



# **Southern Water Services Limited Annual Report and Financial Statements 2016–17**

Committed to our customers

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**Registered office**  
 Southern House  
 Yeoman Road  
 Worthing  
 West Sussex  
 BN13 3NX

Registered no. 02366670

# About us

## Our business

We are proud to deliver water and wastewater services to more than 4.6 million customers across the South East.

We aim to be a leader in our sector, achieving this by:

- providing a proactive service, which satisfies expectations and builds trust with our customers
- supporting the most vulnerable members of our communities
- working in partnership with our customers to ensure future water resources by continuing to reduce water usage and leakage across our network
- building better relationships with community organisations and stakeholders to ensure we maximise every opportunity to provide a more tailored service to our customers
- embracing technology, adapting and evolving our infrastructure and the services we offer to ensure they meet both the existing and future needs of our customers, in an affordable way
- taking steps to improve our relationship with the environment we rely on and planning our future investments so they increase the wide range of benefits that we derive from nature.



<b>Water</b>	
People served, millions	2.5
Number of properties, millions	1.1
Number of metered properties	984,656
Average daily water supply, millions of litres per day	532
Number of service reservoirs	188
Number of water treatment works	91
Length of water mains, kilometres	13,870

<b>Wastewater</b>	
People served, millions	4.6
Number of properties, millions	2.0
Average daily wastewater recycled, millions of litres per day	717
Length of sewers, kilometres	39,594
Number of wastewater treatment works	365
Number of pumping stations	3,243

<b>Finance</b>	<b>2016–17</b>	<b>2015–16</b>
Turnover <sup>1</sup>	<b>£809.7m</b>	£803.7m
Operating profit	<b>£258.9m</b>	£284.5m
Profit before interest and tax	<b>£259.3m</b>	£284.9m
(Loss)/profit for the financial year <sup>2</sup>	<b>(£175.7m)</b>	£119.9m
Capital investment	<b>£341.4m</b>	£241.2m
Non-current assets (excluding debt)	<b>£5,774.9m</b>	£5,678.8m
Return on capital employed (ROCE) <sup>3</sup>	<b>4.7%</b>	5.1%
Average water and wastewater customer bill	<b>£412</b>	£418

<sup>1</sup> Non-appointed activities (these are not regulated by our licence but related to our business, such as property search information) were 1.2% of our statutory turnover.

<sup>2</sup> The loss of £175.7m for the year (2016: profit of £119.9m) was as a result of the fair value movement on derivative financial instruments, further information can be found on page 56.

<sup>3</sup> ROCE is presented as the ratio of profit before interest and tax to non-current assets excluding debt less current liabilities.

## A year in review

- Nearly 90% of customers now have a meter. As a direct result of metering and our water efficiency programme, we continue to exceed our target of reducing per capita consumption, achieving 131 litres per person, per day during 2016–17.
- We completed a total of more than 4,900 free water saving home visits for customers in 2016–17.
- We have the lowest average water supply bill of all the 10 major water and sewerage companies in England and Wales for 2016–17.
- Despite historically recording one of the lowest leakage levels of any of the water and sewerage companies in the UK, we continue to set ourselves stretching targets. As a result we missed our target for this year, although we remain on track to hit our five-year leakage commitment.
- For the 18<sup>th</sup> consecutive year we have achieved the Royal Society for the Prevention of Accidents' gold award for health and safety.
- We have reduced the number of written complaints we received during 2016–17 by 47%, while escalated complaints fell by 71%.
- We improved our customer satisfaction score or Service Incentive Mechanism score, achieving 78, an improvement on 73 for 2015–16. We achieved a position of 16<sup>th</sup> out of 18 companies in industry league tables in terms of Ofwat's customer satisfaction survey.
- We were the ninth most improved company in terms of customer satisfaction out of 244 organisations, according to the Institute of Customer Service.
- Our proactive contact team has spoken to more than 100,000 customers throughout the year, identifying problems before they become a concern.
- Our target for 2016–17 was to increase the number of customers who had received help to pay their bills and manage their debt to 149,000. We significantly exceeded this figure, providing more than 194,000 customers with financial assistance and debt advice.
- We increased the number of 'excellent' bathing waters in our region to 51 from last year's total of 43. We were aiming for 54 in total so bathing water enhancement will continue to be a key focus in 2017–18.
- Despite missing our targets for 2016–17, we have continued to reduce sewer flooding on our network. Both internal and external flooding incidents are down on 2015–16 – internal reduced from 492 to 448, with external flooding down from 8,314 to 8,009 during 2016–17.
- We have set a new 100% record for recycling – none of the sludge waste produced at our wastewater sites has been sent to landfill since 2014 and no grit and screenings since July 2016.
- We have launched a new community grant scheme, to help those directly affected by our activities.
- We are ahead of our promise commitment to increase the amount of renewable energy we use across our operations to 15%, recording a figure of 17% during 2016–17.
- Overall, we have not incurred any Ofwat ODI rewards or penalties in 2016–17 for our performance commitments.
- We have started a programme of enhancing our processes to ensure our ongoing reporting to DWI, the Environment Agency and Ofwat responds to feedback received.

### Customer feedback:

"Thank you and indeed everyone at Southern Water who have been exceptionally helpful over the past few months in finding the leak over some half a mile of pipework. Throughout, yourself and others at Southern Water have been exceptionally helpful, good natured and instructive and this really is enormously appreciated."

#### **Sir Frederick Hervey-Bathurst, Stockbridge, Hampshire**

"The lip reading skill gives students confidence in leading their every day lives, handling transactions and conversations, following plays on television and helping them to feel less excluded from society. The grant has not only enabled us to continue but to find new members, be able to plan outings and plan additional evening classes. I feel sure that the lip reading classes not only give confidence but extend life and ward off dementia. We are looking to the future not just struggling to exist."

#### **Heather Wilson – Chairperson of Lancing and Southwick Lip Reading Group, recipients of a Southern Water Community Grant, West Sussex**

“They were really good, they came at a set time, sent a text to say they were on their way! They have potentially reduced our water intake by some 34%, saving us approximately £300+ per year. We didn't pay a penny; it's well worth doing.”

**Debbie Stevens, Worthing, West Sussex**

## Our promises



### Responsive customer service

- Quick and effective resolution of your queries – 90 per cent resolved first time by 2020
- Improved service to you and your community – increase the number of customers who feel our service meets their individual needs and those of their community
- Improved ranking in our regulator's league table for customer satisfaction – be among the best by 2020
- Direct compensation paid if we let you down – this will be linked to the service standards set out in our updated Customer Charter



### Looking after the environment

- No 'serious pollution incidents' affecting local rivers, streams and beaches caused by our operations by 2020
- Aim for 100 per cent compliance by our wastewater treatment works with required standards – at least maintain performance at 98.6 per cent (2014–15 target level)
- Increase by seven the number of beaches with 'excellent' bathing water quality by 2020
- Increase the proportion of renewable energy we use to 16.5 per cent 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



### A constant supply of high-quality drinking water

- No restrictions on water use, such as hosepipe bans, unless there are at least two dry winters in a row
- Reduce leakage by 2020 – target of 86 million litres a day by 2020, equating to a reduction of almost two million litres a day
- No increase in the average time you are without water, for example because of a burst water main
- Aim for 100 per cent compliance with drinking water quality standards – at least maintain performance of 99.93 per cent then 99.95 per cent from 2017–18
- No increase in the number of households suffering from persistent low water pressure
- Help reduce the effect of hard water in homes and businesses – increased customer understanding through better information and advice



### Better information and advice

- Ten per cent reduction (15 litres per person, per day) in average water use by 2020 with better advice on saving water, energy and money – we will reduce average water use from 148 litres (2012–13) to 133 litres per person, per day\*
- Improved advice on how to prevent blocked drains to help reduce blockages – increase the number of customers who know how to help prevent blockages in drains and sewers
- A 50 per cent reduction in bill queries by 2020
- Customers provided with better information about what we do, why we do it and what it costs – increase the number of customers who understand how we use the money they pay us



### Removing wastewater effectively

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



### Affordable bills

- Efficiency savings made during 2015–20 to help keep bills as low as possible
- Ten per cent reduction (15 litres per person, per day) in average water use by 2020 with better advice on saving water, energy and money – this will reduce average water use from 148 litres (2012–13) to 133 litres per person, per day\*
- Customers in genuine financial hardship provided with improved support – increase the proportion of customers who take up the support we offer around bills
- Customers provided with better information on how we are providing value for money – increase the number of customers who feel our services provide value for money

\*Note this promise contributes to both better information and advice and affordable bills

## How we measure our progress

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 below show how we have performed against these targets in 2016–17.

Our Customer Advisory Panel (CAP), regulators and auditors independently monitor this plan – see page 20 for more information on our CAP.

Responsive customer service	Performance 2016–17	Performance 2015–16	Comment
Customer satisfaction Service Incentive Mechanism (SIM) score <sup>1</sup>			Customer satisfaction, measured by our SIM score, has increased for the second year running. Our SIM score for 2016–17 has consistently improved – our performance has seen us move up the industry league tables from 18 <sup>th</sup> to 16 <sup>th</sup> position in terms of Ofwat's customer survey
Percentage of contacts resolved first time			
Percentage of customers who feel our service meets their individual needs <sup>2</sup>		N/A	
Percentage of customers who feel our service meets the needs of their community <sup>2</sup>		N/A	
Number of compensation payments made to customers (Company Charter and Guaranteed Standards Scheme)			

Affordable bills	Performance 2016–17	Performance 2015–16	Comment
Customers in genuine hardship with improved support			Innovative partnerships have enabled us to beat our target, helping more than 194,000 customers over the past two years with financial support to pay their bills.
Percentage of customers who feel our services provide value for money <sup>2</sup>		N/A	

Better information and advice	Performance 2016–17	Performance 2015–16	Comment
Water usage, per capita consumption (litres/head/day)			Improvements in the way we record unwanted customer contact have led to an increase in the number of billing queries reported. Overall, customer contact by phone has reduced, with more than 80,000 customers opting for online account management.
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 <sup>2</sup>		N/A	
Percentage of customers who are aware how their money is used <sup>2</sup>		N/A	
Percentage of customers who are aware of how to deal with hard water <sup>2</sup>		N/A	

<sup>1</sup> We reported in our annual performance report 2015–16 that the call categorisation of unwanted and wanted calls was associated with a degree of subjectivity, and that additional processes and controls were required to further mitigate the risk of call mis-categorisation. We stated that we would put in place an action plan to minimise these issues going forward. Within this regulatory year, we are pleased to report that due to the action plan, the accuracy of our reported unwanted contact volumes has improved over the last quarter of 2016–17. Further actions are planned in the 2017–18 year to continue to improve our reported unwanted contact volumes.

<sup>2</sup> For 2015–16 we refined the customer survey questions we use to measure performance against these promises. We have agreed an update to our final determination with Ofwat and this was published on 3 March 2017. Future performance will be measured against the 2015–16 position on a consistent basis.

A constant supply of high-quality drinking water	Performance 2016–17	Performance 2015–16	Comment
Water quality (Mean Zonal Compliance) (%)			We were disappointed to have missed our leakage target last year to record a final figure for the year of 88.1 million litres per day – the target was 87.1 million litres per day. We remain on track to meet our five-year target to cut leakage by two million litres per day to a total of 86 million litres per day
Number of contacts regarding discolouration per 1,000 population			
Leakage (Ml/day)			
Customer minutes lost supply > 3 hours			
Number of properties with low water pressure			
Number of customers affected by temporary use bans			
Maintain asset health			

Removing wastewater effectively	Performance 2016–17	Performance 2015–16	Comment
Number of blockages per km/year			Our fat, oil and grease campaign has helped reduce the number of blockages. Targeting hotspots will help us reduce flooding further.
Number of internal flooding incidents			
Number of external flooding incidents			
Number of customer complaints regarding odour			
Maintain asset health			

Looking after the environment	Performance 2016–17	Performance 2015–16	Comment
Wastewater treatment works compliance (%) <sup>3</sup>			Despite not meeting our target on distribution input, the amount of water we take from the environment has been steadily decreasing since 2004 when it peaked at 599.27 million litres per day. In five years between 2011 and 2016, we reduced the volume of water we abstract by almost 56 million litres per day
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) (the amount of water put into supply)			
Renewable energy usage			

<sup>3</sup> Our wastewater treatment works compliance and the number of category 3 pollution incidents remain subject to further assurance.

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 some cases we have incurred a penalty for the shortfall.

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

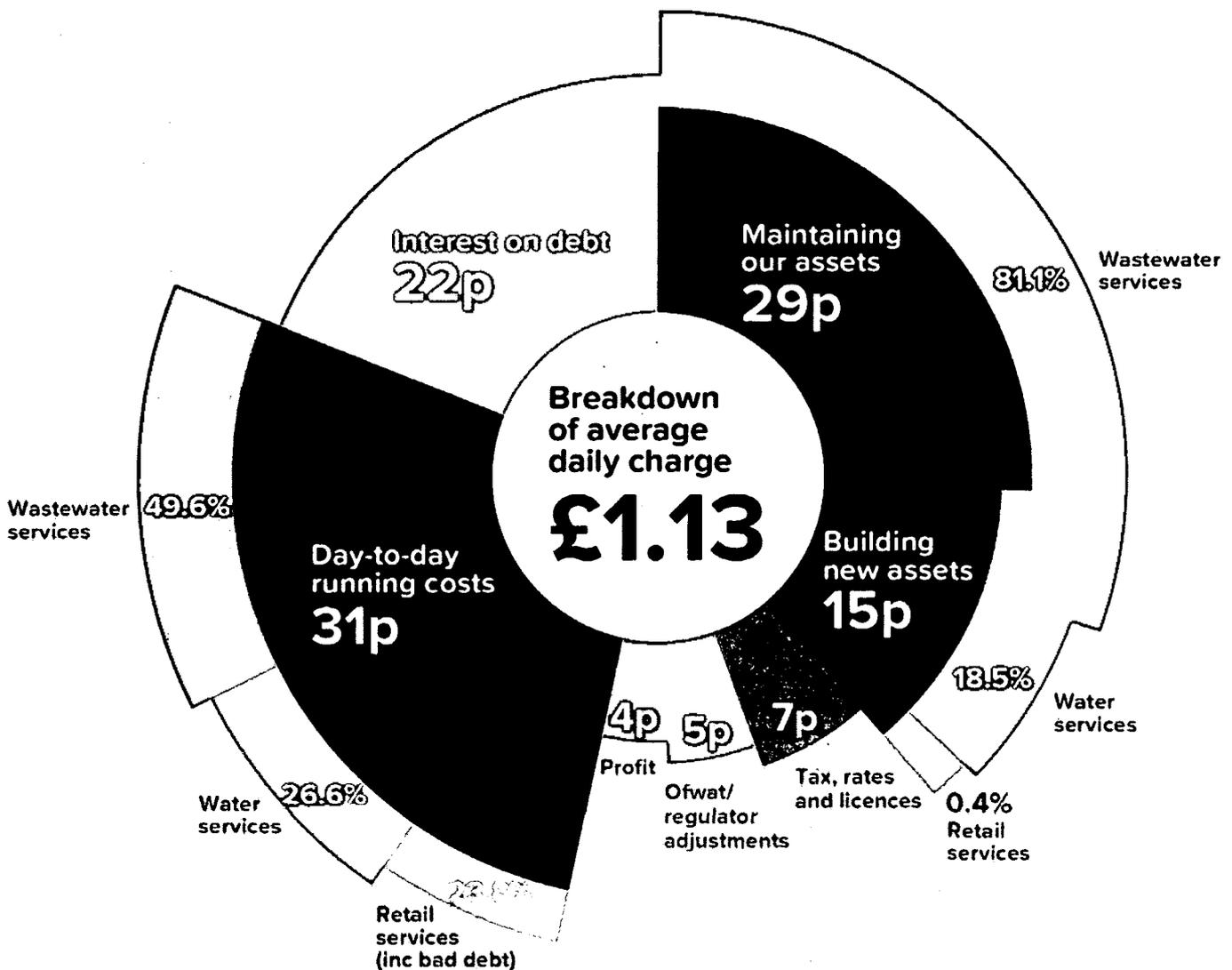
The detailed definition and explanation for red/amber/green on each commitment, together with the potential reward/penalty associated with them, is given in Appendix 2 of the Annual Performance Report – this section of the report is also downloadable from our website: [southernwater.co.uk/annualreport](http://southernwater.co.uk/annualreport).

### Where your money goes

The average bill for household customers who received both water and wastewater services from us during 2016–17 was £412, equivalent to £1.13 per household, per day. This money contributes directly to our £3.2 billion investment for 2015–20 to ensure we deliver the promises we made to our customers in our business plan.

We are committed to keeping our customers informed about where and how their money is spent, so we make a point of including a full breakdown in our annual billing leaflet, each year. Around 56% of our customers agree that they are clear about what we do and how their money is spent.

The diagram below illustrates how an average annual bill contributes to our business, based on 2016–17 figures.



**Day-to-day running costs** – this includes wages, power, chemicals, materials and bad debt\* costs.

\*Bad debt = the cost of providing for unpaid customer charges.

**Interest on debt** – interest on money we have borrowed to finance improvements to the business over the long term.

**Maintaining our existing assets** – this includes our pipe network, treatment works and capitalised employee costs.

**Building new assets** – contributing to projects to enhance treatment standards and cater for growth.

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

**Ofwat/regulator adjustments** – applied by Ofwat for the period 2010–15, relating to customer satisfaction, cost-savings and revenue collection.

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

**Retail** – covers the cost of handling customer enquiries and the provision of services from billing to debt collection.

**Water services** – the treatment and distribution of water for supply.

**Wastewater services** – the collection and treatment of wastewater for return to the environment.

# Welcome to Southern Water

## Chairman's introduction

As we enter the third year of the current business plan period of 2015 to 2020 Southern Water has seen some significant improvements in both its operational and customer service performance. For example, we have seen further reductions in flooding and blockages across the network and reduced restoration of service times where water supplies have been interrupted. At the same time we have been working hard to make improvements in more challenging areas such as data quality and customer service.

Our renewed focus on customer service included the appointment of Simon Oates, formerly our Director of Strategy, to the post of Chief Customer Officer and the expansion of our proactive customer team. By better predicting what our customers need we have been able to increase the number of issues resolved before they become a concern. This is evidenced in the 47% reduction in the number of written complaints received over the past year, and the 71% reduction in the number of escalated complaints. Our historic performance was significantly below industry average in this area and while we are pleased with this performance we recognise that we still have more to do.

In other areas we continue to face challenges from our regulators Ofwat, the Drinking Water Inspectorate and the Environment Agency. These are each covered in more detail in our Chief Executive's summary.

Ofwat constantly reviews the information we report to our stakeholders, and during 2016–17 its view was that we failed to meet requirements in terms of our information transparency and quality. As a Board, we called for an urgent review of our monitoring framework, and we have since made a number of changes which we are sure will restore confidence in the way that we present our data. We are also working with Ofwat in relation to the management and operation of our wastewater treatment works and the reporting of relevant information in connection with them.

The Board remains fully focused on further improving performance over the coming years to meet and exceed the expectations of our customers and wider stakeholders.

## Governance and the Board

Last year saw a number of significant changes to the Board. Matthew Wright stepped down as CEO on 31 December 2016. I would like to take this opportunity to thank Matthew for his valuable contribution to Southern Water during his six years of service. He was replaced by Ian McAulay. Ian is well qualified to lead the business as we look to deliver a significant capital programme, improve customer service and set out our plans for the long-term development of Southern Water. Ian comes with substantial experience in the UK regulated utility, construction and environmental services sectors with United Utilities and Viridor and I am delighted to welcome him to the Board.

At the end of February of this year and after three successful years in the post, Robert Jennings stepped down as Chairman and I am grateful to him for his focused leadership which meant that I inherited a Board of talented individuals who are well positioned to lead the company in to the next price review period. It was an enormous privilege to become Chairman of the Southern Water Board in March 2017, having served as an independent non-executive director for the past two years, and I look forward to working with the Board in continuing to improve performance and deliver innovative solutions to the challenges facing the sector.

During 2017–18 we will be looking to strengthen the Board with the appointment of two further non-executive directors. These new appointments, which we will announce in due course, will provide the additional expertise to support the executive team as they take the company to a leadership position in the sector.

## Key highlights

We based our Five-year Business Plan 2015 to 2020 around achieving a set of promises made to our customers. As highlighted in our Year In Review, over the past year we have continued to deliver on these commitments by:

- improving our customer satisfaction score and position in industry league tables

- increasing the number of customers we contact proactively to resolve problems before they become a concern. Our proactive team has contacted more than 100,000 customers during 2016–17
- increasing the number of customers we are helping with debt prevention advice, affordable tariffs and water-saving home visits
- continuing to reduce sewer flooding by tackling blockages on our network
- setting a new 100% record for recycling
- launching a new community grant scheme to help those directly affected by our activities
- increasing the number of excellent bathing waters in our area to 51 from 43 last year
- working hard to maintain industry leading standards in health and safety
- continuing our work with customers to reduce consumption and keep leakage levels on our network to a minimum.

Our Strategic Report (pages 20 to 80) will describe in more detail how we have delivered these benefits to customers.

### **Our people**

On behalf of the Board, I would like to thank the dedicated employees who give this company its energy and enthusiasm, as well as our partners and contractors for their contribution to our successes. As I visit some of the many Southern Water sites, I am always impressed by the dedication that our employees show in ensuring we deliver the level of service our customers have a right to expect, and I look forward to meeting many more of them during the course of this year.

Our commitment to ensuring that we safeguard the future by taking on young people as apprentices, trainees and graduates will receive a higher level of focus in the coming year as we review progress in this critical area.

Finally, I would like to thank my fellow Board members for their strategic contributions, which have been critical in developing a customer-focused approach to our future plans.

### **A look ahead**

We have a lot to be proud of over the past year with progress made in a number of challenging areas. As with all significant improvements though, we recognise that there will always be opportunities to do more and our management is committed to maintaining this positive transition.

We are tackling issues such as climate change and population growth head on, developing innovative and resilient solutions, such as water reuse schemes and energy-from-waste initiatives, to ensure we maintain a sustainable service for our customers.

We have begun work on our next business plan for 2020–25 and have been talking to customers and stakeholders across our region to understand their priorities. We have also launched an interactive, Have Your Say area on our website so customers are able to share their views with us.

We have now published the first part of our Strategic Statement, Let's Talk Water – Starting the Conversation. This important document sets out key messages from our customers and stakeholders about their priorities for the next 25 years, as well as providing a view on the specific challenges faced by our region. In it we also identify possible ways in which we can transform our business to ensure that we can continue to deliver these priorities, while meeting the challenges we face and taking advantage of the opportunities we have to deliver smarter solutions.

We are currently seeking feedback on whether we have captured the right priorities and identified the right challenges and opportunities to enable us to finalise our Strategic Statement, which will be published in the autumn. The ongoing insight that we gain from these conversations will form the basis of all subsequent plans, including our Drought Plan, Water Resources Management Plan and Business Plan, which we will publish between now and 2020.

Our plans must demonstrate that customers have had their say, are charged a fair price and their needs have been balanced with the needs of the environment. These plans are then scrutinised and reviewed by our regulators, the Consumer Council for Water and our independent Customer Advisory Panel to confirm this is the case.

As the regulatory landscape changes, preparing ourselves for the introduction of retail competition for water services to non-household customers has also been a high priority. We announced last year that we were selling our non-household retail business to Business Stream, a specialist retailer at the forefront of the competitive market in Scotland. Around 100,000 of our non-household customers have been transferred so our teams have been working hard to ensure the transition to Business Stream has been as smooth as possible. This was completed successfully in time for the opening of the non-household market on 1 April 2017.

We remain confident in the long-term prospects of the company and in our ability to thrive in an increasingly challenging environment and we look forward to making further progress in 2017–18.

A handwritten signature in black ink, appearing to read 'Bill Tame', with a long horizontal flourish extending to the right.

Bill Tame  
Chairman

## **Our Board**

The Board is responsible for the strategic direction of our business. Throughout most of 2016–17, it was made up of:

- an independent non-executive chairman
- two executive directors (the Chief Executive Officer and Chief Financial Officer)
- five non-executive directors – four of whom are independent.

The operation of the company is overseen by the Executive Leadership Team, which is headed by the Chief Executive and Chief Financial Officers and, during 2016–17, four functional directors. None of these functional directors is a member of the Board.

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

## Chief Executive's summary

As the new chief executive of Southern Water, first of all I would like to say how delighted I am to have joined the business. A chartered civil engineer by trade, I have worked in the water sector for more than 30 years so although I am new to the role, I was already familiar with Southern Water and our service providers.

Our Strategic Report, in the following pages, will focus on our collective performance over the past year. While it is pleasing to report that we have achieved a number of successes, I will also be highlighting some of the key challenges we face as a business and some of our opportunities for transformation in the future.

We continue to deliver on the commitments we made to our customers for 2015–20, maintaining performance in several areas of our operation, such as, preventing pollution and flooding incidents and odour prevention, while sustaining a positive improvement trajectory in customer service. We intend to build on these areas of good practice as we move forward, playing to our strengths and performing to our potential in every area of our business.

However, we will also be focusing on those areas where we have not performed well, and improving communication with our regulators, customers and stakeholders about the issues that are important to them. By proactively engaging in this way we will address challenges with our historical performance reporting and data quality so all our stakeholders can have confidence that we are delivering on our promises and improving our levels of service.

By working collaboratively, sharing ideas and developing innovative solutions, we will continue to improve in those areas where we are already doing well, while also making the changes necessary to ensure Southern Water is seen as a leading company that we can all be very proud of, and that delivers the sustainable service our customers expect.

### Serving our customers

Over the past year we have completed an end-to-end assessment of our customer service processes, working to improve responsiveness and ensure we are focusing on the individual needs of our customers. We have looked at how we can make it easier to do business with us online, over the phone or face-to-face, resulting in improvements to our website and customer contact centre.

Our new online services portal allows our customers to manage their account, at a time that is convenient to them, while the expansion of proactive and digital teams in our contact centre has increased the number of problems we are able to solve, quickly, before they become an issue for our customers. This new approach has increased customer satisfaction and driven down complaints so we are confident that these improvements are adding value to our customer experience.

A key focus for us over the past year has also been improving our contact with some of our most vulnerable customers. We have been working closely with partner organisations, such as the Citizens Advice Bureau and housing associations to identify those in challenging circumstances so we are then able to apply a more targeted approach to our service. We plan to continue to build on these partnerships in the year ahead so we are able to extend the reach of our support services to those most in need.

### A changing landscape

The water industry is changing, and at pace. Competition has already been introduced this year, with our former non-household customers now able to choose their water provider for the first time. We decided to sell our non-household retail business to Business Stream, a specialist company in this field. Similar changes are being discussed for household customers too, although ministers have not committed to making a decision on whether or not to introduce household competition until the end of this Parliament.

Increased competition does not mean any differences in regulatory scrutiny, in fact it will lead to a need for more transparency and consistency. The information we report to our stakeholders is rightly, constantly under review by our regulator, Ofwat, and this year we fell short of its requirements. Ofwat assesses companies into one of three categories based on the level of trust it has in the information it receives from them. Its level of trust and confidence in our reports, chiefly relating to data quality, transparency, board governance and narrative explanations for stakeholders, had reduced. As such, Ofwat assigned us an assurance rating of 'prescribed' – lower than our previous rating of 'targeted'.

Our Board responded immediately and, with the company's executive team, instigated an urgent review of the quality measures applied to our published information. As a result, we have made substantial improvements in a

number of areas and will continue to make further improvements in order that our customers and stakeholders can have confidence in the way that we present our information.

These steps were detailed in our revised Final Assurance Plan, published in March of this year. Ofwat's feedback also helped to inform the new structure of this report for 2016–17, with the introduction of a new governance reporting framework, more detailed data quality information and the introduction of more transparent performance reporting and case studies in the Strategic Report.

While we were pleased to exceed our target level of compliance against the Drinking Water Inspectorate's (DWI) quality measures this year, it raised some concerns regarding our monitoring and reporting processes, and our compliance with Water Quality regulations regarding the collection of the required number of samples. While we have made substantial improvements in some areas, we recognise that we have further improvements still to make. We are working closely with the DWI to address these. The DWI's concerns are outlined in our updated Statement of Risks, Strengths and Weaknesses, January 2017, and Final Assurance Plan, March 2017, which are available on our website – [southernwater.co.uk/our-reports](http://southernwater.co.uk/our-reports).

We provide a significant amount of data to the EA about the performance of our assets and any wastewater or sewage discharges we make into what is known as the 'water environment', such as rivers, streams and coastal waters. We have identified the need to review and improve our end-to-end reporting processes with a view to implementing process and control improvements. Detailed process reviews have continued and a programme of improvements is being developed. We will establish a programme of rolling audits of our EA reporting and data integrity, starting with the 2017–18 internal audit programme of assurance. In addition, we will complete assurance of the 2015–16 and 2016–17 data. Independent external assurers will be assigned to the review, which will commence in August 2017.

As mentioned on page 11, we are also working with Ofwat in relation to the management and operation of our wastewater treatment works and the reporting of relevant information in connection with them.

### **Innovation and resilience**

Our customers expect a constant supply of safe, clean water and we take the delivery of this service very seriously. Which is why although we exceeded our compliance target for water quality, achieving 99.97%, we were disappointed that in 2016–17 we fell short of our leakage targets. This is an area where historically we have performed strongly. We are working hard to continue to improve our performance and we remain on track to hit our five-year target.

Over the past year we have had a number of operational successes in terms of our management of water pressure on our network and a reduction in the number of complaints about discolouration. The number of properties receiving low pressure dropped during the year to 222, fewer than our target of 257 properties, while just 1,825 of our 2.4 million drinking water customers notified us of discolouration in 2016.

The performance of our wastewater treatment works was also strong and we are pleased to see a reduction in pollution incidents. We are also ahead of our promise commitment to increase the amount of renewable energy we use across our operations.

We saw a 4% reduction in flooding incidents over the past 12 months as a result of previous flood mitigation work and our planned maintenance activity, and overall, since the start of the current five-year period, external flooding incidents have reduced by 18%. However, there is still more to do and partnerships with customers will help move this work forward.

As a provider of water and wastewater services to an ever-increasing population, we need to continue to improve our service offering, providing innovative solutions to ongoing challenges such as climate change, population growth and water scarcity.

We are already developing these solutions in a number of areas:

- Looking at the opportunity to purchase abstraction licences, which are currently owned but not used by farmers and industries.
- Developing water re-use schemes that allow us to take highly treated wastewater and put it back into the natural water cycle, before abstracting it again and treating it to drinking water quality standards.
- We are fitting monitors to our sewer overflows, which help track flows and prioritise areas for investment and improvement to protect the natural environment.
- We are investing in the development of new drainage systems that manage the impact of development and increasing amounts of rainfall entering sewers and drains.

- We are also trialling new technologies that allow us to extract energy from our water and wastewater treatment processes. This includes looking at new nutrient extraction technology to protect our water supply and potentially using extracted materials to generate products that have value elsewhere.

You can read more about the innovative solutions we are developing to embrace these future challenges in our 'Sustainability and environmental responsibility' section, on pages 47 to 49.

### **Working in partnership**

In addition to working with our supply chain contractors to deliver day-to-day services to our customers, we partner with a variety of organisations across our region to further improve our service and resilience levels.

We are already working with farmers, landowners and environmental organisations to better manage our wider area – catchment management – ensuring our region's natural assets are more secure and viable as a continuing source of water.

To reduce our impact on the environment, we are teaming up with university and technology experts to help us better understand, predict and model changes. We are also trialling new technologies and processes that limit pollutants being released into the environment, to help maintain higher quality bathing waters.

Another innovative partnership under way is the Integrated Water Resources Plan for the whole of the South East. This goes beyond water companies, to embrace all those who abstract water from the environment and have a role in ensuring water is not wasted. This involves setting up 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.

The challenges of water scarcity, population growth and climate change facing the South East will require greater collaboration both within and across sectors. It will be a critical part of achieving outcomes, which deliver long-term resilience with multiple benefits from both the water and wastewater parts of our business. It is only by working with partners in this way that we can really start to make solid plans for the future, looking beyond 2020.

### **Looking after each other**

In order to deliver this step change, we know that we need to look after our employees by fostering a safe working environment, providing continuous professional development, equal opportunities for all and creating a rewarding place to work.

We want to encourage a culture where we are collectively responsible, for not just for our own safety, but also and for ensuring we look after our customers and each other. This year we launched a new Speak Up policy, which actively encourages all employees to raise concerns about practices or situations that could affect our business.

While we recorded an increased number of reportable injuries in 2016–17, we are pleased to report that we achieved the Royal Society for the Prevention of Accidents' gold award for Health and Safety for the 18<sup>th</sup> consecutive year. Our aim is to continue to build on our reputation for strong health and safety performance over the coming year, with a particular focus on our wellbeing initiatives, which are designed to encourage good personal physical and mental health.

Good employee engagement is increasingly becoming one of the key differentiators in business. Put simply, engaged employees and high-performing teams help drive safety, productivity, profitability and customer focus.

Over the coming year we will be renewing our focus in this area, and we will be taking a fresh look at our company brand and our story. This will help us to align our business priorities with individual team objectives, encouraging local level action planning to help drive positive change and improvements across the company.

Our commitment to talent management is visible throughout the business. We safeguard our future by taking on young people as trainees and graduates. We are among the first in the water industry to train all our operators to NVQ level 3, while we also have a number of our operational leaders undertaking the Level 4 Diploma, ensuring that we have continued investment in water and wastewater management skills.

Not only are we encouraging the development of skills within our business, we continue to lend active support to a variety of initiatives to promote Science, Technology, Engineering and Maths careers to young people so that we are able to recruit from the broadest possible talent pool.

## Our community

Over the past year we have actively contributed to the wellbeing of our customers and our communities. As well as launching a new community grants scheme, our employees gave 4,000 hours – almost 560 days – of their time to help community projects through our company volunteer scheme.

Our Learn to Swim scheme celebrates its 25<sup>th</sup> anniversary in 2017. During that time more than 750,000 children across the region have been taught how to stay safe around water. This year we helped to teach more than 14,000. It is a source of great pride to everyone in the company that we are able to do our bit to keep our children safe.

We continued our partnerships with local schools, sports clubs and theatre companies to educate customers about how we can save water and prevent blockages and sewer flooding. And through a variety of fundraising events and local initiatives we also raised a total of more than £139,890 for various regional charities over the course of the year.

## Financial results

During 2016–17 our operating profit was £258.9 million, a reduction of 9.0% from the previous year.

The 2015–16 operating profit included a one-off benefit from the refund of historical business rates charges of £13.3 million. Taking this into consideration, our operating profit reduced by £12.3 million and was principally the result of increased depreciation charges, which result from the continued significant investment in our assets.

In total our revenue increased by £6.0 million to £809.7 million reflecting increased customer numbers from new connections and higher levels of billed consumption in part offset by an overall reduction in our tariffs. This increase in revenue was offset by a similar increase in underlying operating costs.

During the year we have undertaken a number of initiatives specifically targeted at improving our customer service performance. These increased our operating costs by £4.0 million and have focused on reducing complaints, assisting customers in financial hardship and improving our future bad debt performance.

The costs associated with these initiatives together with inflation on our cost base were, in part, offset by the delivery of operating efficiencies totalling £8.6 million. These efficiencies were delivered through a focus on reducing our power consumption, in particular minimising usage at peak times and making improvements to operational processes, for example reducing chemical usage and waste disposal costs.

I believe these initiatives and efficiencies, along with the continuing delivery of our capital investment programme will enable us to continue to make improvements over the coming year and assist in the delivery of the promises we made to customers and stakeholders in our business plan.

## The road ahead

We have had both a successful and challenging year, and we are determined to build on our strengths and eliminate weaknesses.

Our sector is changing and over the next three years we intend to embrace these changes and continue to innovate to improve our service levels in order to meet the promises we made to customers in our business plan 2015–20. And, as we begin our customer consultation and price review process and plan for 2020 onwards, we look to build a resilient and sustainable business model that will rise to challenges facing our business and the sector as a whole while defining our role in relation to the environment.

It gives me great pleasure to thank all those who work for Southern Water for their continued hard work and dedication. Without their efforts we would not have achieved so much.



Ian McAulay  
Chief Executive Officer

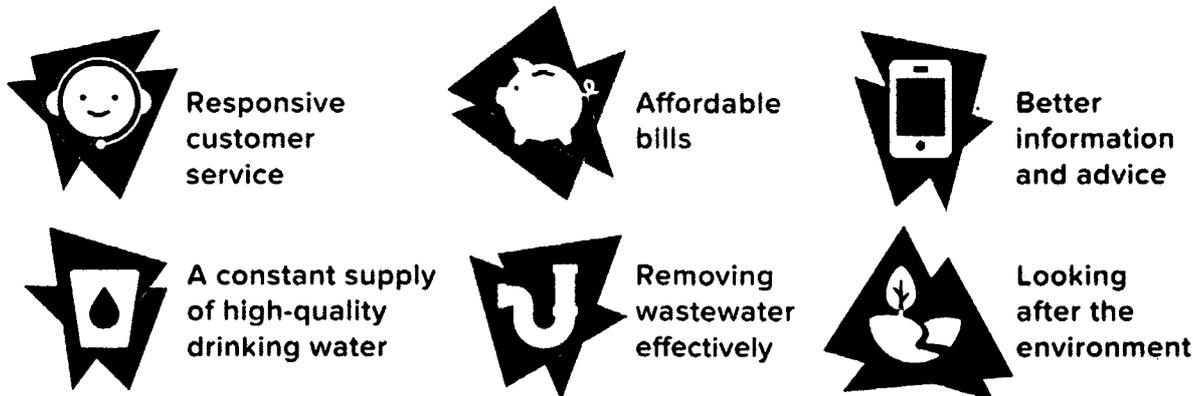
## Strategic report

### Our plan

We are now at the end of the second year of our five-year business plan – a plan built around insight from conversations with more than 34,000 of our customers.

This feedback helped us define six key priorities and 26 specific promises, with measurable outcomes and clear performance targets for our teams to work towards. Over the five years of our plan (2015–20), we will spend more than £3 billion improving water and wastewater services – with £1.8 billion invested in new or improved assets alone, equivalent to almost £1,000 for every property in our region. Over the same period, average bills will fall by eight per cent before inflation.

These plans are scrutinised by our regulators, the Consumer Council for Water and our independent Customer Advisory Panel to ensure our customers' views are represented, their bills are kept affordable and their needs have been balanced with the needs of the environment.



As you will see, the vast majority of this report is focused on giving an overview of how we are doing against the promises we made in our business plan. We will do this by revisiting and reviewing those performance measures and targets we set ourselves. We will also be doing something new this year, highlighting individual case studies to demonstrate the key successes celebrated and challenges faced over the past year.

The remaining pages will focus on defining our vision for the development of our business over the longer term, highlighting some of the broader challenges faced by the industry and the communities we serve and how we are planning to address these beyond 2020.

### Our Customer Advisory Panel – an independent view

Our Customer Advisory Panel (CAP) was established as a result of a commitment made in our business plan 2015–20.

Its purpose is to provide independent advice and to challenge us on the delivery of our business plan commitments, acting on behalf of customers where performance is less than promised. As part of this, it produces an annual report, available on our website – [southernwater.co.uk/CAP](http://southernwater.co.uk/CAP) – which details its thoughts on our performance over the year.

CAP also reviews our statement of risks and the ways in which we provide data assurance. If the CAP had a doubt about the quality of performance data, the first line of response would be to challenge the company. If necessary, the CAP would ask for the company to take further steps to redress quality issues. If issues remained, the CAP has a budget to commission independent assurance and/or research.

The CAP operates on a transparent basis and should stakeholders wish to know anything else about the part it plays in performance reporting they are invited to write to the Chair, Anna Bradley: C/O Customer Advisory Panel secretariat, Southern Water, PO Box 41, Worthing, BN13 3NZ.

### Competition for businesses

From April 2017 non-household customers have been able to choose which company provides their water and wastewater retail services. Basically, this means the handling of customer queries as well as billing and meter reading, cash and debt collection and advice on water use.

After considering a number of options, we made the decision to sell our non-household retail business to Business Stream, a specialist company in this field, so we can concentrate on our wholesale operation – the delivery of water and wastewater services – and our domestic retail customers.

Although we are not competing in the non-household retail market, as a wholesaler we still have an important role to play. We continue to operate the network of pipes, mains and treatment works across Sussex, Kent, Hampshire and the Isle of Wight, selling water on a wholesale basis to new retailers that enter the competitive market.

### **Beyond 2020 – Have Your Say**

We have just started a really important conversation with our customers about water and the role it plays in our daily lives, at home, in society, the economy and environment.

Whether we live in towns, villages or big cities, we all use water, every day. And, whether we think about it or not, we all have a view when it comes down to the question of how it should be used and how much we are willing to pay for it.

*Our consultation process – the first step of our five-year price review with our regulators – is a chance for customers to tell us what they think about water, wastewater, bills and our service in general.*

It is also a chance for us to understand our customers' priorities so we can begin to develop our next five-year delivery plan 2020–25. This will support and refresh our long-term strategy for water and wastewater services, our Drought Plan for 2018 to 2023 and our long-term Water Resources Management Plans for 2020 to 2070.

We will be running the consultation until the autumn so please take this opportunity to Have Your Say and help us plan for the future. Go to our website and tell us what you think – [southernwater.co.uk/haveyoursay](http://southernwater.co.uk/haveyoursay).

## Working for our customers

### Responsive customer service

	2016–17		2015–16
	Target	Achieved	Achieved
Customer satisfaction Service Incentive Mechanism (SIM) score <sup>1</sup>	81	78	73
Contacts resolved first time (%)	82	67	67
Customers who feel our service meets their individual needs (%) <sup>2</sup>	67	66	66
Customers who feel our service meets the needs of their community (%) <sup>2</sup>	34	35	33
Number of compensation payments made to customers (Guaranteed Standards Scheme and Customer Charter)	2,904	2,436	3,912

1 We reported in our annual performance report 2015–16 that the call categorisation of unwanted and wanted calls was associated with a degree of subjectivity, and that additional processes and controls were required to further mitigate the risk of call mis-categorisation. We stated that we would put in place an action plan to minimise these issues going forward. Within this regulatory year, we are pleased to report that due to the action plan, the accuracy of our reported unwanted contact volumes has improved over the last quarter of 2016–17. Further actions are planned in the 2017–18 year to continue to improve unwanted contact volumes. Unwanted calls is a component of the SIM score.

2 For 2015–16 we refined the customer survey questions we use to measure performance against these promises. We have agreed an update to our Final Determination with Ofwat and this was published in March 2017. Future performance will be measured against the 2015–16 position on a consistent basis.

Through the adoption of a proactive, insight-led approach to customer service we have improved customer satisfaction levels over the past year, and we are working hard to continue this positive trajectory.

Throughout the year our regulator Ofwat uses the Service Incentive Mechanism (SIM) score to judge how well we serve our customers. All water companies are assessed in this way, with Ofwat taking into account quantitative and qualitative data, such as unwanted contact and levels of customer satisfaction. Over the five-year business plan period our SIM performance, compared to other water companies, will result in either a reward or penalty.

Our SIM score for 2016–17 has consistently improved, with us achieving a final score of 78. Although our target was 81, our performance has seen us move up the industry league tables from 18<sup>th</sup> to 16<sup>th</sup> position in terms of Ofwat's customer satisfaction survey. We recognise that we are still at the lower end of this league table and need to improve further; we are working hard to continue this positive movement.

In January 2017 the Institute of Customer Service ranked us as the ninth most improved company (out of 244) in terms of customer satisfaction. Its survey draws on data from 42,500 customer experiences across 200 organisations in 13 sectors. We are enormously proud of this achievement and it is a demonstration of the hard work put in by our teams over the past year to:

- launch online services – at year end we had more than 80,000 customers registered who are able to self-serve using their accounts
- make improvements to our billing process to ensure every customer is paying the right amount – we have stopped bills with significant consumption increases going out to customers automatically. Instead, we proactively contact those affected to make sure our charges are explained and any problems that may have led to increased usage are discussed
- make improvements to our payment plans – we recently changed our payment scheme algorithm to improve the way these plans are calculated, meaning more stable payments for customers.

Obviously, we still have some way to go to exceed our targets but we are confident that these changes will continue to improve satisfaction levels.

By working to identify potential issues before they become a concern for our customers we are hoping to reduce the need for them to pick up the phone. In January 2017 alone, our proactive team contacted more than 12,000 customers to talk them through the support options available to them. And we know our customers appreciate it because, as well as telling us so, the number of written complaints we record has been falling steadily.

In 2015–16, around 2.5% of customers would call to complain after receiving letters requesting a reassessment of their payment schemes. Today, that figure has fallen to under 1%.

When customers do have to contact us, we are working hard to improve our first contact resolution. Unfortunately, we fell short of our target of 82% of calls resolved first time during 2016–17, achieving a figure of 67%, maintaining performance levels achieved for 2015–16. We are determined to do better and are introducing a number of measures to improve our service. These include:

- making it easier for customers to access their accounts online (as previously mentioned)
- setting up a designated team to manage and simplify the home move process
- ending the frustration and confusion caused to customers who receive separate bills from both us and South East Water. These customers will now have just a single bill and one point of contact for enquiries.

By better managing our resources, improving our forecasting methods and making changes to our phone system, we are now answering more of our calls within the first 30 seconds.

These concentrated efforts to improve our customer service mean that we maintained a figure of 66% of our customers who agree that the services we provide meets their needs, while 35% agree that we met the needs of their community, an increase from 33% in 2015–16. Our Customer Advisory Panel continues to help us better capture our customers' views and further drive our insight-led approach to serving our customers.

On those occasions where we fall short of our customers' expectations we offer them compensation under our Guaranteed Standards Scheme and Customer Charter. These payments, alongside the enhanced payments agreed with Ofwat in our business plan, are made if we fail to offer a minimum standard of service, whether this is a failure to respond to a written complaint, an interruption in service or a failure to attend scheduled appointments.

We made a total of 2,436 payments in 2016–17, totalling £453,984, a decrease from last year's total of 3,912. This means we exceeded our target of making no more than 2,900 payments for the year. This reduction has been achieved by improving the time taken to resolve our written customer complaints as well as through operational improvements, such as reduced internal and external flooding incidents and fewer interruptions to customers' water supply.

## **Putting our customers first**

### **The first point of contact – Chris Brown, Proactive Customer Contact Manager**

In the past, the majority of complaints to Southern Water were either about requests for increases in payment scheme instalments or higher than expected bills. To tackle this, we set up a proactive team in 2016 to contact customers in advance of receiving unexpectedly high bills, and find out what we could do to help them.

The team focused on two particular groups:

- Customers on metered payment schemes whose monthly instalments needed to be raised because the current amounts were not covering their actual water use.
- Customers whose accounts indicated a sharp increase in water consumption that was about to generate a high value bill.

When a customer is due to receive a letter telling them their monthly payments need to be increased, we will text, write or call them directly to let them know and invite them to get in touch with us. We can then chat to them about why their consumption might be greater than they were budgeting for and offer advice ranging from water-saving tips to information on schemes to help manage payments.

Similarly, if our meter monitors show that a customer has a sudden and unexpected spike in their water consumption, we can help them identify why that might be. For example, they may have carried out some work to their property, which temporarily required a lot of water or there might be more people staying at the property than usual.

By talking to customers before their bills arrive, we can prepare them for increases and help to identify issues such as leaks along the pipe network which, if left undetected, could damage their homes. We can also discuss options available to those who may need bespoke payment arrangements to manage specific medical requirements – such as having a family member on dialysis – or who might be in genuine financial hardship and struggling to pay.

Our first year with the proactive team has been a huge success. We have contacted over 100,000 customers by phone, text and letter and made a significant contribution to the 47% reduction in written complaints.

**When customers do complain – Jill Warburton, Customer Relations and Digital Manager**

We have reduced escalated complaints by 71% compared to last year. Of course, we cannot take all the credit, as a lot of this success is the result of our colleagues in other areas resolving customers' queries.

In a large number of cases though we are providing a better response first time because our team has shared feedback and lessons learned from our handling of complaints to help improve processes. We have also created a quality monitoring process where we listen in on calls and provide development for team members who need extra help.

I am proud of the family atmosphere we foster within our team. It is a difficult area of the business to work in and you need a lot of resilience so it is important that we support each other through complicated or difficult cases, and work as a close team. In this way, we are able to make sure each case is seen through from start to finish, with every promise made to the customer kept.

As a result we have only seen 22 out of more than 7,000 complaints received this year put forward to the Water Redress Scheme – an independent process for adjudicating unresolved disputes following the complaint process with both the water company and the Consumer Council for Water (CC Water). We were judged to be at fault in only 10 of these cases, resulting in small redress payments made to customers. Feedback from the adjudicator has been extremely complimentary about how we resolve written complaints.

## Affordable bills

	2016–17		2015–16
	Target	Achieved	Achieved
Customers in genuine hardship provided with improved support	149,900	<b>194,726</b>	142,040
Customers who feel we provide value for money (%) <sup>1</sup>	62	<b>57</b>	61
Efficiency savings (£m)	N/A	<b>67</b>	56

<sup>1</sup> For 2015–16 we refined the customer survey questions we use to measure performance against these promises. We have agreed an update to our Final Determination with Ofwat and this was published in March 2017. Future performance will be measured against the 2015–16 position on a consistent basis.

We made a number of commitments to our customers in our business plan, but perhaps the most important to them were our promises to provide value for money and help for those experiencing financial difficulties when paying their water bills.

Our affordability teams have delivered some great results over the past year:

- Increasing the take up of our range of social tariffs and schemes – our target for 2016–17 was to increase the number of customers who had received help to pay their bills and manage their debt to 149,000. We significantly exceeded this figure, providing more than 194,000 customers with financial assistance and debt advice.
- Promoting our water-saving home visits to those customers struggling to pay their bills – during these visits, we fit water-saving devices to taps, toilets and showers.
- Improving customers' experience of us by getting the message out that we are here to listen and support them through the payment process.

Over the past year we have also been working to put into place a new Community Engagement Programme to support those customers most in need. Its ultimate goal will be to encourage them to reconnect with the payment process and keep them informed about our schemes and tariffs, within a community setting.

By taking the time to meet customers face-to-face in areas where we have seen high levels of disengagement, our field engagement managers can both reconnect with customers who had stopped talking to us and help more of those most at risk of falling into debt.

We have also continued to work with key stakeholders to raise awareness of the additional services we offer so they are in a better position to advise customers that come to them with financial concerns.

Over the coming year we will be looking to take this programme further, introducing a more tailored billing and collections process that supports customers at earlier points in their journey with us. We will be introducing a new process for our agents who are in contact with our most vulnerable customers, raising awareness about the support services on offer from their colleagues, local councils and police. It is essential that our teams have an understanding and appreciation of the range of customers' vulnerable circumstances, from their ability to pay to short and long-term ill health.

We will also be looking to expand our community partnerships, working collaboratively with local support organisations, such as StepChange, local authorities and housing associations, who can raise awareness of the help we can offer.

One example of a key partnership already in place is the work we are doing with the Citizens Advice Bureau (CAB). We work both at a regional and local level with them to identify and signpost customers to our specialist debt advice service. As a result, we have strengthened local relationships, providing training and raising awareness among their teams.

We publicise these services through information leaflets, customer bills, our website, social media campaigns and adverts in the local press, but working with partners like the CAB ensures we create long-lasting and sustainable relationships, which enable us to increase the number of vulnerable customers we can reach.

### **Our tariffs and schemes**

Overdue bills and bad debt have an impact on every customer's bill so it is important we do all we can to help those in genuine financial hardship and reduce the burden of non-payment on others. At the same time, we also have to manage our own costs.

We offer a range of different payment schemes and tariffs, including:

- **Essentials** – for customers whose annual water service charges represent at least 3% of household income, after deducting council tax and housing costs. For 2016–17, we broadened our eligibility criteria to help those in receipt of pension credit. Our target is to have 65,500 customers on our Essentials tariff by 2020.
- **WaterSure** – for those who use a large amount of water as a result of particular medical conditions or large families.
- **Water Direct** – where bills may be paid from a customer's existing benefit schemes directly to us.
- **NewStart** – for those in a position to make contributions towards paying current costs in regular instalments, with us taking off the same amount from their outstanding debt.

### **Value for money**

We want our customers to feel that the services we provide are affordable and represent value for money. For an average household in 2016–17, combined water and sewerage services cost less than £1.13 per day – that's less than a cup of coffee or a newspaper.

We committed to keep our bills affordable so over the five years of our business plan 2015–20, our average charges will fall 8% before inflation.

We set our charges schemes each January based on an agreed set of price limits put in place by our regulator, Ofwat. We also seek external assurance on these price limits from our auditors and discuss any proposed changes to our charges with the Consumer Council for Water (CC Water) before they are finally agreed.

Each year we provide customers with a breakdown of where their money goes – in other words, what we spend it on – with their annual bill. Again this year we worked closely with the CC Water to ensure that our billing information leaflet was both simple and accessible (see *Transparent and clear bills* on page 30 for more detail on how we provide customers with *Better Information and Advice*).

We survey our customers every year to find out whether they think the service they received represented good value for money. At the end of 2016–17, 57% of our customers agreed, compared with 61% in 2015–16. We had hoped to increase this figure so in the coming year we will focus on promoting the breadth of service we offer our customers both today, and in terms of the planning we undertake for a sustainable future. Campaigns will highlight the benefits of metering, our water efficiency initiatives and the various affordability tariffs we supply to those in need of extra support.

### **Working more efficiently**

As well as the work we do to help our customers directly, we also know it is important to keep our bills as low as possible by constantly improving how efficiently we deliver our services.

In 2016–17, two years into our five-year business plan, we have delivered £67 million of cost reductions.

In order to deliver these savings, we have continued with the implementation of our integrated change delivery programme, which comprises six strategic projects and more than 36 individual initiatives to improve services. This programme is:

- reducing the number of complaints and improving customer satisfaction (see pages 22 to 24)
- improving the systems used by our teams by delivering new field tablets and timesheet functionality to the field
- installing solar technology at five suitable sites (see page 46) and replacing outdated technology
- improving customer service with the introduction of online billing and self-service account management and a simpler and clearer billing process. The project is also looking at our debt prevention and collection process and all contracts and sourcing options to drive efficiencies

- modernising our working environment, providing space for partner co-location to enable teams to collaborate on projects.

We have also embedded new ways of managing and delivering major capital investment projects and programmes, using industry best practice tools and processes. Working in partnership with leading organisations in our sector, and our wider supply chain, we are improving efficiency by applying a standardised approach to design, improving productivity through off-site construction techniques and reducing waste through collaborative and lean working initiatives.

We have increased our investment in research and development, forming new partnerships with universities and other technology-led organisations that will help us to identify and implement the next generation of efficiency savings. These partnerships will also 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. The highlight of this year has been the establishment of an Innovation Hub with the University of Portsmouth, based at our Petersfield Wastewater Treatment Works – for more on this see our ‘Sustainability and environmental responsibility’ section on pages 47 to 49. The hub is looking at new technology solutions to our “small site challenge” and is focused on developing solutions to meet the stringent environmental requirements we face on our small rural wastewater treatment works in a cost-effective way.

Through these various programmes we aim to make overall efficiency savings totalling £200 million by 2020, keeping bills lower than they would otherwise have been.

## **Putting our customers first**

### **Hard to reach customers, Sam Gill, Customer Service Adviser**

I work with our partners, Orbit, to identify customers who are struggling to pay their bills, for whatever reason – particularly those who are in debt to us.

Making sure we follow the latest data protection rules, we help Orbit to gather the most up-to-date information about these customers so that when they pay them a visit, they can offer the right help to get them out of debt. We have been working with them for about 13 months now and in that time we have referred more than 67,000 customers to them, with a 46% contact success rate. In other words, they have been able to have meaningful discussions with these customers, and as a result, another 36% of that 67,000 are now on one of our support schemes or tariffs.

Out of the visits completed so far we have only received 12 customer complaints – that represents around 0.02%. For an operation of this size, we see this as a real success.

It helps that the field officers are now using interactive technology to complete surveys with customers, rather than paper forms. These are available on tablet devices, which the officer can take in to people’s homes, where they are able to offer tailored advice, in real time. It means the teams are able to ask the right questions of that particular customer.

After the visits are done, the Orbit teams send us a weekly update, with each customer assigned to the most appropriate agent. Any accounts that they feel they need more detail on are also referred back to us so that we can conduct more research.

It is working really well and we have also started to offer additional services to the visits. For example, Orbit is now extending the offer of a water-saving visit to those customers most in need. This means we are able to help them reduce their water usage by installing free water-saving products, which over time help them reduce their bills. This is also proving really popular, with a 93% success rate on referrals.

### **A better collections process, Ella Scanlon, Customer Service Agent**

I joined the company about nine months ago and things have really changed since I have been here. I used to spend a lot of my day on the phone, but now we are allocated promises made to our customers to work on. It means we spend more time problem solving and taking action for our customers than just answering calls. It also means we are all more involved in the whole collection process, rather than just focusing on our own area so when

a customer calls, we are better prepared to answer their questions, rather than having to refer them to another member of the team.

We meet to have a 'huddle' every day where we discuss the most urgent customer cases, and the volume of calls dealt with and check we are on target. Those agents who have performed really well are rewarded with incentives and their names are clearly displayed on the boards, which encourages the rest of us to improve and help more customers!

It is also a great opportunity to discuss team workloads so we can share any problems we are having with customer queries and review customer comments on our feedback system. It is a much more structured approach. We know what our targets are and they are achievable, which is really important for us, and our customers as we are able to resolve more of their queries. It has created a better working atmosphere as well, as everyone gets their moment to shine, if they work hard. In that sense, it is more rewarding and you have a sense of accomplishment when your name goes up on the board as it means you have delivered a great service to our customers.

## Better information and advice

	2016–17		2015–16
	Target	Achieved	Achieved
Water usage, per capita consumption (litres per head per day)	134.27	<b>131.29</b>	129.72
Number of unwanted billing queries <sup>1</sup>	49,000	<b>145,962</b>	62,726
Customers who are aware of the causes of blocked drains (%) <sup>2</sup>	78	<b>79</b>	77
Customers who are aware of how their money is used (%) <sup>2</sup>	61	<b>56</b>	60
Customers who are aware of how to deal with hard water (%) <sup>2</sup>	58	<b>56</b>	57

1 We reported in our annual performance report 2015–16 that the call categorisation of unwanted and wanted calls was associated with a degree of subjectivity, and that additional processes and controls were required to further mitigate the risk of call mis-categorisation. We stated that we would put in place an action plan to minimise these issues going forward. Within this regulatory year, we are pleased to report that due to the action plan, the accuracy of our reported unwanted contact volumes has improved over the last quarter of 2016–17. Further actions are planned in the 2017–18 year to continue to improve our reported unwanted contact volumes.

2 For 2015–16 we refined the customer survey questions we use to measure performance against these promises. We have agreed an update to our Final Determination with Ofwat and this was published in March 2017. Future performance will be measured against the 2015–16 position on a consistent basis.

Over the past year we have engaged with our customers on a one-to-one basis through targeted campaigns to address a number of key issues they told us were important to them, such as:

- saving water, energy and money
- transparent and fair charges for services
- how to prevent flooding and damage to their properties and possessions
- how we spend their money on improving our levels of service
- managing the effects of our region's hard water on household appliances.

Our website is a key communication channel for us, as demonstrated by the more than two million visits it received this year, an increase on last year's figure of 1.5 million.

In direct response to this and feedback we have received from customers, we have spent a lot of time on improvements to our online services, launching both account management functionality and refining our live incident update service for customers during 2016–17.

We are also continuing to engage with customers via our social channels. Launching both Instagram and Snapchat accounts this year, in support of our existing Twitter and Facebook channels, we have seen an increase in levels of engagement with:

- 556% rise in Twitter views, with 720,000 likes, shares retweets and comments
- Facebook – a 200% rise in followers with 5,300 likes and shares over the year.

These daily interactions with our customers are only making it easier for us to provide information and advice on the issues they tell us are so important to them.

### Saving water energy and money

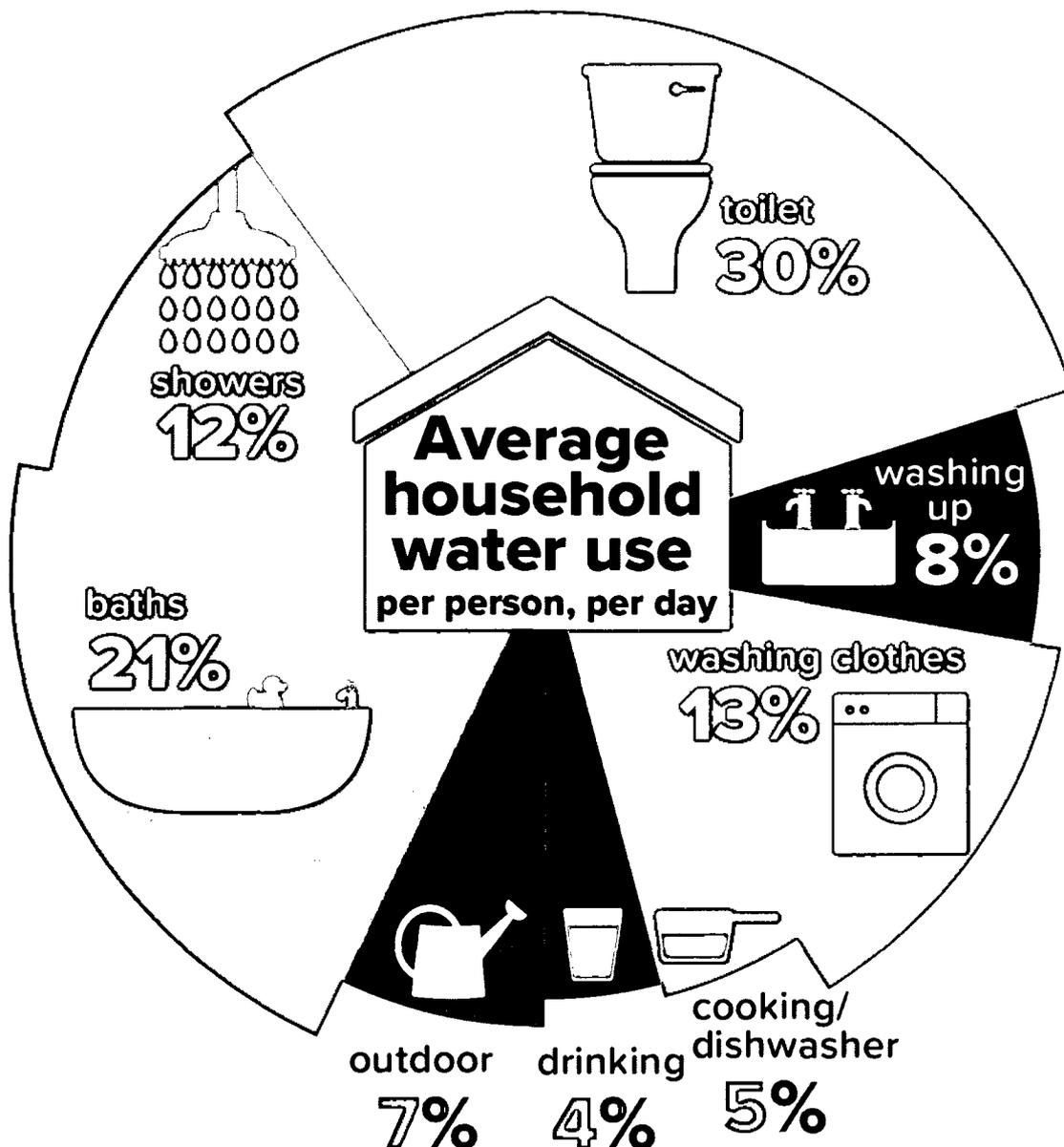
Throughout 2016–17 our water efficiency team, and partners Aqualogic, visited customers' homes and small businesses to offer water-saving advice and fit free products to help them reduce their water use and bills.

By targeting customers who use a lot of water and focusing on promotion of the visits in water scarce areas we offered help where it was needed most and reached a total of over 4,900 households and premises. We also visited 118 schools, where again we fitted products to help them save water and money, and distributed education

packs for teachers to help bring water efficiency to life in the region’s classrooms.

We have been working closely with local councils and housing associations during 2016–17 to make sure customers struggling to pay their bills also have access to water-saving advice and products, with the ultimate goal of helping them reduce their water bills over the long term. Local authority planning teams have also engaged with us to pilot a project to encourage housing developers to build new homes with water efficiency standards built in, which also benefits new home owners as they have lower bills.

As a result of our continued focus on water efficiency behavioural changes and the physical installation of the latest water-saving products, we have seen an average water use of 131 litres per person, per day during 2016–17, beating our target of 134. During 2015–16 we achieved 130 litres per person, per day. The increase in consumption is partly due to a warmer than average summer during 2016.



**Transparent and clear bills**

We know that simple, transparent and fair bills are important to our customers – they told us when we conducted the research for our business plan and they continue to tell us through contact with our customer service teams. We are also aware that the number of queries we receive relating to bills is too high, as explained in the footnote to the table on page 29. While we have improved the accuracy of our unwanted calls categorisation, resulting in a significant increase in the reported number against our target of 49,000, it is now important that we look to drive the number down and improving the clarity of bills is one way we can do this.

We listened and in 2015 we started a comprehensive review of our billing process, in partnership with the Consumer Council for Water (CC Water) and the UK Customer Service Institute. This involved analysing contact data and complaints, while conducting face-to-face interviews with customers to understand which areas of our billing process were most frustrating and where they would like to see improvements.

This prompted us to design a simplified billing process, which we are currently piloting, with plans to implement significant changes over the coming months. The project team's focus over the past year has been to strip back and question the information on our bills, in order to provide customers with greater choice about how they interact with us and more flexibility when it comes to paying their bill.

Alongside this pilot project, we have also worked closely with the CC Water to ensure that our annual billing information leaflet is both simple and accessible. As well as promoting our self-serve online account management service, we introduced practical tips for saving water, energy and money in the home as well as key steps customers can take to help avoid internal flooding incidents. Contact details and links to further information were also more clearly signposted and we included a link to our new Have Your Say pages on our website – [southernwater.co.uk/haveyoursay](http://southernwater.co.uk/haveyoursay) – where customers are able to share their views and help us develop our plans for the future.

New processes have also been introduced which help us monitor changes in customer usage patterns so we can proactively contact them before they receive an unexpectedly high bill (see Proactive team case study on page 23), in turn helping to address any issues and save money.

Our overall customer contact by phone has reduced, due to more of our customers opting for online account management. We have also improved our quality assurance and this has resulted in improved accuracy in terms of the way we record unwanted phone contact from customers, this resulted in the significant increase in the unwanted billing queries that we have reported.

A range of different training methods have been used to embed the improved quality assurance processes and we will continue to reinforce quality during 2017–18. In addition, we are making improvements to reduce the volume of queries received including– setting up joint billing with one of our neighbouring water companies and the creation of a dedicated Home Move team – and we expect our unwanted contact volumes to reduce as a result of this work.

### **Helping our customers to Keep It Clear**

To support our wastewater teams in the fight against internal and external flooding incidents, we have continued to ramp up our fight against fat, oil, grease and unflushables such as wet wipes, sanitary items and cotton buds, by educating customers about what should and should not go into the sewer network.

We are now two years into our five-year, £1.4 million programme and have seen a steady increase in the number of customers (79%) who now understand the root cause of sewer blockages in and around their homes, an increase on 77% during 2015–16.

This increased awareness is the result of ongoing media campaigns, a concentrated programme of regional visits to customers' homes and talks held with local community groups in areas where repeat blockages occur. During these visits our teams are able to offer advice and free products to help with the management of fat, oil, grease (FOG) and unflushables.

Our protection teams have also partnered with local environmental health officers to visit food establishments (such as cafés, fast-food outlets and restaurants) to conduct assessments, building relationships at a national level with chains including Whitbread, Greene King, Prezzo, Harry Ramsden's and Sainsbury's.

Our teams also regularly present at forums such as the Sewerage Network Abuse Partnership group and the FOG Forum run by British Water.

In February 2017 we launched our new campaign, The Unflushables, which is run jointly with the Consumer Council for Water (CC Water). This is the first time CC Water has partnered with a water company on such a campaign.

### **How we spend our customers' money**

While we realise that we are in a privileged position as the only provider of water services to our customers, we want to make sure they fully understand where their money goes. Around 56% currently say they know how we spend their money, compared with 60% in 2015–16. While we are disappointed this figure has not increased, we aim to continue to improve this level of awareness by providing:

- open and transparent updates on our performance against our promise commitments through annual reporting and promotion on our website and social media channels
- clearer information with customers' bills
- advice at community events about saving water, how to prevent blocked drains and how we can help customers struggling to pay their bills. During 2016–17, we attended 17 events, talking to thousands of our customers
- updates on our capital construction schemes to customers directly affected by our planned improvement work as well as local media and key stakeholders. Our dedicated capital communications team has sent more than 33,000 letters and dealt with more than 1,100 individual enquiries linked to 70 different schemes under construction during 2016–17.

### **Tackling the issue of hard water**

Much of the water we supply is drawn from underground chalk aquifers where the levels of calcium carbonate are very high. As a result of this, our water can be considered hard. Of course, the level of hardness will depend on where the water is sourced, but as water hardness does not affect the quality of the drinking water we provide, we do not add softeners at any of our treatment works.

As water hardness can affect customers' household appliances, we offer advice about how to address the issues caused both via our website, which includes a handy postcode tracker and through the distribution of 'Water in the Home' booklets which contain practical tips and useful contacts for homeowners.

In order to understand our customers' awareness of this issue we conduct an annual survey, which revealed 56% are aware of how to deal with hard water. This is roughly the same level as last year. We aim to increase this level of awareness year-on-year and will do this via our social channels and website.

### **Working with our customers**

#### **Saving water, energy and money – Ben Earl, Water Efficiency Manager**

Customers seem really pleased with the results of our water-saving visits, and initial analysis suggests they are saving an average of 10% on water usage. Partnership working has been a critical part of the programme with chambers of commerce, local authorities, national parks and community groups all playing their part to increase the understanding of water efficiency and enabling more customers to have access to this important service.

We helped to set up an innovative new partnership working group with Brighton & Hove City Council, the Consumer Council for Water and University of Sussex to target customers struggling to pay their water bills – if they make up more than 3% of their household income.

Customers are contacted by the city council and offered water-saving products and affordability assessments aimed at reducing bills and consumption. Working together means water efficiency advice can be more tailored and long-term monitoring of water use, bills and payment patterns can be better managed. Customers are then tracked for a period of up to two years to see what impact the water efficiency interventions and engagement have had.

A similar project in South Hampshire was set up to look at resource availability challenges, as there is a lot of housing development in the area. At the moment, water resources are largely supplied from local aquifer sources and by river water abstraction from internationally designated wildlife habitats. With the Hampshire Wildlife Trust we are working together to trial a collective water-saving target and reward system across local parishes in and around Cheriton, near Winchester. Overall water savings will be measured and verified and the community rewarded using a 'community tariff investment fund' as an incentive.

## **Improving communication with our customers**

### **Creating a one-stop shop for customers – Chris Hazell, Digital Developer**

For a long time, our customers had been asking us to share more information with them via our website during incidents, such as bursts and water outages. We listened and spent a long time analysing their feedback online to enable us to create a really responsive and intuitive incident experience for our customers at southernwater.co.uk.

Our incident update system was launched last year, and has had a really positive impact so far – reducing contact during incidents and even generating positive feedback from our customers.

It works by providing live information from our operations teams, via a simple Google map interface on our homepage. Customers can visit and instantly see where the incident has occurred and what we are doing to fix it. Our duty managers then update the incident timeline as there are any developments.

We also added a link to Twitter, following the initial launch, so that customers do not have to visit our site to get the updates; they can simply follow our feed. This feature is linked to the duty manager's updates on the main site so they are not spending too much time online when they should be managing the incident.

There is even a text alert function on the system, which means the team responsible for updates get a quick reminder of when they need to notify customers of any developments. This has worked really well, with the teams having much more time to focus on fixing the problem at hand.

We are hoping that roadworks and information about our construction projects will soon be added to the same map interface so customers have all the information they need about the work we are doing in their community, at their fingertips.

## Delivering reliable services

### A constant supply of high-quality drinking water

	2016–17		2015–16
	Target	Achieved	Achieved
Overall drinking water quality index (%)	99.95	<b>99.97</b>	99.98
Number of contacts regarding discolouration (per thousand population)	0.85	<b>0.74</b>	0.80
Leakage (million litres of water per day)	87	<b>88</b>	84
Customer minutes lost supply > 3hrs	9	<b>7</b>	12
Number of properties with low water pressure	257	<b>222</b>	288
Number of customers affected by temporary use bans	0	<b>0</b>	0
Asset health	Stable	<b>Stable</b>	Stable

Providing safe, clean drinking water is undoubtedly the most important aspect of our service in the eyes of our customers.

We are pleased to say we exceeded our target of 99.95% compliance against the Drinking Water Inspectorate's (DWI) quality measures this year, achieving 99.97%. However, the DWI has raised concerns regarding our monitoring and reporting processes so we are working closely with them to overhaul our practices.

We also reached or exceeded targets in some areas to deliver on the promises we made to our customers. For example, we have maintained water pressure in customers' homes and reduced the number of complaints about discolouration of drinking water. In fact, one of our initiatives which is indirectly helping to reduce incidents of discolouration is also helping emergency crews to save lives, and could even become a template for other water companies. See our case study on page 37.

We always work hard to get it right, so we were disappointed that in 2016–17 we fell short of our leakage target, an area where historically we have performed very strongly. Leakage increased during 2016–17 largely due to fluctuations in ground conditions caused by dry, cold weather putting pressure on our pipe network which led to an increase in cracks or splits.

In terms of abstraction, we are still taking less water from the environment than during the last major drought of 1976, while we have seen an increase in customers of 18.7%. Reducing abstraction, leakage and the demand for water has been at the forefront of our plans since our company was established with privatisation in 1989. This has been achieved with massive reductions in leakage, down from an estimated 235 mega litres per day (ml/day), at the time of privatisation, to 88 ml/day. In addition to our efforts to reduce leakage we implemented a highly successful programme to universally meter our customers' homes across our region. Nearly 90% of customers now have a meter and the scale of savings has been high. Demand for water has dropped from 650 ml/day in 1983 to 532 ml/day today. Universal metering led to a 16.5% reduction in usage and our water-saving visits are now showing a further 6% on top of this achievement.

All of this has occurred against a backdrop of changing climatic conditions, varying consumer trends and an increase in population. Our demand reduction plan targets those 40% of customers that did not see their bills reduce as a result of moving on to a water meter. This, in conjunction with wider partnership working, is increasing customers' understanding of how water is used and demonstrating how each customer can make simple savings. The business is now exploring community incentives to further widen the reach of our programmes.

As a responsible guardian of such a precious resource, in a region already classified as 'water-stressed', we proactively engage with stakeholders to prepare for every possible scenario, including drought conditions. We believe that by working in partnership with our stakeholders and regulators, and by managing our resources carefully, we can be confident in our ability to deliver high-quality drinking water, on demand, well into the future.

### **Maintaining drinking water quality**

The quality standards required by the Drinking Water Inspectorate (DWI) are quite rightly set high and any failure to achieve our targets is taken extremely seriously by our company.

This year the DWI has raised enforcement actions regarding our monitoring and reporting processes, and our compliance with Water Quality regulations regarding the collection of the required number of samples. We have also had delays to some improvement schemes.

The DWI's concerns are outlined in our updated Statement of Risks, Strengths and Weaknesses, January 2017, and our Final Assurance Plan, March 2017, which are available on our website at [southernwater.co.uk/our-reports](http://southernwater.co.uk/our-reports). Other information is available in the three documents listed in the footnote below<sup>1</sup>.

We recognise that although we have met our required standards as set out in the table above, we need to work harder to continue to improve our performance in this area. We have in place a continued programme of work to ensure we meet the required reporting standards, and an action plan has been completed to review the end-to-end process from planning and scheduling the drinking water sampling, through to reporting data to the DWI. We provide regular updates to the DWI under our enforcement action plans.

We agree with our regulator that all of our stakeholders, including customers, should be able to have full confidence in the integrity of our data and so we have begun a transformation programme to improve our performance and compliance in information management, project delivery and risk management. While we have made improvements in some areas, we recognise that we have further improvements still to make.

### **Reducing incidents of discolouration**

When we carry out a repair on our 13,870 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 customers' pipes, although, it is understandably worrying for people.

In 2016, just 1,825 of our 2.4 million drinking water customers notified us of discolouration. This is a rate of fewer than 0.74 contacts per 1,000 customers served. This excellent result exceeded the performance target we set in our plan and is testament to the care and professionalism of our employees and service partners. Our case study shows how one Southern Water initiative in Kent is indirectly contributing to our low discolouration figures as well as helping to save lives (see page 37).

### **Keeping leakage to a minimum**

We were disappointed to have missed our leakage target last year to record a final leakage figure for the year of 88.1 million litres per day – the target was 87.1 million litres per day. This was the result of a large increase in leaks and bursts across the network, which had been caused largely by the weather conditions of a dry summer followed by spells of extreme cold weather in the winter. The fluctuations in ground conditions caused by this weather combination put pressure on our pipe network and led to an increase in cracks or splits.

However, although this performance was not as good as we would have liked, our overall performance in managing leakage remains strong. We remain on track to meet our five-year target for reducing leakage, keeping the promise we made to our customers under our business plan for 2015–20, to cut leakage by two million litres a day to a total of 86 million litres a day. To provide some context, 86 million litres of water is around 15% of the total amount of water we put into supply each day. After 2020 we want to go even further and our ambition is to bring leakage down to 75 million litres a day by 2040.

Currently, we have an expanded Leakage team in place, made up of more than 120 people. They are all focused solely on finding and fixing leaks on network of water mains. Additional support is provided by a further 400 Southern Water employees and contractors.

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<sup>1</sup> Chief Inspector's report: [www.dwi.gov.uk/about/annual-report/2016/2016-public-Q1.pdf](http://www.dwi.gov.uk/about/annual-report/2016/2016-public-Q1.pdf)  
Enforcement orders: [www.dwi.gov.uk/stakeholders/improvement-programmes/list.htm#srnimp](http://www.dwi.gov.uk/stakeholders/improvement-programmes/list.htm#srnimp)  
Consumer Council for Water report: [www.ccwater.org.uk/wp-content/uploads/2016/11/Delving-into-water-2016.pdf](http://www.ccwater.org.uk/wp-content/uploads/2016/11/Delving-into-water-2016.pdf)

During 2016, we identified and repaired more than 20,000 leaks on our network. Over half of these were found and addressed proactively by our Leakage team. The remainder were reported to us by customers via our dedicated Leak Line; we are very grateful to everyone who contacts us to tell us about a leak.

Our aim is always to repair leaks as quickly as possible, depending on the local circumstances – such as needing to secure a permit to carry out work on a busy road or gain permission to access private land.

We also rely on leak alarms that are built in to our water meters, which we installed under our pioneering universal metering programme. The alarms alert our engineers to unexpectedly high water consumption and enable us to contact customers even before they might know a leak exists. We can then highlight to a customer where they have a leak on their private supply pipe or plumbing system, so they can reduce any water wastage. Of course, we can also fix any leaks on our pipes that are pinpointed.

Tackling leakage on our network of water mains is a top priority for us. We are working to do this as cost effectively as possible, investing tens of millions of pounds across the five years to 2020. Customers have clearly told us that they want us to reduce leakage as much as we can, while at the same time keeping their bills as low as possible.

### **Supply interruptions and water pressure**

As noted above, sudden changes in water pressure, ground movement caused by fluctuating temperatures and defective pipes can all result in burst water mains. Bursts on our larger diameter mains can have dramatic effects and affect 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 that exceed three hours, where customers are most inconvenienced. During the year we ensured that on average, water supplies were not interrupted for longer than seven minutes per customer.

One of the ways we have achieved this has been by changing our working methods. In the past, we would shut off a mains water supply while we fixed a leak. Now, we attempt to fix the leak while the water supply is still running so our customers are not inconvenienced.

We have also introduced better pressure management, with more than 40% of our network now subject to pressure control. Using modulation techniques and valves, we can control water flow at peak times, which means we can reduce the wear and tear on pipes caused by sudden increases in water pressure. We are pleased that the number of properties receiving low pressure dropped during the year to 222, fewer than our target of 257 properties.

### **Avoiding water restrictions**

We believe that all stakeholders, including our customers, need to have confidence in our ability to supply high-quality drinking water on demand.

One of the measures we aim to meet is keeping the number of temporary use bans to an absolute minimum – such as asking customers not to use hose pipes. We made a promise that we would not impose such restrictions unless we had experienced two unusually dry winters in a row. During 2016–17 none of our customers experienced a temporary use ban, but we know that any failure on our part to plan ahead properly could mean we have to introduce them in the future.

Therefore, hand in hand with our efforts to reduce leakage from our network and educate our customers about the importance of water efficiency, we develop detailed plans to manage the impact on our water supplies of issues like climate change and population growth.

Our [Water Resources & Drought Strategy](#) gives an overview of our plans to manage water resources over the next 25 years and we are continually updating our drought plans. More information about our water resources planning can be found on our website at [southernwater.co.uk/water-resources-plan](http://southernwater.co.uk/water-resources-plan).

## **Maintaining our sites and infrastructure**

We are continuing to invest in maintaining and replacing our treatment works and pipe networks so we can deliver a high-quality service to customers.

To measure how well we are looking after the long-term health of our assets, we have agreed a set of performance indicators with our industry regulator, Ofwat.

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.

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

Among the water supply projects we are proud to have invested in during 2016 are:

- The Gaters Mill trunk main installation in Southampton, which will be used to transfer water to our customers in Hampshire and which forms part of our wider water resources programme.
- The £8 million Woolmans Wood mains replacement scheme in Chatham, Gillingham and Rochester, which will improve water supply in the region.
- Extensive improvement programmes at Brede and Beauport water supply works.

The combined investment in the above projects alone totals more than £20 million.

## **Putting our customers first**

### **Keeping our customers informed, Dave Seager, District Manager**

When we got the call from the gas company that a main had burst on Palatine Road in Worthing, we immediately sent out one of our inspectors and shut down supply, as the water was flooding their work excavation.

I was called in and made my way down from Horsham. By the time I arrived, our team had isolated the main. Obviously this meant that our customers were without water so we had to act quickly. We placed an order for water tankers to supply surrounding homes, as at this point we were not sure how long it would take us to return supply.

It was a tricky situation as the valve we needed to access was in the middle of the roundabout and it was already under water, but we managed to isolate it safely within the hour and return supply to customers. Of course, we still had to fix the main and ensure this would not happen again, and this was going to take a lot longer.

As we excavated down, around the main, we found it was sitting under six high voltage electricity cables so we had to stop work until these could be switched off and tested to ensure the burst had not caused any damage. We then had to have these cables carefully moved, divert the main and create two new avenues so that the same burst could not happen again. It also meant that if a burst happened in the future our teams would be able to work in a safer location; we prefer not to work in the middle of a roundabout!

The whole fix took just over a week so we had a lot of interest from local residents as the burst meant we had to close a section of the roundabout. Despite this, and the traffic changes it caused for local residents, we had a really positive response from customers. We made a point of talking to them, on the ground, throughout the fix. I think the team did a great job of keeping everyone informed. We even had some congratulations from our customers on Facebook so I am really proud of the work our team did with customers.

## **Putting safety first**

### **Water to the rescue, Don Winzer, Distribution Compliance Manager**

We have made real-time plans available to fire crews which track the flow and water pressure of nearby hydrants. Fire officers can access the information on the way to an emergency scene so they know which hydrants will be most effective to use when they get there. This means they can connect their pumps quickly to the most powerful hydrants and get on with saving lives.

Following a recent presentation to senior officers for Kent, we are now discussing ways to promote the idea country-wide.

And it is not just good news for saving lives. The hydrant pressure maps mean fire crews are more aware of how much water they use, which is better for the environment. Meanwhile, directing emergency crews to take water from the mains also results in fewer incidents of discolouration for our customers.

**Steve Lewis, Kent Fire and Rescue's Resilience Manager**

A fire and rescue authority must take all reasonable measures to make sure adequate supplies of water are available in the event of fire. Fire hydrants form an important part of our fire fighting tactics and provide water at most incidents we attend. Knowing which hydrants will provide the greatest volume of water is very important and impacts on our resources and tactics. The working partnership we have built with Southern Water has helped inform our tactical plans as well as enabling us to minimise the disruption to customers' supplies. This data-sharing has therefore benefitted us both and we will continue to work together to find new ways of improving the operations and service provided by both organisations.

## Removing wastewater effectively

	2016–17		2015–16
	Target	Achieved	Achieved
Number of blockages per km	0.58	<b>0.55</b>	0.56
Number of internal flooding incidents	436	<b>448</b>	492
Number of external flooding incidents	9,694	<b>8,009</b>	8,314
Number of customer complaints regarding odour	390	<b>326</b>	262
Asset health	Stable	<b>Stable</b>	Stable

We have committed £1.8 billion to maintain, enhance and extend our wastewater and water operations between 2015 and 2020. This investment, combined with a programme to educate our customers about how to Keep It Clear and reduce sewer blockages, is having a positive effect on the way we deliver our service.

The number of sewer blockages and external flooding events are down, fewer customers are bothered by smells from our operational sites and our assets are meeting compliance targets – limiting sewer collapses and rising mains failures on our network, for example.

It can be devastating to our customers when they experience the result of a sewer flood inside their property, which is why we are pleased with the steady reduction in the number of internal flooding incidents over the past year.

We have introduced a range of initiatives to tackle such flooding incidents, which go beyond what we are legally required to do and which you can read more about below. They include a combination of better monitoring, more detailed planning and closer working with our customers, other stakeholders and business partners.

There will always be factors beyond our control, such as unusual weather events, that put pressure on our sewer system or geographical features, which make some areas more prone to flooding. But we can plan better, build more resilience into our network and improve the advice we give customers on what they can do to help themselves, such as guidance on what not to flush or pour down sinks to keep sewers clear.

And, as well as advising on preventive action, we are also working directly with organisations at a national level, like the manufacturers of wet-wipes to persuade them to make clear on their labels that they should not be flushed.

### Reducing blockages along our network

In 2016–17, we exceeded our target of reducing blockages to 0.58 per kilometre of sewer, achieving 0.55. This was the result of the introduction of more targeted network maintenance including jetting sewers at the highest risk of blockages. We are also beginning to see the benefits of our extensive education campaign to make customers and businesses aware of the causes of regular blockages.

Blockages can be caused by a build-up of fat, oils and grease (FOG), wet-wipes, sanitary products, nappies and other 'unflushables'. These entirely preventable blockages can lead to flooding from our network, pollution to watercourses and considerable customer inconvenience. Worse still, when blockages lead to flooding inside a customer's property, the distress caused can be considerable. This is why it is so important to us that we work with stakeholders to tackle the causes of blockages at their source. It costs around £1.8 million every year to remove blockages from our sewer network.

We have lifted nearly 2,000 manhole covers to check sewers in around 700 areas. Our campaign to visit 'blockage hotspots' has seen us visit around 20,000 homeowners to give advice on how to keep sewers and drains clear. Read all about how our teams deliver this message on the ground in our case study on page 41.

More information on our FOG programme, which involves stakeholders in taking measures to prevent the build-up of fat, oil and grease, and our joint campaign with the Consumer Council for Water, 'The Unflushables', is in the Better Information and Advice section of this report, on pages 29 to 33.

### **Limiting flooding from sewers**

We understand just how upsetting sewer flooding can be for our customers – especially when it happens inside someone's property. This is why we have promised to work with our local partners to reduce incidents of flooding inside homes and businesses by 25% by 2020.

We have introduced a range of new working practices to help us respond to this challenge. These include holding morning conference calls with our engineers and technicians who speak with affected customers to plan how we can fix problems more quickly. We have also become better at identifying problems earlier by more targeted use of CCTV to both investigate the causes of flooding incidents as well as proactively check for issues such as tree roots pushing through pipes.

Initiatives such as these, combined with our campaigns to reduce blockages have resulted in a reduction in internal flooding incidents from 492 during 2015–16 to 448 for 2016–17 – sadly this is higher than our target of restricting these incidents to 436, but we are confident that the work we are doing in this area will see this figure continue to decrease.

We are also on track to exceed our target of reducing the number of external flooding incidents (those that occur outside properties) for the second year in a row. Overall, there has been a 4% reduction in such flooding incidents over the past 12 months as a result of previous flood mitigation work and our planned maintenance activity. However, there is still more to do and partnerships with customers will help move this work forward.

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 addition, parts of our region suffer 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. One of the ways we tackle the problem is by drawing up dedicated infiltration reduction plans for those areas worst affected by groundwater flooding.

Once we have identified where the flooding occurs, the causes of it, and drawn up a bespoke action plan of solutions for tackling it, we then share our plans with stakeholders such as local authorities and the Environment Agency. The benefit of this is that these partners can work with us on preparing timescales for carrying out the necessary improvements and on keeping the public informed on what is happening, why it is happening and when. We were the first company in the UK to develop these dedicated infiltration reduction plans.

We are also working closely with Kent County Council (KCC) on a number of opportunities to reduce flooding incidents across the Kent region. One area in which we have a shared interest is the Downs Road/Dolphins Road area of Folkestone. Both parties are present at regular meetings with the National Flood Forum & Downs Road Flood Action Group.

KCC is aiming to address surface water flooding issues in the Dolphins Road area and now has a detailed design to install 23 rain gardens running along the length of the road. Its solution will provide some benefit to our combined sewer system in the area, helping us control water flow during storms so we have committed to partially fund the scheme. Surface water will enter the rain gardens and will then be held back and stored there, being introduced to the sewer at a much slower rate, reducing the risk of overloading and consequential flooding.

### **Tackling complaints about odour**

In 2016–17, we had 326 complaints about smells from our treatment works and pumping stations. This beats our target of limiting complaints about odour to fewer than 390.

However, complaints about smells have dropped by more than half in the past 10 years and we are on track to keep to the commitment we made in our business plan 2015–20 of reducing the figure by a further 5% over the next three years.

Over the full five-year period of our business plan we will be investing significantly in large schemes to reduce smells. For example, at Portswood Wastewater Treatment Works we will be spending in the region of £5 million to install roofs and buildings, replace and install new equipment and provide automatic cleaning systems. Another project installed chemical dosing systems at three pumping stations in Hampshire over the past year to reduce gases commonly associated with the smell of rotten eggs, such as hydrogen sulphide.

We have also improved a dosing system at our Earnley wastewater treatment site in West Sussex after a customer complained of odour, following a survey of the network. You can read more about the work to reduce odours in our case study on page 42.

### **Maintaining our sites and infrastructure**

We own and operate over 39,500 kilometres of sewers. We have also now taken ownership of a further 746 pumping stations following the transfer of private pumping stations in October 2016. The total number has increased to 3,243 wastewater pumping stations.

Our customers expect us to manage our infrastructure strategically to ensure our sewerage network and wastewater treatment works are able to respond to the challenges of the future such as population growth, new development and less predictable weather patterns that occur as the climate changes.

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.

### **Putting our customers first**

#### **Helping prevent internal floods, Matt Collins, Field Customer Engagement Officer**

I quite regularly visit customers outside normal office hours to attend an internal flooding incident.

It is horrible to see the devastation it causes: children's toys, precious family photographs, furniture – everything needs to be replaced if it has come into contact with untreated sewage. Although we sympathise with customers affected, in many cases we are only able to advise them and their neighbours about how to prevent further issues in the future.

When we have lifted the lids on manholes and shown customers the sort of things that have caused the blockage, up to 70% of the time it is the result of what we call FOG and 'rag', formed by 'unflushable' materials like wet-wipes and solidified fats, which have clumped together and clogged the sewer. I also have found a pick-axe, a teddy bear and one of my colleagues also found a bed sheet that had been flushed into the pipe network last year.

Since we started working more closely with customers to advise them on what they can do to help themselves by only flushing what we call the three Ps – pee, poo and paper – we have seen a drop in the number of internal floods that we get called to out of hours.

We visit areas where we have seen a history of blockages due to FOG and rag and go from house to house visiting customers to give advice on how to prevent this happening again.

We often help to physically clear blockages ourselves if we can – so we carry rods and CCTV cameras with us. If we cannot tackle something alone, we make notes and call our wastewater colleagues and contractors to get the blockages cleared as part of a joined-up response to keeping drains and sewers running freely. We will follow up on progress once a blockage has been dealt with and report back to the customers concerned. Our customers have told us they were really happy with this service, as we are keeping them fully informed.

We also deliver talks to community groups and support action days in hotspot areas where localities have repeated incidents of sewer blockages. Knowing that you are helping people avoid the devastation and heartbreak of internal flooding is really important to me and my colleagues on the FOG and Unflushables teams. Once you have seen how distressing it is, all you ever want to do is help customers avoid it happening to them again.

## **Putting our environment first**

### **A breath of fresh air at our sites, Carolin Till, Air Quality Technician**

My job is to work with the operations teams and the contractors at our wastewater sites to make sure we keep smells to a minimum.

It is extremely important to us to be good neighbours and work in a way that does not disturb people living near our treatment works and pumping stations.

We know it can be horrible when smells carry into the air from our sites and we take any complaint about odour very seriously.

It is my job to conduct odour surveys across the whole region, when required, so that I can help local teams identify sources of odour and monitor the progress of dealing with these smells effectively.

We have established a good working relationship with local councils so we can inform them of any work we are carrying out that is likely to cause issues. On occasions customers will complain to their local authority about odour from our works and it is important these are passed on to us. We also want to make sure that customers are encouraged to call our customer services line because this means their complaints are then logged on our systems and can be dealt with as soon as possible. We have regular review meetings with our odour control contractor to ensure the systems are working efficiently and to discuss any issues that arise.

We try to make sure customers are kept informed of anything, such as repairs to our networks, that might cause a temporary odour nuisance. I know that if it were me, I would want to know what was happening, why it was happening and for how long – so we try to let our customers know these things too. It is about being respectful of the impact our business might have on customers' lives.

In the past 10 years, the number of complaints about odours from our sites has been falling steadily. This is really gratifying because everyone involved in our wastewater removal service works so hard to operate this aspect of the business with consideration for our communities. We cannot always stop things from breaking down but we can be courteous about explaining what has happened, how we are going to fix it and what we intend to do to stop it happening again.

## Protecting our natural resources

### Looking after the environment

	2016–17		2015–16
	Target	Achieved	Achieved*
Wastewater treatment works compliance (%)*	100	<b>99.32</b>	99.32
Maintain bathing waters with 'excellent' water quality at 54	54	<b>51</b>	43
Number of serious pollution incidents (category 1 and 2)	6	<b>3</b>	7
Number of less serious pollution incidents (category 3)*	221	<b>143</b>	163
Distribution input (million litres per day)	525.06	<b>532.28</b>	520.64
Renewable energy use (%)	16.3	<b>17.0</b>	17.3

\* The number of category 3 pollution incidents and Wastewater Treatment Works compliance remains subject to further assurance.

The performance of our wastewater treatment works continued to be strong during 2016–17 (though this remains subject to further assurance). This has been achieved through a range of measures including the introduction of targeted training courses to boost the expertise of our wastewater treatment operators.

The number of excellent bathing waters in our region currently stands at 51, a big improvement on last year's 43. Although we missed our target of achieving excellent status at 54 of our region's bathing waters in 2016, there is no single region-wide cause. Issues, such as the impact of bird life and dogs fouling on the beach, misconnections to the surface water system and the impact of urban and agricultural run-off, and the performance of the sewerage system, have all played a part in affecting the quality of our region's bathing waters.

We are pleased to see a further reduction in pollution incidents. The number of serious pollutions, classified by the Environment Agency (EA) as category 1 and 2 incidents, is among the lowest in our history. Last year there were three category 2 incidents – an improvement on the seven events recorded in the previous year. We restricted the number of category 3 (less serious) pollution incidents, exceeding our target of 221. At the end of the year, we had managed to limit these incidents to 143\*. This also represents a reduction on the 2015–16 figure of 163. We are pleased this year-on-year improvement has continued. We expect our pollution performance to be just above industry average and we aim to work to continue this reduction in pollution incidents in future. However, as mentioned previously, we are also working with Ofwat in relation to the management and operation of our wastewater treatment works and the reporting of relevant information in connection with them.

We are also ahead of our promise commitment of 15% to increase the amount of renewable energy we use across our operations, recording a figure of 17% during 2016–17.

We always aim to operate our business in a way that respects the environment in which we operate and protects resources into the future. We provide a significant amount of data to the EA about the performance of our assets and any wastewater or sewage discharges we make into what is known as the 'water environment', such as rivers, streams and coastal waters. We have identified the need to review and improve our end-to-end reporting processes with a view to implementing process and control improvements. Detailed process reviews have continued and a programme of improvements is being developed. We will establish a programme of rolling audits of our EA reporting and data integrity, starting with the 2017–18 internal audit programme of assurance. In addition, we will complete assurance of the 2015–16 and 2016–17 data. Independent external assurers will be assigned to the review, which will commence in August 2017.

One of the central themes of this improvement strategy is to get better at building effective working relationships. This means encouraging our own teams to work together so any issues of concern can be addressed more quickly. It also means liaising with our customers, stakeholders and regulators to keep them informed about our work.

We have:

- set up specialist teams to provide a more integrated approach to managing our sites
- launched educational campaigns to involve the public and stakeholders in our work to protect our beaches and keep sewers clear of blockages.

### **Bathing water**

One of the ways we can influence bathing water quality is through partnerships with the public to tackle some of the root causes of pollution together. By educating customers to change some of their behaviours we can be more effective in keeping bathing water clean and preventing blockages that might lead to discharges. We also work with stakeholders in agriculture and business to advise on their wastewater management.

Our environment and wastewater strategy, and stakeholder teams are working with local authorities, landowners and highways agencies on projects such as our Bathing Water Enhancement Programme. The programme aims to bring a further seven bathing waters across the region to 'excellent' standard by 2020. We have completed technical investigations of 21 bathing waters and will continue to engage with customers and stakeholders over the coming months. Seven have now been selected, with a further six identified for potential discretionary funding. We are currently exploring funding partnerships with local authorities in this area.

Since the enhancement programme launched, we have:

- delivered briefings face-to-face, over the phone or via email to coastal MPs, the Environment Agency, World Wildlife Fund, Natural England, Marine Conservation Society, Rivers Trusts, National Farmers' Union, Keep Britain Tidy and Surfers Against Sewage
- sent letters to coastal council chief executives and leaders
- held briefings with local environment and tourism teams and stakeholders such as local environmental groups, farmers and landowners
- produced Statements of Intent countersigned by the councils to agree collaborative working.

There have also been targeted approaches for areas causing particular concerns. One example of this is the Thanet Bathing Water Steering Group, which brings together members of the local district council, the EA, Kent County Council and local businesses to collaborate on technical solutions and proactive education campaigns to tackle beach pollution. The group was set up in 2014 as part of a bespoke action plan and meets regularly to maintain the excellent quality of the area's bathing waters.

Since the failure of our pumping station at Foreness Point near Margate in 2012 – which resulted in two unauthorised releases of wastewater for which we were fined in 2016 – we have invested £4 million in the site and have a further £6 million investment plan. Thanks also to the strong partnerships we have formed with stakeholders such as Thanet District Council and the regional arm of the EA, Thanet's beaches are now some of the best in the country, boasting seven blue flags and three seaside awards.

In 2016, we had a heartening response from the public and other stakeholders to our Beauty of the Beach campaign. Run jointly with the EA South East, the campaign was launched to mark the 2016 bathing water season (May to September). It involved 'days of action' in key areas of our region including Broadstairs, where we joined forces with Thanet District Council and the EA to help local residents, businesses, visitors and tourists understand how their actions can affect the quality of our coastal bathing waters.

To mark the end of the season we produced a campaign video explaining how members of the public can play their part in protecting and enhancing the beauty of the beach. The video has been viewed more than 10,000 times since its launch in September 2016.

Meanwhile, we are required to meet ever more challenging environmental targets to ensure our natural environments remain healthy. For instance, our bathing waters are home to nature's larder with a number of designated shellfish beds around the coast.

As custodians of the water environment, we have a duty to plan and invest carefully to build resilience into our water resources. We work with university and technology experts to better understand, predict and model new technologies that limit pollutants being released into the environment that may find their way into our bathing waters.

For example, we have two innovative projects in progress looking at the presence of metaldehyde – a chemical contained within pesticides – in our water supply. One with Arvia Technology, looking at removing metaldehyde

through a chemical process and another with the University of Brighton that is helping us track the use of the chemical in our catchment areas.

### **Preventing pollution**

We are pleased to see a reduction in pollution incidents. The number of serious pollutions, classified by the EA as category 1 and 2 incidents, is among the lowest in our history. Last year there were three category 2 incidents – an improvement on the seven events recorded in the previous year. We restricted the number of category 3 (less serious) pollution incidents, exceeding our target of 221. At the end of the year, we had managed to limit these incidents to 143\*.

The improvement is due to a range of initiatives including the adoption of new approaches to managing and replacing faulty equipment, improved liaison between teams to identify and flag up potential problems earlier, and more targeted spending on capital projects.

Another recent initiative involves us working closely with the farming community in our region to help reduce the amount of fertiliser that inadvertently gets into aquifers during muck-spreading. We use satellite pictures of fields to advise farmers how to change muck-spreading routes to accommodate the geography and geology of the land. This helps prevent fertilisers from seeping into aquifers or running off into rivers and polluting clean water sources.

\*The number of category 3 pollution incidents remains subject to further assurance.

### **Reducing the amount of water we take from the environment**

To supply high-quality drinking water to our customers, we need to take water from local rivers and underground sources through a process called abstraction. We promised our customers we would reduce the amount of water we abstract to help protect the environment. During 2016–17 we took 532 million litres each day from our region's resources – higher than the target we had been aiming to stay within of 525 million litres.

Summer 2016 temperatures in the South East were slightly higher and maintained for longer than those seen in recent years. The impact, as the warmer weather continued into the autumn, was a prolonged increase in customer demand, which in turn had an impact on the volume of water we had to abstract to maintain supplies.

However, despite not meeting our target last year, the amount of water we take has been steadily decreasing since 2004 when it peaked at 599 million litres per day. In five years between 2011 and 2016, we reduced the volume of water we abstract by almost 56 million litres a day.

As a company operating in a water-stressed region, we need to strike the right balance between protecting customers' supplies and the needs of the environment. Therefore, we are working on a number of initiatives such as trading water with companies in areas with more abundant water resources, reducing leakage from our network, water re-use, helping our customers use less water and working with developers to make sure new homes are more water efficient (see pages 29 to 30).

We operate in three water resource areas – Western, Central and Eastern. We share boundaries with several water companies in the South East and work closely with them to plan for the best value water resources. Together we make up the Water Resources in the South East group, along with Defra, the Environment Agency, Ofwat, Natural England and the Consumer Council for Water. This group develops a regional plan, which takes account of demand for water, the environment and the ability of companies to share water resources. In this way, we are growing a 'regional grid' in the South East to move water around and develop new joint water resources where they are most needed.

We also have a comprehensive programme to find and repair leaks across our region from 2015–20, with additional targeted campaigns in the Worthing and Hastings areas of Sussex and on the Isle of Wight. Reducing the amount of water which leaks from pipes reduces our need to abstract water from rivers and groundwater, so helps protect the environment

## **Renewable energy**

Part of our commitment to working with respect for the environment involves using as little of the Earth's resources as we can. This means replacing traditional energy sources with renewable supplies wherever possible in our day-to-day operations.

For instance, we generate energy in our combined heat and power plants (CHP) using biogas from our wastewater sludge digestion processes. During 2016–17, 17% of our total energy use came from renewable sources – slightly exceeding our target of 16.3%.

We have invested more than £5 million this year to replace the CHP plant with more efficient larger engines at our Gravesend (Kent), Fullerton (Hampshire) and Goddards Green (Sussex) sludge treatment centre sites. We have also increased our capacity by installing additional CHP engines at Budds Farm and Millbrook sites located in Hampshire. We are also introducing solar panels at our sites (see case study below) and continuing to investigate opportunities to help us close the gap between the energy we use and the energy we supply to support our work.

## **Putting our environment first**

### **The future's bright for renewable energy – Emma Bennett, Carbon Policy Manager**

As Carbon Policy Manager, it is important to me that Southern Water should seize every opportunity to keep its carbon footprint as small as possible.

One of the ways that we can limit the impact we have on the environment is by generating our own energy through the use of renewable energy.

Therefore, it has been a really exciting year for us as we have seen the introduction of solar panels after considerable amount of planning for them. We are spending £4 million to deliver solar power at three of our largest water treatment centres at Testwood and Otterbourne in Hampshire and at Hardham in Sussex. The capacity from all three sites equates to four megawatts – the equivalent to providing power for 1,000 homes for an entire year.

The power we generate from our new panels will be used on site in our treatment processes.

Working with our delivery partners, such as Fatou Tambadou, Project Manager, Arcadis, we hope this is just the start of many similar projects to help us become as self-sufficient as possible in providing our own energy supplies.

## Sustainability and environmental responsibility

	2016–17		2015–16	
	Target	Achieved	Target	Achieved
Greenhouse gas emissions – ktCO <sub>2</sub> e	281	245	281	267
KgCO <sub>2</sub> e per person supplied with treated water <sup>1</sup>	-	25	-	27
KgCO <sub>2</sub> e per person supplied with wastewater services <sup>1</sup>	-	35	-	39

<sup>1</sup> There are no targets for these indicators

KgCO<sub>2</sub>e – Kilograms carbon dioxide equivalent

One of our most important duties is to plan ahead to protect the region's water resources. Future generations of customers rely on our ability to adapt our operational and business practices now, so that our services can be resilient in the face of future challenges such as population growth and climate change.

### Carbon performance

Climate change is one of the biggest issues facing the environment. Preparing for its impact means not only planning for how our business will be able to work efficiently and maintain good quality services for customers with a dwindling supply of water, but how as a business, we do not contribute to the problem. Therefore, we want to limit the amount of greenhouse gases (carbon emissions) our operations produce.

We are pleased to report that the greenhouse gases produced by our operations have gone down again this year. In 2016–17, we produced emissions equivalent to 245 kilotonnes of carbon dioxide. These are produced from our consumption of grid electricity and natural gas, our transport and from our wastewater and sludge treatment processes.

Our operational emissions for 2016–17 were 8% below those of the previous year, our lowest for five consecutive years in real terms. We did this by consuming less power from the national grid due to making key sites more energy efficient and maintaining our usage of our own renewable energy. In addition the grid power that we used was cleaner because the national grid is using more renewable energy in its supply.

We have continued to focus on renewable energy generation, which was one of our key customer promises. We have been certified to Carbon Trust Standard since 2011 and will be seeking reaccreditation again this year. The Carbon Trust Standard recognises excellence in monitoring and managing carbon emissions.

We continued to participate in the government's Carbon Reduction Commitment Energy Efficiency Scheme and will buy government carbon allowances at a cost of £3.3 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, pumping stations and processes. The team considers the greenhouse gases resulting from the materials we use and the energy efficiency of the design. The designs must also make us more resilient in the face of future pressures from issues such as population growth, increased treatment standards and climate change.

We started a number of initiatives in 2016 including:

- a scheme to allow Southern Water to use power stored in batteries so we can be more efficient in the way we use energy drawn from the National Grid, reducing the amount of power we need to draw at peak times
- a review and assessment of existing pump systems to improve their performance
- investment into real-time control systems so the correct quantities of power and chemicals can be adjusted to suit the load that is being treated

- investigations into how we can make the most of our existing anaerobic digestion assets to generate more power from our sludge treatment processes.

### **Recycling waste**

During the wastewater process, sludge is produced. This can be used to generate energy and during 2016–17 we produced 17% of our energy needs from sludge. We also recycled 100% of our sludge and grit and screenings waste for the first time in 2016–17, with none being sent to landfill. See our case study on page 49 for details of what we are doing to recycle our waste materials.

### **Conservation and biodiversity**

During 2016–17 we became the first water company to meet a tough new international environmental standard. The ISO14001 International Standard for Environmental Management Systems was changed in 2015, when companies were given three years to bring their systems up to the new level.

It has taken us less than a year with the audit report praising our high level of management leadership and commitment and our engagement with our stakeholders and employees.

Over the past year we have begun to implement management plans at nine of our landholdings that have more than a hectare of land designated as a Site of Special Scientific Interest (SSSI). The plans will help these SSSIs achieve Natural England's 'favourable status' by 2020.

We have also introduced plans to control, or where possible eradicate, invasive non-native species such as Japanese knotweed and Himalayan balsam on a further 33 of our sites. The control of these species enhances biodiversity, protects our assets and benefits the communities in which we operate. Japanese Knotweed, for example, can cause structural damage to roads, reservoirs and buildings. Most of these invasive species can out-compete our native species, potentially driving them to extinction.

We have developed a new biodiversity policy to provide us with a framework that makes sure we incorporate these considerations into our planning processes across the business. These range from building biodiversity into our development projects – for example providing bird and bat boxes and setting aside tree-planting and wild flower areas – to larger initiatives such as conducting ecology surveys of our land to assess its potential for related improvements.

We are committed to meeting international targets for protecting and enhancing global biodiversity. This commitment includes making sure we factor in regional enhancements when planning our water supply and wastewater management strategies.

In addition we work with local and national interest groups to reverse biodiversity loss in our region. For example, we are currently developing ways to prevent the potential transfer of invasive non-native species between river catchments in our large impounding reservoirs. And we are raising awareness of good biosecurity measures, such as the Check, Clean, Dry campaign for anglers and boat-owners.

We now have three full-time ecologists and a back-up team of 50 ecologists employed by our business partners, all dedicated to delivering ecological surveys, watching briefs, appraisals and mitigation plans for all our projects.

During 2016 six of our pollution incidents occurred inside either an SSSI or an area of Priority Habitat. In addition a further 10 incidents occurred upstream of a protected site. None of these incidents caused any damage to the protected sites.

Where our engineering work potentially affects a European Protected Species, we will apply for licences to disturb them. In 2016 Natural England granted us two licences to disturb dormice and one to disturb Great Crested Newts on projects to provide new sewers to Mountfield and Three Oaks in East Sussex.

We were very proud to acquire our first Great Crested Newt Low Impact Class Licence from Natural England. The licence means we can fast-track applications to capture and relocate newts for low impact projects if necessary. Normally, we would have to submit a very detailed licence application to manage newts on each project. We also recently won a coveted Institute of Water Innovation Award for our bat location technology in the South East.

### **Embracing innovation**

To ensure we protect water resources and build resilience into our business we need to take advantage of technologies and innovations that will provide solutions to some of our greatest challenges, such as climate

change. However, we also want to go further by establishing ourselves as a leader in developing innovative solutions to benefit the whole of the water industry.

In partnership with the University of Portsmouth, we have invested in a £2.5 million Innovation Hub, based in Petersfield to look at projects including new options for removing potentially harmful chemicals from small sewage treatment works. We also have partnerships in place with the Universities of Brighton and Southampton to take advantage of local expertise in developing new approaches to established challenges. For instance, metaldehyde is a chemical used by farmers to keep slugs away from crops and it can end up in the water supply. We now have two projects in place which are helping us to tackle the problem, one with the University of Brighton to map and predict the presence of metaldehyde. Another, with a company called Arvia Technology, which is trialling how to remove it through a chemical process.

Projects designed to transform the way we approach our challenges include real-time water quality trials. Conducted with a partner company, Intellitect, the project uses probes along the distribution network so we can alert customers in advance to issues like discolouration.

Longer term goals include applying a 'circular economy' approach, where we extract value from our waste materials by, for example, removing and selling nutrients from our wastewater treatment process. We are also looking at storing power generated by our operations to sell back to the National Grid. Eventually, we also hope to provide integrated water, wastewater and energy networks for the communities we serve. We already invest in renewable technologies such as solar power at our sites (see page 46), and we extract biogas from wastewater, which we convert into electricity.

Existing technology available via our meters alert us when there might be a leak on the pipes serving a property, and we are also looking into the development of smart bills that will provide customers with detailed information about their water use, allowing them to reduce what they pay even further. In the future we can then work with our customers and communities to trial new charges that reward them for using less water.

We are fitting monitors to our Combined Sewer Overflows (that allow excess flows of highly diluted, screened wastewater to go into watercourses, rivers and the sea) to help us monitor flows and prioritise areas for investment.

We have also been looking into the development of Sustainable Drainage Systems (SuDs), which manage the impact of development and increasing rainfall by slowing and holding back the water that runs off from a site, allowing natural processes to break down pollutants which could otherwise damage the environment.

We continue to develop these solutions so we are prepared for a future where areas of our business will be subject to competition. Indeed, from 2020 we will find ourselves competing to develop new water resources and sludge recycling methods. Our delivery model could also be challenged, with more expensive projects potentially contracted out to other companies to design, build, finance and operate.

## **Putting our environment first**

### **100% recycling record, Nigel Heward, Waste and Recycling Manager**

I am really proud of our record in recycling our waste materials and believe we are among the best in our industry in this field.

All the biosolids we produce from treated sludge goes to our local farmers to use as fertiliser on agricultural land – some 250,000 tonnes of it every year. And since July 2016, all of the grit and screenings (rag and unflushable items that get filtered out from our sewers) are now either recycled or composted – 10,000 tonnes' worth. In other words, that is 260,000 tonnes of waste that is kept away from landfill sites.

This result is achieved with a lot of hard work and effort – not just from our own teams, but by our partners at MTS Cleansing. In fact, I would say that it is the great relationships we have with our partners that enables us to perform as well as we do. Together, we are always looking at ways to do even better. For instance, we are currently investigating how we can maintain our results but at reduced costs.

In the end, it is about working responsibly towards the environment in the way we know our customers want us to.

## Our Southern Water

We directly employed more than 2,400 people in Kent, Sussex, Hampshire and the Isle of Wight as of 31 March 2017 and many more through our suppliers.

Working collaboratively with our partners is key to the success of every aspect of our business. Whether servicing the buildings we work in, the systems we use to manage our sites or supporting major construction projects, they enable us to meet our customer priorities.

We actively promote diversity among our workforce and as an equal opportunity employer; we do not discriminate on the grounds of age, race, gender or disability.

### Health and safety

We have maintained our industry-leading health and safety record throughout 2016–17 marking significant periods without serious incident despite an increased risk profile due to the start of our capital delivery programme.

For the 18th consecutive year we achieved the Royal Society for the Prevention of Accidents (RoSPA) gold award and will be presented with our fourth Order of Distinction at its international Occupational Health and Safety Awards. We are the first water company to receive such an accolade.

Although we missed our target of 0.28 reportable injuries per 100 full-time employees and contractors, recording a final figure of 0.34, we continue to focus on health and safety at our sites. Our employee-only total for this measure was 0.21.

Our Aim for Zero Injuries campaign played a vital part in our continuing performance. Its initiatives included a major health and safety conference for more than 200 staff and contractors to share best practice. We are also carrying out further work to concentrate on managing road risk, such as highlighting the dangers of using a hands-free mobile phone while operating a vehicle in a company-wide communications campaign.

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

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. At Southern Water we have recognised this for some years and our ongoing wellbeing initiatives are designed to encourage good personal physical and mental health – a particular focus of the programme over the past year.

During the year we worked closely with our supply partners and recommitted to our Wellbeing Promise, which sets clear joint aims for us to work together on wellbeing. Specific campaigns in the last year included everything from wellbeing days and specialist health presentations to activities like our static bike challenge and WaterAid Mountain Challenge.

We are committed to the National Workplace Wellbeing Charter, a national award for England, which provides businesses across the country with accreditation and recognition for their efforts on workplace wellbeing, achieving the first accreditation award of 'commitment status'.

In the wider community, we participated in the Water Safety Forum and assisted with the implementation 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 businesses take sensible steps to improve awareness of health and safety issues.

### Putting safety first

#### One point of contact, Dawn Sargeant, Facilities Manager

We spent a lot of time recently reviewing our safety procedures around major incidents, particularly on some of our larger occupied sites. We found that there was still some confusion over who was co-ordinating the evacuation of colleagues and the emergency services also found it difficult to know who to approach.

To fix this problem, we came up with a simple colour-coding system for our first-aid, fire and incident control officers; they would wear green, red and white hi-visibility vests respectively. It has worked really well so far when

we have run through drills at our sites. The local fire service has also commended us for the initiative, as it makes it so much easier for them to find who is in charge of the incident.

It was a simple fix but it is having a big impact, and we have now rolled the initiative out across our larger sites at Durrington, Falmer, Otterbourne, Horsham and Chatham. We are encouraging our colleagues in operations to replicate it at all of our manned sites.

### **Developing talent**

Our commitment to developing employees remained a key focus during 2016–17. We completed a restructure of our Learning and Development team, which aligned specialist learning professionals with key functions and people development initiatives.

As a result of this renewed focus, we saw 1,683 employees attend a training programme – this equates to approximately 73% of the workforce.

Many of the programmes we deliver support professional development, including those designed for particular specialisms such as engineering and construction. These and other programmes were made available to employees across our business, helping to develop a multi-skilled workforce and invest in our future.

Health, safety and wellbeing remains a top priority, and over the past year we have run 341 health and safety training delivery days, for over 2,000 employees.

Our pre-leadership, residential event, the Employee Development Programme continues to be a success with employees returning to the business inspired by their projects, which in many cases gain executive sponsorship (see case study on page 51).

We are also planning for the 'next generation', with a total of eight graduates on the current programme in engineering and construction – all of them have now started on their chosen chartered pathways. In 2017–18 we will double this intake of graduates and apprentices as the 'next generation' initiative expands to cover more areas of the business.

In Operations we are committed to continually raising standards and ensuring our people are trained and developed so that they are highly competent in carrying out their roles and responsibilities across both our wastewater and water supply operations.

In water supply operations we are also among the first in the water industry to train all our operators to NVQ level 3, once again demonstrating our commitment to developing our people. We also have a number of our operational leaders undertaking the Level 4 Diploma, ensuring that we have continued investment in water and wastewater management skills.

In 2016 we were recognised by the Association of Talent Development for our work in the field of Predictive Learning Analysis. This involves applying an engineering tool – predictive analysis – to training evaluation. This new approach to training evaluation was applied to our High Performance Resilience at Work programme, enabling us to improve our programme significantly.

### **Putting our people first**

#### **Employee development programme, Julie Dixon, Customer Adviser**

I did not know anything about the employee development programme when I was nominated to take part, but now I can't stop telling everyone about it!

My manager put me forward and I am so pleased they did. It is a residential course so it is completely immersive. You get to spend a number of days with people from all departments across the company. I work in Customer Engagement, which can feel quite isolated from the rest of the business at times so I really enjoyed interacting with colleagues from operations and engineering, in particular. I found it fascinating to learn about what they did every day, and how the company really works.

As part of the course we were given a number of time-critical tasks to complete in our assigned groups. These ranged from creating products and a business plan to researching and presenting a designated subject matter to the Executive Leadership Team. Although it was difficult at first, as everyone had lots of different opinions and very different ways of approaching the work in hand, we soon found our rhythm and everyone slotted into roles required within the team for each of these tasks.

We have all kept in touch since the course, and we have managed to meet up once or twice to talk about how everyone has developed in the meantime. I think we all left with a fire in our belly to develop the skills we had

learnt, and with an increased sense of confidence in our own abilities. The course really helps you understand your strengths and areas for development. I have enrolled and completed two courses at a local college since taking part: team leadership and business administration, and I'm keeping an eye on different roles that become available in the business where I might be able to progress and apply the new skills I am learning.

I really cannot stress how beneficial this course was to my development, and that it would be a great course to offer to all employees.

### **A great place to work**

We want Southern Water to be a great company to work for and our focus on employee engagement over the year is testament to that. Our team of ambassadors are responsible for helping managers to deliver team-specific engagement plans throughout the business.

These engagement plans are developed each year following the completion of the The Sunday Times Best Companies Index survey. Our score increased again this year by another 10 points, which saw us move closer to being classified in the 'Ones to Watch' category. Certain areas of the survey, such as My Manager saw some positive movement and Wellbeing engagement factors for the organisation overall increased. A total of 74% of employees completed the survey during 2016–17.

Southern Water works hard to encourage a culture where every employee is collectively responsible, for not just for our own safety, but also and for ensuring our customers and colleagues are looked after. This year we launched a new Speak Up policy, which actively encourages all employees to raise concerns about practices or situations that could affect our business.

At the same time we have started to take a fresh look at our company story and culture, which will help us to align business priorities with individual and team objectives, helping to drive positive change and improvements across the company.

Southern Water's STAR awards were introduced to recognise the work of the company's outstanding employees. Winners are nominated by their peers and the awards are widely regarded as a mark of respect among colleagues.

There are 14 awards across 11 categories designed to showcase the work of employees who embody Southern Water's core values in the way they carry out their duties. The 5th annual awards in 2016 were another huge success with over 300 nominations, with 33 individuals winning awards.

### **Putting our community first**

#### **Recognising exceptional employees, Jack Riley, Assistant Category Manager**

I won the 'Community' award, largely as a result of my work with WaterAid. I run the regional lottery for WaterAid UK, which raises funds for the charity and last year I joined a group of volunteers on a trip to Mozambique to help the charity introduce life-saving sanitation and clean water systems to some of the poorest communities in the world.

I found the experience life-affirming and it strengthened my resolve to promote the work of WaterAid both inside and outside Southern Water. We take so much for granted and I was completely overwhelmed to witness first-hand the extreme challenges faced by schools, health centres and communities that do not have access to clean, safe drinking water and sanitation. It was humbling to spend time with families who do not have access to these basics and see how they cope with all the health risks that goes along with that. It was also amazing to see how contributions support WaterAid (formed by the UK Water Industry over 30 years ago) with its global goal to reach everyone, everywhere by 2030.

When I was told I had been nominated by colleagues for the community award, I was taken aback at first. It was unbelievable to be nominated and then to win because I see so many of my colleagues who I think deserve recognition for their work more than I do. I don't take praise very well and it still hasn't really sunk in that I won. I was just so proud to be able to support WaterAid and communities like those I met in Mozambique.

## Working in our communities

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.

### Educating our customers

We are committed to educating people about how to use water wisely, keep their drains clear and, where possible, save money on their bills. This year we have attended 16 community events, speaking to more than 148,000 customers, offering advice on the responsible management of water and wastewater.

Our Sporting Chance programme is now in its sixth year, and this year we welcomed a new partner to the scheme. Hampshire County Cricket Club will help us to engage more children in the west of our region.

Working alongside – Brighton & Hove Albion Football Club, Gillingham Football Club, Kent County Cricket Club, Portsmouth Football Club and Sussex County Cricket Club – we were able to give almost 5,000 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 piloted our 'School Gates' outreach programme to complement Sporting Chance. We were able to engage parents with the same messages as their children about water efficiency, keeping sewers clear and health in an effort to get the message to the whole family! We hope to extend this programme in the next 12 months.

Our water efficiency team has also been hard at work educating our existing and future customers. It has:

- provided 141 primary schools with our Be a Water Hero education pack and resources enabling them to launch and run their own Water-Saving Mission
- delivered water-saving workshops for children at sustainability education events in The New Forest, Brighton, Eastleigh and Littlehampton
- helped teachers to deliver their own water-saving education through workshops for teachers in partnership with the South Downs National Park Authority and Eco-Schools England
- worked in partnership with the Footprint Trust to deliver water-saving assemblies and workshops on the Isle of Wight at 13 schools and to 3,519 children. In addition, the Footprint Trust delivered 11 'Can you be a Water Hero' workshops to 695 pupils and eight 'Is your school wasting water?' surveys were conducted with 215 pupils and school staff
- provided free Waterwise and Sewerwise talks to schools and other groups across our region. Southern Water employees volunteer for these talks, which aim to take Key Stage 2 students and community groups through various water-saving and blockage prevention messages. Around 50 talks have taken place since April 2016.

Our Capital Delivery team worked with 300 students from schools close to East Worthing Wastewater Treatment Works who put their engineering skills to the test to tackle the problem of fat, oil and grease in the network. The 13 and 14 year olds undertook all aspects of design and build to create a 'water treatment works' capable of filtering wastewater, then collecting, detecting and pumping clean water back out into the environment. Part of a wider community engagement programme, these workshops aimed to teach the next generation about the complexity of wastewater treatment and the issues caused by unflushables such as wet-wipes and fat, oil and grease in the network.

### 25 years of Learn to Swim

We are committed to ensuring that all children in our area know how to stay safe around water. Our flagship community programme Learn to Swim celebrates 25 years in 2017. During that time more than 750,000 children across the region have been taught how to stay safe around water. This year we helped to teach more than 14,000. It is a source of great pride to everyone in the company that we are able to do our bit to keep our children safe.

We have been championing swimming teachers with the support of the Amateur Swimming Association since 1992. Together with supply chain partners we provide schools and clubs with equipment and training.

We are very proud that former Olympic gold medallist Duncan Goodhew and Invictus Games champion Mike Goody continue their support for the scheme. To mark our 25<sup>th</sup> anniversary we held a celebratory lunch at the Amex Stadium in Brighton ahead of meetings with our partner the Amateur Swimming Association on how we take Learn to Swim forward in the next 25 years.

We also held two achiever events for children in Gillingham, Kent and Portsmouth, Hampshire where dozens of youngsters were recognised for their achievements in the pool. We were delighted to welcome the local MPs to both events.

### **One of our achievers, Josh Puttick, from Polegate, in East Sussex**

Josh had avoided swimming lessons at school because of a painful ear condition – but he was soon to realise why swimming is a lesson that can save a life. Josh was enjoying an afternoon on Eastbourne Pier with his Mum in July 2014 when a fire broke out which destroyed much of the Victorian structure. As they were evacuated from the burning buildings – Josh's Mum was reminded that he couldn't swim. The memories of that day encouraged Josh to sign up for swimming lessons with his local club. He started his Learn to Swim lessons as a complete beginner and within months he was showing a natural aptitude and progressing quickly.

### **Access and recreation**

Our four reservoirs Darwell, Powdermill, Weir Wood in East Sussex and Bewl Water on the Kent and 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 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 and a contrast to our ultra modern wastewater treatment works at nearby Peacehaven. These entertaining and educational tours look at the history behind the construction of our sewers. In a typical year, almost 1,700 visitors take a tour and learn more about the architecture and history of this hidden environment.

### **Charity and volunteering**

We actively contribute to the wellbeing of our customers and our communities, and our employees are encouraged to get involved. During the past 12 months, our employees gave 4,000 hours – almost 560 days – of their time to help community projects through our company volunteer scheme.

In 2016–17 we launched our community grants scheme to help those directly affected by our activities. The pilot scheme in East Worthing, which was attached to the upgrade of our wastewater treatment works, was awarded £10,000 in grants for a number of local projects including the Lancing and Sompting Lip Reading Group and the Men in Sheds project, working to tackle isolation around dementia and other issues.

Our Hazard and Near Miss reporting scheme raised more than £5,000 (£2 per hazard reported) which was divided between the Kent, Surrey & Sussex Air Ambulance Trust (KSSAAT) and the Hampshire and Isle of Wight Air Ambulance.

We have taken part – and sponsored each other to take part – in a range of events to benefit causes, including Cancer Research UK, Macmillan Cancer Support, Against Malaria Foundation, St Barnabas Hospice and Chestnut Tree House Hospice for Children.

And we are continuing our long relationship with WaterAid, the international charity that helps provide poor communities with access to clean water and sanitation systems.

In fact a total of more than £139,890 was raised for good causes over the course of the year as a result of our fundraising efforts.

KSSAAT was selected by employees as our company charity for 2016–18 on a two-year fundraising partnership. We have set ourselves an ambitious target of raising £100,000 to help the charity continue with its life-saving missions. This is a charity that has touched the lives of many of our customers and employees.

Our partnership with KSSAAT is about much more than money. We also work with the charity to:

- provide great volunteer opportunities for our employee scheme
- awareness training on first aid
- wellbeing opportunities, including a chance to take part in the Brighton marathon and 10k run
- joint safety campaigns.

We also support four charity partners helping them to complete projects that reflect our values and messaging. Our partners for 2016–17 were:

- Honeypot Children's Charity
- Howletts Wild Animal Trust
- Chailey Heritage
- SSAFA – The Forces' Charity.

### **Putting our community first**

#### **Dave Gilbert, Leakage Technician at our Kent headquarters in Chatham**

One summer day in 2010 Dave took the call that every parent dreads. His son had been taken to hospital with serious head injuries. He left work immediately and rushed to the specialist head injuries unit at the Royal London Hospital. He found his son on life support in an induced coma and he later discovered the crucial role played by the air ambulance team in saving his life.

Dave's son was riding a quad bike when the throttle stuck, causing him to plough into a telegraph pole and land on a road. The air ambulance was called, and the crew gave him the critical care on site that he needed to stay alive. He made a full recovery and now works in the water industry. Dave has no doubt that had it not been for the crew of the air ambulance his son may not have survived.

#### **Our annual events**

Our big annual events are designed to get participants engaged with our chosen charities. Our popular race day in October 2016 brought in more than £23,000, which was donated to our company charity the Kent, Surrey & Sussex Air Ambulance Trust in Brighton.

Our first Festive Friday Christmas event was a huge success with hundreds of employees joining in some seasonal fun to raise money for our company charity raising more than £700 in Christmas raffles and 'sElfie' competitions.

This year we are planning a company day at Bewl Water to celebrate our employees' successes and reflect our values as a caring and responsible employer.

## Financial performance

### Financial results

#### Accounting policies

The accounting policies of the company, which are consistent with the prior year, are set out on pages 115 to 124.

#### Income statement

Our income statement is summarised in Table 1 below.

Table 1	Years ended 31 March		Change
	2017 £m	2016 £m	%
Revenue	809.7	803.7	0.7
Other operating income	1.3	1.7	(23.5)
Operating costs	(306.9)	(286.3)	7.2
Depreciation, net of amortisation	(245.2)	(234.6)	4.5
Operating profit	258.9	284.5	(9.0)
Profit on disposal of fixed assets	0.4	0.4	-
Net finance costs	(103.1)	(86.2)	19.6
Fair value losses on derivative financial instruments	(416.8)	(70.4)	492.0
(Loss)/profit before tax	(260.6)	128.3	(303.1)
Tax	84.9	(8.4)	-
(Loss)/profit for the financial year	(175.7)	119.9	(246.5)

Revenue increased to £809.7 million (2016: £803.7 million). This increase relates to our main water and wastewater income and arises from an increase in customers from new connections and higher levels of consumption billed in the year offset by an overall reduction in tariff.

Operating costs increased by £20.6 million to £306.9 million (2016: £286.3 million). This is largely due to a one-off refund of historic rates charges received in 2015–16 of £13.3 million. Adjusting for this, the increase in our underlying operating costs was £7.3 million. The major reasons for the movement in underlying operating costs are described below and in Table 2.

During 2016–17 we undertook a number of projects to change processes, investing £4.0 million, in order to improve overall customer service performance. These were focused on proactive contact with customers, reducing complaints, providing help and assistance to customers in financial hardship and initiatives to improve our future bad debt performance. While we have continued to see an increase in the level of bad debt charge during this financial year, we are working hard to make improvements and reduce this in the future.

The cold weather over the winter, which followed a dry autumn, resulted in an increased number of bursts and repairs which led to an increase in our level of leakage. In order to tackle this increase, additional costs of £0.9 million were incurred during the year to help find and fix leaks from the water network.

These cost increases were offset by a number of efficiencies and cost reductions, totalling £8.6 million, during the year. These focused on reducing our power consumption, in particular during peak times, improving operational processes, such as reducing chemical usage, waste disposal costs and tankering requirements. It also looked at more efficient ways of using our own teams to make repairs rather than using external contractors. In addition we benefited from improvements to costs in certain contracts and lower costs from dealing with groundwater flooding.

Unfortunately, during 2016–17 we were prosecuted for pollution incidents which occurred at Margate in 2012 and 2014. This prosecution resulted in a fine of £2.0 million, which increased our operating costs in this financial year. Since those incidents, we have also made considerable investment to mitigate the risk of future incidents, improve resilience at the site and ensure that bathing water in the area is cleaner than ever.

<b>Table 2</b>	
<b>Year-on-year increase/(decrease) in operating costs</b>	<b>£m</b>
Inflation	5.7
Customer services improvement programme	4.0
Increased bad debt charge	3.8
Increased leakage detection and repair activity	0.9
Power efficiencies	(2.4)
Process efficiencies	(4.0)
Procurement savings	(1.4)
Lower costs from dealing with groundwater flooding	(0.8)
Margate – fine	2.0
Other	(0.5)
<b>Movement in operating costs</b>	<b>7.3</b>

Depreciation increased to £245.2 million (2016: £234.6 million) as a result of the continuing significant capital investment programme. New schemes commissioned during the year added £11.9 million to the depreciation charge. A further increase for the full year impact of schemes commissioned in the prior year was offset by a reduction for schemes fully written down of £4.3 million.

Operating profit for 2016–17 decreased to £258.9 million (2016: £284.5 million), a 9.0% reduction as a result of the factors set out above.

The profit on disposal of fixed assets of £0.4 million (2016: £0.4 million) mainly relates to the sale of land, buildings and equipment, surplus to operational requirements.

Net finance costs increased to £103.1 million (2016: £86.2 million). This was largely driven by higher indexation on inflation-linked bonds of £20.9 million (2016: £10.0 million) as a result of increasing RPI in 2016–17 together with interest on new loans issued during the year of £4.2 million.

The fair value loss on our derivative financial instruments amounted to £416.8 million (2016: loss £70.4 million). To calculate the fair value of our derivative instruments we discount their forecast future cash flows using UK Government bond yields. These future forecast cash flows are predictable, and match the future forecast movement in our revenues and 'Regulatory Capital Value', but government gilt yields are constantly moving, with the result that the valuation of our derivative instruments can be volatile. There has been a significant reduction in gilt yields during the year which results in a large increase in the liability associated with our derivative instruments for this period, despite there being little change to their future forecast cash flows. The changes in value that are recorded during the lives of derivatives do not represent cash flows.

We have recognised a total tax credit to the income statement of £84.9 million (2016: £8.4 million tax charge). This differs from the credit that may be expected of £52.1 million, based on the loss before tax of £260.6 million and the current period tax rate of 20%, as described in note 9. The difference is primarily due to the company receiving losses from other companies in the Southern Water group for nil payment. In addition, a credit of £16.9 million is recognised for the impact of future tax rate changes, announced by the government, on the deferred tax liability of the company.

The loss after taxation for the year amounted to £175.7 million (2016: profit £119.9 million).

**Cash flow statement – summary**

Our cash flow statement is summarised in Table 3 below:

Table 3	Years ended 31 March	
	2017 £m	2016 £m
Net cash inflow from operating activities	512.9	466.9
Net cash used in investing activities	(224.3)	(164.9)
Net cash used in financing activities	(21.2)	(457.6)
Net increase/(decrease) in cash and cash equivalents	267.4	(155.6)

Net cash inflow from operating activities has increased to £512.9 million for 2016–17 from £466.9 million in 2015–16. This increase mainly results from an increase in the level of creditors during 2016–17 compared to a reduction in creditors in the prior year. This movement in the creditor position is driven in part by the timing of payments to suppliers as well as an increase in the value of deposits and deferred revenue held on the Balance Sheet associated with developer activity. In addition in 2015–16 we made a lump sum contribution in respect of our pension deficit of £30.6 million and received a one-off refund of historic rates charges of £13.3 million. The net impact of these transactions reduced the cash inflow from operating activities in 2015–16 by £17.3 million.

The net cash used in investing activities increased to £224.3 million for 2016–17 from £164.9 million in 2015–16. This increase mainly results from the profile of our capital investment programme. This financial year, 2016–17, was the second year of the current regulatory period and as a result there was a significant increase in the number of investment projects in construction.

The net cash used in financing activities decreased to £21.2 million (2016: £457.6 million). This reduced cash outflow principally results from the timing of payments of accrued indexation associated with derivatives in place on some of our debt which fell to £2.5 million in the current year (2016: £298.4 million) and the net impact of new loans offset by loan repayments which resulted in a cash inflow of £238.3 million in the current year (2016: inflow £110 million).

Overall these resulted in a net increase in cash and cash equivalents of £267.4 million (2016: net decrease of £155.6 million).

**Statement of financial position – summary**

Our statement of financial position is summarised in Table 4 below:

Table 4	Years ended 31 March	
	2017 £m	2016 £m
Non-current assets	6,587.2	6,491.0
Current assets (excluding cash)	200.0	194.7
Cash and cash equivalents	285.3	17.9
<b>Total assets</b>	<b>7,072.5</b>	<b>6,703.6</b>
Current liabilities	(349.5)	(277.0)
Non-current liabilities	(5,768.9)	(5,066.8)
<b>Total liabilities</b>	<b>(6,118.4)</b>	<b>(5,343.8)</b>
<b>Total net assets</b>	<b>954.1</b>	<b>1,359.8</b>
<b>Total equity</b>	<b>954.1</b>	<b>1,359.8</b>

At the end of the year to 31 March 2017, we had non-current assets of £6,587.2 million (2016: £6,491.0 million), an increase of £96.2 million from March 2016. This increase results from capital investment in tangible and intangible assets of £341.4 million offset by depreciation of £245.2 million.

Current assets increased to £200.0 million (2016: £194.7 million). This increase largely results from an increase of £7.5 million in an inter-company debtor in relation to interest payments with Southern Water Services (Finance) Limited (SWSF). During February and March 2017, we raised final bills to our non-household customers ahead of their transfer to Business Stream. This final billing resulted in a transfer from accrued to billed debt and accelerated some cash receipts, which contributed to reducing our overall debt position by £12.3 million. This reduction was offset by increases in prepayments for certain contracts and in our VAT recoverable from HMRC.

Current liabilities increased to £349.5 million (2016: £277.0 million). This increase is driven by an increase in capital creditors of £37.5 million, linked to the increase in capital expenditure during the year as a result of a larger number of projects in construction, together with an accrual for the final dividend approved by the Board at the end of March of £63.2 million. These increases were offset by the repayment of a short-term loan of £50.0 million from the drawdown of a term facility in 2015–16.

At 31 March 2017 non-current liabilities totalled £5,768.9 million (2016: £5,066.8 million). The increase of £702.1 million principally resulted from movements on the value of our derivative financial instruments and pension deficit as a result of the significant reduction in gilt yields during the years which are used to value these liabilities together with a net increase resulting from new loans issued of £248.4 million.

The net increase in the liability associated with derivative financial instruments during the year was £414.3 million. During 2016–17 we repaid £2.5 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 £416.8 million. Further details can be found in note 20 to the financial statements.

Overall, net assets decreased from £1,359.8 million to £954.1 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 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 Southern Water Services Group (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).

In addition to the dividend paid to SWSG of £45.5 million, ordinary dividends totalling £124.2 million were declared in relation to 2016–17 (2016: £79.6 million), of these £61.0 million was paid during 2016–17 and the final dividend of £63.2 million was paid in April 2017. These dividends were paid through our group structure resulting in a dividend of £108.2 million being paid to the shareholders of our ultimate parent company GSH.

Further details are shown on page 68.

## **Capital reduction**

During the year, we undertook a bonus issue of 735,000,000 ordinary shares out of the revaluation reserve. Following this bonus issue, we completed a capital reduction exercise, creating £735.0 million of distributable reserves. On completion of this process, the issued share capital remained unchanged from the share capital in issue at the start of the year.

The revaluation reserve was created as part of the prior year conversion to International Financial Reporting Standards (IFRS), and has been converted into distributable reserves to offset the negative impact that conversion to IFRS had on our reserves.

## **Taxation**

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

Our Tax Policy is consistent with the overall values and Corporate Strategy of the company and will consider financial risk, reputational risk, and social responsibilities. Our approach to tax planning is to align to business decisions made in the best interests of customers and stakeholders rather than use tax planning to drive or determine business decisions. Our focus is therefore on compliance, and our tax planning is always aligned with our commercial and economic activity.

Our approach to tax management is compliant with tax laws, rules, regulations and reporting requirements in all of our operations. Management of our tax affairs is carried out by an internal tax team with the support of professional tax advisors and specialist tax support. Professional tax advisors are used in circumstances when additional advice is deemed appropriate (for example, to ensure compliance with new legislation and tax planning). We use specialist tax support in the preparation of our capital allowances.

Risk is managed by ensuring there are sufficient processes and controls in place. Internal assurance for the company is carried out by our Internal Audit team and we have also used the services of professional tax advisors to assist us with our tax compliance. Our Tax Policy extends to the wider group and ensures all companies

within the Southern Water and Greensands groups are subject to UK tax, and all companies are UK tax resident irrespective of their place of incorporation.

A key factor in managing tax is our relationship with HMRC. We meet all statutory and legislative requirements and we manage our tax affairs in an open and transparent way. This extends to us sharing information with HMRC, such as internal audit findings. HMRC share our view of our low risk approach to the management of our tax affairs with an HMRC assessment of us as a 'low-risk' company.

Our taxable profits are generally different to our accounting profits for the following reasons:

- Capital allowances and depreciation – we have a large capital expenditure programme and this is charged against taxable profits as capital allowances. These are applied at different rates than the depreciation charged against profits in the financial statements. As a result, there is a timing difference between deductions made against our taxable profits and those made against our accounting profits. Due to the scale of our capital expenditure programme and the level of capital allowances utilised, our taxable profit is reduced.
- The treatment of interest costs – we borrow money to finance our capital expenditure programme. The interest associated with this borrowing is recognised as both an accounting and tax expense, so reducing profit and the amount of tax we pay. There are however, differences between the amount of interest recognised for accounting profits and for taxable profits. Examples are that movements on the fair value of our financial derivatives are not recognised in our taxable profits, and interest is capitalised in our financial statements, with no corresponding treatment in the calculation of our taxable profits.
- Group relief – Southern Water is part of the Greensands Holdings group of companies as set out on page 65. All of these companies are taxable as UK companies and profits or losses of these companies within the group can be set-off against one another in the financial year.
- Changes to future tax rates – The financial statements carry the temporary differences between our taxable profits and our accounting profits as a deferred tax balance on the statement of financial position. Changes to the future rate of corporation tax revise the carrying value of these differences.

The benefit of our large capital expenditure programme and the interest on borrowings, on our tax charge is passed to our customers through reduced bills. There is no corporation tax allowance within our customer bills for the regulatory period from April 2015 to March 2020.

Details of our tax charge for the current financial year are disclosed in note 9 to the financial statements and the current year charge to the income statement is also explained further on page 57.

Our contributions to the Exchequer amounted to £65.2 million. These are explained below:

- Business rates of £26.0 million paid to local authorities (2016: £25.7 million) and payments to the Environment Agency of £7.6 million (2016: £8.4 million) for abstraction licences and discharge consents, 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 £28.3 million (2016: £26.7 million) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions.
- Carbon Reduction Commitment of £3.3 million (2016: £3.8 million) levied on our power costs, which reduces profits chargeable to corporation tax.

Payments have also been made to other group companies of £11.4 million for tax losses surrendered to the company. These were paid to SWSG and then repaid to us as interest. Overall, Southern Water pays 5.8 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 company to HMRC in 2016–17.

**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%, comfortably within our debt covenants.

Senior adjusted cash interest cover (measured as the ratio of 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	%
2013–14 performance	78
2014–15 performance	78
2015–16 performance	79
2016–17 performance	77
Covenanted lock-up level	<85

Senior adjusted cash interest cover	Times
2013–14 performance	1.6
2014–15 performance	1.6
2015–16 performance	1.9
2016–17 performance	1.9
Minimum target trigger level	1.1

Credit rating	As at 31 March 2017
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

During the year the credit rating agencies each reviewed their assessment of the credit ratings for Southern Water. The credit ratings of Standard and Poor's and Fitch remain unchanged and are Stable. Moody's updated the outlook on their credit ratings of Southern Water from Stable to Negative. This change reflects Moody's view of how well Southern Water is currently positioned to withstand a material reduction to the regulatory return on RCV after 2020.

## Capital structure

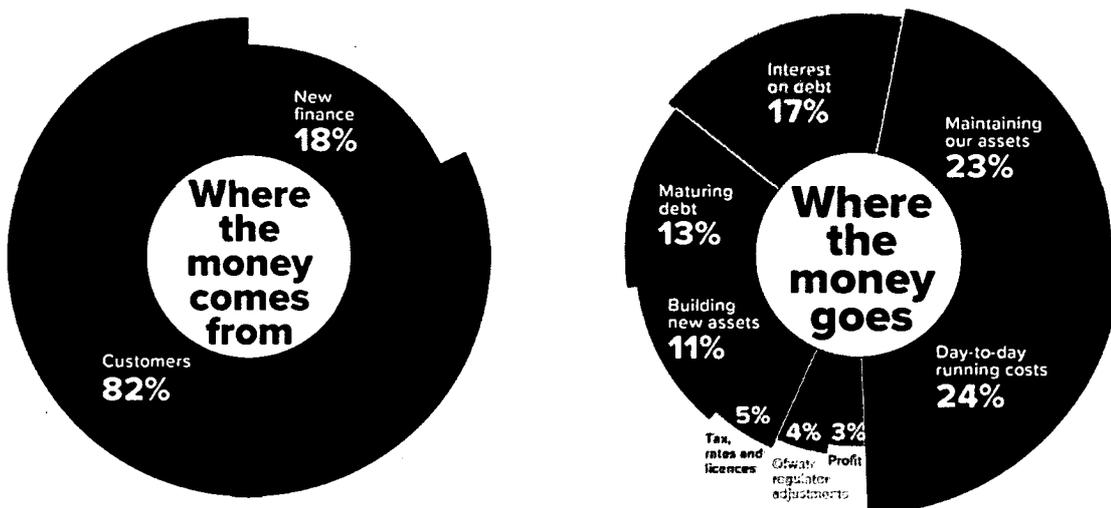
### Why Southern Water raises finance

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 m<sup>3</sup> 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 the 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, power, chemicals, materials and bad debt\* costs.

\*Bad debt = the cost of providing for unpaid customer charges.

**Interest on debt** – interest on money we have borrowed to finance improvements to the business over the long term.

**Maintaining our existing assets** – this includes our pipe network, treatment works and capitalised employee costs.

**Building new assets** – contributing to projects to enhance treatment standards and cater for growth.

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

**Ofwat/regulator adjustments** – applied by Ofwat for the period 2010–15, relating to customer satisfaction, cost-savings and revenue collection.

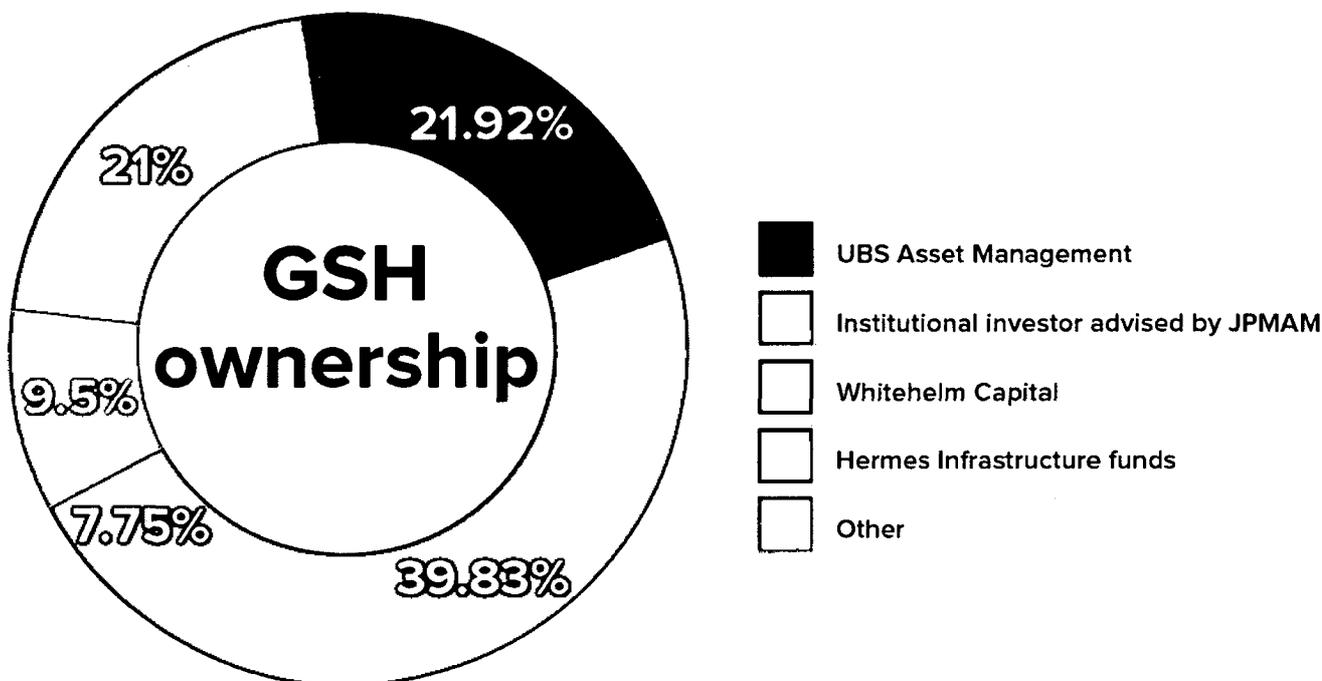
**Profit** – the return earned on shareholders' investment in the business.

## How we are structured

Southern Water Services Limited (SWS) is a privately owned company and is the principal subsidiary of Greensands Holdings Limited (GSH). All companies in the group are UK tax resident and liable for tax in the UK.

### Ownership

GSH is owned by a consortium of long-term investors representing infrastructure investment funds, pension funds and private equity and no single shareholder has majority control.



**UBS Asset Management** – a large-scale global asset manager, offering investment capabilities across all major traditional and alternative asset classes

**JP Morgan Asset Management (JPMAM)** – a large-scale global asset manager advising institutional investors

**Whitehelm Capital** – Shareholding managed by Whitehelm Capital on behalf of Motor Trades Association of Australia and Prime superannuation funds

**Hermes Infrastructure funds** – Hermes Infrastructure is part of Hermes Investment Management and is a specialist infrastructure manager operating a diversified, well-established, UK-focused shared investment platform. With £4.1bn of assets under management, Hermes Infrastructure is one of the UK's largest direct investors

**Other** – other minor shareholdings held by infrastructure investment companies

### GSH Board

The GSH board comprises five members in addition to the Chairman. Three of those members are appointed by a shareholder represented by JP Morgan Asset Management, one is appointed by shareholders represented by UBS Asset Management and one is appointed by shareholders represented by Hermes. Another shareholder is entitled to appoint an observer to attend and take part, but not vote, at Greensands Board meetings.

The former Chairman of Southern Water Services, Robert Jennings, was 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, providing 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. In his role as Chairman, Robert united the respective Boards in this common aim. Taking this into consideration it was felt that his cross directorship did not undermine his independence.

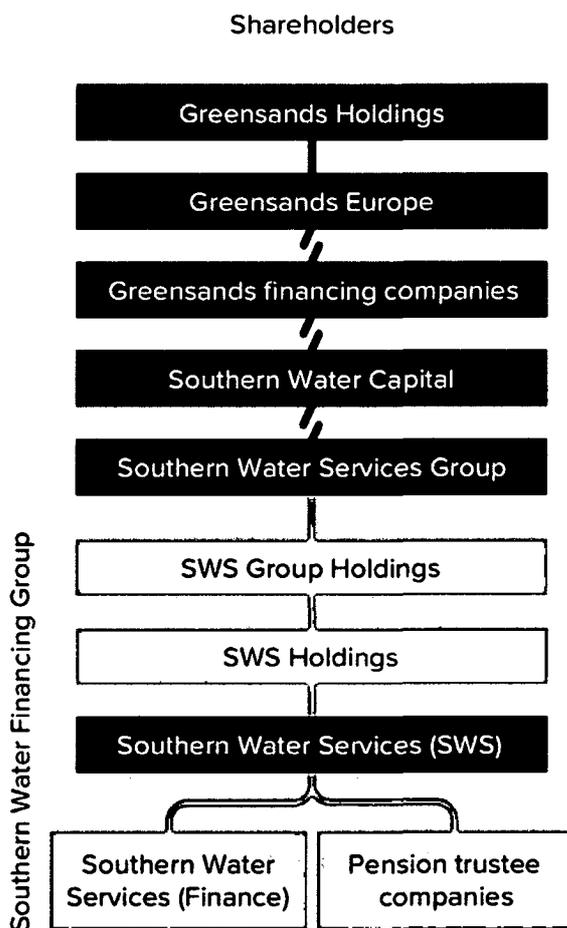
Following Robert's resignation in February 2017, Bill Tame was appointed Chairman of Southern Water Services. GSH is currently reviewing its board and governance structure and a chairman has not yet been appointed therefore, from 1 March 2017 no independent members of our Board sit on the board of GSH.

**Group structure**

In September 2007, the Greensands group of companies was established for the purpose of the acquisition of 100% of the share capital of Southern Water Capital Limited, the then ultimate parent company of Southern Water from the Royal Bank of Scotland (investing £1.9 billion of equity and debt to finance the acquisition).

The holding company structure for SWS is shown in the diagram below and this is followed by an explanation of the principal companies in the structure.

**Southern Water ownership structure summary**



**Greensands Holdings (GSH)** – Established in 2007, as a single purpose entity for the acquisition of the Southern Water Capital group, GSH is the ultimate parent company of Southern Water and all other group companies, with no minority interests. GSH is a Jersey registered company, but it is UK tax resident and, as such, is liable for tax in the UK. The only operating company in the group is Southern Water Services. Accordingly, the GSH board shares and supports the aims of the Board of Southern Water for the long-term success of that company. GSH holds 100% of the share capital of Greensands Europe and has no direct holdings in any other entities. Further details can be found in the GSH annual report and financial statements which are published on our website.

**Greensands Europe** – Was established as part of the financing for the acquisition of the Southern Water Capital group from RBS in 2007. Greensands Europe has issued debt that is held by our shareholders in proportion to their respective shareholdings.

**Greensands financing companies** – A number of financing companies were established as part of the acquisition in 2007 to provide additional external financing. Security granted to the lenders of this financing 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.

**Southern Water Capital (SWC)** – Was the previous holding company for the Southern Water group established as part of the sale of Southern Water by Scottish Power in 2002. SWC does not trade and holds preference shares in SWS from which it receives dividends.

**Southern Water Services Group (SWSG)** – The immediate parent company of the securitised group which acts as a holding company for this group following the financial restructuring on 2003.

**Southern Water Financing Group** – Southern Water established a financing structure, known as a Whole Business Securitisation (WBS), in 2003 following its sale by ScottishPower. The aim of this refinancing was to reduce our financing costs and gain access to long-term and secure sources of finance. Reducing financing costs ultimately benefits our customers in the form of lower bills. The securitisation structure continues to be in place today.

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 Services (Finance) (SWSF)** – Our financing subsidiary, SWSF, was established for the express purpose of raising debt finance on our behalf under the securitisation in 2003.

Due to administrative reasons applicable at the time of the WBS it was necessary for SWSF to be registered in the Cayman Islands in order to raise debt listed on bond markets. This requirement is no longer necessary but the cost of unwinding this structure is considered prohibitive.

SWSF is wholly and exclusively resident for tax in the UK and files tax returns only with HMRC. This means that any profit or loss made by these companies is subject only to UK tax.

## How we finance the business

In note 19 to the financial statements, we provide an analysis of our outstanding debt at 31 March 2017 and 31 March 2016. Our loans comprise sterling bonds, issued by our financing subsidiary SWSF, and listed on the UK Stock Exchange, other loans including loans from US insurance companies, 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% 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% 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% of RCV in any two consecutive years and 40% 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 continuing 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 have 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 2017, 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 taxable expense which can be used within the Greensands Holdings group of companies.

## Interest and dividends payments 2016–17

Fig. 1

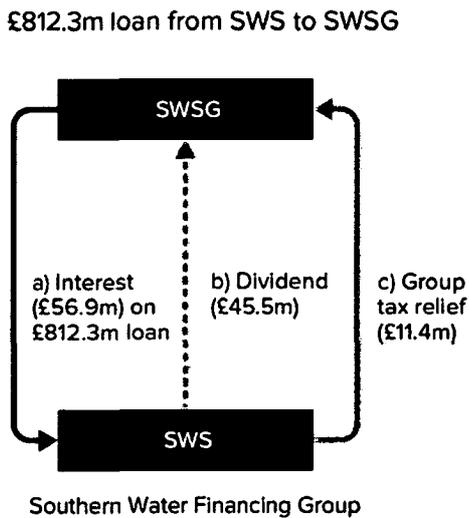
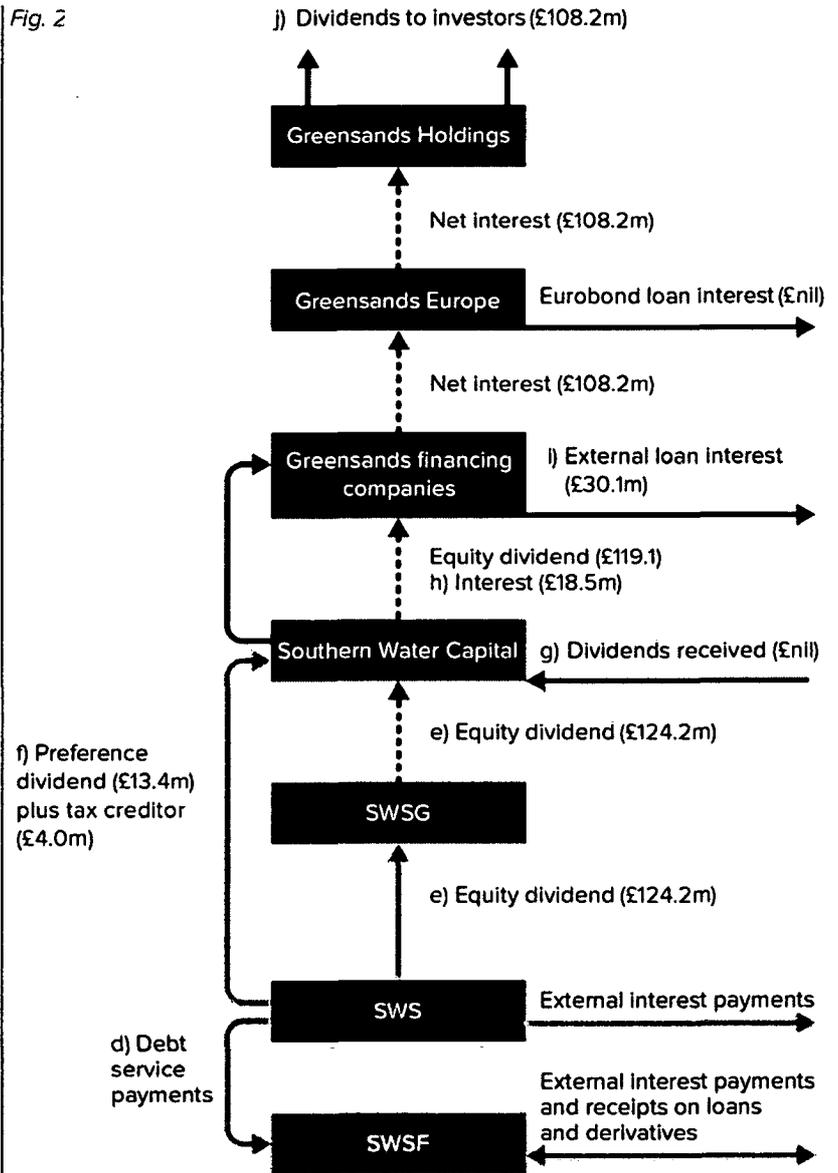


Fig. 2



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 of which £108.2 million was ultimately paid to investors (see j).
- f) Interest payments on the preference shares and payment of tax creditor.
- 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 81. In developing our code we drew on the appropriate principles of the UK Corporate Governance Code (UK Code). In accordance with provision C.2.2 of the 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 based on a rolling five-year period for the following reasons:

- i. The company benefits from a rolling 25-year operating licence.
- ii. The wholesale and retail price controls set by Ofwat provide a high degree of certainty over cash flows through to the end of the current regulatory period, March 2020.
- iii. Additional protection is afforded between price controls by Ofwat's primary legal duty to ensure that water and wastewater companies can finance their functions.

In assessing the viability of Southern Water over a five-year period to March 2022, 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 70. These include the impacts of:

- incidents, for example severe weather, cyber security or a major operational event, resulting in additional operating costs and/or remedial capital investment
- a deterioration in the defined benefit pension scheme deficit requiring additional contributions
- an extension from our current regulatory planning cycle ending March 2020, into the next regulatory planning cycle by the use of regulatory scenarios for the period from March 2020.

For each scenario the impact has been assessed to ensure that our ratios are not breached and that headroom is maintained to ensure we can continue to achieve our operating company and holding company debt service and gearing targets. To the extent that any of these scenarios, in isolation or combination, would place our financial ratios at risk, the directors are confident that this could be mitigated by application of the Board's flexible dividend policy alongside targeted management actions.

In making their assessment, the directors have made the following key assumptions:

- Funding for the ongoing capital investment programme will continue to be available in all plausible market conditions.
- The weighted average cost of capital for the next AMP period, commencing April 2020, will be sufficient to enable us to finance our functions.
- Capital markets will be available for the refinancing of debt, credit facilities and financial derivative maturities when they fall due (please see note 19 for details of our borrowings).

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 2022.

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

- 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 2017.
- 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 and Compliance Committee and Board.
- The company's track record in being able to raise new forms of finance in most market conditions.

## 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 risks are considered by our Executive Leadership 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.

Our 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. Risk management and internal control systems are monitored by our Board. This covers all material controls including financial, operational and compliance controls.

The purpose of our approach to risk management is to support better decisions through an improved understanding of risk.

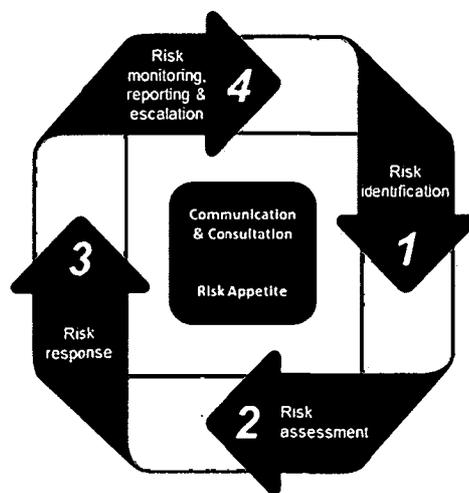


Figure 1: Southern Water Risk management process

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
- 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, risks 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 Leadership 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.

Risk appetite is the Board's expression of the types and amounts of risk it is willing to take or accept in pursuit of its objectives. The mitigating actions applied to each principal risk are considered by the Board against the effectiveness of the existing control environment. This determines the appropriate level of response to ensure compliance with the Board's group risk appetite, policies and procedures, and management plans and objectives.

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 2016–17 has improved compared to prior years. A continued improvement will be required over the next three years to avoid a financial penalty for this business plan period at the next Price Review.

We have set ourselves challenging targets, including, for example, identifying then reducing our unwanted call volumes and our improvement programmes are working to deliver these for our customers.

**Mitigation:** Improvements to customer service are being made continually. We plan to use more insight into customer trends to design a broader range of tailored services and training for our staff.

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 will continue to improve our customers' experience by providing enhanced online facilities for them to manage their accounts. Where customers do need to speak to us directly, we have ensured the opening hours of our contact centre are convenient and our bills will be 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 ongoing Brexit process may adversely affect the economic climate and customers' ability to pay.

In 2016–17, the bad debt charge to the income statement increased to £25.3 million (2015–16: £21.5 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 the introduction of a social tariff since 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.

In addition we have partnered with Orbit, a company that provides specialist debt advice to customers in financial difficulty.

This year we will be enhancing our customer data to enable us to tailor the experience they receive from us and in order for us to reach out to those customers, who may be in financial hardship, quicker. We are also looking at new schemes, tariffs and additional services we can offer customers who are in vulnerable circumstances.

Outcomes affected



Responsive customer service



Affordable bills



Having a firm financial footing

## Climate

### Resilience to drought

**Commentary:** Some areas of the South East are classified as areas of “severe water stress”. Climate change and more variable weather patterns are predicted to pose an increasing challenge for all water companies in the region in future years in terms of the volume of water available.

Given that we supply drinking water to more than one million households across Kent, Sussex, Hampshire and the Isle of Wight it is critical that we are able to ensure we have access to adequate water resources to supply customers and support the economy.

After the lower than average rainfall received during the winter of 2016–17 and subsequent spring, this risk has increased.

**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 measures that we will take across our region to achieve our target for the Security of Supply Index. These measures include schemes such as: leakage reduction, strategic transfers and the development of new resources. We have also completed our Universal Metering Programme with nearly 90% of customers now having a meter.

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 control, 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 seen in recent years have also highlighted the need to protect our water and wastewater treatment works and pumping stations from being affected during a flood.

We have met, or improved upon, our business targets this year for sewer blockages, sewer collapses, external flooding, and internal flooding incidents as a result this risk has reduced.

**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 39,594 kilometres of sewers and 3,243 wastewater pumping stations well maintained. It will also fund our replacement or refurbishment of about 100 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

## Operational

### 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
- 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 (DWI).

DWI enforcement actions are referred to on page 35.

The only water quality and supply resilience performance target we failed to meet or improve upon during the year was leakage. We achieved a figure of 88.1 million litres per day, which exceeded our target of 87.1 million litres per day.

**Mitigation:** To avoid such incidents we prioritise investments in the maintenance of critical assets and technology. We also make sure our employees follow company processes and procedures. New employees are also trained in these processes and procedures.

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 drinking water quality compliance of 99.97%. 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. Our activities to improve water quality include 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

## Operational (continued)

### 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.

Additionally, because of the nature of our activities, we hold and process large quantities of data considered sensitive within the meaning of the Data Protection Act, including personal data on our customers and employees. Therefore the protection of the security and integrity of data under our control is of utmost importance.

**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 used industry experts to review our cyber security maturity and help develop an improvement plan.

We undertake penetration testing to assure our security measures during the year or when we make improvements to our IT environment.

We have clear policies identifying the need to have in place safeguards surrounding the collection, handling, storage and destruction of personal data, and ensuring our compliance with the Data Protection Act (DPA). This policy is supported by Data Protection training which is mandatory for all staff, and assured via the Letter of Compliance process.

Our data protection policies are currently being updated to ensure we comply with our obligations under the General Data Protection Regulation (GDPR), which replaces the DPA in May 2018.

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

## Operational (continued)

### 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.

The performance of our wastewater treatment works continued to be strong during 2016–17 (though this remains subject to further assurance).

As mentioned previously, we are also working with Ofwat in relation to the management and operation of our wastewater treatment works and the reporting of relevant information in connection with them.

**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. We also monitor any instances when our Combined Sewer Overflow (CSO - back up over flow pipes) are used, to proactively ensure we can identify infrastructure under stress. 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 £45.2 million at our wastewater treatment works and pumping stations to reduce risks at critical sites, and invested £11.5 million in sewer maintenance and rehabilitation.

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

Outcomes affected



Removing wastewater effectively



Looking after the environment

## Operational (continued)

<b>Health and safety</b> 	
<p><b>Commentary:</b> The health and safety of our employees and the public in the provision of our services is of 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 &amp; 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.</p>	<p><b>Mitigation:</b> 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. Health and safety performance and compliance is monitored and reported to the Board on a monthly basis and to the tri-annual Board Health and Safety Committee. The Executive Leadership 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.</p> <p>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. Additionally, every employee has ready access to a copy of the corporate policy statement and health and safety processes and procedures.</p>
<p><b>Outcomes affected</b></p>	<div style="display: flex; justify-content: space-around; align-items: center;"> <div style="text-align: center;">  <p>Having great people</p> </div> <div style="text-align: center;">  <p>Working in partnership</p> </div> </div>

## 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.

During the year, Moody's updated the outlook on the credit ratings of Southern Water from Stable to Negative. The change to outlook reflects Moody's view of how well Southern Water is currently positioned to withstand a material reduction to the regulatory return on Regulatory Capital Value (RCV) after 2020. We will be considering this as part of our PR19 Business Plan submission.

**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% of RCV in any single regulatory period (and 20% 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 ongoing monitoring and forecasting of our cash flow and we take steps to manage this when necessary.

Credit ratings comprise regulatory framework, financial risk and operational risk. Regulatory risk is improving as we gain clarity of PR19, albeit the key value for the weighted average cost of capital (WACC) is uncertain. Financial risk is stable for the current AMP6 (PR14) period, in part supported by our stated gearing targets. Operational risk is supported by our annual improvement since 2011.

**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 the cost of funding pension promises. Increased scrutiny of deficit recovery proposals by The Pensions Regulator could result in a higher funding requirement for the final salary pension scheme in the future. In addition to the regular dialogue with the Trustees Southern Water is also in ongoing discussions and correspondence with The Pensions Regulator regarding the current deficit and the Board are keen to agree a reasonable resolution of a long-term funding solution for the scheme.

**Mitigation:** We have agreed a long-term funding and risk management strategy with the Trustees. This is monitored regularly by us and the Trustees, and mitigating actions are reviewed and implemented as appropriate. We are currently in the process of agreeing the 2016 valuation with the Trustees.

**Outcomes affected**



Having a firm financial footing



Having great people

## Strategy and Regulation

### Compliance with regulations and legislation

**Commentary:** We are a highly regulated business with three main regulators: Ofwat, the Drinking Water Inspectorate (DWI) and the Environment Agency (EA). 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.

This risk has increased since the 2016 Annual Report due to issues with our regulators Ofwat, DWI and the EA.

Last year Ofwat determined that we fell short in our reporting requirements to our stakeholders. Its level of trust and confidence in our reported information reduced, chiefly relating to data quality, transparency, board governance and narrative explanations for stakeholders. Consequently, Ofwat assigned us an assurance rating of 'prescribed' – lower than our previous rating of 'targeted'.

The DWI has raised enforcement actions against us regarding our monitoring and reporting processes, and our compliance with Water Quality regulations regarding the collection of the required number of samples.

We provide a significant amount of data to the EA about the performance of our assets and any wastewater or sewage discharges we make into what is known as the 'water environment', such as rivers, streams and coastal waters. We have identified the need to review and improve our end-to-end reporting processes with a view to implementing process and control improvements. Detailed process reviews have continued and a programme of improvements is being developed. We will establish a programme of rolling audits of our EA reporting and data integrity, starting with the 2017–18 internal audit programme of assurance. In addition, we will complete assurance of the 2015–16 and 2016–17 data. Independent external assurers will be assigned to the review, which will commence in August 2017.

The performance of our wastewater treatment works continued to be strong during 2016–17 (though this remains subject to further assurance).

As mentioned previously, we are also working with Ofwat in relation to the management and operation of our wastewater treatment works and the reporting of relevant information in connection with them.

Note – further details are included in our updated statement of Risks, Strengths and Weaknesses, January 2017, available on our website at: [southernwater.co.uk/our-reports](http://southernwater.co.uk/our-reports).

**Mitigation:** During the year a number of issues were raised by our regulators. We agree that all of our stakeholders, especially our customers, should be able to have full confidence in the integrity of our data and so we have begun a transformation programme to improve our performance and compliance in information management, project delivery and risk management. We report regularly on progress of this improvement programme to our regulators.

In relation to the comments raised by Ofwat in its Company Monitoring Framework assessment, an internal working group was formed which met regularly to review progress against the actions identified to improve our reporting for 2016–17. We have also discussed our proposals with Ofwat to improve its confidence in our approach.

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

## Strategy and Regulation (continued)

### 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 and we are working hard to ensure our focus is maintained to complete all works 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 be compromised. Any failure to deliver would also 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 early part of the programme is behind that set out in the business plan, increasing the risk in this area. We have worked this year to close this shortfall and we remain on track to deliver our required outcomes by the end of the investment programme in 2020.

**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

## Strategy and Regulation (continued)

### 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-household customers opened, which required structural changes within the company to allow us to continue to comply with regulatory requirements and to manage the anticipated shift in customer base.

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.

Our current business plan and approved pricing structure, runs until 2020. We have therefore commenced projects to prepare for Ofwat's next Price Review process in 2019 (PR19) and to plan for 2020 onwards. Our challenge is to present a business plan to Ofwat that will deliver improvements for our customers and our infrastructure according to an equitable pricing structure by the submission deadline at the end of 2018.

We must also ensure we continue to monitor and adapt to any changes in the assessment criteria we are measured against by the Drinking Water Inspectorate and the Environment Agency.

**Mitigation:** Throughout the fiscal year we engaged constructively with Ofwat and Defra on the proposals for market reform. We actively participated in numerous workshops held by Ofwat, Open Water and Market Operator Services Limited (MOSL). We established a market readiness programme to co-ordinate the changes required in the business, including a steering group chaired by our Director of Strategy attended by our Chief Executive and Chief Financial Officers.

After considering a number of options, we made the decision to sell our non-household retail business to Business Stream, a specialist company in this field. The market opened successfully on 1 April 2017.

In order to prepare for the PR19 Price Review process, we have instigated projects to consult with our customers and determine the core values and outcomes that matter most to them and integrate within our next business plan. We are also initiating projects to prioritise the areas within our company that we will focus on from 2020 onwards.

We continue to closely monitor developments in the requirements from our regulators Ofwat, The Drinking Water Inspectorate and the Environment Agency. To anticipate any such changes we have proactively initiated programmes of investment in our infrastructure that will help us to be prepared and resilient to their changes.

**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 27 June 2017 and signed on its behalf by Joanne Statton, Company Secretary.

Joanne Statton  
Company Secretary  
27 June 2017

## 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
- 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 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 (GSH), has committed to assist us. We continue to have regard to corporate governance practices and developments in other sectors and the Board has, during this year, commenced a review of its governance framework. We note that the FRC is undertaking a fundamental review of the UK Corporate Governance Code in 2017 and we will consider this, as well as recommendations from Ofwat, as part of future developments to our code.

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 March 2017 following the departure of Robert Jennings, who had served on the Board in this role through April 2014 to 28 February 2017. I was previously one of four independent non-executive directors.

During the past year our Nomination Committee was tasked to consider candidates for the Chief Executive Officer role and my appointment as Chairman. As a result of this process, Ian McAulay was appointed with effect from 1 January 2017, followed by appointment to the Board from 1 February 2017. In addition, as a result of my appointment to the role of Chairman and a vacancy for a shareholder appointed non-executive director, the Nomination Committee is undertaking a recruitment exercise to fill these vacant positions. As part of this process the Nomination Committee evaluated the skill sets of the Board. While concluding that the current skills and experience of the Board provided good coverage, knowledge and diversity, the Nomination Committee has identified the principal areas of expertise required by candidates for the current vacancies.

During 2016–17 the Board was comprised of an independent non-executive Chairman, two executive directors, (the Chief Executive Officer and Chief Financial Officer) and non-executive directors. The number of non-executive directors has changed during the year as a result of the resignation of one investor nominated director and my appointment as Chairman. At all times during the year the majority of non-executive directors have been 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. The composition of the Board has changed during the period, with one of the shareholder directors resigning as a result of the sale of its shareholding by Future Fund, and my appointment to the role of Chairman.

The presence of the non-executive directors, only one of which is 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 87 to 89.

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 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.

My predecessor, Robert Jennings, was also independent Chairman of the GSH board during the past year, 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. Taking this into consideration it was felt that his cross directorship did not undermine his independence. GSH is currently reviewing its board and governance structure and a chairman has not yet been appointed, therefore, from 1 March 2017 no independent members of our Board sit on the board of GSH.

### **Investor representation**

Our investors comprise the Greensands Consortium, the membership of which is explained on page 64 and our [website](#).

One investor, but not all, is 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 three 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 would normally meet without the Chairman at least once a year and appraise the Chairman's performance annually. However, as a result of my appointment from 1 March 2017, this appraisal will take place as part of the Board evaluation 2017–18.

The Board considers the independent non-executive directors to have been, and to continue to be, independent in character and judgment 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 is currently one non-executive director, who is nominated to the Board by one of our three major investors. He brings the extensive knowledge, skills and resources of his nominating investors and employers as well as his own personal skills, experience and knowledge of businesses and business sectors similar to our own. On our Board, he has all the duties, obligations and rights of a director of Southern Water and acts in the best interests of the company. He does not receive any remuneration from Southern Water. The Nomination Committee is currently leading the process for the appointment of a second non-executive director who will represent the views of other investors at the Board.

### **Chief Executive Officer**

The Chief Executive Officer, Ian McAulay, 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.

Ian was appointed as Chief Executive following the resignation of Matthew Wright after nearly six years' service.

### **Chief Financial Officer**

The Chief Financial Officer, William Lambe, is a member of the Board with all the responsibilities of a director of the company. In his executive role and reporting to Ian McAulay, he has 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 is reviewed annually by the Chief Executive Officer.

### **Executive Leadership Team**

Reporting to Ian McAulay, the Executive Leadership 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.

### **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 Leadership 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 and water resource management planning. 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 April meeting and I have undertaken evaluations of individual non-executive directors' performance. Overall, the Board is considered to be working well, while recognising the significant change of the company with the appointment of a new Chief Executive Officer and Chairman at the beginning of 2017.

## 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 2016–17 the Greensands Holdings board and shareholders approved:

- the decision to dispose of the non-household retail business with effect from 1 April 2017
- the bonus issue of 735,000,000 ordinary shares out of the revaluation reserve followed by a capital reduction exercise, creating £735.0 million of distributable reserves.

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 10 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 months when there is no scheduled meeting (August and December). The Board primarily holds its meetings at its principal office in Worthing with at least two meetings each year held in London to facilitate meetings with investors.

In addition to the scheduled Board meetings, the Board and the company's Executive Leadership Team met in September, to discuss strategic considerations of the company, including Water 2020, market reform, innovation and customer experience. Additionally, the Board met separately to discuss the bonus issue of share capital and capital reduction exercise, disposal of the non-household business and matters relating to compliance.

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 2016–17			
Bill Tame	9/10	Robert Jennings (resigned 28 February 2017)	9/9
Ian McAulay (appointed 1 February 2017)	2/2	Matthew Wright (resigned 31 December 2016)	7/7
William Lambe (appointed 3 May 2016)	9/9		
Paul Sheffield	10/10		
Rosemary Boot	9/10		
Lisa Harrington	8/10		
Mark Walters	9/10	Bronte Somes (resigned 19 May 2016)	1/1

Note – Attendance includes attendance in person and by phone.

#### 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 2016–17 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.

#### Remuneration

The directors' remuneration report is set out on pages 95 to 105.

#### 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.

A handwritten signature in black ink, appearing to read 'Bill Tame', with a long horizontal flourish extending to the right.

Bill Tame  
Chairman

## **Board of directors**

The day-to-day running of Southern Water is led by Ian McAulay, Chief Executive Officer, and the Executive Leadership Team, which reports to our Board of Directors.

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### **Bill Tame**

#### **Chairman**

Bill Tame joined the Board in January 2015 and was appointed Chairman on 1 March 2017.

A chartered accountant by training, Bill held a number of senior finance roles at Courtaulds plc, the UK FTSE 100 chemicals company, both in the UK and overseas, operating as chief financial officer in Europe, based in France and then as finance director in Asia Pacific, based in Singapore.

He subsequently worked as finance director for Scapa Group plc before joining the board of Babcock International Group plc in 2002 as group finance director, a role he held during Babcock's development from a small cap company to its position as a member of the FTSE 100. Following the acquisition by Babcock of the international aviation services business, Avincis, in 2014, Bill assumed the role of chief executive officer of Babcock's Global Growth & Operations with responsibility for the integration, business development and operations of its international businesses.

From 2006 he was senior independent director and chairman of the audit committee of Carclo plc, a quoted small cap company, before joining Southern Water Services Limited as a non-executive director and Chairman of the Audit and Risk Review Committee in 2015.

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### **Ian McAulay**

#### **Chief Executive Officer**

Ian joined Southern Water as CEO in January 2017 and was appointed to the Board from 1 February. Ian has more than 30 years of global water and environmental experience and a significant record of achievement operating in both publicly quoted FTSE 100/250 companies and privately held enterprises.

Ian holds an honours degree in Civil and Environmental Engineering and is a Chartered Member of the ICE, CIWEM.

Throughout his career he has managed major utility, construction and consulting businesses in the UK, Belgium, India and the USA. He has enhanced this practical experience with professional executive education, most notably at Harvard Business School.

He has extensive experience in the UK regulated utility, construction and environmental services sectors, holding board positions across a broad range of commercial and statutory organisations. In his previous role he served as an executive director of the Pennon Group plc and chief executive of its subsidiary company, Viridor, one of the largest renewable energy and recycling companies in the UK.

In a non-executive capacity, he serves as an independently appointed member of Greater Manchester Authorities Low Carbon Hub Board and Scottish Government's 2020 Climate Change Board. He has also provided expert input to Government Review Groups and Industry Partnerships with particular emphasis on the UK skills agenda and development of future smarter regulation and environmental policy.

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### **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.

William is a member of the Institute of Chartered Accountants England and Wales.

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## **Paul Sheffield**

### **Senior independent non-executive director**

Paul Sheffield joined the Board in June 2014.

In his executive career, he spent over 32 years with Kier Group plc — the construction, services and property group — serving as its chief executive officer between 2010 and 2014. Between 2014 and 2017 he headed up the construction operations for the European and Middle Eastern business for Laing O'Rourke Services, delivering some of the biggest capital projects under way in the region today.

Graduating as a Civil Engineer in 1983, Paul spent 15 years working on major capital projects around the world and has over 19 years of board level experience, where he has gained significant exposure and experience of strategy, productivity and efficiency - key facets of any successful organisation.

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## **Rosemary Boot**

### **Independent non-executive director**

Rosemary Boot joined the Board in March 2015.

In March 2017 she was appointed as a non-executive director of Impact Healthcare REIT plc, a UK care home real estate investment trust that recently undertook a £160 million IPO and listed on the London Stock Exchange.

Previously Rosemary was the chief financial officer of Future Cities Catapult, one of a network of technology and innovation centres established by the UK Government. She has also 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.

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## **Lisa Harrington**

### **Independent non-executive director**

Appointed in April 2015, Lisa has a real passion for customers and a strong track record of delivering customer experience improvement in a variety of transformation and operational roles.

Up to May 2017, Lisa was the chief customer officer of British Telecom. Before BT, Lisa spent 11 years with Accenture, specialising in customer service consulting and delivering big transformation projects for companies such as Microsoft, Compaq, Vodafone and Sainsbury's. She also served as a non-executive director for the NHS West London Mental Health Trust:

When she is not working, she enjoys spending time with her young family.

## **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.

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## **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.

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Other Board members who served in 2016–17 were:

#### **Robert Jennings** – Chairman (resigned 28 February 2017)

Robert Jennings joined the Board in July 2012 as an independent non-executive director and was appointed Chairman in April 2014.

#### **Matthew Wright** – Chief Executive Officer (resigned 31 December 2016)

Matthew Wright joined the Board in February 2011 and served as Chief Executive Officer until his resignation.

#### **Bronte Somes** – Non-executive director

Bronte Somes joined the Board in April 2015 and served as a non-executive director until her resignation on 19 May 2016. With effect from 20 July 2016, Bronte was appointed as a director of our parent company Greensands Holdings.

### **Executive Leadership Team**

Reporting to Ian McAulay, the Executive Leadership Team in 2016–17 consisted of:

#### **William Lambe** – Chief Financial Officer (from 3 May 2016)

#### **Philip Barker** – Director of Operations

#### **Chris Maloney** – Director of Transformation and People

#### **Simon Oates** – Director of Strategy (to September 2016) and Chief Customer Officer (from September 2016)

#### **Richard Price** – Director of Engineering and Construction

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### 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 ARRC was chaired by Bill Tame until 28 February 2017 when he became Chairman of the company and Rosemary Boot was appointed as the Interim Chairman of the committee from 1 March 2017. The other members of the ARRC are Lisa Harrington, Mark Walters and Paul Sheffield (appointed 1 March 2017), whose experience and background are set out on pages 88 to 89.

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 2016–17 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
- Regulatory reporting obligations
- Annual risk review.

Audit and Risk Review Committee attendance in 2016–17			
Bill Tame (to 28 February 2017)	3/3	Lisa Harrington	3/4
Mark Walters	4/4	Paul Sheffield (appointed 1 March 2017)	1/1
Rosemary Boot (appointed 1 March 2017)	1/1		

Note – Attendance includes attendance in person and by phone.

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

### Financial statements

The ARRC received and reviewed the financial statements, including the key areas of judgment and estimation uncertainty set out in note 2 and the external audit report from Deloitte regarding the year-end financial statements, considering any items of significant judgment 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 capital reduction exercise that was completed during January 2017.

### Our Ofwat Performance Commitments

For the five-year business plan, we appoint a certifier to independently confirm that we have a robust system of internal controls in place for performance reporting and that such information in the Annual Report fairly represents the company's progress and delivery of its promises. The certifier attends the ARRC and reports formally its results of its assurance. For the current year, there were no significant issues to report.

### 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. During the year the company reviewed and refreshed its whistleblowing policy. A new Speak-Up campaign was launched in January 2017 and forms part of a wider cultural transformation programme.

Further details of our internal control framework, including the main features of our internal control and risk management systems, can be found in the Annual Report on page 70.

### **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 also 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**

While 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
- 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 26 September 2016 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 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 10 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 financial statements.

## 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.

During the year the H&SC looked in depth at the company's contractor performance and the company's progress on wellbeing. The committee held its November meeting at the company's Woolston Wastewater Treatment Works, the location having been chosen so that the committee could see first-hand an active construction site.

The members of the H&SC are Paul Sheffield (Chairman of the committee), Ian McAulay (from 1 February 2017), Matthew Wright (to 31 December 2016), Rosemary Boot and Mark Walters.

The H&SC met on three occasions in 2016–17.

Health and Safety Committee attendance in 2016–17			
Paul Sheffield	3/3	Ian McAulay (from 1 February 2017)	1/1
Rosemary Boot	3/3	Mark Walters	3/3
Matthew Wright (to 31 December 2016)	1/2		

Note – Attendance includes attendance in person and by phone.

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.

During the year the Nomination Committee met to discuss the appointment of the Chief Executive Officer, Ian McAulay and the Chairman, Bill Tame. When the committee considered the appointment of the Chairman, Bill Tame left the meeting and took no part in the discussions. The committee is currently considering candidates for appointment to non-executive vacancies on the Board, supported by The Zygos Partnership.

The members of the Nomination Committee are Bill Tame (Chairman from 1 March 2017) Robert Jennings (Chairman to 28 February 2017), Paul Sheffield (deputy chairman) and all other non-executive directors.

The Nomination Committee met on three occasions in 2016–17.

Nomination Committee attendance in 2016–17			
Bill Tame	3/3	Robert Jennings (resigned 28 February 2017)	1/1
Paul Sheffield	3/3	Lisa Harrington	2/3
Rosemary Boot	3/3	Mark Walters	3/3

Note – Attendance includes attendance in person and by phone.

In addition, the members of the Nomination Committee met as required during the year to discuss the appointments to the Board.

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

## Directors' Remuneration Report

This report details the activities of the Remuneration Committee for the period to 31 March 2017. 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) 3.09 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

It has been another year of driving performance improvement, aligning our employees to deliver the outcomes and expectations of our customers and shareholders. Our remuneration strategy was reviewed in February 2017 and a number of improvements were agreed for 2017–18, including the introduction of a new incentive plan.

We believe our policy to align employee pay with the interests of customers and shareholders while keeping total pay levels competitive with our sector and regional competitors meets our stakeholders' needs.

We recognise that much has changed in the past three years. We have revisited our remuneration philosophy, reviewed our remuneration strategy from the top down and listened to views from shareholders, the government and regulators. The resulting changes to our directors' remuneration policy are outlined on page 104. We have also managed significant internal change – the transition to a new Chairman and Chief Executive plus changes in leadership in Customer Engagement, Strategy and Regulation and Transformation and People. We also recognise the significant challenges that our industry faces, as outlined in our Chief Executive's summary on page 16. In light of this, it is right to be prudent on pay levels. We have only increased base pay compensation by 2.2% this year and have awarded a lower bonus payment than in the previous year.

### Our remuneration philosophy

In 2016, the committee carried out a fundamental review of our remuneration philosophy and the resulting pay structures. We continue to believe in our current approach, where the remuneration policy for our executive directors is aligned with that for other employees. Remuneration is clearly aligned to the performance of the company and the value delivered for our customers and shareholders. Long-term thinking is core to Southern Water as our success depends on providing our customers with resilient and sustainable services whilst ensuring our shareholders meet their long-term financial goals. Our philosophy is to reward value creation and recognise appropriately employees who do the right thing, delivering good outcomes for our customers, investors and shareholders.

We compete for talent in both UK and regional marketplaces, with employees primarily in Kent, Sussex, Hampshire and the Isle of Wight. Our key competitors are located throughout the UK and many of the skills and capabilities we compete for are within the utilities sector. It is against this backdrop, and also our proximity to the highly competitive London markets, that we determine both our pay structures and levels of pay, to ensure that we are able to attract, motivate, reward and retain the best people.

We have also been very mindful of the wide range that exists in all organisations between employees' average pay and executive pay. In recognising our executive structure we have been keen to ensure that we hold executive pay, benefits and retirement packages at the lower end of the FTSE 250 comparator range while creating a competitive package for most employees.

We believe in a structured approach to assessing performance and determining annual bonus awards, which is outcomes based, with a strong element related to how the outcomes are achieved. For the executive directors, this includes taking a balanced approach to encourage the creation of sustainable results and ensuring that a link exists between customers'/shareholders' and employees' interests. This requires growing the business profitably and sustainably, while retaining and developing our talented people who are key to organisational stability and long-term success. We look to appropriately reward all employees who adhere to the company's values – everyone matters, taking ownership, always improving, customers first, local pride and succeeding together – as well as demonstrating the behaviours we expect in a customer-centric culture. Our discretionary approach also ensures we assess performance on the management of risks and adherence to compliance controls. Our remuneration philosophy supports our long-term approach by deferring a significant part of variable remuneration, which provides clear alignment with the long-term interests of customers and shareholders, through awards under the Long-Term Incentive Plan (LTIP).

The Remuneration Committee's assessment of overall company performance resulted in an annual bonus pool for 2016–17 which is equivalent to 59% of the total potential. Awards from this pool were made based on an assessment of the individual performance during the year of each participant in the scheme.

**Remuneration in 2017–18**

With effect from 1 April 2017, the committee implemented a new incentive scheme, the Bonus Banking Plan (BBP), which incorporates the existing annual and long-term bonus schemes. This was primarily 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 perpetual plan and each year's award will be added to a 'bonus bank' with a pay out from the bank, equivalent to 50% of the carrying balance, being made in the year subject to performance. The committee will review the performance metrics each year to ensure that they best reflect the company's priorities. Malus and claw-back entitlements have also been included in the scheme.

The 2018 Long-Term Incentive Plan will continue to operate, until its original vesting date of 31 March 2018.



Paul Sheffield  
27 June 2017

## 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 (to 28 February 2017), Bill Tame, Rosemary Boot, Lisa Harrington, Mark Walters and Bronte Somes (to 19 May 2016).

Only RemCom members are entitled to attend meetings, but the Director of Transformation and People and the Chief Executive Officer, Ian McAulay, attend by invitation. The Director of Transformation and People 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 2016–17 are shown in the table below:

Remuneration Committee attendance in 2016–17			
Paul Sheffield	4/4	Robert Jennings (resigned 28 February 2017)	3/3
Bill Tame	4/4	Rosemary Boot	4/4
Lisa Harrington	3/4	Mark Walters	4/4
Bronte Somes (resigned 19 May 2016)	1/1		

Note – Attendance includes attendance in person and by phone.

### 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 are 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, 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.

An investor representative non-executive director sits on the RemCom and is closely involved in setting remuneration levels, monitoring the performance of the executive directors, agreeing payments and approving any changes to reward packages. This involvement ensures that shareholders play a key part in shaping remuneration policy and decisions. Along with the independent non-executive directors they ensure that the link between pay and performance is closely managed.

To ensure that our remuneration practices remain competitive, the RemCom periodically calls upon experienced specialist consultants. The RemCom last received advice regarding overall remuneration in 2014–15 from Towers Watson (a leading global professional services company) and intends to undertake further reviews every three years. A full review is planned for 2017–18. During 2016–17, PricewaterhouseCoopers have been engaged to undertake a review of the design of the Long-Term Incentive Plan and bonus scheme with the intention of implementing a 'bonus banking' plan from 1 April 2017.

#### **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 2016–17 year are shown below:

Ian McAulay	Chief Executive Officer (CEO) – appointed 1 January 2017 (appointed to the Board 1 February)
Matthew Wright	Chief Executive Officer (CEO) – resigned 31 December 2016
William Lambe	Chief Financial Officer (CFO) – appointed 3 May 2016

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 2017.

Matthew Wright resigned from the business on 31 December 2016 and we appointed Ian McAulay to the role of Chief Executive Officer with effect from 1 January 2017.

## 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 2016.

The policy reflects the Board's objectives for good corporate governance, high quality of service to all our customers as well as sustained and long-term value creation for shareholders by eliminating waste from our processes and focusing on efficiency. 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 70% of fixed salary excluding any pension allowance. The only exceptions for 2016–17 are the CEO (100%) and the CFO (80%). Performance-based remuneration is disbursed as a cash bonus. Executive directors are covered by four 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% performance-related and 40% non-performance-related for the CEO and 55% performance-related and 45% 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
<b>Base salary</b>	<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"> <li>• The base salary is a fixed figure and does not vary in relation to business or individual performance.</li> <li>• Reviewed annually with changes effective from 1 July if applicable.</li> <li>• Consideration given to individual and company performance.</li> <li>• General pay increases to all employees taken into consideration.</li> <li>• 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.</li> <li>• Referenced against UK companies of a similar size, utility companies and other water companies.</li> </ul>	Base salary increases are applied in line with the annual review.	No
<b>Annual incentive scheme (Bonus)</b>	<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"> <li>• The performance measures included within the annual bonus scheme are selected to ensure that we are focused on our strategic objectives.</li> <li>• The balance and nature of the objectives is reviewed annually.</li> <li>• 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.</li> <li>• The KPIs for 2016–17 are shown on page 62.</li> <li>• The threshold, mid-point and stretch targets are established annually by the RemCom, making sure they are sufficiently stretching while also recognising the nature and risk profile of the company.</li> </ul>	Maximum percentage of salary – shown in table on page 104.	No

		<ul style="list-style-type: none"> <li>• Where applicable, between 60% and 80% of the bonus pool is created for achieving the mid-point target and 100% for achieving the stretch target.</li> <li>• RemCom has discretion to amend or withdraw payments based on the consideration of other factors which could significantly affect business performance.</li> <li>• From 2017–18 the annual incentive scheme will be replaced by the BBP detailed on page 104.</li> </ul>		
<b>Long-Term Incentive Plan (LTIP)</b>	Aligns interests of executives, customers and shareholders.	<ul style="list-style-type: none"> <li>• The current scheme was introduced on 1 April 2015 and covers a three-year performance period to 31 March 2018.</li> <li>• Subject to continuing employment over the three-year period.</li> <li>• If the participant resigns during the period then participation in the scheme will lapse.</li> <li>• The RemCom has the discretion to make awards for 'good' leavers as appropriate subject to performance.</li> <li>• From 2017–18 the long-term incentive scheme will be replaced by the BBP detailed on page 104.</li> </ul>	The annualised maximum award for each director is:  CEO £504k  CFO £188k	No
<b>Pension</b>	Defined contribution scheme minimises the risk to the company associated with defined benefit pension plans.	<ul style="list-style-type: none"> <li>• A company contribution into a defined contribution scheme, or</li> <li>• A cash allowance in lieu of pension.</li> </ul>	Contribution of:  CEO 18%  CFO 15%	No
<b>Other benefits</b>	Provides market competitive benefits.	<ul style="list-style-type: none"> <li>• Car allowance</li> <li>• Health cover</li> <li>• Disturbance or relocation allowances.</li> </ul>	Based on individual circumstances.	No

A basic pay increase of 2.4% for William Lambe for 2017–18 was approved in May 2017 and will be applicable to his basic salary with effect from 1 July 2017. This is in line with the average pay increase for the remainder of employees in the business. As Ian McAulay joined the company on 1 January 2017 he has not been awarded a salary increase for 2017–18.

The terms of the contracts for the executive directors require notice periods of 12 months by both parties for Ian McAulay 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:

<b>Directors' remuneration for 2016–17</b>							
<b>£'000</b>	<b>Base salary</b>	<b>Benefits</b>	<b>Relocation</b>	<b>Annual Bonus</b>	<b>Total</b>	<b>DC pension contribution / compensation</b>	<b>Total including pension</b>
Ian McAulay	105.0	3.2	7.6	68.2	<b>184.0</b>	18.9	<b>202.9</b>
Matthew Wright	277.4	379.4	-	166.4	<b>823.2</b>	49.9	<b>873.1</b>
William Lambe	227.9	6.8	5.6	119.2	<b>359.5</b>	34.2	<b>393.7</b>

Matthew Wright left his position of CEO on 31 December 2016 and the benefits disclosed for him here include a sum for loss of office totalling £369,822. Of this, £184,911 remains unpaid along with the potential performance bonus of £166,419, which remain subject to approval by the RemCom.

<b>Directors' remuneration for 2015–16</b>						
<b>£'000</b>	<b>Base salary</b>	<b>Benefits</b>	<b>Annual Bonus</b>	<b>Total</b>	<b>DC pension contribution / compensation</b>	<b>Total including pension</b>
Matthew Wright	364.4	12.7	273.2	<b>650.3</b>	65.6	<b>715.9</b>
Michael Carmedy	255.6	12.9	153.4	<b>421.9</b>	38.3	<b>460.2</b>

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:

<b>£'000</b>	<b>2016–17</b>			<b>2015–16</b>		
	<b>Fees</b>	<b>Other</b>	<b>Total</b>	<b>Fees</b>	<b>Other</b>	<b>Total</b>
Robert Jennings (Chairman to 28 February 2017)	206.2	76.3	<b>282.5</b>	225.0	1.1	<b>226.1</b>
Bill Tame (Chairman from 1 March 2017)	66.7	2.6	<b>69.3</b>	50.0	0.4	<b>50.4</b>
Paul Sheffield	60.0	1.4	<b>61.4</b>	56.7	0.4	<b>57.1</b>
Rosemary Boot	50.0	1.0	<b>51.0</b>	50.0	0.7	<b>50.7</b>
Lisa Harrington	50.0	1.4	<b>51.4</b>	50.0	0.4	<b>50.4</b>
David Golden	-	-	-	15.0	7.0	<b>22.0</b>
Mark Walters	-	-	-	-	-	-

Robert Jennings left his position of Chairman on 28 February 2017 and received a payment of £75,000 in lieu of notice.

The other amounts payable to the non-executive directors include taxable expenses incurred in the attendance at Board meetings. In 2015–16 payments were also made 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 2016–17 were set and approved in June 2016.

A balanced scorecard, based on five measures, was used for the creation of the bonus pool. The standard weightings applied to each measure were balanced at 50% for operational and customer performance and 50% for financial performance. The measures for 2016–17 were Service Incentive Mechanism (SIM – qualitative ranking), Outcome Delivery Incentives (ODIs), cash collection, operational expenditure (Opex) and the bad debt provision charge. For some of the measures, stretch targets and weightings are possible to reward exceptional performance but the overall value of the bonus pool cannot exceed 100%.

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 2016–17 together with the maximum bonus opportunity available to each executive director are shown in the table below. The performance for 2016–17 was assessed in May 2017 by the RemCom and the achievement against each target together with the personal achievement level and payments made in relation to 2016–17 are also shown below.

Performance measure		Standard weight for 2016–17 (as % of bonus pool)	Stretch weight for 2016–17 (as % of bonus pool)	Achievement 2016–17 (as % of bonus pool)
Service standards	<p>Deliver a targeted improvement in the Service Incentive Mechanism qualitative score for 2016–17.</p> <p>Purpose – to deliver significant improvements in customer service performance.</p> <p>Measure – Ofwat SIM qualitative score.</p>	25%	30%	0%
Outcome delivery incentives	<p>ODIs target the priority improvement areas for customers through the attachment of financial incentives to ODIs, mostly in the form of penalties.</p> <p>Purpose – to maintain Asset Health by focusing on the avoidance of annual Ofwat penalties.</p> <p>Measure – the avoidance of annual Asset Health penalties across all of the ODI measures.</p>	25%	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 financial statements.	15%	18%	17.4%
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 financial statements.	15%	18%	16.8%
Bad debt provision charge	To bring the level of bad debt charge down in line with that of other water and wastewater companies. Purpose – to reduce the impact of bad debt costs to the company and drive future improvements in cash collection. Measure – ratio of bad debt charge to revenue.	20%	24%	0%
	<b>Total maximum/actual award</b>	<b>100%</b>	<b>Max 100%</b>	<b>59.2%</b>

Bonus 2016–17	Ian McAulay	Matthew Wright	William Lambe
Maximum bonus opportunity (% of base salary)	100%	100%	80%
Bonus percentage awarded based on business and personal performance (% of base salary)	65%	60%	52%
Qualifying months	3	9	11
Base salary (£'000)	£420.0	£369.9	£250.0
Bonus (£'000)	£68.2	£166.4	£119.2

The bonuses awarded to Ian McAulay and William Lambe were paid in July 2017. The provisional bonus reported for Matthew Wright remains unpaid and is subject to final consideration and approval by the RemCom.

### Bonus Banking Plan

The RemCom has agreed to replace both the annual bonus scheme and the LTIP with a single scheme, the Bonus Banking Plan (BBP) commencing from 1 April 2017.

The new scheme is designed to align the remuneration of the executive directors in delivering the business strategy to fulfil the short-term and long-term aims of customers, stakeholders and shareholders. It will use a balanced scorecard approach and performance will be assessed against six short-term measures, cash collection, operational expenditure, bad debt provision, outcome delivery incentives, SIM and capital expenditure and long-term measures of total shareholder return and average cost to serve – which will help ensure we can keep bills at an affordable level despite ongoing investment in the renewal of our infrastructure.

Any award made will form a bonus bank with 50% of the value in the bank being paid out and the remainder being carried forward.

**Long-Term Incentive Plan**

The LTIP for the period 1 April 2015 to 31 March 2018 was agreed by the RemCom in June 2015.

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 17 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%
<b>Total maximum/actual award</b>		<b>100%</b>

To date no payments have been made in relation to this scheme. An accrual has been made in the financial statements for the period to 31 March 2017 in anticipation of the final award under the LTIP. The value of the cumulative accrual following the second year of the scheme is shown below:

Ian McAulay – accrual at March 2017 £88k  
 William Lambe – accrual at March 2017 £120k  
 Matthew Wright – accrual at March 2017 £366k

Actual performance against the scheme will be assessed in 2018–19 by the RemCom and the value of any award may differ from the accruals made. The recognition of an accrual for an award does not constitute confirmation of an obligation to make a payment under scheme. As Matthew Wright resigned from the company on 31 December 2016 he is no longer eligible to participate in the scheme and an accrual has been made in respect of his service for the period to 31 December 2016.

Ian McAulay and William Lambe have both joined the scheme and their entitlements under the scheme will be pro-rated based on their dates of joining the company.

## Directors' report for the year ended 31 March 2017

The directors of Southern Water Services Limited (registered no. 02366670) present their report and the audited financial statements for the year ended 31 March 2017.

### 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 20 to 80.

### Future developments

The information regarding future developments of the company can be found in our Annual Report on pages 20 to 80.

### Post balance sheet events

On 1 April 2017, the company disposed of its non-household retail business function to Business Stream as disclosed in note 33.

### Results and dividends

The income statement on page 110 shows the company's results and profit for the year. Further details are also available in the Annual Report on pages 56 to 62.

Interim dividends of £812.37 per ordinary share (2016: £812.37 per share), totalling £45.5 million (2016: £45.5 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 financial statements.

Ordinary dividends totalling £124.2 million, equivalent to £2,217.86 per share, (2016: £79.6 million, equivalent to £1,421.31 per share) were declared in the year. Of these dividends £61.0 million (£1,089.29 per share) was paid during the year and the final dividend of £63.2 million (£1,128.57 per share) was paid after the year end. Of these dividends £108.2 million was paid to our ultimate investors.

The revaluation reserve arose on transition to IFRS at 1 April 2014, when the company elected to measure its infrastructure and operational assets at their fair value and to use that fair value as their deemed cost at that date. During the year, the company undertook a bonus issue of 735,000,000 ordinary shares out of its revaluation reserve. Following this bonus issue, the company completed a capital reduction exercise, creating £735.0 million of distributable reserves.

### Directors and their interests

The directors who held office during the year ended 31 March 2017 and up to the date of signing the financial statements, unless otherwise stated, were as follows (further details can be found on pages 87 to 89):

Bill Tame	(Independent non-executive director) (appointed as Chairman 1 March 2017)
Robert Jennings	(Independent non-executive director) (resigned 28 February 2017)
Ian McAulay	(Executive director – Chief Executive Officer) (appointed 1 February 2017)
Matthew Wright	(Executive director – Chief Executive Officer) (resigned 31 December 2016)
William Lambe	(Executive director – Chief Financial Officer) (appointed 3 May 2016)
Paul Sheffield	(Senior independent non-executive director)
Rosemary Boot	(Independent non-executive director)
Lisa Harrington	(Independent non-executive director)
Mark Walters	(Non-executive director)
Andrew Truscott	(Alternate non-executive director)
Bronte Somes	(Non-executive director) (resigned 19 May 2016)
Paul Moy	(Alternate non-executive director) (resigned 19 May 2016)

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 £1.0 million (2016: £0.7 million).

## Financial risk management

The Financial Risk Management Policy is included in the Strategic Report on pages 70 to 80.

## 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.

**Speak Up:** Employees are actively encouraged to Speak Up if they see things that are not quite right. This helps us work better as a company and fosters a culture where we ensure that we are always doing the right thing for each other, our customers, the environment and other stakeholders.

## 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 43 to 49. 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 2017.

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 20 to 80.
- 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 56 to 62.
- The company has available a combination of cash and committed undrawn bank facilities totalling £635.3 million at 31 March 2017 (2016: £357.9 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.

#### **Long-term viability statement**

In accordance with provision C.2.2 of the 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. Details of its assessment and the associated viability statement can be found on page 69 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 Annual Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), including FRS 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 judgments and accounting estimates that are reasonable and prudent
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

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

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

### **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  
27 June 2017

## Financial statements

### Income statement

For the year ended 31 March 2017

	Note	2017 £m	2016 £m
<b>Continuing operations</b>			
<b>Revenue</b>	4	<b>809.7</b>	803.7
Other operating income	4	1.3	1.7
Operating costs			
- before depreciation and amortisation		(306.9)	(286.3)
- depreciation and amortisation		(245.2)	(234.6)
Total operating costs		(552.1)	(520.9)
<b>Operating profit</b>	5	<b>258.9</b>	284.5
Profit on disposal of fixed assets		0.4	0.4
Finance income	8	58.1	59.3
Finance costs	8	(161.2)	(145.5)
Fair value losses on derivative financial instruments	20	(416.8)	(70.4)
Net finance costs	8	(519.9)	(156.6)
<b>(Loss)/profit before taxation</b>		<b>(260.6)</b>	128.3
Taxation	9	84.9	(8.4)
<b>(Loss)/profit for the financial year</b>		<b>(175.7)</b>	119.9

The notes on pages 115 to 150 form part of these financial statements.

**Statement of other comprehensive income**

For the year ended 31 March 2017

	Note	2017 £m	2016 £m
<b>(Loss)/profit for the year</b>		<b>(175.7)</b>	119.9
<b>Other comprehensive (loss)/income:</b>			
<b>Items that cannot be reclassified to profit or loss:</b>			
Actuarial loss on pension scheme	22	<b>(71.4)</b>	(14.0)
Movement on deferred tax relating to retirement benefit obligations	21	<b>12.8</b>	2.8
Deferred tax movement due to rate change	21	<b>(1.7)</b>	18.6
<b>Total other comprehensive (loss)/income for the year, net of tax</b>		<b>(60.3)</b>	7.4
<b>Total comprehensive (loss)/income for the year attributable to the owner of the company</b>		<b>(236.0)</b>	127.3

**Statement of financial position**

as at 31 March 2017

	Note	2017 £m	2016 £m
<b>Non-current assets</b>			
Intangible assets	11	61.1	42.0
Property, plant and equipment	12	5,684.6	5,607.5
Other non-current assets	13	812.3	812.3
Investments	14	29.2	29.2
		<u>6,587.2</u>	<u>6,491.0</u>
<b>Current assets</b>			
Inventories	15	2.7	2.4
Trade and other receivables	16	197.3	192.3
Cash and cash equivalents	29	285.3	17.9
		<u>485.3</u>	<u>212.6</u>
<b>Total assets</b>		<u>7,072.5</u>	<u>6,703.6</u>
<b>Current liabilities</b>			
Trade and other payables	17	(310.1)	(188.1)
Borrowings	18	(39.4)	(88.9)
		<u>(349.5)</u>	<u>(277.0)</u>
<b>Non-current liabilities</b>			
Borrowings	19	(3,933.7)	(3,631.8)
Derivative financial instruments	20	(1,338.0)	(923.7)
Deferred tax liabilities	21	(257.6)	(365.0)
Retirement benefit obligations	22	(176.9)	(102.3)
Provisions for liabilities	23	(0.5)	(0.5)
Other non-current liabilities	24	(62.2)	(43.5)
		<u>(5,768.9)</u>	<u>(5,066.8)</u>
<b>Total liabilities</b>		<u>(6,118.4)</u>	<u>(5,343.8)</u>
<b>Net assets</b>		<u>954.1</u>	<u>1,359.8</u>
<b>Equity</b>			
Called up share capital	25	0.1	0.1
Share premium account	26	46.3	46.3
Revaluation reserve	27	-	745.1
Retained earnings	28	907.7	568.3
<b>Total equity</b>		<u>954.1</u>	<u>1,359.8</u>

The financial statements of Southern Water Services Limited (Registered no. 02366670) on pages 110 to 150 were approved by the Board and authorised for issue on 27 June 2017. They were signed on its behalf by:



William Lambe  
Chief Financial Officer

**Statement of changes in equity**

For the year ended 31 March 2017

	Called up share capital (Note 25) £m	Share premium account (Note 26) £m	Revaluation reserve (Note 27) £m	Retained earnings (Note 28) £m	Total £m
<b>Balance at 31 March 2015</b>	<b>0.1</b>	<b>46.3</b>	<b>757.3</b>	<b>553.9</b>	<b>1,357.6</b>
Profit for the financial year	-	-	-	119.9	119.9
Other comprehensive income for the year	-	-	-	7.4	7.4
<b>Total comprehensive income for the year</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>127.3</b>	<b>127.3</b>
Equity dividends paid (Note 10)	-	-	-	(125.1)	(125.1)
Revaluation reserve transfer	-	-	(12.2)	12.2	-
<b>Balance at 31 March 2016</b>	<b>0.1</b>	<b>46.3</b>	<b>745.1</b>	<b>568.3</b>	<b>1,359.8</b>
Loss for the financial year	-	-	-	(175.7)	(175.7)
Other comprehensive loss for the year	-	-	-	(60.3)	(60.3)
<b>Total comprehensive loss for the year</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(236.0)</b>	<b>(236.0)</b>
Issue of bonus shares	735.0	-	(735.0)	-	-
Capital reduction	(735.0)	-	-	735.0	-
Equity dividends paid/declared (Note 10)	-	-	-	(169.7)	(169.7)
Revaluation reserve transfer	-	-	(10.1)	10.1	-
<b>Balance at 31 March 2017</b>	<b>0.1</b>	<b>46.3</b>	<b>-</b>	<b>907.7</b>	<b>954.1</b>

The revaluation reserve arose on transition to IFRS at 1 April 2014, when the company elected to measure its infrastructure and operational assets at their fair value and to use that fair value as their deemed cost at that date.

During the year, the company undertook a bonus issue of 735,000,000 ordinary shares out of its revaluation reserve. Following this bonus issue, the company completed a capital reduction exercise, creating £735.0 million of distributable reserves.

**Statement of cash flows**

For the year ended 31 March 2017

	Note	2017 £m	2016 £m
Cash from operating activities	29	524.3	482.0
Tax paid		(11.4)	(15.1)
<b>Net cash generated from operating activities</b>		<b>512.9</b>	<b>466.9</b>
<b>Investing activities</b>			
Interest received		57.9	59.7
Purchase of property, plant and equipment		(246.7)	(237.9)
Purchase of intangible assets		(31.1)	(6.8)
Receipt of grants and contributions		3.1	5.2
Sale of property, plant and equipment		-	0.6
Movement on loan to subsidiary		(7.5)	14.3
<b>Net cash used in investing activities</b>		<b>(224.3)</b>	<b>(164.9)</b>
<b>Financing activities</b>			
Equity dividends paid		(106.5)	(125.1)
Interest paid		(136.8)	(132.5)
Preference share dividends		(13.4)	(11.2)
Payment of derivative accretion		(2.5)	(298.4)
Repayment of short-term borrowings		(80.0)	-
Repayments of obligations under finance leases		(0.3)	(0.2)
Issue costs of new loans		-	(0.2)
Proceeds of new loans		318.3	110.0
<b>Net cash used in financing activities</b>		<b>(21.2)</b>	<b>(457.6)</b>
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>267.4</b>	<b>(155.6)</b>
Cash and cash equivalents at beginning of the year		17.9	173.5
<b>Cash and cash equivalents at end of the year</b>		<b>285.3</b>	<b>17.9</b>

## Notes to the financial statements

For the year ended 31 March 2017

### 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 company is a private company limited by shares and is registered in England and Wales. 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 20 to 80.

These financial statements have been 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.

The financial statements have been prepared on a going concern basis under the historical cost convention, as modified by the revaluation of property, plant and equipment, available-for-sale financial assets, and financial assets and financial liabilities (including derivative instruments) at fair value through profit and loss.

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
- 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 the company website, [southernwater.co.uk](http://southernwater.co.uk).

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.

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**1 Accounting policies (continued)**

**Adoption of new and revised accounting and financial reporting standards**

The amendments to the following revised accounting standard have been adopted in the current year:

<p><i>Amendments to IAS 1 Disclosure Initiative</i></p>	<p>The company has adopted the amendments to IAS 1 <i>Disclosure Initiative</i> for the first time in the current year. The amendments clarify that an entity need not provide a specific disclosure required by an IFRS if the information resulting from that disclosure is not material, and give guidance on the bases of aggregating and disaggregating information for disclosure purposes. However, the amendments reiterate that an entity should consider providing additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, events and conditions on the entity's financial position and financial performance.</p> <p>The amendments also address the structure of the financial statements by providing examples of systematic ordering or grouping of the notes.</p> <p>The adoption of these amendments has not resulted in any impact on the financial performance or financial position of the company.</p>
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## Notes to the financial statements (continued)

For the year ended 31 March 2017

### 1 Accounting policies (continued)

#### 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 20 to 80.

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 108.

In addition and in accordance with provision C.2.2 of the UK Code, the Board has 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 five-year period and full details of the assessment and the viability statement are set out within the Strategic Report on page 69.

#### 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.

#### 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.

## **Notes to the financial statements (continued)**

For the year ended 31 March 2017

### **1 Accounting policies (continued)**

#### **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**

Taxation in the income statement represents the sum of the tax currently payable and deferred tax.

Current taxation is based on the result 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 reporting 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.

#### **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.

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**1 Accounting policies (continued)****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.

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 works is officially taken over from the contractor, following completion of performance and take-over tests.

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.

## Notes to the financial statements (continued)

For the year ended 31 March 2017

### 1 Accounting policies (continued)

#### 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 income statement, 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.

#### Grants and contributions

Grants 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.

## Notes to the financial statements (continued)

For the year ended 31 March 2017

### 1 Accounting policies (continued)

#### 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.

#### 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.

## Notes to the financial statements (continued)

For the year ended 31 March 2017

### 1 Accounting policies (continued)

#### 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.

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 22.

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.

## Notes to the financial statements (continued)

For the year ended 31 March 2017

### 1 Accounting policies (continued)

#### 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 the income statement.

#### 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 2017

### **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 2017

### 2 Critical accounting judgments 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 judgments, 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.

#### Judgments

Critical judgments, apart from those involving estimations, that are applied in the preparation of the financial statements are discussed below:

#### Revenue recognition

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.

#### 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 based on judgments made in respect of the proportion of capital work performed by these functions. The assessment of useful economic lives is also a key judgment in determining the carrying value of property, plant and equipment.

#### Provisions and contingent liabilities

The company exercises judgment in recognising provisions (see note 23) and the exposures to contingent liabilities related to pending litigation or other outstanding claims subject to negotiated settlement, mediation, arbitration or government regulation, as well as other contingent liabilities (see note 30). Judgment is necessary in assessing the likelihood that a pending claim will succeed, or a liability will arise, and the point of recognition for the associated liability.

#### Sources of estimation uncertainty

The key assumptions about the future, and other key sources of estimation uncertainty at the reporting period end that may have a risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year are discussed below:

#### 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.

#### Allowance for doubtful receivables

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, among 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.

## **Notes to the financial statements (continued)**

For the year ended 31 March 2017

### **2 Critical accounting judgements and key sources of estimation uncertainty (continued)**

#### **Sources of estimation uncertainty (continued)**

##### **Retirement benefit obligations**

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 £71.4 million (2016: loss of £14.0 million).

The pension cost and liabilities under IAS 19 are assessed in accordance with directors' best estimates using the advice of an independent qualified actuary and assumptions in the latest actuarial valuation. The assumptions are based on member data supplied to the actuary and market observations for interest rates and inflation, supplemented by discussions between the actuary and management. The mortality assumption uses a scheme-specific calculation based on CMI 2015 actuarial tables with an allowance for future longevity improvement.

The principal assumptions used to measure schemes' liabilities, sensitivities to changes in those assumptions and future funding obligations are set out in note 22 of the financial statements.

##### **Provisions and contingent liabilities**

The company evaluates its exposures to contingent liabilities relating to pending litigation or other outstanding claims and recognises provisions using estimates to quantify the possible range of the financial settlement. Because of the inherent uncertainty in this evaluation process, actual losses may be different from the originally estimated provision.

### **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 2017

**4 Revenue**

An analysis of the company's revenue is as follows:

<b>Continuing operations</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
Water and sewerage services	<b>764.8</b>	759.0
Other services	<b>44.9</b>	44.7
<b>Total revenue</b>	<b>809.7</b>	803.7
Other operating income	<b>1.3</b>	1.7
Interest receivable (note 8)	<b>1.2</b>	2.4
Interest revenue from Southern Water Services Group Limited	<b>56.9</b>	56.9
<b>Total income</b>	<b>869.1</b>	864.7

Other operating income includes rents receivable.

**5 Profit for the year**

Profit for the year has been arrived at after charging/(crediting):	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
Depreciation on		
- owned assets	<b>229.6</b>	224.6
- assets held under finance leases	<b>0.7</b>	1.3
	<b>230.3</b>	225.9
Amortisation of intangible assets included in other operating expenses:		
- other	<b>14.9</b>	8.7
Profit on disposal of fixed assets	<b>0.4</b>	0.4
Research and development expenditure	<b>1.0</b>	0.7
Rentals under operating leases:		
- Properties	<b>1.7</b>	1.7
- Vehicles	<b>2.2</b>	2.2
Employee costs (note 6)	<b>56.5</b>	56.3
Amortisation of grants and contributions (note 24)	<b>(1.2)</b>	(1.1)
Rates rebate (see note below)	<b>-</b>	(13.3)
Fees payable to the company's auditor in respect of:		
- Statutory audit of the company's financial statements	<b>0.3</b>	0.2
- Other services pursuant to legislation	<b>0.1</b>	0.1
- All other services	<b>0.2</b>	0.7

Audit-related and non-audit services primarily relate to regulatory assurance fees, and other taxation and professional fees.

**Note** 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 2017

**6 Employee information**

	2017 £m	2016 £m
<b>(a) Employee costs (including directors' emoluments):</b>		
Wages and salaries	81.9	77.4
Social security costs	8.3	7.1
Pension costs - Defined contribution	2.6	2.3
- Defined benefit	5.1	6.3
Total employee costs	<u>97.9</u>	<u>93.1</u>
Less: charged as capital expenditure	<u>(41.4)</u>	<u>(36.8)</u>
Charged to the income statement	<u>56.5</u>	<u>56.3</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:

	2017 Number	2016 Number
Operations	1,298	1,239
Customer services	317	378
Corporate centre	505	502
	<u>2,120</u>	<u>2,119</u>

**7 Directors' emoluments**

	2017 £000	2016 £000 (restated)*
Aggregate emoluments (including benefits in kind)	1,616	1,633
Compensation for loss of office	370	-
	<u>1,986</u>	<u>1,633</u>

\*The prior year amount has been restated to include an amount of £104,000 for cash allowances in lieu of pension.

No retirement benefits accrued to directors (2016: nil) under a Southern Water defined benefit scheme. No retirement benefits accrued to directors (2016: nil) under a Southern Water defined contribution scheme.

The emoluments disclosed include sums for loss of office and bonus awards to the highest paid director totalling £351,000 which have not yet been paid. These remain subject to approval by the Remuneration Committee.

A long-term incentive plan (LTIP) is in operation for the three-year 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 £574,000 has been accrued for the period to 31 March 2017 in relation to this scheme and is not included within the figures disclosed above.

Further details can be found in the Directors' Remuneration Report on pages 95 to 105.

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**7 Directors' emoluments (continued)**

Details of emoluments and benefits for the highest paid director:

	2017 £000	2016 £000
Highest paid director's aggregate emoluments and benefits	503	716
Compensation for loss of office	370	-
	<u>873</u>	<u>716</u>

During the year the company made contributions of £nil (2016: £nil) to a money purchase pension scheme in respect of the highest paid director's qualifying services.

**8 Net finance costs**

	2017 £m	2016 £m
<b>Finance income</b>		
Interest revenue from Southern Water Services Group Limited	56.9	56.9
Deposit income on short-term bank deposits	1.2	2.4
	<u>58.1</u>	<u>59.3</u>
<b>Finance costs</b>		
Interest payable on other loans	(6.8)	(6.1)
Interest paid to Southern Water Services (Finance) Ltd	(133.6)	(128.5)
Indexation	(20.9)	(10.0)
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	0.7	0.6
Other finance expense (note 22)	(3.7)	(3.9)
Dividends on preference shares – see note (a) and (b) below	(13.4)	(11.2)
	<u>(169.8)</u>	<u>(151.2)</u>
Amounts capitalised on qualifying assets	8.6	5.7
	<u>(161.2)</u>	<u>(145.5)</u>
<b>Fair value losses on derivative financial instruments</b>		
Derivative financial instruments not designated as hedges	(416.8)	(70.4)
	<u>(519.9)</u>	<u>(156.6)</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 4.23% to expenditure on such assets (2016: 4.00%).

**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 (2016: £9.0 million).
- (b) Dividend due to the Class A2 preference shareholders of £134.73 (2016: £67.35) per share totalling £4.4 million (2016: £2.2 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 2016 (see note 19(vii)).

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**9 Taxation**

	2017 £m	2016 £m
<b>Current tax:</b>		
Current year	11.4	11.4
Adjustment in respect of prior years	-	8.8
<b>Total current tax charge</b>	<u>11.4</u>	<u>20.2</u>
<b>Deferred tax:</b>		
Origination and reversal of timing differences	(79.3)	9.7
Adjustment in respect of prior years	(0.1)	0.5
Effect of corporation tax rate change	(16.9)	(22.0)
<b>Total deferred tax credit</b>	<u>(96.3)</u>	<u>(11.8)</u>
<b>Total tax credit/(charge) on (loss)/profit</b>	<u>(84.9)</u>	<u>8.4</u>

The tax assessed for the year is different to the standard rate of corporation tax in the UK due to the following factors:

	2017 £m	2016 £m
<b>(Loss)/profit before tax</b>	<u>(260.6)</u>	<u>128.3</u>
Tax at the UK corporation tax rate of 20% (2016: 20%)	(52.1)	25.7
Permanent differences	3.3	2.4
Group relief received for nil payment	(27.9)	(7.0)
Differences between current and deferred tax rates	8.8	-
Impact of tax rate changes	(16.9)	(22.0)
Adjustment in respect of prior years:		
Current tax	-	8.8
Deferred tax	(0.1)	0.5
<b>Total tax (credit)/charge for year</b>	<u>(84.9)</u>	<u>8.4</u>

Factors that may affect future tax charges:

Reductions in the main rate of corporation tax to 19% from the 1 April 2017 and to 18% from the 1 April 2020 were enacted in the Finance Bill 2015, and deferred tax balances at 31 March 2016 are calculated based on these reduced rates.

It was subsequently announced in the 2016 UK Budget that the corporation tax rate would instead reduce to 17% from 1 April 2020.

This further reduction has been substantively enacted in Finance Bill 2016 at the reporting date, and deferred tax balances at 31 March 2017 have been calculated using this reduced rate. A credit of £16.9 million has been recognised in the income statement in the period to reflect the reduction in the deferred tax liability as a result of the rate change.

In addition, charges of £1.7 million have been recognised in the statement of other comprehensive income to reflect the reduction in the deferred tax asset relating to the pension deficit.

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 2017

**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:

	2017 £m	2016 £m
<b>Deferred tax</b>		
Arising on income and expenses recognised in other comprehensive income:		
Tax credit on actuarial losses on defined benefit pension scheme	(12.8)	(2.8)
Deferred tax movement due to rate change	1.7	(18.6)
<b>Total deferred tax credits recognised in other comprehensive income</b>	<u>(11.1)</u>	<u>(21.4)</u>

**10 Dividends**

	2017 £m	2016 £m
<b>Amounts recognised as distributions to equity holders in the year:</b>		
Current year interim dividend of £812.37 (2016: £812.37) per share	45.5	45.5
Current year interim dividend of £1,089.29 (2016: £522.32) per share	61.0	29.2
Current year final dividend of £1,128.57 (2016: £899.11) per share	63.2	50.4
	<u>169.7</u>	<u>125.1</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 of £11.4 million, 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 68 of the Annual Report.

In addition, a current year interim dividend of £61.0 million was paid in October 2016 and a final dividend of £63.2 million was declared in March 2017 and paid in April 2017. £108.2 million of these dividends were ultimately paid to investors in SWS's parent company Greensands Holdings Ltd.

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**11 Intangible assets**

	Externally generated		Total £m
	Assets under construction £m	Computer software £m	
<b>Cost</b>			
At 1 April 2016	11.7	64.5	76.2
Additions	16.9	17.1	34.0
Transfers	(8.5)	8.5	-
<b>At 31 March 2017</b>	<b>20.1</b>	<b>90.1</b>	<b>110.2</b>
<b>Amortisation</b>			
At 1 April 2016	-	34.2	34.2
Charge for the year	-	14.9	14.9
<b>At 31 March 2017</b>	<b>-</b>	<b>49.1</b>	<b>49.1</b>
<b>Net book amount</b>			
<b>At 31 March 2017</b>	<b>20.1</b>	<b>41.0</b>	<b>61.1</b>
At 31 March 2016	11.7	30.3	42.0

The company does not currently have any internally generated intangible assets.

Included within additions above is £1.3 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 £1.8 million (2016: £0.7. million). The company has elected to apply IAS 23 from 1 April 2003, as permitted by the standard.

**12 Property, plant and equipment**

	Land & buildings £m	Plant & machinery £m	Infra- structure assets £m	Assets under construction £m	Other £m	Total £m
<b>Cost</b>						
At 1 April 2016	1,534.4	2,887.9	2,427.3	252.9	606.6	7,709.1
Additions	1.6	87.9	35.9	167.3	14.7	307.4
Transfers	(1.4)	36.2	71.8	(106.4)	(0.2)	-
Disposals	-	(5.5)	(0.3)	-	(1.4)	(7.2)
<b>At 31 March 2017</b>	<b>1,534.6</b>	<b>3,006.5</b>	<b>2,534.7</b>	<b>313.8</b>	<b>619.7</b>	<b>8,009.3</b>
<b>Depreciation</b>						
At 1 April 2016	642.3	1,053.1	56.1	-	350.1	2,101.6
Charge for the year	39.9	117.4	28.7	-	44.3	230.3
Disposals	-	(5.5)	(0.3)	-	(1.4)	(7.2)
<b>At 31 March 2017</b>	<b>682.2</b>	<b>1,165.0</b>	<b>84.5</b>	<b>-</b>	<b>393.0</b>	<b>2,324.7</b>
<b>Net book amount</b>						
<b>At 31 March 2017</b>	<b>852.4</b>	<b>1,841.5</b>	<b>2,450.2</b>	<b>313.8</b>	<b>226.7</b>	<b>5,684.6</b>
At 31 March 2016	892.1	1,834.8	2,371.2	252.9	256.5	5,607.5

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**12 Property, plant and equipment (continued)**

Freehold land is stated at a cost of £51.7 million at 31 March 2017 and 31 March 2016 and is not depreciated.

The company's interest in land and buildings are almost entirely freehold.

Included within additions above is £7.3 million (2016: £5.7 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 £167.4 million (2016: £167.0. 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:

	2017 £m	2016 £m
Net book amount at 31 March	<u>5.3</u>	<u>5.9</u>

**13 Other non-current assets**

	2017 £m	2016 £m
<b>Non-current receivables</b>		
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 annum.

**14 Investments**

	2017 £m	2016 £m
<b>Shares in subsidiary Southern Water Services (Finance) Limited</b>		
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 2017:

	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 2017

**15 Inventories**

	2017 £m	2016 £m
Raw materials	2.0	1.5
Work in progress	0.7	0.9
	<u>2.7</u>	<u>2.4</u>

**16 Trade and other receivables**

	2017 £m	2016 £m
Trade receivables	224.6	198.5
Provision for impairment	(123.3)	(111.9)
Net trade receivables	<u>101.3</u>	<u>86.6</u>
Loan to Southern Water Services (Finance) Limited	8.3	0.8
Amounts owed by other group undertakings	5.2	4.0
Other amounts receivable	9.7	6.2
Accrued income	53.1	80.1
Prepayments	19.7	14.6
	<u>197.3</u>	<u>192.3</u>

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

Accrued income as at 31 March 2017 includes water and sewerage income not yet billed of £50.2 million (2016: £73.1 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:

	2017 £m	2016 £m
At 1 April	(111.9)	(110.5)
Charge for bad and doubtful debts	(25.3)	(21.5)
Amounts written off during the year	13.9	20.1
At 31 March	<u>(123.3)</u>	<u>(111.9)</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:

	2017 £m	2016 £m
Current	0.7	0.7
1-2 years	2.4	0.9
2-3 years	11.8	9.9
3-4 years	14.1	7.0
more than 4 years	39.8	37.5
	<u>68.8</u>	<u>56.0</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 2017

**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:

	2017 £m	2016 £m
Current	59.7	56.5
1-2 years	32.1	30.3
2-3 years	13.7	19.5
3-4 years	8.6	12.5
more than 4 years	6.4	6.7
	<u>120.5</u>	<u>125.5</u>

The amounts above are reconciled to gross and net debtors in the tables below:

**At 31 March 2017**

	Gross £m	Provision £m	Net £m
Not due	35.3	-	35.3
Overdue not specifically provided	120.5	(54.5)	66.0
Overdue and specifically provided	68.8	(68.8)	-
	<u>224.6</u>	<u>(123.3)</u>	<u>101.3</u>

**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>

**17 Trade and other payables**

	2017 £m	2016 £m
Trade payables	18.9	13.7
Amounts owed to group undertakings	86.4	22.2
Capital creditors and capital accruals	96.8	59.3
Taxation and social security	3.0	2.8
Accruals and deferred revenue	105.0	90.1
	<u>310.1</u>	<u>188.1</u>

Amounts owed to group undertakings include the final dividend declared of £83.2 million which was paid in April 2017. The directors consider that the carrying values of trade and other payables are not materially different from their fair values.

**18 Current borrowings**

	2017 £m	2016 £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
Obligations under finance leases	0.5	-
	<u>39.4</u>	<u>88.9</u>

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**19 Non-current borrowings**

	Note	2017 £m	2016 £m
Loans from subsidiary SWSF:	(i)		
Class A £350m – 6.202% fixed rate 2029	(ii)	348.4	348.3
Class A £150m – 3.716% index linked 2034		221.7	217.7
Class A £35m – 3.716% index linked 2034		51.7	50.1
Class A £350m – 6.650% fixed rate 2026	(ii)	348.6	348.5
Class A £150m – 3.826% index linked 2023		221.7	217.7
Class A £350m – 5.010% fixed rate 2021	(ii)	348.2	347.8
Class A £150m – 5.010% fixed rate 2041	(ii)	146.9	146.8
Class A £200m – 4.510% fixed rate 2052	(ii)	197.1	197.1
Class A £300m – 5.135% fixed rate 2056	(ii)	292.5	292.4
Class A £300m – 6.135% fixed rate 2019	(ii)	299.1	298.7
Class A £175m – 2.790% fixed rate 2031	(ii)	173.9	-
Class A £75m – 2.970% fixed rate 2036	(ii)	74.5	-
Artesian £165m – 4.086% index linked 2033		244.0	239.5
Artesian £156.5m – 3.645% index linked 2032		225.8	221.7
<b>Total Class A debt from SWSF</b>		<b>3,194.1</b>	<b>2,926.3</b>
Class B £250m – 4.510% fixed rate 2022	(ii), (iii)	247.1	246.6
Debt issue costs	(iv)	(16.1)	(18.1)
Bond premium deferred		10.2	10.9
Deferred gilt lock proceeds	(v)	5.0	5.1
Deferred proceeds*		105.3	115.0
Other loans from subsidiary SWSF	(vi)	30.3	30.3
<b>Total loans and other borrowings from SWSF</b>		<b>3,575.9</b>	<b>3,316.1</b>
Class B, Term Facility Agreement 2014 £150m – 6-month Libor plus 1.950% 2021		150.0	150.0
Class A, Term Facility Agreement 2016 £50m – 6-month Libor plus 0.500% 2016		-	50.0
Class A £60m – 0.000% index linked 2025	(vii)	62.1	60.5
Class A £40m – 0.000% index linked 2026	(vii)	41.0	-
Class A1 Preference shares	(viii)	32.6	32.6
Class B Preference shares	(viii)	110.0	110.0
Obligations under finance leases		1.5	1.5
<b>Total borrowings</b>		<b>3,973.1</b>	<b>3,720.7</b>
<b>Current borrowings</b>		<b>39.4</b>	<b>88.9</b>
<b>Non-current borrowings</b>		<b>3,933.7</b>	<b>3,631.8</b>

\*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 2017

### 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%. 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% until March 2022 when it reverts to Libor plus a margin to be determined with a premium of 0.01%.
- (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 2017 debt issue costs amounted to £16.1 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 Class A £60 million loan is index linked with an interest rate of 0.00% until August 2025. The Class A £40 million loan is index linked with an interest rate of 0.00% until May 2026.
- (viii) 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 2017

**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 2017 for out-performance in the year ended 31 March 2017.

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.

<b>Repayments fall due as follows:</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
<b>Borrowings excluding finance leases:</b>		
Between one and two years not by instalments	299.1	-
Between two and five years not by instalments	742.8	646.5
After five years not by instalments	<u>2,890.8</u>	<u>2,983.8</u>
	<b>3,932.7</b>	<b>3,630.3</b>
On demand or within one year not by instalments	<b>38.9</b>	<b>88.9</b>
	<u><b>3,971.6</b></u>	<u><b>3,719.2</b></u>
<b>Finance leases:</b>		
Between one and two years not by instalments	0.6	1.3
Between two and five years not by instalments	0.4	0.2
After five years not by instalments	<u>-</u>	<u>-</u>
	<b>1.0</b>	<b>1.5</b>
On demand or within one year not by instalments	<b>0.5</b>	<b>-</b>
	<u><b>1.5</b></u>	<u><b>1.5</b></u>
<b>Borrowings including finance leases:</b>		
Between one and two years not by instalments	299.7	1.3
Between two and five years not by instalments	743.2	646.7
After five years not by instalments	<u>2,890.8</u>	<u>2,983.8</u>
	<b>3,933.7</b>	<b>3,631.8</b>
On demand or within one year not by instalments	<b>39.4</b>	<b>88.9</b>
	<u><b>3,973.1</b></u>	<u><b>3,720.7</b></u>

It is the company's policy to lease certain of its fixtures and equipment under finance leases. 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.

The average lease term is five years.

For the year ended 31 March 2017, the average effective borrowing rate was 5.31% (2016: 6.52%). Interest rates are fixed at the contract date. All leases are on a fixed repayment basis and no arrangements have been entered into for contingent rental payments.

**Notes to the financial statements (continued)**

For the year ended 31 March 2016

**19 Non-current borrowings (continued)**

All lease obligations are denominated in sterling.

The fair value of the company's lease obligations is approximately equal to their carrying amount.

The company's obligations under finance leases are secured by the lessors' rights over the leased assets disclosed in note 12.

**20 Derivative financial instruments****Categories of financial instruments at fair value**

	2017 £m	2016 £m
<b>Derivative assets carried at fair value through profit or loss (FVTPL):</b>		
Interest rate swaps – not hedge accounted	9.3	12.4
<b>Total derivative financial assets</b>	<u>9.3</u>	<u>12.4</u>
	2017 £m	2016 £m
<b>Derivative liabilities carried at fair value through profit or loss (FVTPL):</b>		
Interest rate swaps – not hedge accounted	(1,347.3)	(936.1)
<b>Total derivative financial liabilities</b>	<u>(1,347.3)</u>	<u>(936.1)</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 £1,338.0 million in the statement of financial position.

<b>Changes in value of financial instruments at fair value</b>	2017 £m	2016 £m
Profit for the year has been arrived at after charging/(crediting):		
<b>Financial assets at fair value</b>	(3.1)	(1.4)
Designated as FVTPL		
<b>Financial liabilities at fair value</b>	(413.7)	(69.0)
Designated as FVTPL		
<b>Fair value losses on derivative financial instruments</b>	<u>(416.8)</u>	<u>(70.4)</u>

The derivative liability was reduced by £2.5 million in the year (2016: £298.4 million) due to payment of accrued indexation associated with the swap instruments.

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 2017

**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 2015	590.2	(173.9)	(25.4)	7.3	39 8.2
(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 (restated)	(42.8)	18.4	2.2	0.2	(22 .0)
–other comprehensive income	(18.6)	-	-	-	(18 .6)
At 1 April 2016*	<u>551.9</u>	<u>(165.5)</u>	<u>(19.8)</u>	<u>(1.6)</u>	<u>36 5.0</u>
(Credit)/charge to income statement	(11.4)	(67.5)	0.1	(0.5)	(79 .3)
Prior year adjustment: (Credit)/charge to income statement	0.3	-	-	(0.4)	(0. 1)
Credit to other comprehensive income	-	-	(12.8)	-	(12 .8)
Effect of change in tax rate –income statement	(30.0)	12.9	0.1	0.1	(16 .9)
–other comprehensive income	-	-	1.7	-	1.7
<b>At 31 March 2017</b>	<u><b>510.8</b></u>	<u><b>(220.1)</b></u>	<u><b>(30.7)</b></u>	<u><b>(2.4)</b></u>	<u><b>257.6</b></u>

\* The effect of the change in tax rate in the income statement under the heading 'Revaluation of financial instruments' of £18.4 million in the year ended 31 March 2016 includes £19.4 million previously classified as 'Other timing differences'.

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:

	2017 £m	2016 £m
Deferred tax liabilities	510.8	641.2
Deferred tax assets	<u>(253.2)</u>	<u>(276.2)</u>
	<u><b>257.6</b></u>	<u><b>365.0</b></u>

## Notes to the financial statements (continued)

For the year ended 31 March 2017

### 22 Retirement benefit obligations

The deficit associated with retirement benefit obligations has increased to £176.9 million (2016: £102.3 million) as a result of a decrease in corporate bond yields which decrease the discount rate used to calculate the value of pension scheme liabilities, offset by asset returns.

#### 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.

As part of the company's interactions with both the Trustees and when required the Pensions Regulator, we look to agree a long-term funding and risk management strategy for the pension liability and this is viewed as a key risk as set out on page 77 above. We are currently in regular dialogue with the Trustees and also in ongoing discussions and correspondence with the Pension Regulator regarding the current deficit and the Board are keen to agree a reasonable resolution of a long-term funding solution for the scheme.

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 statement of financial position.

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 2017

**22 Retirement benefit obligations (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 2017 amounted to £2.6 million (2016: £2.3 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.

The principal assumptions in the valuation were as follows:

	<b>2013 SWPS % per annum (pa)</b>
Return on investments: pre-retirement	FI Gilt curve +
Return on investments: post-retirement (pensioner/non-pensioner)	65 bps
Salary growth	2.50%
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% 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 2017–18 are £5.6 million and £0.2 million respectively under the current Schedule of Contributions.

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**22 Retirement benefit obligations (continued)****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 2017 by a qualified independent actuary. The major assumptions used by the actuary are set out in the table below.

	2017 % pa	2016 % pa
Price inflation (RPI)	3.3	3.0
Price inflation (CPI)	2.3	2.0
Rate of increase in salaries (plus an age-related promotional scale)	2.4	2.5
Rate of increase of pensions in payment (MIS* members only)***	2.3	2.0
Rate of increase of pensions in payment (Old section** members only)***	3.3	3.0
Rate of increase of pensions in payment (all other members)***	3.2	2.9
Rate of increase for deferred pensions (MIS* members only)***	2.3	2.0
Rate of increase for deferred pensions (all other members)***	3.2	2.9
Discount rate	2.8	3.6

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

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

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

Assumptions regarding future mortality experience are set based on advice, published statistics and experience. For 2016–17, the company has used the post-retirement mortality assumptions based on the standard SAPS mortality tables together with future improvements in line with CMI 2015 improvements with a long-term improvement rate of 1.25% per annum.

	2017 Years	2016 Years
Longevity at age 65 for current pensioners		
Male	22.7	23.0
Female	24.8	25.1
Longevity at age 65 for future pensioners		
Male	24.4	24.8
Female	26.7	27.0

The assets and liabilities in the schemes and the expected rates of return at 31 March 2017 and 31 March 2016 were:

	Value at 2017 £m	Value at 2016 £m
Equities	186.1	171.5
Government bonds	190.3	196.2
Non-government bonds	355.5	266.3
Cash	11.0	40.1
<b>Total market value of plan assets</b>	<b>742.9</b>	<b>674.1</b>
Total value of plan liabilities	(919.8)	(776.4)
<b>Accrued deficit in the plan</b>	<b>(176.9)</b>	<b>(102.3)</b>
Related deferred tax asset	30.7	19.8
<b>Net retirement benefit obligations</b>	<b>(146.2)</b>	<b>(82.5)</b>

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**22 Retirement benefit obligations (continued)**

The equity investments and bonds which are held in plan assets are quoted and are valued at the current bid price.

<b>Reconciliation of the present value of the scheme liabilities</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
At 1 April	776.4	789.3
Current service cost	5.1	5.4
Interest expense	27.5	26.4
Member contributions	0.2	0.2
Experience gain on liabilities	(12.0)	-
Actuarial (gain)/loss on liabilities:		
- due to changes in demographic assumptions	(11.0)	10.0
- due to changes in financial assumptions	165.6	(27.1)
Benefits paid	(32.0)	(27.8)
<b>Scheme liabilities at 31 March</b>	<b>919.8</b>	<b>776.4</b>

**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.

	<b>Change in assumption</b>	<b>Impact on scheme liabilities (%)</b>	<b>Impact on scheme liabilities (£m)</b>
Discount rate	+/- 1%	-/+ 17	-/+ 156
Rate of inflation*	+/- 1%	+/- 15	+/- 135
Rate of increase in pensions in payment	+/- 1%	+/- 12	+/- 114
Mortality	+/- 1yr	+/- 4	+/- 37

\*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.

<b>Reconciliation of the value of the scheme assets</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
At 1 April	674.1	674.0
Interest income	23.8	22.5
Gain/(loss) on assets above interest	71.2	(31.1)
Employer contributions	5.6	37.2
Member contributions	0.2	0.2
Benefits paid	(32.0)	(27.8)
Administrative expenses	-	(0.9)
<b>Bid value of scheme assets at 31 March</b>	<b>742.9</b>	<b>674.1</b>

The total return on scheme assets was £95.0 million (2016: loss of £9.5 million).

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**22 Retirement benefit obligations (continued)**

<b>Total cost recognised as an expense</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
Current service cost	5.1	5.4
Net interest cost	3.7	3.9
Administration expenses	-	0.9
<b>Total income statement expense before deduction for tax</b>	<b>8.8</b>	<b>10.2</b>
<b>Analysis of the amounts recognised in other comprehensive income</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
Actual return less expected return on pension scheme assets	71.2	(31.1)
Experience gain arising on scheme liabilities	12.0	-
Gain/(loss) due to changes in demographic assumptions	11.0	(10.0)
(Loss)/gain due to changes in financial assumptions	(165.6)	27.1
<b>Total loss recognised in OCI before adjustment for tax</b>	<b>(71.4)</b>	<b>(14.0)</b>

The cumulative amount of actuarial losses recognised in other comprehensive income is £264.9 million (2016: £193.5 million).

<b>Analysis of the movement in the schemes' deficit during the year</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
Deficit in the scheme at 1 April	(102.3)	(115.3)
Employer's contributions	5.6	37.2
Employer's current service cost	(5.1)	(5.4)
Financing charge	(3.7)	(3.9)
Administration expenses	-	(0.9)
Actuarial loss	(71.4)	(14.0)
<b>Deficit in the scheme at end of year</b>	<b>(176.9)</b>	<b>(102.3)</b>

**23 Provision for liabilities**

<b>Environmental obligations</b>	<b>2017</b>	<b>2016</b>
	<b>£m</b>	<b>£m</b>
At 1 April	0.5	0.5
Utilised in year	-	-
<b>At 31 March</b>	<b>0.5</b>	<b>0.5</b>

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, and, as a result, 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 2017

**24 Other non-current liabilities**

	Deferred Revenue £m	Grants & contributions £m	Total £m
Balance at 1 April 2016	14.5	29.0	43.5
Receivable in year	-	20.2	20.2
Released to income statement	(0.3)	(1.2)	(1.5)
<b>Balance at 31 March 2017</b>	<b>14.2</b>	<b>48.0</b>	<b>62.2</b>

These grants and contributions relate to property, plant and equipment.

Deferred revenue £14.2 million (2016: £14.5 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.

**25 Called up share capital**

	2017 £m	2016 £m
<b>Equity shares</b>		
Authorised		
46,050,000 ordinary shares of £1 each	<u>46.1</u>	<u>46.1</u>
Allotted and fully paid		
56,000 ordinary shares of £1 each	<u>0.1</u>	<u>0.1</u>
Non-equity shares		
Issued		
<b>Preference shares</b>		
32,607 Class A1 shares of £1 each	0.0	0.0
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.

**26 Share premium account**

	2017 £m	2016 £m
Balance at 1 April and at 31 March	<u>46.3</u>	<u>46.3</u>

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**27 Revaluation reserve**

	£m
Balance at 1 April 2015	757.3
Transfer to retained earnings	(12.2)
Balance at 1 April 2016	<u>745.1</u>
Capital reduction	(735.0)
Transfer to retained earnings	(10.1)
<b>Balance at 31 March 2017</b>	<b><u>-</u></b>

The revaluation reserve arose on transition to IFRS at 1 April 2014, when the company elected to measure its infrastructure and operational assets at their fair value and to use that fair value as their deemed cost at that date.

During the year, the company undertook a bonus issue of 735,000,000 ordinary shares out of its revaluation reserve. Following this bonus issue, the company completed a capital reduction exercise, creating £735.0 million of distributable reserves. On completion of this process, the issued share capital remained unchanged from the share capital in issue at the start of the year.

**28 Retained earnings**

	£m
Balance at 1 April 2015	553.9
Equity dividends paid	(125.1)
Profit for the financial year	119.9
Other comprehensive income for the year	7.4
Transfer from revaluation reserve	12.2
Balance at 1 April 2016	<u>568.3</u>
Equity dividends paid	(169.7)
Loss for the financial year	(175.7)
Other comprehensive loss for the year	(60.3)
Capital reduction	735.0
Transfer from revaluation reserve	10.1
<b>Balance at 31 March 2017</b>	<b><u>907.7</u></b>

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**29 Notes to the statement of cash flows**

	2017 £m	2016 £m
<b>Cash generated by operations</b>		
<b>Continuing operations</b>		
Operating profit	258.9	284.5
Adjustments for:		
Depreciation of property, plant and equipment	230.3	225.9
Amortisation of intangible assets	14.9	8.7
Difference between pension charge and cash contributions	(0.4)	(31.0)
Amortisation of grants and contributions	(1.2)	(1.1)
<b>Operating cash flows before movements in working capital</b>	<u>502.5</u>	<u>487.0</u>
Increase in inventories	(0.3)	(0.2)
Decrease in receivables	3.3	11.8
Increase/(decrease) in payables	18.8	(16.6)
Cash from operating activities	<u>524.3</u>	<u>482.0</u>
Tax paid	(11.4)	(15.1)
<b>Net cash generated from operating activities</b>	<u>512.9</u>	<u>466.9</u>
<b>Cash and cash equivalents</b>	<b>2017 £m</b>	<b>2016 £m</b>
Cash and bank balances	<u>285.3</u>	<u>17.9</u>

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 2016 £m	Cash flow £m	Other non-cash changes £m	At 31 March 2017 £m
Cash and cash equivalents	<u>17.9</u>	<u>267.4</u>	<u>-</u>	<u>285.3</u>
Derivative financial instruments	(923.7)	2.5	(416.8)	(1,338.0)
Debt issue costs	18.1	-	(2.0)	16.1
Gilt lock proceeds	(5.1)	-	0.1	(5.0)
Borrowings due within one year	(90.7)	50.0	-	(40.7)
Borrowings due after one year	(3,641.5)	(288.3)	(12.2)	(3,942.0)
Finance leases	(1.5)	0.3	(0.3)	(1.5)
<b>Net debt</b>	<u>(4,626.5)</u>	<u>31.9</u>	<u>(431.2)</u>	<u>(5,025.8)</u>

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**29 Notes to the statement of cash flows (continued)**

Balances at 31 March 2017 comprise:	Non- current assets £m	Current assets £m	Current liabilities £m	Non- current liabilities £m	Total £m
Cash and cash equivalents	-	285.3	-	-	285.3
Derivative financial instruments	-	-	-	(1,338.0)	(1,338.0)
Debt issue costs	-	-	1.9	14.2	16.1
Gilt lock proceeds	-	-	(0.1)	(4.9)	(5.0)
Borrowings due within one year	-	-	(40.7)	-	(40.7)
Borrowings due after one year	-	-	-	(3,942.0)	(3,942.0)
Finance leases	-	-	(0.5)	(1.0)	(1.5)
Net debt	-	285.3	(39.4)	(5,271.7)	(5,025.8)

The non-cash movement of £431.2 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.

Borrowings due within one year relate to amounts owed to group undertakings that are repayable on demand (see note 19).

**30 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 (2016: £nil).

Companies of the size and scale of Southern Water are sometimes subject to a number of claims disputes and potential litigation. The significant ones currently include ongoing investigations by regulatory bodies (the EA, DWI and Ofwat) as well as a potential claim in respect of property search income. The directors consider that, where it is possible to be estimated reasonably an appropriate position has been taken in reflecting such items in these financial statements. It is not currently possible to estimate the financial effect and likely timing of any associated outflow of some of these given the early stage of the investigations and claims and the potential range of outcomes.

**31 Financial commitments**

(a) Capital commitments are as follows:

	2017 £m	2016 £m
Contracted for but not provided for in respect of contracts placed in respect of property, plant and equipment	354.8	183.9
Contracted for but not provided for in respect of contracts placed in respect of intangible assets	9.7	9.9

**Notes to the financial statements (continued)**

For the year ended 31 March 2017

**31 Financial commitments (continued)**

(b) The company as lessee

	2017 £m	2016 £m
Lease payments under operating leases recognised as an expense in the year	<u>3.9</u>	<u>3.9</u>

As at 31 March 2017 and 2016, the company had outstanding commitments for future minimum lease payments under non-cancellable operating leases in respect of vehicles and land and buildings which fall due as follows:

	Land and Buildings		Other	
	2017 £m	2016 £m	2017 £m	2016 £m
Within one year	1.7	1.7	0.2	0.2
In the second to fifth years inclusive	6.2	6.3	0.3	0.4
After five years	<u>13.0</u>	<u>14.5</u>	<u>0.1</u>	<u>0.1</u>
	<u>20.9</u>	<u>22.5</u>	<u>0.6</u>	<u>0.7</u>

Operating leases are charged to the income statement over the lease term.

Operating lease payments represent rentals payable by the company for certain of its office properties and company vehicles.

Commercial vehicle leases are negotiated for an average term of five years, and rentals are fixed for an average of five years, with an option to extend on an adhoc basis at the then prevailing market rate.

**32 Related party transactions and ultimate controlling 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 largest shareholder in GSH as at 31 March 2017 is an institutional investment company advised by JP Morgan Asset Management owning 39.8%.

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% wholly owned, equivalent disclosures are given in the group financial statements of GSH.

**33 Post balance sheet events**

Following careful consideration of the options available regarding the opening of the non-household retail market, the company disposed of its non-household retail business function with effect from 1 April 2017. It is estimated that this disposal will have an immaterial impact on operating profit.

## **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 2017 which comprise the Income Statement, Statement of Other Comprehensive Income, Statement of Financial Position, Statement of Changes in Equity, the Cash Flow Statement and the related notes 1 to 33. 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 2017 and of its loss 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.

**Independent auditor's report to the members of Southern Water Services Limited (continued)**

**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.

A handwritten signature in black ink that reads "Anthony Matthews". The signature is written in a cursive style and is underlined with a single horizontal line.

Anthony Matthews (Senior statutory auditor)  
for and on behalf of Deloitte LLP  
Statutory Auditor  
London, United Kingdom

04 July 2017