mechanism introduced at the last price review, this is likely to result in pressure on bills from 2015-16. We have held discussions with Ofwat during the year about smoothing these increases, by recovering part of the revenues in the current period and part in the next five-year period, which would require an Interim Determination of K (IDoK). However, we have concluded that given the current economic climate and rate of inflation and K factors for this year and next, it would not be appropriate for customers to face higher bill increases at this time.

## SOUTHERN WATER SERVICES LIMITED

### OPERATING AND FINANCIAL REVIEW (continued)

#### B FINANCIAL PERFORMANCE

##### Accounting policies

The accounting policies of the Company, which are consistent with the prior year, are set out on pages 37-40

##### Profit and loss account

The profit and loss account of Southern Water Services Ltd is summarised in Table 1

Table 1	Years ended 31 March		Change
	2012 £m	2011 £m	%
Turnover	716.2	647.1	10.7
Cost of sales and admin expenses	(240.6)	(231.3)	4.0
Depreciation	(204.1)	(185.8)	9.8
Other income	0.1	0.1	0.0
Operating profit before exceptional item	271.6	230.1	18.0
Exceptional item	0.0	(38.6)	(100.0)
Operating profit after exceptional item	271.6	191.5	41.8
Profit on disposal of fixed assets	1.2	0.8	50.0
Net interest payable	(187.9)	(180.2)	4.3
Profit before tax	84.9	12.1	601.7
Tax	(5.0)	19.9	(125.1)
Profit after tax	79.9	32.0	149.7

Turnover increased by 10.7 per cent to £716.2m (2010-11 £647.1m) compared with an average tariff increase on metered and unmetered income of 6.1 per cent, derived from an RPI of 4.7 per cent at November 2010 together with an allowance from Ofwat of 1.4 per cent for the transitional tariffs being offered to customers under the Company's Universal Metering Programme. The K factor for the year was nil as reported in section A. The significant increase over and above the tariff change reflects the impact of a one-off adjustment to turnover made during 2010-11, following a review of the method for estimating the amount of metered water and wastewater charges unbilled at the year-end. This review highlighted that an element of the previous year's estimated unbilled charges, were not subsequently being billed and an adjustment to turnover was therefore made to reflect the previously overestimated accrual.

Cost of sales and administrative expenses increased by 4.0 per cent to £240.6m (2010-11 £231.3m). This increase resulted mainly from the impact of new obligations including the adoption of private sewers and the carbon reduction commitment charge, together with inflation. Taking these items into consideration, the underlying operating costs fell in real terms by 2.3 per cent.

This real terms reduction has been achieved through process reviews and a focus on maintaining tight budgetary controls. This includes reducing the work issued to external contractors through more efficient use of our own internal resources and reductions in electricity costs and greater use of our Combined Heat and Power (CHP) facilities.

Depreciation increased by 9.8 per cent to £204.1m (2010-11 £185.8m) as a result of the continuing significant capital investment programme and an increase in the Infrastructure Renewals Charge reflecting the greater level of capital expenditure on infrastructure assets.

Operating profit for 2011-12, before exceptional items increased to £271.6m (2010-11 £230.1m), an 18.0 per cent improvement.

The exceptional item of £38.6m in 2010-11 related to a one-off revision to the level of bad debt provision carried against outstanding receivables.

The profit on disposals of £1.2m (2010-11 £0.8m) relates mainly to the sale of land and buildings.

Net interest payable of £187.9m increased by 4.3 per cent (2010-11 £180.2m). This increase principally related to non-cash interest associated with inflation on index-linked bonds, offset by reductions in interest payable following the repayment of part of the preference shares, the amortisation of a swap receipt and a reduction in the non-cash financing charge on the pension deficit.

**OPERATING AND FINANCIAL REVIEW (continued)**

**B. FINANCIAL PERFORMANCE (continued)**

The tax on ordinary activities of £5 0m (2010-11 £19 9m credit) reflects the increase in profit before tax and the impact of changes made to the future taxation rate on the deferred tax liability as described in note 8

The profit after taxation for the year amounted to £79 9m (2010-11 £32 0m)

**Cash flow statement**

Net cash inflow from operating activities increased to £487 1m for 2011-12 from £462 4m in 2010-11 This increase mainly reflects the increased operating profit resulting from the price increase on income offset by increases to costs for new obligations and inflation, together with an improvement in working capital

The net cash outflow from returns on investment and servicing of finance reduced to £80 7m for 2011-12 from £99 1m in 2010-11 This reduction results from lower interest paid following the full year effect of re-financing in 2010-11 and the partial repayment of the preference shares in 2011-12

The outflow of cash relating to the purchase of tangible fixed assets was £466 0m (2010-11 £385 4m) and the net cash outflow before financing in 2011-12 was £127 1m (2010-11 £103 0m) The increase in cash outflow in relation to capital expenditure results from the profile of the overall capital programme, with the most notable increases being in relation to the metering programme, the adoption of private sewers and repairs and renewals to assets There was also a reduction in the level of capital creditors at the year end as the Brighton and Hove project nears completion

The reduction in dividends paid in 2011-12 relates to the final dividend for 2009-10 of £35 0m which was paid on 24 May 2010 and reported in the accounts for 2010-11 The interim dividends paid in the year totalling £42 1m being £751 43 per ordinary share (2010-11 £42 1m) are paid to Southern Water Services Group Ltd (SWSG) and are offset by interest receivable from SWSG of £56 9m (2010-11 £56 9m)

During the year, net cash inflow from financing was £30 5m as a result of an increase in a capital facility and a swap receipt offset by the repayment of part of the preference share capital

**Balance sheet**

At the end of the year to 31 March 2012, Southern Water had fixed assets of £4,138 7m (2010-11 £3,912 3m) an increase of £226 4m from March 2011 This increase largely results from capital investment of £443 4m offset by depreciation of £206 8m

Debtors falling due within one year increased to £163 5m at 31 March 2012 from £148 1m, the increase results from the higher short term inter-company cash debtor with Southern Water Services (Finance) Limited (SWSF)

As at 31 March 2012, creditors falling due within one year totalled £250 6m, the increase from £228 6m at 31 March 2011 results from an increase in amounts owed to group undertakings, offset by a reduction in capital creditors

Creditors falling due after one year increased by £137 9m to £3,666 5m as at 31 March 2012, this increase principally resulted from inflation on index-linked bonds of £113 5m, the increase in the capital facility offset by the repayment of an inter-company creditor

The net pension deficit increased in value to £69 7m following the latest actuarial valuation, as described in note 22

Overall net assets and shareholder's funds increased from £799 4m to £806 7m

The directors have not declared a final dividend for 2011-12 (2010-11 nil)

**OPERATING AND FINANCIAL REVIEW (continued)**

**B FINANCIAL PERFORMANCE (continued)**

**Dividend policy**

Dividends are proposed with due regard to the following constraints

- 1 Assessment of headroom under debt covenants
- 2 Assessment of the impact on the Company's credit rating
- 3 Assessment of the liquidity position and ability to fulfil licence conditions
- 4 Assessment of key areas of business risk
- 5 Assessment of current year and cumulative distributable reserves
- 6 Directors duties under law and Ofwat administered regulatory arrangements

Distribution proposals submitted to the Board will also include an assessment of the Company's performance against the business plan including expected performance over the balance of the regulatory period

These tests are not applied to the interim dividends paid to Southern Water Services Group (SWSG) as the dividend payment is instantly offset by a corresponding interest receipt from SWSG

No ordinary dividend was paid or declared in relation to 2011-12

**Financial KPIs**

Under our financial debt structure, there are a comprehensive set of covenanted financial ratios. Of these, there are two key ratios, namely the ratio of net debt to Regulatory Capital Value (RCV) and the ratio of adjusted cash income to net interest cost

The net debt used in the net debt RCV ratio is calculated from Southern Water's Regulatory Accounts as short and long-term senior borrowings, less cash and short-term deposits. The RCV for each year is set by Ofwat for five year periods at periodic reviews and reflects forecast growth in the asset base. It is adjusted at each periodic review for any out-performance, shortfalls in outputs or permitted additional investment and for certain asset disposals. The ratio of senior debt to RCV is targeted to be maintained at below 85 per cent, in line with our debt covenants

Senior adjusted cash interest cover (measured as net cash inflow from operating activities less Current Cost Depreciation and the Infrastructure Renewals Charge, to senior debt interest) is targeted to be maintained above 1.1 times, to meet covenanted levels

**Net debt: RCV**

2009-10 performance	80%
2010-11 performance	81%
2011-12 performance	81%
Covenanted lock-up level	<85%

**Senior cash interest cover**

2009-10 performance	1.5 times
2010-11 performance	1.4 times
2011-12 performance	1.6 times
Minimum target trigger level	1.1 times

**OPERATING AND FINANCIAL REVIEW (continued)**

**C. CAPITAL STRUCTURE, LIQUIDITY AND OTHER FINANCIAL MATTERS**

**Capital structure and borrowing covenants**

Southern Water carried out a refinancing of its regulated business in 2003 with the aim of replacing a short term parent company loan and reducing its cost of capital through a substantial increase in the proportion of debt finance. At the same time a Common Terms Agreement (the CTA) between the members of the Southern Water Financing Group and its debt investors was entered into. The CTA sets out the arrangements for the ongoing management of Southern Water's debt issuance programme, including a set of financial covenants, trigger events and events of default.

**Interest rate, liquidity and cash management risk**

Southern Water hedges its exposure to interest rate risk on at least 85 per cent of its outstanding debt liabilities in respect of Class A and Class B debt for the period to the next periodic review and at least 70 per cent in the next period (on a rolling basis) into either index-linked or fixed rate obligations.

Additional funds are raised as required, to ensure that sufficient cash and/or facilities are available to fund the business for at least the next twelve months.

The Company sets exposure limits for, and deposits cash balances with, organisations whose credit ratings are rated a minimum of Moody's P1, Standard & Poor A1 or Fitch F1.

The regulatory framework, under which revenues and the RCV are indexed, exposes Southern Water to inflation risk. This risk is managed through the use of index-linked instruments within the overall debt portfolio.

An analysis of net debt is included in note 21(b) to the financial statements.

**Credit risk**

Approximately 82 per cent of the water and wastewater services revenue is received from household customers. The 1999 Water Act prohibits the disconnection of domestic customers for failure to pay water and wastewater charges. An extensive range of collection and recovery methods are employed, as appropriate to the individual circumstances of the customer, to minimise the risk of non-payment. For non-domestic customers, the right to disconnect supplies for non-payment remains and is exercised as appropriate.

The level of provision against non-collection of charges is reviewed on an annual basis, based on the age profile of the debt and the likelihood of recovery. The Company strives to assist customers who are in financial hardship and provides schemes to help them manage their payments.

**Holding company**

The ultimate holding company of Southern Water is Greensands Holdings Limited (Greensands).

In April 2011, the principal borrowings of Greensands were refinanced. A long term financing structure has been put in place, comprising a £1.0bn Euro Medium-Term Note programme, out of which a £250.0m listed bond has been issued by Southern Water (Greensands) Financing Plc. Along with a new £225.0m bank facility, this has been used to refinance the £441.2m of existing Greensands holding company debt and to provide a liquidity facility at the holding company.

No change has been made to the Southern Water securitisation covenants as a result of this transaction.

In April 2011, Southern Water also strengthened its inflation hedging by taking on £441.2m of long dated inflation linked debt at their market value, in return for the cancellation of an equivalent value (£124.0m) of cumulative redeemable preference shares.

**OPERATING AND FINANCIAL REVIEW (continued)**

**D. OPERATIONAL PERFORMANCE**

**Customer services**

Ofwat now measures company performance on the delivery of customer service using the Service Incentive Mechanism (SIM), which focuses on six quantitative measures and one qualitative measure. The SIM index influences the outcome of a price review as price limits can be adjusted for comparatively good or poor performance against the index. The first such consideration will be at the price review in 2014, based on performance in years 2011-12 to 2013-14.

There are two parts of the SIM index, quantitative and qualitative.

The quantitative measures cover inbound telephone calls and written complaints. The telephone calls focus on the number of occasions all lines are busy, the number of abandoned calls and the number of unwanted calls. Unwanted calls are broadly defined as a call the company would not have received if an action or inaction had not given cause for a customer to contact us, other than when specifically requested or required to do so. All of these criteria incur one point for each occurrence. The scoring for telephone calls is weighted and based on the number per 1,000 connections (water and/or sewerage) to give comparability between companies. The scoring mechanism is weighted for written complaints according to escalation level. A weighting of 5 points is incurred for each written complaint received, a weighting of 100 points for each escalated written complaint and 1,000 points for each investigation carried out by the Consumers Council for Water.

The qualitative measure is determined by a "consumer experience survey", which is conducted on a quarterly basis. Each quarter, a market research company, acting on behalf of Ofwat, contact approximately 200 customers whose enquiry has been resolved within a defined period. Each customer ultimately ranks the level of service they consider that they received from "very satisfied" (5) to "very dissatisfied" (1).

There is a "Think Customer" initiative and action plan in place across the business to improve the customer experience which is co-ordinated by Customer Services and ensures appropriate business processes are in place to deliver an improving SIM performance. We pay particular attention to our SIM score and our comparative performance with other water companies, aiming to achieve an incremental improvement in both the score and our relative positioning each year.

As a result of our continuous improvement initiatives, our SIM score has increased from 54 last year to 65 for the year ending March 2012, delivering a 20 per cent improvement, and meeting our internal target.

This performance has been achieved despite a very challenging period as a result of higher than expected customer contacts associated with annual billing during March, which adversely affected the quantitative elements of SIM.

**Water services**

Our Water Resources Management Plan was approved by Defra and was published in October 2009. The Water Resources Management Plan sets out how the Company intends to meet its anticipated demands over the next 25 years. The plans are reviewed every year and consulted on in detail every five years, or when there has been a material change in circumstances. In the South East of England an additional layer of interaction occurs as each of the companies, Ofwat, the Environment Agency and the Consumers Council for Water work together to find the best regional solution for customers.

The core aspect of the plan is to meet the anticipated demand in the most cost effective and sustainable way. For the current regulatory period this will be achieved through an industry leading Universal Metering Programme, developing new resources and leakage reductions.

The provision of high quality drinking water is fundamental to public health. The Drinking Water Inspectorate (DWI) oversees standards of drinking water in England & Wales and Southern Water is required to monitor water quality at its water treatment works, reservoirs and at customer taps. The overall DWI measure of tests meeting the standards at customer taps is reported as a percentage of mean zonal compliance and is measured over the calendar year. This is the key measure of the quality of water received by customers. Maintaining mean zonal compliance as close to 100 per cent as practicable is a key target to ensure consistently high standards for customers.

**OPERATING AND FINANCIAL REVIEW (continued)****D. OPERATIONAL PERFORMANCE (continued)****Water Services (continued)*****Drinking water compliance (based on calendar years)***

2005 performance	99 96%
2006 performance	99 95%
2007 performance	99 95%
2008 performance	99 97%
2009 performance	99 98%
2010 performance	99 90%
2011 performance	99 88% *

\* Note the calculation method in relation to compliance with the regulatory quality standards for taste and odour changed in 2011

***Leakage (based on financial years) – Prior years restated***

2005-06 performance	93 MI/d
2006-07 performance	82 MI/d
2007-08 performance	88MI/d
2008-09 performance	92 MI/d
2009-10 performance	97 MI/d
2010-11 performance	96 MI/d
2011-12 performance	82 MI/d

Drinking water quality continued to be high across the region. Mean zonal compliance, based on compliance with DWI standards at the customer tap remained high at 99.88 per cent for the 2011 calendar year. To maintain these high standards, each year over 640,000 tests are carried out on water from its source to the customer's tap. Drinking water supply operations are accredited to ISO 9001 standards. Over the current price limit period further capital investment will be made in order to reduce turbidity (cloudiness) at four sources and reduce nitrate concentrations at a further two groundwater sources.

Minimising leakage, together with metering, is a key component of the strategy to ensure adequacy of water resources. Southern Water's aim is to beat annual leakage targets agreed with Ofwat. The target was 93 MI/d for 2011-12.

We have beaten our Ofwat leakage target by some 11MI/d and this result re-affirms our commitment to leakage reduction as a key component of balancing the supply demand balance. This result also demonstrates to our customers some of the measures we are taking to beat the current drought. We remain the water and sewerage company with the lowest leakage on a per property basis.

**OPERATING AND FINANCIAL REVIEW (continued)****D. OPERATIONAL PERFORMANCE (continued)****Wastewater services and the environment**

The operation of such an extensive wastewater infrastructure has the potential to cause adverse effects on the natural environment. Southern Water's goal is to minimise these potential impacts by ensuring that pollution incidents are kept to a minimum and treated wastewater is appropriately and safely recycled back into the environment. We are committed to meeting or improving upon legislative and regulatory environmental requirements and codes of practice.

Unfortunately there has been deterioration in some aspects of our environmental performance during 2011 in particular pollution incidents and treatment works compliance. To address this we have instigated a wide scale programme of works across our wastewater asset base in order to reverse this recent performance.

***Pollution incidents (based on calendar years)  
(Category 1 'Major', Category 2 'Significant')***

2005 performance	13 Category 1&2 pollution incidents
2006 performance	15 Category 1&2 pollution incidents
2007 performance	7 Category 1&2 pollution incidents
2008 performance	4 Category 1&2 pollution incidents
2009 performance	9 Category 1&2 pollution incidents
2010 performance	7 Category 1&2 pollution incidents
2011 performance	21 Category 1&2 pollution incidents

***Wastewater treatment works compliance (No. of works failures of numeric consents – based on calendar years)***

2005 performance	14
2006 performance	15
2007 performance	3
2008 performance	3
2009 performance	4
2010 performance	4
2011 performance	11

Southern Water recognises that its activities have an effect on the natural environment, through the abstraction of water for supply and the release of treated wastewater to water courses and the marine environment. Both abstraction and the recycling of wastewater are regulated by the Environment Agency via abstraction licences and discharge consents.

During the 2011 calendar year the majority of our 370 Wastewater Treatment Works met their consent conditions but, unfortunately, 11 failed.

Pollution incidents occur mainly as a result of issues in the sewerage network. Incidents are classified as Category 1, 2 or 3 by the Environment Agency with categories 1 and 2 representing the most serious incidents. While Southern Water always works hard to avoid any incidents occurring, the nature of wastewater operations and the extent of the sewerage network mean that, on occasions, there will be some incidents. Southern Water has an incident response team to ensure that where incidents do occur, their impact on the environment is minimised. Both minimising the number of pollution incidents and ensuring compliance with discharge consents continue to be part of the Company's targets.

**Bathing water quality**

During the 2011 bathing water season (1 May to 30 September) the Environment Agency tested 82 beaches in the region for compliance with the EU Bathing Water Directive standards. Only one of these beaches failed to meet the mandatory or 'good' EU standard. This failure was not associated with Southern Water infrastructure. Furthermore 76 per cent met the much stricter (20 times tighter) guideline or 'excellent' standard.

**OPERATING AND FINANCIAL REVIEW (continued)**

**D. OPERATIONAL PERFORMANCE (continued)**

**Energy use**

Southern Water is implementing a range of initiatives during AMP5 to reduce energy consumption and CO2 emissions to mitigate climate change

We have made significant investment in biogas fuelled CHP (Combined Heat and Power) and now have 13 operational units with the capacity to generate over 13 per cent of our power demand. The CHP units produce renewable energy by capturing bio-gas created during the wastewater treatment process. This gas is then used to provide power and heat to the works, with any surplus power exported to the National Grid. The amount of renewable energy we generated from our CHP units increased by 30 per cent in 2010-11 and in 2011-12 this increased by a further 9 per cent.

Work also started during the year to build a new CHP unit at our new Peacehaven Wastewater Treatment Works (WTW). We are also investigating the delivery of a further 3 CHP units at Bexhill and Hastings WTW, Ford WTW and Sandown WTW and these units are expected to be fully operational in 2013. Additional CHP heat recovery is also being considered at Budds Farm WTW and Millbrook WTW so that all our process thermal requirements can be met via renewable sources.

Opportunities for solar energy are also being explored. Changes to the Government incentives available have caused some uncertainty within the solar power industry and this has created delays but we continue to review the opportunities to add solar power to our renewable generation portfolio.

Some of our standby generators are being updated to provide additional capacity for Short Term Operating Reserve (STOR) which is a scheme where National Grid can call upon our generators to operate during times of high energy demand on the network in exchange for an "Availability" and "Utilisation" payment.

**Energy efficiency**

Improved energy efficiency is also a key focus for AMP5 and we have a range of initiatives including improved pump and blower efficiency monitoring to enable approximately 100 of our largest and most used pumps and blowers to always operate at the peak of their performance.

Advanced aeration control is another initiative that we are exploring. The technology aims to deliver the correct amount of air to the aeration lanes in our wastewater treatment works based on the influent quantity and quality in real time, thus avoiding over aeration and wasted energy. The same project will also enable reduced use of chemicals such as polymer and methanol.

We are also making significant investment in improving management information on energy consumption, to help our carbon footprint as well as reduce costs. We have installed 2,000 smart meters at our smaller sites to provide accurate and timely consumption data which is transmitted to our Energy Management System. We are now reaping the rewards of this more accurate billing and consumption data, as estimated billing is avoided and the accuracy of our reporting on energy consumption, costs and carbon emissions is significantly improved. Rolling the smart metering programme out to a further 1,000 sites is also being considered.

**OPERATING AND FINANCIAL REVIEW (continued)**

**D. OPERATIONAL PERFORMANCE (continued)**

**Cleaner Seas for Sussex**

Southern Water started construction work during the summer of 2009 on its £300m scheme to bring significant environmental improvements to the East Sussex coastline around Brighton. The Company is building a wastewater treatment works and sludge recycling centre on land at Lower Hoddern Farm in Peacehaven. Once complete it will deliver modern wastewater treatment facilities to serve the communities between Hove and Peacehaven and will ensure that we meet the requirements of the EU Urban Wastewater Treatment Directive.

Southern Water awarded a contract to B&H 4Delivery in June 2009 to commence the building works to deliver this vitally important scheme by the spring of 2013. Work is nearing completion on ten sites located between Brighton Marina and Friars Bay, Peacehaven, constructing the new wastewater treatment works, 11 kilometres of new sewer tunnel, three pumping stations, and access points to allow us to connect the new system to the existing sewer network.

The concrete structures, including the pumping stations at Marine Drive and Portobello, as well as the treatment works at Peacehaven, are mostly complete. Finishing works and landscaping works are ongoing at all sites. Mechanical and electrical fittings at all sites are ongoing with most of the plant installation complete. Testing and commissioning of various components of the pumping stations and treatment works commenced in December 2011.

All sections of the new sewer tunnel between Brighton Marina and Peacehaven are now complete. The outfall tunnels from Peacehaven to Friars Bay as well as the section of the outfall pipe under the seabed are also now complete. The remaining work at the outfall pipes will be completed in the first half of 2012.

Extensive community and stakeholder engagement is being conducted, and includes sponsorship and other initiatives, such as newsletters, a dedicated website, community liaison group meetings, one-to-one meetings, letters and updates.

## **OPERATING AND FINANCIAL REVIEW (continued)**

### **E. LOOKING AHEAD**

#### **AMP5**

2011-12 was the second year of the current five year regulatory period, AMP5

Over this period Southern Water expects to deliver capital investment of about £1.8bn. This expenditure will allow us to maintain our asset base in a way that continues to deliver stable service to customers, as well as secure adequate resources to meet growth and deliver environmental improvements and improved levels of service.

The largest single project in the programme is the completion of the Cleaner Seas for Sussex project, which commenced in AMP4 and is expected to be complete by March 2013.

Our five year Universal Metering Programme will increase the proportion of customers who pay according to measured volumes to 92 per cent. We believe water metering is the fairest way to charge for water and the overwhelming majority of our customers agree. The programme will entail the installation of around 486,000 meters. During the year we reached the landmark of 150,000 meters installed under the programme. We also began switching the first customers to a metered charge basis. Following installation of the meter all customers are given a three-month period to understand and, if appropriate, adjust their consumption before the meter is 'switched on'. Metering leads on average to consumption reductions of about 10 per cent. Our programme will, therefore, help ensure that we can meet the demand of all of our current and future customers as well as benefit the environment.

Delivering 'stable' serviceability across all of our assets is a key target for AMP5. In 2010-11 we assessed our wastewater infrastructure assets as less than stable. Ofwat agreed with our assessment and we embarked on a wastewater Below Ground Improvement Plan (BGIP) designed to return our performance to stable. For wastewater non-infrastructure and both water sub-service areas, serviceability was assessed by both Ofwat and us as stable. For wastewater infrastructure, five of the six measures have either improved since last reporting period, or have been maintained as stable. The sixth measure of pollution incidents did not improve. Whilst the pollution measure would not indicate 'stable' serviceability if considered in isolation from other factors, the overall improvements in other factors and detailed investigation into causes of pollutions indicate an overall stable position.

#### **The 2014 price review**

Ofwat will next set price limits for the industry in 2014. For the past 18 months it has been engaged in an extensive review of its approach to setting price limits and will publish more details on 'Future Price Limits' proposals in the Autumn. What is clear is that there will be considerable changes to some aspects of the price setting process and an additional focus on companies' engagement with customers and other stakeholders.

We have already begun our preparations for the price review, establishing our programme management office and beginning our engagement with customers and stakeholders on the long term outcomes they want delivered. Over the next year we will be reviewing and publishing our long-term strategy, reflecting the external pressures on the industry and the outcomes our customers tell us they want us to deliver.

As required by Ofwat, we have also established a Customer Challenge Group (CCG) whose role will be to challenge the Company's plans and the robustness of its engagement with customers and report to Ofwat on the same. Anna Bradley has been appointed as the independent Chair of this new Group and the first meetings have been held. We believe Anna's expertise and experience as a customer advocate, and the collective experience and skills of the group, will deliver significant benefits to our plans and we look forward to working positively with the CCG throughout the price review process.

#### **Water White Paper**

As well as Ofwat's programme of regulatory reform, in December the Government published a Water White Paper setting out its vision for the industry. The White Paper set out proposals to improve the management of water resources, extend competition for commercial customers and facilitate entry at other points in the value chain. However, it did not mandate legal separation of retail and wholesale functions, as proposed by the Cave Review of Competition in the sector, noting its commitment to maintaining investor confidence in the sector through evolutionary reforms.

As a company operating in a particularly water-stressed part of the country, we welcome the proposals for reform of the water abstraction regime and look forward to working with both Ofwat and Defra to develop the proposals. We also welcome the commitment of both Government and Ofwat to maintaining a stable regulatory and legislative regime for the sector, which will need to continue to attract significant investment to deliver improvements to customers and the environment.

**OPERATING AND FINANCIAL REVIEW (continued)**

**F. RESOURCES AND KEY RELATIONSHIPS**

**Management**

The Board of Southern Water is responsible for the overall strategic direction of the business. During the year the Board has consisted of two executive directors, the Chief Executive Officer and the Chief Financial Officer, an independent non-executive Chairman, and five non-executive directors, of whom three are independent. We are required by our regulatory licence to have at least three independent non-executive directors.

Details of the Board are given on page 27 of the accounts and published on our website.

The day-to-day operations of the business are overseen by the Executive Management Team. This group, led by the Chief Executive Officer, consists of the Chief Financial Officer and the directors of each department: Market Reform and Business Effectiveness, Operations, Capital Delivery & Commercial, Asset Management, Customer Services, IT and Estates, Human Resources, Communications and the Company Secretary and General Counsel.

**People**

At the year end, Southern Water had 1,898 full time equivalent (FTE) staff across the region. This number has increased by 336 from last year. We have seen a total of 488 FTE starters within the 2011-12 financial year, compared to 181 FTE starters in the 2010-11 financial year. This increase is driven by strengthening the asset management capability, company wide "Shaping the Future" initiatives and in-sourcing some previously out-sourced activities.

Southern Water's focus has been to drive employee engagement and business performance through integrated organisational development, reward and learning and development strategies. The Company is committed to improving employees' skills through continued learning, and our investment in staff development continued through the year. During the year, 110 employees attended Leadership Conferences to engage people and develop business solutions to further improve operational performance and services to customers.

The development of the skill base was further enhanced during the year with an increased intake of apprentices and graduates to the business. In addition, we continued the sponsorship of an innovative engineering Masters degree in conjunction with the University of Brighton alongside some of our service delivery partners such as Morrison, 4D, and Clancy Docwra.

The Company also opened a training facility within our Falmer offices to increase the flexibility of our training delivery, and developed a Shaping the Future initiative to improve Programme & Project Management, and Performance Management skills across the organisation, alongside an accredited development programme for first line managers.

**Key Partners**

The Multi Services Framework agreement, awarded in 2009 for all core Utility Services in AMP5, is provided to Southern Water by

- Clancy Docwra Limited for maintenance of the water distribution and sewerage networks across the whole region and Mechanical & Electrical (M&E) work on the Isle of Wight,
- Morrison Utility Services Limited for Mechanical & Electrical work in the East of the region,
- Barhale Trant Utilities Limited for Mechanical & Electrical work in the West.

Our commercial arrangements continue with 4Delivery to deliver the £300m Cleaner Seas for Sussex wastewater treatment scheme in Peacehaven and the Single Entity Contract (SEC) to deliver the quality improvements projects to treatment works across our region.

As of 1 October 2011, property owners were no longer responsible for certain sewer pipes that connect their homes to public sewers. New legislation transferred responsibility for these pipes, called private sewers and lateral drains, to Southern Water. To support this, and following an open-market competitive tender, Southern Water awarded a four year framework contract to Dyno-Rod Ltd for sewerage maintenance services including blockage clearance, CCTV and sewer repair services.

Southern Water also awarded a new 5 year Waste Management and Recycling Contract to MTS Cleansing Services Ltd, commencing in November 2011. MTS now handle all inter-site, emergency and non-routine tankering and cake operations, as well as removal of grit and screenings, general rubbish and fly tipped material together with all bio-solids recycling.

**OPERATING AND FINANCIAL REVIEW (continued)**

**F. RESOURCES AND KEY RELATIONSHIPS (continued)**

**Key Partners (continued)**

Southern Water awarded a contract, through its Multi Services Framework, to Morrison Utility Services for 48.5km of mains renewal in Chatham, Kent. The 18 month programme commenced in the summer of 2011.

Following a detailed review of our regulatory water sampling and analytical requirements, Southern Water agreed to extend the Water Quality Services Contract with Eurofins Environmental Limited to June 2015. Eurofins has been providing these services to Southern Water since July 2007.

## OPERATING AND FINANCIAL REVIEW (continued)

### G. RISK MANAGEMENT

A central database of key risks is maintained and managers and relevant staff have access and the ability to raise and manage risks. Risks are assessed in terms of impact in the following areas

- Financial
- Reputation
- Health and safety
- Security of supply
- Regulatory, environmental and legal

Creating clear visibility throughout the organisation of all key risks ensures that adequate controls are put in place, and mitigating action taken, to reduce the impact and/or likelihood of the risk materialising. All risks within the database are assigned to designated managers to ensure clear ownership of each risk and responsibility for its control and mitigation.

All risks scoring in the highest category are reviewed by the Chief Executive Officer and all risks above a specified threshold are reviewed regularly by the Executive Management Team. Newly registered, or escalating risks are alerted to a relevant manager, Director, or the Chief Executive Officer as appropriate.

Over the period of review, the Company governance process required senior managers to sign a six-monthly Letter of Compliance, certifying that the function for which they are responsible understood the importance of risk management and that risks of corporate significance were raised and managed in accordance with Company guidelines.

### KEY RISKS

#### Regulatory risk

Southern Water is a highly regulated business. The water sector has three main regulators – Ofwat, the Environment Agency and the Drinking Water Inspectorate. Not meeting any of the regulatory requirements or failing obligations placed upon the Company by regulators could result in financial loss through the price setting mechanism, fines, legal enforcement action and ultimately the loss of the appointment as a water and sewerage undertaker. Any change in regulatory policy could also have a significant impact on the organisation. The most prominent of these risks currently is the risk of adverse changes to the regulatory regime and market reform.

Ofwat continues to review and revise the regulatory regime to ensure it remains fit to face the challenges of the future, including the greater use of market mechanisms in order to drive innovation and efficiencies. This raises the risk that any significant changes to the regulatory regime will disadvantage water companies in general or Southern Water specifically.

#### Mitigation

We continue our constructive engagement with Ofwat and Defra on the proposals for reform and are also working with Water UK to ensure that any changes deliver better, more effective, regulation in the interests of all stakeholders.

#### Operational risk

Water and sewerage services are essential to public health and the safeguarding of the environment. Whether arising from a failure to maintain and invest in assets or operational issues, any failures could lead to interruptions to public water supplies, risk to health through supply of unfit water, or severe environmental damage from the failure of our wastewater assets. These are ongoing risks which are managed as part of the everyday business, but the impact of failure is potentially significant for both customers and the environment.

The key risks in this area are as follows:

#### **The risk of not containing pollution incidents and works compliance targets not being met**

Southern Water operates 370 wastewater treatment works and, following the adoption of private sewers in October 2011, now manages approximately 39,000km of sewers across five counties. While one of the key objectives for the Company is to minimise the impact of its operations on the environment, the scale of these operations means that despite proactively managing associated risk, some incidents and compliance failures still occur, perhaps as result of poor maintenance, human error or system incapacity.

As well as the risk of damage to the environment, or distress to customers, such incidents can impact our serviceability rating given by Ofwat, lead to prosecutions by the Environment Agency and fines being imposed, and damage the reputation of Southern Water.

**OPERATING AND FINANCIAL REVIEW (continued)**

**G. RISK MANAGEMENT (continued)**

**KEY RISKS (continued)**

**Operational risk (continued)**

**Mitigation**

Southern Water has recruited 60 new Asset Management roles and is investing approximately £400m on wastewater asset maintenance over AMP5. It also has a pollution incident response team on standby to ensure that where incidents do occur, their impact on the customers and environment is minimised. Significant focus continues in the area of pollution reduction through a dedicated team leading planned programmes of sewer maintenance and rehabilitation, rising main replacement, extensive jetting and condition-based monitoring.

**The risk of not containing microbiological failures and water supply works compliance targets not being met**

Southern Water operates 94 water supply works across the region. It is essential for the Company to minimise any breach of regulations affecting water quality to reduce any public health risks. The safeguarding of public health is paramount and we have in place control procedures to ensure this. Any regulation breach is thoroughly investigated and action taken to correct.

Such incidents can lead to enforcement by the Drinking Water Inspectorate and affect our serviceability rating given by Ofwat, both of which can damage the reputation of Southern Water.

**Mitigation**

To minimise the risk of such incidents and failures, Southern Water is carrying out a Water Compliance Project which has and will continue to deliver improvements to all operational water supply works over the early part of AMP5.

**The risk to security of supply**

Southern Water supplies drinking water to over 1 million properties across Kent, East and West Sussex, Hampshire and the Isle of Wight. Following two successive winters of significantly lower than average rainfall there is a risk that the water resources available will not meet customer demand.

**Mitigation**

To minimise the risk to customers' supplies the Company has implemented its Company Drought Plan. The measures already implemented have

- Reduced leakage to below the Company target,
- sought drought permits to increase the storage in Bewl Water,
- issued temporary use bans across all Sussex and Kent,
- changed the mode of operation of water sources and commenced strategic transfers to move water between reservoirs and water supply zones,
- undertaken a comprehensive water awareness campaign to make customers aware of the drought and the need to be water efficient.

**OPERATING AND FINANCIAL REVIEW (continued)**

**G. RISK MANAGEMENT (continued)**

**KEY RISKS (continued)**

**Financing risk**

The Company intends to at least maintain its present risk profile. It does not enter into treasury transactions for the purpose of speculation, but will do so only to manage risk inherent in the business or funding on a prudent basis.

Negative cash flows before financing, which have been a feature of the water industry since privatisation as a result of mandatory capital investment requirements, result in an ongoing need to maintain access to the capital markets.

**The risk of a significant increase in interest rates or closure of the capital markets to water companies in general**

Any significant movement in interest rates or reduction in the availability of credit to the water industry might put at risk the Company's ability to finance the future capital investment programme.

**Mitigation**

This risk is managed by ensuring that sufficient cash reserves and liquidity facilities are maintained to finance business operations for at least 12 months, and the aggregate nominal value of debt maturities does not exceed 40 per cent of RCV in any single regulatory period (and 20 per cent of RCV in any 24 month period). Exposure to interest rate rises on current borrowings is also hedged by a subsidiary company, Southern Water Services (Finance) Limited, and accordingly current borrowings are at either fixed rates or index-linked.

There are no debt maturities to 31 March 2013, with the next debt maturity being a £100m bank loan due June 2013.

The Company ensures that sufficient funds are available for its operational and capital investment programme through ongoing monitoring and forecasting of cash flow and takes steps to manage this accordingly.

**The risk of a sustained period of negative inflation**

Although inflation is currently above the Bank of England target, both revenues and capital values are linked to RPI, and a sustained period of negative inflation causing a reduction in cash inflow from revenue linked to inflation, along with a reduction in the Regulatory Capital Value would result in a strain on the debt/RCV ratio included in our debt covenants.

**Mitigation**

This risk is managed by the inclusion of index-linked debt and derivatives within the borrowing portfolio of Southern Water, which has the result of moving the value on index-linked debt and derivatives in line with movements in inflation, albeit with a time lag.

**The risk of a ratings downgrade below investment grade**

An investment grade credit rating is required to be maintained to ensure continued access to the capital markets, in order to efficiently finance the capital investment programme, and to refinance existing debt maturities when they fall due. This requirement is a condition of the regulatory licence (and also a primary duty of Ofwat when setting prices to ensure companies can finance their functions), and a condition of borrowing covenants where a failure to maintain certain prescribed credit ratings could lead to a restriction on dividend payments.

Credit ratings are

- Standard & Poor's Class A debt, A-(negative outlook), Class B debt, BBB (negative outlook)
- Fitch Class A debt, A-, Class B debt, BBB
- Moody's Class A debt, Baa1 (negative outlook), Class B debt, Ba1 (negative outlook), Corporate family rating Baa2 (negative outlook)

**Mitigation**

The Company has an internal business plan which is expected to stabilise the overall credit rating position.

A primary duty of Ofwat when setting prices is to ensure companies can finance their functions and a company can apply to reset customer prices during the five yearly regulatory period through an Interim Determination of K (IDoK).

**OPERATING AND FINANCIAL REVIEW (continued)**

**G. RISK MANAGEMENT (continued)**

**KEY RISKS (continued)**

**Capital investment risk**

The 2011-12 accounts mark the completion of the second year of the current five year regulatory review period. For this period, a capital investment programme of £1.8bn has been allowed for in price limits by Ofwat.

**The risk of not delivering the capital programme**

Whilst the Company remains on target to deliver the programme, there are pressures on the programme which are being managed to deliver Regulatory outputs and stable serviceability within the funding allowed by Ofwat. Failure to deliver significant elements of the capital programme, risks adjustments to the Regulatory Capital Value at the next review, enforcement action by the Environment Agency, DWI or Ofwat and threatens the integrity of services.

**Mitigation**

Progress against the allowed investment programme is monitored closely to ensure that any risks or potential programme slippage are pro-actively managed with our regulators and other stakeholders.

**The risk of a significant impact from the adoption of private sewers**

The new legislation to transfer privately owned sewers and lateral drains to water and wastewater companies came into effect on 1 October 2011. The total length of transferred sewers is unknown, but we estimate that it may be as much as 17,000 km, which has a potentially significant impact on our capital and operational expenditure. However, the level of incidents so far on the newly transferred sewers is significantly lower than that expected, and planned for, which could be attributed to lower than expected rainfall since adoption of private sewers and low customer awareness of the new legislation.

**Mitigation**

A reactive sewers team which includes our contractor Dyno-Rod was set up to maintain serviceability of the newly adopted assets. The costs associated with maintaining these newly adopted assets were not allowed for when Ofwat set price limits in 2009 but, as this is a change of legislation, they qualify as a 'relevant change of circumstance' under the conditions of our Licence, which means that we can apply to Ofwat for an interim determination of our K factor (IDoK) to recover the costs incurred.

If the low level of activity experienced to date continues the costs of private sewers will not reach the materiality threshold required to qualify for an IDoK. However significant elements of the expenditure will be "logged up" and charges recovered in future periods.

## OPERATING AND FINANCIAL REVIEW (continued)

### H. CORPORATE RESPONSIBILITY

#### Environmental Governance

In 2008 Southern Water was registered to ISO14001, the international standard for environmental management. Southern Water's management is committed to the development and execution of its environmental management system requirements. In 2011 we were pleased to be re-certified to this standard.

The aims of Southern Water's Environmental Management System (EMS) are

- To identify, manage and mitigate our impacts on the environment to ensure that present and future environmental effects are controlled and that the Company's environmental performance continually improves
- To ensure compliance with environmental legislation, to identify and minimise environmental risk, to prevent pollution and to maximise efficiency savings

The scope of Southern Water's ISO14001 certification covers "the supply of water and treatment of wastewater, including management of capital projects by project teams and supply chain arrangements, control of operational and maintenance activities on our assets, control of waste and its transfer on specific sites and landfill facilities"

Southern Water's full commitment to the environment is presented within the Environment Policy, signed by the Chief Executive Officer. This is communicated to all employees and relevant contractors.

We have examined the Company's operational activities to determine their potential impact on the environment and combined this with environmental legislation and regulations that apply. This influences environmental improvement and action plans through the development of objectives and targets, which are reviewed on a regular basis. This effectively maintains the performance commitments in our Environment Policy, supported through a programme of training, checking, audit and management review.

#### Health and Safety

We recorded our best ever annual health and safety performance in terms of reportable injuries (RIDDORs) in the reporting year. The figure of seven RIDDORs in 2011-12 beat our previous best result of eight, which was recorded the year before. We believe this performance is sector leading and is in the order of twice as good as the industry average.

The health and safety of all employees, customers and contractors is an ongoing priority for the Company. There are regular meetings of employee representatives and every member of staff can see and comment on the health and safety corporate policy statement.

Other health and safety successes included receiving the Royal Society for the Prevention of Accidents (RoSPA) President's Award for the fourth year running. This award is presented to companies which have achieved excellent health and safety performance over a number of years. Several key contractors were also recognised by RoSPA, winning a number of awards during the year.

During 2011-12, a range of health and safety initiatives were run by the Company and contractors under the award-winning 'Aim for Zero Injuries' campaign. A health and safety conference took place for more than 250 operational staff and key contractors as part of a number of activities to support the European Week of Safety and Health. A conference for office-based staff was held for the first time and concentrated on topics related to health and wellbeing. In addition, the Company continued to support campaigns by the UK Health and Safety Executive (HSE) and the European Agency for Safety and Health at work.

The Company is a member of the HSE's stakeholder group and has played an active role as a partner in developing the new Estates Excellence model for improving health and safety which has been adopted for national implementation.

#### Community Programme

We continue to play an active part in the communities we serve and are committed to supporting them through a series of programmes, partnerships, sponsorships and donations.

Our flagship Learn to Swim programme reached its 20<sup>th</sup> year in 2012 and a congratulatory Early Day Motion was tabled in the House of Commons. The scheme teaches about 38,000 children to swim each year and during the year, five new pools and clubs joined, bringing the total number to 85. Paralympic gold medallist Sascha Kindred and Olympic gold medallist Duncan Goodhew act as ambassadors for the award-winning programme which is also supported by British swimmer Karen Pickering.

**OPERATING AND FINANCIAL REVIEW (continued)**

**H CORPORATE RESPONSIBILITY (continued)**

**Community Programme (continued)**

We continued to sponsor the South and South East in Bloom competition, which attracted 251 entries, including 85 in the schools' section. We also continued our award-winning Blooming Schools programme in which more than 74,000 children have created 494 gardens in their schools. To celebrate the 10<sup>th</sup> anniversary of the sponsorship, we held a competition to create a community legacy garden. Children from the winning school, St Margaret's at Angmering in West Sussex, created the garden with the help of celebrity gardener Chris Collins.

Now in its 13th year, our popular water efficiency play, *The Drips*, was seen by more than 4,000 children aged five to 11. Facepack Theatre visited 24 schools and gave performances of the show, which incorporates our water efficiency and water for health characters Mr Save-It and Mr Drink-It.

Ten secondary schools from across our region took part in the 2011 Water Design Challenge. The Education programme, which supports our five-year metering programme, tasked the students to come up with ways to save water with the support of a professional design mentor. The winning school, Fort Pitt Grammar in Kent, designed a water-saving toilet cistern device which was presented at the Big Bang 2012, the largest science and technology event in the UK.

We launched a programme of partnerships with professional sports clubs in our region. The Sporting Chance programme includes:

- Saints and Savers – an education programme delivered in partnership with the Saints Foundation, the charity arm of Southampton Football Club. Workshops promoting water for health and water efficiency took place in 25 schools in Southampton and involved 2,719 children.
- GLOW – Gillingham Learn Our Way puts youth coaches from Gillingham Football Club into schools across the Medway towns in Kent. The programme, which promotes water for health, is engaging with about 1,000 pupils.
- Southern Water Ashes – our partnership with Sussex Cricket Club brought the sport to 500 students in Sussex and highlighted the importance of drinking water for health.
- Albion in the Community – an education programme delivered by the community arm of Brighton and Hove Albion Football Club that focuses on the importance of water in our lives, water for health and water efficiency was launched with 880 children taking part in the first year.
- Nelson Investigates – primary school children in Portsmouth are benefiting from a programme run in partnership with Portsmouth Football Club's Community and Study Centre. In the first year nearly 500 students were involved in workshops which explained the history of the sewer system and showed where wastewater goes before it is released into the environment. The workshops also highlighted the problems caused when fat, oil and grease and non-biodegradable items are disposed of in the sewer system.
- Tennis in Eastbourne – we partnered with not-for-profit organisation Tennis in the Park to take the sport into primary schools in the town, giving 400 children the chance to take part. We also held a tennis taster day, which was visited by more than 3,000 people and also promoted water for health.

We worked in partnership with the Smallpiece Trust to deliver STEM Days in 10 secondary schools on the Isle of Wight and Isle of Sheppey. About 500 students took part in a water-themed practical challenge, using skills associated with science, technology, engineering and maths. In addition, we joined STEM Sussex to work with students in Brighton as part of the Engineering Education Scheme. Members of our Peacehaven team helped youngsters to solve real-life problems associated with large construction projects.

We again supported the Brighton Theatre Royal's creative educational programme and more than 180 children attended workshops where they learned the importance of staying hydrated during exercise. In addition, we continued to support the Brighton Festival Fringe by sponsoring Fringe City and 1,642 people visited Brighton's Victorian sewers on organised tours.

During the summer, our water café visited 17 events to promote water efficiency across our water supply area. We were also actively involved in Junior Citizen events in Horsham and Crawley, engaging with more than 2,000 young people about water efficiency.

We supported numerous other events and projects, including Kent Coastal Week, a programme of activities for families around the Kent coastline, Trees for Shade, a tree planting scheme in association with West Sussex County Council, Run the World, in which 4,238 children from Brighton ran 1km, totalling the distance from Brighton to Bangalore, Personal Bests, a school sports programme in Winchester, and Even Keel, a sailing programme for youngsters in Kent.

## **OPERATING AND FINANCIAL REVIEW (continued)**

### **H. CORPORATE RESPONSIBILITY (continued)**

#### **Community Programme (continued)**

More than £325,000 was raised through charity events. These included our annual ball, which raised £110,000 for the National Society for the Prevention of Cruelty to Children, the Royal National Lifeboat Institution, Cancer Research UK and WaterAid. The same charities benefited from £80,000 raised at our annual race day, along with St Barnabas Hospice, AAIR (Asthma, Allergy and Inflammation Research), Chestnut Tree House Children's Hospice, Help for Heroes, Macmillan Cancer Support and our regional Air Ambulance Trusts.

Our 12th WaterAid golf day raised £10,000 for the charity, which provides water, sanitation and hygiene education to some of the world's poorest people. Our Health and Safety Charity Challenge, in which we make a donation for each hazard or near miss reported in the workplace, raised £13,640 for regional Air Ambulance trusts.

In addition, monthly Dress Down Days and charity initiatives at our main offices raised more than £19,000 for 40 charities and our Community Chest forum made 115 donations totalling over £10,175.

Staff contributed £2,324 through the company workplace giving scheme and another £1,550 was donated to staff for charity fundraising activities.

Our Community Volunteering Programme gives staff the opportunity to spend two days a year helping a charity or community project and 208 days were taken during the year.

Staff from the Company delivered 73 Waterwise talks to 2,589 people including schools and community groups.

#### **Awards and Achievements**

Our work was recognised with a number of awards:

- In the 2011 Utility Industry Achievement Awards, our Church Farm reservoir at Hardham in West Sussex won the Capital Project Management category while our 'intelligent' water metering programme was named IT Initiative of the Year.
- We were successful for the sixth consecutive year at the 2012 Water Industry Achievement Awards, winning the Customer Satisfaction Initiative of the Year category for our sympathetic approach to customer debt through our Debt Advice Centre. We were also highly commended in the Carbon Reduction Initiative of the Year category. This recognised our industry-leading work with MWH/4Delivery on catchment-based consenting which focuses on how we can meet required quality standards at wastewater treatment sites at a lower carbon cost. We were also shortlisted in three other categories.
- Our communications team was named Outstanding In-House PR Team for the fifth consecutive year at the regional Chartered Institute of Public Relations (CIPR) Awards in both the Home Counties South and Wessex areas. We also won nine other gold CIPR awards for initiatives including our Learn to Swim scheme, Drips school play, campaign and website to inform customers about our metering programme and our communications and community work in building a new wastewater treatment works at Peacehaven in Sussex.
- Our Learn to Swim scheme won the Best Corporate Social Responsibility Strategy category in the 2011 CorpComms Awards.
- Our health and safety performance was recognised with a further Royal Society for the Prevention of Accidents (RoSPA) President's Award, presented to companies demonstrating outstanding performance in health and safety.
- We received new ISO 14001 certification for the next three years, confirming that we continue to meet the international standard for Environmental Management Systems.
- We were again awarded the Carbon Trust Standard in recognition of our steps to measure and manage carbon emissions over a three-year period.
- In the Considerate Constructors Scheme's 2011 National Site Awards, we won silver for our Ashford Wastewater Treatment Works, Eastney Pumping Station and Peacehaven projects and bronze for our Twyford Water Supply Works scheme.

## SOUTHERN WATER SERVICES LIMITED

### REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2012

The directors of Southern Water Services Limited (Registered no 02366670) present their report and the audited financial statements for the year ended 31 March 2012

#### PRINCIPAL ACTIVITIES

The principal activities of the Company, also referred to as SWS, are the provision of water supply and wastewater services in the South East of England. The Company is regulated by the Water Services Regulation Authority (Ofwat) and supplies water to over 2.4 million people and provides wastewater services to 4.4 million people.

#### BUSINESS REVIEW

The information that fulfils the requirement of the business review can be found in the Operating and Financial Review (OFR) on pages 5 to 26, which are incorporated in this report by reference.

#### FUTURE DEVELOPMENTS

The information regarding future developments of the Company can be found in the Operating and Financial Review (OFR) on pages 5 to 26.

#### RESULTS AND DIVIDENDS

The profit and loss account on page 33 shows the Company's results and profit for the year. Further details are also available in the OFR on pages 8 to 10.

Interim dividends of £751.44 per ordinary share (2010-11 £751.53 per share), totalling £42.1m (2010-11 £42.1m) were paid during the year to Southern Water Services Group Limited (SWSG). These dividends, along with associated group tax relief, enable SWSG to pay the interest of £56.9m due to Southern Water Services Limited on an inter-company loan as disclosed in note 7 to the accounts.

Total dividends paid and charged in the current financial year were £42.1m (2010-11 £77.1m). The directors do not recommend payment of a final dividend for 2011-12 (2010-11 £nil).

#### DIRECTORS AND THEIR INTERESTS

The directors who held office during the year ended 31 March 2012 and up to the date of signing the financial statements were as follows:

Michael Welton	(Chairman) ( <i>Resigned 20 February 2012</i> )
Colin Hood	(Chairman) ( <i>Appointed 20 February 2012, previously Non-Executive Director</i> )
Matthew Wright	(Executive Director – Chief Executive Officer)
Michael Carmedy	(Executive Director – Chief Financial Officer) ( <i>Appointed 1 November 2011</i> )
Robert Armstrong	(Independent Non-Executive Director)
Cheryl Black	(Independent Non-Executive Director)
David Golden	(Independent Non-Executive Director)
Peter Antolik	(Alternate Non-Executive Director) ( <i>Appointed 22 February 2012</i> )
Paul Moy	(Non-Executive Director)
Bronte Somes	(Alternate Non-Executive Director) ( <i>Appointed 19 July 2011</i> )
Surrnder Toor	(Alternate Non-Executive Director) ( <i>Resigned 20 February 2012</i> )
	(Non-Executive Director) ( <i>Appointed 22 February 2012</i> )
Jaron Yuen	(Alternate Non-Executive Director) ( <i>Resigned 19 July 2011</i> )

None of the directors who held office during the financial year had any disclosable interests in the shares of the Company or the Group.

#### RESEARCH AND DEVELOPMENT

The improvement of existing services and processes, together with the identification and development of new technology and solutions, are important aspects of the Company's strategy to enhance the quality of service to customers and improve methods of working. Research and development expenditure for the year amounted to £0.5m (2010-11 £0.9m, including £0.4m on fixed assets).

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**FINANCIAL RISK MANAGEMENT**

The Financial Risk Management policy is included in the OFR on pages 5 to 26

**EMPLOYEES**

***Employee involvement***

The Company recognises the importance of its employees and is committed to effective two-way communication and consultation

The Company has established Business Involvement Groups to facilitate meaningful consultation between Company Management and employees through elected Employee Representatives. The Groups meet regularly at both a functional and company-wide level. An employee survey is also completed on an annual basis to seek input from employees

The Company recognises the rights of every employee to join a trade union and participate in its activities. SWS has a single union agreement with Unison

The Company publishes its own in-house newspaper, 'Southern Water News' on a regular basis. General information is posted on the Company Intranet and regular team briefing sessions are also held. The information in these publications and briefings covers a wide range of subjects that affect the business including, progress on business and capital projects, the impact of regulatory issues, including the recent Ofwat price determination and wider financial and economic issues that may affect the Company

***Equal opportunity***

The Company's policy is to promote equality of opportunity in recruitment, employment continuity, training and career development. The Company takes full account of the needs of people with disabilities and follows set policies and procedures to support reasonable adjustments in the workplace

***Health and safety***

The Company recognises its duties to make proper provision for the health, safety and welfare at work of its employees

Every employee receives a copy of the corporate policy statement on health and safety. There are regular meetings of employee representatives and managers to consider all aspects of health and safety. In addition there is a health and safety management review group which ensures that there is an adequate system for meeting the Company's responsibilities for health and safety to its staff, customers and members of the public

SWS provides an internal occupational health service for employees, including the provision of physiotherapy. These services have been developed and are continuously reviewed to ensure they meet the needs of the business and our employees at work

**CREDITOR PAYMENT POLICY AND PRACTICE**

The Company's current policy and practice concerning the payment of its trade creditors is to follow the Better Payment Practice Code. Copies of the Code may be obtained from the Department of Trade and Industry or from the website [www.payontime.co.uk](http://www.payontime.co.uk)

The Company's policy and practice is to agree terms of payment when agreeing the terms of the transaction, to include the terms in contracts and to pay in accordance with its contractual and legal obligations. The Company's trade creditor days at 31 March 2012 were 57 days (2010-11 42 days)

**ENVIRONMENTAL ISSUES**

The Company is committed to meeting or improving upon legislative and regulatory environmental requirements and codes of practice, and aims to contain the environmental impact of its activities to a practicable minimum

The Company's environmental performance is reported in its annual Stakeholder Report. The Company recognises its responsibility to operate within a framework that supports sustainable development and has established, where possible, indicator targets which are measurable. Performance against these targets is monitored and reported regularly

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**CHARITABLE DONATIONS**

The Company made donations of £320,181 (2010-11 £286,403) to a variety of charities over the year. Donations in the year comprised £220,000 (2010-11 £220,000) to the Southern Water Charitable Trust Fund, a charitable trust set up to assist customers who are suffering hardship, poverty or a poor quality of life by providing grants to help them pay their water bills, and a further £100,181 (2010-11 £66,403) of donations to other charities within the region.

No political donations were made.

**LAND AND BUILDINGS**

In the opinion of the directors, the market value of land is significantly more than its book value, however it would not be practicable to precisely quantify this.

**GOING CONCERN**

The directors believe, after due and careful enquiry, that the Company has sufficient resources for its present requirements and, therefore, consider it appropriate to adopt the going concern basis in preparing the financial statements to 31 March 2012. Further information is set out in note 1 'Going concern' on page 37.

**QUALIFYING THIRD PARTY INDEMNITY**

Following shareholder approval the Company has also provided an indemnity for its directors and the secretary, which is a qualifying third party indemnity provision for the purposes of the Companies Act 2006.

SOUTHERN WATER SERVICES LIMITED

**REPORT OF THE DIRECTORS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**STATEMENT OF DIRECTORS' RESPONSIBILITIES**

The directors are responsible for preparing the annual report and the financial statements in accordance with applicable law and regulations

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that period. In preparing these financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently,
- make judgements and accounting estimates that are reasonable and prudent,
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements, and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the Company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

**STATEMENT OF DISCLOSURE OF INFORMATION TO AUDITOR**

Each of the persons who is a director at the date of approval of this report confirms that

- (1) so far as the director is aware, there is no relevant audit information of which the Company's auditor is unaware, and
- (2) he/she has taken all the steps that he/she ought to have taken as a director in order to make himself/herself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418 of the Companies Act 2006.

**AUDITOR**

Deloitte LLP have indicated their willingness to continue in office.

Approved by the Board of Directors and signed by order of the Board



Kevin Hall  
Company Secretary  
27 June 2012

## **CORPORATE GOVERNANCE**

Southern Water Services is a private company which is committed to maintaining high standards of corporate governance and the directors take account of the principles of good governance as described in the UK Corporate Governance Code

### **THE BOARD OF DIRECTORS**

The Board is responsible for the overall strategic direction of the business. During the year the Board has consisted of two executive directors, the Chief Executive Officer and the Chief Financial Officer, an independent non-executive Chairman, and five non-executive directors, of whom three are independent.

The Board reviews risk management arrangements and the effectiveness of the Company's internal control systems through the work of the Audit and Risk Review Committee.

A summary of the Company's principal risks is contained in the Operating and Financial Review section on pages 5 to 26. The Company has established a system of risk management that assists management in identifying, assessing, and mitigating financial, operational and compliance risks.

Matters reserved to the Board include major strategic and financial decisions, including investment and divestment, business and financial plans and significant contracts and commitments.

The Board held ten scheduled monthly meetings during the year, and received financial and performance reports for the other two months.

### **PRINCIPAL COMMITTEES OF THE BOARD**

The four committees of the Board are as follows:

- Audit and Risk Review
- Regulatory
- Health and Safety
- Compensation and Human Resources

Each committee has written terms of reference and the committees exercise oversight on behalf of the Board and provide advice to the Board in their remit areas. Other committees are formed as and when required to deal with specific matters.

#### **Audit and Risk Review Committee**

The committee is primarily responsible for reviewing and advising on matters relating to the annual statutory and regulatory accounts, and monitoring and reviewing the effectiveness of financial, operational and regulatory internal controls and risk management processes to identify and manage significant financial and non-financial risks and exposures. The committee considers any other corporate governance matters assigned to it by the Board.

#### **Regulatory Committee**

The committee has been primarily responsible for reviewing and advising on the Price Review for 2010-2015. It did not meet during 2011-12 but members of the Board met monthly with the Executive Management on regulatory matters. In 2012-13, these monthly meetings are continuing and the committee is resuming its remit to review governance, policy and strategy with regulatory implications and provide guidance on current, emerging and future regulatory matters, and to advise the Board generally on regulatory strategy.

#### **Health and Safety Committee**

The committee is responsible for reviewing and advising on the Company's health and safety policy and the implementation of, and compliance with, agreed policies, applicable guidance and standards. The committee reviews incident and accident prevention performance and policies, and any other matters assigned by the Board.

#### **Compensation and Human Resources Committee**

The role of the committee is to ensure that the Company's directors and senior managers are fairly rewarded for their overall contribution to Company performance, giving due regard to market rates, individual performance and the financial health of the Company. The committee reviews proposals for the total remuneration package, to include salary and benefits, and any other matters assigned by the Board.

**CORPORATE GOVERNANCE (continued)**

**PRINCIPAL COMMITTEES OF THE BOARD (continued)**

**INTERNAL CONTROL**

The Company's systems of internal control, including internal financial control, are designed to manage but not totally eliminate, the risk of failure to achieve business objectives. They only provide reasonable, but not absolute, assurance against material errors, losses, fraud or breaches of laws and regulations.

**Standing instructions**

In response to The Bribery Act 2010, which came into force on 1 July 2011, the Company revised and re-launched its policies on business integrity, covering matters such as bribery, business conduct, and ethics. The standing instructions to employees designed to enhance internal control are regularly updated and communicated to staff through the Company's intranet training and policy tools.

**Organisation Structure**

The organisation structure details lines of authority and control responsibilities. The performance management system establishes targets, reinforces accountability and awareness of controls, and identifies appropriate training requirements.

**Strategic Plan**

There are effective business planning, risk assessment and financial reporting procedures, including the annual preparation of detailed operational budgets for the year ahead and projections for subsequent years.

**Risk management**

Throughout the year, the Audit and Risk Review Committee and the Executive Management review and monitor risks and systems for internal control, supported by the use of risk registers.

**Internal audit and risk management**

An internal audit function provides independent scrutiny of internal control systems and risk management procedures.

**Control self-certification**

A self-certification process is in place whereby management is required to confirm that the system of internal control is operating effectively and employees are aware of the Company's principal policies.

**Auditor's independence and objectivity**

The Audit and Risk Review Committee is also responsible for reviewing and advising on the engagement, remuneration, effectiveness and independence of the external auditors and the scope of audit work.

Details of the fees paid to the external auditor during the year ended 31 March 2012 for audit and non-audit services are set out in note 4 to the financial statements on page 41 of this annual report and financial statements.

SOUTHERN WATER SERVICES LIMITED

**PROFIT AND LOSS ACCOUNT**

For the year ended 31 March 2012

	Note	2012 £m	2012 £m	2011 £m	2011 £m
<b>Turnover</b>	2,3		<b>716.2</b>		647.1
Cost of sales	3				
- before exceptional item		<b>(417.3)</b>		(382.6)	
- exceptional item	4	-		(38.6)	
Cost of sales including exceptional item			<b>(417.3)</b>		(421.2)
<b>Gross profit</b>			<b>298.9</b>		225.9
Administrative expenses	3		<b>(27.4)</b>		(34.5)
Other operating income	3		<b>0.1</b>		0.1
<b>Operating profit before exceptional item</b>			<b>271.6</b>		230.1
<b>Exceptional item</b>			-		(38.6)
<b>Operating profit</b>			<b>271.6</b>		191.5
Profit on disposal of fixed assets			<b>1.2</b>		0.8
<b>Profit on ordinary activities before interest and taxation</b>			<b>272.8</b>		192.3
Interest payable and similar charges	7		<b>(250.2)</b>		(240.5)
Interest receivable and similar income	7		<b>62.3</b>		60.3
<b>Profit on ordinary activities before taxation</b>	4		<b>84.9</b>		12.1
Tax on profit on ordinary activities	8		<b>(5.0)</b>		19.9
<b>Profit on ordinary activities after taxation</b>	20		<b>79.9</b>		32.0

The above results relate to continuing operations

The Notes on pages 37 to 58 form part of these financial statements

There is no difference between the profit on ordinary activities before taxation and the retained profit for the years stated above and their historical cost equivalents

SOUTHERN WATER SERVICES LIMITED

**STATEMENT OF TOTAL RECOGNISED GAINS AND LOSSES**

For the year ended 31 March 2012

	Note	2012 £m	2011 £m
<b>Profit on ordinary activities after taxation</b>		<b>79.9</b>	<b>32.0</b>
Actuarial (loss)/gain recognised in the pension scheme	20,22	<b>(40.0)</b>	48.6
Movement on deferred tax relating to pension deficit	17	<b>9.5</b>	(18.5)
Movement on current tax relating to pension deficit		-	4.1
<b>Total recognised gains for the year</b>		<b><u>49.4</u></b>	<b><u>66.2</u></b>

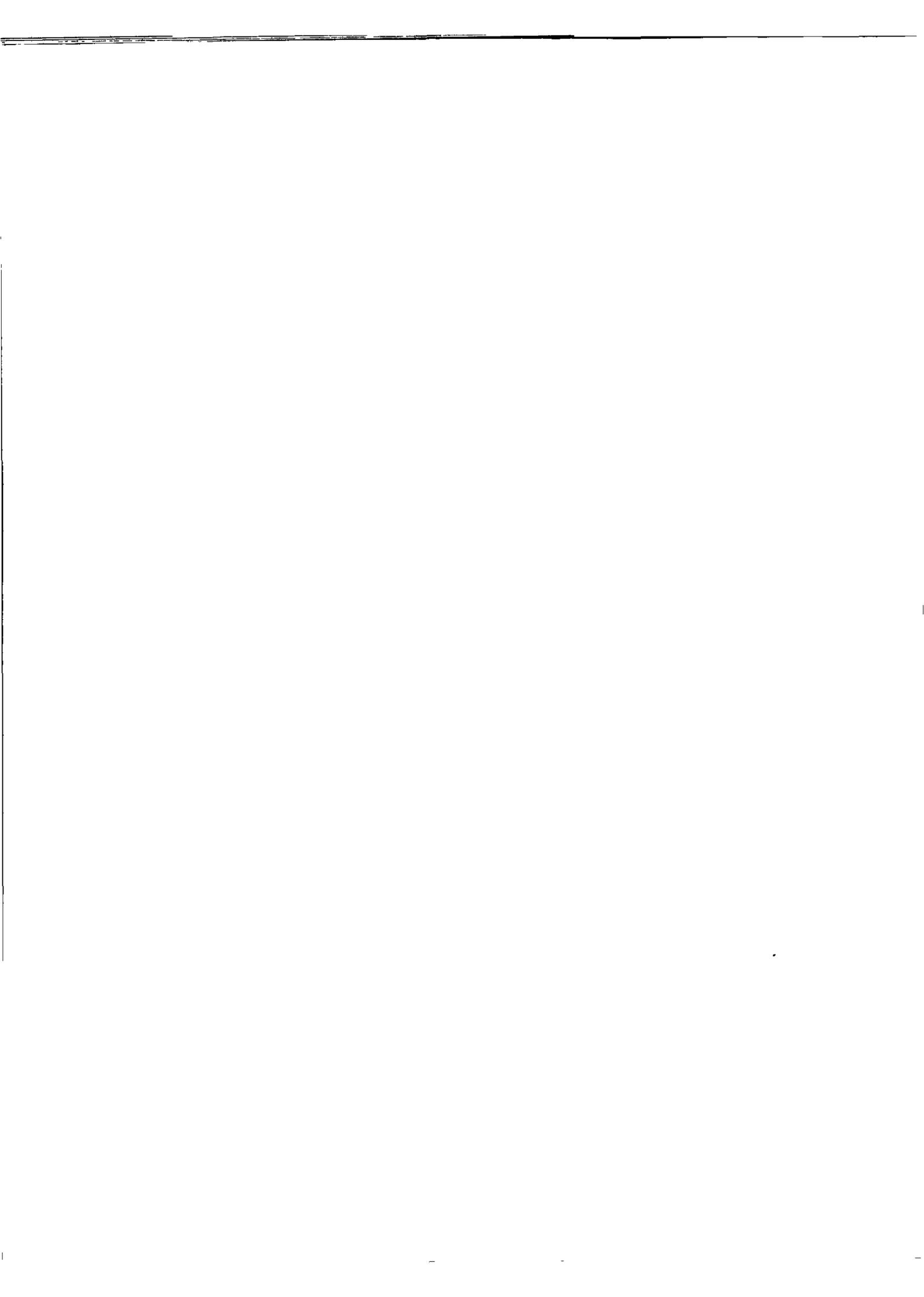
SOUTHERN WATER SERVICES LIMITED

**BALANCE SHEET**  
As at 31 March 2012

	Note	2012 £m	2011 £m
<b>Fixed assets</b>			
Tangible assets	10	4,109.5	3,883.1
Investments	11	29.2	29.2
		<u>4,138.7</u>	<u>3,912.3</u>
<b>Current assets</b>			
Stocks	12	1.9	1.6
Debtors amounts falling due within one year	13	163.5	148.1
Debtors amounts falling due after more than one year	14	812.3	812.3
Cash at bank and in hand		75.4	172.0
		<u>1,053.1</u>	<u>1,134.0</u>
<b>Creditors: amounts falling due within one year</b>	15	<u>(250.6)</u>	<u>(228.6)</u>
<b>Net current assets</b>		<u>802.5</u>	<u>905.4</u>
<b>Total assets less current liabilities</b>		<u>4,941.2</u>	<u>4,817.7</u>
<b>Creditors amounts falling due after more than one year</b>	16	(3,666.5)	(3,528.6)
<b>Provision for liabilities</b>			
Environmental obligations	17	(0.8)	(0.9)
Deferred taxation	17	(349.6)	(402.9)
<b>Grants and contributions</b>	18	(47.9)	(49.1)
<b>Net assets excluding pension deficit</b>		<u>876.4</u>	<u>836.2</u>
<b>Pension deficit</b>	22	(69.7)	(36.8)
<b>Net assets</b>		<u>806.7</u>	<u>799.4</u>
<b>Capital and reserves</b>			
Called up share capital	19	0.1	0.1
Share premium	20	46.3	46.3
Profit and loss account	20	760.3	753.0
<b>Total shareholder's funds</b>		<u>806.7</u>	<u>799.4</u>

The financial statements of Southern Water Services Limited (Registered no 02366670) on pages 33 to 58 were approved by the Board and authorised for issue on 27 June 2012. They were signed on its behalf by

  
Michael Carmedy  
Chief Financial Officer



SOUTHERN WATER SERVICES LIMITED

**CASH FLOW STATEMENT**  
for the year ended 31 March 2012

	Notes	2012 £m	2011 (Restated)* £m
<b>Net cash inflow from operating activities</b>	21	487.1	462.4
<b>Returns on investments and servicing of finance</b>			
Interest received		59.7	60.3
Interest paid		(129.5)	(137.1)
Preference share dividends		(10.9)	(22.3)
<b>Net cash outflow from returns on investments and servicing of finance</b>		<u>(80.7)</u>	<u>(99.1)</u>
<b>Taxation</b>		(23.2)	(23.4)
<b>Capital expenditure and financial investment</b>			
Purchase of tangible fixed assets		(466.0)	(385.4)
Receipt of grants and contributions		11.7	9.3
Sale of tangible assets		0.9	0.2
Movement on loan to subsidiary*		(14.8)	10.1
<b>Net cash outflow for capital expenditure and financial investment</b>		<u>(468.2)</u>	<u>(365.8)</u>
<b>Equity dividends paid</b>		(42.1)	(77.1)
<b>Net cash outflow before financing</b>		<u>(127.1)</u>	<u>(103.0)</u>
<b>Financing</b>			
Increase in borrowings		50.0	-
Repayment of loans		(19.5)	(13.7)
<b>Net cash inflow/(outflow) from financing</b>		<u>30.5</u>	<u>(13.7)</u>
<b>Decrease in net cash</b>		<u>(96.6)</u>	<u>(116.7)</u>
<b>Reconciliation to net debt</b>			
Net debt at beginning of year		(3,373.2)	(3,188.8)
Decrease in net cash		(96.6)	(116.7)
Movements in borrowings		(30.5)	13.7
Other non cash changes		(112.5)	(81.4)
<b>Net debt at end of year</b>		<u>(3,612.8)</u>	<u>(3,373.2)</u>

\* To aid clarity, loans to subsidiaries have been reclassified as financial investments in the current year (previously included within net cash flow from operating activities) and the prior year comparative has been restated accordingly

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012**

**1 Accounting policies**

The principal accounting policies, which have been applied consistently throughout the current and preceding year, are set out below

**Basis of accounting**

The financial statements have been prepared on the going concern basis, under the historical cost convention, and in accordance with applicable accounting standards and, subject to the treatment of infrastructure grants and contributions described below, with the requirements of the Companies Act 2006

**Basis of preparation**

The financial statements contain information about Southern Water Services Limited ("SWS") as an individual company and do not contain consolidated financial information as the parent of subsidiary companies. The Company is exempt under Section 400 of the Companies Act 2006 from the requirement to prepare consolidated financial statements as it and its subsidiary undertaking are included by full consolidation in the consolidated financial statements of the ultimate holding company, Greensands Holdings Limited

**Going concern**

The Directors have undertaken a detailed review of the Company's liquidity requirements compared with the cash and facilities available, the financial covenant position including projections based on future forecasts, the current ratings and financial risk and have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future being a period of at least 12 months from the approval of these financial statements. For this reason they continue to adopt the going concern basis of accounting in preparing the annual financial statements

**Tangible fixed assets and depreciation**

Tangible fixed assets are stated at historic purchase cost less accumulated depreciation and any provision for impairment. Cost includes the original purchase price of the asset and the costs attributable to bringing the asset to its working condition for its intended use, these include materials, labour and applicable overheads. Interest costs are not capitalised

- i) Infrastructure assets (being mains and sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls) comprise a network of assets covering the Company's geographic area

Expenditure on infrastructure assets relating to increases in capacity or enhancement of the network and on maintaining the operating capability of the network in accordance with defined standards of service, is treated as an addition to fixed assets and is stated at cost after deducting grants and contributions. Staff costs that directly relate to the construction of a specific infrastructure asset are capitalised on the basis of the amount of time spent by individuals on projects

The depreciation charge for infrastructure assets is the estimated level of annualised expenditure required to maintain the operating capability of the network and is based on the asset management plan determined by Ofwat as part of the price regulation process. The asset management plan is developed from historical experience combined with a rolling programme of reviews of the condition of the infrastructure assets

- ii) Other tangible fixed assets (including above ground assets, plant and equipment) are stated at cost less accumulated depreciation and any provision for impairment. These assets are depreciated down to their residual values on a straight-line basis over their estimated operating lives which are principally as follows

	<u>Years</u>
Buildings	10 - 60
Operational structures	15 - 80
Fixed plant	10 - 40
Vehicles, computers and mobile plant	3 - 10

Operational structures are assets used for wastewater and water treatment purposes. These include water tanks and similar assets

- iii) Freehold land is not depreciated
- iv) Assets in the course of construction are not depreciated until they are commissioned. Commissioning is deemed to occur when a new works is officially taken over from the contractor following completion of performance and take-over tests
- v) Private Sewers have been adopted during the year and have been valued at nil value, as permitted by UKGAAP and by reference to the net present value of the incremental cash flows as a result of the adoption. These assets form part of our infrastructure assets and expenditure associated with them has been treated as described above

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**1 Accounting policies (continued)**

**Grants and contributions**

Revenue grants and contributions are credited to the profit and loss account in the year to which they relate

Capital grants and customer contributions in respect of additions to non-infrastructure tangible fixed assets are treated as deferred income and released to the profit and loss account over the estimated operational lives of the related assets in accordance with the provisions of the Companies Act

Grants and capital contributions received relating to infrastructure assets have been deducted from the cost of tangible fixed assets as permitted by Statement of Standard Accounting Practice (SSAP) 4 This is not in accordance with Schedule 1 of the Companies Act 2006 which requires tangible fixed assets to be stated at their purchase price or production cost The Act does not permit the deduction of contributions

This departure from the requirements of the Act is, in the opinion of the directors, necessary for the financial statements to give a true and fair view because infrastructure assets do not have determinable finite lives Accordingly related capital contributions would not be recognised in the profit and loss account The effect of this treatment on tangible fixed assets is disclosed in note 10

**Leased assets**

Where the Company enters into a lease which entails taking substantially all the risks and rewards of ownership of an asset, the lease is treated as a "finance lease" The asset is recorded in the balance sheet as a tangible fixed asset and is depreciated over its estimated useful life or the term of the lease, whichever is shorter Future instalments under such leases, net of finance charges, are included within creditors Rentals payable are apportioned between the finance element, which is charged to the profit and loss account, and the capital element which reduces the outstanding obligation for future instalments

Rentals payable under operating leases are charged to the profit and loss account as incurred

The sale of income rights relating to aerial masts and sites owned by the Company to third parties is treated as an operating lease Income received from such sales is received entirely in advance and is therefore taken to deferred revenue and will be credited to other operating income in the profit and loss account over the life of the lease

Sale and leaseback transactions occur when an asset is sold but use is immediately re-acquired by entering into a lease with the buyer Where the new lease is an operating lease, the transaction is treated as the disposal of an asset and the operating lease accounted for in accordance with existing policies

**Fixed asset investments**

Investments held as fixed assets are stated at cost, less provision, if appropriate, for any impairment in value other than a temporary impairment in value The carrying values of fixed asset investments are reviewed for impairment in periods if events or changes in circumstances indicate the carrying value may not be recoverable

**Stocks**

Stock is held for use in the production of water supply and treatment of wastewater Stock is held at replacement cost

**Deferred revenue**

Deferred revenue includes monies received from customers where the related turnover has not yet been recognised Amounts are deferred to the balance sheet and released to the profit and loss account in line with the period of the service provided

**Provisions**

An environmental provision is made in accordance with FRS12 for the costs relating to the decommissioning of abandoned sites No reimbursement is expected

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**1 Accounting policies (continued)**

**Taxation**

The taxation charge in the profit and loss account is based on the profit for the year as adjusted for disallowable and non-taxable items using current rates and takes into account tax deferred because of timing differences between the treatment of certain items for taxation and accounting purposes

Deferred taxation is provided on all timing differences that have originated but not reversed by the balance sheet date, calculated at the rate at which it is expected the tax will arise in accordance with FRS19 'Deferred Tax'. Deferred taxation balances are not discounted. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered

**Turnover**

Turnover represents the income receivable (excluding value added tax) in the ordinary course of business for goods and services provided and, in respect of unbilled charges, includes accrued income

Turnover relates to services provided in the year and excludes payments received in advance which are recorded as deferred revenue

Unmetered income is based on either the rateable value of the property or on an assessed volume of water supplied. Metered income is based on actual or estimated water consumption

Turnover includes an estimate of the consumption between the date of the last meter reading and the period end. The unbilled income accrual is based on estimated usage from the last meter reading date through to the end of the reporting period. The accrual is estimated using a defined methodology based upon historical billing and consumption information and the applicable tariff

**Bad debts**

The bad debt provision is calculated by applying estimated recovery rates to various categories of debt and reflecting past collections experience and expectations of future recovery of outstanding receivables at the year end

**Pensions**

SWS operates a defined benefit pension scheme, the assets of which are held separately from those of the Company in independently administered funds. An independent actuary conducts a valuation of this pension scheme every three years

In accordance with FRS 17 the pension deficit has been recognised on the balance sheet and operating and financing costs of pension and post-retirement schemes are recognised separately in the profit and loss account

Pension scheme assets are measured using market value. Pension scheme liabilities are measured using the projected unit actuarial method and are discounted at the current rate of return on a high quality corporate bond of equivalent terms and currency to the liability. The increase in the present value of the liabilities of the Company's defined benefit pension schemes expected to arise from employee service in the period is charged to operating profit. The expected return on the schemes' assets and the increase during the year in the present value of the schemes' liabilities arising from the passage of time are included in other finance income. Actuarial gains and losses are recognised in the statement of total recognised gains and losses

Service costs are systematically spread over the service lives of the employees and financing costs are recognised in the period in which they arise. The costs of past service benefit enhancements, settlements and curtailments are also recognised in the period in which they arise

The differences between actual and expected returns on assets and liabilities during the year, including changes in actuarial assumptions, are recognised in the statement of total recognised gains and losses

The Company also operates a defined contribution pension scheme. The assets of the scheme are held separately from those of the Company in an independently administered fund. Company contributions to the scheme are charged to the profit and loss account in the period to which they relate

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**1 Accounting policies (continued)**

**Research and development**

Expenditure on research and development is charged to the profit and loss account as it is incurred. Expenditure on fixed assets relating to development projects is written off over the expected useful life of those assets.

**Preference shares**

Preference shares are classified as debt in accordance with FRS 25 'Financial instruments disclosure and presentation'. The preference shares are redeemable on a specific date or at the Company's option anytime earlier. Dividends on preference shares classified as debt are recognised in the profit and loss account through interest payable. The value of the debt has been based on the original nominal value and share premium on issue of the shares.

**Capital instruments**

Interest-bearing borrowings are recorded at the proceeds received, net of direct issue costs. Finance charges are accounted for on an accruals basis in the profit and loss account and are added to the carrying amount of the instrument to the extent that they are not settled in the period in which they arise.

The issue costs of capital instruments are amortised over the life of the financial instrument to which they relate.

Premiums and proceeds from gilt lock agreements received on issue of debt instruments are credited to the profit and loss account over the term of the debt at a constant rate on the carrying amount.

The carrying value of index-linked debt instruments is adjusted for the annual movement in the retail price index. The change in value arising from indexation is charged or credited to the profit and loss account in the year in which it arises.

**2 Segmental analysis**

The directors believe that the whole of SWS's activities constitute a single class of business. The Company's turnover is generated wholly from within the United Kingdom.

**3 Classification of turnover and revenue costs**

Turnover represents the income receivable for providing water supply and wastewater services and is generated wholly in the United Kingdom.

Cost of sales reflects the direct costs of providing water supply and wastewater services. Administrative expenses comprise the indirect costs of the business. Other operating income relates to rents receivable.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**4 Profit on ordinary activities before taxation**

Profit on ordinary activities before taxation is stated after charging/(crediting)	<b>2012</b>	2011
	<b>£m</b>	£m
Employee costs (note 5a)	<b>40.5</b>	40.4
Depreciation on		
- owned assets	<b>206.4</b>	185.4
- assets held under finance leases	<b>0.4</b>	0.4
	<u><b>206.8</b></u>	<u>185.8</u>
Rentals under operating leases		
Vehicles	<b>3.7</b>	3.5
Research and development expenditure	<b>0.5</b>	0.5
Amortisation of grants and contributions (note 18)	<b>(2.7)</b>	(2.7)
Exceptional item (see note (a) below)	<b>-</b>	38.6
Fees payable to the Company's auditor in respect of		
- Statutory audit of the Company's financial statements	<b>0.2</b>	0.2
- Other services pursuant to legislation	<b>0.1</b>	0.1
- All other services	<b>0.1</b>	0.8

- (a) The exceptional item of £38.6m in 2010-11 relates to a revision of the level of bad debt provision required for outstanding receivables

**5 Employee information**

	<b>2012</b>	2011
	<b>£m</b>	(Restated)* £m
<b>(a) Employee costs (including directors' emoluments):</b>		
Wages and salaries	<b>52.7</b>	46.9
Social security costs	<b>4.7</b>	4.0
Pension costs - Defined contribution	<b>0.7</b>	0.4
- Defined benefit	<b>6.2</b>	8.1
Total employee costs	<u><b>64.3</b></u>	<u>59.4</u>
Less charged as capital expenditure	<u><b>(23.8)</b></u>	<u>(19.0)</u>
Charged to the profit and loss account	<u><b>40.5</b></u>	<u>40.4</u>

Employee costs that are charged as capital expenditure are those directly related to the construction or acquisition of assets

\* The prior year has been restated to correct wages and salaries which included an element of pension costs

**(b) Average number of persons employed by activity**

The average monthly numbers of persons (including executive directors) employed by the Company during the year was

	<b>2012</b>	2011
	<b>Number</b>	Number
Operations	<b>941</b>	886
Customer Services	<b>447</b>	325
Corporate Centre	<b>354</b>	294
	<u><b>1,742</b></u>	<u>1,505</u>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**6 Directors' emoluments**

	2012 £000	2011 £000
Aggregate emoluments (including benefits in kind)	1,225	1,090
Compensation for loss of office	-	1,730
Company pension contributions to money purchase pension schemes	63	147

No retirement benefits accrued to directors (2010-11 none) under a Southern Water defined benefit scheme  
 Retirement benefits accrued to two directors (2010-11 two) under a Southern Water defined contribution scheme

Details of emoluments and benefits for the highest paid director

	2012 £000	2011 £000
Highest paid director's aggregate emoluments and benefits	632	361

During the year the Company made contributions of £48,583 (2010-11 £81,939) to a money purchase pension scheme in respect of the highest paid director's qualifying services

**7 Interest**

	2012 £m	2011 £m
<b>Interest payable and similar charges</b>		
Interest payable on other loans	5.5	6.4
Interest paid to group companies	121.3	131.4
Indexation	113.5	84.0
Amortisation of issue costs	2.7	2.7
Amortisation of gilt lock proceeds	(0.1)	(0.1)
Amortisation of deferred credits	(9.8)	(5.0)
Amortisation of bond premium	(0.6)	(0.6)
Amortisation of discount	0.3	0.3
Other finance expense (note 22)	-	(0.9)
Dividends on preference shares- see note below	17.4	22.3
<b>Total interest payable and similar charges</b>	250.2	240.5
<b>Interest receivable and similar income</b>		
Interest receivable from Southern Water Services Group Limited	56.9	56.9
Deposit interest receivable	2.4	3.4
Other finance interest (note 22)	3.0	-
<b>Total interest receivable</b>	62.3	60.3

Class A1 preference share dividends amounted to £40 per share and Class B £70 per share (totalling £9.6m (2010-11 £13.7m))

A dividend due to the Class A2 preference shareholders of £7.8m (2010-11 £8.6m) was declared and settled in the year at base value plus an amount for out-performance in the year ended 31 March 2011 (see note 16(v))

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**8 Tax on profit on ordinary activities**

	2012 £m	2011 £m
<b>Current tax:</b>		
UK corporation tax on profits for the year	50.5	32.3
Adjustment in respect of prior years	1.6	(4.6)
	52.1	27.7
<b>Deferred tax:</b>		
Origination and reversal of timing differences	(20.4)	(16.4)
Adjustment in respect of prior years	(3.8)	(1.2)
Pension cost relief in excess of pension charge	4.9	-
Effect of corporation tax rate change	(29.1)	(31.0)
Impact of rate change on pension charge	1.3	1.0
Total deferred tax	(47.1)	(47.6)
 Total tax on profit on ordinary activities	5.0	(19.9)

The tax assessed for the year is different to the standard rate of corporation tax in the UK (26%) due to the following factors

	2012 £m	2011 £m
<b>Profit on ordinary activities before tax</b>	84.9	12.1
<b>Current tax:</b>		
UK corporation tax on profits for the year at 26% (2011 28%)	22.1	3.4
Adjustment in respect of prior years	1.6	(4.6)
Pension cost relief in excess of pension charge	(4.9)	-
Permanent differences	12.9	12.5
<b>Tax charge on ordinary activities</b>	31.7	11.3
Timing differences	20.4	16.4
<b>Current tax charge for year</b>	52.1	27.7

**Factors that may affect future tax charges**

On 21 March 2012 the UK Government announced a reduction in the main rate of corporation tax from 26% to 24% effective from 1 April 2012. The rate change was substantively enacted by the balance sheet date, and deferred tax balances have been calculated using the new rate of 24%. A £29.1m credit is recognised in the profit and loss account in the year to reflect the reduction in the deferred tax liability as a result of the rate change. In addition, charges of £1.3m in the profit and loss account and £0.9m in the statement of total recognised gains and losses are recognised to reflect the reduction in the deferred tax asset relating to the pension deficit.

The Government has also indicated that it intends to enact future reductions in the main tax rate of 1% each year down to 22% by 1 April 2014. The future main tax rate reductions are expected to have a similar impact on the financial statements as outlined above albeit at a rate of reduction of 1% rather than 2%, however the actual impact will be dependent on the Company's deferred tax position at that time.

Based on current capital investment plans, the Company expects to continue to be able to claim capital allowances in excess of depreciation in future years at a similar level to the current year.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**9 Dividends per share**

	2012 £ per ordinary share	2011 £ per ordinary share	2012 £m	2011 £m
<b>Ordinary shares</b>				
Interim dividend – Q1	187.86	182.78	10.5	10.2
Interim dividend – Q2	187.86	182.78	10.5	10.2
Interim dividend – Q3	187.86	182.78	10.6	10.3
Interim dividend – Q4	187.86	203.09	10.5	11.4
Total interim dividend	751.44	751.43	42.1	42.1
Final dividend – prior year	-	625.00	-	35.0
<b>Total ordinary dividend</b>	751.44	1,376.43	42.1	77.1

The directors do not recommend payment of a final dividend for 2011-12. The final dividend paid in 2010-11 related to the year ended 31 March 2010 and was declared on 28 April 2010 and paid on 24 May 2010.

The interim dividends totalling £42.1m are paid to Southern Water Services Group Limited (SWSG). These dividends, along with associated group tax relief, enable SWSG to pay the interest of £56.9m due to Southern Water Services Limited on an inter-company loan as disclosed in note 7.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)

**10 Tangible fixed assets and capital commitments**

**(a) Tangible assets**

	Freehold land & buildings £m	Plant & Machinery £m	Infra- structure assets £m	Assets in the course of construction £m	Other £m	Total £m
<b>Cost:</b>						
At 1 April 2011	1,329.3	1,687.2	1,801.9	478.8	512.9	5,810.1
Additions	0.3	70.3	69.5	253.0	50.3	443.4
Transfers	1.0	40.8	33.4	(90.3)	15.1	-
Grants & contributions	-	-	(8.1)	(2.1)	-	(10.2)
Disposals	-	-	(3.9)	-	(38.4)	(42.3)
<b>At 31 March 2012</b>	<b>1,330.6</b>	<b>1,798.3</b>	<b>1,892.8</b>	<b>639.4</b>	<b>539.9</b>	<b>6,201.0</b>
<b>Accumulated depreciation:</b>						
At 1 April 2011	418.4	603.1	570.9	-	334.6	1,927.0
Charge for the year	34.9	66.9	64.1	-	40.9	206.8
Disposals	-	-	(3.9)	-	(38.4)	(42.3)
<b>At 31 March 2012</b>	<b>453.3</b>	<b>670.0</b>	<b>631.1</b>	<b>-</b>	<b>337.1</b>	<b>2,091.5</b>
<b>Net book amount</b>						
<b>At 31 March 2012</b>	<b>877.3</b>	<b>1,128.3</b>	<b>1,261.7</b>	<b>639.4</b>	<b>202.8</b>	<b>4,109.5</b>
At 31 March 2011	910.9	1,084.1	1,231.0	478.8	178.3	3,883.1

Of the additions and transfers into infrastructure assets, the amount spent on infrastructure renewals net of contributions during the year ended 31 March 2012 and 31 March 2011 was £86.5m and £62.5m, respectively. The associated contributions were £4.1m for the year ended 31 March 2012 and £3.6m for the year ended 31 March 2011.

For the years ended 31 March 2012 and 31 March 2011, the net book value of infrastructure assets is stated after deducting grants and contributions since privatisation of £195.6m and £187.5m, respectively.

Freehold land is stated at a cost of £46.0m and £46.2m at 31 March 2012 and 31 March 2011, respectively, and is not depreciated.

Other assets relate primarily to computer equipment, meter reading devices and motor vehicles.

One asset held under a finance lease has been capitalised and included in plant and machinery.

	2012 £m	2011 £m
Cost	11.7	11.7
Aggregate depreciation	(10.6)	(10.2)
Net book amount	<u>1.1</u>	<u>1.5</u>

Outstanding payments and interest associated with this lease are not material.

	2012 £m	2011 £m
<b>(b) Capital commitments</b>		
In respect of contracts placed	<u>291.9</u>	<u>402.3</u>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**11 Fixed asset investments**

	2012 £m	2011 £m
<b>Shares in group undertakings</b>		
At 1 April and 31 March	<u>29.2</u>	<u>29.2</u>

The investment represents a 100% holding of the issued Ordinary shares of Southern Water Services (Finance) Ltd ("SWSF"), a company incorporated in the Cayman Islands. The principal activity of the company is to raise debt finance.

The directors are satisfied that the carrying value of the investment is supported by the underlying assets and activities of SWSF.

There are no indirect subsidiaries resulting from this investment.

**12 Stocks**

	2012 £m	2011 £m
Raw materials	1.0	1.1
Work in progress	0.9	0.5
	<u>1.9</u>	<u>1.6</u>

**13 Debtors: amounts falling due within one year**

	2012 £m	2011 £m
Trade debtors	62.1	69.6
Loan to subsidiary	20.4	5.6
Amounts owed by group undertakings	2.5	2.4
Other debtors	9.5	9.4
Accrued income	55.6	48.1
Prepayments	13.4	13.0
	<u>163.5</u>	<u>148.1</u>

Amounts owed by group undertakings are unsecured, interest-free and settled regularly.

**14 Debtors: amounts falling due after more than one year**

	2012 £m	2011 £m
Loans owed by group undertakings	<u>812.3</u>	<u>812.3</u>
	<u>812.3</u>	<u>812.3</u>

Loans owed by group undertakings represent a loan to Southern Water Services Group Limited which is secured on the assets held under the Southern Water Services Group Security agreement and repayable on 31 July 2052 with interest payable at 7% per annum.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**15 Creditors: amounts falling due within one year**

	2012	2011 (Restated)*
	£m	£m
Trade creditors	15.7	12.3
Loans from group undertakings (see note (i) below)	30.3	30.3
Amounts owed to group undertakings	53.5	27.9
Capital creditors and capital accruals	55.3	77.8
Taxation and social security	2.3	2.0
Debt issue costs (note 16 (vi))	(2.6)	(2.7)
Accruals and deferred revenue	86.0	75.6
Bond premium deferred	0.3	0.3
Deferred gilt lock proceeds (note 16 (vii))	0.1	0.1
Deferred proceeds	9.7	5.0
	<u>250.6</u>	<u>228.6</u>

\* The prior year has been restated for a reclassification of goods received not invoiced from trade creditors to accruals

**Notes**

- (i) The loan from group undertakings is unsecured, interest free, and shall be repayable in whole or part upon demand at any time, provided that
- (a) on the date of such demand, no class A debt is outstanding, no class B debt is outstanding and no mezzanine debt is outstanding, or
  - (b) the consent of the Security Trustee is given

**16 Creditors: amounts falling due after more than one year**

	2012	2011
	£m	£m
Loans and other borrowings		
Loan from Southern Water Services (Finance) Limited	3,295.0	3,201.1
Capex facility £100m – 6 month Libor plus 3% 2013	100.0	50.0
Class A1 Preference shares (see note (v) below)	32.6	150.0
Class B Preference shares (see note (v) below)	110.0	110.0
Debt issue costs (see note (vi) below)	(41.6)	(44.4)
Bond premium deferred	4.8	5.1
Deferred gilt lock proceeds (see note (vii) below)	5.5	5.7
Deferred proceeds*	144.2	34.7
Total Loans and other borrowings	<u>3,650.5</u>	<u>3,512.2</u>
Deferred revenue (see note (viii) below)	16.0	16.4
<b>Total Creditors falling due after more than one year</b>	<u>3,666.5</u>	<u>3,528.6</u>
	2012	2011
	£m	£m
<b>Repayments fall due as follows:</b>		
Between two and five years	100.0	50.0
After five years not by instalments	3,437.6	3,461.1
	<u>3,537.6</u>	<u>3,511.1</u>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**16 Creditors: amounts falling due after more than one year (continued)**

Under the loan agreements between SWS and SWSF, SWSF advances an amount equal to each bond or other debt raised at the same interest rate plus 0.01%. Therefore each individual back to back inter-company loan has been separately disclosed

An analysis of the loans is shown below -

Loans	2012 £m	2011 £m
Class A £350m - £349.3m 3.350% index linked 2029/2037 & £0.7m 6.202% fixed rate 2029 (note (i) below)	372.2	353.7
Class A £150m - 3.716% index linked 2034	197.5	188.2
Class A £35m - 3.716% index linked 2034	46.7	44.5
Class A £350m - £141.9m 3.709% index linked & £208.1m 6.650% fixed rate 2026 (note (i) below)	357.6	350.0
Class A £150m - 3.826% index linked 2023	197.6	188.2
Class A £350m - £177.0m 2.070% index linked & £173.0m 5.010% fixed rate 2021 (note (i) below)	363.0	353.7
Class A £150m - 0.510% index linked 2041 (note (i) below)	190.0	181.3
Class A £200m - 0.070% index linked 2052 (note (i) below)	247.6	236.2
Class A £300m - 0.490% index linked 2056 (note (i) below)	338.9	326.9
Class A £300m - £195.0m Libor plus 3.029% 2019 & £105.0m 6.135% fixed rate 2019 (note (ii) below)	300.0	300.0
Artesian £165m - 4.086% index linked 2033	217.3	207.0
Artesian £156.5m - 3.645% index linked 2032	201.2	191.6
<b>Total Class A Debt</b>	<b>3,029.6</b>	<b>2,921.3</b>
Class B £250m - 7.879% fixed rate 2038 (note (iii) below)	250.0	250.0
Senior Mezzanine £127.2m - 11.97% fixed rate 2038 (note (iv) below)	15.4	15.4
Inter-company creditor	-	14.4
Debt issue costs (note (vi) below)	(41.6)	(44.4)
Bond premium deferred	4.8	5.1
Deferred gilt lock proceeds (note (vii) below)	5.5	5.7
Deferred proceeds*	144.2	34.7
<b>Total loans and other borrowings from SWSF</b>	<b>3,407.9</b>	<b>3,202.2</b>
Capex facility £100m - 6m Libor plus 3% 2013	100.0	50.0
Class A1 Preference shares (note (v) below)	32.6	150.0
Class B Preference shares (note (v) below)	110.0	110.0
<b>Total loans and other borrowings</b>	<b>3,650.5</b>	<b>3,512.2</b>

\*Deferred proceeds represent consideration received by the Company in connection with taking on various debt obligations where were "out of the money" at the time the debt obligations were entered into. The deferred proceeds are amortised over the lives of the related debt instruments.

These loans (excluding the preference shares) are guaranteed and secured pursuant to a guarantee and security agreement (the Security Agreement). The agreement is over the entire property, assets, rights and undertaking of each of SWS, SWSF, SWS Holdings Limited, and SWS Group Holdings Limited. In the case of SWS, this is to the extent permitted by the Water Industry Act 1991 and Licence. Further, the Company has a contingent liability arising on certain inter-company financing arrangements which will have the effect that if certain refinancings do not take place when the underlying instruments mature in 2021 to 2029, the Company will make good certain obligations of its subsidiary SWSF. The directors do not believe this to be likely and the liability, if any, cannot currently be quantified as it will depend wholly on the circumstances at the time of the maturity.

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)

## 16 Creditors: amounts falling due after more than one year (continued)

In respect of the specific instruments above

- (i) As at 31 March 2012, SWSF was party to various swap agreements converting a total of £1,318.2m of Class A debt from the original fixed interest rate to a real interest rate linked to RPI (Retail Price Index) plus capitalised inflation on the nominal value of the underlying Class A debt

The table below analyses the total value of swaps entered into by SWSF as at 31 March 2012

Nominal value of debt	Original Fixed interest rate	Swapped Index Linked interest rate	Nominal value of debt plus capitalised RPI
£349.3m	6.192%	3.340%	£371.5m
£141.9m	6.640%	3.699%	£149.5m
£177.0m	5.000%	2.060%	£190.0m
£150.0m	5.000%	0.500%	£190.0m
£200.0m	4.500%	0.060%	£247.6m
£300.0m	5.125%	0.480%	£338.9m
<u>£1,318.2m</u>			<u>£1,487.5m</u>

- (ii) SWSF has entered into swap agreements that have converted £195m of its Class A £300m from a fixed rate of 6.125% to floating rates of Libor plus a margin with a Libor cap at 5%. This swapped rate has been reflected in the rate charged to SWS plus 0.01%
- (iii) The interest rate on the Class B £250m is fixed at 7.879% until March 2014 when it reverts to Libor plus a margin to be determined with a premium of 0.01%
- (iv) The interest rate on the Senior Mezzanine loan is fixed at 11.97% until March 2022 when it reverts to Libor plus 6.25% with a premium of 0.01%
- (v) The preference shares issued have been classified as loans in the financial statements as required by FRS 25. All shares are redeemable at the option of SWS at any time

The Class A1 and B preference shares, which do not carry voting rights, were issued on 23 July 2003, and are redeemable at their nominal value plus the share premium paid, on 31 March 2038 or at the Company's option anytime earlier. Class A1 and B shares were issued at £1,000 per share and the amounts received totalled £260.0m for both classes of shares. Class A2 preference shares were issued for £0.01 per share on 7 May 2003 and the amount received totalled £1,500. Class A2 shares, which do not carry voting rights, are also redeemable at nominal value. Shareholders are entitled to receive dividends annually as follows -

Class A1 - £40 per share

Class A2 - the base value dividend plus an amount for Company out-performance and any savings arising from any refinancing of the Mezzanine debt. The base value is £nil per share increasing by £15 every five years. (Out-performance from 1 April 2007 onwards is the difference between Southern Water Services Limited's audited 'profit before interest and taxation' and the targeted 'profit before interest and taxation' as determined by Ofwat in the periodic review.)

Class B - £70 per share

These dividends are payable on 31 March and 30 September each year

It is anticipated that a dividend will be declared and paid to the A2 preference share holders in September 2012 for out-performance in the year ending March 2012

On winding up the preference shareholders rank above ordinary shareholders with the preference shareholders being paid in order of Class A1, Class A2 then Class B

During the year, the Company redeemed 117,393 of its Class A1 and A2 preference shares totalling £117.4m plus accrued dividends of £6.6m

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)

## 16 Creditors: amounts falling due after more than one year (continued)

- (vi) Debt issue costs represent issue fees paid to SWSF. Where these costs are attributable to a specific instrument they are being amortised over the life of that instrument. The remaining costs are being amortised over the weighted average life of the loan advances noted above. As at 31 March 2012 debt issue costs amounted to £44.2m of which £2.6m represents the short-term amount which is disclosed separately in note 15.
- (vii) Prior to the issue of the Class A £300m bond in the year to 31 March 2008, SWSF entered into a gilt lock agreement, resulting in the receipt of £6.3m, which was advanced to SWS along with the proceeds of the bond issue. The proceeds have been deferred in the financial statements of SWS and are being released to the profit and loss account over the life of the loan.
- (viii) Deferred revenue relates to the proceeds from the sale of income rights relating to aerial masts and sites owned by SWS. The income will be credited to the profit and loss account evenly over the life of the lease.

## 17 Provision for liabilities

(a) Environmental obligations	2012 £m	2011 £m
At 1 April 2011/2010	0.9	0.3
Utilised in year	(0.1)	-
Increase in year	-	0.6
At 31 March 2012/2011	<u>0.8</u>	<u>0.9</u>

The environmental provision relates to costs for the decommissioning of abandoned sites. No reimbursement is expected. The period over which the provision will be utilised cannot be determined thus the provision is not discounted. Discounting the provision would not materially affect its value.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**17 Provision for liabilities (continued)**

<b>(b) Deferred taxation</b>	<b>2012</b>	<b>2011</b>
	<b>£m</b>	<b>£m</b>
Accelerated capital allowances	371.8	426.8
Other timing differences	(22.2)	(23.9)
<b>Deferred taxation</b>	<b><u>349.6</u></b>	<b><u>402.9</u></b>

<b>Movement in deferred tax provision</b>	<b>2012</b>	<b>2011</b>
	<b>£m</b>	<b>£m</b>
Deferred tax provided at 1 April 2011/2010	402.9	451.5
Prior year adjustment	(3.8)	(1.2)
Deferred tax charge in Profit and Loss Account	(20.4)	(16.4)
Effect of corporation tax rate change	(29.1)	(31.0)
<b>Deferred tax provided at 31 March 2012/2011</b>	<b><u>349.6</u></b>	<b><u>402.9</u></b>

<b>Deferred tax asset relating to pension deficit</b>	<b>2012</b>	<b>2011</b>
	<b>£m</b>	<b>£m</b>
<b>At 1 April 2011/2010</b>	<b>23.3</b>	<b>42.9</b>
Adjustment in respect of prior years	-	(0.1)
Deferred tax charge in profit and loss account	(4.9)	-
Deferred tax charged to the statement of total recognised gains and losses	10.4	(17.7)
Impact of rate change		
Charge in profit and loss account	(1.3)	(1.0)
Charged to the statement of total recognised gains and losses	(0.9)	(0.8)
<b>At 31 March 2012/2011</b>	<b><u>26.6</u></b>	<b><u>23.3</u></b>

The total deferred tax asset of £26.6m (2010-11 £23.3m) relating to the pension deficit has been deducted from the pension deficit and so has not been included in this balance

**18 Grants and contributions**

	<b>£m</b>
At 1 April 2011	49.1
Receivable in year	1.5
Released to profit and loss account	(2.7)
<b>At 31 March 2012</b>	<b><u>47.9</u></b>

These grants and contributions relate to non-infrastructure assets

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**19 Called up share capital**

	2012 £m	2011 £m
<b>Equity shares</b>		
Authorised		
46,050,000 ordinary shares of £1 each	<u>46.1</u>	<u>46.1</u>
Allotted and fully paid		
56,000 ordinary shares of £1 each	<u>0.1</u>	<u>0.1</u>
Non-equity shares		
Issued		
<b>Preference shares</b>		
32,607 Class A1 shares of £1 each	0.0	0.2
32,607 Class A2 shares of £0.01 each	0.0	0.0
110,000 Class B shares of £1 each	<u>0.1</u>	<u>0.1</u>

The preference shares are classified as debt in line with FRS 25. They are disclosed within note 16 at an amount of £142.6m including share premium of £142.5m. The total statutory company share premium of £188.8m includes ordinary share premium of £46.3m.

**20 Reconciliation of movement in shareholder's funds**

	Called up share capital £m	Share premium £m	Profit and loss account £m	Total £m
At 1 April 2011	0.1	46.3	753.0	799.4
Profit after tax	-	-	79.9	79.9
Dividends paid	-	-	(42.1)	(42.1)
Actuarial loss on pension scheme	-	-	(40.0)	(40.0)
Movement on deferred tax relating to pension asset	-	-	9.5	9.5
<b>At 31 March 2012</b>	<u>0.1</u>	<u>46.3</u>	<u>760.3</u>	<u>806.7</u>

The profit and loss reserve includes recognised losses of £96.3m (2010-11 £60.1m) less deferred taxation of £26.6m (2010-11 £23.3m) in respect of pension scheme liabilities of the Company pension fund.

	Called up share capital £m	Share premium £m	Profit and loss account £m	Total £m
At 1 April 2010	0.1	46.3	763.9	810.3
Profit after tax	-	-	32.0	32.0
Dividends paid	-	-	(77.1)	(77.1)
Actuarial gain on pension scheme	-	-	48.6	48.6
Movement on deferred tax relating to pension asset	-	-	(18.5)	(18.5)
Movement on current tax relating to pension asset	-	-	4.1	4.1
<b>At 31 March 2011</b>	<u>0.1</u>	<u>46.3</u>	<u>753.0</u>	<u>799.4</u>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**21 (a) Cash flow from operating activities**

	2012 £m	2011 (Restated)* £m
<b>Continuing operations</b>		
Operating profit	271.6	191.5
Depreciation charge	206.8	185.8
Difference between pension charge and cash contributions	(0.8)	0.8
Amortisation of grants and contributions	(2.7)	(2.7)
(Decrease)/increase in environmental provision	(0.1)	0.6
Increase in deferred revenue due after one year	-	-
Increase in stocks	(0.3)	(0.4)
(Increase)/decrease in debtors	(1.0)	76.3
Increase in creditors	13.6	10.5
<b>Total net cash inflow from operating activities</b>	<b>487.1</b>	<b>462.4</b>

\* To aid clarity, loans to subsidiaries have been reclassified as financial investments in the current year (previously included within net cash flow from operating activities) and the prior year comparative has been restated accordingly

**21 (b) Analysis of net debt**

	At 31 March 2011 £m	Cash Flow £m	Other non- cash changes £m	At 31 March 2012 £m
Cash deposits	172.0	(96.6)	-	75.4
Cash	172.0	(96.6)	-	75.4
Debt issue costs	47.1	-	(2.7)	44.4
Gilt lock proceeds (see note 16)	(5.8)	-	0.1	(5.7)
Loans due within one year	(30.3)	(50.0)	-	(80.3)
Loans due after one year	(3,556.2)	19.5	(109.9)	(3,646.6)
	<b>(3,373.2)</b>	<b>(127.1)</b>	<b>(112.5)</b>	<b>(3,612.8)</b>

The non-cash movement of £112.5m relates to an increase in debt as a result of indexation plus the amortisation of loan issue costs, gilt lock proceeds, deferred proceeds, and partial settlement of the preference share dividend

Loans due within one year relate to loans from group undertakings that are repayable on demand (see note 15)

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**22 Pensions**

The Company accounted for pension costs during the year under FRS17. These disclosures show a net FRS 17 deficit (after deferred tax) of £69.7m (2010-11 deficit £36.8m). The deficit has arisen mainly as a result of lower expected future returns on investments and turbulence in the stock market. The movement in the deficit is mainly due to changes in actuarial assumptions (financial and demographic) in the year. These movements are analysed below.

**Pension schemes operated**

The Company principally operates two schemes, details of which are shown below.

- 1 Southern Water Pension Scheme (SWPS), a funded defined benefit scheme, was closed to new members on 31 December 1998, re-opened in July 2003 and closed once more to new entrants on 1 April 2005. This scheme has nine trustee directors. The Southern Water Services Executive Pension Scheme (SWEPS) was also closed to new entrants and merged with the SWPS, on 1 April 2005.

The assets of the scheme are held separately from those of the Company. Legal and General and Blackrock are unit registrars for Southern Water Pension Scheme unit holdings, and appoint custodians at individual Pooled Fund level (not Client holding level).

- 2 A second company stakeholder scheme, which is a defined contribution scheme, is also available to all employees.

Contributions made to the defined contribution scheme for the year ended 31 March 2012 amounted to £0.7m (2010-11 £0.4m). No contributions were outstanding at the year end.

Members of all schemes receive an annual statement of their accrued benefits.

The latest actuarial valuation of the SWPS was carried out as at 31 March 2007 using the projected unit method. The valuation of the combined scheme as at 31 March 2010 is currently in progress. The assumptions that have the most significant effect on the results of the valuation are those relating to the rate of return on investments, the rate of future pensionable salary increases and the level of pension increases.

For closed schemes under this method the current service cost will increase as the members of the schemes approach retirement.

Expected employer and employee contributions to the defined benefit scheme for 2012-13 are £8.1m and £0.3m respectively.

The principal assumptions in the valuation were as follows:

	<b>2007</b>
	<b>SWPS</b>
	<b>% pa</b>
Return on investments pre-retirement	<b>6.6</b>
Return on investments post-retirement	<b>5.2</b>
Salary growth	<b>4.5</b>
Pension increases on the excess over guaranteed minimum pensions	<b>3.2</b>

The assets of the scheme had a market value of £410.6m at 31 March 2007. This was sufficient to cover 81% of the scheme's benefits.

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**22 Pensions (continued)**

**FRS 17 - assumptions, asset, liability and reserves disclosures**

The formal actuarial funding valuations were carried out as at 31 March 2007 and updated to 31 March 2012 by a qualified independent actuary. The following disclosures are combined for the SWPS and SWEPS. The major assumptions used by the actuary are set out in the table below.

	<b>2012</b>	2011	2010
	<b>% pa</b>	% pa	% pa
Price inflation (RPI)	<b>3.0</b>	3.5	3.8
Price inflation (CPI)	<b>2.1</b>	2.6	-
Rate of increase in salaries (plus an age-related promotional scale)	<b>3.0</b>	3.0	4.3
Rate of increase of pensions in payment (MIS* members only)***	<b>2.1</b>	2.6	-
Rate of increase of pensions in payment (Old section** members only)***	<b>3.0</b>	3.5	3.8
Rate of increase of pensions in payment (all other members)***	<b>3.0</b>	3.3	3.8
Rate of increase for deferred pensions(MIS* members only)***	<b>2.1</b>	2.6	-
Rate of increase for deferred pensions(all other members)***	<b>3.0</b>	3.5	3.8
Discount rate	<b>4.8</b>	5.6	5.7
Expected return on assets	<b>5.4</b>	6.9	7.2

\* MIS refers to the Southern Water Mirror Image Pension Scheme. Pensions in payment and deferment for this section will be indexed in line with the Consumer Price Index.

\*\* For this section the Trustee will endeavour to meet any indexation of excess pension above the 5% per annum cap on increases that apply to other sections of the Scheme.

\*\*\* in excess of any Guaranteed Minimum Pension (GMP) element.

Assumptions regarding future mortality experience are set based on advice, published statistics and experience. In 11-2012, the Company has used the post-retirement mortality assumptions comprising the '92' series based medium cohort mortality tables modified for appropriate assumptions.

	<b>2012</b>	2011
	<b>years</b>	years
Longevity at age 65 for current pensioners		
Male	<b>21.9</b>	21.8
Female	<b>24.7</b>	24.7
Longevity at age 65 for future pensioners		
Male	<b>23.3</b>	23.2
Female	<b>26.2</b>	26.2

The assets and liabilities in the schemes and the expected rates of return at 31 March 2012 and 31 March 2011 were:

	<b>Rate of return</b>	Rate of return	<b>Value</b>	Value
	<b>2012</b>	2011	<b>at 2012</b>	at 2011
			<b>£m</b>	£m
Equities	<b>7.1%</b>	8.0%	<b>268.9</b>	325.8
Government bonds	<b>3.1%</b>	4.3%	<b>118.9</b>	79.8
Non-Government bonds	<b>4.6%</b>	5.6%	<b>125.1</b>	92.0
Cash	<b>3.0%</b>	3.9%	<b>6.9</b>	3.0
Total market value of Plan assets			<b>519.8</b>	500.6
Total value of Plan liabilities			<b>(616.1)</b>	(560.7)
Accrued deficit in the Plan			<b>(96.3)</b>	(60.1)
Related deferred tax asset			<b>23.1</b>	15.6
Deferred tax on current year pension contribution			<b>3.5</b>	7.7
<b>Net pension liability</b>			<b>(69.7)</b>	(36.8)

The equity investments and bonds which are held in plan assets are quoted and are valued at the current bid price following the adoption of the amendment to FRS17.

The pension deficit includes a deferred tax asset of £3.5m in relation to the increased pension contribution made by the Company during the year to 31 March 2010.

SOUTHERN WATER SERVICES LIMITED

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)

**22 Pensions (continued)**

**Reconciliation of the present value of the scheme liabilities**

	2012 £m	2011 £m
At 1 April 2011/2010	560.7	589.0
Current service cost	6.2	8.1
Interest cost	31.0	33.3
Member contributions	0.3	0.3
Actuarial loss/(gain) on liabilities	39.5	(47.5)
Benefits paid	(21.6)	(21.3)
Administrative expenses paid	-	(1.2)
Curtailments	-	-
<b>Scheme liabilities at 31 March 2012/2011</b>	<b>616.1</b>	<b>560.7</b>

**Sensitivity analysis of scheme liabilities**

The sensitivity of the present value of the scheme liabilities to changes in the principle assumptions used is set out below

	Change in assumption	Impact on scheme liabilities (%)	Impact on scheme liabilities (£m)
Discount rate	+/- 1%	-/+ 13	-/+ 80
Rate of inflation*	+/- 1%	+/- 12	+/- 74
Rate of increase in salaries	+/- 1%	+/- 3	+/- 18
Rate of increase in pensions in payment	+/- 1%	+/- 9	+/- 55
Mortality	+/- 1 yr	+/- 2	+/- 12

\*A change in inflation is assumed to be reflected in a change in the assumed rates of deferment revaluation, salary increase and pension increase (on pension in excess of GMP)

**Reconciliation of the fair value of the scheme assets**

	2012 £m	2011 £m
At 1 April 2011/2010	500.6	480.2
Expected return on assets	34.0	34.2
(Loss)/gain on assets	(0.5)	1.1
Employer contributions	7.0	7.3
Member contributions	0.3	0.3
Benefits paid	(21.6)	(21.3)
Administrative expenses paid	-	(1.2)
<b>Bid value of scheme assets at 31 March 2012/2011</b>	<b>519.8</b>	<b>500.6</b>

The actual gain on scheme assets was £33.5m (2011 £35.3m)

**Analysis of amounts charged to operating profit are as follows:**

	2012 £m	2011 £m
Employer's current service cost	6.2	8.1
Expected return on pension scheme assets	(34.0)	(34.2)
Interest on pension scheme liabilities	31.0	33.3
Curtailments	-	-
<b>Total P&amp;L expense before deduction for tax</b>	<b>3.2</b>	<b>7.2</b>

SOUTHERN WATER SERVICES LIMITED

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)**

**22 Pensions (continued)**

**Analysis of the amounts recognised in STRGL:**

	2012	2011
	£m	£m
Actuarial return less expected return on pension scheme assets	(0.5)	1.1
Experience (loss)/gain arising on scheme liabilities	(4.9)	6.0
(Loss)/gain on change of assumptions (financial and demographic)	(34.6)	41.5
<b>Total (loss)/gain recognised in STRGL before adjustment for tax</b>	<b>(40.0)</b>	<b>48.6</b>

The cumulative amount of actuarial losses recognised in the statement of total recognised gains and losses is £132.3m (2010-11 £92.3m)

**Analysis of the movement in the schemes' deficits during the year**

	2012	2011
	£m	£m
Deficit in the scheme at 1 April 2011/2010	(60.1)	(108.8)
Employer's contributions	7.0	7.3
Employer's current service cost	(6.2)	(8.1)
Cost of curtailments	-	-
Other finance expense	3.0	0.9
Actuarial (loss)/gain	(40.0)	48.6
Deficit in the scheme at end of year	(96.3)	(60.1)
Deferred tax relating to scheme deficit	23.1	15.6
Deferred tax on current year pension contribution	3.5	7.7
<b>Net deficit at end of year</b>	<b>(69.7)</b>	<b>(36.8)</b>

**History of gains and losses for the year to 31 March 2012 are as follows:**

	2012	2011	2010	2009	2008
<b>a. Experience adjustment on planned assets</b>					
Amount (£m)	0.5	(1.1)	(83.6)	104.3	37.5
<b>b. Experience adjustment on scheme liabilities</b>					
Amount (£m)	4.9	(6.0)	12.9	(13.1)	7.1
<b>c. Total amount recognised in the STRGL</b>					
Fair value of assets at year end (£m)	519.8	500.6	480.2	318.8	398.4
Actuarial value of liabilities at year end (£m)	(616.1)	(560.7)	(589.0)	(434.5)	(479.4)
Deficit in scheme at year end (£m)	(96.3)	(60.1)	(108.8)	(115.7)	(81.0)

The assets in the current year and the years ended 31 March 2011, 2010 and 2009 have been valued at bid value as per FRS 17 amendment. Southern Water has taken advantage of an exemption in FRS 17 amendment, not to restate the years prior to 31 March 2009 at bid value.

**NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 MARCH 2012 (continued)****23 Contingent liabilities**

Contractors submit claims to the Company for the estimated final cost of their works. These claims are reviewed to assess where the liability for the costs rests and the amount that will actually be settled. The expected amount is included within capital creditors and a further sum is identified as a contingent liability, representing a proportion of the difference between the contractor's claim and Southern Water's valuation.

The Company had no contingent liabilities for capital claims at the year end (2010-11 £nil)

**24 Financial commitments**

As at 31 March 2012, the Company had annual commitments under non-cancellable operating lease agreements in respect of vehicles and land and buildings for which the payment extends over a number of years as follows

	Land and Buildings		Other	
	2012 £m	2011 £m	2012 £m	2011 £m
Expiring within one year	-	-	-	0.1
Expiring between two and five years	-	-	0.1	0.1
Expiring after more than five years	1.3	1.3	0.1	0.1
	<u>1.3</u>	<u>1.3</u>	<u>0.2</u>	<u>0.3</u>

Operating leases are charged to the profit and loss account over the lease term

**25 Related party transactions and ultimate holding party**

The immediate parent undertaking is SWS Holdings Limited

The ultimate parent company and ultimate controlling party is Greensands Holdings Limited, a company incorporated in Jersey

The major shareholders in Greensands Holdings Limited as at 31 March 2012 are IIF International SW UK Investments Limited (advised by JP Morgan Investments Inc) and The Northern Trust Company

Greensands Holdings Limited is the only group company to prepare consolidated financial statements, copies of which may be obtained from the Company Secretary of Greensands Holdings Limited at Southern House, Yeoman Road, Worthing, BN13 3NX

The Company has taken advantage of the exemption under Financial Reporting Standard 8 (revised) in not disclosing details of transactions with other companies which are 100% owned on the basis that the consolidated financial statements in which the Company is included are publicly available

**INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF SOUTHERN WATER SERVICES LIMITED**

We have audited the financial statements of Southern Water Services Limited for the year ended 31 March 2012 which comprise the profit and loss account, the statement of total recognised gains and losses, the balance sheet, the cash flow statement and the related notes 1 to 25. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

**Respective responsibilities of directors and auditor**

As explained more fully in the statement of directors' responsibilities, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

**Scope of the audit of the financial statements**

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by the directors, and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the annual report to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

**Opinion on financial statements**

In our opinion the financial statements

- give a true and fair view of the state of the Company's affairs as at 31 March 2012 and of its profit for the year then ended,
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, and
- have been prepared in accordance with the requirements of the Companies Act 2006.

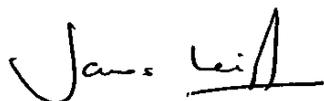
**Opinion on other matters prescribed by the Companies Act 2006**

In our opinion the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

**Matters on which we are required to report by exception**

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us, or
- the financial statements are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or we have not received all the information and explanations we require for our audit.



James Leigh (Senior Statutory Auditor)  
For and on behalf of Deloitte LLP  
Chartered Accountants and Statutory Auditors  
London  
27 June 2012