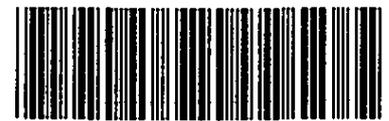




Annual Report and Financial Statements 2015–16

Delivering life's essentials



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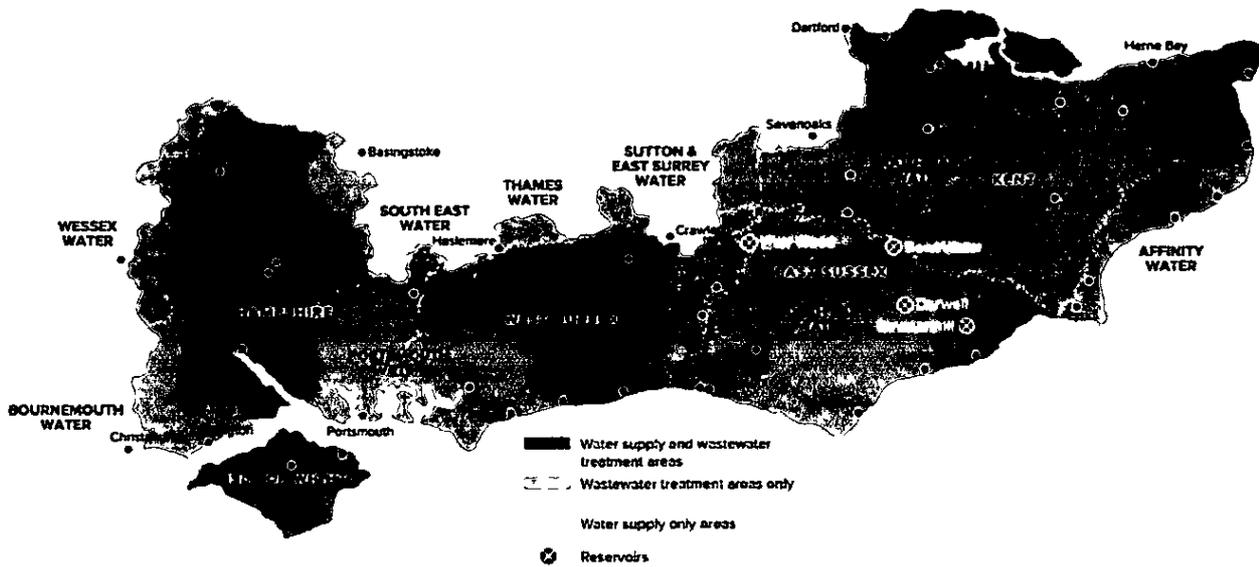
At a glance

Our business

We're proud to provide water and wastewater services to more than 4.6 million people across the South East

Our vision is to be recognised as the UK's leading water company and we will achieve this by

- Providing excellent customer service – which meets and more often exceeds our customers' expectations,
- Embracing innovation and working collaboratively – so that we invest in, and operate, our mains, sewers and treatment works efficiently and effectively, and
- Delivering value for money to our customers and shareholders – focusing on cost management and efficient investment in our assets to keep bills affordable and generate reasonable returns on investment



Water	
People served, millions	2.5
Number of properties, millions	1.1
Number of metered properties	945,168
Average daily water supply, millions of litres per day	521
Number of service reservoirs	195
Number of water treatment works	83
Length of water mains, kilometres	13,837

Wastewater	
People served, millions	4.6
Number of properties, millions	2.0
Average daily wastewater recycled, millions of litres per day	719
Length of sewers, kilometres	39,600
Number of wastewater treatment works	366
Number of pumping stations	2,375

Finance	2015–16	2014–15
Turnover*	£803.7m	£826.2m
Operating profit	£284.5m	£331.5m
Profit before interest and tax	£284.9m	£332.8m
Profit for the financial year	£119.9m	£93.6m
Capital investment	£241.2m	£298.4m
Non-current assets (excluding debt)	£5,678.8m	£5,672.3m
Return on capital employed (ROCE)**	5.1%	5.9%
Average water and wastewater customer bill	£418	£434

Note – The 2014–15 figures have been restated reflecting the adoption of International Financial Reporting Standards (IFRS)

* Non-appointed activities (not regulated by our licence but related to our business, such as property search information) were 1.4 per cent of our statutory turnover

** ROCE is presented as the ratio of profit before interest and tax to non-current assets excluding debt less current liabilities

Our performance

Responsive customer service	Performance 2015–16	Comment
Customer satisfaction		
Service Incentive Mechanism (SIM) score		
Number of compensation payments made to customers (Guaranteed Standards Scheme)		We have adopted a new proactive approach to service, contacting our customers before problems arise. As a result, in the last quarter of the year we received nearly 30 per cent fewer customer complaints than in the same period the year before.
Percentage of contacts resolved first time		
Percentage of customers who feel our service meets their individual needs ¹	N/A	
Percentage of customers who feel our service meets the needs of their community ¹	N/A	

Affordable bills	Performance 2015–16	Comment
Percentage of customers who feel our services provide value for money ¹	N/A	We have helped more than 142,000 of our most vulnerable customers with financial assistance and debt advice during 2015–16. We've done this by partnering with the charity StepChange and local advisory services to reach more of those in need.
Customers in genuine hardship with improved support		

Better information and advice	Performance 2015–16	Comment
Water usage, per capita consumption (litres/head/day)		
Number of unwanted billing queries (unwanted from a customer's point of view)		
Percentage of customers who are aware of the causes of blocked drains ¹	N/A	Our customer surveys allow us to develop information to ensure we provide practical advice to save water, prevent blockages and manage water hardness in homes and businesses.
Percentage of customers who are aware how their money is used ¹	N/A	
Percentage of customers who are aware of how to deal with hard water ¹	N/A	

¹ During the year we have refined our customer survey questions which have been used to measure performance against these promises. As such there is no comparison to target in 2015–16. Future performance will be measured against the 2015–16 position on a consistent basis.

A constant supply of high-quality drinking water	Performance 2015–16	Comment
Customer minutes lost supply > 3 hours		The water we supply to our customers is among the highest quality in the UK and our leakage performance is also among the best
Leakage (Ml/day)		
Water quality (Mean Zonal Compliance) (%)		
Number of contacts regarding discolouration per 1,000 population		
Number of properties with low water pressure		
Number of customers affected by temporary use ban		
Maintain asset health		

Removing wastewater effectively	Performance 2015–16	Comment
Number of blockages per km/year		We missed our reduction target for internal flooding incidents this year, but we remain on track to achieve the 25 per cent reduction in flooding promised to customers by 2020. We invested £45 million this year maintaining and improving our wastewater network
Number of internal flooding incidents		
Number of external flooding incidents		
Number of customer complaints regarding odour		
Maintain asset health		

Looking after the environment	Performance 2015–16	Comment
Wastewater treatment works compliance (%)		Despite falling short of our target to maintain 54 bathing waters at the 'excellent' standard – 99 per cent of the bathing waters in our region (82 of the 83) passed a set of stringent new standards – giving us the best water quality in the country
Maintain the number of bathing waters assessed with excellent water quality		
Number of serious pollution incidents (category 1 and 2)		
Number of less serious pollution incidents (category 3)		
Distribution input (Ml/day)		
Renewable energy usage		

In our business plan we set out 26 clear customer promises for the period 2015–20. We also agreed some additional commitments with Ofwat when it reviewed our plan. The tables above show how we have performed against these targets in 2015–16.

In summary,

- Green indicates where we have met or beaten the performance commitment
- Amber indicates where we have missed our performance commitment but are still on target to deliver the outcomes we promised to customers
- Red indicates where we have not met our performance target and have not delivered the outcomes we promised to customers. In one case we have incurred a penalty for the shortfall.

Further explanation on our performance is set out in the subsequent sections.

The detailed definition and explanation for red/amber/green on each commitment are given in Appendix 2 of the Annual Performance Report published on our website.

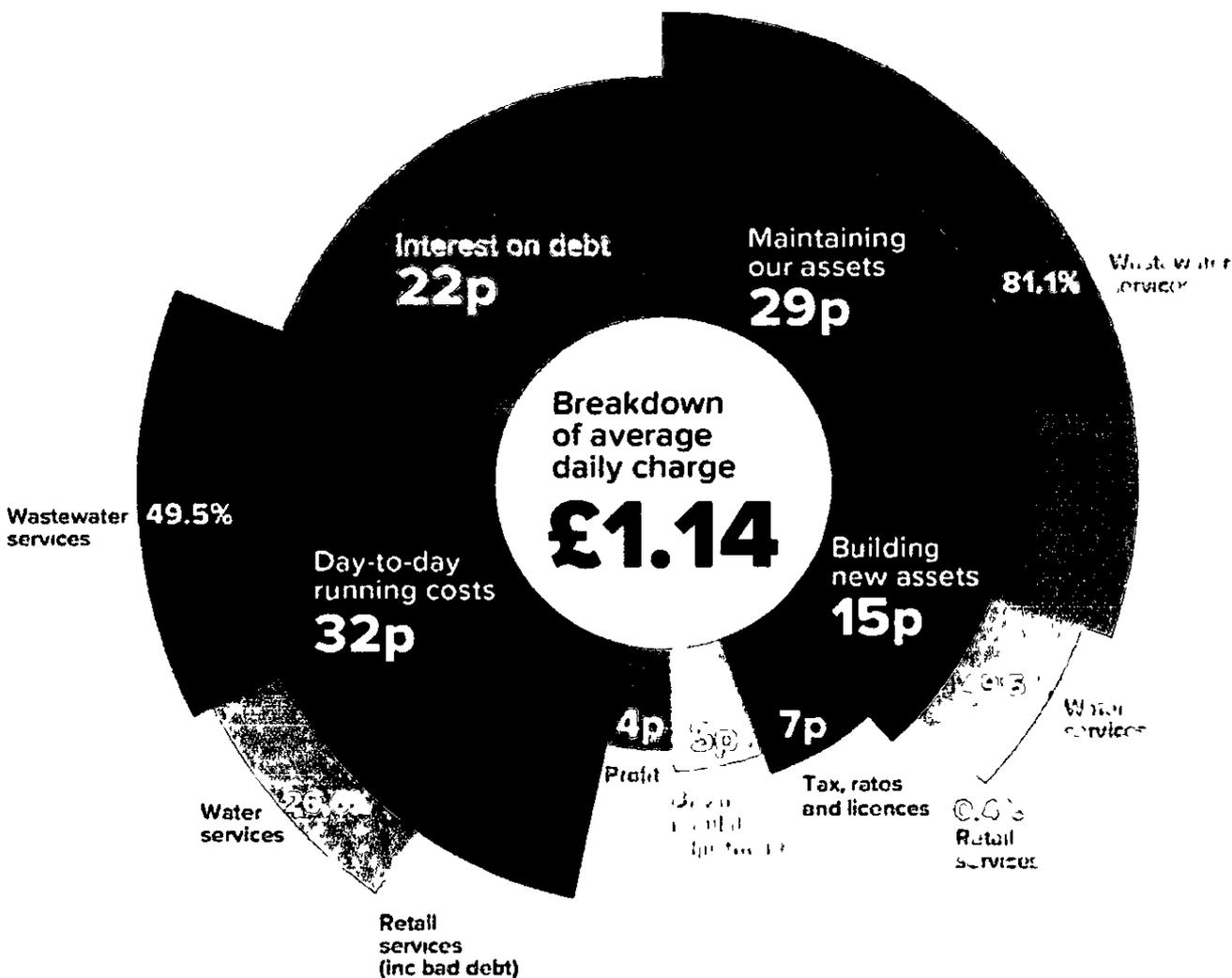
Where your money goes

The average combined bill for our household water and wastewater customers in 2015–16 was £418, equivalent to £1.14 per day

Over this five-year period, 2015–20, we are planning to spend £3 billion operating, maintaining and improving our assets. Of this, £1.8 billion relates to investment in new and improved assets, which is equivalent to almost £1,000 for every property in our region

We recognise that it is important for customers to understand where their money goes and we have committed to increase awareness of this through our reporting. This information is clearly explained in a leaflet sent out each year to customers as part of our annual billing process. Currently 60 per cent of our customers say they know what we do and how we spend their money

The diagram below illustrates how an average annual bill contributes to our business, based on 2015–16 figures



Day-to-day running costs – this includes wages for direct employees and people indirectly employed through our supply chain as well as power, chemicals and materials costs and the cost of providing for bad debt when charges are not paid by customers

Interest on debt – interest incurred on money we have borrowed to finance the business. This borrowing helps us to spread the cost for customers of improvements made to our services over the longer term

Maintaining our existing assets – expenditure to maintain our underground pipe network and treatment works, including capitalised employee costs

Building new assets – for example our £63 million modernisation of the treatment works at Woolston in Southampton and other projects to enhance treatment standards and cater for growth

Tax, business rates and licences – this includes corporate taxes, business rates on buildings, wastewater treatment works and water supply works and Environment Agency licences

Ofwat/regulator adjustments – these adjustments, rewards and penalties, have been applied by our regulator Ofwat in the period 2010–15. These relate to customer satisfaction, cost savings and revenue collection

Profit – the return earned on shareholders' investment in the business

Retail – handling customer enquiries regarding the network and water and wastewater charges and the provision of services from billing through to debt collection

Water services – the treatment and distribution of water for supply to customers

Wastewater services – the collection and treatment of wastewater from customers for return to the environment

Welcome

Chairman's introduction

On behalf of Southern Water's Board of Directors, I would like to welcome you to the company's Annual Report and Accounts 2015–16

Pride in our progress

As our Chief Executive Matthew Wright will report in more detail in his review, 2015–16 was our best ever year in terms of the operational performance we have delivered for our customers. We have continued to sustain industry-leading performance in health and safety, leakage and drinking water quality while making a host of improvements across many other areas of the business.

In areas where we have faced challenges in the past, such as customer service, we are starting to see signs of improvement. We are conscious that there is more to do but we are committed to building on the successes and, indeed, the setbacks made in this first year of our five-year plan.

We are already starting to think about the challenges ahead and the next business plan period of 2020–25 and how we deal with issues like climate change and population growth. We're leading the charge on innovative solutions which will build greater levels of resilience into the services we provide to customers, for example water re-use and using waste to generate energy.

There are many more exciting plans to share over the coming year. For example, the launch of a pioneering integrated water cycle management programme (IWCM) will see us develop collaborative partnerships with a range of industries, such as agriculture and tourism, in order to look holistically at all the factors influencing water supply, demand and wastewater disposal. It is only by working with partners in this way that we can really start to make solid plans for the future, even beyond 2020.

Prudent management

Our Business Plan 2015–20 is focused on improving the essential services we provide to our customers, based on direct feedback from them. This year, customers have already seen a number of direct benefits:

- In 2015–16, our average bill fell by nearly four per cent, from £434 to £418. During the five-year period of our 2015–20 plan, the average bill paid by our household customers is forecast to fall by eight per cent, before the impact of inflation.
- In April 2015 we introduced a new social tariff, called Essentials, for customers struggling to pay their bills. It provides lower bills for customers who spend a large proportion of their household income on water service charges.
- We have seen a drop in the number of pollution incidents – both the number of total pollution incidents and serious pollution incidents fell significantly in 2015.
- We beat our leakage target for the fifth consecutive year by reducing leakage to 84 million litres per day, against an agreed target of 88 million litres.
- Over the past year we've beaten the target we set ourselves to help our customers reduce average water use, with a final figure of 130 litres per person, per day against a target of 135 litres.
- We are proud that the quality of our drinking water is outstanding. This year we've provisionally achieved 99.98 per cent compliance against the Drinking Water Inspectorate's (DWI) overall water quality measures, subject to confirmation.
- Our bathing water quality is now the best in the country. This result puts us in a strong position to continue our Bathing Water Enhancement Programme – designed to go beyond basic regulatory requirements and provide a boost to local economies by improving coastal water quality along the 1,100 kilometres of coastline in our region.
- We've completed the first year of our £1.8 billion capital investment programme, with more than 250 projects now under way to repair, refurbish and upgrade our assets.
- In the last quarter we've also started to see a marked improvement in the quality of our customer service and we are confident that we will continue to make headway in this area.

Our credit rating continues to be strong thanks to effective cost control and prudent financial management. This has meant we have retained access to capital markets on favourable terms, which enables us to keep prices down and continue investing for our customers.

This report will describe in more detail how we have delivered benefits to customers in each of the areas I have highlighted above, but I think it's fair to say we can look back with some pride at how we've begun to realise our five-year plan.

Listening to customers

My thanks go to the Southern Water Customer Advisory Panel (CAP), which provides independent and critical appraisal of how well we are meeting our customers' needs. Chaired by Anna Bradley, the panel members work hard to provide the independent challenge and scrutiny which help us to ensure the six priorities in the business plan are being delivered, and the 26 customer promises are being met. I speak for the Board when I offer them my gratitude for their oversight and diligence.

The road ahead

To conclude, there is a tremendous amount of progress to be proud of but we should not under-estimate the challenges facing our company and our sector. Competition is entering the market, technologies are changing forever the way we interact with customers and, in the long term, issues like climate change and population growth loom large. But we are confident that the Southern Water team is up to the challenges ahead – particularly if the company's strong performance over the past year is an example of the sound management and robust planning of which it is capable.

We have a diverse Board from a range of professional backgrounds who, I'm proud to say, form a strong team. This year has been one of bedding-in and setting our collective experience to work on delivering the goals for the business plan period 2015–20 and beyond. The strategic contributions from our non-executive directors have been critical in developing a more customer-focused approach and supporting our capital delivery planning.

On behalf of the Board, I would like to thank the dedicated members of staff who give the company its passion and energy, as well as our partners and contractors for their contribution to Southern Water's successes. I am very proud to be the Chairman of such an aspirational organisation.



Robert Jennings
Chairman

Our Board

The Board is responsible for the overall strategic direction of the business. During 2015–16, it was made up of an independent non-executive Chairman, two executive directors (the Chief Executive Officer and Chief Financial Officer) and six non-executive directors, four of whom are independent.

The day-to-day operation of the company is overseen by the Executive Management Team, which comprises the Chief Executive Officer, Chief Financial Officer and five functional directors. None of these five directors is a member of the Board.

The ultimate holding company of Southern Water Services (Southern Water) is Greensands Holdings (Greensands), owned by a consortium of pension and infrastructure funds, which are committed to a long-term investment in our business.



The Board members and Company Secretary are pictured above. They are, from left, front row
Robert Jennings, Chairman
Joanne Statton, Company Secretary
Matthew Wright, Chief Executive Officer
Rosemary Boot, independent non-executive director
Mark Walters, non-executive director

Left to right, back row
Bill Tame, independent non-executive director
Bronte Somes, non-executive director
Lisa Harrington, independent non-executive director
William Lambe, Chief Financial Officer
Paul Sheffield, independent non-executive director

Find out more about the Board on pages 76–79

Chief Executive's summary

I'm pleased to introduce Southern Water's Annual Report for 2015–16. The report marks the completion of year one of our five-year business plan for 2015–20. And, as the report will demonstrate, we've made a strong start.

The business plan for 2015–20, or AMP6, was based on the most ambitious and extensive programme of customer and stakeholder research in Southern Water's history. The feedback from more than 34,000 people informed the six priorities that have laid the foundations of our business objectives. In addition, we made 26 promises relating to these priorities, against which customers can judge our performance.

As we look back on our progress at the end of this first year of our five-year plan, I'm proud to report that in almost all aspects of our business – leakage rates, drinking water quality, wastewater treatment, bathing water quality, health and safety – the performance we have delivered places us among the best in our sector.

In areas where we have faced challenges in the past, such as customer service, we are seeing signs of improvement, although we know there is more work to be done and we are committed to building on the progress made.

This annual report looks in detail at our performance over the past year and how it measures up to the promises we made to our customers. We have sought to be open and transparent about when we've done well but also where we have fallen short, and we have set out how we intend to meet our customers' expectations across all areas of our business in the future. Performance highlights from the past year include:

Health and safety

We continue to lead the industry with our excellent health and safety performance, achieving the lowest number of injuries in our history. We recorded an uninterrupted run of no reportable injuries to any member of staff for 427 days. An injury becomes reportable when a person is away from work, or unable to perform their normal work duties, for more than seven consecutive days as the result of their injury.

Leakage

We beat our regulatory target for the fifth consecutive year by reducing leakage to 84 million litres per day, against a target of 88. This puts us at the top of the sector league tables and means that Southern Water has had the lowest levels of leakage in the industry for more than 10 years.

Drinking water quality

Our drinking water quality is, once again, outstanding. We provisionally achieved 99.98 per cent against the Drinking Water Inspectorate's quality measures, subject to confirmation. As a result, of the 10 largest water companies in the UK, we expect to be confirmed as sector leaders for the 2015 calendar year.

Wastewater treatment

We achieved 99.3 per cent compliance with current environmental standards at our wastewater treatment works. We had failures at two works and while we strive for 100 per cent compliance, this performance represents the best in our history. It also places Southern Water alongside the industry leaders.

Bathing waters

We recorded our best ever performance for the quality of our coastal bathing waters. All but one of our 83 designated bathing sites met more stringent requirements under the new European Bathing Water Directive, the lowest failure rate of any region in the UK.

Bathing water quality is affected by many factors in and outside Southern Water's control, which is why we continue to work with partners, such as local authorities and environmental groups, to keep our beaches as clean as they can be. This approach paid dividends in Hastings where we worked with the council to identify issues with the public and private sewer network to achieve a 'good' classification under the new more stringent bathing water standards.

Pollution incidents

We had 167 pollution incidents in 2015 – a reduction of 43 per cent compared with 2014 and our best performance in 15 years. In fact, we have seen a major improvement in our pollution performance over the past five years, with the number of less serious category 3 incidents falling from 466 in 2011 to just 160 in 2015. In addition, the number of serious pollutions fell from 21 in 2011 to seven in 2015.

Improving customer service

We've continued to improve the quality and responsiveness of our customer service but there is certainly more to do. Our score against Ofwat's measure of customer satisfaction, the Service Incentive Mechanism (SIM), disappointingly places us at the bottom of the industry league table for elements of our customer service, for example, call handling times and how we deal with customer complaints.

This is something we are determined to address. Indeed, during 2015–16 we have already laid the foundations for future improvements which will help us fulfil our customers' expectations.

Our customer service teams have worked hard over the past year to implement significant changes. Since 1 December 2015 more than 80 per cent of calls have been answered within 30 seconds, addressing one of our customers' main frustrations – a desire to have their calls answered quickly and have any problems resolved first time. We've also brought in new systems, such as Rant & Rave, which enable customers to give us instant feedback so we can act immediately if we've got something wrong.

Most importantly, the number of complaints to our company is now starting to fall. In the last quarter of the year we received nearly 11 per cent fewer complaints than in the same period the year before.

Our aim is to better predict what customers need so that potential issues can be resolved before they become a problem. One way we're doing this is through our new proactive customer contact team. When a problem is identified – such as an unusual increase in a customer's water use – the proactive team contacts them to find out the source of the increase and offer support. The team can then establish if the increase is due, for example, to more people at the property or a previously undetected leak in the pipe network.

We're confident that measures such as this will help us provide the high-quality service our customers expect and deserve, more of the time.

Planning ahead

We're privileged to provide essential water and wastewater services to the communities we serve so we must think about, and plan for, the longer term. Therefore, at the same time as focusing on the delivery improvements today, we are also planning and investing to address the challenges of tomorrow.

Climate change, tighter environmental standards and rapid population growth in our area are all combining to place greater pressure on the water and wastewater services we provide. Outlined below are some of the innovative ways in which we're seeking to mitigate these pressures and maintain, or improve, service levels for customers well into the future.

Resilience

Improving the resilience of the water and wastewater services we provide while at the same time responding to growth and protecting the environment is a challenge being faced by the whole industry. In the South East, an area of water stress and high environmental sensitivity, the challenge is even more acute.

We have therefore developed an innovative, industry-leading approach to plan for sustainable supplies of drinking water. We examined thousands of future drought scenarios to help us create realistic plans and our expertise in this area has been critical to the development of a National Water Resources Framework, which will inform national planning for future water resource needs across the country.

We have also established a group that is looking to develop a single water resource management plan for our region. This will enable us to take a holistic look at growth in the region and identify solutions that increase the resilience of our service while protecting the environment.

In addition, we are developing two specific water re-use schemes, which will provide a vital resource to support the rivers we abstract from during droughts. We believe there is potential for water re-use schemes to play a far greater role in securing water supplies for future generations.

Higher standards

Our Bathing Water Enhancement Programme is the first in the country that seeks to go beyond minimum performance levels and deliver even higher standards of bathing water quality. We're doing this because our customers told us that the standard of bathing water, and associated beach quality, is crucial to the lifestyle and livelihood of the South East.

Working with local authorities, the Marine Conservation Society and a host of other local stakeholders, we're currently examining how we can move another seven bathing waters in our region to the 'Excellent' standard needed for Blue Flags to be awarded.

Affordability and vulnerability

We're leading the water sector in supporting customers who are most in need. We've joined forces with organisations such as local authorities, including Brighton & Hove City Council, and consumer debt advice agencies, to provide proactive guidance for customers in financial difficulty.

We now offer a range of tariffs with tailored payment options for those who qualify for extra help. And we ensure that free water-saving advice – which can contribute to lower bills – is widely available via our website, publications and through external partners such as housing associations.

As the first water company to complete the delivery of a universal metering programme, we have ensured that the vast majority of our customers, around 90 per cent, now only pay for the water they use. Alongside our metering programme we're providing free water-saving audits, in order to help our customers save water, energy and money.

Building strong partnerships

A key theme of our 2015–20 business plan is the need to establish better relationships with stakeholders in our region to deliver our targets and promises.

With this in mind, we introduced our stakeholder engagement team in April 2015 to build on our relationships with local opinion formers. Since its launch, the team has briefed MPs and organisations such as charities, chambers of commerce and local authorities on the key aspects of our plan. We hope this will strengthen relationships between Southern Water and different agencies to shape regional and national policy.

A great example is our recent partnership with Natural England to employ water 'catchment rangers' to work with farmers on solutions to the use of nitrates and pesticides which can affect water quality and the health of our rivers.

Finances

Alongside the delivery of the 26 promises we made in our business plan for 2015–20, we will also reduce average bills over the five-year period by eight per cent before inflation.

Consequently, our financial results for 2015–16 reflect a reduction in revenues of almost three per cent, to £804 million, down from the £826 million reported in 2014–15.

The reduction in revenues also contributed to a lower operating profit of £284 million – a 14.2 per cent reduction from the previous year.

To assist in delivering improved performance for our customers, we have also seen an increase in operating costs this year. In total, operating costs increased to £286 million from £273 million in the prior year. This increase has been driven by initiatives to improve our customer service, such as the creation of a proactive, outbound customer contact team.

Costs were also added this year by a programme of work aimed at introducing more efficient ways of working across the business and by the cost of preparations for the introduction of market reform and retail competition for non-household customers

Over the past five years, our shareholders have supported us in strengthening the business by not taking a dividend. This has enabled us to make considerable improvements to our operational performance over 2010–15. In addition, this support meant we could reduce our gearing, the ratio of debt to equity used to finance the business, in turn reducing our financial risk, strengthening our overall financial position and improving our credit ratings.

As a result of these improvements, we are now in a much stronger position financially and operationally. As a consequence, in 2015–16, we resumed dividend payments with shareholders receiving £79.6 million.

Community pride

At Southern Water, we are proud to serve our local communities. So, at the same time as providing essential water and wastewater services to the south east of England, it's important that we give something back.

This year, our community engagement team talked to more than 20,000 customers at 22 events where they offered practical advice and help on key issues such as water efficiency, affordability and the correct disposal of fat, oil and grease.

We've also raised more than £182,000 for a number of local charities, including the Air Ambulance Trusts, and provided support for children's hospitals and centres for adults with a range of disabilities. We also continue to support the international charity, WaterAid – our supporters across the business raised a grand total of £75,000 for the charity in the past year.

Our employees put in more than 24,000 volunteering hours in 2015–16. Their efforts included community gardening, decorating at a local children's hospice and even building nest boxes for endangered dormice.

Our Learn to Swim programme continues to go from strength to strength and this year alone we helped more than 30,000 children learn to swim. The scheme celebrates 25 years in 2017 and, to date, we have helped more than 700,000 children develop this life-saving skill.

Thanks to our employees

Finally, I would like to pay tribute to our employees in what has been a landmark year in terms of performance. It is only as a result of their hard work, dedication and commitment that I can report the progress we have made in the past 12 months. I think we can look back at the first year of delivering our plan with a mixture of pride at what we have achieved and optimism that we've laid foundations for a strong future.

With four more years of our five-year plan to go, the need to tackle some long-term challenges facing the industry and the opening of the market to competition, this is an exciting, if challenging, time for our organisation.

Despite the challenges we face, I know that we don't just want to be good at what we do, we want to be the industry leaders. With the drive, commitment and engagement of our employees, stakeholders and customers, we can be optimistic about the opportunities for success that lie ahead.

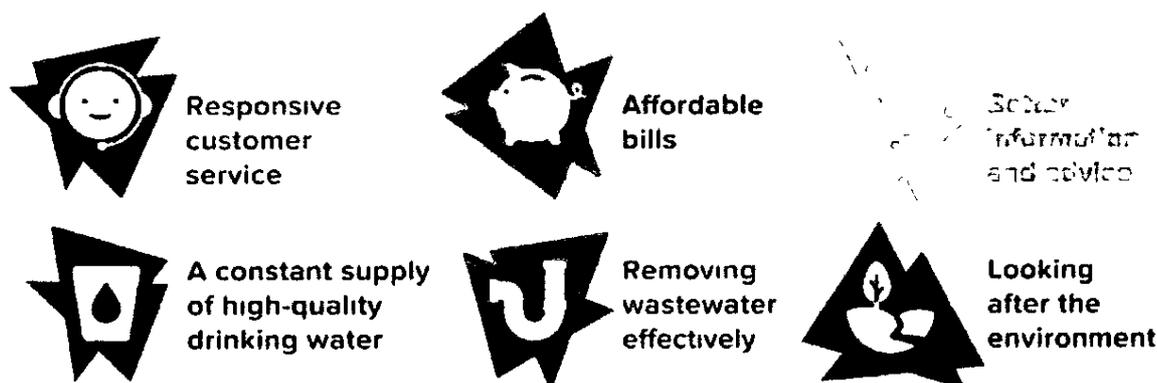


Matthew Wright
Chief Executive Officer

Strategic report – an introduction

This report marks the successful completion of the first year of our ambitious five-year business plan for 2015–20 – a plan that is built around our customers' priorities

We conducted the most extensive programme of customer and stakeholder engagement in our history, consulting more than 34,000 people over a period of 18 months to find out what was important to them. Based on the insights and feedback gathered from this research, we defined six key customer priorities (see graphic below), and 26 specific promises, with measurable outcomes and clear performance targets which we are confident will deliver industry-leading water and wastewater services for our customers



Over the course of our five-year plan, we will spend around £3 billion improving the services we provide in the areas of highest customer priority. Of this £1.8 billion relates to investment in new and improved assets, which is equivalent to almost £1,000 for every property in our region. Over the same period of time, the average household bill for our customers will fall by eight per cent before inflation.

The majority of this document is focused on reporting openly and transparently on the promises we made to our customers and how we measured up against the targets we set for ourselves based on their priorities.

The remainder will outline how we plan to develop our business to get us ready for the challenges that we – and our colleagues in the water sector – face over the longer term.

A great start

We can look back with some pride at the past year's performance. We delivered our best ever performance against many of our key measures. Highlights from the year include:

- Our leakage teams beat our target for the fifth consecutive year, reducing leakage to 84 million litres per day, against a target of 88 million litres. This performance means we remain as industry leaders.
- We provisionally achieved 99.98 per cent compliance against the Drinking Water Inspectorate's quality measures – this equates to only two failures in every 10,000 samples – making us sector leaders for the 2015 calendar year, subject to confirmation.
- We achieved our best performance in 15 years in terms of pollutions, with a 43 per cent drop in the number of incidents.
- We achieved the best performance in our history for meeting stringent environmental standards at our wastewater treatment works with 99.3 per cent meeting their permit.

At the same time, we continue to look after our people. Southern Water's credentials as a safe place to work are again outstanding and we continue to lead the industry in health and safety. Last year we achieved the lowest number of injuries in our history.

Rewards and penalties

To underpin the performance promises that we made to our customers we have agreed with Ofwat that a number of our targets, for the period 2015–20, should have financial penalties associated with them. In a smaller number of cases there is also the opportunity for us to earn rewards if we beat our targets.

These financial penalties and rewards are attached to those measures our customers told us were most important to them and will be reflected in customer bills in future investment periods

All but one of the 83 bathing waters in our region met the new, tighter minimum standards introduced this year. Despite this excellent result, due to some extreme weather experienced in August, we did not meet our target to maintain water quality at 54 of the region's beaches at the very highest "excellent" status – which is consistent with the standard required for a Blue Flag.

Our performance of 43 beaches at excellent status means we will face a financial penalty of £1.458 million.

A number of our promises have rewards and penalties attached that are based on performance over the whole five-year period of our business plan. This means we only earn a reward, or incur a penalty, if performance across the whole period is better or worse than our target, rather than for individual years.

Based on performance in the first year, we would incur a penalty in respect of internal sewer flooding, where we are above our target, but we will be working hard to beat our target in future years to offset this.

We are on track for a reward for helping customers to reduce the amount of water they use, where we have beaten our consumption target in the first year of our plan. We are also on track for a reward for beating our leakage target in the first year.

Overall, based on our first year performance we would expect to face a net penalty, with the penalties for not meeting our beaches and flooding targets exceeding the potential rewards in respect of consumption and leakage. However this will depend on how we perform for the remaining four years of our business plan period.

Future challenges

Providing essential services to 4.6 million people across Kent, Sussex, Hampshire and the Isle of Wight, is just one part of what we do as a water and wastewater company.

A huge amount of our time is spent planning for and investing in the future, factoring in issues such as climate change, population growth and tighter environmental standards.

Throughout this report we will outline some of the innovative approaches we are adopting to meet these future challenges and maintain and improve on the levels of service we provide to the communities we serve. A few highlights are listed below:

- We've introduced a new proactive service model which aims to remove the need for customers to contact us by anticipating potential issues and proactively contacting them. This new service model, along with improvements to our billing information, will help us meet our target to move up our regulators' league table of service performance and continue to build on improvements already made.
- The South East is an area of water stress so we have to make sure we plan to deliver a sustainable supply of drinking water for future generations. To do this, we have modelled thousands of drought scenarios and worked with partners to develop a single Water Resources Management Plan. We are also looking at two specific water re-use schemes, which will ultimately lower the amount of water we take from rivers during droughts.
- Our customers told us that clean, safe bathing waters were a priority, so we have invested in a new Bathing Water Enhancement Programme which sees us working with organisations such as the Marine Conservation Society and a host of other stakeholders to raise the standards of bathing water across more of the beaches in our region to 'excellent'.
- Working with debt agencies and local councils, such as Brighton & Hove City Council, we have developed a range of flexible payment options and tariffs for our customers in financial difficulty. As part of this programme our water-saving team has started a series of home visits and free retrofits of devices to further help those customers struggling with high bills.

These are just a few examples of the proactive approach we're taking to address the issues our customers have said were most important to them.

The regulatory landscape is also changing, with the introduction of retail competition for water and sewerage services to non-household customers in England from April 2017. The changes will allow these customers to choose which company provides their water and sewerage retail services.

The purpose of market reform in the water sector is to stimulate innovation and deliver a choice to non-household customers of who provides their retail service.

Water companies will be required to separate the wholesale and non-household retail parts of their businesses to create a level playing field for new entrants to the market. These new companies can provide retail services, but the existing water companies will maintain responsibility for the water and sewerage networks in the region, i.e. the wholesale activities.

More than 100,000 of our non-household customers will be affected. Our market reform readiness programme is well under way to deliver the business changes needed to meet the challenge of a new market and continue to deliver our customer promises.

After looking carefully at the options available to us – that will ensure both compliance and a business model that will thrive in the new market – we have decided to sell our non-household retail business to Business Stream, a specialist retailer who has been at the forefront of the competitive market in Scotland.

Customers

Responsive customer service

	2015–16		2014–15
	Target	Achieved	Achieved
Customer satisfaction			
Service Incentive Mechanism (SIM) score ¹	79	73	72
Contacts resolved first time (%)	80	67	N/A
Customers who feel our service meets their individual needs (%) ²	N/A	66	N/A
Customers who feel our service meets the needs of their community (%) ²	N/A	33	N/A
Number of compensation payments made to customers (Guaranteed Standards Scheme)	3,783	3,912	3,711

¹ Call categorisation of unwanted and wanted calls is associated with a degree of subjectivity. Our year end audit identified that additional assurance processes and controls need to be implemented to further mitigate the risk of call mis-categorisation. As a result, we will put in place an action plan to minimise any issues going forward. Call categorisation is a component of SIM. In addition, the calculation method changed for SIM during 2014–15. The prior year score has been restated to reflect this new methodology.

² During the year we have refined our customer survey questions which have been used to measure performance against these promises. As such there is no comparison to target in 2015–16. Future performance will be measured against the 2015–16 position on a consistent basis.

We're continuing to improve the quality and responsiveness of our customer service but there is more to do

We promised our customers we would do the following

- Improve our customer satisfaction scores and ranking in our regulators' league table (SIM score)
- Resolve their queries quickly, with 90 per cent resolved first time by 2020
- Demonstrate an improvement in our services by increasing the number who felt we met their needs and those of their community
- Pay direct compensation to those customers we let down

We have continued to make progress with improving the responsiveness and quality of the service we provide to our customers, but we have not done this as quickly as we would have liked during the year or met some of the ambitious targets we set ourselves.

Our performance in the second half of the year, and in particular in the last quarter, showed signs of significant and sustained improvement. Customer complaints were 11 per cent lower at the start of the year than the equivalent period last year and customer satisfaction improved significantly, with scores of 4.13 (out of a maximum of 5) in the final survey, compared with 3.80 at the beginning of the year.

This improvement reflects the implementation of a new proactive customer service model. Following detailed analysis of the root causes of dissatisfaction and research with our customers, we have moved to a model that aims to identify issues and contact customers before they would normally become aware there was a problem. For example, now the vast majority of our customers are metered, almost 90 per cent, we can identify any changes in consumption patterns and make contact with the customer before they receive a higher bill. This allows us to understand why a customer's consumption may have changed so we can take appropriate action, for example, because of a leak, issues with the meter reading or changes in family circumstances we might adjust a customer's bill accordingly.

In order to deliver this step change in customer experience, during 2015–16 we outsourced all in-bound calls relating to billing to the specialist provider Capita based in the UK. This enabled us to restructure our key customer teams and take stock of our internal systems and processes. It has also enabled us to quickly deliver significant improvements in call waiting times.

Based on the changes we have made and the performance improvements we have seen so far, we are confident that we can meet our targets and move up our regulators' league table

Customer satisfaction

Our customers have said clearly that they want us to improve the quality of customer experience we offer them. To meet their needs, we set ourselves some ambitious targets in our Business Plan 2015–20.

During 2015–16, we invested significant time and resources to develop a deeper understanding of what our customers expect from us and what we need to do to address areas of our service with which they are dissatisfied.

Ofwat uses the Service Incentive Mechanism (SIM) to assess how well all water companies serve their customers. SIM is made up of two elements: a quantitative and a qualitative assessment of customer service. The quantitative assessment looks at levels of unwanted contact (from a customer's point of view) including written complaints. The qualitative assessment looks at customers' overall satisfaction with the service they have received, when they have had cause to contact us. The overall SIM score is weighted one third on the quantitative assessment and two thirds on the qualitative.

Based on performance over the five years from 2015–20, companies that achieve a better than average SIM score can earn financial rewards, while those that are below average receive a financial penalty. These rewards and penalties will be reflected in customers' bills from 2020.

Our customer service performance continued the trend of improvement established under our previous business plan, but we did not hit all of our targets for this year. In 2015–16 we marginally improved our SIM score to 73, up from 72 in 2014–15. Despite the improvements we have delivered we remain at the bottom of the industry league table for SIM, missing our target score of 79 for this year.

Unless we improve our performance in the remaining years of the business plan period, our performance this year means we would receive a financial penalty.

In the second half of the year we began to see the results of our work to transform our approach from one that reacts to customers to one that anticipates potential problems before customers become aware of them. Customer satisfaction, as measured by Ofwat's SIM survey, has increased by nine per cent between the first and last quarters of the year – from 3.80 to 4.13 out of 5. There has also been a decrease in the number of calls we receive. In total, during the last year we received 1.5 million phone calls, a 25 per cent drop in customer calls from our 2014–15 figure of 2.0 million.

Resolving issues and meeting our customers' needs

Our aim is to remove the need for customers to contact us by anticipating potential issues and proactively contacting them.

On those occasions where it is necessary for customers to contact us, it is important that we deal with their queries quickly and effectively. We are continuing to see improvements in the speed with which we answer customer calls. By early 2016, we were beating our monthly target to answer 80 per cent of calls within 30 seconds.

We also promised that we would deal with more issues at the first point of contact. By 2020 we have committed to resolving 90 per cent of issues at first contact. We have set ourselves challenging improvement targets for each year up to 2020 in order to achieve this, with a target for 2015–16 of 80 per cent of calls resolved first time. Disappointingly, despite the improvements we have seen in this area, we missed our target for the year, with a performance of 67 per cent.

Despite the challenges we have faced in rapidly improving our customer service performance, 66 per cent of our customers agree the services we provide meet their needs while 33 per cent agree that we met the needs of their community. During the year we have worked with our Customer Advisory Panel to refine the way we measure our performance against this promise to better capture our customers' views. We will aim to improve on this performance each year.

We want to ensure we provide a range of channels for our customers to interact with us and to pay their bills, by providing clear, easily accessible information. To enable us to do this we regularly attend community events, work with local schools, social groups and charities and work directly to help those customers with specific needs.

Recognising when we get it wrong

If we fail to provide an appropriate service we compensate customers under our Guaranteed Standards Scheme (GSS). The GSS sets out a minimum standard of service customers should receive from us in a range of areas including responding to complaints and queries, interruptions to supply and flooding from sewers.

The GSS also includes enhancements to the statutory payments which we agreed with Ofwat as part of the review of our business plan. These enhanced payments to customers include compensation for poor service in specific areas, such as missed appointments, County Court judgments (for unpaid debt) issued in error and sewer flooding inside homes or businesses. The areas covered by the additional compensation reflect research, carried out for our business plan to find out what customers found most frustrating in terms of service failure.

We made 3,912 GSS payments during 2015–16 totalling £454,000, an increase of 201 payments from last year, meaning we missed our target of no more than 3,783. The increase in payments was almost entirely due to a rise in the number of complaints not responded to within 10 days. This reflected the increased level of complaints we were receiving at the start of the year. Following the reduction in the number of complaints being received by the last quarter, we are now responding to most complaints within five days. There were improvements in water quality during the year, resulting in fewer calls about discolouration, taste and odour in 2015–16, at 58 compared with 77 calls the year before.

Customer improvements

Further improvements are planned to ensure that we provide a service which fully meets our customers' expectations and helps us achieve our target to be one of the best performers in Ofwat's SIM league table.

In the first half of the year we will focus on improving the way we deal with complaints, as well as how we calculate payment schemes and pay any refunds. We will maintain our focus on a proactive approach to contact with customers, intervening to address issues before they become aware of a problem.

Over the next 18 months we will be building, testing and rolling out a completely new billing experience for our customers. This ambitious programme aims to reduce complaints by a further 40 per cent over the next year and help customers manage their accounts more easily. The programme will

- Improve the way that we welcome new customers to Southern Water, ensuring they understand the payment options available to them,
- Provide customers with the choice of receiving simplified electronic or paper bills,
- Introduce more services including the ability to set up a new account and manage more transactions, via our website,
- Provide monthly consumption monitoring and alerts for our most vulnerable customers, to avoid the risk of any bill surprises, and
- Allow customers to monitor the progress of their queries and complaints online.

Initially we will pilot these new services with those customers that contact us most often, to ensure that they meet their expectations and deliver the benefits we expected. These pilots will cover more than 180,000 of our customers. We will then roll out the new services to all customers as they are proven.

As we develop these services we will continue to engage with our customers to understand how their expectations are changing over time and ensure that we develop our processes in response. We know our customers don't want to call us, but sometimes things go wrong and they have to. When they do, we want to make sure we offer them the best possible service. This means our teams need to be armed with up-to-date information about customer accounts, such as meter readings and billing history, so they can offer customers feedback, in real time via a range of responsive, proactive communications channels.

Affordable bills

	2015–16		2014–15
	Target	Achieved	Achieved
Customers in genuine hardship provided with improved support	127,500	142,040	113,210
Customers who feel we provide value for money (%) ¹	N/A	61	N/A
Efficiency savings (£m)	N/A	56	N/A

¹ During the year we have refined our customer survey questions which have been used to measure performance against these promises. As such there is no comparison to target in 2015–16. Future performance will be measured against the 2015–16 position on a consistent basis.

We are committed to providing value for money and helping customers in financial hardship who struggle to pay their water bills

We promised our customers we would do the following:

- Provide more support for those experiencing genuine financial hardship
- Provide better information on how we are improving value for money
- Deliver efficiency savings of at least £200 million between 2015 and 2020 to keep bills as low as possible

In the past year we have increased the level of practical support and advice we offer to customers in financial difficulty. Our new social tariff, Essentials, has launched and we've also started working with StepChange, one of the UK's leading debt charities. By working in partnership with trusted third-sector organisations we can be more effective at identifying vulnerable customers and providing them with a more holistic approach to managing their financial challenges.

There was a significant focus in the year on proactive debt prevention and early collection of money owing from our customers prior to debt collection agency involvement, usually after a period of 57 days. A review of our debt-recovery procedures has also started. This will help us to further reduce debt levels, and achieve our ultimate aim to be a leader in affordability, helping vulnerable customers.

We are proud to have been recognised in two recent reports by Ofwat for the standard of the support we offer to vulnerable customers in our area².

Customers in genuine hardship

In 2015–16, we helped more customers in genuine hardship by providing better information, supplying targeted advice and introducing new tariffs and payment schemes that support customers to tackle their affordability challenges head on.

Our target for 2015–16 was to increase the number of our most vulnerable customers who have received help to pay their bills and manage their debt to 129,500. We significantly exceeded this figure, providing 142,040 customers with financial assistance and debt advice.

We have continued our water efficiency and affordability programme, which offers free water-saving audits, targeting vulnerable customers and homes with unusually high water consumption. During these audits, we fit water-saving devices to taps, toilets and showers. We then monitor the customer's bills to see if better water efficiency is reducing their consumption and, therefore, their bill. If consumption doesn't fall, it helps us highlight other factors that may need to be addressed, such as a leak on a supply pipe or within the customer's plumbing.

² Affordability and debt (December 2015) and Vulnerability focus report (February 2016)

We have joined the Consumer Council for Water (CCW) and Brighton & Hove City Council to support customers already classified as 'fuel poor'. These customers are offered advice and practical help to lower their water costs, alongside a service that helps them fill in applications for our financial assistance schemes.

In the last year we have undertaken over 12,000 debt advice visits using a specialist partner, Orbit, putting affordability rather than debt at the heart of conversations with customers. We are also working with the charity StepChange to identify and support our most vulnerable customers, such as those who are unable to meet their payments or who have difficulty applying for one of our tariffs or schemes. The charity also regularly recommends our schemes to any customer they come into contact with who is in financial difficulty.

Raising awareness of the services and support we offer is critical so we work hard to publicise our services through a wide range of channels including information leaflets within customer bills, on our website, raising awareness through social media campaigns, adverts in local papers and local authority tenant magazines.

Tariffs and schemes

Overdue bills and bad debt are a significant issue for the water industry, they have an impact on every customer's bill. Ofwat estimates that customer debt adds around £21 to the average customer bill.

It is essential we do all we can to help those in genuine financial hardship and reduce the burden of non-payment on other customers while managing our costs. We do this through a range of different payment schemes and tariffs, including:

- WaterSure for those who have a water meter and use a large amount of water,
- Water Direct where bills may be paid from a customer's existing benefit schemes directly to Southern Water, and
- NewStart for those in a position to make contributions towards paying current costs in regular instalments, with Southern Water taking off the same amount from their arrears.

We have significantly increased the number of customers on these supportive payment schemes from 32,000 in March 2015 to 50,000 in March 2016.

We established a new outbound contact centre which will focus on debt prevention and early cash collection, for example, discussing high value bills and payment scheme increases with customers, before their bills arrive.

By changing the way we analyse our data we hope to increase early debt collection rates, working with customers to get a better picture of current and former occupancy and enabling them to consolidate their debt via one of our affordable customer repayment schemes rather than passing them on to debt collection agencies.

The debt advice visits we are offering with Orbit have already allowed us to successfully re-engage with a significant number of customers (40 per cent) who had not previously responded to traditional approaches.

Social tariff

Some customers are not able to pay their water bills without help. Either their financial situation is severely challenging for reasons beyond their control, or their consumption needs are high because of special requirements.

Following a successful pilot in 2014–15, in partnership with the Citizens Advice Bureau, in 2015–16 we saw the full roll-out of our new social tariff – called Essentials. The tariff is targeted at customers who have genuine financial difficulty paying their water bills.

Customers spending at least five per cent of their disposable household income on water service charges qualified for the Essentials tariff and were eligible for a reduction in their bills ranging from 20 per cent to 90 per cent. When coupled with our NewStart scheme, this gives our most financially vulnerable customers a way to address their debt while ensuring they make a contribution towards the cost of water services.

In 2015–16 we accepted 9,453 customers on to the Essentials tariff and we were able to identify more customers that we could have helped but who fell beneath our initial affordability threshold. Therefore, for 2016–17, we have broadened our eligibility criteria to help more people. In future, those whose water bills take up three per cent or more of their disposable income will be eligible for the social tariff as well as vulnerable customers in receipt of pension credit. Our target is to have 65,500 customers on our Essentials tariff by 2020.

Value for money

It is important that, as well as being affordable, customers feel they receive value for money from their water services. For an average household in 2015–16, water and sewerage services cost less than £1.15 per day. That's less than the price of a broadsheet newspaper, less than half the cost of gas and electricity services, and less than the average cost of a cup of coffee.

Over the period of our business plan, average charges will fall eight per cent before inflation.

At the end of 2015–16, 61 per cent of our customers felt that the service they received represented good value for money. Through our work to explain what we do with the money our customers pay us, and what they receive in turn, we are committed to increasing the proportion of customers who feel we deliver value for money.

We will survey our customers each year in order to track our progress and publish the results online and include them in our annual report.

Working more efficiently

As well as helping customers directly, it is important that we ensure our bills remain affordable by constantly looking at ways to improve how efficiently we deliver our services. In 2015–16 (year one of our five-year business plan) we delivered £56 million of cost reductions. To help deliver these savings we have:

- Established an integrated change delivery programme, comprising six strategic projects and more than 36 individual initiatives to improve services and save money. These programmes include the introduction of a new work and asset management system which enables us to work more efficiently,
- Refreshed our 'react and maintain' operational partnerships, working with Clancy Docwra, Cappagh Browne and BTU (Barhale Trant Utilities) to deliver savings in our daily operational costs such as day-to-day repairs and maintenance of our network of water mains and sewers,
- Fundamentally changed the way we deliver major capital investment to improve the operation of our networks and treatment facilities, working in partnership with some of the leading organisations in our sector. MWH Global was appointed as our Strategic Solutions Partner, supporting our in-house engineering team to ensure we achieve best value in the planning and design stages of our major construction projects. CDMP (MWH and Costain) and GTM (Galliford Try and Imtech) maintain and improve our water and wastewater treatment works and MGJV (Morrison Utility Services and Galliford Try joint venture) expand and maintain our water mains and sewer networks,
- Increased our investment in research and development. New partnerships with universities and other technology-led organisations will help us to identify and implement the next generation of efficiency savings and help us plan to ensure that we can meet the challenges of the future, and continue providing reliable services for our customers. Over the five-year plan period we will invest £15 million in research and development.

Over the course of delivering our five-year plan, we aim to make overall efficiency savings totalling £200 million. These savings mean bills will be lower than they would otherwise have been and have contributed to a reduction in average customer bills in 2015–16 of nearly four per cent. Where we beat these efficiency targets, we will share the benefits 50/50 with customers in the form of lower customer bills from 2020 onwards.

Better information and advice

	2015–16		2014–15
	Target	Achieved	Achieved
Water usage, per capita consumption (litres per head per day)	135 02	129 72	134 84
Number of unwanted billing queries ¹	44,100	62,726	29,326
Customers who are aware of the causes of blocked drains (%) ²	N/A	77	N/A
Customers who are aware of how their money is used (%) ²	N/A	60	N/A
Customers who are aware of how to deal with hard water (%) ²	N/A	57	N/A

1 Call categorisation of unwanted and wanted calls is associated with a degree of subjectivity. Our year end audit identified that additional assurance processes and controls need to be implemented to further mitigate the risk of call mis-categorisation. As a result, we will put in place an action plan to minimise any issues going forward.

2 During the year we have refined our customer survey questions which have been used to measure performance against these promises. As such there is no comparison to target in 2015–16. Future performance will be measured against the 2015–16 position on a consistent basis.

Our customers have told us they want better information and advice about what we do, how we are performing and how we spend their money

We promised our customers we would do the following:

- Provide better information to help reduce average water use per person, per day, from 148 litres to 133 litres by 2020
- Be clearer with our billing to reduce the number of queries we receive by half from 49,000 to 24,500 by 2020
- Improve the advice we give on issues such as how to prevent blocked drains and deal with hard water
- Provide better information on how we spend customers' money

Following the successful completion of our universal metering programme in 2015–16, this year also saw the launch of our new water efficiency programme. Over the next five years we'll be carrying out thousands of visits to provide both domestic and business customers with advice and free products to help them reduce their water use and their bills. A particular focus will be on local schools, teaching our next generation of customers about the importance of saving water.

Working with local partners as well as national organisations we will continue to raise the profile of water efficiency and ensure we lead the debate on issues such as water labelling and changes to building standards.

We have completed an end-to-end review of our billing process and a restructure of our customer service teams, following extensive research. The adoption of a new proactive customer strategy and deeper analysis of data will enable us to drive down the number of times customers need to contact us with a query about their bill.

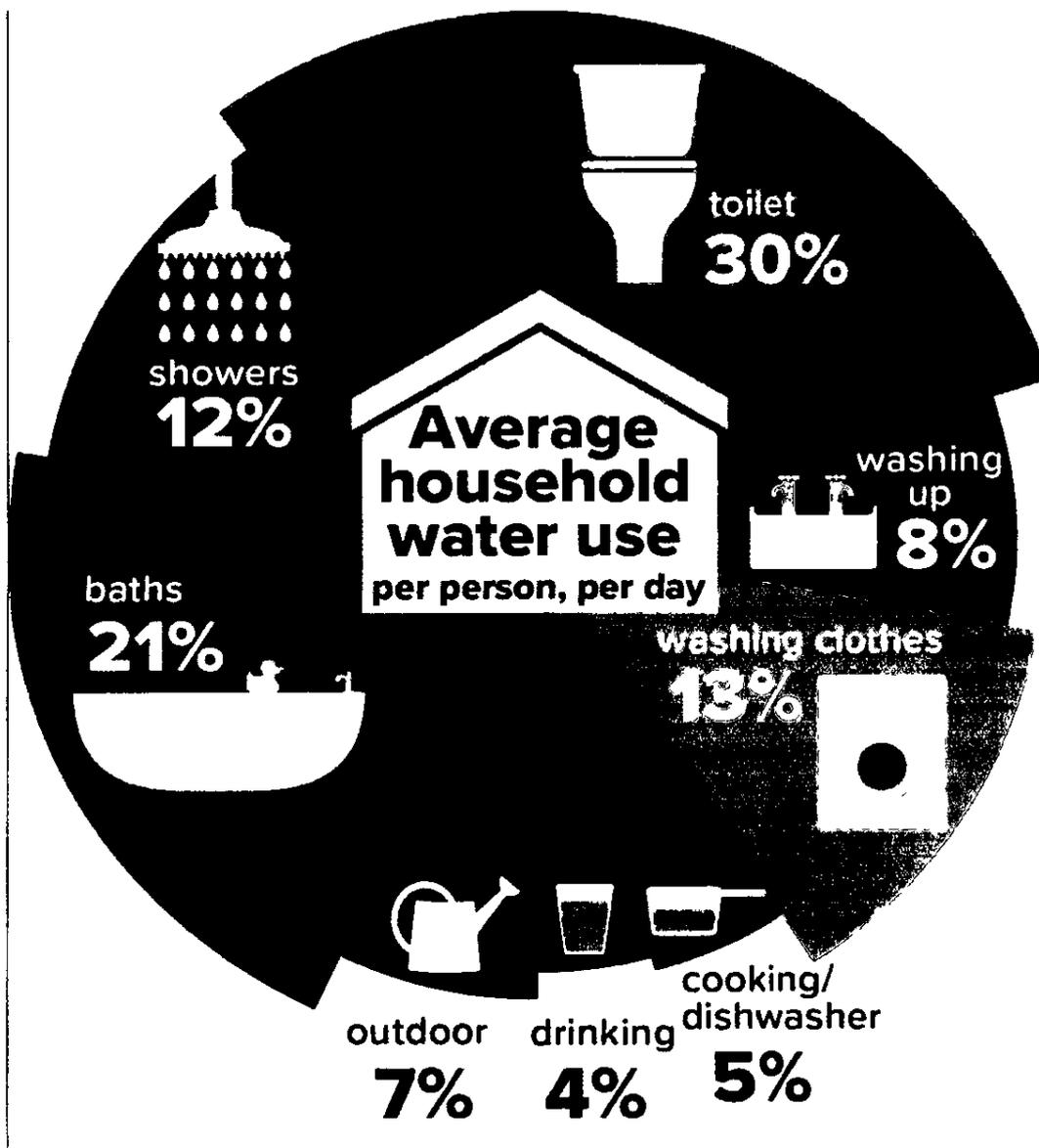
By integrating our water-saving messages and advice about our fat, oil and grease campaign, we have helped provide customers with a better understanding of the whole water cycle. Supported by a programme of targeted home visits, the distribution of our new 'fat' packs, as well as effective maintenance and cleaning of our network, we have increased awareness of what can safely be put down the drain and reduced blockages in our network.

In response to customer feedback, we've also stepped up our use of social media and invested in a new responsive, clutter-free website to provide better real-time information about what we do, why we do it and how much it costs, as well as advice about managing the effects of hard water.

Saving water

Small savings across our two million customers really add up and help us to reduce the amount of water we need to take from the environment

Over the past year we've beaten the target we set ourselves to help our customers reduce average water use to less than 135 litres per person, per day, with a final figure of 130. If we break this figure down, based on our research with customers, an average person is using 33 per cent on personal washing, 30 per cent on toilet flushing and 26 per cent on washing clothes and dishes (see diagram below). If we can sustain these reductions for the next five years then we can earn an incentive reward, of up to £6.9 million. This will be reflected in customers' bills from 2020. If we do not meet our target over the five years we could face a penalty of up to £11 million.



During the year we launched our new water efficiency plan, which builds on the pioneering universal metering programme we rolled out between 2010 and 2015. This plan will help customers save water and, as a consequence, save energy and money.

Over the next five years we will visit thousands of homes, delivering simple advice about how to save water. We will also supply and fit free water-saving products including dual-flush devices to toilets, water-efficient showerheads and tap regulators.

We have joined forces with AquaLogic, a specialist water efficiency company with a track record of working with water companies across the UK, to deliver this innovative programme. Since we launched the programme in November 2015, we have visited well over 1,000 customers, focusing on those households using more water than expected as well as those struggling to afford their bills. We'll also be working with small businesses to deliver similar water and energy audits.

For the next generation, we've developed a new education programme aimed at teaching primary school children how to save water at school and at home. The campaign is led by our Water Hero characters, who have been a huge hit on social media. Our Water Hero tweets were viewed by 362,000 people during the launch week of the campaign.

As part of this programme we'll also be fitting water-saving devices to save schools money. In the past six months, 36 schools from our region have signed up to the programme, with the first 14 primary schools receiving a bespoke education pack and water-saving visit. In the next year we plan to expand this service further to another 60 local schools.

More broadly, we help our customers save water by providing clear and accessible information and advice across a range of channels – our website and social media, community road shows, information leaflet drops and home visits.

Partnership working is at the heart of our water efficiency strategy. By working with local authorities, for example, we are hoping to get closer to our customers and deliver added benefits. Planning policy is an area we have been keen to highlight, to encourage more developers to build water efficient homes. We've been working with Ofwat to explore financial incentives for those who champion water efficiency. We have also continued to lead industry efforts to encourage the adoption of water efficiency labelling of bathroom fittings.

Simple bills

We know that simple, clear bills are important to our customers. This issue was highlighted in the customer feedback we gathered when we were developing our business plan and a large proportion of the contacts we receive from customers relate to the clarity of their bills.

Before we take action it is important that we understand in detail the issues that cause customers to have to contact us about their bills and this has been the focus of our activities through the year. To do this we have been analysing all of our contact data, including complaints, to understand the issues that prompt contact and dissatisfaction. We have carried out further research with our customers to understand which parts of our billing process they find most difficult and where they would like to see improvements. Our continued work with customer-focused organisations such as Consumer Council for Water (CCWater) and the UK Customer Service Institute has helped inform this project at every stage.

So, while we're disappointed that the level of billing queries has risen during the year to 62,726, missing our target of 44,100, we are confident that we have a clear understanding of the issues on which to build our improvement programme.

Based on this detailed knowledge, in February 2016 we started to design a new customer billing process, which will be piloted and implemented over the next 18 months. It will focus on simplifying our bills and providing customers with greater choice about how they interact with us as well as more flexibility when it comes to paying their bill.

We plan to build in new processes which will enable us to monitor changes in customer usage patterns so we can proactively contact customers before they receive an unexpectedly high bill. Providing customers with relevant and timely information about their water usage will also help them to save money.

As a first step in ensuring customers have clear information about their water service, over the past year we have worked with CCWater to review the supporting information sent out as part of our annual billing process, redesigning and rewriting our customer information leaflets to make them easier to read and understand.

We are confident that the new billing process will enable us to meet our target to reduce the number of billing contacts to less than 25,000 a year by 2020.

Keep it Clear

Complementing our water-saving messages, we also have a fat, oil and grease (FOG) programme under way to help tackle blockages across our network of drains and sewers. The initiative has so far helped to boost the number of customers who are aware of the causes of blocked drains to 77 per cent. We are pleased with this level of understanding and we are committed to improving on this figure next year.

A dedicated customer engagement team has visited hundreds of homes in sewer blockage 'hotspots' this year to talk about how to prevent blockages from cooking waste and flushable items, such as wet wipes, nappies and sanitary products. They will visit in excess of 20,000 homes over the next four years as part of this programme.

Joining forces with other regional water companies, we have promoted the Keep it Clear message, which offers customers clear advice about protecting their homes from flooding by only flushing the three Ps – pee, poo and paper – and collecting cooking waste to dispose of in the bin.

We've distributed hundreds of new 'fat' packs containing

- A sink strainer, to catch leftover food waste for binning,
- A pot scraper, to clean waste and cold fat from pans for placing into the bin, and
- A silicone funnel for customers to pour used cooking oil into a bottle for disposal.

These packs, and the supporting information provided by the engagement teams, have also been distributed alongside our water-saving literature at 22 road show events during 2015–16.

Hard water

The majority of water we supply is hard as it comes from underground chalk aquifers where the levels of calcium carbonate are very high. Levels of hardness vary from source to source across the region we serve.

We do not soften water at any of our treatment works as the degree of hardness does not affect the quality of the drinking water. We do, however, advise customers that it can affect household appliances like kettles or showers.

We made a promise to provide better information to increase customers' awareness of how to manage the effects of hard water, in the home or place of business. We have developed improved information and advice, which is now available on our website alongside a postcode checker that helps customers identify whether they live or work in a particularly hard water area.

We have surveyed customers to understand base levels of awareness about hard water and are committed to increasing levels of awareness year-on-year. Currently, 57 per cent of customers are aware of how to deal with hard water. Over the next year we will be improving the information we provide so that more customers know how to manage the effects of hard water.

Explaining what we do

We recognise that we are in the privileged position of providing essential services over which customers currently have no choice of provider. That means it is important for us to explain to customers where their money goes and we have committed to increase awareness of this through our reporting. Currently, 60 per cent of our customers say they know what we do and how we spend their money. We want to keep increasing this level each year.

We are committed to open and transparent reporting of our performance against the promises that we made to our customers and we don't just plan to do this in our annual report. We have also carried out research with customers to find out how they would like to receive information about our performance.

Based on the feedback we received, we now plan to implement a tailored communication campaign over the summer to meet their needs. One suggestion, which we'll be exploring, is the addition of a bespoke reporting area of our website where our customers and stakeholders will be able to find detailed, but clear information about our activities and performance.

With every bill that we send out we include a breakdown of how we spend customers' money. We have continued to attend local events with our Water Café, giving us a chance to tell customers what we do and provide advice on

saving water, avoiding blocked drains and managing the effects of hard water. During the year we attended more than 22 events, talking to more than 20,000 people.

Where we are carrying out any planned works, we have a dedicated customer team which works alongside our construction partners, to ensure that we explain what is happening, when work will be taking place and why. Supporting our engineering and construction teams to deliver our planned investment programme, this team is involved at every stage of the project, from planning through to delivery, to ensure we provide timely, relevant and proactive communications to customers, stakeholders and media. This minimises unwanted contact and promotes the benefits of the investment we are delivering in the communities we serve.

For more information

More than 1.5 million people visited our website over the past year, demonstrating that it has become a key point of contact with our customers and stakeholders. As a result, and in direct response to customer feedback, we have invested in a new, clutter-free responsive website for southernwater.co.uk, which, in due course, we will be inviting people to experience through a live testing site. This will allow us to gather vital feedback about the new functionality we're developing so that we can quickly respond to any problems our customers are having.

A particular area of focus has been our new 'What's Going On' service on our website. A quick click takes customers through to a timeline where they can track the progress of live incidents, hour by hour. This new feature is also supported by a live Twitter feed that appears on the homepage.

Our Live Chat service now hosts more than 6,000 conversations a month and enables customers' queries to be dealt with swiftly. We're now planning further improvements to ensure we are keeping up with customer expectations and developing the right kind of digital experience.

Social media

We've expanded significantly our social media channels and re-launched our @SouthernWater Twitter feed in August 2015.

Over the past year we've achieved around a 200 per cent rise in Twitter views and around 4,000 in users linking through to the website. On Facebook, we started providing proactive shareable content in January and have seen a huge rise in the number of people we now reach.

Southern Water is now number three in Facebook's 'pages to watch' (which compares the performance of our page with other water companies). When we launched we were at number six and have risen to number three with nearly 1,200 likes. Only Yorkshire Water and Thames Water have a larger following in the water sector.

This improved social media presence is making it easier for us to build and support our local online communities by providing information and advice on key issues such as how to save water, save money and prevent blockages.

Services

A constant supply of high-quality drinking water

	2015–16		2014–15
	Target	Achieved	Achieved
Overall drinking water quality index (%)	99.98	99.98	99.97
Number of contacts regarding discolouration (per thousand population)	0.83	0.80	0.58
Leakage (million litres of water per day)	88	84	82
Customer minutes lost supply > 3hrs	8	12	6
Number of properties with low water pressure	254	288	254
Number of customers affected by temporary use bans	0	0	0
Asset health	Stable	Stable	Stable

We've provisionally achieved 99.98 per cent compliance against the Drinking Water Inspectorate's (DWI) water quality measures, which puts us at the top of the industry league tables, subject to confirmation

We promised our customers we would do the following

- Maintain the excellent quality of their drinking water and reduce discolouration incidents
- Not increase the average amount of time they are left without water
- Reduce the amount of water lost through leakage
- Keep down the number of households suffering from persistent low water pressure
- Avoid any restrictions on water use, such as hosepipe bans, unless we have experienced two dry winters

Delivering these promises demands continuous operational focus and vigilance, with a particular emphasis on the protection of public health. We are proud that our water service performance over the calendar year 2015 was once again industry-leading.

We expect the DWI to confirm in July that our performance against their overall drinking water quality index will put us among the top companies in our sector for the past year.

Our leakage performance also continues to be the best of any of the 10 major water and sewerage companies, with leakage as a percentage of water put into supply being around ten per cent lower than the average. While we continue to ask our customers to use water wisely, it is vital that we strive to avoid unnecessary wastage.

As well as the hard work of our leakage detection teams, this reflects the benefits of our universal metering programme, completed in 2016. Close to 90 per cent of our customers now have water meters, giving us a much better understanding of where water is being used. The new meters we installed also have built-in leak alarms to give us early warning of any issues.

Sadly, we missed our target for customer interruptions to supply. This was affected by two particularly challenging incidents, which affected large numbers of customers. However, our underlying performance, excluding these two incidents, was better than our target level.

All of the water service performance targets have financial penalties associated with them if we do not meet our targets, while there is the potential for us to earn rewards for beating our targets on leakage. We did not incur any financial penalties in the report year.

Drinking water quality

Providing a constant supply of high-quality drinking water is critical to ensure we protect the health of all our customers and local communities

Effective water treatment and its safe distribution through our network of pipes to homes and businesses ensures customers can enjoy safe, wholesome water

The UK has some of the highest standards of water quality in the world, and we are proud that our water quality performance places us among the leading companies in our sector

To maintain high standards of drinking water quality and safeguard public health, we carry out over 500,000 water quality tests each year at sampling points across all of our 83 water supply works, our 195 service reservoirs and at a randomly selected sample of customers' properties. We also respond to and investigate customer complaints about water supply, for example in response to contact about an unusual taste or odour from drinking water

A system of automated controls at our water supply works ensures that, if the quality of treated water is reduced it is prevented from entering the public water supply while we respond and adjust our treatment processes. We use the flexibility at the reservoirs and within our network to keep water available for customers while we carry out any necessary work

We are proud that the quality of our drinking water is outstanding. This year we've provisionally achieved 99.98 per cent compliance against the Drinking Water Inspectorate's (DWI) overall water quality measures. We expect to have the highest quality water of the 10 largest water and sewerage companies in the UK (subject to DWI verification)

When we carry out a repair on our 13,700 kilometre network of water mains, there is the potential for water to be temporarily discoloured. This is often the result of harmless factors like air in the water, disturbance of mains deposits during scheduled work or residues from the customer's domestic pipes. However, it is understandably worrying for our customers

Just 4,000 of our 2.4 million drinking water customers notified us of discolouration in 2015. This is a rate of less than one (0.8) customer contact per 1,000 customers served. This excellent result, which beat the performance target we set in our plan, is testament to the care and professionalism of our employees

Leakage

We continue to lead the UK water sector on leakage and we've beaten our target for the fifth consecutive year, reducing leakage from our network and customers' supply pipes to 84 million litres per day against our target of 88 million litres per day

Last year we lost the equivalent of 16 per cent of the water that was put into supply. This was the lowest leakage level of any of the water and sewerage companies. For comparison, the average leakage level for the 10 water and sewerage companies in England and Wales was 23 per cent in 2014–15

This industry-leading performance is down to our hard-working teams who, 24 hours a day, find and repair leaks on our 13,700 kilometre network of water mains. Of the 21,000 leaks repaired over the year, 15,000 were found by our leakage team. Locating leaks on our extensive network of mains is done both through visual inspection and through constant monitoring of flow levels. Measuring any flows at night, when there is little consumption, helps us pinpoint any unusual patterns that may indicate a leak

Our pioneering universal metering programme has also helped us detect and fix leaks due to the meters' built-in leak alarms that alert our engineers to unexpectedly high consumption. This means that in many cases we can act quickly and proactively to fix the pipes concerned before our customers even notice any impact on their service

Burst mains and water pressure

Sudden changes in water pressure, ground movement caused by freezing temperatures and pipe defects can all result in burst water mains. Bursts on our larger diameter mains can have dramatic effects and impact on a large number of customers.

While we continually monitor the serviceability of our mains, some level of bursts on a network of almost 14,000 kilometres is inevitable. When we do suffer a mains burst, our priority is to ensure we isolate the problem and restore supplies to customers. We can often do this by simple changes to the way we route flows through the network. However, where large mains are affected this can be more difficult.

We always measure the number of minutes that customers are without water, but our performance target reflects only those interruptions which exceeds three hours, where customers are most inconvenienced.

During the year we missed our target for interruptions of no more than nine minutes on average per customer, with a performance of 12 minutes. This was affected by two major bursts on large trunk mains: one near Sittingbourne, Kent, which led to a loss of supply to the Isle of Sheppey, in January 2016 and one in Hastings, East Sussex in August 2015. These incidents affected 10,300 customers. Without them we would have beaten our target with an underlying performance of three minutes.

During these major incidents, our teams worked around the clock, in difficult circumstances, to solve the problems. To restore supplies to customers on the Isle of Sheppey, for example, we needed to tunnel under the A249 dual carriageway at a depth of 20 metres. We made sure that customers had alternative supplies of water and we kept customers, stakeholders and the media informed about what had happened and what we were doing about it.

While interruptions on this scale are regrettable and we do all we can to manage such risks, we were pleased to receive positive feedback from customers about the way we managed the incidents.

Low water pressure can be caused by a range of issues, such as changes to the operation of the supply network, new connections to the network or high demand. It can affect the operation of household appliances such as showers and heating systems. We monitor our network to ensure that the number of customers experiencing such problems does not increase and work with those customers affected to mitigate the effects.

Disappointingly, despite these efforts, the number of properties reporting low pressure reached 297 out of 1.1 million that we supply. This is higher than our predicted target of no more than 254 properties.

Water restrictions

In the event of a drought we sometimes have to impose restrictions on non-essential water use, such as the use of hosepipes, to preserve water supplies. The last time we had to impose restrictions on water use as a result of a drought was in April 2012. Thanks to a combination of reductions in customer demand, assisted by our metering programme, lower leakage and relatively benign weather conditions, we have not had to impose any restrictions since then.

We have committed to ensuring that we will avoid the need to impose restrictions unless we have experienced two dry winters. During the winter, our groundwater sources refill, enabling us to extract water to meet higher customer demand over the summer period. Without winter recharge, sources can become depleted and prevent us from taking water from them. If we do impose water use restrictions before we have had two dry winters we will pay a financial penalty reflecting the number of customers affected.

Maintaining our sites and infrastructure

As well as delivering the promises we made to our customers over the next five years, we have a responsibility to ensure we can continue to deliver high-quality services to our customers over the long term. To do this it is essential that we continue to invest in our treatment works and pipe networks and operate them responsibly.

To measure how well we are looking after the long-term health of our assets, we have agreed a set of performance indicators with the industry regulator, Ofwat. These indicators apply to all water companies and enable a comparative assessment of performance. They include, for example, measures of the quality of water leaving our treatment works, and the number of bursts we experience on our water network. If we fail to meet any of these targets then we receive financial penalties associated with them.

This year we have achieved an assessment of 'stable' asset health – which means we have met or beaten all of the performance measures set. This performance reflects the benefits of our continuing investment programme, which will see us spending around £3 billion during 2015–20 to improve the services we provide to our customers. Of this investment, approximately £1.8 billion will be spent specifically on building, repairing, refurbishing and upgrading our assets.

As well as routine maintenance and our rolling mains replacement and refurbishment programme, we have also completed a number of important upgrades to our facilities this year. For example, during the year we invested around £2 million to repair structural faults in the reservoir at Cooks Castle on the Isle of Wight, to maintain drinking water quality and secure a resilient supply for our customers.

These important investments will help us deliver a reliable service to our customers today, as well as ensuring that we can continue to do so long into the future.

Removing wastewater effectively

	2015–16		2014–15
	Target	Achieved	Achieved
Number of blockages per km	0.57	0.56	0.55
Number of internal flooding incidents	446	492	487
Number of external flooding incidents	9,694	8,314	9,796
Number of customer complaints regarding odour	390	262	364
Asset health	Stable	Stable	Stable

Our multi-million pound investment in wastewater assets continues to deliver improvements for customers

We made the following promises to our customers

- No increase in the number of blockages in our sewers
- A 25 per cent reduction in sewer flooding inside homes and businesses by 2020
- No increase in the number of incidents of sewer flooding affecting outside areas
- A five per cent reduction in the number of complaints about smells from our treatment works and pumping stations by 2020

To achieve this we're investing a total of £1.8 billion between 2015–20 to maintain, enhance and extend our wastewater and water sites and networks. We've also launched a major campaign to help customers better understand what can and cannot be flushed down the toilet and poured down sinks – with the aim of reducing blockages in our network, which can lead to flooding from sewers.

Through responsible management of our works and investment at key sites, we have recorded one of the lowest levels of complaints about smells. Our investment and maintenance programme has ensured we have met, or improved on, all our asset health measures.

Blockages

Managing sewer blockages is one of the biggest challenges we face in removing wastewater effectively. Blockages, which can be caused by a build-up of fat, oils and grease (FOG), or wet wipes, sanitary products, nappies and other 'non-flushables', can lead to flooding from our network, pollution to watercourses and customer inconvenience. So reducing the number of blockages can have multiple benefits for both customers and the environment.

In the past year we met our target of reducing blockages to 0.57 per kilometre of sewer, achieving 0.56.

We have achieved this through regular routine maintenance of our network – for example jetting those sewers which are at highest risk of blockages – combined with an extensive education campaign to ensure that our customers and businesses understand what they can safely flush down the toilet or put down their sinks.

Working in partnership with our customers in this way is vital to our success. Around two-thirds of blockages are caused by fat, oil and grease being poured down sinks, and from non-flushable items. It costs around £1.8 million every year to have these obstructions removed. All of these types of blockages are entirely preventable and our FOG programme is focused on educating our customers about what not to pour down the drains. More information on this programme can be found in our *Better Information and Advice* section, see pages 25 to 29.

Flooding from sewers

Flooding from sewers is one of our customers' biggest concerns. In particular, internal flooding of properties with sewage is unacceptable. Customers expect us to maintain a sewerage system that is 'out of sight and out of mind'.

We never underestimate how distressing it is to experience a flood inside someone's home or business and do everything we can to support our customers should the worst happen. Clean-up services are offered to customers within 12 hours of an internal flooding incident if it has been caused by one of our sewers. Our advisers are available by phone, email or online to guide those who have been affected on the next steps.

The overall trend in the number of internal flooding incidents is down and we are on track to achieve our promised 25 per cent reduction by 2020. But due to an extraordinarily wet August which put exceptional pressure on our network, we had 492 recorded incidents against our target of 446 for the year.

We beat our target of reducing the number of external flooding incidents (those that occur outside properties) with 8,314 incidents in the year against a target of 9,694. But there is still more to do and partnerships with customers will help move this work forward.

We own and operate 39,600 kilometres of sewers which includes approximately 17,500 kilometres of sewers that were privately owned until October 2011. We also operate 2,375 wastewater pumping stations and will be taking responsibility for an estimated further 640 private pumping stations from October 2016.

As most of our sewers take rainwater run-off in addition to wastewater from homes and businesses, the performance of the network is susceptible to extremes of rainfall and can result in variations in performance year on year.

In comparison to other parts of the UK, our region suffers from high groundwater levels during periods of prolonged rainfall. This is mainly due to the predominantly chalk geology of the North and South Downs which contain aquifers that supply clean water to many of our customers. In some cases, high groundwater levels can enter our sewers. When this happens, the sewers can flood.

We were the first company in the UK to develop dedicated infiltration reduction plans for those areas worst affected by groundwater flooding.

We are developing new, holistic methods of protecting our sewerage network and our customers from groundwater flooding by building stronger partnerships with agencies such as local authorities, landowners and the Environment Agency.

Tackling odour

Tackling smells is always a priority for us and our long-term prevention work continues to pay off.

In 2015–16, we received fewer complaints than ever about smells from our treatment works and pumping stations. The final figure of 262 complaints was down from 364 in the year before.

This improved performance is part of a long-term trend in which complaints about smells have dropped by more than half in the past 10 years. We have made a commitment in our business plan to reduce the figure by a further five per cent over the next four years.

Over the full period of the Southern Water Business Plan 2015–20, we will be investing significantly in large schemes to reduce smells.

For example, a £20 million major maintenance scheme at East Worthing Wastewater Treatment Works is part of an ongoing programme to provide a long-term solution to problems including the maintenance of two nine-metre long screens which continue to get clogged with debris. The two screens filter out items such as wet wipes and sanitary products that have been wrongly flushed down toilets. If left to accumulate, these items are a major contributor to the odour problem.

We're also investing in our people by ensuring we have specifically trained employees on site to communicate better with customers and other stakeholders. We're continuing to focus on maintaining the high standards we have set with an effective planned maintenance programme of odour control units, operational awareness of odour control through management plans and an effective reactive response should a problem arise.

Where there is a risk of smells arising from essential maintenance or activities associated with our investment programme, we work hard to keep customers informed. We understand that when people know what is going on it makes any inconvenience easier to bear. We are using letter drops, meetings and maintaining regular contact with key stakeholders in affected areas to keep customers informed.

Maintaining our sites and infrastructure

As well as delivering the promises we made to our customers over the five years of our plan, we have a responsibility to ensure we can continue to deliver high-quality wastewater services to our customers over the long term. To do this it is essential that we continue to invest in our treatment works and pipe networks and operate them responsibly.

To measure how well we are looking after the long-term health of our wastewater assets, we have agreed a set of performance indicators with the industry regulator, Ofwat. These include, for example, the compliance of our treatment works with their environmental permits, the rate of collapses on our sewer network and flooding from our sewers. If we fail to meet any of these targets then we receive financial penalties associated with them.

This year we have achieved an assessment of 'stable' asset health – which means we have met or beaten all of the performance measures set by Ofwat. This performance reflects the benefits of our ongoing investment programme, which will see us spend around £1.8 billion between 2015–20 to build, repair, refurbish and upgrade our assets.

We spent more than £45 million in 2015–16 as part of our programme of maintenance, repair and refurbishment of the wastewater network. We have completed extensive reviews of our pumping stations' efficiency and put in place a flood mitigation programme to prevent the same issues recurring. This included a £10 million programme to replace essential kit in 500 pumping stations.

Other projects to reduce the risk of flooding from our network include the installation of new pumping stations and a sewerage network at Botley Park in Hampshire. This ambitious scheme involves tunnelling under rail infrastructure at a cost of £6.9 million.

This level of investment, combined with programmes to educate and advise customers on how to help us keep sewers and pipes operating efficiently, is contributing to making Southern Water's wastewater service more effective.

Environment

Looking after the environment

	2015–16		2014–15
	Target	Achieved	Achieved
Wastewater treatment works compliance (%)	100	99.32	98.98
Maintain bathing waters at 54	54	43	54
Number of serious pollution incidents (category 1 and 2)	8	7	12
Number of less serious pollution incidents (category 3)	283	160	283
Distribution input (million litres per day)	525.48	520.64	524.24
Renewable energy use (%)	14.4	17.3	16.0

The environment is at the heart of our business. We have a duty to ensure we carry out our daily operations in a way that protects our rivers, streams and coastal waters while also playing a key role in improving the health of our local environment.

We promised our customers we would do the following:

- Aim for 100 per cent compliance by our wastewater treatment works with required standards – and at least maintain performance at 97.7 per cent
- Increase by seven the number of beaches with 'excellent' bathing water quality by 2020
- Ensure our operations will cause no serious pollution incidents affecting local rivers, streams and beaches by 2020
- Reduce the amount of water we take from the environment by 1.4 per cent, despite predicted population growth of four per cent
- Increase the proportion of renewable energy we use to 16.5 per cent by 2020

In 2015–16 we made a great start to fulfilling these promises. We have significantly improved compliance with environmental standards at our wastewater treatment works, achieving over 99 per cent compliance with permits. The region's bathing waters are the cleanest in England with 82 of our 83 bathing water sites meeting tougher new European quality standards.

The number of pollution incidents in 2015 fell by 43 per cent on the year before, making last year's performance our best in 15 years. In addition, we've also beaten our target for the amount of water we take from the environment and are continuing our efforts to generate more renewable energy.

All but one of the 83 bathing waters in our region met the new, tighter minimum standards introduced this year. Despite this excellent result, due to some extreme weather experienced in August, we did not meet our target to maintain water quality at 54 of the region's beaches at the very highest 'excellent' status – which is consistent with the standard required for a Blue Flag.

Our performance of 43 beaches at 'excellent' status means we will face a financial penalty of £1.458 million, which will be reflected in customers' bills from 2020. Following investigation of the causes, we have put in place a number of improvements for the 2016 bathing water season and expect to get back to the target level of 54.

Wastewater treatment

Every day we remove and treat 718 million litres of wastewater from people's homes and businesses before releasing it safely back into the rivers and coastal waters

Our region contains many environmentally sensitive sites, including the chalk streams in Hampshire, important shellfish beds along parts of our coastline and bathing waters across Kent, Sussex, Hampshire and the Isle of Wight. Each of our 366 wastewater treatment works has a unique set of standards, set by the Environment Agency (EA), that we have to meet before we release the treated water back into the environment. These standards ensure the water released is of the highest quality, protecting the ecological health and biodiversity of our region's rivers, streams and coastal waters.

These watercourses play an important part in making the South East a great place to live, work and visit, and are critical in boosting the region's economy. A large proportion of our investment programme is targeted at making further environmental improvements across the region.

The performance of our wastewater treatment works has been an area of particular focus this year. As a result of this, 99.3 per cent of our 293 works which have stringent environmental permits met the required quality standards over the last year. This represents a further improvement on last year and is helping to make sure our local environment is protected.

To achieve this we've spent more than £160 million on operating, maintaining and improving our treatment works over the past year. We have also completed a focused programme of activities, including

- A thorough reassessment of our risks, including analysis of the root cause of historic performance failures and a review of the operating plans for all of our medium and large-sized treatment works and a re-prioritisation of our planned maintenance programme to address the highest risks,
- Enhanced training for our operators, using a 'licence to operate' model,
- Ensuring that we maintain adequate spares for critical equipment, improving the speed with which we make repairs to assets that have failed and minimising the equipment out of operation, and
- Ensuring that trade effluent customers – those discharging non-domestic effluent to the sewers – are complying with the terms of the consents issued to them and identifying other risks from illegal discharges to the sewers.

The concerted effort that we have put into this area over the past year is continuing to yield benefits with all our 366 treatment works achieving standards in the first three months of 2016.

Bathing water

The 1,100 kilometres of coastline and 83 designated bathing waters that sit within our region are one of the South East's greatest assets and are vital to the local economy.

We play an important role in protecting these coastal waters to ensure they are of the highest quality and have invested millions of pounds in doing so over the past 25 years. As a result, bathing waters in our region have never been cleaner.

In 2015, a more stringent set of standards was introduced to measure bathing water quality across Europe. The highest, 'excellent', standard is now twice as high as it was previously. Instead of an annual measurement, now four years worth of water quality samples contribute to the bathing water classification made by Defra.

The EA takes weekly samples at all designated sites during the bathing water season on behalf of Defra. The 83 in our region are all beaches but elsewhere in the country some lakes and ponds are also sampled.

All but one of the designated bathing waters across our region met the higher European standards. Only Walpole Bay in Margate failed to reach the minimum standard. This is believed to be a result of seaweed build up in the bay rather than anything to do with our sites in the area. Even though we believe Walpole Bay failed for natural reasons, we would rather not have any beaches failing in our region. Therefore we are committed to working with the local council and the EA to look at ways to address this.

In addition to meeting the new minimum European standards, we set ourselves a further target to improve bathing water quality across our region, something that is extremely important to our customers. To do this we look at the

last year's bathing water results and compare performance to previous years. The samples taken in 2015 alone saw 43 bathing waters reach the excellent standard, falling short of our target to maintain 54 bathing waters at 'excellent'

This is largely because the South East experienced the wettest August since 1977, which impacted on water quality towards the end of the summer. Although disappointing, having investigated the reasons for the decline in performance at these beaches and put in place improvements we are confident that we will recover the position for the 2016 bathing water season.

We are also making good progress on our programme to bring a further seven bathing waters across the region to 'excellent' standard by 2020. We have started technical investigations of several bathing waters and will be engaging with customers and stakeholders over the coming months as part of our Bathing Water Enhancement Programme.

The improvement programme has been driven by our customers' desire for clean, safe access to bathing water and beaches and by our own commitment to protect the environment and support the communities we serve.

Collaboration with local authorities, farmers and other agencies is a key part of delivering these improvements and we are developing important partnerships on the ground. Delivering this programme is the first step towards our long-term ambition, as set out in our Strategic Statement (April 2013), to bring all coastal waters at bathing sites in the region up to the standard required to achieve Blue Flag status by 2040.

Preventing pollution

We recorded 167 pollution incidents in 2015 – a reduction of 43 per cent compared with 2014 and our best performance in 15 years.

Pollution incidents are categorised into three levels of severity, with categories one and two being the most serious. In 2015, the number of serious incidents fell to seven, beating our business plan target of eight. We have made significant improvements since 2011, cutting the number of serious pollution incidents by two thirds. Our aim is to eliminate all serious pollution incidents by 2020.

We have achieved a large reduction in the number of the less serious, category three pollutions. In 2015 we had 160 incidents, beating our target of 283, despite a very wet period during January and February.

We have achieved this by expanding and optimising our sewer jetting programme to target hotspots where we experience a higher rate of blockages, which can lead to pollution. We've also launched a targeted customer education campaign in these areas to tackle the causes of sewer blockages.

In addition, we have enhanced our risk assessment programme so we can better pinpoint the likelihood and consequences of failure at our sites including pumping stations, pipes and sewers.

And where we do experience incidents, we have made sure that we react quickly, prioritising those with the highest risk of causing pollution. We make sure that we learn from any flooding incidents that do occur and we make the necessary repairs to make sure it doesn't happen again.

We have made good progress as a result of these improvements, but there is more to do and we will maintain our focus in this area. We are confident that we will achieve our promise to have no serious pollution incidents by 2020 and reduce the number of category three incidents to no more than 158.

Reducing the amount of water we take from the environment

In order to supply our customers with high quality, healthy drinking water we need to take water from local rivers and underground sources through a process called abstraction. We promised our customers that we would reduce the amount of water we abstract, in order to help protect the environment.

Last year the amount of water we put into supply each day reduced by nearly 2.5 million litres to 520.64 million litres per day, beating our year one target by one million litres.

We are committed to reducing abstraction levels further, despite predicted population growth in our supply area of around 90,000 people by 2020. To do this we need to continue to reduce leakage from our network, help our customers use less water and make sure the homes of the future are more water efficient.

The government has committed to reforming the rules around abstraction by 2020. The current legislation has been in place for more than 50 years and no longer meets the needs of the environment or abstractors.

As a company operating in a water-stressed region, we expect the reforms to strike the right balance between protecting customers' supplies and the needs of the environment. We believe there is potential for the reforms to be more progressive, allowing us to trade water easily with other abstractors within our catchments and develop future water resources that will benefit other water users.

To explore the issue further, we co-hosted an event with colleagues from Anglian Water in December 2015 to discuss the Australian experience of abstraction reform and what lessons could be learned for the UK. We are also progressing two pilot projects to look at the opportunity for trading with other water companies. We look forward to working with Defra, the EA and our peers, and contributing to the development and implementation of the new system.

Renewable energy

We are currently ahead of our promise to increase the amount of renewable energy we use across our operations, with 17.3 per cent of our total energy use now coming from renewable sources.

In the past year we have been focusing on increasing the efficiency of our 16 Combined Heat and Power Plants (CHP), which turn sewage sludge biogas into power that is used to run our sites.

We are committed to ensuring that we produce renewable energy through heat recovery from waste or solar power, to offset the energy consumption from our daily activities.

Our plan to generate more renewable energy for use at our sites is, therefore, continuing. We have selected sites where we propose to install photovoltaic (solar power) panels and we have also undertaken energy audits as part of the Energy Savings Opportunity Scheme.

Environmental responsibility

Carbon performance

	2015–16		2014–15	
	Target	Achieved	Target	Achieved (restated)
Greenhouse gas emissions – ktCO ₂ e	281	267	386	273
KgCO ₂ e per person supplied with treated water	-	27	-	27
KgCO ₂ e per person supplied with wastewater services	-	39	-	41

Note - Last year's figures have been restated to reflect annual changes in carbon reporting and emission factors

We've continued to reduce our greenhouse gas emissions

Our customers told us they wanted us to demonstrate our care for the environment. Part of this is responding to issues such as climate change and keeping our carbon emissions (greenhouse gases) to a minimum.

During the year we produced greenhouse gases equivalent to 267 kilotonnes of carbon dioxide. These emissions result from our consumption of grid electricity and natural gas, our transport and from our wastewater and sludge treatment processes.

Our operational emissions for 2015–16 were two per cent below those of the previous year, our lowest emissions for four consecutive years in real terms. This reduction has been calculated using consistent emission factors for all years to identify a real change in performance rather than changes to UK emission factors. We did this by generating more renewable energy to run our operations and by making key sites more energy efficient.

We achieved our fourth Carbon Trust Standard accreditation in recognition of our excellence in monitoring and managing carbon emissions and have continued to focus on renewable energy generation, which was one of our key customer promises. And we have increased the proportion of renewable energy generated to over 17 per cent of our overall electricity consumption.

We continued to participate in the government's Carbon Reduction Commitment Energy Efficiency Scheme and will buy government carbon allowances at a cost of £3.8 million for the year to be compliant with regulations.

Low carbon design

Our in-house engineering team is responsible for designing improvements to our treatment works and pumping stations and ensuring they use materials and processes which reduce greenhouse gases for the whole of their operational life.

The designs must also factor in the pressures of population growth, increased treatment standards and carbon impact.

Recycling waste

During the wastewater process, sludge is produced. This solid matter, which is treated, is often recycled for use as a source of fertiliser by local farmers. We produce about 240,000 tonnes annually and sometimes it is necessary to send it to landfill, which is costly and means we lose the nutrient benefit of sludge applied to land.

In 2015 we sent no sludge to landfill for a second year running. This is a remarkable improvement from 2013–14 when we sent 808 tonnes. In addition, the majority of grit and screed – the debris removed from wastewater – is also still being diverted away from landfill with more than 95 per cent now composted.

Conservation and biodiversity

In the last year we've agreed management plans for our sites of special scientific interest (SSSIs) with Natural England to achieve 'favourable condition' ratings. We have compiled management plans for our 11 largest SSSI locations (sites of one hectare or larger).

Our work is continuing to control the risks associated with invasive plant species such as Himalayan balsam, Japanese knotweed and giant hogweed at sites across our region including Brede Water Supply Works, Powdermill Reservoir, Ashford Wastewater Treatment Works and Bewl Water Reservoir. The work is achieving great results in biodiversity improvements, asset protection and community support. Asset protection is also enhanced by removing species which can damage reservoirs and other vital infrastructures.

About us

Our workplace

Health and safety

We continued to lead the industry with our excellent health and safety performance and achieved the lowest number of injuries in our history. We recorded 427 days without a reportable injury to a member of staff and there were an exceptionally low number of supply partner injuries.

Our total of 0.14 reportable injuries per 100 full-time employees/contractors beat our target of 0.31 and was the result of our longstanding and continued commitment and focus on safety. Our employee-only total was 0.09.

For the 17th consecutive year, we achieved the Royal Society for the Prevention of Accidents (RoSPA) gold award and were presented with our third Order of Distinction in their international Occupational Health and Safety Awards. We're the first water company to receive such an accolade.

Our Aim for Zero Injuries campaign played a vital part in our exemplary performance. Its initiatives included a two-day health and safety conference for more than 500 staff and contractors to share best practice. We are also carrying out further work to concentrate on managing road risk.

We continued our campaign to encourage staff to report hazards at work, donating £2 for each one recorded to our regional Air Ambulance Trusts.

Safety at work receives a great deal of attention because the outcomes of getting it wrong are immediate and can be devastating. However, it is equally important to keep general staff health in focus.

Increasingly organisations are realising that health issues identified at work are often linked and influenced by personal health and fitness outside work. At Southern Water we have recognised this for some years and our ongoing wellbeing initiatives are designed to encourage good personal health.

During the year we worked closely with our supply partners and recommitted to our Wellbeing Promise which sets clear joint aims for us and our staff to work together on their wellbeing. Specific campaigns in the last year included wellbeing days where a range of external specialists visited us to advise and encourage staff on improving their personal health and fitness. Examples ranged from staff pedalling their way to fitness with a static bike challenge and tackling the WaterAid Mountain Challenge, to attending a presentation by a specialist consultant on men's health and cancer.

In the wider community, we continued with our long-running Learn to Swim programme for children (see our Community section on page 46 for more information). Nationally, we participate in the Water Safety Forum and assist with the formulation of the national drowning prevention strategy.

Also at national level we work with the Health and Safety Executive and other stakeholders to support and promote the Estate Excellence programme, an initiative designed to help small to medium-sized enterprises take sensible steps to improve awareness of health and safety issues in their businesses.

Our people

As of 31 March 2016, we directly employed 2,259 people across Kent, Sussex, Hampshire and the Isle of Wight. We also indirectly provide employment to many more through our suppliers.

People development

We are committed to providing training and career development opportunities for all of our employees' and we also recognise the need to support their wellbeing.

Nurturing in-house expertise is an investment in the company's future, therefore, we have continued to implement our leadership development programme to cultivate talented employees. As part of this, 24 of our line managers took part in our Leaders for Tomorrow scheme, which sees them complete a series of practical modules throughout the year. Around 26 middle managers completed the Inspired Leader Programme, a 12-month programme focused on improving a series of key people management skills. We also hosted a number of business lead conferences for senior managers from all areas of the business this year, where they defined joined-up approaches to achieve our business goals.

Around 40 of our most outstanding junior colleagues were put through our five-day residential course in the past 12 months. Called the Employee Development Programme, the scheme offers attendees a forum to develop their own, innovative business ideas. They then pitch their propositions to members of the Executive Management Team.

In our Operations team, we had a number of graduates from our award-winning apprenticeship programme. All of our operators work to the highest standards, regularly completing Licence to Operate training, which tests their knowledge of water and wastewater processes, and our apprentices are no exception. We asked them to conduct more than 60 water supply competency assessments and 265 wastewater assessments during the current year.

In addition, we sustained our customer-focused Ambassador Programme, which 81 employees attended during the year. This scheme provides training in customer service skills and continues to contribute significantly to our service improvements in Operations.

Our commitment to developing employees' potential continued with the creation of four talent pools sponsored by the Executive Management Team. We held discussions with employees to identify their career development needs, which led to 115 personal development plans being put into place. A number of graduates also joined our corporate graduate programme during the year, we spoke at the region's schools to promote the water industry as a career and continued with our STEM work to ensure a talent pipeline for the future.

We're also investing in our customer services teams to ensure we meet our customers' needs. A series of training events to help employees improve their skills have been held, including an extensive management development programme, training on metering and water usage, and 123 people were also given training on how to use a new customer feedback system. We also provided coaching, mentoring and secondment opportunities.

Employee engagement

When we recruit and invest in the development of good staff, we want to keep them.

We survey our staff every year to find out what they really think of us and how we can be a better employer. The latest engagement survey was filled in by an impressive 76 per cent of the workforce. We received 2,003 comments from employees on why Southern Water is a good place to work and suggestions for how we could improve. Our two biggest directorates increased their overall engagement score. As a result of staff feedback, we are continuing to conduct a development process for managers on how they motivate, care for, consider and talk to their teams.

Once again we held our Staff Thanks and Recognition (STAR) awards and received 294 nominations for 15 honours, including Employee of the Year. Staff are nominated by their colleagues in categories that reflect the company's principles: customers first, everyone matters, always improving, local pride, taking ownership and succeeding together.

As part of our comprehensive strategy to safeguard the wellbeing of our employees, 15 people were given the opportunity to attend a time management programme, eight people attended a leadership behaviour programme and 196 employees attended a resilience programme.

Our suppliers

This has been an important year during which we have further developed the way we work with our suppliers

Our aim is to become true partners with our strategic and important suppliers and contractors, working collaboratively with them rather than them simply providing us with a product or service

Unlocking the power of procurement through the use of technology has made it easier for us to identify new opportunities, engage the supply market more efficiently and ensure we meet new Utilities Contract Regulations

We've continued to develop and evolve our framework that looks at managing the whole contract from its inception to its end, which means we are building even closer relationships with our supply chain and they work with us rather than for us

We approach the next financial period with confidence that together with our suppliers we will provide excellent services for our customers

Our community

Our community work is a mixture of supporting charitable activities and providing free educational resources to promote wise water use

We pride ourselves on being rooted in and contributing to the communities where our customers live and work and we do so through a variety of initiatives

Education

We're committed to educating people about how to use water wisely. Our mime show, The Drips, took messages about wise water use to around 5,300 children in the past year and staged 28 plays in our region's schools.

We've also attended 22 community events with our road show and offered advice on the responsible management of water and wastewater to more than 20,000 of our customers.

Our Sporting Chance programme is in its fifth year. With our five partners – Brighton & Hove Albion Football Club, Gillingham Football Club, Kent County Cricket Club, Portsmouth Football Club and Sussex County Cricket Club – we gave more than 20,000 children the chance to experience sport with professional coaches while learning about why water is important to health, how to be water efficient and why keeping our sewers clear is so important. We're aiming to increase that number over the next year to 25,000 by recruiting the community teams at Hampshire Cricket Club and Crawley Town FC.

We are also planning to introduce a 'School Gates' outreach programme to complement Sporting Chance. This means that parents will receive the same messages as their children about water efficiency, keeping sewers clear and health.

Learn to swim

Our flagship community programme Learn to Swim celebrates 25 years in 2017. During that time more than 700,000 children across the region have been taught how to stay safe around water and another 30,000 will be taught this year.

We're grateful to our scheme ambassadors, former Olympic gold medallist Duncan Goodhew and Invictus Games veteran Mike Goody, for their support. This year's instructors' seminar was focused on helping to teach people with disabilities to get the most from swimming. We also held two achiever events for children in Gillingham, Kent, and Fareham, Hampshire where dozens of youngsters were recognised for their swimming skills.

Access and recreation

Our four reservoirs Darwell, Powdermill and Weir Wood in East Sussex and Bewl Water on the Kent/Sussex boundary all offer outdoor activities such as fishing and sailing. Bewl is the biggest stretch of open water in the South East and our largest reservoir. Each year it attracts an estimated 98,000 visitors who take part in windsurfing, sailing, fishing, cycling, walking and boat trips.

We have a long-standing partnership with the Hampshire and Isle of Wight Wildlife Trust which manages our Testwood Lakes site near Southampton on our behalf. Testwood Lakes has a purpose-built education centre which hosts environmental activities for the thousands of children, many of them on school trips, who visit each year.

Other visitor attractions in our region include the historic steam pumping engines at our water supply works in Brede, East Sussex, which are cared for and displayed by Brede Steam Engine Society.

Our sewer tours offer a fascinating insight into the essential network beneath Brighton's streets. These entertaining and educational tours look at the history behind the construction of our sewers. In a typical year, some 1,500 visitors take a tour and learn more about the architecture and history of this hidden environment.

Charity and volunteering

We contribute to the wellbeing of our customers and our communities, and our staff are actively encouraged to get involved in work to improve their communities. During the last 12 months, Southern Water staff gave 24,000 hours of their time to help community projects.

One of our highlights this year was a visit by His Royal Highness the Duke of Gloucester to Southern Water's multi-award winning wastewater treatment works in Peacehaven. Hosted by Southern Water Chief Executive Matthew Wright, the Duke met staff and heard how the site treats 95 million litres of wastewater every day from Brighton & Hove and the surrounding towns. He was also shown its 18,000 square metres of green roof, one of Europe's largest.

Other guests at the event included pupils and staff from Chailey Heritage School, the beneficiary of £6,000 of fundraising since 2013. While there, the Duke officially opened a new conference room named The Heritage Room in recognition of the school.

Annual events

Southern Water's big annual events are designed to get participants engaged with our chosen charities. Our last annual ball raised £100,687 for Cancer Research UK. Our popular race day brought in more than £28,000, which was split between the Rainbow Centre in Fareham which helps people with neurological disorders, and the Rockinghorse Children's Charity in Brighton. In fact, a total of £182,000 was raised for good causes over the course of the year as a result of our fundraising efforts.

We've taken part – and sponsored each other to take part in – a range of events to benefit causes including the Air Ambulance Trusts in Kent, Sussex, Hampshire and the Isle of Wight, The Snowdrop Trust, Action Research for Children and Macmillan Cancer Support.

We're continuing our long relationship with WaterAid, the international charity which helps provide poor communities with access to clean water and sanitation systems. During 2015–16 we raised a total of £75,000 through various activities.

We're also looking ahead to celebrating our 10th charity race day this October which we hope will be more successful than ever.

Financial performance

Financial performance

Accounting policies

The financial results have been prepared in accordance with FRS 101 (Financial Reporting Standard 101) for the first time this year, having previously applied generally accepted accounting practice in the UK (UK GAAP). As a result the prior year comparatives have been restated. Reconciliations from UK GAAP to IFRS for the income statement and balance sheet in respect of prior years are presented in note 31 of the financial statements.

The accounting policies of the company are set out on pages 103 to 112.

Income statement

Our income statement is summarised in Table 1 below.

Table 1	Years ended 31 March		Change
	2016 £m	2015 £m	%
Revenue	803.7	826.2	(2.7)
Other operating income	1.7	1.2	41.7
Operating costs	(286.3)	(273.1)	4.8
Depreciation, net of amortisation	(234.6)	(222.8)	5.3
Operating profit	284.5	331.5	(14.2)
Profit on disposal of fixed assets	0.4	1.3	(69.2)
Net finance costs	(86.2)	(91.9)	(6.2)
Fair value losses on derivative financial instruments	(70.4)	(130.3)	(46.0)
Profit before tax	128.3	110.6	16.1
Tax	(8.4)	(17.0)	(50.6)
Profit for the financial year	119.9	93.6	28.1

Revenue decreased by 2.7 per cent to £803.7 million (2014–15 £826.2 million) principally because of the application of new price controls at the start of the regulatory period. Our water and wastewater wholesale revenue, which accounts for some 90 per cent of our total revenue, is now subject to an annual revenue cap. Under these revenue caps, the total revenue we were permitted to recover from our main charges in 2015–16 was some three per cent lower than our actual revenue in 2014–15.

Operating costs increased by 4.8 per cent to £286.3 million (2014–15 £273.1 million) and the major reasons for this movement of £13.2 million are described below and in Table 2.

As a result of the transition to IFRS we are no longer permitted to account for our infrastructure maintenance and repairs using renewals accounting. Consequently, certain expenditure to maintain our infrastructure assets that was previously capitalised under UK GAAP is now treated as an operating cost. Due to the nature of maintenance work, this has the effect of making operating expenditure more volatile, depending on the level of maintenance and repair activity carried out in any one year.

Table 2	
Year-on-year increase/(decrease) in operating costs	£m
Inflation	3.4
Increased bad debt charge	2.6
Infrastructure maintenance expenditure	6.6
Market reform preparation	2.0
Customer services improvement programme	2.9
Change programme	4.0
Refund of rates charges	(13.3)
Insurance proceeds received 2014–15	2.4
Other	2.6
Movement in operating costs	13.2

In 2015–16 we undertook additional planned works on our sewer network in order to reduce the level of pollution and flooding incidents. This additional work, together with the change in accounting treatment, resulted in an increase in operating costs of £6.6 million.

During 2015–16 we have also undertaken a number of specific projects which have resulted in increased operating costs. These include preparations for market reform, which will see the introduction of retail competition for non-household customers, initiatives to improve our customer services performance, such as the creation of a proactive outbound contact team, and an overall change programme aimed at making business improvements to help drive future efficiencies.

These cost increases were offset by a successful appeal against historic rates charges which resulted in the receipt of a refund of £13.3 million.

Depreciation increased by 5.3 per cent to £234.6 million (2014–15 £222.8 million) as a result of the continuing significant capital investment programme. As we reached the end of our previous five-year capital investment programme, AMP 5, a large number of schemes were commissioned during the year, adding a further £8.0 million to the depreciation charge on top of the full-year impact of schemes commissioned during 2014–15.

Operating profit for 2015–16 decreased to £284.5 million (2014–15 £331.5 million), a 14.2 per cent reduction as a result of the factors set out above.

The profit on disposal of fixed assets of £0.4 million (2014–15 £1.3 million) mainly relates to the sale of land, buildings and equipment, surplus to operational requirements.

Net finance costs of £86.2 million decreased by 6.2 per cent (2014–15 £91.9 million). This is largely driven by lower indexation on inflation-linked bonds as a result of lower RPI in 2015–16. This accounted for a reduction of £11.8 million offset by higher net interest payable of £7.7 million following a step up in the interest payable on some of the financial instruments.

As a result of adopting FRS 101, fair value movements on our financial instruments are now recorded through our income statement. During 2015–16, the underlying liability associated with our financial instruments increased, resulting in a loss of £70.4 million being recorded in the income statement (2014–15 loss £130.3 million).

We have recognised a total tax charge to the income statement of £8.4 million (2014–15 £17.0 million). This differs from the charge that may be expected of £25.7 million, based on the profit before tax of £128.3 million and the current period tax rate of 20 per cent, as described in note 9. This is primarily the result of the announcement of the reduction in the rate of corporation tax from 20 per cent to 19 per cent with effect from 1 April 2017 and 18 per cent from 1 April 2020. A credit of £22.0 million is recognised for the impact of these changes on the deferred tax liability of the company.

The profit after taxation for the year amounted to £119.9 million (2014–15 £93.6 million)

Cash flow statement – summary

Our cash flow statement is summarised in Table 3 below

Table 3	Years ended 31 March	
	2016 £m	2015 £m
Net cash inflow from operating activities	466.9	480.2
Net cash used in investing activities	(164.9)	(252.3)
Net cash used in financing activities	(457.6)	(189.9)
Net (decrease)/increase in cash and cash equivalents	(155.6)	38.0

Net cash inflow from operating activities has decreased to £466.9 million for 2015–16 from £480.2 million in 2014–15. This decrease results from the impact of the lower charges to customers, reducing our cash inflow from revenues, the payment of lump sum contributions in respect of our pension deficit, lower payments of group tax relief and the settlement of an inter-company debtor in 2015–16.

The net cash used in investing activities decreased to £164.9 million for 2015–16 from £252.3 million in 2014–15. This decrease mainly results from the transition between two regulatory periods. Capital schemes relating to the previous regulatory period reached completion and new capital projects associated with our plans for 2015–20 are in early stages of design and construction and, therefore, incurring lower levels of expenditure.

The net cash used in financing activities increased to £457.6 million (2014–15 £189.9 million). This increased cash outflow principally results from the payment of accrued indexation associated with derivatives in place on some of our debt of £298.4 million (2014–15 £5.0 million) and the payment of ordinary dividends excluding those in relation to the SWSG dividend loop, of £79.6 million, offset by cash received from new loans of £110.0 million.

Overall these resulted in a net decrease in cash and cash equivalents of £155.6 million (2014–15 net increase of £38.0 million).

Statement of financial position – summary

Our statement of financial position is summarised in Table 4 below

Table 4	Years ended 31 March	
	2016 £m	2015 £m
Non-current assets	6,491 0	6,484 6
Current assets (excluding cash)	194.7	222 7
Cash and cash equivalents	17.9	173 5
Total assets	6,703.6	6,880 8
Current liabilities	(277 0)	(248 0)
Non-current liabilities	(5,066 8)	(5,275 2)
Total liabilities	(5,343 8)	(5,523 2)
Total net assets	1,359 8	1,357 6
Shareholder's equity	1,359 8	1,357 6

At the end of the year to 31 March 2016, we had non-current assets of £6,491 0 million (2014–15 £6,484 6 million), an increase of £6 4 million from March 2015. This increase mainly results from capital investment in tangible and intangible assets of £241 4 million offset by depreciation of £234 6 million.

Current assets decreased to £194 7 million (2014–15 £222 7 million). This decrease largely results from a reduction of £14 3 million in an inter-company debtor in relation to interest payments with SWSF and a lower level of accrued income as a result of the impact of lower charges to customers of £8 7 million.

Current liabilities increased to £277 0 million (2014–15 £248 0 million). This increase is driven by a new short-term loan of £50 0 million from the drawdown of a term facility, offset by an expected reduction in capital creditors of £9 5 million, linked to the lower capital expenditure in the year as we reached the end of our five-year capital programme for AMP5, and the payment of a lump sum contribution to the pension scheme of £15 9 million which was accrued at 31 March 2015.

At 31 March 2016 non-current liabilities totalled £5,066 8 million (2014–15 £5,275 2 million). The reduction of £208 4 million principally resulted from the decrease in the liability associated with derivative financial instruments of £228 2 million.

During 2015–16 we repaid £298 4 million of accrued indexation associated with these instruments, which was offset by an increase in the liability due to the impact of market rates on the underlying instruments of £70 4 million. Further details can be found in note 20 to the accounts.

In addition to the reduction in the derivative liability, our pension liability reduced by £13 1 million following the payment of a deficit contribution of £30 6 million which offset the impact of market movements on the deficit. Our deferred tax balance also reduced by £33 6 million as a result of the announcement of future changes to corporation tax rates. These reductions were offset by new loans issued of £60 0 million.

Overall, net assets increased from £1,357 6 million to £1,359 8 million.

Dividend policy

We aim to deliver a sustainable long-term capital structure, taking into account the interests of all stakeholders. Our shareholders are long-term investors and fully support the strategy adopted.

Our dividend policy is to propose dividends having given due consideration to the following financial and performance criteria:

- 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 our performance against the business plan, including expected performance over the balance of the regulatory period.

Our dividend policy, and the associated financial and performance criteria, is intended to support the credit ratings of the business and ensure continued access to diversified sources of finance.

These tests are not applied to the interim dividends of £45.5 million paid to SWSG, as this dividend payment is instantly offset by a corresponding interest receipt from SWSG and therefore does not get distributed to the shareholders of our ultimate parent company, Greensands Holdings Limited (GSH).

Over the past five years, our shareholders have supported us in strengthening our financial position and in delivering improved operational performance. This support has placed us in a stronger position for the start of this five-year period and, as a result, we have been able to resume dividend payments this year. Ordinary dividends totalling £79.6 million were paid in relation to 2015–16 (2014–15: nil). These dividends were paid through our group structure to the shareholders of our ultimate parent company GSH.

Taxation

We manage our tax affairs in an open and transparent way and contribute materially to the Exchequer each year

All companies within the Southern Water and wider Greensands groups are UK tax resident, ensuring that each company is subject to UK tax. Tax planning is always aligned with our commercial and economic activity. This practice continues to be recognised by HMRC, which assesses us as a 'low-risk' company.

Our rate of corporation tax against accounting profits – our effective tax rate – is less than the statutory rate of corporation tax published by HMRC because of differences in the way in which some items of expenditure are treated for accounting and tax legislation. This is especially the case with regard to capital investment expenditure, where the UK taxation system recognises the benefit to the economy of investment in UK infrastructure. Since privatisation in 1989, the water industry has been required to make significant capital investment to improve environmental performance and resilience to drought and flooding, maintain existing assets and, in particular for us, accommodate population growth in the South East. Our taxable profits are lower than our accounting profits as a result of the tax treatment of our capital expenditure. This has the effect of reducing the amount of tax we pay, the benefit of which is passed to our customers through reduced bills.

Another aspect of our significant capital investment programme is that we borrow money to finance our capital investment. The interest associated with this borrowing is recognised as both an accounting and tax expense, so reducing profit and further reducing the amount of tax we pay. Again, the benefit of this is passed to our customers through reduced bills.

Our contributions to the Exchequer amounted to £51.3 million. These are explained below:

- Business rates of £25.7 million paid to local authorities (2014–15: £25.1 million) and payments to the Environment Agency of £8.4 million (2014–15: £8.4 million), which reduce profits chargeable to corporation tax. In 2015–16, these payments were offset by a refund of historic rates charges totalling £13.3 million following an appeals process in relation to historic charges.
- Employment taxes of £26.7 million (2014–15: £23.3 million) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions.
- Carbon Reduction Commitment of £3.8 million (2014–15: £3.7 million) levied on our power costs, which reduces profits chargeable to corporation tax.

Payments have also been made to other group companies of £15.1 million for tax losses surrendered to the company. Of these, £11.4 million was paid to SWSG and then repaid to us as interest, with the remainder paid to the Greensands financing companies. Overall, Southern Water pays 12.4 pence in the pound for losses surrendered from group companies. As a result of capital allowances and interest charges, no corporation tax was paid by the group in 2015–16.

Financial KPIs

Within our financial debt structure is 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 net cash income to net interest cost.

The net debt to RCV ratio is calculated as short and long-term senior borrowings, less cash and short-term deposits to the RCV (all values taken from our Regulatory Accounts). The RCV is set by Ofwat at each five-year periodic review and reflects forecast growth in the asset base from capital investment and inflation. The RCV is adjusted at each periodic review for relevant changes to the level of expenditure or performance during the five-year period. The ratio of senior debt to RCV is targeted to be maintained at around 80 per cent, comfortably within our debt covenants.

Senior adjusted cash interest cover (measured as net cash inflow from operating activities less RCV depreciation to senior debt interest) is targeted to be maintained above 1.1 times to meet covenanted levels.

Net debt / RCV	%	Senior adjusted cash interest cover	Times
2012–13 performance	79	2012–13 performance	1.5
2013–14 performance	78	2013–14 performance	1.6
2014–15 performance	78	2014–15 performance	1.6
2015–16 performance	79	2015–16 performance	1.9
Covenanted lock-up level	<85	Minimum target trigger level	1.1

Credit rating	As at 31 March 2016
Standard & Poor's	Class A debt A- Class B debt BBB
Fitch	Class A debt A- Class B debt BBB
Moody's	Class A debt Baa1 Class B debt Ba1

In February 2015, Moody's removed the negative outlook on our credit ratings following an assessment of the PR14 Final Determination (the regulatory business plan for the period April 2015 to March 2020), including a recognition of our improved operational and financial performance in recent years. All credit ratings are now 'stable'.

Capital structure

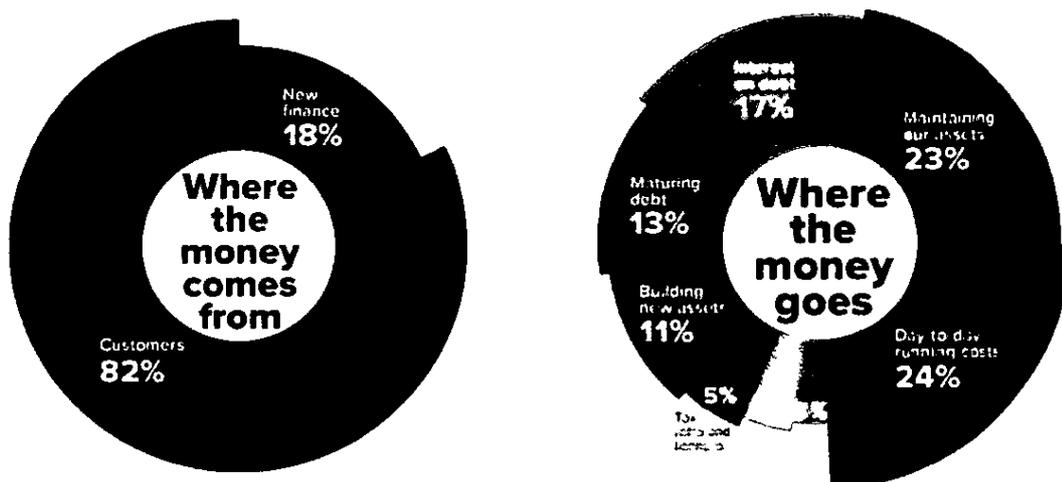
Why Southern Water raises finance

Significant capital investment has been a feature of our business since privatisation in 1989. We have invested in both maintaining our existing asset base and constructing new assets in order to improve the environmental quality of wastewater, improve the quality of drinking water and accommodate population growth in our area of operation. As an example, before privatisation, 350,000 m³ of wastewater per day was discharged into our coastal waters untreated, but the completion of our £300 million Cleaner Seas for Sussex scheme in 2013 marked the conclusion of a programme of capital investment to fully treat wastewater of the coastal towns and cities from Kent to Hampshire and the Isle of Wight. A further example is a current £63 million construction project at Woolston which will improve the quality of effluent discharged into the River Itchen as well as reduce odours.

We raise finance to pay for the construction of new assets and to repay loans taken out in previous years. In addition we are partly financed by shareholder equity, sufficient in size to absorb financial risk and contribute to the financing of construction of new assets.

The level of customer charges is calculated to cover our operating expenditure, our annual financing costs (including any equity return to our shareholders) and the amount required to invest in and maintain our assets, such as water pipes, sewers, pumping stations and treatment works.

The charts below illustrate the sources and uses of expected cash flows for the current regulatory period, April 2015 to March 2020, and demonstrate our requirement to raise finance to fund our capital investment programme. The data is based upon the regulatory price determination, which sets out both our performance obligations and the limits on customer charges for this current five-year price period.



Day-to-day running costs – this includes wages for direct employees and people indirectly employed through our supply chain as well as power, chemicals and materials costs and the charge made providing for bad debt when charges are not paid by customers.

Maintaining our existing assets – capital expenditure to maintain our underground pipe network and treatment works, including capitalised employee costs.

Interest on debt – interest incurred on money we have borrowed to finance the business. This borrowing helps us to spread the cost for customers of improvements made to our services over the longer term.

Maturing debt – this relates to the repayment of loans as they mature and is offset by new finance raised.

Building new assets – for example our £63 million modernisation of the treatment works at Woolston in Southampton and other projects to enhance treatment standards and cater for growth.

Tax, rates and licences – this includes corporate taxes, business rates on buildings, wastewater treatment works and water supply works and Environment Agency licences.

Ofwat / regulator adjustments – these adjustments, rewards and penalties have been applied by our regulator Ofwat in the period 2010–15. They relate to customer satisfaction, cost savings and revenue collection.

Profit – return earned on ultimate shareholders' investment in the business.

Capital structure and borrowing covenants

We refinanced our regulated business in 2003 with the aim of reducing our cost of capital and gaining access to long-term and secure sources of finance. This was achieved by replacing a short-term parent company loan with a series of listed bonds issued under a long-term framework for sustainable future financing (known as securitisation), which continues to be in place today.

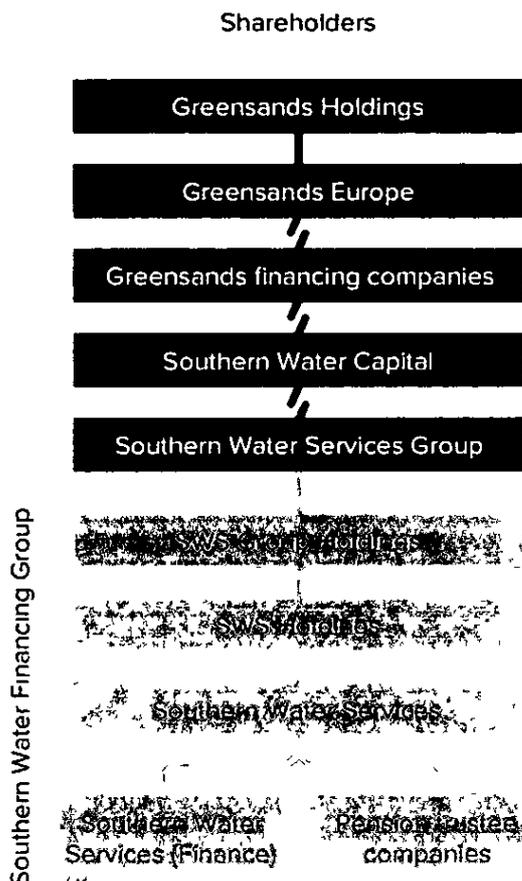
Our financing subsidiary, Southern Water Services (Finance) (SWSF), was established for the express purpose of raising debt finance on our behalf. The Southern Water Financing Group (see ownership chart below) was also established at that time to create a financial ring-fence to protect our ongoing operation from lenders in the event of default.

The financing group, whose immediate parent is SWSG, provides security to finance providers in the form of a charge over the share capital of SWS Group Holdings (SWSGH). No security is provided over our individual regulated operating assets. This structure ensures that, in the unlikely event that either Southern Water or SWSF were to default on their debt obligations, we will continue to operate our business as usual. Debt providers are not permitted to either break up or interrupt our business and can therefore only look to a new owner of the financing group to recover their debt in the unlikely event of serious default.

In 2003, a Common Terms Agreement (CTA) between the members of the financing group and its debt investors was established. The CTA sets out arrangements for the ongoing management of our debt issuance programme as well as a number of operating arrangements in order to minimise our financial risk and adhere to good industry practice.

One of the CTA arrangements is a limit on the indebtedness of Southern Water and SWSF. This includes precautionary 'early warning' limits which prevent us from paying dividends if a limit is breached. We ensure that we operate with sufficient financial headroom against these limits and have not breached a limit at any time since the implementation of the financing framework in 2003.

Southern Water ownership structure summary



Greensands Holdings (GSH) is the ultimate parent company of Southern Water and all other group companies, with no minority interests. A number of Greensands companies were set up to finance the acquisition of the share capital of Southern Water Capital (SWC) from the Royal Bank of Scotland in October 2007 (investing £1.9 billion of equity and debt to finance the acquisition). The shareholders of GSH are a consortium of infrastructure funds and pension companies, with no single shareholder having majority control.

There is additional indebtedness at the level of the Greensands financing companies. Security granted to these lenders is limited to the share capital of Greensands Holdings Ltd. There are no debt guarantees in place between the Greensands financing companies and the Southern Water Financing Group, with the result that SWS is fully protected, and fully isolated, from a default at any Greensands company.

Shareholders of GSH are represented on our Board through two non-executive directors. During 2015–16 the Board also consisted of a further four non-executive directors, who are independent of the shareholders, a non-executive Chairman, the Chief Executive Officer and the Chief Financial Officer. You can find out more about our Board on page 76.

Our Chairman is also independent Chairman of the GSH Board, which meets four times a year. The purpose of GSH is to act as a single-purpose entity, being the ultimate holding company for Southern Water, and provide the financing structure for the group. As a consequence, the GSH Board complements and supports the aims of the Board of Southern Water for its long-term success and our Chairman unites the respective Boards in this common aim. As a result we feel his cross directorship does not undermine his independence. No other independent members of our Board sit on the Board of GSH.

All companies within the Greensands Holdings group of companies are UK resident for tax, with all profits and losses falling within the UK tax jurisdiction.

How we finance the business

In note 19 to the financial statements, we provide an analysis of our outstanding debt at 31 March 2016 and 31 March 2015. Our loans comprise sterling bonds, issued by our financing subsidiary SWSF, and listed on the UK Stock Exchange, plus bank loans, and a loan from the European Investment Bank.

The regulatory framework, under which revenues and the RCV are indexed, exposes us to inflation risk. This risk is managed through the use of inflation-linked loans and derivatives within the overall debt portfolio. We do not intend to access future inflation-linked debt through the use of derivatives but will instead seek such debt from natural sources, such as public and private bond markets. As a consequence, we expect the proportion of the RCV and debt that is currently linked to inflation through the use of derivatives will decrease over time.

We are not restricted to issuing sterling bonds but will ensure any other currency loans are fully hedged back to sterling. We also hedge our exposure to interest rate volatility by ensuring that at least 85 per cent of our outstanding debt liabilities (in respect of Class A and Class B debt) is either inflation-linked or fixed rate for the current five-year regulatory period and at least 70 per cent in the next period (on a rolling basis).

We also consider refinancing risk by ensuring that loan maturities are not concentrated in any single year or regulatory period. When issuing new loans, we test that refinancing obligations are less than 20 per cent of RCV in any two consecutive years and 40 per cent of RCV within any five-year regulatory period. The maturity profile of loans extends to March 2056, which ensures we comfortably meet this test. Although not formally required, we ensure that inflation-linked swap accretion payments are included within our maturity analysis.

We ensure that sufficient liquidity (cash and committed bank facilities) is in place to fund the business for at least the next 12 months (including loan and inflation-linked swap accretion maturities), an important consideration given that we have negative cash flow generation in the majority of years as a result of our ongoing capital investment programme.

As a result of our prudent liquidity policy, we can at times have large cash balances. We reduce the risk of losing cash on deposit, from bank or fund failure, by setting maximum limits on cash deposits and minimum credit ratings for each bank or fund. Banks must have, as a minimum, a credit rating of P1 (Moody's), A1 (Standard & Poor's) or F1 (Fitch). Funds must be the most secure rating of AAA rated.

In addition to our loans as analysed in note 19, we have in issue a loan of £812.3 million to SWSG which was put in place as part of the refinancing in 2003 (note 13). We receive £56.9 million annual interest on this loan from SWSG. In order to enable SWSG to make this payment, it receives dividend and tax payments from us. For the year ended 31 March 2016, the dividend was £45.5 million and the tax payment, in respect of the taxable losses incurred by SWSG, amounted to £11.4 million. This loan provides no tax benefit to either us or the Greensands Group, with the tax payment we make to SWSG simply negating any tax effect of this loan. This is illustrated in figure 1 of the diagram below.

The Greensands companies also have their own loans – a UK-listed bond and bank loan issued by Southern Water Greensands (Financing) (SWGF), represented in the diagram below as part of the Greensands financing companies, and Eurobonds issued by Greensands Europe. Interest on these loans may result in a tax expense which can be used within the Greensands Holdings group of companies.

Interest and dividends payments 2015–16

Fig 1

£812.3m loan from SWS to SWSG

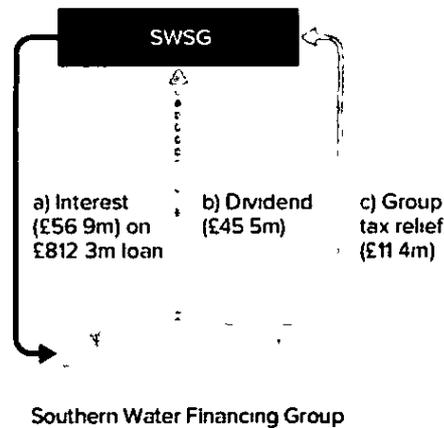
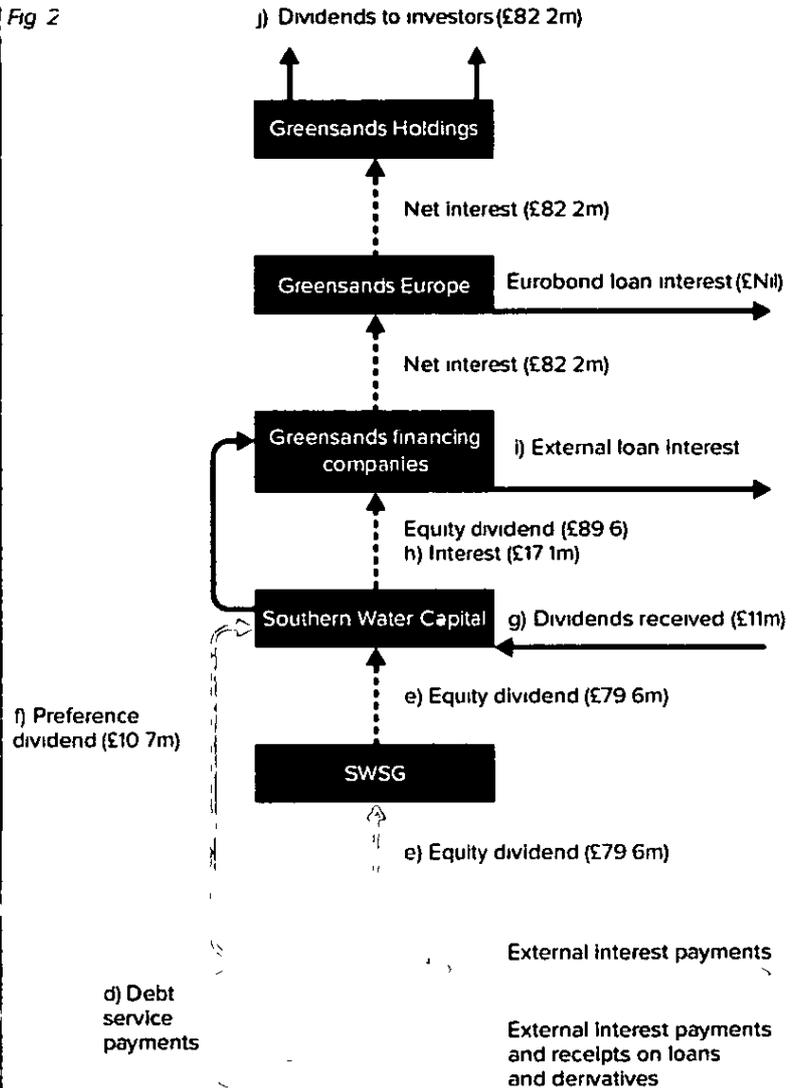


Fig 2



Footnote

- a) Interest paid by SWSG to SWS on £812.3m loan
- b) Dividend paid by SWS to SWSG to facilitate the interest payment on the £812.3m loan
- c) Payment of group tax relief by SWS for the taxable losses at SWSG
- d) Interest payments from SWS to SWSF on the loans taken out by SWSF on behalf of SWS. This is then used by SWSF to pay the interest on these external loans
- e) Ordinary dividend ultimately paid to investors
- f) Interest payments on the preference shares
- g) Dividends received from other group companies
- h) Interest payable on inter-company loans
- i) External interest payable funded from interest receivable and cash held in the Greensands financing companies
- j) Dividends paid to investors

Viability statement

Details of our Code of Board leadership, transparency and governance are set out in the corporate governance section of the Annual Report on page 70. In developing our code we have drawn on the appropriate principles of the UK Corporate Governance Code (UK Code). In accordance with provision C 2.2 of the 2014 UK Code, the Board has assessed the prospects of the company over a longer period than the 12 months required by the 'Going Concern' provision. The Board has selected to conduct this review each year based on a rolling three-year period for the following reasons:

- i The certainty on wholesale and retail price controls is provided for each five-year period in a Final Determination by Ofwat,
- ii The internal planning cycle looks forward to the end of the regulatory period and is, on average, three years, and
- iii A three-year review minimises the period of uncertainty in years at the end of each planning cycle.

In assessing the viability of Southern Water over a three-year period to March 2019, the directors have taken into account current performance and the financial and operational impacts, in severe but plausible scenarios, of the principal risks documented in the Strategic Report on page 61. These include the impacts of:

- Incidents, for example severe weather, cyber security or a major operational event, on operating costs and remedial capital investment,
- Market reform on future revenues, and
- Changes to RPI or interest rates.

For each scenario the impact has been assessed to ensure that our ratios are not breached and that headroom is maintained to ensure that we can continue to achieve our operating company and holding company debt service and gearing targets.

In addition, the directors have assumed that funding for the ongoing capital investment programme will continue to be available in all plausible market conditions.

Based on this assessment, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period to March 2019.

In arriving at their opinion the directors have taken into account:

- The certainty of wholesale and household retail price controls to March 2020 provided by the 2014 Final Determination by Ofwat, following its acceptance by the Board,
- The financial strength of the company at the balance sheet date and the fact that it has arranged £350 million of five-year committed bank facilities as back up liquidity (maturing in 2019), of which £350 million remains undrawn at 31 March 2016,
- The key financial ratios over the planning horizon of the company's three-year assessment period as reflected in strong investment grade credit ratings with stable outlook,
- The company's annual budget and business plan projections, including stress testing reflecting plausible but severe combinations of the principal risks of the business,
- The company's formal risk and governance arrangements which are monitored by the Audit Risk & Compliance Committee and Board,
- The Licence which is in place on a rolling 25-year basis, and
- The primary duty of Ofwat to ensure that water and wastewater companies can finance their functions.

Risks

Risk management is a core component of our wider governance and internal control framework, which provides the overarching structure through which the company is managed to achieve its objectives

The most significant risks facing us are referred to as 'the principal risks'. These are risks that are considered by the Executive Management Team and Board to have the greatest potential to affect the achievement of strategic objectives, based on outputs from the "top down" and "bottom up" risk assessment exercises and their ongoing review and monitoring

The Board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives

Our strategy for risk management is that all principal risks are identified, assessed and managed to within acceptable levels. To achieve this, the Board and management promote a culture that encourages routine consideration of principal risks in key decisions and supports integration of risk management with our critical processes and ways of working

The Board monitors our risk management and internal control systems which cover all material controls including financial, operational and compliance controls

The purpose of risk management is not to make our company risk averse, as taking risk is something we must continue to do in order to achieve our objectives and be successful. Rather, it is to support better decisions through an improved understanding of risk, which means taking the right risks for the right benefits and returns

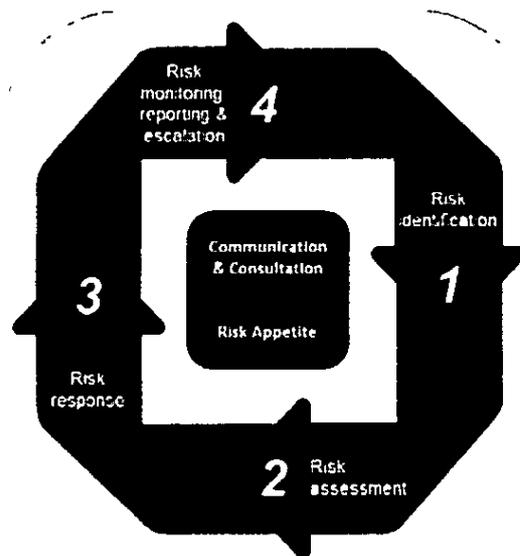


Figure 1 Southern Water Risk management process

The objectives of our risk management strategy are to

- Identify and understand all the principal risks that we face,
- Select and proactively take the risks that give us the right returns, and understand their potential impact on the company,
- Take action to manage the risks we do not want to be exposed to, ensuring our resources are effectively and efficiently prioritised and used, and
- Monitor and report the risks we are taking against our desired strategic objectives

Every employee is responsible for helping us to effectively manage our risk exposures and making us a more resilient organisation, able to successfully respond to our changing environment

We ensure controls are in place so we can take action to minimise the impact of risks. To do this, they are managed through a central database where they are ranked and assigned to senior managers who are responsible for implementing mitigation plans. Risks are reviewed each month and the highest are escalated to our Executive Management Team, the Board and the Audit and Risk Review Committee. Any new risks added to the database with a score above a certain level are passed to a director and Chief Executive Officer for immediate review

The principal risks we face are disclosed below



Unchanged in the year



Risk reduced in the year



Risk increased in the year

Customer

Customer service

Commentary: Increasing customer expectations and rising standards of customer service across the sector mean that we may incur financial penalties if we do not continuously improve our customer service performance

The Service Incentive Mechanism (SIM) was developed by Ofwat to incentivise improvements in customer service and compares performance across the water sector

Our SIM performance for 2015–16 was below average which means that, if we do not improve over the next four years, we would face a financial penalty at the next Price Review

We have set ourselves challenging targets and our improvement programmes are working to deliver these for our customers

Mitigation: Improvements to customer service are being made on a continuous basis. Staff are being provided with increased training and development and we are carrying out ongoing research to better understand our customers' experiences. We continue to actively engage with our customers and stakeholders in order to strengthen our links with local organisations such as councils and community groups

We are improving our customers' experience by providing new facilities for them to manage their accounts online and, where customers do need to speak to us directly, we have ensured the opening hours of our contact centre are convenient. Additionally, our bills are being redesigned to make them easier to understand

Outcomes affected



Responsive customer service



Better information and advice

Bad debt

Commentary: The level of customer bad debt, which cannot be recovered and has to be written off as a loss, continues to be a significant issue for the water industry. In the current economic climate, there is a risk that the number of customers who do not pay their bills will increase. This puts an additional burden on customers who do pay their bills.

We note that the result of the recent referendum may adversely affect the economic climate and customers' ability to pay.

In 2015–16, the bad debt charge to the income statement increased to £21.5 million (2014–15 £18.9 million)

Mitigation: We understand that some customers may experience financial difficulties, particularly in difficult economic times. We encourage customers who are struggling to make payments to contact our Affordability team as early as possible. To assist those in difficulty we offer a range of flexible instalment plans and tariffs, including a new social tariff from April 2015. We are proactive in collecting payment from our customers and in helping households to pay their bills and debt. When necessary, we also use a leading debt management system, and a panel of Debt Collection Agencies to recover overdue payments to keep bad debt to a minimum.

Outcomes affected



Responsive customer service



Affordable bills



Having a firm financial footing

Operational

Resilience to drought

Commentary The South East is classified as an area of “severe water stress” and changing weather patterns are predicted to pose an increasing challenge for all water companies in the region in future years. We supply drinking water to more than one million households across Kent, Sussex, Hampshire and the Isle of Wight and it is critical we are able to maintain access to adequate water resources to continue to do so now and in the future.

Mitigation. Through our investment planning process, we identify and then develop those schemes which are necessary to ensure we can meet anticipated demands for water over the next 25 years.

Our long-term investment plan sets out the additional water that we will secure across our region to achieve our target for the Security of Supply Index. We continue to drive down leakage and we have finished our Universal Metering Programme which has helped drive consumption down further.

Should a drought occur, as in 2012, we have a Drought Plan which we would follow to introduce measures to conserve water and secure additional resources through Drought Permits and Drought Orders and by changing the way in which we operate our sources. We also maintain our Water Resources Management Plan, using an industry-leading approach which allows us to plan to operate under a wider range of droughts than we have seen in the past.

Outcomes affected



A constant supply of high-quality drinking water



Looking after the environment

Preventing flooding of our sites and from our network

Commentary: Changing rainfall patterns, more frequent storms and rising sea levels, could all lead to an increased risk of flooding if volumes overwhelm our assets. Excessive rainfall results in high groundwater levels which are not possible to remediate adequately, causing flooding to private land and property, contamination of water supply, infiltration / inundation of sewers and a breach of flood defences and protection. The serious floods in recent years have also highlighted the need to protect our water and wastewater treatment works and pumping stations from being put out of action during a flood.

We have met, or improved upon, our business targets this year for sewer blockages, sewer collapses and external flooding, although internal flooding incidents are marginally higher than our target.

Mitigation To help combat this risk, we have prioritised schemes for investment in 2015–20. We are investing £426 million during this period to provide a reliable and effective wastewater service, part of which will be used to keep our 39,600 kilometres of sewers and 2,385 wastewater pumping stations well maintained. It will also fund our replacement or refurbishment of about 224 kilometres of sewers, with the parts of our network in most need of repair and of most structural use targeted first.

We are also focusing on reducing the risk of blockages, which are a major cause of flooding from sewers. This will include carrying out targeted surveys of our sewers using cameras, performing regular sewer cleaning work, and putting more resources into keeping our drainage plans up to date to fully understand how much capacity we will need for the years ahead. We will also provide our customers with better information about the causes of blockages and how they can prevent them. Through investment of £268 million, we intend to ensure there is no increase in the number of blockages in our sewer network.

Outcomes affected



Removing wastewater effectively



Looking after the environment

Resilient supply of good quality water

Commentary We must ensure we can supply enough drinking water to cater for a growing population of more than two million people. Should operational treatment processes fail, the water supply becomes contaminated, or our water distribution network fail

- There is a risk that water could be supplied to customers that is unfit for consumption, and would require a widespread boil water notice in order to protect public health,
- Large numbers of customers could find their water supply becomes cut off, or
- Harmful chemicals could be released to the environment

This could cause damage to our reputation, and lead to prosecution and fines by the Environment Agency or the Drinking Water Inspectorate

We experienced one such issue in January 2016, when water supply to 4,000 customers on the Isle of Sheppey was interrupted by a burst main. Due to the size of the burst it took several days to repair, but we were able to react quickly and ensure water was provided to the affected customers through rezoning and bottled water, until our construction teams had repaired the burst water mains

We met or improved upon all our performance targets for the year in respect of water quality and supply resilience and outperformed our leakage target

Mitigation: Avoiding incidents is managed by taking a prioritised approach to investing in the maintenance of critical assets and technology and through staff adherence to company processes and procedures. New employees are trained in these processes and procedures and their importance

In the event of interruption to supply, emergency plans have been developed to ensure continued supply of water to customers, either through use of alternative supply pipes, tankering or provision of bottled water

We have provisionally achieved industry leading drinking water quality compliance of 99.98 per cent. Our Business Plan 2015–20 includes schemes to add carbon filters and other more advanced filters at our water treatment works in high risk areas such as Hastings, to help improve the taste and smell of water. Part of our activities to improve water quality includes upgrades to wells and boreholes, service reservoirs and water supply works, as well as flushing mains and cleaning service reservoirs, which store water underground before it is pumped to customers' taps

To avoid problems associated with nitrates and pollutants being washed into rivers from high surface run off after heavy rain, we have processes to stop water abstraction during and after heavy storms. Drinking Water Safety Plans have been completed which identify where and how problems can arise with drinking water quality and cover the entire supply system, from catchment to customers' taps

Outcomes affected



A constant supply of high-quality drinking water



Looking after the environment

Cyber security

Commentary: We provide water and wastewater services to customers across our regional infrastructure, which is considered critical national infrastructure

As a result, we recognise our operational and enterprise IT systems may be a potential target for cyber threats which could have a significant impact on our business reputation and operational assets

Mitigation We manage this risk through IT security standards, ongoing monitoring of threats to, and activities on, our IT infrastructure as well as incident management plans

We continue to invest in cyber threat mitigation strategies in response to the changing risk landscape and we work with the Centre for Protection of National Infrastructure. Over the past 12 months we have continued to undertake employee campaigns to raise awareness of IT security and data protection risks

Outcomes affected



Responsive customer service



Removing wastewater effectively



A constant supply of high-quality drinking water



Having a firm financial footing



Better information and advice



Looking after our assets

Wastewater treatment works failures and pollution incidents



Commentary: Our region benefits from a high quality environment, both inland and coastal. We are fortunate to have some extremely rare habitats, as well as some of the best quality river fishing and coastline in the UK.

One important factor affecting the long-term quality of the environment is the nature, volume and frequency of permitted discharges into them. We have a number of carefully managed infrastructure assets which are allowed to discharge into the receiving environment.

Reliable wastewater services are essential to maintain public health and protect the environment. Ensuring our assets operate effectively is critical in minimising the risks to public health and/or the environment from pollution and/or sewer flooding.

As well as the potential to cause damage to the environment or distress to customers, incidents like these can also lead to prosecution and fines by the Environment Agency and cause damage to our reputation.

We have met or improved upon all our business targets for the year in respect of our Wastewater Treatment Works compliance and pollution incidents.

Mitigation: We continue to operate and maintain our assets effectively.

We monitor the functionality and performance of our assets on a continuous basis through a central control room. This together with our new works management system has significantly improved the way in which we dispatch work. We can respond quicker to asset-related events and deliver the required planned preventative maintenance more efficiently.

The majority of our £1.8 billion capital investment programme for 2015–20 is targeted to maintain, enhance and extend our wastewater and water sites and networks to reduce the risk of asset failures and asset-related incidents. This investment allows us to ensure a resilient wastewater service whilst accommodating increases in demand as a result of population growth, meeting new environmental standards and adapting to climate change.

In the last year we have invested £13.2 million at our wastewater treatment works and pumping stations to reduce risks at critical sites, and invested £9.3 million in sewer maintenance and rehabilitation.

In addition, we have started our customer-orientated fats, oils and grease educational programme which is targeted at those catchments with blockage hotspots. We are also increasing customer awareness on how to avoid blocked drains.

Outcomes affected



Removing wastewater effectively



Looking after the environment

Health and safety



Commentary: The health and safety of our employees and the public in the provision of our services is our highest priority. The nature of our work requires that our employees and contractors undertake activities or use equipment which, if uncontrolled, has the potential to cause significant harm. We and our contractors have comprehensive processes and procedures to prevent injury and occupational ill-health. Failure to comply with our Health & Safety Management System could result in death, serious injury or adverse health effects. In addition to the personal impact these would have, we could be liable for prosecution under the Health and Safety at Work and Corporate Manslaughter Acts. In addition, there would be a significant reputational risk arising from the adverse publicity.

Mitigation: We have taken all necessary steps to ensure the potential health and safety risk is suitably mitigated and controlled. We have a clearly defined strategy, safety protocols and standards that are set. These are monitored and reported to the Board on a monthly basis and to the tri-annual Board Health and Safety Committee. The Executive Management Team monitors health and safety performance via detailed reports at the monthly Health and Safety Management Review meeting. This group ensures there is an adequate system for meeting our responsibilities to our staff, customers and members of the public. These services have been developed and are continuously reviewed to ensure they meet the needs of the business and our employees at work.

Additionally, every employee has ready access to a copy of the corporate policy statement and health and safety processes and procedures. All staff receive suitable health and safety training, and we have a campaign to encourage staff to report 'near misses' or hazards at work to help further reduce the risk of injuries or ill-health.

Outcomes affected



Having great people



Working in partnership

Financial

Financing our business

Commentary: A significant change in interest rates, a reduction in the availability of credit to the water industry, or a decrease in our credit rating, could put our ability to finance our capital investment programme or refinance our existing debt maturities at risk in the future. This is required as a condition of our regulatory licence and our borrowing covenants, where a failure to maintain certain credit ratings could lead to a restriction in dividend payments.

As a minimum, we intend to maintain our current risk profile. We only enter into treasury transactions to manage inherent risk and support prudent funding, not to speculate.

Our current credit ratings are

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

We note that the result of the recent referendum will increase uncertainty in this area for the short term.

Mitigation: We ensure that we maintain sufficient cash reserves and liquidity facilities to finance our operations for at least 18 months.

We also ensure the aggregate nominal value of debt maturities does not exceed 40 per cent of Regulatory Capital Value (RCV) in any single regulatory period (and 20 per cent of RCV in any 24 months). Exposure to interest rate rises on our current borrowings is also hedged by a subsidiary company, Southern Water Services (Finance) Limited, and current borrowings are at either fixed rates or index-linked. We ensure that sufficient funds are available for our operational and capital investment programme through on-going monitoring and forecasting of our cash flow and we take steps to manage this when necessary.

We have reduced leverage from levels at the start of the AMP5 period (April 2010) and improved operational performance. This positive action has stabilised our credit ratings.

A primary duty of Ofwat when setting prices is to ensure companies can finance their functions. If necessary, a company can apply to reset customer prices in special circumstances during the five-yearly regulatory periods through an Interim Determination of K (IDoK).

Outcomes affected



Having a firm financial footing



Looking after our assets

Defined benefit pension scheme

Commentary: We operate a defined benefit pension scheme which has been closed to new entrants from 1 April 2005. We remain liable for rights earned by past and present members of the scheme. Changes in demographics and fluctuations in investment markets may affect our ability to fund pension promises.

Mitigation: We have agreed a deficit and risk management strategy with the Trustees. This is monitored regularly by ourselves and the Trustees, and mitigating actions are reviewed and implemented as appropriate.

Outcomes affected



Having a firm financial footing



Having great people

Strategy and Regulation

Delivery of our capital investment programme

Commentary: We have a capital investment programme of £1.8 billion between 2015 and 2020. We have plans in place to ensure we will deliver this, however, we have to ensure our focus is maintained to complete all our work on time.

If we are unable to deliver significant parts of the programme on schedule, our ability to provide an excellent service to our customers could become compromised, as well as prevent us from fulfilling the promises that we have made in our business plan and lead to possible action by the Environment Agency, Drinking Water Inspectorate or Ofwat.

Capital expenditure in the first year of the programme was behind that set out in the business plan, increasing the risk in this area slightly. We remain on track to deliver our required outcomes.

Mitigation: We have transformed our capability during the course of the current capital investment programme to bring significant investment capability in-house. This includes the establishment of an in-house engineering function, a specialist programme management function and asset planning systems, processes and capabilities. Progress against the capital programme is overseen by our Investment Committee and we have adapted our monthly reporting procedures to ensure the delivery of the business plan is given the greatest level of focus within the company. We work closely with our regulators and other interested parties to resolve issues as they arise.

Outcomes affected



Responsive customer service



Removing wastewater effectively



Looking after the environment



Having a firm financial footing



A constant supply of high-quality drinking water

Compliance with regulations and legislation

Commentary: We are a highly regulated business with three main regulators: Ofwat, the Environment Agency and the Drinking Water Inspectorate. If we do not meet the standards set by these bodies, we could face fines, legal action and, in the worst case, the loss of our appointment as a water and wastewater company.

Mitigation: We have procedures in place to comply with legislation and key procedures have been certified to meet relevant industry standards, including ISO 9001 and ISO 14001.

Internal monitoring and assurance is undertaken during the year and annual reporting is supported by external verification through our financial and technical auditors to provide assurance on compliance with our obligations.

Awareness training is provided throughout our company for critical compliance issues, such as the Bribery Act and Competition Law, to ensure everyone understands our legal obligations. All sections of the business review compliance with company procedures through self-assessment every six months and implement improvement plans if necessary.

Outcomes affected



Responsive customer service



Removing wastewater effectively



Looking after the environment



Having a firm financial footing



A constant supply of high-quality drinking water

Regulatory reform 

Commentary During recent years, there has been a significant focus on reform within the water industry, concentrating on the introduction of competition and a greater use of market mechanisms to promote innovation and efficiency. From April 2017, the retail market for non-domestic customers will be opened, which will require structural changes within the company to allow us to continue to comply with regulatory requirements and to manage the anticipated shift in customer base.

Mitigation We have continued to engage constructively with Ofwat and Defra on the proposals for market reform. During the year we have actively participated in numerous workshops held by Ofwat, Open Water and MOSL. We have established a market readiness programme to co-ordinate the changes required in the business, including a steering group chaired by our Director of Strategy and which includes our Chief Executive and Chief Financial Officers.

The regulatory framework continues to evolve as it is reviewed to ensure that it is fit for the challenges of the future. This includes assessing the costs and benefits of extending retail competition to all residential customers and proposals to move to CPI instead of RPI as the basis for setting price controls.

During the year we have taken an active participation in workshops and consultations held by the 'Open Water' programme, which will deliver the market codes, systems and contracts needed to implement the wholesale and retail arrangements outlined in the draft Water Bill.

Outcomes affected	 Responsive customer service	 A constant supply of high-quality drinking water	 Affordable bills	 Removing wastewater effectively
	 Looking after the environment	 Better information and advice	 Having a firm financial footing	 Looking after our assets

The Strategic Report was approved by the Board of Directors on 28 June 2016 and signed on its behalf by J Statton, Company Secretary



Joanne Statton
Company Secretary
28 June 2016

Corporate Governance

Chairman's overview

Introduction

We are committed to maintaining high standards of leadership, transparency and governance. We have adopted our own code and have committed to comply with its letter and spirit. As the Board, we fully accept our responsibility and accountability to stakeholders for ensuring effective governance processes are in place and followed.

The Board's role is to

- Ensure that the company's obligations to, and interests of, its stakeholders, including customers and regulators, are known and met appropriately,
- Provide effective leadership and collective responsibility for the long-term success of the company, to the benefit of its stakeholders,
- Determine overall strategic aims and direction,
- Ensure that sufficient resources are available to the Chief Executive Officer and his team to operate, manage and develop the business appropriately, and
- Ensure that appropriate and effective processes and controls are in place to assess and manage risk.

Southern Water Code of Board leadership, transparency and governance

In the Southern Water Code of Board leadership, transparency and governance, we have fully reflected the Ofwat Principles (published in April 2014) and drawn extensively on the appropriate principles of the UK Corporate Governance Code. We have committed to comply with the letter and the spirit of the principles and commitments of the Southern Water Code and the board of our parent company, Greensands Holdings, has committed to assist us. We continue to have regard to corporate governance practices and developments in other sectors and will review the Southern Water Code again in the current year 2016–17.

The Southern Water Code is published on our [website](#).

Board membership

I was appointed to the position of independent non-executive Chairman of the Board on 1 April 2014 and served on the Board in this role throughout 2015–16.

During 2015–16 the Board was comprised of an independent non-executive Chairman, two executive directors (the Chief Executive Officer and Chief Financial Officer) and six non-executive directors, of whom four are independent. I believe that, during the year, we comprised a balanced and rounded Board, giving independent support and advice as well as providing new ideas and healthy challenge. As part of the annual Board review, our Nomination Committee evaluated the skill sets of the Board and concluded that the current skills and experience of the Board provided good coverage of knowledge and diversity.

The presence of the non-executive directors, only two of whom are not independent, and the independent non-executive Chairman ensures that we achieve an appropriate balance of governance. The members of the Board, their biographies and descriptions of their complementary skills and extensive experience are on pages 76 to 79.

All members of the Board were and are able to allocate the necessary time to the company and its areas of business to discharge their responsibilities effectively.

Chairman

As Chairman, my role is to lead the Board in its shared responsibilities, to encourage and facilitate the contributions of its members and to ensure adherence to the governance principles and processes of the Board. I have ensured that the new members of the Board receive appropriate induction and ongoing training.

I discuss and agree agendas for Board meetings with the Chief Executive Officer and Company Secretary, although any director may sponsor an item to be included on the agenda. I have authority to act and speak for the

Board between its meetings, including engaging with the Chief Executive Officer. I report to the Board, chairmen of its committees and individual directors as appropriate on decisions and actions taken between meetings of the Board. I also meet with the non-executive directors, without the executive directors present, to consider the performance of the executive directors and to provide feedback. I am continuing to increase open and constructive contact between all members of the Board, in both formal and informal meetings.

Investor representation

Our investors comprise the Greensands Consortium, the membership of which is explained on our [website](#).

Two investors, but not all, are directly represented on the Board and I ensure that the views of all investors can be communicated to the Board.

Senior independent non-executive director

Paul Sheffield is the senior independent non-executive director. He chairs the Health and Safety Committee and Remuneration Committee and is also a member of the Nomination Committee. He would chair Board meetings in the event that I am unable to do so for any reason and is available to discuss matters or concerns with investors as required. Paul has been a non-executive director for two years and brings with him considerable experience in construction and engineering.

Independent non-executive directors

The independent non-executive directors are valued members of the Board. As well as meeting the company's obligation in its licence to have independent non-executive directors, they bring overall independent advice, review and challenge on behalf of all stakeholders, including customers. The independent non-executive directors have been appointed for their individual external expertise and experience in specific areas, such as customer service, the environment, operations, procurement, capital project delivery and finance, and for the range of their experience of general corporate management. They meet without the Chairman at least once a year and appraise the Chairman's performance annually.

The Board considers the independent non-executive directors to have been, and to continue to be, independent in character and judgement and persons of standing with relevant experience, collectively having connections with, and knowledge of, the company's area and understanding of the interests of our customers and how these can be respected and protected.

The standard terms and conditions of the independent non-executive directors are published on our [website](#).

Shareholder representative non-executive directors

There are two non-executive directors, each of whom is nominated to the Board by one of our two major investors. They bring the extensive knowledge, skills and resources of their nominating investors and employers as well as their own personal skills, experience and knowledge of businesses and business sectors similar to our own. On our Board, they have all the duties, obligations and rights of a director of Southern Water and act in the best interests of the company. They do not receive any remuneration from Southern Water.

Chief Executive Officer

The Chief Executive Officer, Matthew Wright, is a member of the Board and has all the responsibilities of a director of the company. In his executive role, responsibility has been delegated to him to achieve the company's strategy. He is empowered to take all decisions and actions that further the company's strategy and which, in his judgement, are reasonable within the Chief Executive Officer's limits set out in the company's internal controls. The non-executive directors, led by the Chairman, appraise his performance annually.

Chief Financial Officer

The Chief Financial Officer, for the reporting year, Michael Carmedy, resigned at the end of March 2016, having been a member of the Board with all the responsibilities of a director of the company for the past four years. In his executive role and reporting to Matthew Wright, he had the responsibility to manage the company's financial affairs and assist the Chief Executive Officer in the delivery of the company's strategy. His executive performance was reviewed annually by Matthew Wright. In anticipation of Michael Carmedy's departure, the Board appointed William Lambe as his successor, and he took up his appointment in May.

Executive Management Team

Reporting to Matthew Wright, the Executive Management Team supports him in driving the implementation of strategy in the company. The team is committed to do this in a responsible way that takes account of our commitment to our customers, the environment, the communities in which we live and work and all our other stakeholders and with a view towards the long-term responsible stewardship of the business.

Role of the Company Secretary

All directors have access to the advice and services of the Company Secretary, Joanne Statton, and the Company Secretariat team. The Company Secretary is responsible for ensuring that the Board operates in accordance with the governance framework it has adopted and that there are good information flows to the Board and its committees and between senior executives and the non-executive directors. The appointment and removal of the Company Secretary is reserved to the Board.

After 40 years, Kevin Hall retired from Southern Water in September 2015 and Joanne Statton was appointed, by the Board, as his successor. I wish to thank Kevin Hall for his commitment and invaluable assistance to the Board and the company over the years.

Director induction, training and development

On appointment to the Board, a director will discuss and agree induction coverage and then an appropriate comprehensive and individualised induction pack is provided, which will include information on the company and holding group structure, the regulatory framework of our business, customer service and the operation of assets, strategic plans, financial reports, business plans and our governance framework. This and further relevant information, is summarised in the directors' handbook.

Meetings are arranged with members of the Executive Management Team and with external advisers, who provide support to the relevant Board committees the directors may serve on, as well as visits to operational and office sites.

Directors received updates and presentations through the year on matters such as Ofwat's Water 2020 programme, market reform, the company's environmental programme, water resource management planning and the requirements for a viability statement under the Corporate Code. They also have access to professional development provided by external bodies and our specialist advisers.

Board evaluation

In accordance with the Southern Water Code, I undertook the process of Board evaluation and effectiveness. The results of the evaluation were presented to the Board at its February meeting and reflected that, overall, the Board is considered to be working well, within an open and collaborative approach. Governance continues to be in good order and there were no areas of major concern or weakness identified. As part of the effectiveness review, the Board considered its objectives for the coming year and these will be reviewed during 2016–17.

Subsequently, Paul Sheffield, senior independent non-executive director, led a review and appraisal of my performance as Chairman, without my participation. I am pleased to record that my chairmanship was unanimously supported by the Board and no areas of major concern or weakness were identified.

Board operation

There is good understanding of the principles and processes in place regarding the tasks and activities of the Board, the authority delegated to the Chief Executive Officer and the relationship between us

The following matters are routinely determined by the Board

- Business strategy
- Financing strategy
- Business plans
- Approval of annual budgets
- Fixing of principal charges and charges schemes
- Approval of financial statements
- Key regulatory submissions (including, but not limited to, market reform, price review submissions to Ofwat, Interim Determination of K applications, Risk and Compliance Statement and Regulatory Financial Statements)
- Key customer and stakeholder publications (including, but not limited to, the Annual Report)
- Entering into significant contracts or commitments (including capital schemes over £5 million and disposals over £1 million)
- Approval of dividends
- Commencing into new businesses
- Appointment or removal of auditor
- Appointment and remuneration of independent non-executive directors
- Appointment or removal of the Company Secretary
- Amendment, qualification, addition to or removal from the above

The Shareholders' Agreement of our parent company, Greensands Holdings, reserves certain matters by exception to the Board and shareholders of that company. A list of these matters is published on our [website](#). During the year 2015–16, no such matters have been decided by that Board or those shareholders.

Good governance requires a clear division of responsibilities between the Chairman and Chief Executive Officer. A statement of these responsibilities is published on our [website](#).

Board meetings

The Board held nine scheduled monthly meetings during the year. The agenda and papers are sent to Board members in advance of each meeting. The monthly financial, performance and economic regulation reports are also distributed for the other three months when there is no scheduled meeting (August, October and December). The Board holds its meetings at its principal office in Worthing but at least two meetings each year are held in London to facilitate meetings with investors.

In addition to the scheduled Board meetings, the Board and the company's Executive Management Team met in October, to discuss strategic considerations of the company, including Water 2020, market reform, innovation and customer experience.

Directors have access to the advice and services of the Company Secretary and are able to take appropriate independent professional advice for the performance of their duties. Where a director has a concern over any unresolved matter, he/she is entitled to require the Company Secretary to record that concern in the minutes of a meeting. Should the director later resign over the issue, I, as Chairman, would bring it to the attention of the Board.

Attendance at scheduled monthly Board meetings in 2015–16			
Robert Jennings	9/9		
Matthew Wright	9/9	Michael Carmedy (resigned 31 March 2016)	9/9
Paul Sheffield	9/9	Lisa Harrington (appointed 1 April 2015)	8/9
Bill Tame	7/9	Rosemary Boot	9/9
David Golden (resigned 23 June 2015)	3/3		
Bronte Somes	9/9	Mark Walters	9/9

Note – Attendance includes attendance in person and by telephone

Board committees

We have established standing committees of the Board with specific responsibilities. They assist by monitoring and reviewing performance and issues in the areas within their respective scopes and by advising and making recommendations to the Board. Specific responsibilities have been delegated to those committees.

The standing committees of the Board that met in 2015–16 are

- Audit and Risk Review
- Health and Safety
- Remuneration
- Nomination

Each committee has written terms of reference to exercise oversight on behalf of the Board and provide advice in its remit area. These terms of reference are published on our [website](#).

Other committees are constituted if and when required for specific matters.

The company has previously appointed a Regulatory Committee. However, given the significance of the regulatory issues and changes that are taking place in the regulatory environment, in particular market reform and Water 2020, such regulatory matters have been discussed and decided by the full Board. Consequently, the Regulatory Committee did not meet during the year. This position will continue to be reviewed by the Board, which itself receives both an economic regulation and market reform report at each scheduled monthly meeting and for the other three months, as described above.

Remuneration

The directors' remuneration report is set out on pages 84 to 93.

Interests

No director declared a material interest at any time during the year in any contract of significance with the company.

Conflicts of interests

Conflicts or potential conflicts are governed by the Companies Act 2006. The Board does not have power to authorise conflicts. If a conflict should arise, the conflicted director takes no part in discussions or voting on that issue.

Annual General Meeting

Southern Water Services Limited is a private company with single corporate ownership and is not required to hold an Annual General Meeting

Conclusions

The Board and I remain committed to the company continuing to follow good corporate governance to underpin business strategies and plans which ensure that its obligations to, and interests of, its stakeholders, in particular customers and regulators, are known and met appropriately



Robert Jennings
Chairman

Board of Directors

The day-to-day running of Southern Water is led by Matthew Wright, our Chief Executive Officer, and our Executive Management Team, which reports to our Board of Directors



Robert Jennings

Chairman

Appointed Chairman in April 2014, Robert joined the Board as an independent non-executive director in July 2012

Robert is also the Department for Transport's representative on the board of Crossrail and Chairman of Sequoia Economic Infrastructure Income Fund Limited

He joined SG Warburg & Co in 1986 and remained with the organisation until February 2009 where for many years he had been head/joint head of the bank's infrastructure group. During this period, he was also seconded to HM Treasury on two occasions.

Robert graduated from Bristol University in 1976 after reading Economics and Accounting.

Articled to Coopers and Lybrand, he became a Chartered Accountant in 1979 and, in 2005, was made a CBE in recognition of his services to the transport sector and finance industry.



Matthew Wright

Chief Executive Officer

Appointed in February 2011, Matthew Wright joined us from United Utilities where he was managing director, Asset Management and Delivery.

Prior to that, he was managing director, Operations, and his role included management of the operations, maintenance and customer service activities of United Utilities' regulated water and wastewater business as well as oversight of the company's external contracts with Dwr Cymru Welsh Water, Scottish PFI projects and other industrial customers.

Matthew has more than 25 years' experience of utility management in both UK and international markets.

He joined United Utilities in 2007 from Scottish Power's US operation, where he was executive vice-president of PacifiCorp's transmission, distribution and customer service division.

He has also held senior management positions in operations, regulation, corporate strategy and commercial utility functions.



William Lambe

Chief Financial Officer

William joined Southern Water in May 2016 from Thames Water, where he held the position of finance director for the Thames Tideway Tunnel.

William has a wealth of financial experience in the UK and overseas and has worked for companies including, KPMG, BG Group plc, Wolseley plc and Thames Water.



Paul Sheffield
Senior independent non-executive director

Paul Sheffield joined the Board in June 2014. In addition to this role he is currently managing director of the European hub for Laing O'Rourke – the engineering and construction enterprise.

In his career, Paul enjoyed over 30 years with Kier Group plc, the construction, property and services business starting as a graduate Civil Engineer in 1983. He spent 17 years working on a series of significant infrastructure projects around the world and then led a number of the company's business units in the UK and was chief executive officer for the group from 2010 to

2014



Bill Tame
Independent non-executive director

Bill Tame joined the Board in January 2015.

He is currently chief executive of the Babcock Group's International Division, having joined the Babcock Board as group finance director in 2002.

Bill is a member of the Institute of Chartered Accountants.



Rosemary Boot
Independent non-executive director

Rosemary Boot joined the Board as an independent non-executive director in March 2015.

She is chief financial officer of Future Cities Catapult, one of a network of technology and innovation centres established by the UK Government.

Previously she worked at Circle Housing Group and was involved in setting up the government-owned Low Carbon Contracts Company and Electricity Settlements Company. From 2001 to 2011 she was group finance director of the Carbon Trust, the independent company set up in 2001 to work with business and the public sector to accelerate the move to a sustainable, low carbon economy. Prior to that, she worked for 16 years as an investment banker, primarily advising large listed UK companies on mergers and acquisitions.

Rosemary is also a governor of the Conservatoire for Dance and Drama, the higher education institution for the performing arts, and a trustee of Green Alliance, the environmental think tank.



Lisa Harrington
Independent non-executive director

Appointed in April 2015, Lisa is the chief customer officer of BT Group where she is responsible for driving customer focus into every aspect of their business

Previously, Lisa was managing director of Customer Service and CIO of BT's Wholesale line of business. She has also held a number of other transformation and customer service roles during her 10 years at BT

Before BT, Lisa spent 11 years with Andersen Consulting (now Accenture), specialising in customer experience consulting and delivering big transformation projects for companies such as Microsoft, Compaq, Vodafone and Sainsbury's



Bronte Somes
Non-executive director

Bronte Somes joined the Board in April 2015 having previously held shareholder representative positions within the wider Southern Water group over the past four years and having served as alternate non-executive director to Paul Moy on the Southern Water Board

Bronte is a senior investment principal for UBS Infrastructure and Private Equity, a division of UBS Asset Management. Based in London, Bronte is responsible for principle investment activity across Europe

Before joining asset management, Bronte worked for more than a decade in UBS Investment Bank's infrastructure group where she gained extensive experience as an adviser within the infrastructure sector. Before that, Bronte worked as a finance lawyer at Clifford Chance in London



Mark Walters
Non-executive director

Mark Walters joined the Board in March 2014 having previously held shareholder representative positions within the wider Southern Water group over the past five years

A seasoned investment professional, he is an executive director and asset manager with the JP Morgan Infrastructure Investments Group, based in London, and is responsible for principle investment activity across Europe

Mark holds board appointments across a number of JP Morgan's utility investments, including Electricity North West and Zephyr Investments Ltd, and is actively engaged in the strategic oversight and development of these businesses

Before joining JP Morgan, Mark held investment and advisory positions at Macquarie Bank, Deloitte and Arthur Andersen, where he started his career. Mark is a Chartered Accountant and a fellow of the ICAEW



Joanne Statton
Company Secretary

A qualified solicitor, Joanne has worked for Southern Water since 1997

She became Company Secretary of both Southern Water and the Greensands companies in 2015, supporting and advising both boards and businesses

Other Board members who served in 2015–16 were

David Golden – Senior independent non-executive director (resigned 23 June 2015)

David Golden joined the Board in November 2003 and served as the senior independent non-executive director until his resignation

Michael Carmedy – Chief Financial Officer (resigned 31 March 2016)

Michael Carmedy joined the Board in November 2011 and served as Chief Financial Officer until his resignation

Executive Management Team

Reporting to Matthew Wright, the Executive Management Team in 2015–16 consisted of

Michael Carmedy – Chief Financial Officer (to 31 March 2016)

Kevin Hall – Company Secretary and General Counsel (to 30 September 2015)

Philip Barker – Director of Operations

Mel Karam – Director of Infrastructure (to 29 April 2015)

Chris Maloney – Director of People and Transformation

Simon Oates – Director of Strategy

Lesley Ottery – Director of Transformation (to 31 August 2015)

Richard Price – Director of Engineering and Construction (from 20 April 2015)

Jennie Reglar – Director of Procurement (to 16 November 2015)

Susan Stockwell – Chief Customer Officer (to 31 March 2016)

Audit and Risk Review Committee

This report describes the role of the Audit and Risk Review Committee (ARRC) and the work it has undertaken during the year

The members of the ARRC are Bill Tame (Chairman), Lisa Harrington (from 1 April 2015), Bronte Somes (from 1 April 2015) and Mark Walters, whose experience and background are set out on pages 76 to 79

The members of the committee receive updates on financial reporting, risk, internal audit and the regulatory framework in various forms throughout the year. The Chairman of the Board, Chief Executive Officer, the Chief Financial Officer, and the Head of Audit and Risk are invited to all meetings and are usually in attendance. In addition, key members of the finance team and the external auditor are invited to the ARRC meetings, excluding the annual risk review. Other members of senior management are also invited to attend when necessary or appropriate. The ARRC has access to the services of the Head of Audit and Risk, the Company Secretary and external professional advisers to assist it in performing its duties.

The ARRC met four times in 2015–16 and its work focused on the following key areas:

- Financial statements
- Internal controls
- Corporate governance matters
- Internal audit
- Areas of risk
- Oversight of internal and external audit
- The regulatory reporting obligations
- Annual risk review

Audit and Risk Review Committee attendance in 2015–16

Bill Tame	4/4	Lisa Harrington	3/4
Bronte Somes	4/4	Mark Walters	4/4

Note – Attendance includes attendance in person and by telephone

The terms of reference of the ARRC are published on our [website](#)

Financial statements

The ARRC received and reviewed the financial statements and the external audit report from Deloitte regarding the year-end financial statements, considering any items of significant judgement that have been made and general IT controls, before making a recommendation to the Board to approve the annual results. There were no significant issues to be addressed.

The ARRC also reviewed and discussed the changes to the financial statements that will result from the transition to Financial Reporting Standards 101 (FRS 101) in 2015–16.

Internal controls

The ARRC receives regular reports from Internal Audit in respect of its work on internal controls and reviews management letters received from the external auditor. In addition, our risk management processes and arrangements are also monitored and reviewed together with the ongoing development of the compliance and assurance processes in respect of the key risks.

The ARRC also receives a regular report of incidents of fraud or bribery, including the actions taken to investigate and respond to the incidents and information on potential incidents of wrong-doing under investigation. There were no material incidents during the year.

Further details of our internal control framework, including the main features of our internal control and risk management systems in relation to the financial reporting process, can be found in the Annual Report on page 61.

Oversight of internal audit and external audit

The ARRC is responsible for overseeing the work of the Internal Audit function and also for managing the relationship with the external auditor. It reviews the performance of the internal and external auditors annually to ensure that they are effective and recommends to the Board whether the external auditor should be reappointed.

The ARRC regularly holds discussions with both the internal and external auditors in the absence of management.

Internal audit

The Head of Audit and Risk and the team report on a day-to-day basis to management on the effectiveness of the company's systems of internal controls and the adequacy of these systems to manage business risk and to safeguard the company's assets and resources. This work is reported to the ARRC on a regular basis and is a key element of the assurance that the ARRC receives on the risks and controls in the company.

The ARRC reviews, at least annually, the level of resources and the budget of the Internal Audit function. The Head of Audit and Risk is free to raise any issues with the ARRC or its Chairman at any time during the year.

Risk

Whilst the Board is ultimately accountable for ensuring risks are managed effectively across Southern Water and for maintaining robust systems of risk management and internal control, the ARRC is responsible for the robust assessment of the principal risks facing the company, monitoring its risk management and internal control systems and testing its effectiveness. The Chairman of the ARRC reports to the Board those matters reviewed and discussed by the Committee at its previous meeting.

In addition to monitoring individual risks, the ARRC, on behalf of the Board, also undertakes ongoing performance monitoring of the systems of risk management and internal control to ensure they are effective and performing as expected.

The ARRC is responsible for overseeing and challenging the effectiveness of Southern Water's approach to risk management. Key responsibilities include:

- Ensuring the Board receives appropriate assurance that the systems of risk management and internal control are operating effectively, and that all significant failings and weaknesses and principal risks have suitable management activities in place to rectify and/or remain within defined risk appetite,
- Endorsing an internal audit plan that is informed by principal risk exposures, including overseeing targeted reviews of key risk and control areas, and
- Maintaining an assurance landscape that has integrity, independence and reliability.

A risk update report is issued to, and reviewed by, the ARRC four times a year, including one meeting that focuses extensively on risk. This meeting occurred on 29 September 2015 and comprised a high level review of all risks on the corporate dashboard and their movements compared to prior quarters, as well as detailed reviews of risks of key strategic focus. The Chairman of the ARRC provided a comprehensive report to the Board of the review undertaken.

External auditor

Deloitte LLP was appointed our auditor in 2011 following a tendering process. The ARRC considers the auditor's effectiveness each year and would report to the Board any concerns over the auditor's continuing appointment.

The ARRC reviews annually information provided by the external auditor confirming its independence and objectivity within the context of applicable regulatory requirements and professional standards, including any non-audit work. Under the Southern Water Code of Board leadership, transparency and governance, the external audit contract will be put to tender at least every ten years. We would also initiate a tender process if there were any concerns about the quality of the audit or the independence and objectivity of the auditor. There are no contractual obligations that act to restrict the Board's choice of external auditor.

All audit related and non-audit fees are subject to a formal approval process before engagement. Details of the amounts paid to Deloitte for these services are provided in note 5 to the accounts.

Health and Safety Committee

The Health and Safety Committee (H&SC) is responsible for reviewing and advising on our health and safety policy and the implementation of, and compliance with, agreed policies, applicable guidance and standards. The H&SC reviews incident and accident prevention performance and policies and any other matters assigned by the Board.

The members of the H&SC are Paul Sheffield (Chairman of the committee), Matthew Wright, Rosemary Boot and Mark Walters. David Golden had been a member during the reporting year and resigned on 23 June 2015.

The H&SC met on four occasions in 2015–16.

Health and Safety Committee attendance in 2015–16			
Paul Sheffield	4/4	Matthew Wright	4/4
Rosemary Boot	4/4	Mark Walters (appointed 1 May 2015)	3/3
		David Golden (resigned 23 June 2015)	1/1

Note – Attendance includes attendance in person and by telephone.

The terms of reference of the H&SC are published on our [website](#).

Nomination Committee

The Nomination Committee is responsible for reviewing the structure, size and composition of the Board and evaluating the balance of independence, skills, experience, knowledge and diversity. It prepares descriptions of roles, specifies the capabilities required and leads the process for identifying and nominating candidates for the approval of the Board.

The members of the Nomination Committee are Robert Jennings (Chairman), Paul Sheffield (deputy Chairman) and all non-executive directors.

The Nomination Committee met on three occasions in 2015–16.

Nomination Committee attendance in 2015–16			
Robert Jennings	3/3	Bill Tame	1/3
Paul Sheffield	3/3	Bronte Somes	3/3
Rosemary Boot	3/3	Mark Walters	3/3
Lisa Harrington	3/3		

Note – Attendance includes attendance in person and by telephone.

The terms of reference of the Nomination Committee are published on our [website](#).

Directors' Remuneration Report

This report is on the activities of the Remuneration Committee for the period to 31 March 2016. It sets out the remuneration policy and remuneration details for the executive and non-executive directors of the company. It has been prepared in accordance with our Code, the guidance issued by Ofwat in Regulatory Accounts Guidance (RAG) 3.08 and, where relevant for a non-listed company, has taken into account the requirements of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

Chairman's annual statement

On behalf of the Board, I am pleased to present the Remuneration Report for the year ended 31 March 2016, which sets out the remuneration policy for the directors of Southern Water Services Limited and provides details of their remuneration in respect of the year ended 31 March 2016.

I was appointed chairman of the committee with effect from 24 April 2015 and have chaired the committee throughout 2015–16.

Following the annual review of the committee's effectiveness in 2014–15, the structure and membership was revised and from April 2015, four new independent non-executive directors joined the committee. Strengthening the committee in this way has provided an additional balance of skills, experience and knowledge to enable the committee to provide sound judgement and decision making in matters related to the company's short and long-term remuneration strategy. In particular, additional strengths in both customer focus and sustainability were added to the committee.

As part of a strategy to improve the links between achievement of personal objectives and reward outcomes, a new bonus scheme design was implemented in 2015 for both executive and senior management who are eligible for a payment under the incentive arrangements. This focused the executive and senior management on improving business effectiveness through improvements in service to customers, operational efficiency and performance, achieving ODIs set by Ofwat in the PR14 price review whilst at the same time ensuring sufficient financial returns to maintain investor confidence and enable the company to finance the business at competitive rates.

As a result of the improving company performance and the Remuneration Committee's assessment of performance against the personal objectives of each individual executive director, the annual bonus payments for 2015–16 were assessed to be 75 per cent of annual bonus potential.

Remuneration in 2016–17

The committee believes the remuneration policy currently in place is working well to support the company's strategy in the current economic environment and to retain and motivate our experienced management team ahead of the next price review period.

With effect from 1 April 2015, the committee implemented a new Long-Term Incentive Plan to incentivise our executive directors to deliver the ambitious AMP6 Business Plan and to ensure the focus remains on delivering improving customer service and shareholder value. It is a three year rolling plan, which will vest, subject to the performance conditions outcomes, on 1 June 2018. The committee proposes to award new plans every two years on 1 April. The committee will review the performance metrics for each scheme to ensure that they best reflect the company's priorities. The metrics for the 2018 Long-Term Incentive Plan ensure greater alignment of the long-term incentive arrangements with the delivery of shareholder value, whilst maintaining high levels of customer service.



Paul Sheffield
28 June 2016

Remuneration Committee

The Remuneration Committee (RemCom) is a committee of the Board of Southern Water Services Limited (SWS). The RemCom has responsibility for setting remuneration policy and structure for the executive directors and senior management. It is also responsible for setting the remuneration of the Chairman. The RemCom has defined terms of reference, which are published on our [website](#).

Committee membership

We recognise that the independent non-executive directors have an important role to play in determining and challenging remuneration policy and practice. In order to reflect this, the independent non-executive directors represent a majority on the committee.

The RemCom is chaired by senior independent non-executive director Paul Sheffield. The other members are Robert Jennings, Bill Tame, Rosemary Boot, Lisa Harrington, Bronte Somes and Mark Walters. Paul took over the role of chairman from David Golden in April 2015, following David's decision to step down from the Board.

Only RemCom members are entitled to attend meetings, but the Director of People and the Chief Executive Officer, Matthew Wright, attend by invitation. The Director of People and Transformation, Chris Maloney, acts as secretary to the RemCom on behalf of the Company Secretary.

No attendee participates in discussions regarding their own remuneration.

Details of the attendance during 2015–16 are shown in the table below.

Remuneration Committee attendance in 2015–16			
Paul Sheffield	5/5	David Golden	2/2
Robert Jennings	5/5	Rosemary Boot	5/5
Bill Tame	3/5	Lisa Harrington	4/5
Bronte Somes	5/5	Mark Walters	5/5

Note – Attendance includes attendance in person and by telephone.

How the Remuneration Committee sets the remuneration policy

The primary objective of our remuneration policy is to ensure that competitive reward packages are offered that will attract, retain and motivate talented and experienced senior executives to run the business effectively and to promote the success of SWS.

Within these arrangements, a significant proportion of reward is based on performance against demanding targets. These targets are set by the RemCom based on key strategic priorities benefiting customers, investors and other stakeholders and consistent with a Board-approved level of risk.

The overall aim is that executive directors' remuneration should be market-competitive relative to other comparable companies and with a significant proportion being performance related. The performance related element is only paid out if stretching short-term and long-term targets are achieved that benefit both customers and shareholders. In setting the remuneration policy for executive directors, the RemCom takes into account the remuneration practices found in other UK companies of a similar size or operating in the same sector. It also ensures that the remuneration arrangements for the executive directors are appropriate when compared with those for other senior executives and the wider workforce.

In particular, the RemCom is kept informed on a regular basis of

- The level of salary increase for the general employee population
- Company-wide benefit provision and any proposed changes
- Overall spend on management bonus arrangements

Investor representatives sit on the RemCom and are closely involved in setting remuneration levels, monitoring the performance of the executive directors, agreeing payments and approving any changes to reward packages. This close involvement ensures that shareholders play a key part in shaping remuneration policy and decisions and that the link between pay and performance is robustly managed.

To ensure that our remuneration practices are market competitive, the RemCom periodically calls upon experienced specialist consultants. The RemCom last received advice in 2014–15 from Towers Watson (a leading global professional services company) and intends to undertake further reviews every two to three years.

Directors' pay and standards of performance

As required by the Water Act 2003 and Regulatory Accounting Guidance from Ofwat, additional information is given below regarding the remuneration of the directors of SWS.

Executive directors who served during the 2015–16 year are shown below.

Matthew Wright	Chief Executive Officer (CEO)
Michael Carmedy	Chief Financial Officer (CFO)

Details are given below of the remuneration policy for the directors of SWS and the amounts paid to them in the year ended 31 March 2016.

Michael Carmedy resigned from the business on 31 March 2016 and we have appointed William Lambe to the role of Chief Financial Officer with effect from 3 May 2016.

Remuneration Policy

Purpose

The remuneration policy of SWS applies to all its employees. The Board of Directors has adopted the remuneration policy at the recommendation of the Remuneration Committee. The policy applies to remuneration earned from 1 April 2015.

The policy reflects the Board's objectives for good corporate governance as well as sustained and long-term value creation for shareholders. In addition, it ensures that

- SWS is able to attract, develop and retain high-performing and motivated employees in a competitive market
- Employees are offered a competitive and market median-aligned remuneration package which balances the fixed and variable remuneration components according to job role
- Employees feel encouraged to create sustainable results and that a link exists between shareholders/customers and employees' interests

The policy focuses on ensuring sound and effective risk management through

- A stringent governance structure for setting goals and communicating these goals to employees
- Alignment with our business strategy, values, key priorities and long-term goals
- Alignment with the principle of protection of customers and investors ensuring prevention of conflict of interests

Remuneration components

At an annual performance appraisal interview, individual employees and managers evaluate and document performance in the past year and set new goals. The appraisal results in a decision regarding any adjustments required to the employee's fixed salary or on annual performance-based pay. The various remuneration components are combined to ensure an appropriate and balanced remuneration package.

The five remuneration components are

- Fixed remuneration (including fixed supplements)
- Performance-based remuneration (variable percentage of salary)
- Pension schemes, where applicable
- Other benefits in kind
- Severance payment, where applicable

The fixed remuneration is determined on the basis of the role and position of the individual employee, including professional experience, responsibility, job complexity and local market conditions.

The performance-based remuneration motivates and rewards high performers who significantly contribute to sustainable results, perform according to set expectations for the individual in question, strengthen long-term customer relations and generate income and shareholder value.

The Board of Directors has determined a maximum percentage of performance-based remuneration relative to the fixed remuneration for the executive management positions. This percentage varies through the other management levels of the organisation according to the type of position held by the employee and the business directorate in which they are employed. The general maximum limit on variable remuneration remains at seventy per cent of fixed salary inclusive of pension. The only exceptions are the CEO (one hundred per cent) and the CFO (eighty per cent). Performance-based remuneration is disbursed as a cash bonus. Executive directors are covered by two times salary death in service benefit within their contract of employment.

The defined benefit pension scheme, which was closed to new entrants on 1 April 2005, guarantees employees a four times salary cover for death in service and pension payment on retirement after the age of 55. In general, employees are covered by the defined benefits pension scheme or through the defined contribution plans with a pension insurance company. The death in service cover for the defined contribution scheme is two times salary. The pension contributions of employees subject to collective bargaining agreements are regulated by the collective agreement.

Other benefits are awarded on the basis of individual employment contracts and local market practice

Severance payments are payable in accordance with relevant legislation and applicable collective agreements
Severance payments may include variable remuneration, pension or other benefits on a discretionary basis

The design of the total remuneration package for the executive directors ensures that a substantial proportion of the maximum opportunity is dependent on performance. Based on the value of the 2015–18 Long-Term Incentive Plan award and achievement of stretch performance against targets and personal objectives for the annual bonus, the total annual remuneration charged to the company is weighted at around 60 per cent performance-related and 40 per cent non-performance-related for the CEO and 55 per cent performance-related and 45 per cent non-performance-related for the CFO

The table below summarises the elements of our executive directors' remuneration package and our policy for each item

Element of remuneration	Purpose and link to strategy	Policy and approach	Opportunity 2016–17	Change of policy from 2015–16
Base salary	<p>Takes into account experience and personal contribution to our strategy and performance</p> <p>Attracts and retains executives of the quality required to deliver our strategy</p>	<ul style="list-style-type: none"> ▪ The base salary is a fixed figure and does not vary in relation to business or individual performance ▪ Reviewed annually with changes effective from 1 July if applicable ▪ Consideration given to individual and company performance ▪ General pay increases to all employees taken into consideration ▪ Aim to pay within a mid-market range, but may pay higher salaries to attract and retain executives of the right calibre or for out-performance by the individual or company <p>Referenced against UK companies of a similar size, utility companies and other water companies</p>	Base salary increases are applied in line with the annual review	No
Annual incentive scheme (Bonus)	<p>Drives and rewards performance against personal objectives and selected customer, operational and financial KPIs which are directly linked to business strategy</p>	<ul style="list-style-type: none"> ▪ The performance measures included within the annual bonus scheme are selected to ensure that we are focused on our strategic objectives ▪ The balance and nature of the objectives is reviewed annually ▪ A 'bonus pool' is created at a corporate level based on the achievement of the company against these objectives and any individual payment is based on personal performance ▪ The KPIs for 2015–16 are shown on page 92 ▪ The threshold, mid-point and stretch targets are established annually by the RemCom, making sure they are 	Maximum percentage of salary – shown in table on page 92	No

		<p>sufficiently stretching while also recognising the nature and risk profile of the company</p> <ul style="list-style-type: none"> ▪ Where applicable, between 60 and 80 per cent of the bonus pool is created for achieving the mid-point target and 100 per cent for achieving the stretch target ▪ RemCom has discretion to amend or withdraw payments based on the consideration of other factors which could significantly affect business performance 		
Long-Term Incentive Plan (LTIP)	Aligns interests of executives, customers and shareholders	<ul style="list-style-type: none"> ▪ The current scheme was introduced on 1 April 2015 and covers a three-year performance period to 31 March 2018 ▪ Subject to continuing employment over the three-year period ▪ If the participant resigns during the period then participation in the scheme will lapse ▪ The RemCom has the discretion to make awards for 'good' leavers as appropriate subject to performance 	<p>The annualised maximum award for each director is</p> <p>CEO £328k</p> <p>CFO £192k</p>	No
Pension	Defined contribution scheme minimises the risk to the company associated with defined benefit pension plans	<ul style="list-style-type: none"> ▪ A company contribution into a defined contribution scheme, or ▪ A cash allowance in lieu of pension 	<p>Contribution of</p> <p>CEO 18%</p> <p>CFO 15%</p>	No
Other benefits	Provides market competitive benefits	<ul style="list-style-type: none"> ▪ Car allowance ▪ Health cover ▪ Disturbance or relocation allowances 	Based on individual circumstances	No

A basic pay increase of 1.5 per cent for Matthew Wright for 2016–17 was approved in May 2016 and will be applicable to his basic salary with effect from 1 July 2016. This is in line with the average pay increase for the remainder of staff in the business.

The terms of the contracts for the executive directors require notice periods of 12 months by both parties for Matthew Wright and William Lambe. If the notice period is worked, no termination payment is payable, otherwise a payment up to a maximum equivalent to the notice period of basic salary, plus pension and car allowance is payable.

Annual remuneration report

Details of the remuneration received by the executive directors are shown below

Directors' remuneration for 2015–16							
£'000	Base salary	Benefits	Annual Bonus	LTIP award 2015–18	Total	DC pension contribution / compensation	Total including pension

Matthew Wright	364.4	12.7	273.2	-	650.3	65.6	715.9
Michael Carmedy	255.6	12.9	153.4	-	421.9	38.3	460.2

Directors' remuneration for 2014–15							
£'000	Base salary	Benefits	Annual Bonus	LTIP award 2011–15	Total	DC pension contribution / compensation	Total including pension

Matthew Wright	355.5	12.5	226.6	1,250.0	1,844.6	68.4	1,913.0
Michael Carmedy	249.4	11.3	139.7	313.2	713.6	37.4	751.0

A Long-Term Incentive Plan (LTIP) was in place for the period from 2011 to 2015. The Remuneration Committee considered performance against this in April 2015 and agreed for the payments disclosed in 2014–15 to be made in June 2015. These payments are single one-off payments and cover the performance over the four years of the LTIP.

The Chairman and the independent non-executive directors each receive a fee and do not participate in any of our performance-related incentive arrangements. The investor-nominated non-executive directors do not receive any remuneration from the company.

Details of the emoluments received by the Chairman and non-executive directors are shown below

£'000	2015–16			2014–15		
	Fees	Other	Total	Fees	Other	Total
Robert Jennings (Chairman)	225.0	1.1	226.1	225.0	0.9	225.9
Paul Sheffield	56.7	0.4	57.1	41.7	-	41.7
Rosemary Boot	50.0	0.7	50.7	4.2	-	4.2
Bill Tame	50.0	0.4	50.4	12.5	-	12.5
Lisa Harrington	50.0	0.4	50.4	-	-	-
David Golden	15.0	7.0	22.0	60.0	24.4	84.4
Robert Armstrong	-	-	-	41.7	8.8	50.5
Cheryl Black	-	-	-	41.7	8.0	49.7
Bronte Somes	-	-	-	-	-	-
Mark Walters	-	-	-	-	-	-
Paul Moy	-	-	-	-	-	-

The other amounts payable to the non-executive directors include taxable expenses incurred in the attendance at Board meetings, together with payments to David Golden for consultancy services provided separately to his duties as the senior independent non-executive director

None of the directors who held office during the financial year had any disclosable interests in the shares of Southern Water or the group, there are no share options in place and no payments were made to them by any other group companies

Annual performance-related incentive scheme

Our incentive scheme focuses on the achievement of specific strategic goals which are designed to drive exceptional customer service, financial and operational performance. The structure of the scheme and specific target criteria, both used for the creation of a bonus pool and individual objectives, are set and reviewed on an annual basis by the RemCom. The bonus pool targets for 2015–16 were set and approved in June 2015.

A balanced scorecard approach was used for the creation of the bonus pool. Four measures were used in the scorecard: cash collection, operational expenditure (Opex), Service Incentive Mechanism (SIM - qualitative ranking) and Outcome Delivery Incentives (ODIs). The weighting of each was set equally at 25 per cent to balance the financial, operational and customer focus of the company.

Performance-based remuneration is awarded in a manner which promotes sound risk management and does not induce excessive risk-taking. Performance-based pay is granted to reflect our financial results, the results of the business directorate in which the employee is employed and the individual employee's performance. Further, both financial and non-financial factors shall be taken into consideration when determining the individual's bonus, i.e. compliance with internal guidelines and procedures, including customer and investor-related guidelines. A discretionary assessment is always made to ensure that other factors, including factors which are not directly measurable, are considered, including maintaining and promoting corporate values.

Performance-based pay is granted to employees with particular influence on our results and shareholder value. As an overall starting point, we ensure a balanced split between fixed salary and variable pay.

Details of the targets agreed by the RemCom for 2015–16 together with the maximum bonus opportunity available to each executive director are shown in the table below. The performance for 2015–16 was assessed in May 2016 by the RemCom and the achievement against each target together with the personal achievement level and payments made in relation to 2015–16 are also shown below.

Performance measure		Weight for 2015–16 (as % of bonus pool)	Achievement 2015–16 (as % of bonus pool)
Service standards	Deliver a targeted improvement in the Service Incentive Mechanism qualitative score for 2015–16 Purpose – to deliver significant improvements in customer service performance Measure – Ofwat SIM qualitative score	25%	0%
Outcome delivery incentives	ODIs target the priority improvement areas for customers through the attachment of financial incentives to ODIs, mostly in the form of penalties Purpose – to maintain Asset Health by focusing on the avoidance of annual Ofwat penalties Measure – the avoidance of annual Asset Health penalties across all of the ODI measures	25%	25%
Cash collection	Collect a targeted level of cash receipts from unmeasured and measured customers Purpose – to ensure good financial performance and provide our customers with an affordable service and our ultimate shareholders with a return on their investment Measure – financial information from the accounts	25%	25%
Operating costs	Operate the business within a targeted level of total operational expenditure Purpose – to ensure good financial performance and provide our customers with an affordable service and our ultimate shareholders with a return on their investment Measure – financial information from the accounts	25%	25%

Bonus 2015–16	Matthew Wright	Michael Carmedy
Maximum bonus opportunity (% of base salary)	100%	80%
Percentage of maximum bonus awarded	75%	75%
Bonus percentage awarded based on personal performance (% of base salary)	75%	60%
Base salary (£'000)	£364.4	£255.6
Bonus paid (£'000)	£273.2	£153.4

The RemCom has agreed to continue the scheme in 2016–17 and has set the performance measures and weightings for inclusion in the balance scorecard approach as cash collection 15 per cent, operational expenditure (Opex) 15 per cent, bad debt provision charge 20 per cent, Service Incentive Mechanism (SIM) 25 per cent and Outcome Delivery Incentives (ODIs) 25 per cent

Long-Term Incentive Plan

The LTIP for the period 1 April 2015 to 31 March 2018 was agreed by the RemCom in June 2015. The scheme will be a three-year rolling scheme, with overlap, to provide a balanced payment profile equally rewarding customer service delivery and value to the shareholders.

Performance payments under the LTIP will be based on the performance measures shown below.

Performance measure		Weight (% of max. LTIP)
Total shareholder return	Our achievement of a minimum level of shareholder return as measured using an agreed company valuation model that reflects a combination of value appreciation and distribution yield to shareholders	50%
AMP6 delivery plan	Our achievement of AMP6 Delivery Plan efficiencies, consistent with the management team's plans for delivering the required transformation in organisational structure, commercial arrangements, expenditure efficiencies and operational performance. The metric is designed to reward out-performance relative to the 2014 Final Determination.	25%
Service Incentive Mechanism 2016-17	The Company's SIM ranking (qualitative score) published by The Water Services Regulation Authority for the year ending 31 March 2017, measured against the other seventeen English and Welsh Water Only and Water and Sewerage Companies (WOCs and WaSCs)	12.5%
Service Incentive Mechanism 2017-18	The Company's SIM ranking (qualitative score) published by The Water Services Regulation Authority for the year ending 31 March 2018, measured against the other seventeen English and Welsh Water Only and Water and Sewerage Companies (WOCs and WaSCs)	12.5%
Total maximum/actual award		100%

To date no payments have been made in relation to this scheme. An accrual has been made in the accounts for 2015–16 in anticipation of the final award under the LTIP. The value of the accrual for the first year of the scheme is shown below.

Matthew Wright – accrual at March 2016 £193k

Actual performance against the scheme will be assessed in 2018–19 and the value of any award may differ from the accruals made. As Michael Carmedy resigned from the company on 31 March 2016 he is no longer eligible to participate in the scheme and as such no accrual has been made in respect of his service during 2015–16.

Directors' report for the year ended 31 March 2016

The directors of Southern Water Services Limited (registered no 02366670) present their report and the audited financial statements for the year ended 31 March 2016

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 nearly 2.5 million people and provides wastewater services to nearly 4.6 million people.

Strategic report

The information that fulfils the requirement of the Strategic Report can be found in our Annual Report on pages 16 to 69.

Future developments

The information regarding future developments of the company can be found in our Annual Report on pages 16 to 69.

Results and dividends

The income statement on page 98 shows the company's results and profit for the year. Further details are also available in the Annual Report on pages 48 to 54.

Interim dividends of £812.37 per ordinary share (2014–15 £802.21 per share), totalling £45.5 million (2014–15 £44.9 million) were paid during the year to Southern Water Services Group (SWSG). These dividends, along with associated group tax relief of £11.4 million, enable SWSG to pay the interest of £56.9 million due to SWS on an inter-company loan as disclosed in note 10 to the accounts.

Ordinary dividends totalling £79.6 million, equivalent to £1,421.43 per share, (2014–15 £nil) were declared and paid in the year. These dividends were paid to our ultimate investors.

Directors and their interests

The directors who held office during the year ended 31 March 2016 and up to the date of signing the financial statements were as follows and further details can be found on pages 64 to 68.

Robert Jennings	(Independent non-executive chairman)
Matthew Wright	(Executive director – Chief Executive Officer)
Michael Carmedy	(Executive director – Chief Financial Officer) (resigned 31 March 2016)
David Golden	(Senior independent non-executive director) (resigned 23 June 2015)
Paul Sheffield	(Senior independent non-executive director)
Rosemary Boot	(Independent non-executive director)
Lisa Harrington	(Independent non-executive director) (appointed 1 April 2015)
Bill Tame	(Independent non-executive director)
Bronte Somes	(Non-executive director) (resigned 19 May 2016)
Mark Walters	(Non-executive director)
Paul Moy	(Alternate non-executive director)
Andrew Truscott	(Alternate non-executive director)

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 innovative 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 £0.7 million (2014–15 £0.4 million).

Financial risk management

The Financial Risk Management Policy is included in the Strategic Report on pages 61 to 69

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 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, safety and wellbeing: 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.

Disabled employees: Applications for employment by disabled persons are always fully considered, bearing in mind the abilities of the applicant concerned. In the event of members of staff becoming disabled every effort is made to ensure that their employment with the company continues and that appropriate training is arranged. It is the policy of the company that the training, career development and promotion of disabled persons should, as far as possible, be identical to that of other employees.

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 on pages 37 to 42. 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.

Political donations

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 quantify the difference precisely.

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 2016

In forming this assessment the directors have considered the following information

- The company's business activities, together with the factors likely to affect its future development, performance and position, which are set out in the Strategic Report on pages 16 to 69
- The financial position of the company, its cash flows, liquidity position, covenants and borrowing facilities, which are described in the Financial Performance review on pages 48 to 59
- The company has available a combination of cash and committed undrawn bank facilities totalling £357.9 million at 31 March 2016 (2015 £523.4 million). These funds are sufficient to fund the operating and capital investment activities of the company for the 12 months from the date of signing the financial statements
- The company operates in an industry that is currently subject to economic regulation rather than market competition. Ofwat, the economic regulator, has a statutory obligation to set price limits that it believes will enable the water companies to finance their activities

As a consequence, the directors believe that the company is well placed to manage its business risks successfully

The directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. Thus they continue to adopt the going concern basis of accounting in preparing the annual financial statements

Viability statement

In accordance with provision C 2.2 of the 2014 UK Code, the Board have assessed the prospects of the company over a longer period than the 12 months required by the 'Going Concern' provision. Details of their assessment and the associated viability statement can be found on page 60 of this report

Qualifying third party indemnity

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

Directors' responsibilities statement

The directors are responsible for preparing the Strategic Report, the Directors' 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 Financial Reporting Standard 101 Reduced Disclosure Framework. 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 Financial Reporting Standard 101 Reduced Disclosure Framework has been followed, subject to any material departures disclosed and explained in the financial statements
- 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.

Responsibility statement

We confirm that to the best of our knowledge

- the financial statements, prepared in accordance with the relevant financial reporting framework, give a true and fair view of the assets, liabilities, financial position and profit or loss of the company
- the management report, which is incorporated into the Strategic Report, includes a fair review of the development and performance of the business and the position of the company, together with a description of the principal risks and uncertainties that they face

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
- (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 has indicated its willingness to continue in office

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



Joanne Statton
Company Secretary
28 June 2016

Financial statements

Income statement

For the year ended 31 March 2016

	Note	2016 £m	2015 £m
Continuing operations			
Revenue	4	803.7	826.2
Other operating income	4	1.7	1.2
Operating costs			
- before depreciation and amortisation		(286.3)	(273.1)
- Depreciation and amortisation		(234.6)	(222.8)
Total operating costs		(520.9)	(495.9)
Operating profit	5	284.5	331.5
Profit on disposal of fixed assets		0.4	1.3
Finance income		59.3	58.2
Finance costs		(145.5)	(150.1)
Fair value losses on derivative financial instruments	20	(70.4)	(130.3)
Net finance costs	8	(156.6)	(222.2)
Profit before taxation	5	128.3	110.6
Tax on profit	9	(8.4)	(17.0)
Profit for the financial year		119.9	93.6

The notes on pages 103 to 144 form part of these financial statements

Statement of other comprehensive income

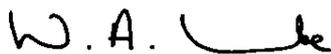
For the year ended 31 March 2016

	Note	2016 £m	2015 £m
Profit for the year		119 9	93 6
Other comprehensive income/(expense):			
Items that cannot be reclassified to profit or loss:			
Actuarial loss on pension scheme	27	(14 0)	(37 4)
Movement on deferred tax relating to pension liability	21	2 8	7 5
Deferred tax movement due to rate change on FRS 101 transition fair value uplift		18 6	-
Total other comprehensive income/(expense) for the year, net of tax		7 4	(29 9)
Total comprehensive income for the year attributable to the owner of the company		127 3	63 7

Statement of financial position
 as at 31 March 2016

	Note	2016 £m	2015 £m
Non-current assets			
Intangible assets	11	42 0	42 9
Property, plant and equipment	12	5,607 5	5,600 2
Other non-current assets	13	812 3	812 3
Investments	14	29 2	29 2
		<u>6,491 0</u>	<u>6,484 6</u>
Current assets			
Inventories	15	2 4	2 2
Trade and other receivables	16	192 3	220 5
Cash and cash equivalents		17 9	173 5
		<u>212 6</u>	<u>396 2</u>
Total assets		<u>6,703 6</u>	<u>6,880 8</u>
Current liabilities			
Trade and other payables	17	(188 1)	(209 1)
Borrowings	18	(88 9)	(38 9)
		<u>(277 0)</u>	<u>(248 0)</u>
Non-current liabilities			
Borrowings	19	(3,631 8)	(3,569 3)
Derivative financial instruments	20	(923.7)	(1,151 7)
Deferred tax liabilities	21	(365 0)	(398 2)
Retirement benefit obligations	27	(102 3)	(115 3)
Provisions for liabilities	22	(0 5)	(0 5)
Other non-current liabilities	23	(43.5)	(40 2)
		<u>(5,066 8)</u>	<u>(5,275 2)</u>
Total liabilities		<u>(5,343.8)</u>	<u>(5,523 2)</u>
Net assets		<u>1,359 8</u>	<u>1,357 6</u>
Equity			
Called up share capital	24	0 1	0 1
Share premium account	25	46 3	46 3
Revaluation reserve		745 1	757 3
Retained earnings		568 3	553 9
Total equity		<u>1,359.8</u>	<u>1,357 6</u>

The financial statements of Southern Water Services Limited (Registered no 02366670) on pages 98 to 144 were approved by the Board and authorised for issue on 28 June 2016. They were signed on its behalf by



William Lambe
 Chief Financial Officer

Statement of changes in equity

For the year ended 31 March 2016

	Called up share capital (Note 24) £m	Share premium account (Note 25) £m	Revaluation reserve £m	Retained earnings £m	Total £m
Balance at 1 April 2014 (UK GAAP)	0.1	46.3	-	994.8	1,041.2
Effect of restatement due to change in accounting framework (note 31)	-	-	769.3	(471.7)	297.6
As restated	0.1	46.3	769.3	523.1	1,338.8
Profit for the financial year	-	-	-	93.6	93.6
Other comprehensive expense for the year	-	-	-	(29.9)	(29.9)
Total comprehensive income for the year	-	-	-	63.7	63.7
Equity dividends paid (Note 10)	-	-	-	(44.9)	(44.9)
Revaluation reserve transfer	-	-	(12.0)	12.0	-
Balance at 31 March 2015	0.1	46.3	757.3	553.9	1,357.6
Profit for the financial year	-	-	-	119.9	119.9
Other comprehensive income for the year	-	-	-	7.4	7.4
Total comprehensive income for the year	-	-	-	127.3	127.3
Equity dividends paid (Note 10)	-	-	-	(125.1)	(125.1)
Revaluation reserve transfer	-	-	(12.2)	12.2	-
Balance at 31 March 2016	0.1	46.3	745.1	568.3	1,359.8

Statement of cash flows

For the year ended 31 March 2016

	Note	2016 £m	2015 £m
Cash from operating activities	26	482 0	517 1
Tax paid		(15.1)	(36 9)
Net cash generated from operating activities		466 9	480 2
Investing activities			
Interest received		59 7	58 1
Purchase of property, plant and equipment		(237 9)	(296 2)
Purchase of intangible assets		(6 8)	(17 7)
Receipt of grants and contributions		5 2	4 9
Sale of property, plant and equipment		0.6	0 3
Movement on loan to subsidiary		14 3	(1 7)
Net cash used in investing activities		(164 9)	(252 3)
Financing activities			
Equity dividends paid		(125.1)	(44 9)
Interest paid		(132 5)	(129 2)
Preference share dividends		(11.2)	(10 7)
Payment of derivative accretion		(298 4)	(5 0)
Repayments of obligations under finance leases		(0.2)	(0 1)
Issue costs of new loans		(0 2)	-
Proceeds of new loans		110 0	-
Net cash used in financing activities		(457 6)	(189 9)
Net (decrease)/increase in cash and cash equivalents		(155.6)	38 0
Cash and cash equivalents at beginning of the year		173 5	135 5
Cash and cash equivalents at end of the year		17 9	173 5

Notes to the financial statements

For the year ended 31 March 2016

1 Accounting policies

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

Basis of preparation

Southern Water Services Limited is a company incorporated in the United Kingdom under the Companies Act. The address of the registered office is given on page 2. The nature of the company's operations and its principal activities are set out in the Strategic Report on pages 16 to 69.

The company meets the definition of a qualifying entity under FRS 100 (Financial Reporting Standard 100) issued by the Financial Reporting Council (FRC). Accordingly, in the year ended 31 March 2016 the company has changed its accounting framework from pre-2015 UK GAAP to FRS 101 'Reduced Disclosure Framework' as issued by the FRC and has, in doing so, applied the requirements of IFRS 1 'First Time Adoption of International Financial Reporting Standards' paragraphs 6-33 and related appendices. The principal accounting policies adopted are set out in this Note 1.

These financial statements were prepared in accordance with FRS 101 incorporating the Amendments to FRS 101 issued by the FRC in July 2015 and the amendments to Company law made by The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 prior to their mandatory effective date of accounting periods beginning on or after 1 January 2016. The prior year financial statements were re-stated for material adjustments on adoption of FRS 101 in the current year. For more information see note 31.

The financial statements have been prepared on a going concern basis under the historical cost convention, except for the revaluation of certain property, plant and equipment and financial instruments. The company has elected to use fair value as deemed cost on transition to IFRS to revalue property, plant and equipment, as permitted by IFRS 1 on first time adoption of FRS 101. Financial instruments are measured at their fair value at the end of each reporting period, as explained in the accounting policies below.

Historical cost is generally based on the fair value of the consideration given in exchange for the goods and services.

Fair value is the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, regardless of whether that price is directly observable or estimated using another valuation technique. In estimating the fair value of an asset or a liability, the company takes into account the characteristics of the asset or liability as if market participants would take those characteristics into account when pricing the asset or liability at the measurement date. Fair value for measurement purposes in these financial statements is determined on such a basis, except leasing transactions that are within the scope of IAS 17 'Leases', and measurements that have some similarities to fair value but are not fair value, such as net realisable value in IAS 2 'Inventories' or value in use in IAS 36 'Impairment of Assets'.

In addition, for financial reporting purposes, fair value measurements are categorised into Level 1, 2 or 3 based on the degree to which the inputs to the fair value measurements are observable and the significance of the inputs to the fair value measurement in its entirety, which are described as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date,
- Level 2 inputs are inputs, other than quoted prices included within Level 1, that are observable for the asset or liability, either directly or indirectly, and
- Level 3 inputs are unobservable inputs for the asset or liability.

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. The group financial statements of Greensands Holdings Limited are available to the public and can be obtained from our website.

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Basis of preparation (continued)

As permitted by FRS 101, the company has taken advantage of the disclosure exemptions available under that standard in relation to non-current assets held for sale, financial instruments, standards not yet effective and related party transactions. Where required, equivalent disclosures are given in the group financial statements of Greensands Holdings Limited, the group accounts are available to the public and can be obtained from our website.

Adoption of new and revised IFRSs

As explained above, the company has adopted FRS 101 for the first time in the current year. As part of this adoption, the following new and revised IFRSs have been adopted in the current year:

<p>Amendments to IAS 1 <i>Presentation of Financial Statements</i></p>	<p>In May 2012 the Annual Improvements to IFRSs 2009 - 2011 made a number of amendments to IFRSs. The amendments that are relevant to the company are the amendments to IAS 1 regarding when a statement of financial position as at the beginning of the preceding period (third statement of financial position) and the related notes are required to be presented. The amendments specify that a third statement of financial position is required when a) an entity applies an accounting policy retrospectively, or makes a retrospective restatement or reclassification of items in its financial statements, and b) the retrospective application, restatement or reclassification has a material effect on the information in the third statement of financial position. The amendments specify that related notes are not required to accompany the third statement of financial position.</p> <p>Subsequent to this in July 2015 the FRC issued further amendments to FRS 101. The principal amendments made were:</p> <ul style="list-style-type: none"> a) A company transitioning to FRS 101 for the first time and applying IFRS 1 First-time adoption of International Reporting Standards, will no longer be required to present an opening balance sheet at the date of transition (although a reconciliation of equity is still required), and b) There is now greater flexibility in the format of the profit and loss account and balance sheet, such that entities can choose to adopt a presentation as if preparing 'IAS accounts'. <p>These amendments have been adopted in preparation of these financial statements and therefore no opening statement of financial position at the date of transition being 1 April 2014 has been presented. A reconciliation of equity is provided in note 31 reflecting the impact of FRS 101 adoption.</p>
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Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Adoption of new and revised IFRSs (continued)

<p><i>IFRS 13 Fair Value Measurement</i></p>	<p>The company has applied IFRS 13 for the first time in the current year. IFRS 13 establishes a single source of guidance for fair value measurements and disclosures about fair value measurements. The scope of IFRS 13 is broad, the fair value measurement requirements of IFRS 13 apply to both financial instrument items and non-financial instrument items for which other IFRSs require or permit fair value measurements and disclosures about fair value measurements, except leasing transactions that are within the scope of IAS 17 'Leases', and measurements that have some similarities to fair value but are not fair value (e.g. net realisable value for the purposes of measuring inventories or value in use for impairment assessment purposes).</p> <p>IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions. Fair value under IFRS 13 is an exit price regardless of whether that price is directly observable or estimated using another valuation technique. Also, IFRS 13 includes extensive disclosure requirements, however the company has taken advantage of the exemption provided under IFRS 101 from providing these disclosures.</p>
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Going concern

The company's business activities, together with the factors likely to affect its future development and position, are set out in the Strategic Report pages 16 to 69.

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. On the basis of their assessment of the company's financial position the directors 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, further details can be found in the directors' report on page 94.

In addition and in accordance with provision C 2.2 of the 2014 UK Code, the Board have assessed the prospects of the business over a longer period than the 12 months required by the 'Going Concern' provision.

The Board has selected to conduct this review each year based on a rolling three-year period and full details of the assessment and the viability statement are set out within the Strategic Report on page 60.

Segmental reporting

The company's revenue arises from the provision of services within the United Kingdom. It has a large and diverse customer base and is not reliant on any single customer.

The Southern Water Board and management team review all internal management information on a single segment basis and accordingly no segmental information is provided in this report.

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Revenue recognition

Revenue represents the income receivable (net of value added tax) in the ordinary course of business for goods and services provided. In respect of unbilled charges, revenue includes an estimate of the consumption between the date of the last meter reading and the period-end. The revenue accrual is estimated using a defined methodology based upon historical billing, consumption information and the applicable tariff.

Revenue from the supply of services represents the value of services provided under contracts to the extent that there is a right to consideration and is recorded at the fair value of the consideration due. Revenue is recognised when the amount of revenue can be measured reliably and it is probable that the economic benefits associated with the transaction will flow to the company. Revenue is not recognised when it is considered probable that economic benefits will not be received. In these circumstances revenue is only recognised when collectability is reasonably certain. Payments received in advance of revenue recognition are recorded as deferred income.

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.

Interest income is recognised on a time proportionate basis using the effective interest method.

Dividend income from investments is recognised when the shareholders' rights to receive payment have been established (provided that it is probable that the economic benefits will flow to the company and the amount of revenue can be measured reliably).

Provision for impairment of trade receivables

The bad debt provision is calculated by applying estimated recovery rates to various categories of debt, reflecting past collections experience and expectations of future recovery of outstanding receivables at the date of the statement of financial position.

Taxation

The taxation charge in the income statement represents the sum of the tax currently payable and deferred tax.

Current taxation is based on the profit for the year as adjusted for disallowable and non-taxable items and items of income or expense which are taxable or deductible in other years. The company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the reporting date.

Deferred taxation is tax expected to be payable on temporary differences between the treatment of certain items for taxation and accounting purposes. Deferred taxation is provided on all temporary-differences that have originated, but not reversed, by the end of the reporting period. It is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised based on tax laws and rates that have been enacted or substantively enacted at the balance sheet date.

Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is regarded as probable that taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the company intends to settle its current tax assets and liabilities on a net basis.

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Intangible assets

Intangible assets are measured at cost less subsequent amortisation and any impairment. Amortisation of intangible assets is calculated on a straight line basis over the estimated useful lives, which are primarily three to 10 years. The estimated useful life and amortisation method are reviewed at the end of each reporting period, with the effect of any changes in estimate being accounted for on a prospective basis.

Expenditure on research activities is recognised as an expense in the period in which it is incurred.

Property, plant and equipment

Property, plant and equipment comprises

- i Freehold land and buildings – comprising land and non-operational buildings
- ii Infrastructure assets – comprising a network of systems consisting of mains and sewers, impounding and pumped raw water storage reservoirs, sludge pipelines and sea outfalls
- iii Plant and machinery – comprising structures at sites used for water and wastewater treatment, pumping or storage where not classed as infrastructure along with associated fixed plant
- iv Other assets – comprising vehicles, computers, mobile plant and meters
- v Assets under construction

All property, plant and equipment is stated in the statement of financial position at cost or at deemed cost on transition to FRS 101, less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Further details surrounding the fair value exercise can be found in note 31 (i).

The difference between depreciation based on the fair valued carrying amounts of assets and depreciation based on the asset's original cost is transferred annually from the revaluation reserve to retained earnings through equity. The costs of repairs to the infrastructure network are recognised in the income statement as they arise.

Expenditure which results in replacement or renewal of infrastructure or enhancements to the operating capability of the infrastructure network is capitalised.

Items of property, plant and equipment that are transferred to the company from customers or developers are initially recognised at fair value in accordance with IFRIC 18 'Transfers of Assets from Customers'. The corresponding credit is recorded as deferred income and released to other income over the expected useful lives of the related assets.

Borrowing costs directly attributable to the construction of qualifying assets, that necessarily take a substantial period of time to get ready for their intended use, are capitalised during the period of time that is required to complete and prepare the asset for its intended use. The commencement of capitalisation begins when both finance costs and expenditures for the asset are being incurred and activities that are necessary to get the asset ready for use are in progress. Capitalisation ceases when substantially all the activities that are necessary to get the asset ready for use are complete. Other borrowing costs are expensed.

Subsequent costs are included in the asset's carrying amount or recognised as separate assets, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the company and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the income statement as incurred.

Freehold land is not depreciated, nor are assets in the course of construction until they are commissioned. Commissioning is deemed to occur when a new work is officially taken over from the contractor following completion of performance and take-over tests.

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Property, plant and equipment (continued)

Other assets are depreciated on a straight-line basis over their estimated operating lives which are principally as follows

<u>Non-infrastructure assets</u>	<u>Years</u>	<u>Infrastructure assets</u>	<u>Years</u>
Buildings	10–60	Water mains	100–120
Operational structures	15–80	Sewers	80–200
Fixed plant	10–40	Reservoirs	200
Vehicles, computers and mobile plant	3–10	Ancillary structures	10–70

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

The estimated useful lives and depreciation method are reviewed at the end of each reporting period, with the effect of any changes in estimate accounted for on a prospective basis.

Impairment of tangible and intangible assets

At the end of each reporting period, the company reviews the carrying amounts of its tangible and intangible assets, to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated to determine the extent of the impairment loss (if any). Where the asset does not generate cash flows that are independent from other assets, the company estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Recoverable amount is the higher of fair value less costs to sell and value in use.

If the recoverable amount of an asset is estimated to be less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount. An impairment loss is recognised immediately in the income statement, unless the relevant asset is carried at a revalued amount, in which case the impairment loss is treated as a revaluation decrease.

Where an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years. A reversal of an impairment loss is recognised immediately in the profit or loss, unless the relevant asset is carried at a revalued amount, in which case the reversal of the impairment loss is treated as a revaluation increase.

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Grants and contributions

Grant and contributions received are treated as either revenue or deferred income in line with IFRIC 18 as defined by the nature of the receipt

Infrastructure receipts, contributions received following new connections towards enhancing the network, are recognised as revenue when they are receivable

Grants and contributions receivable in respect of non-current assets are treated as deferred income and released to other income over the useful economic life of those fixed assets

Grants and contributions received in respect of new connections to the water and sewerage networks are treated as deferred income and released to revenue in line with the expected expenditure they are intended to compensate

Grants and contributions which are given in compensation for expenses incurred with no future related costs are recognised in revenue in the period that they become receivable

Leased assets

Leases are classified as finance leases whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases

The company as lessee

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'. Assets held under finance leases are recognised as assets of the company at their fair value or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The asset is recorded in the statement of financial position as a non-current asset and is depreciated over its estimated useful life or the term of the lease, whichever is shorter. Future liabilities to the lessor under such leases, net of finance charges, are included within creditors. Rentals payable are apportioned between the finance element, which is charged to the income statement, and the capital element which reduces the outstanding obligation for future instalments

Leases where the lessor retains substantially all the risks and rewards of ownership are classified as operating leases. Rentals payable under operating leases are charged to the income statement on a straight-line basis over the period 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

The company as lessor

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 credited to other operating income in the income statement over the life of the lease

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Non-current asset investments

Investments held as non-current assets, including investments in subsidiaries, are stated at cost, less where appropriate, provision for any impairment in value. The carrying values of non-current asset investments are reviewed for impairment in periods if events or changes in circumstances indicate the carrying value may not be recoverable.

Inventories

Inventory is held for use in the production of water supply and treatment of wastewater. Raw materials and work in progress are valued at the lower of cost and net realisable value. Net realisable value is the estimated selling price, less further costs expected to be incurred to completion and costs to be incurred in marketing, selling and distribution.

Deferred revenue

Deferred revenue includes monies received from customers where the related service has not yet been provided.

Amounts are deferred to the statement of financial position and released to the income statement in line with the period of the service provided.

Provisions

Provisions are recognised when the company has a present obligation (legal or constructive) as a result of a past event, it is probable that the company will be required to settle that obligation and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the end of the reporting period, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows.

When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, a receivable is recognised as an asset if it is virtually certain that reimbursement will be received and the amount of the receivable can be measured reliably.

An environmental provision is made for the costs relating to decommissioned or dormant assets which have been identified as having an environmental impact.

Retirement benefits

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.

The liability recognised in the statement of financial position in respect of the defined benefit pension scheme is the present value of the defined benefit obligation at the end of the period less the fair value of plan assets. The current service cost, which is the increase in the present value of the liabilities of the company's defined benefit pension scheme expected to arise from employee service in the period, is charged to operating costs. The net interest on the scheme's net assets/(liabilities) is included in other finance charges. Actuarial gains and losses are recognised in the statement of other comprehensive income.

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Retirement benefits (continued)

The pension cost under IAS 19 'Employee Benefits' is assessed in accordance with the advice of a firm of actuaries based on the latest actuarial valuation and assumptions determined by the actuary. The assumptions are based on information supplied to the actuary by the company, supplemented by discussions between the actuary and management. The assumptions are disclosed in note 27.

Profit before taxation and net assets are affected by the actuarial assumptions used. The key assumptions include discount rates, pay growth, mortality and increases to pensions in payment and deferred pensions, and may differ from actual results due to changing market and economic conditions and longer or shorter lives of participants.

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 income statement in the period to which they relate. Differences between contributions actually paid are shown as either accruals or prepayments in the statement of financial position.

Financial instruments

Financial assets and financial liabilities are recognised in the company's statement of financial position when the company becomes a party to the contractual provisions of the instrument.

Financial assets and financial liabilities are initially measured at fair value. Transaction costs that are directly attributable to the acquisition or issue of financial assets and financial liabilities (other than financial assets and financial liabilities at fair value through profit or loss (FVTPL)) are added to or deducted from the fair value of the financial assets or financial liabilities, as appropriate, on initial recognition. Transaction costs directly attributable to the acquisition of financial assets or financial liabilities at FVTPL are recognised immediately in profit or loss.

Financial assets

(i) Loans and receivables

Trade receivables, loans, and other receivables that have fixed or determinable payments that are not quoted in an active market are classified as 'loans and receivables'. Loans and receivables are measured at amortised cost using the effective interest method, less any impairment. Interest income is recognised by applying the effective interest rate, except for short-term receivables when the recognition of interest would be immaterial.

(ii) Impairment of financial assets

Financial assets, other than those at FVTPL, are assessed for indicators of impairment at each balance sheet date. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been affected.

For financial assets carried at amortised cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate. The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets with the exception of trade receivables, where the carrying amount is reduced through the use of an allowance account.

(iii) Derecognition of financial assets

The company derecognises a financial asset only when the contractual rights to the cash flows from the asset expire, or when it transfers the financial asset and substantially all the risks and rewards of ownership of the asset to another entity. On derecognition of a financial asset the difference between the asset's carrying amount and the sum of the consideration received and receivable and the cumulative gain or loss that had been recognised in other comprehensive income and accumulated in equity is recognised in profit or loss.

Notes to the financial statements (continued)

For the year ended 31 March 2016

1 Accounting policies (continued)

Financial liabilities

Fixed rate interest-bearing borrowings are initially measured at fair value, net of transaction costs and are subsequently measured at amortised cost using the effective interest method, with the interest expense recognised on an effective yield basis

The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments through the expected life of the financial liability, or, where appropriate, a shorter period, to the net carrying amount on initial recognition.

Issue costs in relation to index-linked and variable rate bonds are separately disclosed within creditors.

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 income statement in the year in which it arises.

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

Derecognition of financial liabilities

The company derecognises financial liabilities when, and only when, the company's obligations are discharged, cancelled or they expire.

Derivative financial instruments

The company enters into a variety of derivative financial instruments to manage its exposure to inflation and interest rate risk in line with the company's risk management policy and no speculative trading in financial instruments is undertaken. Further details of derivative financial instruments are disclosed in note 20.

Derivatives are initially recognised at fair value at the date a derivative contract is entered into and are subsequently re-measured to their fair value at the end of each reporting period. The resulting gain or loss is recognised in the income statement immediately.

Certain derivative instruments, principally index-linked swaps, do not qualify for hedge accounting and as such, the company does not currently apply hedge accounting.

Derivatives with a positive fair value and derivatives with a negative fair value are set-off against each other with the net position being presented as either a financial liability or financial asset. A derivative is presented as a non-current asset or a non-current liability if the remaining maturity of the instrument is more than 12 months and it is not expected to be realised or settled within 12 months. Other derivatives are presented as current assets or current liabilities.

Embedded derivatives

Derivatives embedded in other financial instruments or other host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of the host contracts and the host contracts are not measured at fair value through profit and loss.

An embedded derivative is presented as a non-current asset or a non-current liability if the remaining maturity of the hybrid instrument to which the embedded derivative relates is more than 12 months and is not expected to be realised or settled within 12 months. Other derivatives are presented as current assets or current liabilities.

Notes to the financial statements (continued)

For the year ended 31 March 2016

2 Critical accounting judgements and key sources of estimation uncertainty

In the application of the company's accounting policies, which are described in note 1 above, the directors are required to make judgements, estimates and assumptions about the carrying amounts of assets and liabilities that are not readily apparent from other sources. The estimates and associated assumptions are based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Critical judgements in applying the company's accounting policies

The following are the critical judgements that the directors have made in the process of applying the company's accounting policies and that have the most significant effect on the amounts recognised in financial statements:

(i) **Measured income accrual**

The measured income accrual is an estimation of the amount of water and wastewater unbilled at the period end. The accrual is estimated using a defined methodology based upon historical billing and consumption information and the applicable tariff. The calculation is sensitive to estimated consumption for measured customers.

(ii) **Revenue recognition and allowance for doubtful receivables**

The company recognises revenue generally at the time of delivery and when collection of the resulting receivable is reasonably assured. When the company considers that the criteria for revenue recognition are not met for a transaction, revenue recognition is delayed until such time as collectability is reasonably assured. Payments received in advance of revenue recognition are recorded as deferred income.

At each reporting date, the company evaluates the recoverability of trade receivables and records an allowance for doubtful receivables based on experience. This allowance is based on, amongst other things, a consideration of actual collection history. The actual level of receivables collected may differ from the estimated levels of recovery, which could impact future operating results positively or negatively.

(iii) **Pensions**

The company operates a defined benefit scheme as well as a defined contribution scheme. Under IAS 19 'Employee Benefits' the company has recognised an actuarial loss of £14.0 million (2015: loss of £37.4 million). The main assumptions are set out in note 27 of the financial statements.

(iv) **Property, plant and equipment**

The company recognises property, plant and equipment (PPE) on its water and wastewater infrastructure assets where such expenditure enhances a significant length of the network or increases the capacity of the network, whereas any expenditure classed as maintenance is expensed in the period it is incurred. Determining enhancement from maintenance expenditure is a subjective area, particularly when assessing whether the length of network replaced enhances the network. In addition, management capitalise time and resources incurred by the company's support functions on capital programmes.

The estimated useful economic lives of PPE are based on management's judgement and experience. When management identifies that actual useful economic lives differ materially from the estimates used to calculate depreciation, that charge is adjusted prospectively. Due to the significance of PPE investment to the company, variations between actual and estimated useful economic lives could impact operating results both positively and negatively, although historically few changes to estimated useful economic lives have been required.

Notes to the financial statements (continued)

For the year ended 31 March 2016

2 Critical accounting judgements and key sources of estimation uncertainty (continued)

(v) Financial instruments

The fair value of the financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined using valuation techniques

The company uses its judgement to select the most appropriate valuation method for each instrument to estimate expected future cash flows, and apply discount rates that reflect counterparty credit risk. The valuation techniques are described in note 20.

(vi) Taxation

The tax charge is based on the profit for the period and the tax rates in force at the end of the reporting period. Estimation of the tax charge involves an assessment of the potential tax treatment of certain items, which will only be resolved once finally agreed with the tax authorities.

3 Segmental analysis

The directors believe that the whole of SWS's activities constitute a single class of business. The company's revenue is generated wholly from within the United Kingdom. The Southern Water Board and management team review all internal management information on a single segment basis and accordingly no segmental information is provided in this report.

Notes to the financial statements (continued)

For the year ended 31 March 2016

4 Revenue

An analysis of the company's revenue is as follows

Continuing operations	2016	2015
	£m	£m
Water and sewerage services	759 0	781 9
Other services	44 7	44 3
Total revenue	803.7	826 2
Other operating income	1 7	1 2
Interest receivable (note 8)	2 4	1 3
Interest revenue from Southern Water Services Group Limited	56 9	56 9
Total income	864 7	885 6

Other operating income includes rents receivable

5 Profit for the year

Profit for the year has been arrived at after charging/(crediting)	2016	2015
	£m	£m
Depreciation on		
- owned assets	224.6	212 4
- assets held under finance leases	1.3	1 3
	225.9	213 7
Amortisation of intangible assets included in other operating expenses		
- other	8.7	9 1
Research and development expenditure	0.7	0 4
Rentals under operating leases		
Vehicles	2 2	2 1
Employee costs (note 6)	56 3	50 1
Amortisation of grants and contributions (note 23)	(1 1)	(1 0)
Rates rebate (see note below)	(13 3)	-
Insurance proceeds (see note below)	-	(2 4)
Fees payable to the company's auditor in respect of		
- Statutory audit of the company's financial statements	0 2	0 2
- Other services pursuant to legislation	0 1	0 1
- All other services	0 7	0 5

Audit related and non-audit services primarily relate to regulatory assurance fees, and other taxation and professional fees

Note During 2014–15 we received insurance proceeds totalling £2 4 million in relation to the storms experienced in the winter of 2013–14
The rates rebate of £13 3 million, received in 2015–16, relates to a refund of historic rates charges following a successful appeal

Notes to the financial statements (continued)

For the year ended 31 March 2016

6 Employee information

	2016 £m	2015 £m
(a) Employee costs (including directors' emoluments).		
Wages and salaries	77.4	69.6
Social security costs	7.1	6.5
Pension costs - Defined contribution	2.3	2.0
- Defined benefit	6.3	6.9
Total employee costs	<u>93.1</u>	<u>85.0</u>
Less charged as capital expenditure	<u>(36.8)</u>	<u>(34.9)</u>
Charged to the income statement	<u>56.3</u>	<u>50.1</u>

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

(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

	2016 Number	2015 Number
Operations	1,239	1,167
Customer services	378	422
Corporate centre	502	444
	<u>2,119</u>	<u>2,033</u>

7 Directors' emoluments

	2016 £000	2015 £000
Aggregate emoluments (including benefits in kind)	1,529	1,464
Amounts receivable under long-term incentive plans	-	1,563
Company pension contributions to money purchase pension schemes	<u>-</u>	<u>-</u>

No retirement benefits accrued to directors (2015 nil) under a Southern Water defined benefit scheme. No retirement benefits accrued to directors (2015 nil) under a Southern Water defined contribution scheme.

A long-term incentive plan (LTIP) was in operation for the four-year period from 1 April 2011 to 31 March 2015. The Remuneration Committee assessed performance against this plan in April 2015 and agreed for the payments shown above to be made in June 2015.

A new LTIP has been put in place for the period from 1 April 2015 to 31 March 2018. To date no payments have been made in relation to this scheme. A total amount of £193,000 has been accrued in the accounts for 2015–16 in relation to this scheme and this is attributable to the highest paid director.

Further details can be found in the Directors' Remuneration Report on pages 84 to 93.

Notes to the financial statements (continued)

For the year ended 31 March 2016

7 Directors' emoluments (continued)

Details of emoluments and benefits for the highest paid director

	2016 £000	2015 £000
Highest paid director's aggregate emoluments and benefits	716	663
Amounts receivable under long-term incentive plans	-	1,250
	<u>716</u>	<u>1,913</u>

During the year the company made contributions of £nil (2015 £nil) to a money purchase pension scheme in respect of the highest paid director's qualifying services

8 Net finance costs

	2016 £m	2015 £m
Finance income		
Interest revenue from Southern Water Services Group Limited	56.9	56.9
Deposit income on short term bank deposits	2.4	1.3
	<u>59.3</u>	<u>58.2</u>
Finance costs		
Interest payable on other loans	(6.1)	(9.1)
Interest paid to Southern Water Services (Finance) Ltd	(128.5)	(119.7)
Indexation	(10.0)	(21.8)
Amortisation of issue costs	(1.9)	(1.9)
Amortisation of gilt lock proceeds	0.1	0.1
Amortisation of deferred credits	9.7	9.7
Amortisation of bond premium	0.6	0.6
Other finance expense (note 27 pensions)	(3.9)	(4.0)
Dividends on preference shares – (see note (a) and (b) below)	(11.2)	(10.7)
	<u>(151.2)</u>	<u>(156.8)</u>
Amounts capitalised on qualifying assets	5.7	6.7
	<u>(145.5)</u>	<u>(150.1)</u>
Fair value losses on derivative financial instruments		
Derivative financial instruments not designated as hedges	(70.4)	(130.3)
	<u>(156.6)</u>	<u>(222.2)</u>
Net finance costs	<u>(156.6)</u>	<u>(222.2)</u>

The interest revenue from Southern Water Services Group Limited relates to the long-term loan disclosed in note 13

Borrowing costs included in the cost of qualifying assets during the year arose on the general borrowing pool and are calculated by applying a capitalisation rate of 4.00 per cent to expenditure on such assets (2015 3.99 per cent)

Dividends on preference shares

- (a) Class A1 preference share dividends amounted to £40 per share and Class B £70 per share totalling £9.0 million (2015 £9.0 million)
- (b) Dividend due to the Class A2 preference shareholders of £67.35 (2015 £53.11) per share totalling £2.2 million (2015 £1.7 million) was declared and settled in the year at base value plus an amount for out-performance and savings in the year ended 31 March 2015 (see note 19(vii))

Notes to the financial statements (continued)

For the year ended 31 March 2016

9 Tax on profit on ordinary activities

	2016 £m	2015 £m
Current tax		
Current year	11 4	9 5
Adjustment in respect of prior years	8 8	3 1
Total current tax charge	<u>20.2</u>	<u>12 6</u>
Deferred tax		
Origination and reversal of timing differences	9 7	5 8
Adjustment in respect of prior years	0 5	(1 4)
Effect of corporation tax rate change	(22.0)	-
Total deferred tax (credit)/charge	<u>(11 8)</u>	<u>4 4</u>
Total tax charge on profit	<u>8 4</u>	<u>17 0</u>

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

	2016 £m	2015 £m
Profit before tax	<u>128 3</u>	<u>110 6</u>
Tax at the UK corporation tax rate of 20 per cent (2015 21 per cent)	25 7	23 2
Permanent differences	2 4	2 9
Group relief received for nil payment	(7.0)	(10 5)
Impact of tax rate changes	(22 0)	(0 3)
Adjustment in respect of prior years		
Current tax	8 8	3 1
Deferred tax	0 5	(1 4)
Tax charge for year	<u>8 4</u>	<u>17 0</u>

Factors that may affect future tax charges

On 8 July 2015 the UK government announced reductions in the main rate of corporation tax from 20 per cent to 19 per cent from 1 April 2017 and 18 per cent from 1 April 2020. These rate changes were enacted in the Finance Bill 2015 during the year and deferred tax balances have been calculated using these reduced rates. A £22.0 million credit has been recognised in the income statement to reflect the reduction in the deferred tax liability as a result of the rate changes.

A further credit of £18.6 million has been recognised in the statement of other comprehensive income to reflect the reduction in the deferred tax liability as a result of the tax rate changes.

On 16 March 2016 the UK government announced a further reduction in the future main rate of corporation tax from the planned 18 per cent, to a rate of 17 per cent, effective from 1 April 2020, although this reduction was not substantively enacted at the balance sheet date.

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.

Notes to the financial statements (continued)

For the year ended 31 March 2016

9 Tax on profit on ordinary activities (continued)

In addition to the amount recognised in the income statement, the following amounts relating to tax have been recognised in the statement of other comprehensive income

	2016 £m	2015 £m
Deferred tax		
Arising on income and expenses recognised in other comprehensive income		
Tax credit on actuarial losses on defined benefit pension scheme	(2 8)	(7 5)
Deferred tax movement due to rate change on FRS 101 transition fair value uplift	(18 6)	-
Total deferred tax credits recognised in other comprehensive income	<u>(21 4)</u>	<u>(7 5)</u>

10 Dividends

	2016 £m	2015 £m
Amounts recognised as distributions to equity holders in the year:		
Current year interim dividend of £812.37 (2015: £802.21) per share	45 5	44 9
Current year interim dividend of £522.32 (2015: £nil) per share	29 2	-
Current year final dividend of £899.11 (2015: £nil) per share	50 4	-
	<u>125 1</u>	<u>44 9</u>

The interim dividends of £45.5 million are paid to Southern Water Services Group Limited (SWSG). These dividends, along with associated group tax relief, enable SWSG to pay the interest of £56.9 million due to Southern Water Services Limited on an inter-company loan as disclosed in note 13. These transactions are illustrated in the diagram on page 59 of the Annual Report.

In addition a current year interim dividend of £29.2 million was paid in September 2015 and a final dividend of £50.4 million was paid in March 2016. These dividends are ultimately paid to investors in our parent company Greensands Holdings Ltd.

Notes to the financial statements (continued)

For the year ended 31 March 2016

11 Intangible assets

	Externally generated		
	Assets under construction £m	Computer software £m	Total £m
Cost			
At 1 April 2015	20 2	48 2	68 4
Additions	6 8	0 3	7 1
Transfers	(15 3)	16 0	0 7
At 31 March 2016	<u>11 7</u>	<u>64 5</u>	<u>76 2</u>
Amortisation			
At 1 April 2015	-	25 5	25 5
Charge for the year	-	8 7	8 7
At 31 March 2016	<u>-</u>	<u>34 2</u>	<u>34 2</u>
Net book amount			
At 31 March 2016	<u>11 7</u>	<u>30 3</u>	<u>42 0</u>
At 31 March 2015	<u>20 2</u>	<u>22 7</u>	<u>42 9</u>

We currently do not have any internally generated intangible assets

12 Property, plant and equipment

	Land & buildings £m	Plant & machinery £m	Infra- structure assets £m	Assets under construction £m	Other £m	Total £m
Cost						
At 1 April 2015	1,533 2	2,735 4	2,394 6	254 0	569 4	7,486 6
Additions	1 0	67 8	22 8	124 4	18 3	234 3
Transfers	0 2	87 6	9 9	(125 5)	27 1	(0 7)
Disposals	-	(2 9)	-	-	(8 2)	(11 1)
At 31 March 2016	<u>1,534 4</u>	<u>2,887 9</u>	<u>2,427 3</u>	<u>252 9</u>	<u>606 6</u>	<u>7,709 1</u>
Depreciation						
At 1 April 2015	602 3	945 2	28 7	-	310 2	1,886 4
Charge for the year	40 0	110 6	27 4	-	47 9	225 9
Disposals	-	(2 7)	-	-	(8 0)	(10 7)
At 31 March 2016	<u>642 3</u>	<u>1,053 1</u>	<u>56 1</u>	<u>-</u>	<u>350 1</u>	<u>2,101 6</u>
Net book amount						
At 31 March 2016	<u>892 1</u>	<u>1,834 8</u>	<u>2,371 2</u>	<u>252 9</u>	<u>256 5</u>	<u>5,607 5</u>
At 31 March 2015	<u>930 9</u>	<u>1,790 2</u>	<u>2,365 9</u>	<u>254 0</u>	<u>259 2</u>	<u>5,600 2</u>

Notes to the financial statements (continued)

For the year ended 31 March 2016

12 Property, plant and equipment (continued)

Freehold land is stated at a cost of £51.7 million at 31 March 2016 and 31 March 2015 and is not depreciated

Included within additions above is £5.7 million (2015: £6.7 million) of interest that has been capitalised on qualifying assets in accordance with IAS 23 'Borrowing costs'. The cumulative net book value of the borrowing costs capitalised amount to £167.7 million (2015: £168.5 million). The company has elected to apply IAS 23 from 1 April 2003, as permitted by the standard.

Assets held under finance leases

Included in the amounts shown above are the following amounts in relation to property, plant and equipment held under finance leases

	2016 £m	2015 £m
Net book amount at 31 March	<u>5.9</u>	<u>5.1</u>

In accordance with IFRS 1 'First-time Adoption of International Financial Reporting Standards', the company has elected to measure its infrastructure and operational assets at 1 April 2014, being the date of transition to IFRS, at their fair value and to use that fair value as their deemed cost at that date (see note 31).

13 Other non-current assets

	2016 £m	2015 £m
Non-current receivables		
Amounts owed by SWSG	<u>812.3</u>	<u>812.3</u>

Amounts 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 cent per annum.

14 Investments

	2016 £m	2015 £m
Shares in subsidiary Southern Water Services (Finance) Limited		
At 1 April and 31 March	<u>29.2</u>	<u>29.2</u>

The company has the following direct investments in subsidiary undertakings at 31 March 2016

	Registered Office	Class of share capital	Activity
Southern Water Services (Finance) Ltd (SWSF)	Ugland House, PO Box 309, George Town, Grand Cayman	Ordinary (100%)	To raise debt finance
Southern Water Executive Pension Scheme Trustees Limited	Southern House, Yeoman Road, Worthing	Ordinary (100%)	Dormant
Southern Water Pension Trustees Limited	Southern House, Yeoman Road, Worthing	Ordinary (100%)	Dormant

SWSF is registered in the UK for tax purposes

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

Notes to the financial statements (continued)

For the year ended 31 March 2016

15 Inventories

	2016 £m	2015 £m
Raw materials	1.5	1.5
Work in progress	0.9	0.7
	<u>2.4</u>	<u>2.2</u>

16 Trade and other receivables

	2016 £m	2015 £m
Trade receivables	198.5	201.2
Provision for impairment	(111.9)	(110.5)
Net trade receivables	<u>86.6</u>	<u>90.7</u>
Loan to Southern Water Services (Finance) Limited	0.8	15.1
Amounts owed by other group undertakings	4.0	2.9
Other amounts receivable	6.2	6.4
Accrued income	80.1	88.8
Prepayments	14.6	16.6
	<u>192.3</u>	<u>220.5</u>

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

Accrued income as at 31 March 2016 includes water and sewerage income not yet billed of £73.1 million (2015 £81.0 million)

The directors consider that the carrying values of trade and other receivables are reasonable approximations of their fair values

(i) Provision for impairment

Movements on the doubtful debts provision were as follows

	2016 £m	2015 £m
At 1 April	(110.5)	(121.5)
Charge for bad and doubtful debts	(21.5)	(18.9)
Amounts written off during the year	20.1	29.9
At 31 March	<u>(111.9)</u>	<u>(110.5)</u>

At each reporting date, the company evaluates the recoverability of trade receivables and records allowances for doubtful receivables based on experience

The following table provides information regarding the ageing of receivables that are specifically provided for

	2016 £m	2015 £m
Current	0.7	-
1-2 years	0.9	12.3
2-3 years	9.9	8.9
3-4 years	7.0	5.9
more than 4 years	37.5	30.7
	<u>56.0</u>	<u>57.8</u>

A collective provision is recorded against assets which are past due but for which no specific provision has been made. This is calculated based on historical experience of levels of recovery

Notes to the financial statements (continued)

For the year ended 31 March 2016

16 Trade and other receivables (continued)

The aged analysis of receivables that were overdue at the reporting date but not individually provided for is as follows

	2016 £m	2015 £m
Up to 90 days	20.1	23.2
91-365 days	36.4	44.2
1-2 years	30.3	25.9
2-3 years	19.5	14.8
3-4 years	12.5	9.8
more than 4 years	6.7	4.2
	<u>125.5</u>	<u>122.1</u>

The amounts above are reconciled to gross and net debtors in the tables below

At 31 March 2016	Gross £m	Provision £m	Net £m
Not due	17.0	-	17.0
Overdue not specifically provided	125.5	(55.9)	69.6
Overdue and specifically provided	56.0	(56.0)	-
	<u>198.5</u>	<u>(111.9)</u>	<u>86.6</u>

At 31 March 2015	Gross £m	Provision £m	Net £m
Not due	21.3	-	21.3
Overdue not specifically provided	122.1	(52.7)	69.4
Overdue and specifically provided	57.8	(57.8)	-
	<u>201.2</u>	<u>(110.5)</u>	<u>90.7</u>

17 Trade and other payables

	2016 £m	2015 £m
Trade payables	13.7	27.0
Amounts owed to group undertakings	22.2	16.7
Capital creditors and capital accruals	59.3	68.7
Taxation and social security	2.8	2.4
Accruals and deferred revenue	90.1	94.3
	<u>188.1</u>	<u>209.1</u>

The directors consider that the carrying values of trade and other payables are not materially different from their fair values

18 Current borrowings

	2016 £m	2015 £m
Debt issue costs (note 19 (iv))	(1.9)	(1.9)
Bond premium deferred	0.7	0.7
Deferred gilt lock proceeds (note 19 (v))	0.1	0.1
Deferred proceeds	9.7	9.7
Term Facility Agreement 2014 £50m – 6-month Libor plus 0.5% 2016	50.0	-
Other loans from subsidiary SWSF	30.3	30.3
	<u>88.9</u>	<u>38.9</u>

Notes to the financial statements (continued)

For the year ended 31 March 2016

19 Non-current borrowings

	Note	2016 £m	2015 £m
Loans from subsidiary SWSF	(i)		
Class A £350m - 6 202% fixed rate 2029	(ii)	348 3	348 2
Class A £150m - 3 716% index linked 2034		217 7	215 5
Class A £35m - 3 716% index linked 2034		50 1	49 6
Class A £350m - 6 650% fixed rate 2026	(ii)	348 5	348 4
Class A £150m - 3 826% index linked 2023		217 7	215 5
Class A £350m - 5 010% fixed rate 2021	(ii)	347.8	347 4
Class A £150m - 5 010% fixed rate 2041	(ii)	146.8	146 8
Class A £200m - 4 510% fixed rate 2052	(ii)	197 1	197 1
Class A £300m - 5 135% fixed rate 2056	(ii)	292 4	292 4
Class A £300m - 6 135% fixed rate 2019	(ii)	298 7	298 3
Artesian £165m - 4 086% index linked 2033		239 5	237 1
Artesian £156.5m - 3 645% index linked 2032		221 7	219 4
Total Class A debt from SWSF		<u>2,926 3</u>	<u>2,915 7</u>
Class B £250m - 4 51% fixed rate 2022	(ii), (iii)	246 6	246 1
Debt issue costs	(iv)	(18 1)	(19 8)
Bond premium deferred		10 9	11 5
Deferred gilt lock proceeds	(v)	5.1	5 3
Deferred proceeds*		115 0	124 7
Other loans from subsidiary SWSF	(vi)	30 3	30 3
Total loans and other borrowings from SWSF		<u>3,316 1</u>	<u>3,313 8</u>
Class B, Term Facility Agreement 2014 £150m – 6-month Libor plus 1 95% 2021		150 0	150 0
Class A, Term Facility Agreement 2016 £50m – 6-month Libor plus 0 5% 2016		50.0	-
Class A £60m – 0 0% index linked 2025		60 5	-
Class A1 Preference shares	(vii)	32 6	32 6
Class B Preference shares	(vii)	110 0	110 0
Obligations under finance leases		1 5	1 8
Total borrowings		<u>3,720 7</u>	<u>3,608 2</u>
Current borrowings		<u>88.9</u>	<u>38 9</u>
Non-current borrowings		<u>3,631.8</u>	<u>3,569 3</u>

*Deferred proceeds represent consideration received by the company in connection with taking on various debt obligations that 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 undertakings 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 refinancing's 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 (continued)

For the year ended 31 March 2016

19 Non-current borrowings (continued)

Notes in respect of the specific instruments above

- (i) 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 per cent. Therefore each individual back-to-back inter-company loan has been separately disclosed.
- (ii) Fixed rate borrowings are recognised net of issue costs and discounts on issue and are carried at amortised cost using the effective interest rate method.
- (iii) The interest rate on the Class B £250 million is fixed at 4.51 per cent until March 2022 when it reverts to Libor plus a margin to be determined with a premium of 0.01 per cent.
- (iv) Debt issue costs represent issue fees paid to SWSF that are not otherwise accounted for within the amortised cost of specific loans. 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 loans advanced at the time the costs were incurred. As at 31 March 2016 debt issue costs amounted to £18.1 million of which £1.9 million represents the short-term amount which is disclosed separately in note 18.
- (v) Prior to the issue of the Class A £300 million bond in the year to 31 March 2008, SWSF entered into a gilt lock agreement, resulting in the receipt of £6.3 million, 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 income statement over the life of the loan.
- (vi) The loan from SWSF 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
- (vii) The preference 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 £260.0 million 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.)

Notes to the financial statements (continued)

For the year ended 31 March 2016

19 Non-current borrowings (continued)

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 shareholders in September 2016 for out-performance in the year ended 31 March 2016

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

(viii) The Class A £60 million loan is index linked with an interest rate of 0.00 per cent until August 2025

Repayments fall due as follows:	2016	2015
	£m	£m
Borrowings excluding finance leases:		
Between one and two years not by instalments	-	-
Between two and five years not by instalments	646.5	-
After five years not by instalments	2,983.8	3,567.5
	3,630.3	3,567.5
On demand or within one year not by instalments	88.9	38.9
	3,719.2	3,606.4
Finance leases:		
Between one and two years not by instalments	1.3	0.7
Between two and five years not by instalments	0.2	1.1
After five years not by instalments	-	-
	1.5	1.8
On demand or within one year not by instalments	-	-
	1.5	1.8
Borrowings including finance leases:		
Between one and two years not by instalments	1.3	0.7
Between two and five years not by instalments	646.7	1.1
After five years not by instalments	2,983.8	3,567.5
	3,631.8	3,569.3
On demand or within one year not by instalments	88.9	38.9
	3,720.7	3,608.2

Obligations under finance leases comprise optional residual value balloon payments due on vehicle leases at the end of the lease period, where the minimum lease payments (including finance charges) have been prepaid at the start of the lease. If the company opts not to pay the balloon payment, it must return the vehicle to the lessor.

Notes to the financial statements (continued)

For the year ended 31 March 2016

20 Derivative financial instruments**Categories of financial instruments at fair value**

	2016 £m	2015 £m
Derivative assets carried at fair value through profit or loss (FVTPL):		
Interest rate swaps – not hedge accounted	12.4	13.8
Total derivative financial assets	<u>12.4</u>	<u>13.8</u>
	2016 £m	2015 £m
Derivative liabilities carried at fair value through profit or loss (FVTPL)		
Interest rate swaps – not hedge accounted	(936.1)	(1,165.5)
Total derivative financial liabilities	<u>(936.1)</u>	<u>(1,165.5)</u>

The derivative assets and liabilities meet the offsetting criteria in paragraph 42 of IAS 32. This results in the presentation of a net derivative liability of £923.7 million in the statement of financial position.

Changes in value of financial instruments at fair value	2016 £m	2015 £m
Profit for the year has been arrived at after charging/(crediting)		
Financial assets at fair value		
Designated as FVTPL	(1.4)	4.3
Financial liabilities at fair value		
Designated as FVTPL	(69.0)	(134.6)
	<u>(70.4)</u>	<u>(130.3)</u>

The derivative liability has reduced by a further £298.4 million (2015: £5.0 million) due to payment of accrued indexation associated with the swaps.

The fair values of derivative instruments (interest rate swaps) at the reporting date are determined using quoted prices adjusted for credit risk.

The regulatory framework, under which revenues and the RCV are indexed, exposes the company to inflation risk. The company enters into inflation-linked derivative financial instruments to manage its exposure to that risk.

Under interest rate swap contracts, the company agrees to exchange the difference between fixed and floating rate interest amounts calculated on agreed notional principal amounts. Such contracts enable the company to mitigate inflation risk on issued fixed rate debt held.

Notes to the financial statements (continued)

For the year ended 31 March 2016

21 Deferred tax liabilities

Deferred tax is provided as follows

	Accelerated tax depreciation £m	Revaluation of financial instruments £m	Retirement benefit obligations £m	Other- timing differences £m	Total £m
At 1 April 2014	(565.3)	153.2	18.1	(6.2)	(400.2)
(Credit)/charge to income statement	(24.9)	20.7	(0.2)	(1.1)	(5.5)
Charge to other comprehensive income	-	-	7.5	-	7.5
At 1 April 2015	(590.2)	173.9	25.4	(7.3)	(398.2)
(Credit)/charge to income statement	(23.1)	10.0	(6.2)	9.1	(10.2)
Charge to other comprehensive income	-	-	2.8	-	2.8
Effect of change in tax rate					
–income statement	42.8	1.0	(2.2)	(19.6)	22.0
–other comprehensive income	18.6	-	-	-	18.6
At 31 March 2016	(551.9)	184.9	19.8	(17.8)	(365.0)

Deferred tax assets and liabilities are offset where the company has a legally enforceable right to do so. The following is the analysis of the deferred tax balances (after offset) for financial reporting purposes

	2016 £m	2015 £m
Deferred tax liabilities	(641.2)	(590.0)
Deferred tax assets	276.2	191.8
	(365.0)	(398.2)

22 Provision for liabilities**Environmental obligations**

	2016 £m	2015 £m
At 1 April	0.5	0.5
Utilised in year	-	-
At 31 March	0.5	0.5

The environmental provision relates to management's best estimate 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.

Notes to the financial statements (continued)

For the year ended 31 March 2016

23 Other non-current liabilities

	Deferred Revenue	Grants & contributions	Total
	£m	£m	£m
At 1 April 2015	14.9	25.3	40.2
Receivable in year	-	4.8	4.8
Released to income statement	(0.4)	(1.1)	(1.5)
At 31 March 2016	14.5	29.0	43.5

These grants and contributions relate to property, plant and equipment

Deferred revenue £14.5 million (2015 £14.9 million) 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 income statement evenly over the life of the lease.

24 Called up share capital

	2016 £m	2015 £m
Equity shares		
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		
Preference shares		
32,607 Class A1 shares of £1 each	0.0	0.0
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 redeemable preference shares are presented as a liability (see note 19) at an amount of £142.6 million including share premium of £142.5 million and accordingly are excluded from called up share capital in the balance sheet. The total statutory company share premium of £188.8 million includes ordinary share premium of £46.3 million.

Notes to the financial statements (continued)

For the year ended 31 March 2016

25 Share premium account

	Share premium £m
Balance at 1 April and at 31 March	<u>46.3</u>

26 Notes to the statement of cash flows

	2016 £m	2015 £m
Cash generated by operations		
Continuing operations		
Operating profit	284.5	331.5
Adjustments for		
Depreciation of property, plant and equipment	225.9	213.7
Amortisation of intangible assets	8.7	9.1
Difference between pension charge and cash contributions	(31.0)	(16.5)
Amortisation of grants and contributions	(1.1)	(1.0)
Operating cash flows before movements in working capital	<u>487.0</u>	<u>536.8</u>
Increase in inventories	(0.2)	(0.2)
Decrease/(Increase) in receivables	11.8	(16.6)
Decrease in payables	(16.6)	(2.9)
Cash from operating activities	<u>482.0</u>	<u>517.1</u>
Tax paid	(15.1)	(36.9)
Net cash generated from operating activities	<u>466.9</u>	<u>480.2</u>

Notes to the financial statements (continued)

For the year ended 31 March 2016

26 Notes to the statement of cash flows (continued)

Cash and cash equivalents	2016 £m	2015 £m
Cash and bank balances	<u>17.9</u>	<u>173.5</u>
	17.9	173.5

Cash and cash equivalents comprise cash and short-term bank deposits with an original maturity of three months or less. The carrying amount of these assets is equal to their fair value.

Analysis of net debt	At 1 April 2015 £m	Cash flow £m	Other non-cash changes £m	At 31 March 2016 £m
Cash and cash equivalents	<u>173.5</u>	<u>(155.6)</u>	-	<u>17.9</u>
Derivative financial instruments	(1,151.7)	298.4	(70.4)	(923.7)
Debt issue costs	19.8	0.2	(1.9)	18.1
Gilt lock proceeds	(5.3)	-	0.2	(5.1)
Borrowings due within one year	(40.7)	(50.0)	-	(90.7)
Borrowings due after one year	(3,580.2)	(60.0)	(1.3)	(3,641.5)
Finance leases	(1.8)	0.2	0.1	(1.5)
Net debt	<u>(4,586.4)</u>	<u>33.2</u>	<u>(73.3)</u>	<u>(4,626.5)</u>

Balances at 31 March 2016 comprise:	Non- current assets £m	Current assets £m	Current liabilities £m	Non- current liabilities £m	Total £m
Cash and cash equivalents	-	<u>17.9</u>	-	-	<u>17.9</u>
Derivative financial instruments	-	-	-	(923.7)	(923.7)
Debt issue costs	-	-	1.9	16.2	18.1
Gilt lock proceeds	-	-	(0.1)	(5.0)	(5.1)
Borrowings due within one year	-	-	(90.7)	-	(90.7)
Borrowings due after one year	-	-	-	(3,641.5)	(3,641.5)
Finance leases	-	-	-	(1.5)	(1.5)
Net debt	-	<u>17.9</u>	<u>(88.9)</u>	<u>(4,555.5)</u>	<u>(4,626.5)</u>

The non-cash movement of £73.3 million relates to an increase in debt as a result of indexation, movements on the fair value of derivatives, plus the amortisation of loan issue costs, gilt lock proceeds, deferred proceeds and a reduction in finance lease obligations.

Loans due within one year relate to loans from group undertakings that are repayable on demand (see note 19).

Notes to the financial statements (continued)

For the year ended 31 March 2016

27 Pensions

The deficit associated with retirement benefit obligations has decreased to £102.3 million (2015: £115.3 million) as a result of an increase in the yields of AA-rated corporate bonds which increase the discount rate used to calculate the value of pension scheme liabilities, offset by lower asset returns than expected.

Pension schemes operated

The company principally operates one defined benefit pension scheme (final salary) and one defined contribution scheme, 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 Trustees are responsible for administering the Fund which is held separately from 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). The company directors are responsible for setting the accounting assumptions for the fund for inclusion in these financial statements.

The main risks of the scheme are as follows:

a) Asset volatility

For the purpose of setting the contribution requirements, the calculation uses a discount rate set with reference to government bond yields, with allowance for additional return to be generated from the investment portfolio – whereas under FRS 101, the defined benefit obligation is calculated using a discount rate set with reference to corporate bond yields.

The schemes hold a significant proportion of their assets in growth assets. The returns on these assets may be volatile and are not correlated to the value placed on the liabilities. This means that the deficit may be volatile in the shorter term, which may result in an increase in the contribution requirements and an increase in the net defined benefit liability recorded on the balance sheet. However, the company believes that return-seeking assets offer an appropriate level of return over the long term for the level of risk that is taken. Furthermore, the scheme's other assets are well-diversified by investing in a range of asset classes, including liability driven investments, government bonds and corporate bonds.

b) Changes in bond yields

A fall in bond yields increases the value placed on the liabilities for reporting purposes and for setting the company's contribution requirements. However, in this scenario the scheme's investment in corporate and government bonds is expected to increase and therefore offset some of the increase in the value placed on the liabilities.

c) Life expectancy

The majority of the scheme's obligations are to provide benefits for the life of the member, so increases in life expectancy will result in an increase in the scheme's liabilities. This is particularly significant where the longer duration and inflation-linked nature of the payments result in higher sensitivity to changes in life expectancy. The scheme does not contain a hedge against increases in future life expectancy.

Notes to the financial statements (continued)

For the year ended 31 March 2016

27 Pensions (continued)

d) Inflation risk

The majority of the scheme's benefit obligations are linked to inflation and higher out-turn inflation will lead to a higher benefit obligation (although in most cases caps on the level of inflationary increases are in place to protect the plan against extreme inflation) The majority of the schemes' assets do not provide a direct hedge against changes in inflation as they are either fixed-interest in nature e.g. corporate bonds and government bonds, or have an indirect link to inflation e.g. equities

- 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 2016 amounted to £2.3 million (2015: £2.0 million). No contributions were outstanding at either 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 2013 using the projected unit method. For closed schemes under this method the current service cost will increase as the members of the schemes approach retirement. The assumptions that have the most significant effect on the results of the valuation are those relating to the rate of return on investments, and the level of inflation, which drives pension increases in the SWPS.

Notes to the financial statements (continued)

For the year ended 31 March 2016

27 Pensions (continued)

The principal assumptions in the valuation were as follows

	2013 SWPS % per annum (pa)
Return on investments pre-retirement	FI Gilt
Return on investments post-retirement (pensioner/non-pensioner)	curve + 65 bps
Salary growth	2.5%
Pension increases on the excess over guaranteed minimum pensions (where capped at 5% pa)	2.75%

The term 'FI Gilt curve' refers to the generally available fixed interest gilt yield curve agreed by the Trustees and the company for the purposes of the 2013 actuarial valuation

The assets of the scheme had a market value of £574.5 million at 31 March 2013. This was sufficient to cover 77 per cent of the scheme's benefits. The duration of the scheme liabilities is 21 years.

Expected employer and employee contributions to the defined benefit scheme for 2016-17 are £6.1 million and £0.2 million respectively under the current Schedule of Contributions.

IAS 19 – assumptions, asset, liability and reserves disclosures

The formal actuarial funding valuation was carried out as at 31 March 2013 and updated to 31 March 2016 by a qualified independent actuary. The major assumptions used by the actuary are set out in the table below.

	2016 % pa	2015 % pa
Price inflation (RPI)	3.0	3.0
Price inflation (CPI)	2.0	2.0
Rate of increase in salaries (plus an age-related promotional scale)	2.5	2.5
Rate of increase of pensions in payment (MIS* members only)***	2.0	2.0
Rate of increase of pensions in payment (Old section** members only)***	3.0	3.0
Rate of increase of pensions in payment (all other members)***	2.9	2.9
Rate of increase for deferred pensions (MIS* members only)***	2.0	2.0
Rate of increase for deferred pensions (all other members)***	2.9	2.9
Discount rate	3.6	3.4

* MIS refers to the Southern Water Mirror Image Pension Scheme. Pensions in payment and deferral 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 five per cent per annum cap on increases that apply to other sections of the Scheme.

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

Notes to the financial statements (continued)

For the year ended 31 March 2016

27 Pensions (continued)

Assumptions regarding future mortality experience are set based on advice, published statistics and experience. For 2015–16, the company has used the post-retirement mortality assumptions based on the standard SAPS mortality tables together with future improvements in line with CMI 2014 improvements with a long-term improvement rate of 1.25 per cent per annum.

	2016 Years	2015 Years
Longevity at age 65 for current pensioners		
Male	23.0	23.0
Female	25.1	25.1
Longevity at age 65 for future pensioners		
Male	24.8	24.7
Female	27.0	27.0

The assets and liabilities in the schemes and the expected rates of return at 31 March 2016 and 31 March 2015 were

	Value at 2016 £m	Value at 2015 £m
Equities	171.5	282.2
Government bonds	196.2	159.1
Non-government bonds	266.3	208.8
Cash	40.1	23.9
Total market value of plan assets	674.1	674.0
Total value of plan liabilities	(776.4)	(789.3)
Accrued deficit in the plan	(102.3)	(115.3)
Related deferred tax asset	19.8	25.4
Net pension liability	(82.5)	(89.9)

The equity investments and bonds which are held in plan assets are quoted and are valued at the current bid price.

Reconciliation of the present value of the scheme liabilities	2016 £m	2015 £m
At 1 April	789.3	671.9
Current service cost	5.4	4.8
Interest expense	26.4	29.8
Member contributions	0.2	0.2
Actuarial (gain)/loss on liabilities		
due to changes in demographic assumptions	10.0	(1.7)
due to changes in financial assumptions	(27.1)	109.8
Benefits paid	(27.8)	(25.5)
Scheme liabilities at 31 March	776.4	789.3

Notes to the financial statements (continued)

For the year ended 31 March 2016

27 Pensions (continued)**Sensitivity analysis of the scheme liabilities**

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

	Change in assumption	Impact on scheme liabilities (%)	Impact on scheme liabilities (£m)
Discount rate	+/- 1%	-/+ 15	-/+ 116
Rate of inflation*	+/- 1%	+/- 13	+/- 101
Rate of increase in pensions in payment	+/- 1%	+/- 11	+/- 85
Mortality	+/- 1yr	+/- 3	+/- 23

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

The above sensitivity analysis is based on a change in an assumption while holding all other assumptions constant. In practice, this is unlikely to occur, and changes in some of the assumptions may be correlated. The methods and types of assumptions used in preparing the sensitivity analysis did not change compared to the previous period.

Reconciliation of the value of the scheme assets	2016	2015
	£m	£m
At 1 April	674.0	581.5
Interest income	22.5	25.8
(Loss)/gain on assets above interest	(31.1)	70.7
Employer contributions	37.2	23.4
Member contributions	0.2	0.2
Benefits paid	(27.8)	(25.5)
Administrative expenses	(0.9)	(2.1)
Bid value of scheme assets at 31 March	674.1	674.0

The total (loss)/return on scheme assets was (£9.5) million (2015: £94.4 million)

Total cost recognised as an expense	2016	2015
	£m	£m
Current service cost	5.4	4.8
Net interest cost	3.9	4.0
Administration expenses	0.9	2.1
Total income statement expense before deduction for tax	10.2	10.9
Analysis of the amounts recognised in other comprehensive income	2016	2015
	£m	£m
Actual return less expected return on pension scheme assets	(31.1)	70.7
(Loss)/gain due to changes in demographic assumptions	(10.0)	1.7
Gain/(loss) due to changes in financial assumptions	27.1	(109.8)
Total loss recognised in OCI before adjustment for tax	(14.0)	(37.4)

The cumulative amount of actuarial losses recognised in other comprehensive income is £193.5 million (2015: £179.5 million)

Notes to the financial statements (continued)

For the year ended 31 March 2016

27 Pensions (continued)

Analysis of the movement in the schemes' deficit during the year	2016	2015
	£m	£m
Deficit in the scheme at 1 April	(115.3)	(90.4)
Employer's contributions	37.2	23.4
Employer's current service cost	(5.4)	(4.8)
Financing charge on net balance sheet position	(3.9)	(4.0)
Administration expenses	(0.9)	(2.1)
Actuarial loss	(14.0)	(37.4)
Deficit in the scheme at end of year	(102.3)	(115.3)

28 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 (2015: £nil).

29 Financial commitments

(a) Capital commitments are as follows

	2016	2015
	£m	£m
Contracted for but not provided for in respect of contracts placed	<u>193.8</u>	<u>113.3</u>

(b) The company as lessee

	2016	2015
	£m	£m
Lease payments under operating leases recognised as an expense in the year	3.9	3.8

As at 31 March 2016 and 2015, the company had annual commitments under non-cancellable operating lease agreements in respect of vehicles and land and buildings for which the payments fall due as follows

	Land and Buildings		Other	
	2016	2015	2016	2015
	£m	£m	£m	£m
Expiring within one year	1.7	1.6	0.2	0.2
Expiring between two and five years	6.3	6.2	0.4	0.4
Expiring after more than five years	14.5	16.1	0.1	-
	<u>22.5</u>	<u>23.9</u>	<u>0.7</u>	<u>0.6</u>

Operating leases are charged to the income statement over the lease term.

Notes to the financial statements (continued)

For the year ended 31 March 2016

30 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 (GSH), a company incorporated in Jersey

The major shareholders in GSH as at 31 March 2016 are IIF International SW UK Investments Limited (managed by JP Morgan Investments Inc) and The Northern Trust Company

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

The company has taken advantage of the exemption under FRS 101 'Reduced Disclosure Framework' in not disclosing details of transactions with other companies which are 100 per cent wholly owned, equivalent disclosures are given in the group financial statements of GSH

Notes to the financial statements (continued)

For the year ended 31 March 2016

31 Explanation of transition to FRS 101

This is the first period the company has presented its financial statements under FRS 101 issued by the Financial Reporting Council. The last financial statements prepared under the previous UK accounting framework were for the year ending 31 March 2015. The date of transition was 1 April 2014 and all comparative information in these financial statements has been restated to reflect the company's adoption of FRS 101, except where otherwise required or permitted by IFRS 1.

The following disclosures are required in the period of transition

Reconciliation of statement of financial position at 1 April 2014

Notes	UK GAAP £m	Fair value of property, plant and equipment £m	Property, plant and equipment £m	Borrowing costs £m	Financial instruments £m	Other £m	Restated under FRS 101 £m
		i	ii	iii	iv	v	
Intangible assets	-	-	-	-	-	34 0	34 0
Property, plant and equipment	4,432 0	961 6	4 9	168 5	-	(34 0)	5,533 0
Other non-current assets	812 3	-	-	-	-	-	812 3
Investments	29 2	-	-	-	-	-	29 2
Current assets and liabilities							
Cash and cash equivalents	135 5	-	-	-	-	-	135 5
Other current assets	200 0	-	-	-	-	-	200 0
Current liabilities	(300 6)	-	-	-	-	(1 8)	(302 4)
Non-current liabilities							
Borrowings	(3,821 1)	-	-	-	265 0	1 6	(3,554 5)
Derivative financial instruments	-	-	-	-	(1,026 4)	-	(1,026 4)
Deferred tax liabilities	(314 2)	(192 3)	(7 8)	(33 7)	153 2	(6 5)	(401 3)
Retirement benefit obligations	(72 3)	-	-	-	-	(18 1)	(90 4)
Provisions for liabilities	(0 5)	-	-	-	-	-	(0 5)
Other non-current liabilities	(59 1)	-	29 4	-	-	-	(29 7)
Total net assets	1,041 2	769 3	26 5	134 8	(608 2)	(24 8)	1,338 8
Capital and reserves							
Called up share capital	0 1	-	-	-	-	-	0 1
Share premium account	46 3	-	-	-	-	-	46 3
Revaluation reserve	-	769 3	-	-	-	-	769 3
Retained earnings	994 8	-	26 5	134 8	(608 2)	(24 8)	523 1
Total shareholder's equity	1,041 2	769 3	26 5	134 8	(608 2)	(24 8)	1,338 8

Notes to the financial statements (continued)

For the year ended 31 March 2016

31 Explanation of transition to FRS101 (continued)

Reconciliation of statement of financial position at 31 March 2015

Notes	UK GAAP £m	Fair value of property, plant and equipment £m I	Property, plant and equipment £m II	Borrowing costs £m III	Financial instruments £m IV	Other £m V	Restated under FRS 101 £m
Intangible assets	-	-	-	-	-	42.9	42.9
Property, plant and equipment	4,483.0	946.6	45.0	168.5	-	(42.9)	5,600.2
Other non-current assets	812.3	-	-	-	-	-	812.3
Investments	29.2	-	-	-	-	-	29.2
Current assets and liabilities							
Cash and cash equivalents	173.5	-	-	-	-	-	173.5
Other current assets	219.0	-	-	-	-	3.7	222.7
Current liabilities	(246.5)	-	-	-	-	(1.5)	(248.0)
Non-current liabilities							
Borrowings	(3,857.8)	-	-	-	286.9	1.6	(3,569.3)
Derivative financial instruments	-	-	-	-	(1,151.7)	-	(1,151.7)
Deferred tax liabilities	(336.8)	(189.3)	(12.3)	(33.7)	173.0	0.9	(398.2)
Retirement benefit obligations	(89.9)	-	-	-	-	(25.4)	(115.3)
Provisions for liabilities	(0.5)	-	-	-	-	-	(0.5)
Other non-current liabilities	(56.3)	-	16.1	-	-	-	(40.2)
Total net assets	1,129.2	757.3	48.8	134.8	(691.8)	(20.7)	1,357.6
Capital and reserves							
Called up share capital	0.1	-	-	-	-	-	0.1
Share premium account	46.3	-	-	-	-	-	46.3
Revaluation reserve	-	757.3	-	-	-	-	757.3
Retained earnings	1,082.8	-	48.8	134.8	(691.8)	(20.7)	553.9
Total shareholder's equity	1,129.2	757.3	48.8	134.8	(691.8)	(20.7)	1,357.6

Notes to the financial statements (continued)

For the year ended 31 March 2016

31 Explanation of transition to FRS101 (continued)

Reconciliation of profit for the year ended 31 March 2015

	UK GAAP	Fair value of property, plant and equipment	Property, plant and equipment	Borrowing costs	Financial instruments	Other	Restated under FRS 101
	£m	£m	£m	£m	£m	£m	£m
Notes		i	ii	iii	iv	v	
Revenue	828.6	-	7.4	-	-	(9.8)	826.2
Other operating income	0.2	-	1.0	-	-	-	1.2
Operating costs	(500.5)	(15.2)	18.7	(6.7)	-	7.8	(495.9)
Operating profit	328.3	(15.2)	27.1	(6.7)	-	(2.0)	331.5
Profit on disposal of fixed assets	1.3	-	-	-	-	-	1.3
Net finance costs	(125.7)	-	-	6.7	(103.5)	0.3	(222.2)
Profit before taxation	203.9	(15.2)	27.1	-	(103.5)	(1.7)	110.6
Tax on profit on ordinary activities	(36.7)	3.0	(5.4)	-	20.7	1.4	(17.0)
Profit after taxation from continuing operations	167.2	(12.2)	21.7	-	(82.8)	(0.3)	93.6
Other comprehensive loss							
Items that cannot be reclassified to profit or loss							
Actuarial loss on pension scheme	(42.9)	-	-	-	-	5.5	(37.4)
Movement on deferred tax in relation to pension liability	8.6	-	-	-	-	(1.1)	7.5
Total other comprehensive loss for the year, net of tax	(34.3)	-	-	-	-	4.4	(29.9)
Total comprehensive income for the year	132.9	(12.2)	21.7	-	(82.8)	4.1	63.7

Notes to the reconciliations**(i) Revaluation of property, plant and equipment**

Under IFRS 1 'First-time adoption of International Financial Reporting Standards', the company has elected to measure its infrastructure and operational assets at 1 April 2014, being the date of transition to FRS 101, at their fair value and to use that fair value as their deemed cost at that date

The fair value was estimated based on the Regulatory Capital Value (RCV) plus a premium based on numerous recent transactions that have taken place in the water industry and allocated to those assets to be re-valued

A fair value attributed to net assets was then derived from the total fair value by deducting the book value of debt and cash items. Finally, the resultant value was attributed to the elements of net assets leaving the residual value to be attributed to the property, plant and equipment

Impact

At the date of transition, the value of property, plant and equipment has been increased by £961.6 million, the majority of which is attributable to infrastructure assets

At 31 March 2015, the impact was to increase property, plant and equipment by £946.6 million and to increase deferred tax liabilities by £189.3 million. The impact on profit for the year to 31 March 2015 was to increase the depreciation charge by £15.2 million, with a deferred tax credit of £3.0 million.

(ii) Property, plant and equipment (IAS 16 and IAS 38)

Infrastructure assets

Previously, the company's water and wastewater assets were accounted for in accordance with the renewals accounting provisions of Financial Reporting Standard 15 'Tangible Fixed Assets'. Under renewals accounting, the water and wastewater infrastructure networks were assumed to be single assets. Expenditure on infrastructure assets relating to increase in capacity or enhancements to the networks and on maintaining the operating capability of the networks in accordance with defined standards of service was capitalised. The depreciation charged was the estimated level of annual expenditure required to maintain the operating capability of the networks. Grants and contributions relating to the maintenance of the operating capability of the infrastructure network were taken into account when determining this charge. Grants and contributions relating to the enhancement of the infrastructure network were deducted from the costs of fixed assets.

Renewals accounting is not permitted under International Accounting Standard 16 'Property, plant and equipment' (IAS 16). The carrying value of infrastructure assets has therefore been re-valued at fair value as described above on page 141.

The infrastructure network has been broken down into a number of significant parts based on the type of pipe or structure and its location. Broadly this has resulted in the following significant parts: impounding reservoirs, local and trunk mains, wastewater tunnels and outfalls, sewers and ancillary structures. These have all been assigned residual values of nil and are being depreciated over 10 to 200 years.

From 1 April 2014, infrastructure expenditure that meets the recognition criteria for property, plant and equipment has been capitalised at cost and depreciated over its expected life. Expenditure relating to repair or maintenance has been expensed.

Historic infrastructure receipts previously presented as deductions from infrastructure cost under UK GAAP have been transferred to reserves on transition to IFRS on the basis that they do not relate to a specific asset. From 1 April 2014, these receipts have been recorded as revenue.

From 1 April 2014, infrastructure grants and contributions previously presented as deductions from infrastructure cost under UK GAAP have been allocated to deferred income and amortised over the expected useful lives of the related assets.

Under UK GAAP, no value was recognised for assets transferred or adopted from developers or other third parties at nil consideration. IFRIC 18 'Transfers of Assets from Customer' requires that when an item is transferred from a customer, and it meets the definition of an asset, then it should be recognised at fair value within property, plant and equipment. The deferred credit arising on the adoption of the asset is recognised as other income over the life of the relevant asset.

There are no significant differences between UK GAAP and IFRS in respect of all other fixed assets, including water and water recycling non-infrastructure assets, other than the separate classification of certain assets as intangibles rather than tangible assets in accordance with IAS 38 'Intangible Assets'.

Impact

Reclassifying the historic infrastructure receipts under FRS 101 has resulted in an increase in net assets of £81.2 million and a decrease of £29.4 million in deferred creditors as at 31 March 2014, with a further net £5.5 million transferred to the income statement for 2014–15.

Under UK GAAP, the difference between the cumulative infrastructure renewals expenditure and that charged to the profit and loss account as depreciation (IRC) was held as a prepayment in fixed assets of £76.3 million. As this value does not represent an asset under FRS 101 it has been written off to reserves on transition.

Notes to the financial statements (continued)

For the year ended 31 March 2016

31 Explanation of transition to FRS101 (continued)

ii) Property, plant and equipment (IAS 16 and IAS 38) (continued)

At 31 March 2015, the value of adopted assets recognised in accordance with IFRIC 18 since the date of transition was £6.9 million, with a corresponding credit to other non-current liabilities. In addition grants and contributions received of £4.4 million were transferred to deferred creditors.

As at 31 March 2015, under FRS 101, the annual depreciation charge of infrastructure assets (excluding the fair value depreciation) plus the maintenance costs expensed together with changes to the infrastructure assets qualifying for capitalisation was £21.7 million lower than the total of renewals expenditure recorded under UK GAAP.

(iii) Borrowing costs

Under FRS 101, the company is required to capitalise an element of borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets as part of the costs of that asset. Borrowing costs are capitalised when incurred for the construction of any qualifying assets during the period of time that is required to complete and prepare the asset for its intended use.

Previously, under UK GAAP, borrowing costs were fully expensed as incurred. The change in policy under IFRS has been applied retrospectively with an effective date of 1 April 2003, reflecting the point at which the company was securitised and financed by loans.

Impact

As a result of the retrospective application of IAS 23 'Borrowing Costs', net assets increased by £134.8 million for the year ending 31 March 2014. During 2014–15 borrowing costs of £6.7 million were capitalised and a total of £6.7 million of capitalised borrowing costs was charged as depreciation.

(iv) Financial instruments

Under FRS 101, the company must apply IAS 39 'Financial Instruments: Recognition and Measurement' (IAS 39).

The most significant aspect of applying IAS 39 is in relation to derivatives, principally interest rate swaps on index-linked bonds that are held to protect against the company's exposure to inflation risk.

Under IAS 39, the fair value of these derivatives must be recognised on the statement of financial position, with fair value movements being recognised in the income statement unless cash flow hedge accounting is applied. This has the potential to introduce considerable volatility to the income statement and the statement of financial position.

Also under IAS 39, the general treatment of debt is for it to be carried at amortised cost, such that borrowings are stated at net proceeds received after the deduction of issue costs. Under UK GAAP, the issue costs of debt instruments are amortised at a constant rate over the life of the instrument, whereas under IFRS, the costs are amortised using the 'effective interest rate' method.

Impact

As a result of applying IAS 39, a liability for derivative financial instruments of £1,151.7 million was recorded at 31 March 2015 (31 March 2014: £1,026.4 million). In addition, the capitalised RPI on fixed rate swaps at 31 March 2015 of £282.4 million was transferred from borrowings to derivative financial instruments (31 March 2014: £260.6 million). The impact of recording debt at amortised cost reduced borrowings by £4.5 million at 31 March 2015 (31 March 2014: £4.4 million).

Notes to the financial statements (continued)

For the year ended 31 March 2016

31 Explanation of transition to FRS101 (continued)

(v) Other

Other adjustments arising from the transition relate to pensions, deferred tax and revenue

The pension deficit is presented at its gross value, with the associated deferred tax asset of £25.4 million at 31 March 2015 (31 March 2014 £18.1 million) being transferred to offset the deferred tax liability

In 2014–15 finance costs relating to the pension deficit increased by £3.4 million. This change results from the revised presentation of administrative expenses and changes to the calculation for finance costs under IAS 19 'Employee Benefits'. These changes reclassify £2.1 million as operating costs, reducing the finance charge offset by an increase in the finance charge of £5.5 million. The increase in the finance charge of £5.5 million is offset by an equal movement through the statement of other comprehensive income.

As a result of differences in the treatment timing and temporary differences, an adjustment has been made to deferred tax for assets that previously qualified for industrial buildings allowance of £23.7 million at 31 March 2015 (31 March 2014 £24.6 million).

In 2014–15, both revenue and the bad debt provision have been reduced by £13.3 million on the basis that it is probable that economic benefits will not be received from these charges. In addition, a further £3.5 million of income from electricity generation, previously offset within operating costs, has been re-classified as revenue. Fees associated with arranging a new loan facility of £3.7 million, which had been expensed, have been transferred to current assets to be amortised over the life of the facility.

In 2014–15 intangible assets of £42.9 million (31 March 2014 £34.0 million) have been presented as a separate item on the statement of financial position (SOFP). Previously these assets were recorded within property, plant and equipment. Upon transition to FRS 101 these assets have been identified as meeting the recognition criteria of IAS 38 'Intangible Assets'.

In addition to the adjustment referred to in note (iv) another ramification of adopting IAS 39 has meant that fixed rate bond instruments must be carried at amortised cost using the effective interest rate method. As a result, debt issue costs previously capitalised and held separately on the SOFP are now deducted from the related debt instruments with effective interest being charged to the income statement. Previously these debt issue costs were amortised on a straight-line basis in accordance with the life of the related loan. This has resulted in £1.6 million (31 March 2014 £1.6 million) of long-term debt being reclassified as due within one year.

(vi) Cash flow

The changes made to the cash flow statement reflect the presentational impact of the transition adjustments outlined above.

32 Post balance sheet events

Following careful consideration of the options available to us regarding the opening of the non-household retail market, the company has entered into a transaction to dispose of its non-household retail business function with effect from 1 April 2017. A reasonable estimate of the financial effect cannot currently be made as the terms of the sale are subject to conditions at 31 March 2017.

In addition to the above, one of the major shareholders of Greensands Holdings Limited (GSH), being The Northern Trust Company, sold their shares in GSH, the ultimate parent company, after the reporting date. The shares were acquired by existing shareholders under the pre-emption arrangements on 19 May 2016.

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 2016 which comprise the Income Statement, Statement of Other Comprehensive Income, Statement of Financial Position, Statement of Changes in Equity and the Cash Flow Statement and the related notes 1 to 32. 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), including FRS 101 'Reduced Disclosure Framework'.

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 Directors' Responsibilities Statement, 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 and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. 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 2016 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, based on the work undertaken in the course of the audit

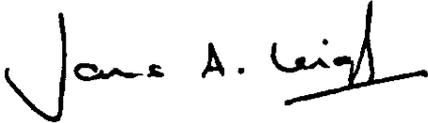
- the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements, and
- the Strategic Report and the Directors' Report have been prepared in accordance with applicable legal requirements.

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified any material misstatements in the Strategic Report and the Directors' Report.

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 Auditor
London, United Kingdom

30 June 2016