



Southern Water Services Limited Annual Report and Financial Statements 2017–18

Focusing on the future

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

Registered no. 02366670

About us

Our business

Our purpose

We provide water and sewerage services to more than 4.6 million customers across Sussex, Kent, Hampshire and the Isle of Wight.

Our vision

We aim to deliver a resilient water future for the South East, working with our partners and taking the lead in our sector. We will do this in the following ways:

- Working for our customers – looking after them, being brilliant at the basics and providing a consistently good service and a customer experience that is accessible to all.
- Delivering reliable services:
 - Investing wisely – finding new ways to adapt and evolve our infrastructure to protect our environment and increase our natural capital. This is a measure of the value our natural environment provides us, including supporting the economy, leisure and recreation, and our health and wellbeing.
 - Planning collaboratively – building better relationships with businesses and community organisations in our region, helping them to better engage with their local water environment and actively support our future plans.
 - Innovating successfully – constantly evolving our technology and searching for new ways to make both our operational and customer services more resilient in the face of both sudden incidents and ongoing challenges.
- Protecting our natural resources – working sustainably and delivering in partnership with our customers to ensure future water resources by continuing to reduce water usage and leakage across our network.



Water	
People served, millions	2.5
Number of properties, millions	1.1
Number of metered properties, millions	0.9
Average daily water supply, millions of litres per day	541
Number of service reservoirs	196
Number of water treatment works	83
Length of water mains, kilometres	13,905

Wastewater	
People served, millions	4.6
Number of properties, millions	2.0
Average daily wastewater recycled, millions of litres per day	743
Length of sewers, kilometres	39,729
Number of wastewater treatment works	365
Number of pumping stations	3,321

Finance	2017–18	2016–17
Turnover ¹	£829.7m	£809.7m
Operating profit	£236.6m	£258.9m
Profit before interest and tax	£248.6m	£259.3m
Profit/(loss) for the financial year ²	£154.7m	(£175.7m)
Capital investment	£440.2m	£341.4m
Non-current assets (excluding debt)	£5,955.6m	£5,774.9m
Return on capital employed (ROCE) ³	4.4%	4.7%
Average water and wastewater customer bill	£420	£412

¹ Non-appointed activities (these are not regulated by our licence but related to our business, such as property search information) were 1.3% of our statutory turnover.

² The loss of £175.7 million in 2016–17 was as a result of the fair value movement on derivative financial instruments.

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

A look back at 2017–18

2017

April – Around 100,000 of our non-household customers – that is commercial customers, such as businesses and charities – were transferred to specialist retailer* Business Stream as the market officially opened to competition.

*Retailers are responsible for the customer service and billing of non-household customers while Southern Water remains responsible for the maintenance and operation of the water and wastewater network, as the wholesaler.

May – Customers were given the opportunity to have their say about priorities for our business until 2025. Our consultation document Let's Talk Water asked them for their views on our plans and how we might meet future challenges. We published a further document in this series in November, which set out our four key themes – long-term resilience, great customer service, affordable bills and innovation – and our 10 customer outcomes that will form the basis of our business plan 2020–25.

"(Southern Water is) changing from a rather insular private monopoly to seeking to engage and listen to customers and stakeholders..." Environmental organisation, Sussex

June – Brighton & Hove residents were offered free water-saving home visits as part of a city-wide bus advertising campaign with our partners The Living Coast. The group has been working with us to offer people tips about how to use water more wisely, reducing the amount they use every day.

"If people could see the consumption of everyone in their town, then maybe you could offer a community award for the household with the biggest reduction." Business representative, Kent

July – The next instalment of our [#BeautyOfTheBeach](#) film went live on our social channels. The ongoing campaign, in partnership with the Environment Agency, asks customers to help keep beaches clear of rubbish over the summer season and has reached more than 20,000 people since its launch in 2016–17.

August – Half-time suddenly got interesting as Brighton and Hove Albion Football Club fans learnt all about how to save water, get advice on their bills and help us plan for the future. As the club's new official sponsor, we were excited to engage with a whole new audience.

September – The Consumer Council for Water published its annual report and despite having reduced written complaints by 47% in 2016–17, we were disappointed to remain at the bottom of its league tables. We are confident the improvements we have made this year in terms of services and customer satisfaction levels will see us move up the table next year.

October – Our employees voted for their favourite regional charities, four of which received a £10,000 donation to fund a vital scheme or project. They were:

- Kent: Beanstalk Children's Literacy Charity
- Sussex: St Barnabas House
- Isle of Wight: Age UK
- Hampshire: The Country Education Trust.

Did you know? During 2017–18 various local and regional charities received £147,700 as a result of employee fundraising

"The company has got more involved with the community." Not-for-profit organisation, Isle of Wight

November – Our customers really care about bathing water quality, which is why we were so pleased to see results announced by Defra showing bathing water in the South East continues to be among the best in the country. Of the 83 designated bathing waters across our region, 53 have achieved 'excellent' status.

December – Water customers got an extra gift from us over the holiday season – a free fix on leaks between their front doors and our water mains throughout 2018.

Did you know? We have continued to help customers cut down on the amount of water they use every day and are on track to exceed our reduction target of 10% (per person, per day) by 2020.

2018

January – The water level at Bewl Water reservoir in Kent was less than 33% of its 131,000 million-litre capacity. As a precaution we applied for a drought permit to the Environment Agency, which would allow us to pump water out of the River Medway system to refill the reservoir even if flows were low. Thankfully it was not needed and Bewl Water was back at 100% by March 2018.

Did you know? Bewl Water is a key resource for our customers in Medway and Thanet as well as for our neighbouring company South East Water. Around 90% of the water that keeps Bewl topped up comes from rivers – we transfer approximately 23 Olympic-sized swimming pools of water a day.

February – Customer feedback helped us further develop our business priorities until 2025 published in the consultation document It's Your Water Too. They were also asked to comment on our long-term Water Resources Management Plan and Drought Plan, which look forward to 2045, via our Have Your Say campaign.

"There seems to have been a greater willingness (by Southern Water) to engage with councillors and officers than was previously the case." Local authority officer, Kent

March – In an unusual freeze and thaw weather event our customers experienced an increased number of bursts on their pipes and on our network. Three times more front-line employees worked day and night to restore normal service within five days, and since then we have put preventative measures in place to reduce the possibility of this happening again.

Did you know? Around £14 million a year is spent on finding and fixing leaks, and more than 100 dedicated teams are searching for leaks across our network 24/7.

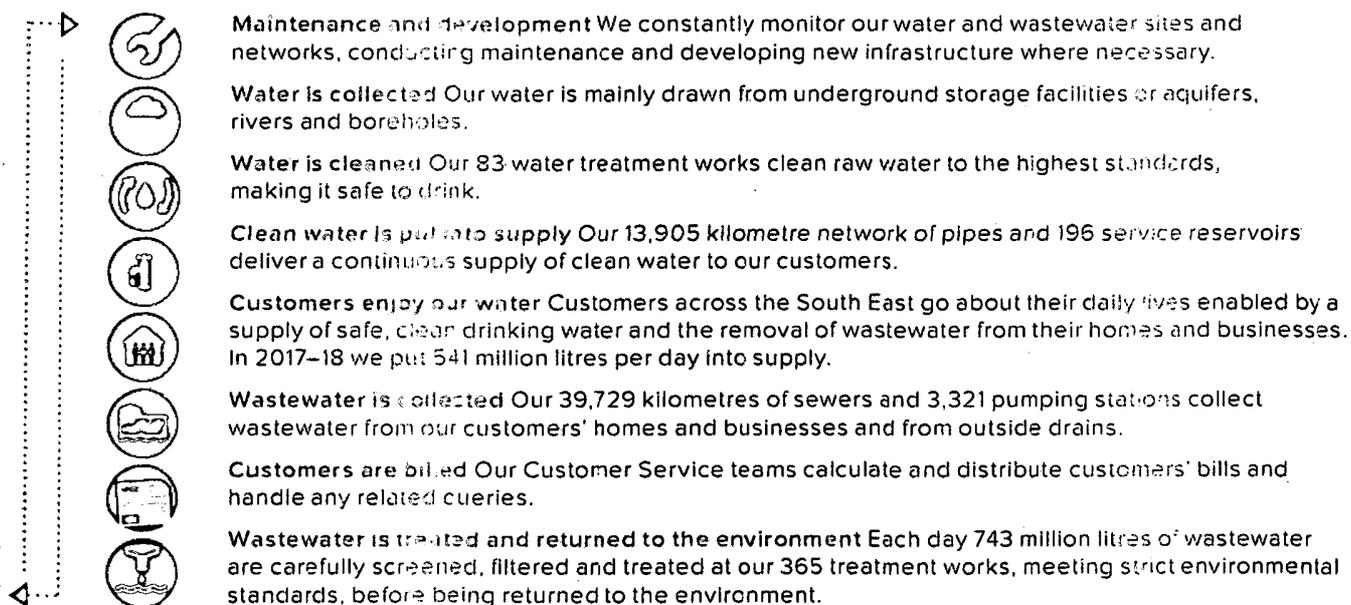
Our business model

As a regulated water and wastewater company, providing essential services to customers across the South East of England, our business model is reliant on a number of key resources and relationships which enable us to meet our obligations for customers, stakeholders, the wider community, regulators and our shareholders. These include:

- Natural resources – managing water resources, protecting the natural environment and processing waste to generate renewable energy.
- Employees – developing and motivating our employees, incentivising employees to deliver a high-quality service to our customers and wider stakeholders.
- Suppliers – building a strong relationship with those companies who work on behalf of Southern Water.
- Assets (infrastructure) – efficient maintenance of our sites, equipment and networks, significant capital investment to construct new assets and innovation to improve future development.
- Financing – maintaining a robust capital structure, long-term debt locked-in at good relative value and proactive engagement with investors to maintain access to a range of markets.

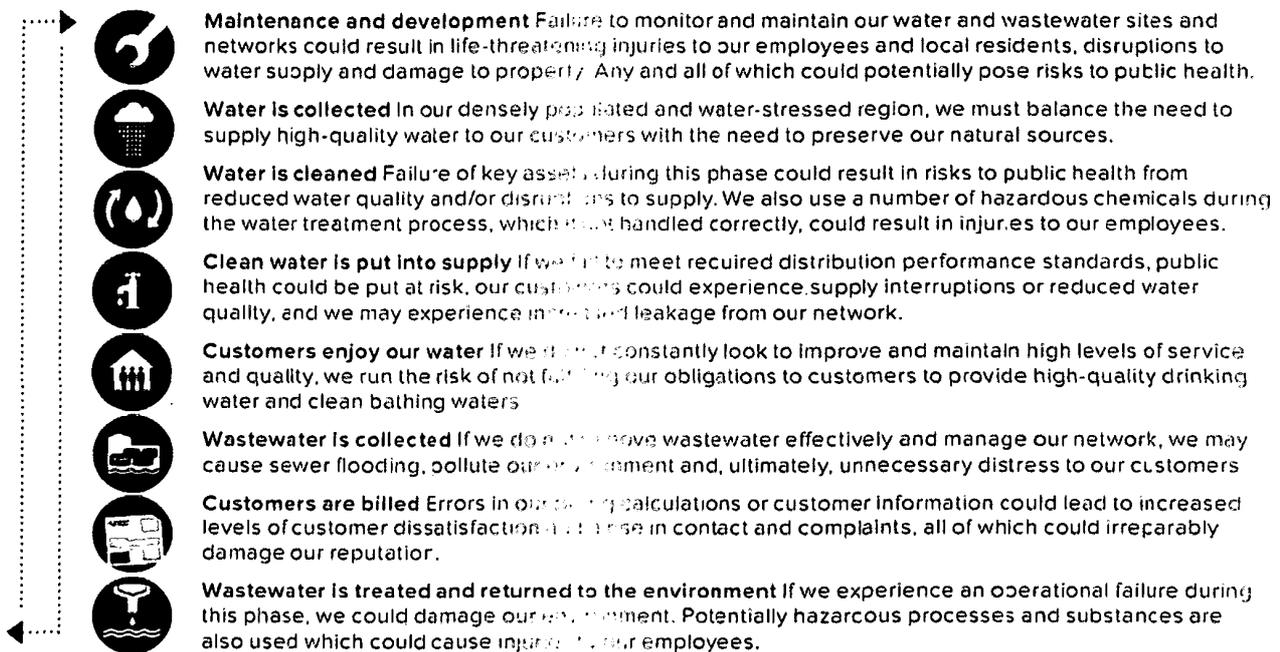
The water cycle

The delivery of water and wastewater services to customers is detailed in the water cycle diagram below. Our capital investment process maintains and constructs the infrastructure needed to support these services, and our customer services team acts as the point of contact with our customers.



Associated risks

Each stage of the water cycle, above, presents a number of opportunities and risks. We always seek to maximise opportunities while quickly identifying, managing and mitigating any risks.



For a more detailed explanation of our principal risks, see the Risks section of our financial performance report on pages 78 to 94.

How we are regulated

Our regulated water and wastewater business works in five-year planning cycles. For each five-year period we develop a business plan based on our customers' priorities for review by our regulator, Ofwat. The plan includes both the forecast costs of delivery of our services, what that means for customers' bills, and measurable targets that reflect what they have told us is important to them.

The forecast costs of delivery of our services include:

- operating costs – the day-to-day running costs of the business
- depreciation costs – the cost of our assets or infrastructure over their lifespan
- a return on capital investment – returns to shareholders who have provided funding for investment and interest on money borrowed to invest
- taxation – what we expect to pay in corporate taxes.

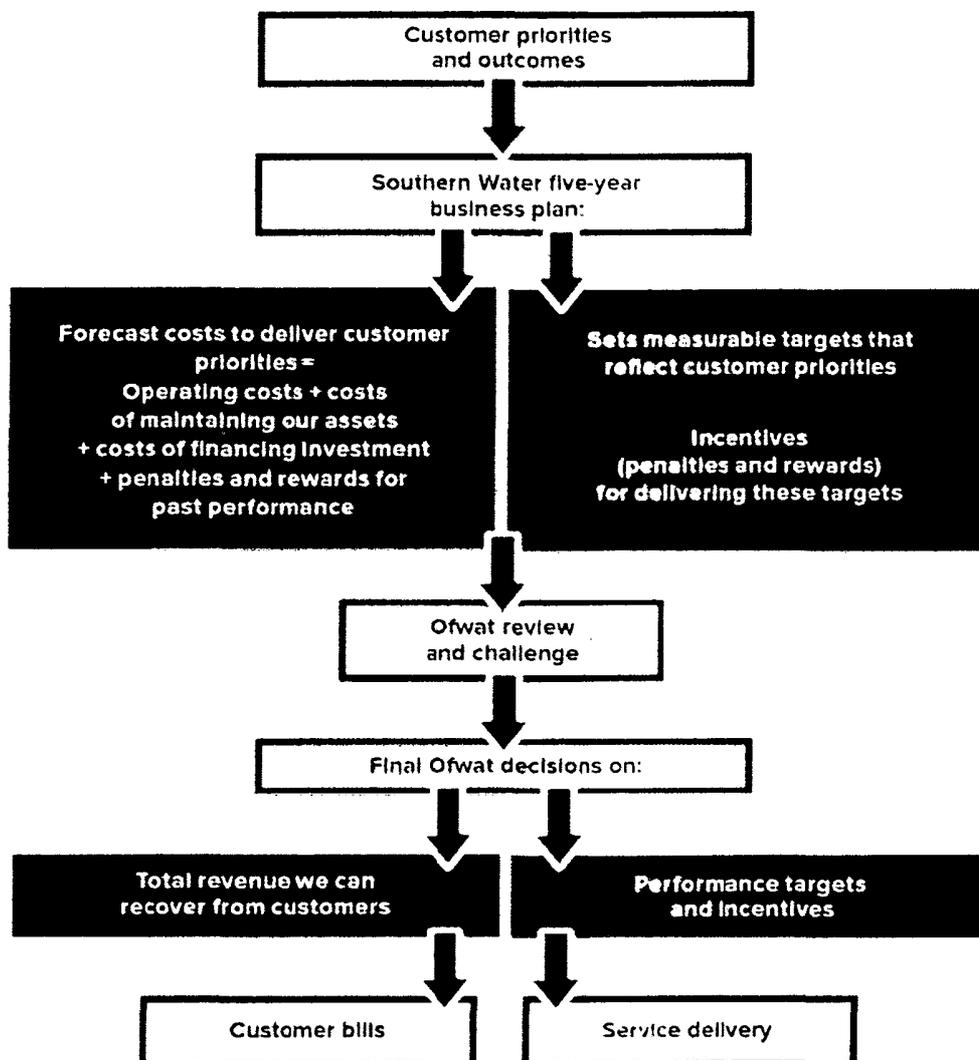
The costs also include any penalties and rewards set by Ofwat for past performance.

Ofwat scrutinises and challenges our plans, benchmarking the proposed costs of delivery, performance targets and incentives against the proposals of the other 17 water companies in England and Wales, to ensure best value for customers. As part of this review it also determines the return our investors can earn, based on evidence from capital markets.

Following its detailed scrutiny, Ofwat then decides how much revenue we can recover from our customers through their water and sewerage bills, and the performance targets that we must meet. Our directors' remuneration (pay) is linked to these performance measures and the value delivered to our customers and shareholders.

Our Five-year Business Plan 2015 to 2020 included 26 clear promises to address issues customers told us were important to them. A number of additional commitments were also made following a review by Ofwat. You can read these in full on page 12.

To make sure we always address our customers' needs in our planning process, we complete a consultation with customers, stakeholders, interest groups and our suppliers. Our independent Customer Challenge Group is especially important in holding us to account and representing the customer's point of view during this process. We gather opinions through workshops, discussion groups, publications, community events and through interactive online tools. We then collate these views and incorporate them into our plans. This extensive consultation process has set our strategic direction for 2020 to 2025. We will be submitting this plan to Ofwat in September.



Our Customer Challenge Group

Our Customer Challenge Group (CCG) 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/CCG – which details its thoughts on our performance over the year. It also reviews our statement of risks and the ways in which we provide data assurance.

The CCG operates on a transparent basis and should anyone 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 Challenge Group secretariat, Southern Water, PO Box 41, Worthing, BN13 3NZ.

How we spend your money

Our charges are set to cover our operating expenditure, 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. In addition, 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 construction of new assets.

Further details of our finances and group structure can be found on page 61.

We are committed to saving our customers money and this is clearly demonstrated by our pledge to keep bill increases under the rate of inflation. The average bill for household customers who received both water and wastewater services from us during 2017–18 was £420, equivalent to £1.15 per household, per day (see diagram below).

The same combined service bill is expected to be £436 for 2018–19, which is £1.19 a day – an increase of 3.8%, or £16 a year, compared with 2017–18.

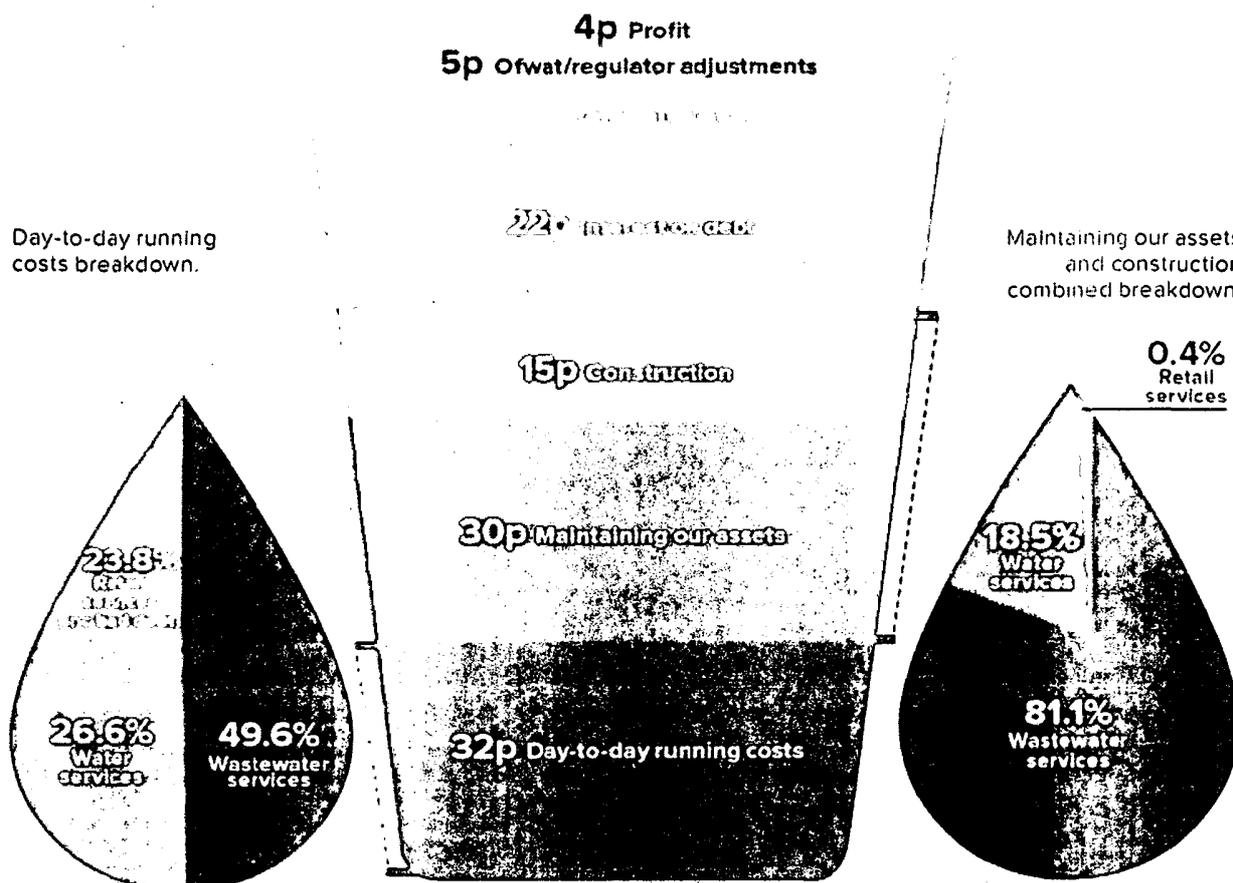
Around 56% of our customers agree that they are clear about what we do and how their money is spent.

Between 2015–20, we are spending a total of £3.2 billion on operating, maintaining and improving our assets. The money customers pay us covers the day-to-day running costs of supplying high-quality drinking water and taking away and treating wastewater. In addition, it supports a £1.8 billion improvement programme to 2020. This includes renewal and expansion of water mains and sewers, along with schemes to help prevent flooding, protect water supplies, reduce leakage, improve water quality and enhance wastewater treatment. These vital services allow our communities to get on with their lives as well as supporting our local economy by helping businesses, hospitals and schools to operate, and by attracting tourists into the region to enjoy our beautiful bathing waters.

Up to 2020 we will be spending an additional £80 million above our existing plan to future-proof our assets and ensure that our treatment plants and network meet the needs of today and tomorrow.

Breakdown of average daily charge

The diagram below illustrates how an average annual bill contributes to our business, based on 2017–18 figures. Comparison costs, according to the Office for National Statistics, are: an 800g loaf of bread = £1.06, two pints of milk = 86p and six large free range eggs = £1.19.



Running costs – includes wages, power, chemicals, materials and bad debt* costs.

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

Interest – on money borrowed to finance improvements to the business over the long term.

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

Construction – contributing to projects to enhance treatment standards and cater for growth.

Tax, rates and licences – includes 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.

Our promises to you

In our Five-year Business Plan 2015 to 2020 we made 26 clear customer promises and a number of additional commitments following Ofwat's review.



Responsive customer service

- Quick and effective resolution of your queries – 90% 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% compliance by our wastewater treatment works with required standards – at least maintain performance at 98.6% (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% by 2020
- Reduce the amount of water we take from the environment by 1.4%, despite predicted population growth of 4%



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% compliance with drinking water quality standards – at least maintain performance of 99.93% then 99.95% 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

- A 10% 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% 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% 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 5% 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
- A 10% 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 track our progress

The table below shows how we have performed against our business plan commitments in 2017–18. Our Customer Challenge Group (CCG), regulators and technical auditors independently monitor this plan – see page 9 for more information on our CCG.

Responsive customer service	Performance 2017–18	Performance 2016–17	Comment
Customer satisfaction Service Incentive Mechanism (SIM) score			We are introducing changes to the way we handle customer enquiries, which we expect to improve our results next year for resolving issues on the first occasion that customers contact us about them.
Percentage of contacts resolved first time ¹			
Percentage of customers who feel our service meets their individual needs			The high level of compensation payments reflects the numbers of customers who experienced an interruption to their water supply during the extreme weather early in 2018.
Percentage of customers who feel our service meets the needs of their community			
Number of compensation payments made to customers (Company Guaranteed Standards Scheme and Customer Charter)			

Affordable bills	Performance 2017–18	Performance 2016–17	Comment
Customers in genuine hardship with improved support			More than 229,000 people in genuine hardship received tailored support from Southern Water in 2017–18 following improvements made to the way we identify and prioritise services to those most in need.
Percentage of customers who feel our services provide value for money			

Better information and advice	Performance 2017–18	Performance 2016–17	Comment
Water usage, per capita consumption (litres/head/day)			Improvements to the way we record unwanted customer contacts (unwanted from a customers' point of view) meant we missed our target to reduce billing queries. However, we are also simplifying our billing information and processes to make them easier to understand. For instance, we are changing our billing cycles as these had been causing confusion for some customers when working out their payment periods.
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			
Percentage of customers who are aware how their money is used			
Percentage of customers who are aware of how to deal with hard water			

A constant supply of high-quality drinking water	Performance 2017–18	Performance 2016–17	Comment
Water quality (Mean Zonal Compliance) (%)			Although we achieved 99.96% compliance with regulatory standards for water quality, our target this year was 100% – higher than for 2016-17. This therefore tipped us into amber.
Number of contacts regarding discolouration per 1,000 population			
Leakage (Ml/day)			Meanwhile, our network is being repaired and upgraded to make it more resilient and able to withstand instances of extreme weather such as the freeze and thaw in early 2018.
Customer minutes lost supply > 3 hours			
Number of properties with low water pressure			
Number of customers affected by temporary use ban			
Maintain asset health			

Removing wastewater effectively	Performance 2017–18	Performance 2016–17	Comment
Number of blockages per km/year			By introducing specialist teams and using new techniques (such as predictive modelling to plan ahead for different scenarios), we have improved our prevention and management of flooding incidents.
Number of internal flooding incidents			
Number of external flooding incidents			
Number of customer complaints regarding odour			
Maintain asset health			

Looking after the environment	Performance 2017–18	Performance 2016–17	Comment
Wastewater treatment works compliance (%) ²			Although our distribution input (the amount of water we put into supply to meet demand) was too high, we are taking steps to reduce it by bringing down the amount of leakage from our network and promoting water efficiency.
Maintain the number of bathing waters assessed with excellent water quality			
Number of serious pollution incidents (category 1 and 2) ³			
Number of less serious pollution incidents (category 3) ³			
Distribution input (Ml/day) (the amount of water put into supply)			
Renewable energy usage			

1 The method for reporting First Contact Resolution has been based on using a 30 day window and is consistent with the figure reported for the prior year. This is inconsistent with the methodology used to set the final determination target which used a 21 day window. Reducing the period for which a second contact is considered a repeat contact, and hence the contact not resolved first time, to 21 days would have resulted in a percentage of contacts resolved first time of 71%. We also note that the final determination specified that the measurement would be undertaken by a third party. In fact the calculation is carried out internally and assured by a third party.

2 An explanation of our wastewater treatment works compliance is on page 49.

3 We have undertaken further external assurance of the category 3 pollution data collected during 2016–17 and 2017–18 and have identified a number of issues with the processes and systems used to generate the spills data which are the subject of an ongoing improvement plan.

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 over the five-year period.
- 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 subsequent sections of this report.

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 southernwater.co.uk/annualreport.

Welcome to Southern Water

Chairman's introduction

It has been a challenging year for the water industry. It has faced tough questions about its financial structures and calls to defend its delivery record. Against this backdrop, Southern Water has continued to supply essential services to households in the South East at high standards that would have been unrecognisable to customers before privatisation in 1989. We are not complacent, however, and are ensuring that we are still improving.

In his summary, our chief executive Ian McAulay highlights aspects of Southern Water's progress in this regard during 2017–18. This is further supported by our Strategic Report pages 28 to 94 which demonstrates the company's continued hard work and commitment to delivering better services.

As providers of essential services, we believe customers have a right to be confident that the company is operating with their interests at its heart. We have a duty, therefore, to get better at addressing concerns about our sector to rebuild trust.

A privilege to serve the public

We know it is a privilege to supply water and/or wastewater services to 4.6 million people, and so we fully expect to be held to account. The water industry is rightly one of the most strictly regulated sectors and we agree that high standards should be demanded of us.

In general, since privatisation, the water industry has undergone a transformation. Figures from our trade body, Water UK, show that productivity has increased by 64% since 1994 with £150 billion invested to produce a 70% improvement in bathing water quality, better than ever drinking water quality, an 86% reduction in pollution incidents, and leakage levels down by 35%.

Meanwhile, in real terms, bills have fallen. Water UK estimates that on average bills are £120 lower than they would have been if the combination of privatisation and tough independent regulation had not happened.

However, we recognise that there will always be opportunities to improve. Where we fall short of meeting the standards we aim for – such as our historic under-performance against our peers in customer satisfaction ratings – we listen to our critics and set about implementing changes. While we are proud of the positive work we are doing in this particular area, we know that we still have a long way to go.

Being attentive to public opinion is part of responding to criticism and so, although Southern Water and all companies in our group, pay all taxes in the UK, we are planning to close our financing company, Southern Water Services (Finance) Ltd, which is registered in the Cayman Islands, which we know contributes to misconceptions about our business practices.

We also acknowledge Ofwat's recent publications regarding governance in the water sector and its proposals for the next business plan for 2020–25. In light of these we will be reviewing our dividend policy and performance related executive pay to ensure that they strike the right balance between the interests of customers, investors and the executive management team.

Whatever financial structure the company has in place, the Board and executive management team are clear about our business priorities. Our customers deserve high-quality drinking water, excellent customer service and protection for their local environment.

Therefore, as a business, we are investing £3 billion between 2015–20 to operate, maintain and improve our assets to build resilience into our network. We also have a programme of research and development to enable us to innovate to improve the company's services while caring for the local environment. We aim to keep our charges as low as possible and so, despite huge infrastructure investments, Southern Water's average combined bill for water supply and sewerage services in 2017–18 was just £1.15 a day.

Our Board has committed to spend an additional £80 million above our existing plan to 2020 to improve performance for our customers and the environment.

A fair workplace

Southern Water would not be able to provide any of its services without skilled employees. To secure and retain the best people, the company ensures all employees are treated fairly and respectfully.

We have recently completed our Gender Pay Gap report and our median gap is 9.0%. The median pay gap among all companies that have reported is 9.7%. This is caused by there being a higher proportion of men in more senior roles in the company. We are implementing plans to help us to address our gender pay gap by taking steps to remove unconscious bias from our recruitment process, ensuring that women are fairly represented in our succession and talent plans. Since the audit took place, two women have joined our Executive team. Our full report on how we propose to manage our gender pay gap can be found at southernwater.co.uk/genderpaygap.

At this point, it is appropriate on behalf of the Board to thank all of Southern Water's employees, partners and contractors, for their continuing hard work, especially during a time of change in the water sector. Despite some controversial headlines, collectively they continue to respond to challenges with dedication and fortitude.

Governance and scrutiny

My first full year as Chairman has been a busy one with the implementation of a new governance structure to improve transparency and accountability by separating the Board meetings of Southern Water Services (Southern Water) and Greensands Holdings, the company's ultimate holding party.

We have said farewell to Mark Walters with thanks for his former service to the Board, and welcomed new members Mike Putnam (independent non-executive director), Wendy Barnes (non-executive director) and Sara Sulaiman (non-executive director). Meanwhile we are recruiting for another new independent non-executive director following the departure of Lisa Harrington in March. We thank Lisa for her contribution to the Board and in particular her insights into improving our customer service. We will also be recruiting an additional experienced operational finance professional, as an independent non-executive director, to strengthen the Board and help the team further improve the efficiency of the business.

To ensure the Board is achieving its objectives, we appointed an external agency to conduct an effectiveness review last year and we will be using the output from the review to ensure we maintain the right mix of style and strengths around the Board table. With the next five-year business plan due to be submitted to Ofwat in September 2018, the focus of the Board has been very much on ensuring that we deliver the best possible plan which delivers resilience in every sense of the word and great outcomes for our customers. The Board has attended a number of day-long workshops to ensure the Board is fully engaged with the company's programme of investment priorities in its next business plan as well as overseeing the schedule of changes being introduced as part of the company's cultural transformation. A number of sub-committees of the Board were established to focus on individual five-year business plan themes to ensure that we had a full understanding of and agreed with the priorities and deliverability of the business plan.

In 2017–18, the Board also presided over some key changes to Southern Water's senior management team and, while acknowledging the contribution of those who have left us, is pleased to have welcomed new faces and promoted others to join Ian McAulay in leading the charge to transform the business.

My thanks go to my fellow Board members for their high level of commitment to providing a stable base on which Southern Water can build a better future for the company.

We never forget that any efficiencies we make in our business need to be framed in the context of how they make life easier for customers. We are therefore indebted to the members of our Customer Challenge Group chaired by Anna Bradley, for providing an independent and critical eye from the customer's perspective.

As well as our duty to respond to customer concerns, the company's management team ensures we are accomplishing our corporate objectives in a way that conforms to guidelines set out by our regulators. Southern Water introduced a Compliance and Asset Resilience directorate in 2017 to apply strict oversight to our reporting metrics and make sure they stand up to close scrutiny.

This leads me on to re-stating the commitment we made last year to working closely with the Drinking Water Inspectorate (DWI), the Environment Agency and Ofwat to address issues they each raised about aspects of our reporting processes. We were pleased to welcome members of the DWI to meet the Board during 2017–18 and will continue to work with all of our regulators to meet the rigorous standards they require. Further details are provided on page 24 in the Chief Executive's Summary and in our Risks report on page 91.

The Board and I are clear that Southern Water is facing a number of historical issues with aspects of internal culture and behaviours that have not always led to the right outcome for customers, regulators, the environment and other stakeholders. By appointing Ian McAulay as Chief Executive Officer we made it our priority to address

these legacy matters, as they directly affect the company's ability to deliver the transformational improvements written into our new business plan. Collectively, we need to ensure we are prepared to deliver improved and resilient services for our customers and communities and this means addressing areas of significant concern with vigour, and introducing measures to ensure we operate within a modern, transparent and ethical compliance framework. The Board and I are also clear, therefore, that the standards and behaviours that may have been followed in the past are not acceptable and will be dealt with openly and decisively.

More information on the company's assurance processes for reporting data is available in our Data Assurance Summary which is published alongside this document and is also available on our website at southernwater.co.uk/our-reports.

Looking ahead

Like every responsible business, Southern Water has long-term operational strategies in place to make sure it can deliver its objectives efficiently and cost-effectively. For us, these objectives must align with our customers' priorities.

By the end of March 2018, we had actively sought the views of thousands of customers as part of our overall engagement programme for our three most important strategies – the Business Plan for 2020 to 2025, our Water Resources Management Plan (which is published every five years and looks ahead to preparing for the next 50) and our Drought Plan (which is regularly reviewed to adapt to changing circumstances and which is due to be published in its latest form this summer).

Each of these pivotal documents underwent a formal consultation process between February and April this year where we targeted customers and stakeholders through workshops, drop-in sessions, online surveys and community events such as roadshows.

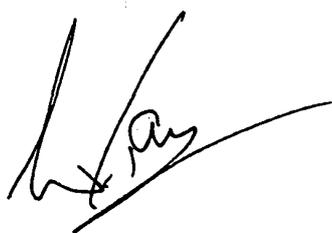
We have also been raising awareness of our future proposals for the business via marketing campaigns on social media and through our relationships with Southampton Football Club, Gillingham Football Club, Brighton & Hove Albion Football Club, Hampshire County Cricket Club, Kent County Cricket Club, Portsmouth Football Club and Sussex County Cricket Club.

It is therefore our customers' and stakeholders' views that are critical in shaping Southern Water's agenda for the future. This is as it should be, and we are proud that with the comments so far, we are already consulting on some ambitious goals for water services in our region.

Plans for 2020 and beyond include:

- building resilience into our water supply by dramatically increasing recycling and targeting reductions in consumption through our Target 100 programme (see the sections on Better information and advice and A constant supply of high-quality drinking water, which start on pages 35 and 41 respectively)
- working with stakeholders to keep rivers, lakes and coasts clean and healthy
- creating sustainable communities
- making the most of our most valuable natural assets to boost the South East economy.

Threats from issues such as climate change and population growth will make for a challenging but exciting time ahead for Southern Water. We know that collaboration with customers and stakeholders will be crucial in determining how successful we are in our plans to manage threats to our region's water supplies. Therefore, as we go about our business in 2018–19 and in the coming years, we will keep working hard to gain and retain the trust and support of our most important partners – the people we serve.



Bill Tame
Chairman

Our Board

The Board is responsible for the strategic direction of our business. The majority of its members are independent of Southern Water Services (Southern Water). Throughout most of 2017–18, it was made up of:

- an independent non-executive chairman
- two executive directors (the Chief Executive Officer and Chief Financial Officer)
- six non-executive directors – four independent non-executive directors and two shareholder-nominated non-executive directors.

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 2017–18, eight 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 Limited (Greensands), a company owned by a consortium of pension and infrastructure funds, committed to a long-term investment in our business.



Members of the Board and Company Secretary at 31 March 2018 are pictured above, from left to right:

Joanne Statton, Company Secretary

Mike Putnam, independent non-executive director

William Lambe, Chief Financial Officer

Wendy Barnes, non-executive director

Sara Sulaiman, non-executive director

Ian McAulay, Chief Executive Officer

Bill Tame, Chairman

Paul Sheffield, senior independent non-executive director

Rosemary Boot, independent non-executive director

Not pictured:

Lisa Harrington, independent non-executive director. Lisa resigned as a director with effect from 31 March 2018.

Find out more about the Board on pages 102 to 105.

Chief Executive's summary

A year of challenge, change and progress

During 2017–18 Southern Water has delivered significant improvements in areas such as customer experience while laying foundations for success in others, such as building more resilience into our core services.

We know that we still have a long way to go to provide the quality of service we aspire to deliver to our customers. However, 2017–18 was a period in which we faced our challenges and began our cultural shift towards becoming the modern, innovative and public service-focused organisation we need to be and know we can be. Cultural change takes time, but we have started by working to be brilliant at the basics so our customers routinely receive the high-quality core services of a clean, safe drinking water supply, wastewater removal and customer care. We have also started to look at what we can do now to harness technology, innovation and adopt new ways of thinking to secure a resilient water future for the South East.

Part of this will mean demonstrating to customers and stakeholders that water is not only vital for life but can enable economic growth, be used as a renewable source of energy and is crucially important to our precious natural environment. We propose to change how we work, improve how we communicate and forge stronger partnerships to help everyone in our region understand the true value of water.

In 2017–18 we worked hard to build trust with customers, stakeholders and regulators. As part of this, we strengthened our accountability processes and reporting procedures by setting up a Compliance and Asset Resilience directorate to bring greater scrutiny and assurance to this area. Our customers have a right to ask questions about how we operate and to receive straight answers, especially at a time when there is so much debate about the legitimacy of the privatised water sector.

In addition, we acknowledge the need to have constructive and progressive relationships with our regulators and are therefore grateful for the time and guidance given to us in the last 12 months by, among others, Ofwat, the Drinking Water Inspectorate (DWI) and the Environment Agency.

In the following pages, I give an overview of the challenges, changes and achievements that have defined Southern Water's year.

A much-improved service but still more to do

Although we remain 15th out of 18 in the industry performance tables for customer satisfaction, the results of our work to transform our customer service meant that at one point during 2017–18, we were the fastest improving company in our sector.

By increasing our focus on what customers need from us, delivering it when they want it and via channels they find most convenient, we have seen some encouraging results. For example in the positive feedback received by our growing Home Move team, who offer tailored advice to customers moving within our area.

In 2017–18 we also cut written complaints by 21%, adding to the 47% reduction we achieved in 2016–17. We have also become much faster at managing written complaints with 75% now resolved within three days.

To make life simpler for customers, we signed a joint billing arrangement with South East Water so those customers whose water and wastewater services are split between our two companies now only receive a single bill. This move was in direct response to customer feedback and we are pleased to have introduced the change seamlessly, transferring around half a million customer accounts.

Helping customers in vulnerable circumstances has always been a focus for us and in 2017 we renewed this commitment, setting up a new steering group as part of our Reach and Support initiative. The group is made up of a regional network of organisations from local authorities to debt management agencies and will enable information-sharing and more tailored support for those customers who need it most.

We know that we still have a long way to go to catch up with the best performers in our industry but the progress we have made over the past year demonstrates our commitment to providing excellent customer service.

Getting better at the basics now while setting goals to be brilliant tomorrow

Getting the basics right every time is extremely important to us and in 2017–18, the 2.5 million customers who receive our drinking water consumed it at a standard that met 99.96% of the quality measures demanded by the DWI.

In our other core service – removing wastewater effectively – we also made progress in 2017–18, thanks to investments in our infrastructure, with a fall in the number of sewer blockages, pollutions and internal and external flooding incidents caused by failures of our networks.

However, we do not underestimate the scale of the task we face in ensuring that we provide consistently excellent core services for every customer, every day. This is always our intention and yet in 2018, some customers were left without their water supply following an exceptional weather event of freeze and rapid thaw of pipes across our network. Although we worked around the clock to get water supplies restored as quickly as possible, with the vast majority back in supply within 12 hours, it took a few days to return some customers to normal service. We sincerely apologised to, and compensated, all those affected. We are also determined to take every lesson we can from this incident to improve both the way we respond to emergency situations and how we prepare our network to be more resistant to extreme weather.

This event crystallised a theme that features strongly in the drafts of our next business plan – that to fulfil our ambition to be brilliant at the basics, we need to focus on building long-term resilience into our networks. Therefore, although before the thaw we had planned for typical winter weather and our Board had approved an additional £80 million to upgrade our water and wastewater operations by 2020, our next business plan will focus on a range of programmes to work systematically and comprehensively towards strengthening our infrastructure. One of these is our Networks 2030 project, which will take a holistic view of network management. You can read more about this in the sections on Delivering reliable services and Protecting our natural resources later in the strategic report, on pages 41 and 48 respectively.

Planning for a resilient water future for the South East and championing the value of water

In 25 years we estimate that we will have lost a third of our water sources through climate change and yet our population will have grown by 20%, with 500,000 additional households. So as well as providing a good level of service today, we have a duty to plan ahead in a region where water sources are already under pressure.

The drought permit we applied for early in 2018 for the River Medway is an example of this. Although the permit was precautionary to mitigate the low levels at Bewl Water reservoir in Kent – which was only 33% full in November 2017 – it was an illustration of the immediate need for our ongoing work to have a responsive Drought Plan and Water Resource Management Plan in place to secure water supplies.

We must also continue to invest in our supply network now, which is why we recently announced an additional £2 million on top of our existing annual spend of more than £14 million a year to find and fix leaks in our network.

However, we cannot tackle water scarcity alone. Following our industry-leading universal metering programme, our customers are now among the most water-efficient in the UK and use around 16% less water than they did in 2010. The UK average, according to Water UK, is 141 litres per person, per day whereas in our region, the average is 129. We are proposing to lead again with an ambitious project called Target 100, which aims to help customers manage their water consumption more efficiently and cut their water use to 100 litres per person, per day by 2040.

So, Target 100 will not just be about building on our existing water efficiency programme; it will also be about raising awareness about the value of water. We will work with energy and food producers, farmers and landowners, local government, regulatory bodies, environmental groups, parish councils, charities and business groups to help drive innovation and behaviours that more effectively manage water resources.

Target 100 is part of a holistic approach to managing what we think of as the utility of water. This means understanding that the work of water utilities is at the heart of communities because efficient water and wastewater services are fundamental to the success of other sectors such as health, business, tourism and leisure, and for the sustainable growth of our economy across the country. For instance, tourists attracted into our region may not be Southern Water customers, but they enjoy the utility of water as they visit our beaches and, as a result, spend time and money in our area, contributing around £12 billion a year to the local economy.

We are investing in research and development into technology, science and processes that can improve all aspects of the water supply and wastewater removal process so we can make the most of the utility of water. In 2017–18 alone, we spent £3.9 million on research and development projects. These included supporting a PhD project to manage microplastics in wastewater, trialling a smart water quality monitoring network, and developing a new digital tool, provisionally called a Waterbit, which allows customers to monitor their real-time water use and help them reduce consumption.

However, innovation is about much more than technology, it is also about radical thinking. We work with some of the brightest minds at the region's universities to help us devise predictive modelling programmes and new technologies but we also plan to set up our own in-house skills academy of problem-solvers.

Meanwhile, our desire to bring innovative ideas together was behind our commissioning of an independent report last year. Called Water Futures, it recognised that the water industry is at a turning point and facing unprecedented change. It also highlighted the extent to which stakeholders across our region need to work together to maximise the outcomes of proposals to protect our water supplies. We have responded in a follow-up document, Southern Water Futures that outlines five initiatives to transform our service and bring stakeholders with us on this journey.

The first of these is Target 100 (mentioned above), while others involve the expansion of our catchment plans, the creation of resource hubs at our larger treatment works, and initiatives under Networks 2030, that will update and automate our network so we can track and fix issues and build capacity sustainably. The full report is available at southernwater.co.uk/waterfutures.

Building better relationships to protect the environment and support the local economy

To maximise the potential of the utility of water in our region, collaborating with customers and stakeholders on projects is crucial. Examples we are working on include catchment plans, which bring together a range of organisations to identify and implement cost-effective solutions to tackling pollution that can affect water quality in specific water source (catchment) areas. One example of this is the Brighton ChaMP (Chalk Management Partnership) which unites Southern Water, Brighton and Hove City Council, the Environment Agency, Natural England, the South Downs National Park Authority, the University of Brighton and Brighton and Lewes Downs Biosphere to protect and improve the quality of groundwater (water that fills pores and cracks in rocks below ground) so it remains a sustainable water resource for public water supply.

Protecting one of the region's greatest assets, its bathing waters, is vital from a number of perspectives including public health and wellbeing, environmental welfare and economic prosperity in the South East. As one of the most highlighted environmental issues of the past year, Southern Water is on a mission to reduce the amount of plastic in the environment, in our business and on our beaches. We have launched a company-wide plastics policy to reduce the amount of single-use plastics, like coffee cups, at our own sites. We are also proud to have piloted a scheme in Brighton working alongside the city council and other stakeholders groups in Brighton and Hove to provide refill sites across the city so people can re-use a single bottle. The pilot was run in partnership with the national Refill campaign.

Meanwhile, in 2017, local communities from the Isle of Wight to the Isle of Sheppey came together with Southern Water to address issues that might be affecting the quality of their bathing waters and ensure their long-term sustainability. These bathing water steering groups are not only helping preserve the beaches for residents of the region to enjoy but they are also putting plans in place to attract money into the region from tourists.

We have also continued to expand our Bathing Water Enhancement Programme, which is a £31.5 million industry-leading initiative to improve the quality of our beaches. It aims to bring a further seven bathing waters across the region to 'excellent' standard by 2020. In 2017–18 we were proud to see that of the 83 designated bathing waters in the region, every one achieved the minimum standards required for the first time in several years. A vast improvement when you consider in 1989, 31% failed to meet the basic standards that were required at the time.

On a personal level, I too have been keen to learn from and work with different industries and share my expertise by joining bodies that support our local economy such as the Greater Brighton Economic Board and CBI, which speaks on behalf of 190,000 businesses of all sizes and sectors.

Improving accountability and responding to challenges

In 2017–18 we worked with our regulators to address issues that will help us improve our business. For instance, our regulator, Ofwat, told us back in 2016 that the standard of some of the information we make publicly available fails to meet its expectations. In addition, we received feedback from our customers and stakeholders that sometimes our communications are confusing, too technical, or that our website is awkward to use. We accepted these criticisms and set about doing more to meet the expectations of our regulators and customers. In 2017, we were pleased that Ofwat acknowledged a significant improvement in the quality of information we present. However, we also fully accept its findings that we still have shortcomings to address.

Meanwhile, we began the 2017–18 period with Enforcement Orders in place from the DWI in relation to the submission of information and data and delays to some improvement works.

We are also assisting the Environment Agency (EA) and Ofwat with ongoing investigations in relation to the operation of some of our wastewater treatment works and reporting processes. We are working proactively with the EA and Ofwat to resolve their investigations which are still evolving.

As part of this process, we have carried out additional assurance on 2016 and 2017 data which has identified a need to correct previously reported performance for Wastewater Treatment Works – population equivalent, and Wastewater Treatment Works – number of failed works. We are currently reviewing the 2015 data and it appears that Ofwat Outcome Delivery Incentive penalties may have been applicable in respect of the 2015 calendar year. The additional technical assurance that we have carried out on wastewater treatment performance data is now being rolled out for the years 2014 to 2010.

We are implementing significant programmes of work which will improve our public health and environmental compliance culture. The assurance process conducted this year has identified a number of areas where we need to strengthen our non-financial reporting processes and these will be incorporated into our improvement programme over the forthcoming year.

As previously mentioned, we have embarked on a programme of improvements to transform our business in all areas from operational to cultural. One of the key areas of improvement is in the way we manage our reporting mechanisms. We know that to protect public health it is vital that our standards comply with those set down by our regulators who need to be able to judge our performance based on the achievement metrics applied to our industry. To that end, our new Compliance and Asset Resilience directorate will improve our risk management, give greater oversight to our reporting procedures and assure the integrity of our data.

As part of this, in September 2017 we commenced a data transformation programme. Led by the newly-created Data Team, this transformation has enabled us to make more use of advanced analytics and data science and the organisation can now look forward to maximising its use of revolutionary artificial intelligence and machine-learning.

We are particularly proud that in November 2017, Southern Water's Data Team began a cross-sector initiative to create a shared portal for common regulatory data and to release open data sets. The Data Team collaborated with technology partners and delivered the platform. The portal, called DataWell, now has seven water companies, a group of universities, Ofwat, the EA and Open Data Institute involved in the project.

Prior to a Public Inquiry in March this year, we reached an agreement with the EA about changes to our licence to take water from the Rivers Itchen and Test. We accepted the licence changes, which reduce the volume of water we can take, and believe the agreement enables a new, positive way forward for both parties, for public water supplies and for the habitats and ecology of the River Itchen and River Test. The EA has given Southern Water reassurances around maintaining public water supplies until new reliable water supplies can be found to replace those lost by the licence changes. In turn, we have committed to a multi-million pound package of monitoring procedures and measures to lessen the environmental impact of potential drought permits and drought orders that may be needed until the replacement supplies (which we are urgently pursuing) can be implemented.

Southern Water is changing. The ambitious plans we are making mean that we cannot have an internal culture and behaviours that fail to deliver on the outcomes we have committed to for customers, regulators, the environment and other stakeholders. In order to deliver improved services and a resilient future for water in the South East, we are undertaking a number of transformational programmes, which rely on us operating within a modern, transparent and ethical compliance framework. Quite simply, the standards and behaviour that had led to some of the legacy issues we are now facing, will not be tolerated. We are drawing a line under the past and look forward to continuing the more collaborative relationships we are establishing with our regulators and stakeholders to benefit customers.

This year, along with other essential service providers, we have responded to the requirements of the European Union's directive on the security of Networks and Information Systems to improve their defences against malicious cyber attacks which could damage the UK's infrastructure, economy or public health. We are strengthening our security systems in line with this to improve our resilience against attempts to disrupt our services. Meanwhile, we are making a significant investment to upgrade our IT systems as part of overall plans to improve the efficiency of our business.

Network security also means protecting our customers, employees, stakeholders and suppliers against the possible misuse of their personal data. In May, the General Data Protection Regulations (GDPR) came into effect to introduce stricter rules on managing the use and storage of personal data. All employees across the business have been made aware of the importance of the secure handling of personal information.

Over the past year, as an industry, we have also faced challenges from politicians and the media to defend our performance record and fitness to serve the public. The question about nationalisation is a fair debate to have but we need to consider whether customers and the environment would truly benefit from a re-nationalised water sector. As our chairman noted in his introduction, Water UK estimates that £150 billion has been invested in the industry since privatisation. It is vital that any future structure of the sector has access to similar funding that keeps pace with a growing population and the impact of climate change while continuing to deliver a high standard of drinking water and the protection of our environment.

We also recognise that while there has been some innovative work taking place in our industry over the years, collectively we have not always shared our achievements, adding to negative public perceptions of our sector.

In fact, Southern Water has a long-established record in many areas such as driving down leakage and water consumption. We also provide excellent value for money given the huge investments we make to improve our service. Our daily combined bill for water supply and sewerage services was just £1.15 in 2017–18, and is predicted to rise to £1.19 in 2018–19.

Providing a stable financial base

As described above, 2017–18 has been a year of significant change and challenge for Southern Water. This is reflected in our operating profit for the year which fell by £22.3 million to £236.6 million, largely driven by an increase in our operating costs this year.

In particular, we have spent an additional £3.9 million setting up the Compliance and Asset Resilience directorate and Data Team. These teams, as I described earlier, have been established to improve the processes and assurance of our non-financial reporting so that customers and stakeholders can have trust in its integrity. In addition, we have spent £3.6 million to improve the operation of our IT systems.

As mentioned earlier, 2017–18 saw some challenging weather conditions. Overall we incurred an additional £4.3 million to mitigate the potential drought, for example pumping to refill our Bewl Water reservoir, and restoring water supplies to customers affected by the bursts following the thaw in March.

We have also been busy this year preparing to submit our business plan for 2020–25 to Ofwat in September 2018. This work, which included consultations with customers and stakeholders, increased our operating costs in the year by £2.9 million. Our focus over the next two years is to transform our business in readiness for the delivery of the next business plan objectives.

In 2017–18, we also saw a significant increase in our capital investment programme as we completed the third year of our current business plan. In total we spent over £440 million investing in our assets during the year. This included the completion of a scheme to replace 30 kilometres of water mains in Kent, the ongoing redevelopment of our Woolston wastewater treatment works and an upgrade to our wastewater treatment works at Eastbourne.

As our Chairman stated in his introduction, the water industry has been the focus of considerable scrutiny during the year, not least in relation to how the industry is financed. We are responding to this in reviewing our current financial structure and have announced that we intend to close our Cayman Islands registered subsidiary.

Any changes we make to our financial structure, along with the continued capital investment in our assets and transformation activities, will be focused on ensuring that we have a stable financial base to deliver on the commitments made in our current and future business plans.

Our people – proudly supporting our communities

Our employees' families play on the beaches, drink the water and use the wastewater services provided by Southern Water. It is therefore important to us to provide as great a service to all our customers as we would like to receive ourselves.

Last year, where we felt new approaches were necessary to improve our effectiveness, for example in Customer Service, we have been lucky to have been supported in implementing these changes by highly accomplished employees. While we have said goodbye to some colleagues who had served the company with dedication and skill, we also promoted many experienced employees from within the business and recruited new people from other sectors to broaden our knowledge and skills-base.

While the changes have been necessary, I do not underestimate how unsettling it can be during periods of transition to new working arrangements. So I am personally grateful for the professionalism shown by colleagues during this time.

As well as being committed to providing the best services we can as employees and, for the most part, customers of Southern Water, my colleagues and I are also commonly members of the communities we serve. Consequently, it is often a labour of love to support community initiatives.

As you will read in the Our Southern Water section on page 56, in 2017–18, our employees spent the equivalent of 623 days volunteering at organisations across the region and raised just under £147,700.

Last year, our Learn to Swim programme – which has taught 750,000 children over the last 25 years to be safe around water – was shortlisted for two awards (Utility Week and the Better Society Awards). We were also pleased to be invited to meet the Department for Digital, Culture, Media and Sport to discuss how we could share our model with other water companies.

We are pleased to have been shortlisted for the Utility Week Stars Awards for our collaborative project to help customers reduce water consumption in our River Itchen Challenge (see page 37).

Protecting the health and safety of our employees and contractors as they go about their work for our company is extremely important. I am therefore pleased that in 2017–18 we received the Order of Distinction from the Royal Society for the Prevention of Accidents in recognition of our excellent record in maintaining staff health and safety over the past 19 years. Last year we recorded two periods of more than 100 days free of any reportable injuries and will be maintaining our vigilance to protect those who work for us from injury and harm.

Of course, caring about health and safety extends to emotional wellbeing and at our sixth Health, Safety and Wellbeing conference in 2017, this was a central theme. Southern Water is committed to the Time to Change programme to tackle the stigma surrounding mental health and we were pleased to reflect this at the conference. More on our health and safety record is in the section on Our Southern Water which begins on page 56.

In April 2017, competition entered the non-household water market. We sold our non-household business portfolio to the company Business Stream, and while we no longer provide retail services to non-household customers, we remain a wholesaler. Our Wholesale Services team has since been recognised in an independent survey by Water.Retail for its hard work in developing relationships with retailers to ensure the efficient, compliant and fair delivery of water and wastewater wholesale services. We were ranked the second-best wholesaler of England's nine water and wastewater companies, narrowly behind first-placed United Utilities. This is great feedback for our team, and has emphasised what we need to do to continue delivering, and improving, our service for retailers.

Focusing on the future

In a number of areas, Southern Water is ahead of its industry colleagues. We have led the way with metering and 100% of the waste from our works and offices has been recycled. This makes us one of only a handful of utilities to achieve a zero waste policy. We were among the first to raise awareness of wet wipes, which clog our sewers, pressed for government action to address the issue, and in 2017 won a CIPR Gold award for our campaign The Unflushables. We want to develop our role as innovators and thought-leaders, not only to provide excellent services for our own customers but to influence the water industry as a whole in the way we value and protect the world's most precious commodity.

Change is coming for the whole of our sector and we are busy making sure we are prepared for it. We know we need to improve in some areas, however, our performance figures from the past year contain some results to be proud of and we are pleased to have set wheels in motion in 2017–18 to achieve our ambitious agenda for the years ahead.

A handwritten signature in black ink, appearing to read 'Ian McAulay', written in a cursive style.

Ian McAulay
Chief Executive Officer

Strategic report

Working for our customers

Responsive customer service

	2017–18		2016–17
	Target	Achieved	Achieved
Customer satisfaction			
Service Incentive Mechanism (SIM) score	79	79	78
Contacts resolved first time (%) ¹	80	67	67
Customers who feel our service meets their individual needs (%)	66	64	66
Customers who feel our service meets the needs of their community (%)	35	34	35
Number of compensation payments made to customers ² (Guaranteed Standards Scheme and Customer Charter)	2,538	9,374	2,436

² The method for reporting First Contact Resolution has been based on using a 30 day window and is consistent with the figure reported for the prior year. This is inconsistent with the methodology used to set the final determination target which used a 21 day window. Reducing the period for which a second contact is considered a repeat contact, and hence the contact not resolved first time, to 21 days would have resulted in a percentage of contacts resolved first time of 71%. We also note that the final determination specified that the measurement would be undertaken by a third party. In fact the calculation is carried out internally and assured by a third party.

³ The significant increase in the number of compensation payments made to customers was due to the February/March freeze and thaw weather event.

In 2017 we introduced some changes to help transform our customers' experience of being served by Southern Water.

These initiatives, outlined below, contributed to us recording our best ever SIM survey score during this year. SIM, which stands for Service Incentive Mechanism, is a measurement taken throughout the year by our regulator Ofwat to judge how well we, and our fellow water companies, serve customers. To work out the score, Ofwat takes into account quantitative data (such as written complaints and calls) and qualitative data (such as survey results on levels of customer satisfaction).

We recognise there is still a great deal to do to move us up the industry league tables for customer satisfaction and that despite some positive results, we remain at the lower end of the rankings. We also, in common with so many of our water industry colleagues, saw an impact on our figures from the extreme weather in late February and early March 2018. The number of compensation payments to customers reflects the level of disruption caused by the loss of water supply during this incident as we explain below.

However, we are confident that the foundations we have laid to improve the way we interact with our customers will become increasingly apparent in the coming year. We look forward to seeing this reflected in next year's SIM score.

Our performance

Customer satisfaction is judged at four points throughout the year and during 2017–18, we recorded our best ever results. However, our scores for the final quarter fell below expectation. Overall, we rose from 16th to 15th in the industry league tables and our SIM score for the year as a whole was 79. This was on target for the year and better than last year's result of 78.

One of the contributors to our better SIM score was a continued reduction of 21% in the number of written complaints we received. We achieved this as part of a new strategy being applied across the whole of our customer service operation that uses analytics to help predict and understand possible sources of dissatisfaction

so we can take steps to address these before our customers are affected. We have introduced a Complaints Action Group whose role is to analyse the root cause of complaints and draw up action plans and campaigns to proactively address areas of concern before they become an issue for customers.

Another factor affecting our SIM score is the number of issues we resolve for customers at the time they were first raised. We were disappointed to miss our target for contacts resolved first time of 80%, achieving 67%. However, as a result of the changes described above in the way we handle complaints, we expect to see better results in the coming year. We have already drastically cut the time we take to respond to complaints relating to billing with 85% now resolved within three days – the vast majority of which are closed within 24 hours – compared with 11% in April 2017.

Each year we also survey our customers to find out how well they feel we meet their needs and those of their community. This year's results fell slightly compared with last year's at 64% and 34% respectively.

Finally, another indicator of quality of service is reflected in the number of payments we make to customers when we fall short of their expectations. Under our Guaranteed Standards Scheme (GSS) and Customer Charter, we pay compensation if we fail to offer a minimum standard of service such as a failure to respond to a written complaint, an interruption in service or a failure to attend scheduled appointments.

Despite tripling the number of frontline staff we dedicated to restoring water supplies during the February/March freeze and thaw, we saw an increase in the number of payments we made to compensate customers for interruptions to their supply. We recognise that it was right to automatically compensate affected customers and also apologised to them for the disruption. The incident caused a rise in our overall total for GSS payments to 9,374 with around 5,000 additional payments made as a gesture of goodwill.

For those families and communities who had also been inconvenienced by school closures during the supply interruptions, we agreed to donate £2,000 to every affected school to go towards projects involving science, technology, engineering and mathematics education. We will also be offering these schools a class with Southern Water engineers and scientists.

How we are improving

New ways of working

In 2017–18 we restructured our Customer Service area. Our Complaints Action Group, mentioned earlier, ensures that we learn from previous customer experience to alter and improve areas that have caused problems previously. Customers are therefore not passed from team to team but are directed to the right people from their first point of contact.

We know from customer feedback that transferring services when they move house can be a source of worry for them. To address this, we grew our specialist Home Move team, which now consists of some 40 advisers. The team is responsible for supporting customers with information and advice on closing down their account at one property and opening another at their new home so that their water services are properly registered at the new address and are ready and waiting for them. (See our case study on page 31).

Customers had told us that receiving separate bills from different water companies was confusing. Therefore, we signed a joint billing arrangement with South East Water last year so that customers served by both us and them, now receive a single bill. We are not only pleased to have been able to improve this experience for our customers, but to have introduced the handover seamlessly in the second half of 2017–18 for the half a million accounts affected.

Another aspect of our restructure has been to streamline and review our outsourced contracts to give us greater quality control over fewer business delivery partners. We are cutting the number of suppliers from four to just one for services such as administrative tasks. We have also changed the number of debt collection agencies we work with from seven to just one. This will dramatically reduce the number of transactions and handovers that are needed to manage each customer's account. This is important as it limits the number of mistakes that can be caused by delayed, mislaid or misunderstood communications as account details pass between organisations.

Training and performance management

We have introduced new training schemes to increase the skill-set of our employees so they feel better equipped and supported in delivering our services to customers, as well as providing them with a more rewarding working environment.

Team members are set clear lines of responsibility so they know what is expected of them and given clear performance targets to help them stay focused and track their progress. Teams meet every morning with their managers to discuss current issues, share best practice and support each other. Any problems are identified and resolved as a group to ensure customers benefit from shared expertise. The results are measured to make sure we are providing a consistent, effective service and that teams are motivated to continue to improve.

More choice for customers

Back in 2016, we began our campaign to offer customers greater choice and flexibility in how they manage their accounts with the setting up of our digital Your Account service.

In 2017, we expanded our digital services to give more customers easier access to their accounts at times that suit them and provide more convenient self-service options to perform account tasks such as paying bills, submitting meter readings and updating contact details. As a result, almost 240,000 customers had taken up the option of signing up for our online services by April 2018.

We had set ourselves the target of having 20% of customer transactions completed online by the end of March 2018. We were pleased to meet this and now, our longer term ambition is to raise this figure to 50–60% by 2020. We aim to do this by using data analysis to help us provide more tailored pathways and by continuing to promote the benefits of simpler access to our customers.

Reducing bad debt

When bills are left unpaid, the costs of following up debts can increase our charges so that everyone ends up paying more – including those who pay their bills on time. We therefore have to tackle debt to keep bills fair for all of our customers.

Part of managing bad debt is understanding why some customers fall into debt in the first place and supporting those in genuine financial hardship, to pay what they can, on time.

We have adopted a new approach to dealing with individuals in debt to provide them with a more tailored service. As a result of this, and a more focused litigation process, we have been able to lower our bad debt levels from £37 million to around £22 million. We have also introduced greater support for customers in vulnerable circumstances, which you can read more about in the next section on Affordable bills on page 32.

Caring for customer information

Part of our responsibility to customers is ensuring the responsible handling of their personal information.

The General Data Protection Regulation (GDPR) came into force in May 2018 to introduce stricter rules on managing the use and storage of personal data. The legislation also addresses the broader issue of containing the ever-growing tide of online criminal activity. The new regulation is being adopted throughout the business but is especially relevant for our Customer Services. Therefore, we have introduced secure areas in the department where information and conversations about customers can be restricted to relevant individuals only, and safely stored.

A sustainable future

Our Customer Service teams will build on the successes and initiatives introduced in 2017–18 to expand our self-service options for customers and develop our new focused teams to respond more expertly to specific issues.

We are also looking to develop our use of speech analytics to identify signs of dissatisfaction in our customers at the end of their calls. This will enable us to proactively contact them with help before their experience leads to a complaint. You can read more about what we are doing to provide a better billing experience in the Better information and advice section of this report on page 35.

We want to be a learning organisation that adopts best practice and uses insights into customer behaviour to cascade down to every section of our company about how people should be served. Our aim is that everyone working in the name of Southern Water – whether they are in our operations teams, inspecting the meter or handling a telephone enquiry – knows how to respond with respect and care.

By eradicating as many causes of frustration as we can, we hope fewer customers will need to contact us with queries or complaints while those who do, will be handled better by more highly trained employees.

Case study: Caitlyn Haselgrove, Customer Service Executive – Home Move team

Moving home made easy

Moving home can be stressful for many reasons but at Southern Water, we realised that we had been part of the problem, with some customers having to contact us multiple times as they changed addresses. Our home move process was therefore inefficient and a regular cause of customer dissatisfaction – so we knew we had to change it.

The decision was made to review the whole journey, looking at every stage from a customer's point of view to anticipate what they might need to do and when they might need to do it, to make sure their water services and associated accounts were in place when they needed them, with minimal fuss. We then set up a new bespoke training programme and recruited a new team of advisers who would be responsible for supporting customers through the whole period from leaving one home and moving into the next. The resulting Home Move team are trained to help using whatever channels are most convenient to our customers whether they prefer to call, write or contact us digitally.

By devoting ourselves to making life a little easier for our customers at this stressful point in their lives, we hope to dramatically improve their experience of being served by Southern Water and build positive relationships with these most important of all stakeholders.

Affordable bills

	2017–18		2016–17
	Target	Achieved	Achieved
Customers in genuine hardship provided with improved support	172,300	229,843	194,726
Customers who feel we provide value for money (%)	62	55	57
Efficiency savings (£m) ¹	N/A	128	67

¹ This is a cumulative figure over the five-year business plan period 2015–20.

One of our most important commitments to customers is to keep their bills affordable, whatever their situation and however it may change.

In order to achieve this we committed to the delivery of £200 million of efficiency savings as part of our £1.8 billion investment in our network from 2015–20, improving our services and innovating where we can so these savings can be passed back to our customers.

Equally important to us, is increasing the number of those who need financial assistance on our range of support schemes and tariffs while also helping them to become more water efficient.

Our performance

It is important that our customers feel we provide value for money with the services we offer. We were the first UK water company to introduce a universal metering programme, which has meant that 60% of our customers are now better off, and we have started an ambitious project called Target 100, which will help our customers reduce their water usage to 100 litres a day by 2040. As well as helping to respond to the pressure on water supplies in our region, encouraging customers to reduce their consumption through Target 100 should also have the added benefit of helping to reduce their bills.

During 2017–18 the combined water and sewerage services for an average household cost less than £1.15 per day – around the same price as a loaf of bread. The same bill is going up by 4p a day over the coming year – with the typical combined service bill for a domestic customer costing around £1.19 a day.

When we completed our annual customer survey, 55% agreed that the service they received represented good value for money, compared to 57% the previous year. The answer to this question was as a result of surveying 1,335 customers online or by post during March to April 2018 and we aim to improve our scores year on year.

Our charges are set each January based on a set of price limits agreed by our regulator, Ofwat. In addition, we seek assurance from our auditors and the Consumer Council for Water before they are finalised, ensuring transparency and independent scrutiny.

These charges are clearly broken down in the How we spend your money section of this report so our customers can see, at a glance, how we use the money they pay us. An explanation of how these charges are set and reviewed is also available at southernwater.co.uk/swcharges, which is clearly signposted from our annual billing leaflet.

Efficiency through transformation

Since 2015, three years into our five-year business plan, we have delivered £128 million of cost reductions. We aim to make overall efficiency savings totalling £200 million by 2020.

In order to do this, we are changing the culture of the business to deliver a three-year Simpler, Easier, Better programme to underpin our next business plan 2020–25. This means improving engagement across the business

and getting the basics right so we can start to develop and innovate. Key opportunities have been identified for us to:

- clarify roles, accountabilities and business priorities, aligning teams behind them
- drive improvements in customer experience and build on our regulatory relationships
- transition from costly, reactive operational processes, planning ahead to prevent incidents
- speed up the decision-making process and implementation of projects
- establish a more consistent approach to leadership and management
- make performance visible and drive a focus on compliance.

During 2015–20 we are also investing £15 million in research and development. Alongside an existing partnership with the University of Portsmouth at our Petersfield Wastewater Treatment Works, we are looking at establishing a new group to coordinate an innovation agenda, drive changes in performance, engagement and generate commercial opportunities. Bluewave, as it is known, will focus on finding new ways of working with customers, partners and others, collaborating with our stakeholders, supply chain and companies both inside and outside the sector.

Our support network

Over the past year we have been further developing our relationships with local authorities, housing associations, debt advice groups and agencies like Citizens Advice to better understand the needs of our customers in vulnerable circumstances so, in turn, we are able to offer the right support and help when it is needed.

Since 2015 a total of 229,843 customers have received tailored advice about how to pay their bills and tackle debt. At this point in our five-year plan we had aimed to reach out to around 172,300 so we are very happy that we have already been able to significantly exceed our original target.

Coupled with this advisory service, we also offer a programme of regular home visits – since 2015 we have carried out 95,000 – through our specialist partners who help us to support customers in need. This delivers:

- independent debt management counselling
- advice about how to access help from specialist support organisations within the community
- water efficiency home visits, offering customers advice about how to save water, energy and money
- information and guidance about how to apply for one of our support schemes or tariffs.

The cost of accounting for bills that remain unpaid unfortunately has an impact on our charges so it is also important we do all we can to help those in genuine financial hardship to reduce the burden of non-payment on others. At the same time, we also have to manage our own costs.

We currently offer a range of 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, or for those in receipt of pension credit.
- 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 who owe us money but haven't been able to make a payment for a while.

How we are improving

We now have a larger team of field engagement advisers, who are out and about meeting our customers in vulnerable circumstances face-to-face at community and job centres and housing associations across our region. Working alongside this field team are our new case management leads who are responsible for the end-to-end management of financial assistance applications.

New training delivered across the billing and collections teams and our service delivery partners means customers can be quickly identified as vulnerable or in need of extra support, and transferred to the case management team. By having early conversations with customers we can understand the reasons for non-payment of bills before they run up serious debt. Those who do fall into debt will be taken through a more tailored process by our new collection partners, and a new litigation team, who work together to streamline those more difficult cases, to make the process of debt collection simpler for customers.

We have also established a Vulnerability Steering Group, which includes Age UK, Step Change, Citizens Advice, Sparse (Sparsity Partnership for Local Authorities), Mind, West Sussex County Council and insight consultants, Huntswood.

This group has been instrumental in helping to shape the development of our Reach and Support programme, which is working to set up a cross-regional approach to vulnerability, adopting a leading identification model and offering clear financial support. This work is informing our next business plan for 2020–25.

A sustainable future

The pace of life only ever seems to get faster, and we think our customers' lives are complicated enough without having to worry about their bills. That is why we are working to put in place a plan for 2020–25 that keeps water as affordable as possible.

This means making sure that when we talk about affordability, we think about all of our customers, and particularly those who might need extra help. Our customers tell us that we should be doing more to support those in difficult circumstances, and we recognise that this could be a short-term difficulty or a long-term need for financial help or extra services. Whatever it is, we want to offer the right support when it is needed.

This means getting to know our customers and their needs more closely, through in-depth research and insight as well as through our Reach and Support work with community organisations and charities. We know we also need to expand our financial assistance schemes and create more tailored support options, based on individual circumstances, for example offering budgeting advice and more payment flexibility. We know this also means providing more accessible channels and services.

The work our field teams do is vital in helping our customers understand how precious water is, and how, by saving as much as they can, they can also save on energy costs. As such, we plan to continue our programme of home visits, particularly for those customers who need to use more water, be it for a medical condition or because they have a large or extended family living with them.

James Gearing, Stuart Bailey and Steven Laker, Field Engagement Officers, Affordability team on promoting our schemes and tariffs

We became field engagement advisers in January. Previously, our colleague Stuart was working on his own across Hampshire, Kent and Sussex. Now there are three of us and we have all got our own patch.

The decision to expand the team was based on needing to connect with more of our stakeholders in the field and develop a better working relationship with companies that are already linked in the support sector. Changes to policy at the national level mean that many of our customers are impacted by issues relating to the 'bedroom tax' and Universal Credit. As a result we have created tailored communications, highlighting how our schemes and tariffs can help them budget better. Our job is then to make sure that we are offering our services to a wider audience to try and help as many people as we can, whether that means adding them to our Priority Services Register or getting them on the schemes and tariffs that will help them better manage their payments.

There is a lot of networking. It is about utilising connections that organisations like Age UK, Citizens Advice, housing associations and StepChange have in order to get the message out.

We have found it quite challenging, but we're looking at what things work and what new ideas we can bring to the table in terms of methods, approach and strategy.

We are not going to see instant benefits. If we have four or five meetings this week, we will not see the results from that for a couple of months, after those trusted, well-known organisations start promoting our schemes and tariffs.

Better information and advice

	2017–18		2016–17
	Target	Achieved	Achieved
Water usage, per capita consumption (litres per head per day)	133.69	128.90	131.29
Number of unwanted billing queries	49,000	181,361	145,962
Customers who are aware of the causes of blocked drains (%)	78	82	79
Customers who are aware of how their money is used (%)	61	56	56
Customers who are aware of how to deal with hard water (%)	58	55	56

During 2017–18 we began a consultation process to inform our future plans, including our Drought Plan, Water Resources Management Plan and business plan 2020–25, which we will publish over the coming months.

This consultation process has broadened conversations we were already having with customers about issues such as saving water, transparent charges, prevention of flooding, how we spend their money and hard water management. Our enhanced customer engagement programme means we are now speaking to a wider spectrum of customers than ever before about how we might better overcome current challenges and plan for a resilient water future for the South East. This rich insight-base is driving our day-to-day decision-making and future planning and will continue to do so.

Our performance

Most people only think about water when they pay their bill or something goes wrong, which is why we need to remind them that by saving water they will also use less energy, help to protect the environment and ultimately save more money on their monthly bills. Getting these messages across will help persuade customers to change their behaviour.

Since 2015, when we made a commitment to our customers to achieve a 10% reduction (15 litres per person, per day) in average water use by 2020, we have spoken to more than 95,800 individual customers about saving water and completed more than 11,000 home visits, to install water-saving and energy efficient products.

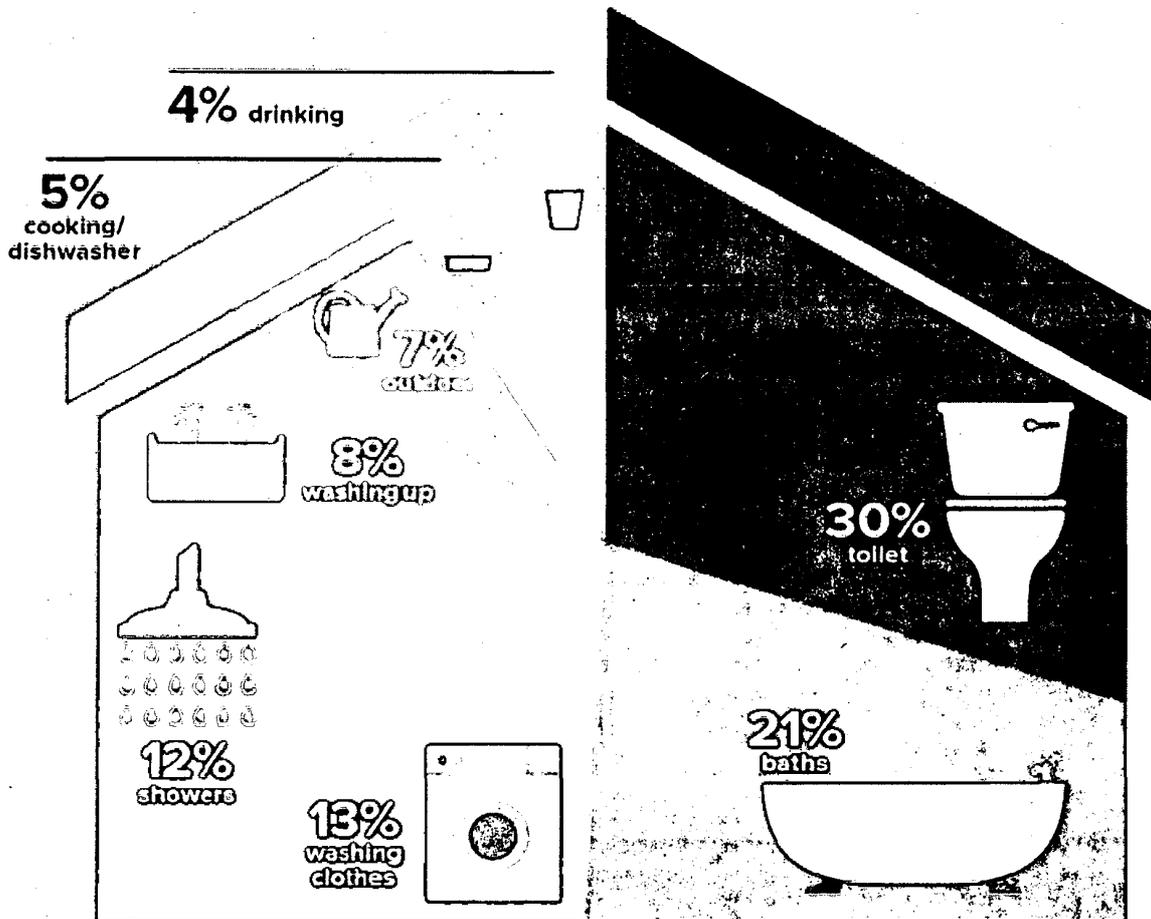
During 2017–18 alone our partners Aqualogic completed a total of 6,178 of these home visits, where they also talked customers through practical, everyday changes they could make in their daily routines to save water in the home and garden. In addition, the water efficiency team has spoken to more than 8,000 customers directly about the value of water at a series of community roadshows across our region and in classrooms and community centres via our Waterwise education programme.

Our continued work with local authorities has also helped us to identify more customers with high water consumption or in vulnerable circumstances who may benefit from water-saving home visits, products and advice to reduce their monthly bills.

During 2017–18 we recorded an average water use of 128.90 litres per person, per day, which is lower than our target of 133.69. This is a decrease on the 131.29 litres per person, per day achieved during 2016–17. This target is based on a five-year average so our per capita consumption figure is in line with the target overall for the first three years. We are pleased that the introduction of water meters to around 90% of our households is continuing to help customers to become more conscious of their water use and make the connection between saving water and reducing bills. You can read about our future plans to encourage customers to go even further to reduce their individual water use later in this section.

In January 2018 alone we proactively contacted 4,736 customers about our water-saving home visits, booking 624 appointments and conducting 498 actual visits.

Average household water use per person, per day



A clear view on billing

Historically, we have underperformed in terms of the number of billing queries we receive, and again this year we have recorded a high level of customer contact, which is why we are constantly reviewing our processes and the reasons why customers contact us.

The majority of complaints we received during 2017–18 were to do with consumption levels, with customers assuming their reading is wrong. Irregular billing cycles were identified as the root cause of this confusion as sometimes the bills would be low and sometimes high. As a result, this cycle process has now been changed with billing teams adopting a ‘right bill, right way, right time’ approach.

Despite such efforts to reduce the number of billing enquiries we received we have still seen an increase in the reported number of unwanted calls, recording 181,361 against our target of 49,000 – these are unwanted from a customer point of view. For example, the starting point or driver for the call may be a billing enquiry but, if at any point during the call, the caller expresses dissatisfaction, then the call moves into ‘unwanted’. This increase is largely due to the fact that the categorisation criteria was changed to make it more consistent during 2016–17, allowing us to more accurately report calls.

Helping customers to keep it clear

We are now three years into our five-year, £1.4 million blockage reduction programme and our fat, oil, grease (FOG) and unflushables team has visited and offered sewer flooding prevention advice to more than 38,000

customers in 1,700 high blockage hotspot locations. The team has also inspected nearly 7,400 manholes, and presented to 250 different customer groups, at days of action or visits to community centres or housing associations.

Our FOG enforcement officers have also visited 1,900 food businesses across our region, in partnership with local authority environmental health officers (EHOs) and, in some cases, the Environment Agency. In many cases, with the support of these EHOs we have been able to prosecute repeat offenders, and convince local councils to include grease management provision in the planning application for new restaurants and catering businesses.

This hard work has seen us beat our target to have a minimum of 78% of customers being aware of the causes of blocked drains, achieving 82% of customers at year-end.

How we spend customers' money

While we are still the only option for water services for our household customers, we see it as an obligation to make sure we are clear about our charges and how we spend the money customers pay us.

Currently around 56% say they know how we spend their money. Although this figure has remained the same as in 2016–17, we aim to build awareness and increase transparency by providing customers with:

- regular updates against our promise commitments through annual reporting, our stakeholder newsletters and promotion on our website and social media channels
- clearly signposted information about our performance from our 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 2017–18, we attended 25 events, talking to more than 20,700 of our customers
- regular updates on our capital construction schemes, particularly for customers directly affected by our planned improvement work, as well as local media and key stakeholders. Our dedicated capital delivery communications team has sent more than 41,000 letters and dealt with more than 1,800 individual enquiries, linked to 86 different schemes under construction during 2017–18.

Helping customers manage the issue of hard water

The water we supply to our customers is largely drawn from underground chalk aquifers (layers of water-bearing rock) where levels of calcium carbonate are high, resulting in it being considered quite hard. But as levels of calcium carbonate do not affect the quality of the drinking water we provide, we do not add any softeners at our treatment works.

However, we know that hard water can affect customers' household appliances so we offer advice about how to address the issues caused on our website, which includes a postcode tracker. Our water distribution teams also offer Water in the Home advice booklets to customers that contain practical tips and useful contacts for homeowners.

In our annual survey to track customer awareness of our performance against our business plan commitments, 55% of customers said they were aware of how to deal with hard water. This figure has slightly fallen since last year, despite an awareness campaign on social media directing customers to advice at southernwater.co.uk/how-hard-is-your-water.

How we are improving

Our customers need water for pretty much everything they do, which is why we know that in a water-stressed region, with population growth and climate change impacting our water sources further, we need to work harder to educate our customers about using water more wisely. The good news is that our most recent customer research and stakeholder engagement work has also shown that customers want to know more about how to use water more efficiently, and they want incentives to save it so we know we can work more collaboratively with them in the future.

This year's River Itchen Challenge pilot in Hampshire is one example of this collaborative approach. This 12-month water efficiency campaign targeted a district-metered area using much higher than average amounts of water, per customer. The project tested the concept of a community reward, which would see the money saved as a result of its reduction in water demand used to fund good causes locally. The project achieved a 5% water saving compared

to neighbouring areas. This pilot was also shortlisted for the Utility Week Stars Awards.

To go even further and help those who want to understand just how much water they are using through real-time displays and bespoke information, we also now have a project underway to enable existing meters to link to an in-home display. If this proves to be cost effective, we hope to roll it out relatively quickly to improve the customer experience.

Reducing billing queries

Over the past year we have focused on getting more customers to transact with us online, while at the same time looking to simplify and better explain our billing information. We hope that this self-service option for customers will mean they can access the information they need more easily and reduce the number of calls they have to make to answer billing queries. We have also made improvements in other areas of Customer Service that will support these changes. These include:

- restructuring our Customer Service department to better serve customers by offering them a single point of contact who can resolve their queries
- a review of all the steps involved in the billing and payment collection process – which included looking at changing our billing cycles to make more practical usage information available to customers and developing a more streamlined and tailored debt recovery process
- the expansion of our specialist Home Move team, to better serve customers moving into, within or out of our area
- reviewing and improving our Cash Collection and Affordability teams to make them more approachable for customers who may be in vulnerable circumstances so that they get the extra support they might need
- making improvements to our customer online portal Your Account – allowing customers to directly manage their account at their own convenience, access usage information and simplify their payment process
- a new Customer Experience team to map out every interaction that customers might need to have with us so that we can improve the way we manage these points of contact right across the business
- a new culture within Customer Service that drives better services for customers by bringing teams together to collaborate on resolving complex issues, and which rewards exceptional performance by employees who hit targets designed to improve customer satisfaction.

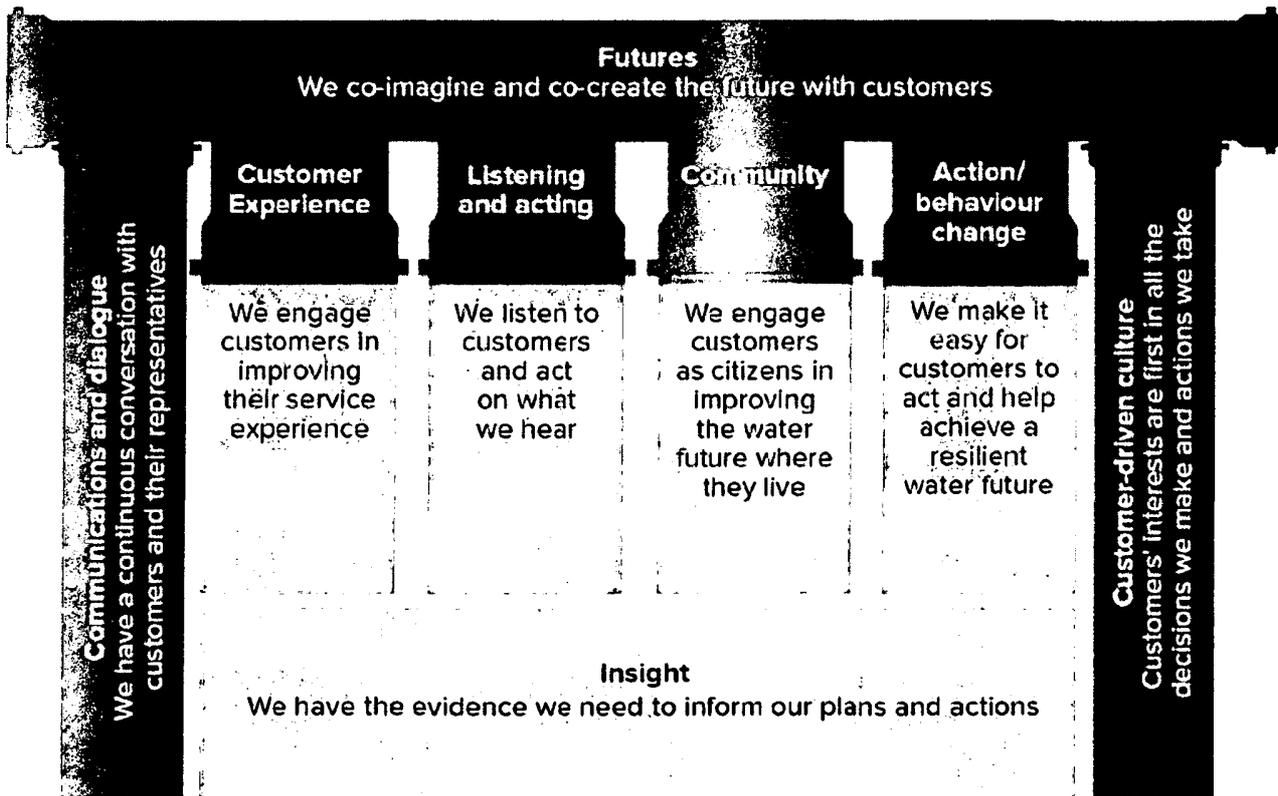
A clear case for collaboration

Our network protection officers have been sharing best practice from their work with food businesses for some time, chiefly with the British Water FOG forum and Water UK. To date the team has also delivered training sessions to eight other water companies, to help improve their blockage reduction programmes.

The team has also been looking at new ways to engage different groups of customers – visitors to our region, future customers and students, for example – and have developed a new augmented reality education experience, which will be used at college and university events and Science, Technology, Engineering and Mathematics (STEM) fairs. This alongside the next instalment of our Unflushables film, on our YouTube channel, will deliver the blockage prevention message to a younger audience.

A sustainable future

As already mentioned, our enhanced customer consultation process has broadened the conversations we were already having with customers, to include capturing their views about how we can better provide resilient services for the future. Inspired by Ofwat's Tapped In document, which champions customer participation in helping to achieve a successful long-term future for water in England and Wales, we have also now established a new engagement framework (see diagram below). It will ensure that our customer insight programme becomes part of how we do business, every day, and that engagement is always high quality, broad and ambitious.



So far, it has involved our dedicated stakeholder, customer research and communications teams hosting more workshops, conducting more interviews and surveys and using new techniques, such as choice experiments, apps and online polls, to increase our level of insight. All of this will help us better tailor our services to customers' needs but, more importantly, ensure our plans for the future reflect their priorities.

Our water future

As a leader in water efficiency and metering we are in a unique position to carry on setting the standard in demand reduction, which is why we have just set a bold, new and UK-leading demand reduction target to reduce water consumption to 100 litres per person, per day across our region by 2040.

Through Target 100 we will:

- make better use of our data to provide more customers with bespoke water-efficiency support – including products and advice
- use a range of levers to incentivise customers to reduce their consumption and maintain low levels of usage
- encourage new homes to be even more water efficient through incentives and the planning process
- pressure government to introduce water labelling across all products to increase customers' awareness of how much is used to create them
- upgrade all our meters to smart meters – giving customers access to real-time information
- educate customers on the true value of water to instil lasting cultural change.

We will be working in partnership at every step of the way and using our influence with other water companies and stakeholders to push for universal metering – regardless of water-stressed status.

Fewer flooding and pollution incidents

We know that dealing with a sewer blockage can be really distressing for our customers so in terms of blockage prevention, in the near future we will be:

- supporting the development of new materials for wet wipes which can be safely flushed down toilets without causing blockages
- seeking out more opportunities to work with partner organisations to help keep rainwater and groundwater out of our sewers and so increase their capacity and reduce flooding
- inspiring and incentivising communities to take pro-active, collective action to help keep their local sewers, pumping stations and treatment works clear of blockages.

We will also be putting ourselves forward to take the lead on flood protection, bringing together the separate parties who currently play a role to co-ordinate new sources of funding. This will enable us to harness new technology, such as smart sensors, across our entire wastewater network so we can find and fix blockages as they happen and prevent flooding and pollution.

CASE STUDY: Cory Reynolds, Head of Communications – Communicating in a crisis

Our priority in any crisis is to keep our customers informed and to support them in any way we can. When earlier this year our region was hit by extreme weather conditions, we knew we needed to get urgent messages to all those affected.

As pipes froze and burst, around 11,000 of our customers were left without their water supply – 251 of whom were without their supply for between two and three days. This was as unacceptable to us as it was to them, and we worked around the clock, tripling our front-line staff numbers, to get households reconnected.

During and after the event, water companies were understandably asked to explain their actions and criticised for an apparent lack of preparedness.

We had planned for typical winter conditions and also committed an additional £80 million in part to upgrade our pipe network by 2020¹.

As soon as weather reports predicted the freeze, we mobilised all of our channels – SMS, Facebook, Twitter, our website, broadcast media and regional newspapers – to deliver notifications, updates and advice to customers across the region. Our media team worked on a 24/7 rota, liaising with local resilience forums to provide joined-up emergency responses.

Customers in vulnerable circumstances were identified through our Priority Services Register. On our digital channels we asked people to alert us to anyone that might need help. Our central planning team then organised door-to-door visits to those households. Hospitals and schools were contacted to help plan their water supply needs, while our colleagues in the Stakeholder team ensured timely messages were received by community leaders.

It's fair to say there were issues that could have been managed differently. Information on bottled water availability, for example, did not always go smoothly. However, we've been focused in recent months on using what we learned during the freeze and thaw to revise processes and procedures to help us respond better in future events.

¹ For more information on creating a resilient network, see the section on Delivering reliable services, which starts on page 41

Delivering reliable services

A constant supply of high-quality drinking water

	2017–18		2016–17
	Target	Achieved	Achieved
Overall drinking water quality index (%)	100	99.96	99.96
Number of contacts regarding discolouration (per thousand population)	0.82	0.82	0.74
Leakage (million litres of water per day)	87	89	88
Customer minutes lost supply > 3hrs	9	17	7
Number of properties with low water pressure	257	243	222
Number of customers affected by temporary use bans	0	0	0
Asset health	Stable	Stable	Stable

We promised our customers that we will provide high-quality drinking water and in 2017–18 we achieved 99.96% compliance with the Drinking Water Inspectorate's (DWI) quality measures.

Protecting public health is the most important aspect of supplying a continuous, high-quality water supply. Water can be contaminated by physical substances such as organic matter, chemicals such as pesticides, biological organisms like bacteria and radiological elements like radon. The potentially devastating effects of a poor water supply not only affect people, but animals, wildlife and the habitats that support them. Therefore, keeping our water clear of pollutants is our most vital function.

As well as continuing to address the reliability of our water supplies and levels of leakage from our network, we introduced a range of initiatives this year including stricter sampling, reporting procedures and a more holistic approach to water management. These, plus our plans for extensive upgrades to our network, are expected to improve our performance as well as making our water supply more resilient in the years ahead.

Our performance

We always aim to comply with the DWI's quality measures, however, during 2017–18 we experienced eight taste and odour tests in Hastings that did not meet our high standards. We have subsequently made improvements to our water treatment processes such as replacing the sampling taps at our service reservoirs. The first changes were made in March 2018, and more are scheduled for completion in September. We are confident that these upgrades will address the issues that occurred in Hastings.

Although there was a rise in the instances of discolouration last winter, we met our target to keep such cases to less than 0.82 per 1,000 customers. There were no specific incidents responsible for this year's slight rise but discolouration usually happens when the flow in a pipe increases significantly or changes direction. Bursts in old iron and steel water mains can cause this. We periodically flush out the mains to fix the problem and are also planning longer-term programmes to proactively replace mains. We will also be making greater use of diagnostic equipment to detect weak points along our network so these can be repaired before they affect our customers.

We were disappointed to miss our leakage target of restricting water loss from our network to 87 million litres per day. We ultimately recorded a figure of 89 million litres. We are looking at the factors which may have contributed to this water loss, such as pressure on our network from extreme weather, and later in this section you can read about how we are tackling leakage now and our plans to build greater resilience into our network in the long-term.

Bursts due to fluctuations in temperature, ground movements and defective pipes can all lead to interruptions in water supply. While we continually monitor the serviceability of our mains, in a network of nearly 14,000 kilometres, some level of bursts is inevitable.

One of our performance targets in this area focuses on customers who are inconvenienced by a supply interruption that lasts longer than three hours. In 2017–18, the average number of minutes that our customers were without water for a period longer than three hours was 17 which missed our target of nine minutes. The figure for 2017–18 reflects the impact of the freeze and thaw event in February and March of 2018.

We are pleased that the number of properties experiencing low water pressure was kept lower than our performance target of 257 at 243, although we continue to work with customers to eradicate this problem altogether. We are continuing with our programme of introducing pressure controls along our network that control water flow at peak times to reduce wear and tear on pipes.

During 2017–18, none of our customers experienced a temporary use ban – such as a ban on using hosepipes. However, our drought plans are continually updated to accommodate changing weather patterns and our focus on resilience means we always aim to ensure we are fully prepared to secure customers' water supplies rather than to wait and see what the weather brings. We recognise how vulnerable the region is to the effects of dry weather and remain ready to take whatever preventative measures we can to support our customers.

This year we have continued to invest in our treatment works and pipe network and our asset health has been reported as stable to Ofwat. This means we have met or exceeded all the performance measures required.

How we are improving

Better water quality

While we achieved 99.96% compliance with the DWI's quality measures during 2017–18, our aim is to reach 100% and, at the very least, keep improving.

As we stated in the introduction to this section, protecting public health is the most important aspect of our water supply operation. Therefore, in 2016–17, action plans were put in place to begin addressing concerns raised by our regulators about some of our monitoring and reporting processes. In 2017–18, we made some progress in these areas but we know we need to do more, and are committed to continue tackling weaknesses in our data-recording systems, business processes and staff training. We signalled our commitment to improve in 2017 by setting up a new Compliance and Asset Resilience directorate.

To reassure our customers, stakeholders and regulators about the integrity of our drinking water measures, this new data compliance team has introduced an enhanced programme of collecting and verifying our data from the planning and scheduling of water sampling through to reporting our results. We are also building stronger relationships with our regulators to help improve the way we work together to achieve common goals.

One way to protect the quality and reliability of customers' drinking water is to improve the equipment we use in our treatment processes. Our ongoing investment programme to upgrade our assets meant that during 2017, we supported a range of projects to improve our water supply. These include:

- The completion of an £8 million scheme to replace 30 kilometres of water mains serving around 4,500 properties in Medway, Kent. Customers in the area now have a more reliable supply of drinking water, stronger, more durable pipes, a reduced risk of bursts and fewer leaks.
- A new trunk main to transfer water from Portsmouth Water Gaters Mill WSW (water supply works) to Southern Water's customers in South Hampshire. The work is part of our South Hampshire water resource plan and wider water mains renewal programme taking place throughout the region. It is also designed to avoid having to take water from the River Itchen in times of severe drought to help protect the river's ecology.

Alongside maintaining and improving the hardware and equipment we use to treat and deliver a wholesome water supply we are also investing in a skilled workforce. We make sure our employees are trained appropriately to perform their jobs and in 2017–18, we completed a series of initiatives to further improve this training.

We also launched Water First, a programme which aims to better identify and manage risks to drinking water through robust and transparent reporting on water quality, regular review of best practice within our sector and continued collaboration with the DWI.

Through the Water First programme we have analysed the entire water cycle – the way we collect water from natural sources, the way we make it safe to drink and how we distribute it to our customers. We have also looked at how we monitor water quality and report back on our findings. From this analysis, we have designed a schedule of improvements to be made from 'source to tap'.

The programme will also conduct a detailed review of risks at our water supply works, building up the information we have about the status of our networks, improving our operating procedures and examining how we can respond better to extreme incidents. We will also look at how we can provide better information to our customers and regulators.

One of our key reporting metrics with the DWI is changing. Mean Zonal Compliance (MZC) will be replaced with Compliance Risk Index (CRI) and the additional metric of Event Risk Index (ERI). The new measures are due to come on line for full reporting from 2020. They are designed to reflect the risk related to a single consumer. Ofwat will make CRI a compulsory measurement (like the current MZC has been). ERI will be an optional reporting metric. Most of the input on the CRI relates to our performance, with key inputs from performance of our treatment works, storage and distribution assets. This work is a central feature of our Water First improvement programme which includes investment in key water assets.

Less leakage

Currently, we have an expanded leakage team in place, made up of more than 120 people. They are focused solely on finding leaks in the network of water mains. Additional support is provided by a further 160 Southern Water employees and contractors who also detect leaks and repair them.

In certain instances, we are also offering to fix leaks for free on some customers' private supply pipes during 2018, which will allow problems to be addressed more quickly.

Our total annual spend on finding and fixing leaks in 2017–18 was £14 million. Our teams identified and repaired more than 24,000 leaks on our network, an increase on 20,000 in 2016–17. Over 15,000 of these were found and addressed proactively by our leakage team, the remainder were reported to us by customers via our technical team. We also identified 3,000 leaks on customers' private supply pipes which meant they could take action to help stop water damage to their property or higher usage bills.

We also make use of leak alarms in the meters we installed under our universal metering programme. The alarms alert our engineers to unexpectedly high water consumption and enable us to contact customers even before they might know an issue exists.

Encouraging more careful water use

While we are still taking less water from the environment (abstraction) than during the last major drought of 1976, we have seen an increase in customers of around 19% in this period and significantly less rainfall across our region due to the impact of climate change.

To mitigate these challenges, we have been proactively liaising with stakeholders in our region, such as farmers, landowners and local authorities, to prepare for a range of different scenarios including drought conditions. We have also targeted whole communities to encourage them to reassess how they value and use water. See our Better information and advice section to read more about our water efficiency initiatives, on page 35.

A sustainable future

In 25 years we will have lost a third of our water sources through climate change, seen a reduction in the amount of water we are allowed to take from rivers and underground sources, and our population will have grown by 20%. We have been preparing to meet these challenges, and you can find out how by reading our Water Resources Management Plan, available at southernwater.co.uk/our-reports.

We are also looking at new ways to help customers better manage their water use and/or manage leaks, in real time. For example, a pilot project called Waterbit is looking at a device that would link customers' meters to a device in their homes, and then display usage information via a digital app.

Our current water efficiency home water-saving visits will continue targeting customers who do not have meters, have regular high consumption and have ageing toilets and high flowing showers. We are also planning to combine our water efficiency and leakage detection work into potentially one visit for the resident while working in partnership with neighbouring water-only companies to expand the scheme to more customers in the South East.

As mentioned in previous sections, we have set ourselves a stretching target to reduce water use to 100 litres per person, per day by 2040. Our Target 100 project will build on our current water efficiency programme and enable us to build more partnerships with stakeholders and customers concerned about water waste. For more information about this industry-leading campaign see our Better information and advice section on page 35.

As part of Water First, we are already taking action to make our water supply network as resilient as possible by using satellite technology to find and fix leaks. While in the longer term, our Networks 2030 initiative, that forms part of our business plan 2020–25 will rationalise and automate the whole of our supply network. These plans include installing 2,500 smart water-quality sensors by 2030 and replacing 490 kilometres of water mains by 2025.

Networks 2030 will link with Target 100 to encourage customers to lower their water consumption while we propose to recycle as much water as we can. Together, these initiatives will help ensure that we can supply safe, clean water for future generations of customers.

Removing wastewater effectively

	2017–18		2016–17
	Target	Achieved	Achieved
Number of blockages per km	0.58	0.49	0.55
Number of internal flooding incidents	414	401	448
Number of external flooding incidents	9,694	7,106	8,009
Number of customer complaints regarding odour	390	381	326
Asset health	Stable	Stable	Stable

Of a £3 billion budget to operate, maintain and improve our assets between 2015 and 2020, £1.8 billion is being specifically directed into building new and upgraded wastewater and water services. This investment continued to deliver results for customers this year.

The number of sewer blockages and internal and external flooding incidents all fell significantly and our network remains stable as we continue to limit the number of sewer collapses and mains bursts.

However, we are still looking at how we can boost our use of new technologies and adopt more proactive working methods so we can build resilience into our wastewater service in order to survive the pressures of population growth and fluctuating weather patterns.

Our performance

We promised our customers that there would be no increase in the number of blockages in our sewer network from 2015–20. In 2017–18, we surpassed our target of limiting blockages to fewer than 0.58 per kilometre with a final figure of 0.49.

We have also reduced the number of instances of internal flooding. The total number of internal floods for 2017–18 was 401 compared with 448 incidents at the same point in 2016–17. This has been achieved by not only responding to the initial incident, but by applying a joined-up approach involving a specialist team of area managers, technicians and service managers.

An investigation team uses new technologies and camera equipment to understand the root causes of the flood and the team decides together on the best course of action to fix the problem straight away. This has cut the average number of repeat incidents of internal flooding year-on-year. This joint problem-solving approach is therefore working and although we believe every incident is one too many, we are pleased to be on track to deliver our promise to customers of cutting the numbers of internal floods by 25% by 2020.

The number of external flooding incidents also fell in 2017–18 to 7,106 compared with 8,009 in 2016–17. 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. However, using techniques such as predictive modelling, we can use data to plan ahead for different scenarios.

While the number of customers bothered by smells from our treatment sites during 2017–18 was less than the target of restricting complaints about odour to below 390, we were disappointed that this was still an increase from the figures recorded in the previous year. Part of the rise in complaints has been due to the adoption of 600 pumping stations which were previously privately owned and for which we had no prior control over standards. These accounted for 32 complaints between January 2017 and January 2018. We have also seen a rise in complaints at our Ashford Sludge Treatment Centre where we have subsequently introduced mitigation measures while we carry out further investigations into the cause of the issues.

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.

Meanwhile, 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 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.

Among the projects in which we have been investing to improve our wastewater service are:

- an ongoing multi-million pound redevelopment of Woolston Wastewater Treatment Works in Southampton
- the completion of work to replace damaged sea defences next to the historic Fort Cumberland site at Eastney, Portsmouth. The new defences will protect the fort and two of our underground storm tanks which are vital in helping to prevent flooding in the city
- the continuation of a £16 million upgrade to our wastewater treatment works at Eastbourne. The site, which serves a population of around 140,000 people, is undergoing a major refurbishment to improve how it treats up to 86 million litres of wastewater a day.

How we are improving

Fighting blockages

It costs around £1.8 million every year to remove blockages from our sewer network so alongside our customer awareness programme we are developing a new risk-based mapping system. This will help us identify sewers at greater risk of blocking with the aim of moving away from reacting to blocks once they have formed, to proactively jetting sewers to keep them clear.

Meanwhile, our Zero Flooding Project, which began in 2017, is looking at decreasing the number of sewer floods in 10 towns and cities across our region – Brighton, Eastbourne, Herne Bay, Maidstone, Margate, Portsmouth, Ryde, Sheerness, Southampton and Worthing. It uses several innovative tools, methods and materials to help understand and improve the way our sewers respond to different circumstances. It will also try different targeted communicational campaigns in different zones to see what works best with our customers in getting them to change their behaviours in terms of what they dispose of through the system.

Network resilience

Our customers expect us to provide an infrastructure that is fit for purpose. We are therefore not only continuing to maintain and replace our existing network where necessary but introducing new structures to allow for future demand on our services.

One such project, due to start in the next year, involves building a 10-kilometre sewer pipeline that will run from the west of Chichester in Sussex, across the north of the city and through to Tangmere, where it will connect to our Tangmere Wastewater Treatment works. We will also upgrade and expand the existing sewer network and provide three new pumping stations to take away and treat wastewater from proposed new homes, identified in Chichester District Council's Local Plan.

The proposal will be sensitive to the local environment and a detailed Environmental Impact Assessment has already been carried out by working closely with local authorities, as well as organisations such as Natural England, the Environment Agency, Sussex Wildlife Trust and Highways England. Our work has included surveys to look for badgers, reptiles, bats and birds, among others. We hope to have completed the project within two years.

We also work with our colleagues in other water and sewerage companies to take a national approach to common issues such as planning for future changing demands on sewer capacity and flood risk. This work is part of the 21st Century Drainage Project being delivered by the organisation UKWIR (UK Water Industry Research) to help prepare the UK for threats from any fluctuating rainfall patterns that could accompany climate change.

A sustainable future

Recycling

The efficient disposal of wastewater requires us to protect the wider environment as well as provide our customer's homes with an essential service to help keep their homes sanitary.

Critical to ensuring a sustainable future for our region's water services is therefore, the development of better recycling opportunities. See the section on Protecting our natural resources on page 48.

We are also looking at turning our state-of-the art treatment works at Peacehaven in Sussex, into a resource hub where we can provide recycled water for agriculture, industry and households. To set an example, we are also proposing trials of rainwater harvesting to enable captured water to be used in our wastewater processes at our own sites.

Influencing

We propose to build stronger relationships with developers, local authorities and the Environment Agency to plan for population growth and encourage more sustainable practices. In our next business plan for 2020–25, we are looking into offering discounts to new properties that are more water efficient and use 'grey water' from washing machines, baths, showers and washing-up water, to flush toilets.

An example of where partnerships with developers are setting the standard for future projects is in Fawley, Southampton where we are already liaising with a local developer about proposals to build 1,500 new homes. We are advising on how the development might incorporate sustainable water practices.

Tackling blockages and floods

As well as investing in our pipes, pumping stations and sewers to cope with extra customer demand, we are also continuing our work to embed behaviour change in our communities to persuade customers to be more careful about what they pour down the sink or flush down the toilet.

We are also upgrading and expanding our network to ensure we support sustainable growth and this means adopting new technologies. Our Drainage 2030 initiative, written into our business plan 2020–25 will look to automate our drainage networks, enabling us to respond faster to blockages, fix leaks, create more capacity and reduce energy use. Better drainage will also help us to protect the quality of our bathing waters while sustainable drainage systems will provide new green spaces in towns and cities. More on Drainage 2030 is in the section on Protecting our natural resources which starts on page 48.

Our document, Southern Water Futures, also provides information on our plans for a joined-up approach to the resilient and environmentally responsible management of our water resources. It can be read in full at [southernwater.co.uk/our-reports](https://www.southernwater.co.uk/our-reports).

Protecting our natural resources

Looking after the environment

	2017		2016
	Target	Achieved	Achieved
Wastewater treatment works compliance (%) ¹	100	99.66	99.32
Maintain bathing waters with 'excellent' water quality at 54	54	53	51
Number of serious pollution incidents (category 1 and 2) ²	4	4	3
Number of less serious pollution incidents (category 3) ²	158	131	143
Distribution input (the amount of water we put into supply in million litres per day)	525.77	541.00	532.28
Renewable energy use (%)	16.5	17.2	17.0

¹ An explanation of our wastewater treatment works compliance is on page 49.

² We have undertaken further external assurance of the category 3 pollution data collected during 2016–17 and 2017–18, and have identified a number of issues with the processes and systems used to generate the spills data which are the subject of an ongoing improvement plan.

We are dedicated to not only conducting our business in a way that causes the least possible harm to our natural resources, but to be a force for good in promoting and protecting the region's water and wildlife habitats.

Yet, despite this commitment, it has been a year of mixed results in terms of our environmental management. As you will read in the more detailed performance section below, in 2017 Ofwat began an investigation into the management, operation and performance reporting of our wastewater treatment works. We know that the performance in this area is critical to ensure the water we recycle to rivers, streams and the sea does not harm the environment and so, as part of company-wide plans to review and improve our processes, data collection, monitoring, training and culture of transparency, we are working with our regulators to address the specific issues surrounding our wastewater treatment works.

We were also disappointed to miss our target for restricting the amount of water we take from the environment to maintain the water supply to 525.77 million litres per day. We achieved 541.00 million litres per day and so we will be continuing our water efficiency initiatives and measures to cut leakage along our pipe network.

Meanwhile, we are pleased to report that this year our bathing waters were judged to be among the best in the UK with all 83 of them meeting the required quality standards and 53 rated as excellent – two more than in 2016. We have also continued to make progress in replacing traditional energy sources with renewable supplies wherever possible in our day-to-day operations.

Our performance

Our aim is for every one of our wastewater sites to be fully compliant with the required standards set for us by our regulators. Although we achieved 99.66% compliance in 2017–18, we know we have much more to do.

To raise the performance levels of our wastewater treatment works in 2017–18, we:

- created a compliance monitoring framework to highlight and manage risks
- used 24/7 online monitoring to identify where problems are emerging and react quickly
- used mobile equipment to mitigate short-term issues and manage compliance risks
- rolled out structured operator skills-training, developed in-house, across our wastewater business

- invested £237 million in wastewater assets (sites and equipment) to improve compliance and meet new regulatory measures.

There are 83 designated bathing waters within the Southern Water region, managed by 21 local authorities. For the first time in several years, every one of them achieved the minimum standard of classification in 2017.

Despite just missing our target to have 54 in the 'excellent' category, we are pleased to be considerably above the threshold set for us by Ofwat of having to achieve 48 excellent bathing waters or face a penalty. The 53 bathing waters achieved is our best performance since 2015, and an improvement on 51 achieved in 2016–17.

We provide a significant amount of data to the EA and Ofwat 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 are committed to transparent reporting of high quality data that can be trusted by our customers, stakeholders and regulators.

We face investigations from the Environment Agency regarding the performance of certain wastewater sites and an investigation by Ofwat into the performance of our wastewater treatment sites and the reporting of relevant compliance information. We are working proactively with the Environment Agency and Ofwat to resolve their investigations which are still evolving. At this time, no clarity of the findings of these investigations or further action and associated financial impact, if any, can be quantified.

In our 2016–17 report we identified the need to review and improve our end-to-end reporting processes with a view to implementing process and control improvements. Our review has identified that we have fallen short of these high standards and we have identified shortcomings in the application of our business processes. We take these shortcomings seriously and have prioritised improvements in controls with regard to our self-monitoring of Wastewater Treatment Works performance. These improvements are already being implemented via additional internal controls and internal assurance and an improved culture with focus on trust and transparency.

Our new Compliance and Asset Resilience directorate is leading improvements in data integrity and the planning, scheduling, monitoring and performance reporting to the Environment Agency and Ofwat. Further information on this programme can be found in our Final Assurance Plan 2018, which is available on our website southernwater.co.uk/our-reports.

We have significantly improved the level of internal assurance which has enabled the independent external assurance of 2017 data. We have also carried out this improved assurance on 2016 data which has identified a need to correct previously reported performance for Wastewater Treatment Works – population equivalent, and Wastewater Treatment Works – number of failed works. We are currently reviewing the 2015 data and it appears that Ofwat Outcome Delivery Incentive penalties may have been applicable in respect of the 2015 calendar year. The additional technical assurance that we have carried out on wastewater treatment performance data is now being rolled out for the years 2014 to 2010.

It is likely that we will be required to make future revenue adjustments and/or pay penalties and fines in relation to any restated figures. The Ofwat investigation could result in Ofwat taking enforcement action which may include the imposition of a financial penalty, which could be material in nature as Ofwat can impose a financial penalty of up to 10% of turnover for each breach. Any penalty or fine will be dependent on a consideration of the severity of the findings of the investigations. These will be subject to ongoing discussion and agreement reflecting, amongst other matters, the mitigating actions being taken by the company to respond to these matters after review.

Our aim is to eradicate all serious pollutions caused to local rivers, streams and beaches by our operations by 2020 and we have already introduced a number of improvements to make this happen. These include closer monitoring of our network using digital equipment to track and fix defects in our sewer network while getting a better understanding of how our sewers react in times of pressure caused, for example, by extreme rainfall. We have also improved liaison between teams to identify and flag up potential problems earlier, as well as taking proactive steps to remove surface water from foul water in combined sewers to prevent flooding that can lead to pollution.

We promised our customers that we would reduce the amount of water we take from the region's rivers and underground sources while continuing to meet demand for high-quality drinking water as the population grows.

In 2017–18, we took 541.00 million litres each day from our local water resources – higher than the target we had been aiming to stay within of 525.77 million litres per day. Although the amount of water we take has been steadily decreasing since 2004 when it peaked at 599 million litres per day, we are disappointed to have missed our target.

There is no single reason for this increase, although climate change, population growth and water usage all play their part.

We are taking steps to secure a more resilient water future for the South East, and our Southern Water Futures publication and Water Resources Management and Drought plans, outline, among other things, our intention to reduce leakage on our network and continue to promote water efficiency. To read these in full, visit southernwater.co.uk/our-reports.

We promised to increase the proportion of renewable energy we use at our sites to 16.5% by 2020. We are therefore pleased that in 2017–18, we exceeded this by taking 17.2% of the energy needed to power our business from sustainable sources. Of this, 17% was from waste and 0.2% was from solar power.

These sources include converting biogas generated as a by-product of our wastewater sludge digestion, into electricity.

How we are improving

Tackling plastic

One of the biggest threats to wildlife in water habitats comes from plastic. In 2018 we introduced a plastics policy to minimise its use at Southern Water's own sites, and as a result we also issued reusable bottles to employees.

This wide-ranging policy, the first of its kind for a water company, includes:

- Carrying out an audit of our plastic use and setting targets for reduction.
- Working with our supply chain to reduce plastics and increase recycling rates.
- Cutting out single-use plastics in our offices and operations, wherever possible.
- Helping promote water bottle refill schemes across our region to reduce reliance on single-use plastic bottles.
- Expanding our Unflushables campaign to highlight the environmental impact of plastic waste.
- Funding academic studies into the removal and recycling of plastic waste.

To cut down on the use of single-use plastics such as drinks bottles, we are trialling a partnership with the national Refill scheme in Brighton which we hope to eventually roll out across our whole region in the next few years.

We have already prepared the way for the scheme in 2017 and by April 2018 we had established partnerships with 30 venues in Brighton and Hove to offer tap water to their customers and display messages about where water comes from. We hope this figure will rise to 100 or more by the end of 2018.

This partnership with Refill also sees us working with the Sugar Smart campaign to promote the health benefits of water and reduce the consumption of sugary drinks in the 11-18 age group. And we have joined forces with the Healthy Choice Award – an initiative being run by the Food Partnership and Brighton & Hove City Council to encourage food outlets across the city to promote healthier food and drink options. This will involve providing customers with access to free drinking water.

Other groups with whom we are collaborating on the Refill project are:

- The Living Coast – an organisation that promotes projects to raise water awareness, water efficiency and green infrastructure such as rain gardens and Refill.
- City to Sea – the company which signed an agreement with Water UK to promote Refill schemes across the UK.
- The Greater Brighton Economic Board – a public/private initiative that stretches from Adur District in the west to Lewes District in the east and then extends up to Crawley and Gatwick in the north. It is formed to promote sustainable development and, as part of its remit, has commissioned an Infrastructure Panel and Water Working Group that are both chaired by Southern Water.
- Brighton & Hove City Council – which is fully behind the wider consortium to promote public health, reduce waste and show the link to the local environment of high-quality drinking water consumption.

- The Sustainable Business Partnership works – which works across the area engaging businesses in different aspects of waste, energy and water issues. Southern Water has partnered with them in the past to promote our small business water efficiency visits.
- Public Health at Brighton & Hove City Council – a division which sits alongside the city council to promote proactive health prevention strategies.
- WaterAid – the charity which works with developing countries to promote access to safe, clean drinking water.

In February 2018, Southern Water delivered its funding to prepare for the Brighton pilot of Refill.

Developing stronger partnerships to tackle pollution

Our catchment management schemes work with farmers and other land users to look at how we can reduce the amount of pesticides and fertilisers that can affect water quality in natural sources and threaten wildlife. An example of this is the Brighton Chalk Management Partnership, which is reducing the amount of pollutants, like nitrates, from entering water supplies. We are also working with the University of Kent on an innovative project to help us predict what our catchments will look like in the future.

Meanwhile, we have engaged Natural England to work with farmers on our behalf, in seven areas near rivers to primarily tackle pollution caused by metaldehyde, a slug repellent. The project will also help reduce the presence of other pollutants that affect water quality such as pesticides, nitrates and faecal organisms. As part of this project, Southern Water has funded 24 farmer and agronomist events, 190 visits to farmers, 215 telephone consultations, 5,544 newsletters and mail shots to farmers and landowners promoting metaldehyde and pesticide programmes, and 38 pesticide-handling training sessions to farmers.

Reducing the amount we take from natural water sources

In our densely populated and relatively dry region, we must balance the need to supply high-quality water to our customers with the need to preserve our natural sources.

As already mentioned in previous sections, we have targeted our involvement in the most water-stressed areas in the South East. Initiatives already underway include:

- Water-saving home visits, local authority partnerships and community initiatives.
- Increased leak detection and repair.
- Changes to abstraction licences, for example for the River Medway.
- Catchment schemes, where we work with farmers and features of the natural environment to improve water quality and protect supply in Medway, Brighton and Worthing. A catchment is an area where water is collected by the natural landscape.
- New water pipelines in Kent, Sussex and Hampshire.
- Supply and import agreements with neighbouring water companies.

The combination of the above work has already delivered a saving of around 6% of vital water supplies.

We have also starting working with developers at two critical sites in our region, building 15,000 new homes – Ebbsfleet Garden City, Kent and Fawley Waterside, Hampshire – to help them create more water efficient homes.

Creating safer environments for wildlife

It is important to us to protect and improve rivers, reservoirs and our region's 700 miles of coastline.

For example, the River Bewl is home to important wildlife including kingfishers, dragonflies, bats and even otters but it is under pressure by releases from nearby Bewl Water reservoir. Bewl Water is a key source of drinking water for Kent and East Sussex, storing water from the River Medway when flows are high. During the summer when extra water is needed, flows are released from the reservoir back into the river. But while this helps ensure that there is always water for all, it also creates unnaturally fast flows in the rivers downstream, which can create problems for wildlife and erode riverbanks.

As a result we are carrying out an enhancement programme to improve the habitat for wildlife by cutting back trees to reduce shading and give the river a rich boost of sunlight to encourage vegetation growth.

We are also making the river a safer, more appealing environment for fish, invertebrates and other wildlife by, for example, using woody debris to slow flows and create more diverse habitats.

Conservation and biodiversity

We are continuing to implement management plans on our 10 largest sites of special scientific interest (SSSI).

Here, we undertake monitoring, such as botanical and dormouse surveys, to continuously improve our understanding of these complex habitats and introduce bespoke management plans at these sites.

We are part of the Check, Clean, Dry initiative steering group which is chaired by the GB Non-Native Species Secretariat. It encourages recreational water users to follow good biosecurity practice to prevent the spread of invasive aquatic species. The group organises engagement events with stakeholders to raise awareness of non-native species and the impact they can have on British plants, animals and ecosystems by spreading disease, competing for habitats and food and direct predation.

Southern Water has implemented 51 invasive species plans. By the end of the 2017–18 season, 24 plans had been completed with monitoring of eradication in place. Another 13 plans will be completed next year (2018–19) while a further 14 plans are due for completion in the longer term. New plans will be established where invasive species are identified. Our grounds maintenance teams complete more than 14,000 site visits each year across all of our sites, so we are able to spot invasive species quickly and act promptly to control them.

Better bathing water

In 2017, we announced the seven bathing waters that will receive additional investment as part of our industry-leading, £31.5 million Bathing Water Enhancement Programme. These seven sites are: Deal Castle, Leysdown and Minster Leas in Kent, Selsey, Middleton-on-Sea and Worthing in Sussex, and Shanklin on the Isle of Wight.

As part of planning to improve the seven sites, a team of experts have carried out a year of detailed investigations including coastal sampling, microbial source-tracing and CCTV surveys. Southern Water is working with local authorities, the EA and other organisations over the next three years to find and fix sources of pollution.

One source of pollution is property misconnections where wastewater pipes are incorrectly plumbed into surface water drains. This means that wastewater from toilets, kitchens and bathrooms is pumped out to sea before it has been treated, affecting the quality of bathing water at local beaches. By April 2018, we had spent two-thirds of our £1 million investment specifically to address misconnections from toilet pipes. The remainder of this money is due to be spent by this August. Last year, we spoke to thousands of customers and worked with local authorities to raise awareness of problems like misconnections and dog waste on our beaches.

A sustainable future

At Southern Water we are proud of the region we serve and understand our part in protecting its environment.

To improve compliance at our wastewater treatment works we are already installing 500 'event duration monitors' in our combined sewers (sewers which collect both rainwater and wastewater) to give us valuable information on how they respond during overloads so we can work to prevent pollution incidents. We recognise the potential impact of pollution incidents, therefore our long-term ambition is to have no serious pollution incidents caused by our operations by 2045. This will involve the expansion of our Catchment First plans, which unite us with farmers, landowners and other stakeholders in taking a holistic approach to keeping pollutants out of our water sources.

Through our Drainage 2030 initiative – part of our business plan 2020–25, we will transform our sewerage networks with new technology and data analytics to predict and prevent blockages and bursts and repair them automatically. We will work with developers on making the 500,000 new homes predicted for our region as environmentally-friendly as possible, for instance using better water recycling systems. We are already liaising with developers at Ebbsfleet Garden City in Kent and Fawley Waterside in Hampshire.

Drainage 2030 will also provide greater resilience to the sewer network by expanding, where possible, schemes that remove surface water from our combined sewers. We have already proved the benefit of this approach in Portsmouth where a third of the storm flows have been removed from the system and diverted to the sea. This

investment addressed sewer flooding in Southsea and also created much needed capacity for growth. Better drainage is also a key part of protecting the quality of our bathing waters.

We are also introducing our Networks 2030 initiative, which proposes rationalising and modernising all of our nearly 14,000 kilometres of water mains. Our vision is for a fully-automated, connected network that reaches the highest standards of compliance.

Our Target 100 programme will aim to reduce the amount of water people use each day from around 130 litres today to 100 litres by 2040. Read more about it in our Better information and advice section on page 35. Target 100 will also help reduce the amount of water we need to take from our rivers.

Another initiative from our 2020–25 plan will look at setting up Resource Hubs. Starting in Brighton, we are looking at turning our state-of-the-art treatment works at Peacehaven into a hub where we could recycle water for use in agriculture, industry or households. The hubs will increase the amount of renewable energy we generate from biogas – a by-product of our wastewater treatment process – and potentially from food waste. The hub would also provide a valuable education, training and community facility. This could become a model to create a network of hubs in the South East.

More information on our plans for a joined-up approach to the resilient and environmentally responsible management of our water resources, is available in Southern Water Futures which can be downloaded at southernwater.co.uk/waterfutures.

Reducing carbon emissions

	2017–18		2016–17
	Target	Achieved	Achieved
Greenhouse gas emissions – ktCO ₂ e	281	228	245
KgCO ₂ e per person supplied with treated water ¹	-	23	25
KgCO ₂ e per person supplied with wastewater services ¹	-	33	35

KtCO₂e – Kilotonnes carbon dioxide equivalent

KgCO₂e – Kilograms carbon dioxide equivalent

¹ There are no targets for these indicators

At Southern Water we want to be part of the answer to reducing carbon emissions that contribute to climate change, not part of the problem.

Therefore, we are pleased that in 2017–18, the carbon emissions (greenhouse gases) produced by our operations have reduced again.

We also continued our efforts to build low carbon design into our treatment works, pumping stations and processes and are looking ahead to how we can use innovation to improve even further in the years ahead.

Our performance

Over the past year we hit our target of restricting carbon emissions from our operations to the equivalent of 228 kilotonnes of carbon dioxide, down from 245 the year before.

We did this by consuming less power from the national grid by making our sites more energy efficient and using our own renewable energy where possible.

We also improved the carbon efficiency of our treatment sites, pumping stations and operational practices by:

- assessing and replacing inefficient aeration blowers to minimise energy demand and reduce our carbon footprint
- implementing a sludge thickening programme on satellite sites reducing road haulage and associated emissions
- installing biogas monitors at our nine largest combined heat and power sites to measure methane and highlight any escapes from the system
- increasing the volume of our chemical storage tanks so they can accept bulk deliveries which minimise road haulage costs and reduce the carbon emissions caused by these journeys
- providing water efficiency visits to our customers using a contractor called Aqualogic. The potential savings from implementing the efficiency recommendations equates to generating 1.4 kilotonnes less of carbon dioxide
- partnering with Ricardo, engineering and environmental consultants, to apply the computer simulation techniques that Ricardo's team uses to optimise high performance cars, to maximise the efficiency of our water network. The information collated through sensors and computer modelling will help us understand our network better and guide our future decisions on where and when repairs and replacements are needed. Creating a more efficient network will cut down on the amount of energy we use to operate it
- replacing older types of lighting with LED replacements to reduce energy requirements and associated emissions.

How we are improving

Recycling waste

Since July 2016, no waste from our works or offices has been sent to landfill, putting us among the industry leaders in this area.

Our biggest achievement has been the recycling of debris that often ends up at treatment works such as wet wipes, cotton buds and sanitary items. Until recently, all of this – about 10,000 tonnes a year – went to landfill. With the support of our partner MTS, which has opened a state-of-the-art recycling plant at its depot in Hoo, Kent, this is now recycled into compost.

We are also recycling 100% of our biosolids (a by-product of the treatment process which is recycled as a fertiliser) and office waste.

Last year we recycled 100% of solid waste from our water treatment and sent nothing to landfill.

A sustainable future

Our long-term ambition is to become carbon neutral but we are already doing what we can to minimise the impact of our business on the environment.

We are looking at installing electric vehicle charging points in Brighton and Hove for use by our colleagues and our fleet of vehicles. We are also increasing the amounts and types of renewable energy we generate by increasing the number of our sites that use solar panels.

We have 365 wastewater treatment works and we currently recycle 743 million litres of water every day – with most of it returned to the sea. Wastewater is a resource that can be used to generate heat and renewable energy, is a potential source of minerals and could be returned to the environment rather than the sea.

Some of our treatment works have the potential to help secure additional resources to increase the resilience of the communities they serve and the region as a whole. Therefore, our proposal to create Resource Hubs (see more on page 53) will dramatically improve our renewable energy performance in the years ahead.

The hubs could use heat generated during treatment to warm community amenities like swimming pools and community centres and increase the amount of renewable energy we generate to make our sites self-sufficient. Excess green power could potentially provide energy to charge electric vehicles or be transferred back to the local grid to provide energy for nearby communities.

The first site to be transformed into a hub will be our Peacehaven works near Brighton where we will look at increasing the amount of renewable energy to 100%, work with the local energy co-op to explore the possibility of increasing energy provided by food waste, and see if we can increase the amount of biogas we generate by taking waste cooking oils from local food businesses.

The Peacehaven hub will also redirect 50 million litres of treated water each day to rivers rather than the sea enabling water reuse schemes and collaboration with South East Water to increase resilience in the wider Brighton area.

Our Southern Water

We directly employed more than 2,300 people in Kent, Sussex, Hampshire and the Isle of Wight as of 31 March 2018 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.

In line with gender pay gap legislation, we report on data relating to salary, bonus and distribution of pay within Southern Water. In 2017, our report into gender pay differences revealed that – based on the median of all our employees' salaries – our gender pay gap was 9% in favour of men. This is caused by there being a lower proportion of women in senior roles in the company. The national average of all companies in the UK who reported is 9.7%.

We accept that, since the audit showed that Southern Water's salary gap was most evident in the highest paid level of the organisation, we must do more to remove barriers that prevent women from pursuing, or being appointed to, senior roles. Two women have subsequently now joined our Executive Leadership Team. Our report on gender pay is available at southernwater.co.uk/genderpaygap.

Our performance

Health and safety

Health and safety at work continues to be one of our main priorities and in 2017–18 we recorded two periods of more than 100 days free of any reportable injury to our own staff or those of our supply chain.

In April we were notified of the award of the Order of Distinction from the Royal Society for the Prevention of Accidents (RoSPA), an external recognition of our commitment to maintaining an excellent health and safety record over the past 19 years.

As the high volume of construction work continues on our sites over the remainder of the year, we are committed to making sure we protect the health and safety of our workforce. While our overall aim is to have no injuries at all, our target was to restrict the number of reportable injuries to less than 0.31 per 100 full-time employees. We are pleased to have done better than this with a total figure of 0.19.

Last year, our Health, Safety and Wellbeing conference attracted more than 250 delegates. Now in its sixth year, the conference brings together people from across Southern Water and our supply chain to share best practice and look at innovations in the health and safety industry. The day was opened by Ian McAulay, Chief Executive Officer for Southern Water, and featured interactive sessions on the themes of leadership, planning, communication and collaboration.

A central focus at the 2017 conference was emotional wellbeing, in line with our Time to Change commitment to tackle the stigma around mental health. Delegates were challenged to think about how they could make a difference to colleague's lives and share their thoughts on a commitment board.

The conference ended with an awards ceremony to recognise employees who had made a positive contribution to health, safety and wellbeing at Southern Water.

We also staged a 'safety stand-down' event at our Falmer office last October, which highlighted issues including how to avoid and report workplace hazards, safe driving practices and awareness of the distractions that can be caused by mobile phones.

Employees are encouraged to report hazards at work and the company donates £2 to our regional Air Ambulance Trusts for each one recorded. In total our employees raised £5,284 during 2017–18 under this scheme.

Great places to get outdoors

We have four reservoirs: Darwell, Powdermill, Weir Wood in East Sussex, and Bewl Water on the Kent and Sussex boundary. These all offer outdoor activities such as fishing and sailing.

Bowl Water is our largest reservoir and is the biggest stretch of open water in the South East. 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.

Our Brighton Sewer Tours are well-attended every year and offer a fascinating insight into this essential network. These entertaining and educational tours look at the history behind the construction of our sewers. In 2017 we delivered 69 tours and saw 1,725 learn about the architecture and history of this environment hidden beneath the streets.

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.

Charity and volunteering

We encourage our employees to give their time to support community projects. During 2017–18, our people spent 4,676 hours – equivalent to 623 days – as volunteers.

Among the many organisations attended by our volunteers were the National Trust, South Downs National Park, Woodland Trust, the Kent, Surrey & Sussex Air Ambulance Trust (KSSAAT), all our regional charities and various beach cleans.

In 2016–17 we introduced our community grants scheme to help those areas that may have been inconvenienced by our activities. Last year we made financial contributions to the following groups who were affected by our project to upgrade Portswood wastewater treatment works. These groups were: Denys Friendlies, Recovered 4 Life, Friends of Portswood Rec, Yellow Door Solent, Friends of Riverside Park, Friends of St Denys and Southampton Mencap.

Our fundraising activities included raising £72,500 last year for our company charity, KSSAAT, bringing the total to £113,000. This is in excess of our pledge to raise £100,000 during our two-year partnership with the charity.

Four new charity partners have each received a £10,000 grant for agreed programmes. These are Age UK, Beanstalk (see the case study below), St Barnabas Hospice, and the Countryside Education Trust.

Just over £1,400 was raised for the Mexico earthquake emergency appeal with matched funding by the company.

In total, we raised almost £147,700 in fundraising for good causes.

Main events held to raise money for our chosen charities included a company family fun day at Bowl Water and a charity clay pigeon shoot. Employees also took part in the Brighton 10K and Marathon to boost funds.

Meanwhile our regional charity partner for the Isle of Wight, Age Concern UK, has been working with us to help deliver age awareness training to our employees. The objective is to help us to better understand the difficulties that elderly people face.

CASE STUDY:

Southern Water Standards Engineer – Assets Reliability, Chris Newnham

Working with Beanstalk

When I heard that Beanstalk had been selected as one of our regional charities for this year, I couldn't wait to get involved. They recruit, train and support volunteers, like me, to provide one-to-one support at school to children who have fallen behind with their reading.

It works a bit like a mentoring programme as you are assigned a single child to work with over a period of time. It was really interesting doing the training, learning about how children learn language phonetically by association, recalling symbols and sounds rather than learning the words themselves. It is very different from how I learnt to read when I was at school. I have also had to go through a lot of screening, including Disclosure and Barring Service (DBS) checks, to become part of the Safe Guardian Network. It is a big responsibility, as I will also need to report any welfare concerns.

I have already started sessions with my allocated child. I love reading so being able to share that passion and help to build a child's confidence is the real reward. He is a great reader, and was just struggling with comprehension. Now he is reading every day and reading at home with his mum, which is great. We are both really into Marvel characters so I asked Beanstalk to get us some books about the X-Men, his favourite.

beanstalkcharity.org.uk

How we are improving

Working with our communities

We are proud to support our local communities through a range of initiatives from helping local charities to providing educational schemes to encourage people to use water wisely.

In 2017, we marked the 25th anniversary of our Learn to Swim programme which over the years has taught this life-saving skill to more than 750,000 children in the South East.

With 700-miles of coastline and so many rivers in our region, it is important to us to teach children to enjoy these natural resources while staying safe around water. As a result, we currently have 83 pools/clubs enrolled in the Learn to Swim scheme and in 2016–17 alone, 14,000 children signed up to a session.

Last year (2017), Learn to Swim was shortlisted for two awards (for Utility Week and the Better Society Awards) and early in 2018, we attended a meeting with the Department for Digital, Culture, Media and Sport to discuss ways of encouraging other water companies to use our model to help to teach more children to swim.

We are proud that former Olympic gold medallist Duncan Goodhew and Invictus Games champion Mike Goody continue to support Learn to Swim as do our instructors and partners at Swim England.

Encouraging awareness of the value of water

A large part of our work in the communities is educating people to use water wisely, keep their drains clear and, where possible, save money on their bills.

Our Sporting Chance programme offers children the chance to work with professional sports coaches to improve their skills while also finding out about the importance of water for health. We also teach them how to be water efficient and why it matters to keep sewers clear.

Now in its seventh year, 8,778 children are engaged with Sporting Chance at 35 schools. We are proud to deliver the scheme in partnership with Brighton & Hove Albion Football Club, Hampshire County Cricket Club, Kent County Cricket Club, Portsmouth Football Club and Sussex County Cricket Club.

A key part of our community education work are our road shows. Between April 2017 and the end of December 2017, we attended 25 events and spoke to around 20,800 customers.

We visited key operational areas including Thanet, Isle of Wight, Brighton and Hove and Worthing to deliver messages about what we do to ensure reliable water and wastewater services now and into the future. We also engage customers in what they can do to help preserve the quality and availability of water, prevent sewer blockages and support our work to protect the environment.

At the beginning of 2018, we introduced a new roadshow vehicle which will enable us to attend more events even in poor weather. The new vehicle features a range of materials to help bring to life the connections between our work and customers' lives. These assets include a virtual reality film and animations to show how we are working to deliver sustainable services.

Our water efficiency team is also hard at work educating our existing and future customers on the value of water.

Last year the team delivered water-saving workshops for children at sustainability education events and created more website downloadable resources for teachers.

The team also arranged 42 free Waterwise or Sewerwise talks to schools and groups since April 2017 with a total of over 4,000 attendees.

Southern Water employees volunteer to give these talks, which take children, students and community groups through various water-saving and blockage prevention messages. Although competition entered the water market in April 2017 and Southern Water no longer provides retail services for non-household customers, we did provide 10 businesses with water efficiency advice at events in Sussex, Hampshire and Kent in the past year. These organisations included the NHS, University of Sussex and B&Q.

Developing talent

Our commitment to developing employees remained a key focus during 2017–18 with a particular emphasis on providing functional, regulatory and compliance training.

As a result of this, 665 employees attended a corporate development programme while more than 1,700 employees attended training programmes specifically tailored to develop their skills in particular roles. This included redeployment support and core skills training Customer Service, IOSH (Institution of Occupational Safety and Health) and Safety and Water Hygiene for our Engineering and Construction team and courses on customer excellence and managing wastewater above ground for our Operations employees.

In Engineering and Construction there has been a significant change in the way in which learning needs are identified. As part of our workforce planning project, we have identified the main skills we require to improve our business and are helping to develop these competencies in our staff. We continue to support employees with gaining diplomas and higher qualifications.

Our Employee Development Programme continues to be a success and more than 100 of our employees took part in this in 2017–18. Currently we are implementing two key projects as a direct result of what they achieved on the programme.

We have successfully developed our 'next generation' strategy and have grown our graduate development programme. We now support 21 graduate trainees across the business with 15 joining us last year. We have also developed a strategy to promote education and training in science, technology, engineering and mathematics as part of our focus in our next business plan on stimulating greater community collaboration and innovation in our region.

As mentioned above, health, safety and wellbeing has been a primary feature of our work this year including the signing by our chief executive, Ian McAulay, of the Time to Change pledge which raises awareness and understanding of mental health issues. We are also working towards the National Workplace Wellbeing Charter building some events into our annual wellbeing calendar. An example of this is our static bike challenge where last year, employees' cycled 1,569 miles to raise money for our company charity, the Kent, Surrey & Sussex Air Ambulance Trust – with Southern Water donating 20p for every mile completed.

Making Southern Water a great place to work

Last year we made fundamental changes to the structure of our Customer Service department to address issues raised by customers and regulators about our performance. While we accept that the changes were necessary, we also appreciate that restructures can be uncomfortable for those involved. We worked hard to minimise any negative impact on our workforce, recruiting for new roles from within existing teams where possible and providing support where we could for those who were moving on. Where previous employees left us, they did so with our gratitude for their past efforts and our best wishes for the future.

We will continue to make the interests of customers our top priority and main driver for change but we recognise that the success of our delivery plans rely on the people we employ to execute them. Therefore it remains our ambition to be a great company to work for and last year, in the face of making some unsettling decisions, we also took the opportunity to revise our colleague engagement activity. In 2017, we partnered with Gallup to reset our approach and help us develop clearer action-planning processes to better support our staff.

The Gallup Engagement Survey is simpler to fill out and easier to understand than our previous surveys and is designed to help us make better use of the responses to build stronger relationships with our employees.

In 2017, 82% of our directly employed workforce completed the survey and results were shared with managers in January 2018. We are using the responses to inform the way we manage our employees so we attract and retain the best candidates for our business. Every manager has been supplied with a support pack and we have 35 engagement coaches, trained by Gallup, who advise, coach and support managers in how to motivate and support their teams to achieve set targets.

A sustainable future

We constantly look for ways to support the communities we serve and next year proposals to expand this work include:

- introducing a pilot scheme to help people coping with dementia to care for their physical health through swimming
- investigating a partnership with the Freshwater Habitats Trust to encourage primary school children to look after their local pond or waterway
- developing a digital app to accompany our Learn to Swim scheme
- hosting our second Community Engagement Conference to showcase our work to promote resilient communities of the future.

Succession planning – nurturing talent in the South East

We already work closely with the region's universities and run an apprenticeship programme to help develop careers and give us access to emerging ideas and technologies. However, we want to go further than this and are looking at setting up our own in-house skills academy to harness and nurture those in our region with the skills we need now and in the future. This will involve us working in partnership with nearby schools and colleges which specialise in teaching science, technology, engineering and mathematics.

By investing in people, we can cultivate talented individuals to not only work for us but make contributions which we hope will benefit the whole of our communities.

Financial performance

Accounting policies

The accounting policies of the company, which are consistent with the prior year, are set out on pages 133 to 141.

Income statement

Our income statement is summarised in Table 1 below.

Table 1	Years ended 31 March		Change
	2018 £m	2017 £m	%
Revenue	829.7	809.7	2.5
Other operating income	2.4	1.3	84.6
Operating costs	(336.0)	(306.9)	9.5
Depreciation, net of amortisation	(259.5)	(245.2)	5.8
Operating profit	236.6	258.9	(8.6)
Other income	11.2	-	-
Profit on disposal of fixed assets	0.8	0.4	100.0
Net finance costs	(118.7)	(103.1)	15.1
Fair value gains/(losses) on derivative financial instruments	46.3	(416.8)	111.1
Profit/(loss) before tax	176.2	(260.6)	167.6
Tax	(21.5)	84.9	125.3
Profit/(loss) for the financial year	154.7	(175.7)	188.0

Revenue increased to £829.7 million (2017: £809.7 million). This increase partly results from changes to our inflation-linked water and wastewater tariffs, in part offset by the loss of income following the sale of our non-household retail business to specialist retailer Business Stream on 1 April 2017.

2017–18 has been a year of change and challenge resulting in an increase in operating costs of £29.1 million to £336.0 million (2017: £306.9 million). The major reasons for this increase are described below and in Table 2.

During 2016–17 we restructured our Customer Service teams to improve performance in this area, focusing on proactive customer contact and initiatives to improve our bad debt performance. This investment in cash collection has seen us spend £3.4 million on debt recovery this year, which has resulted in a reduction of £3.5 million in the bad debt provision charged to the income statement with further reductions expected in the future. Overall, these structural changes have led to efficiencies of £1.9 million across Customer Service in 2018–19.

We began 2017–18 with enforcement orders in place from the Drinking Water Inspectorate and investigations under way from the Environment Agency (EA) and Ofwat. In response we have established a new Compliance and Asset Resilience directorate and implemented a significant programme of work to address the issues raised investing £3.9 million. These changes will improve our risk management and ensure our reporting processes have greater oversight better maintaining the integrity of our data. We have also made improvements to our IT, spending an additional £3.6 million.

Prolonged periods of dry weather during 2017–18 led us to make a precautionary application for a drought permit in early 2018 for the River Medway as Bewl Water, our key resource in that area, was only 33% full. We moved water into Bewl increasing our pumping costs, and also increased our spend on leakage detection to further prepare ourselves for a possible drought.

In addition, during February and March 2018 we experienced some extremely cold weather followed by a rapid thaw. As a result we experienced an increase in the number of bursts on our own network and on customers' pipes, generating additional overtime and pipe repair costs. We also provided emergency water and compensation for customers affected. These weather related issues resulted in additional costs of £4.3 million.

In order to continue to provide a resilient water supply we invested in a variety of projects in 2017–18. In the South Hampshire area we have designed a plan to improve the environmental resilience of the Rivers Test and Itchen for periods of severe drought to help protect the river's ecology. This project has resulted in increased environmental costs of £2.9 million.

We also spent a further £3.5 million on managing our defined benefit pension scheme in 2017–18. This increase resulted from additional advisory costs relating to agreeing a new deficit reduction plan with the Trustees and The Pension Regulator, together with the impact of changing market conditions. These changes included a movement in corporate bond yields, which lowered discount rates, increasing the accounting cost charged to the income statement.

We have also been working hard to prepare our Business Plan for 2020–25 which will be submitted to Ofwat in September 2018. The preparatory work, including consultations with customers and stakeholders, needed to develop this plan resulted in additional costs of £2.9 million this year.

Table 2	
Year-on-year increase/(decrease) in operating costs	£m
Inflation	11.4
Increased debt and cash collection activity	3.4
Decreased bad debt charge	(3.5)
Customer Services efficiencies	(1.9)
Costs resulting from exceptional weather conditions	4.3
Compliance function and data team	3.9
Increased pension costs	3.5
IT improvements	3.6
Additional environmental provisions	2.9
Business Plan 2020–25 (PR 19)	2.9
Other	(1.4)
Movement in operating costs	29.1

Depreciation increased to £259.5 million (2017: £245.2 million) as a result of our significant capital investment programme. New schemes commissioned during the year added £12.8 million to the depreciation charge.

Operating profit for 2017–18 decreased to £236.6 million (2017: £258.9 million), an 8.6% reduction as a result of the factors set out above.

Other income includes the profit of £11.2 million from the sale of our non-household retail business on 1 April 2017. Further details of this transaction are shown in note 5 to the financial statements.

The profit on disposal of fixed assets of £0.8 million (2017: £0.4 million) mainly relates to the sale of surplus vehicles and the release of deferred revenue from the historical sale of income rights relating to aerial masts.

Net finance costs increased to £118.7 million (2017: £103.1 million). This increase was largely driven by higher indexation of £17.9 million on inflation-linked bonds as a result of increasing RPI in 2017–18 together with the full year effect of interest on loans issued in 2016–17 of £3.0 million. This was partially offset by an increase in interest capitalised of £7.9 million resulting from the larger capital investment programme.

The fair value gain on our derivative financial instruments amounted to £46.3 million (2017: loss £416.8 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. For example in 2016–17 in particular, there was a significant reduction in gilt yields which resulted in a large increase in the liability associated with our derivative instruments and a loss of £416.8 million charged to the income statement, 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 charge to the income statement of £21.5 million (2017: £84.9 million tax credit). This differs from the charge that may be expected of £33.5 million, based on the profit before tax of £176.1 million and the current period tax rate of 19%, as described in note 9. The difference is primarily due to the company receiving group relief losses surrendered by other companies in the Southern Water group for nil payment and a deferred tax credit of £6.4 million in respect of prior years.

The profit after taxation for the year amounted to £154.7 million (2017: loss £175.7 million).

Cash flow statement – summary

Our cash flow statement is summarised in Table 3 below:

Table 3	Years ended 31 March	
	2018 £m	2017 £m
Net cash inflow from operating activities	453.1	512.9
Net cash used in investing activities	(416.2)	(224.3)
Net cash used in financing activities	(157.8)	(21.2)
Net (decrease)/increase in cash and cash equivalents	(120.9)	267.4

Net cash inflow from operating activities has reduced to £453.1 million (2017: £512.9 million) largely resulting from movements in working capital.

This decrease is partly due to an increase in debtors in 2017–18 of £23.5 million due to the impact of the sale of our non-household retail business to Business Stream. In the previous year, during February and March 2017, we raised our final bills to our non-household customers and this sped up our cash collection process resulting in a fall in debt of £12.3 million at March 2017. At March 2018, due to timing of the billing of our wholesale water to retailers, we have an increase in unbilled income of £14.4 million.

There has also been an increase in the level of creditors during 2016–17 of £18.8 million compared to a reduction in creditors in 2017–18 of £5.4 million. This 2016–17 movement was driven by an increase in the value of deposits and deferred revenue held on the Balance Sheet associated with developer activity and also by the timing of payments to suppliers, which has partially reversed in 2017–18.

The net cash used in investing activities increased to £416.2 million (2017: £224.3 million). This increase was mainly due to the profile of our capital investment programme. There was a significant increase in the number of investment projects in construction during 2017–18 - the third year of the five-year business plan period - resulting in an increase in capital expenditure of £111.6 million. In addition the inter-company loan to our subsidiary, Southern Water Services (Finance) Limited (SWSF) increased by £96.0 million. We transfer funds to SWSF in order for it to make interest payments on its debt at the end of the year, but this year payments fell into the first week of April 2018 due to the timing of the weekend at the end of March 2018.

The net cash used in financing activities increased to £157.8 million (2017: £21.2 million). This was primarily caused by the previous year's outflows reducing by £238.3 million as a result of the net impact of new loans offset by loan repayments. This was partially offset by lower interest paid in 2017–18 which fell by £112.9 million from the previous year. This fall occurred principally because bond interest payments normally made at the end of the year fell into April 2018.

Overall these resulted in a net decrease in cash and cash equivalents of £120.9 million (2017: net increase of £267.4 million).

Statement of financial position – summary

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

Table 4	Years ended 31 March	
	2018 £m	2017 £m
Non-current assets	6,767.9	6,587.2
Current assets (excluding cash)	326.0	200.0
Cash and cash equivalents	164.4	285.3
Total assets	7,258.3	7,072.5
Current liabilities	(720.5)	(349.5)
Non-current liabilities	(5,475.0)	(5,768.9)
Total liabilities	(6,195.5)	(6,118.4)
Total net assets	1,062.8	954.1
Total equity	1,062.8	954.1

At the end of the year to 31 March 2018, we had non-current assets of £6,767.9 million (2017: £6,587.2 million), an increase of £180.7 million from March 2017. This increase results from capital investment in tangible and intangible assets of £440.2 million offset by depreciation of £259.5 million.

Current assets increased to £326.0 million (2017: £200.0 million) as a result largely of an increase in an inter-company debt with SWSF of £103.5 million. We fund SWSF in order for it to make interest payments on its debt at the year end, and this year a number of interest payments fell into the first week of April 2018 due to the timing of the weekend at the end of March 2018. We also saw an increase in our unbilled income principally due to timing of the billing of wholesale services to our new non-household retail customers of £14.4 million. At March 2017 we did not have any comparable unbilled income as our non-household customers had received final bills during February and March 2017, before their transfer to Business Stream.

Current liabilities increased to £720.5 million (2017: £349.5 million). This increase is principally caused by the transfer of a Class A £300 million loan, repayable in 2019, from long to short-term. Additionally, at March 2018, amounts owed to group undertaking includes an inter-company accrual for bond interest of £117.6 million. This bond interest is normally paid in March but this year was paid in the first week of April 2018 due to the timing of the weekend. These increases were partially offset by the inclusion in current liabilities at March 2017 of an inter-company accrual for the final dividend of £63.2 million.

At 31 March 2018 non-current liabilities totalled £5,475.0 million (2017: £5,768.9 million). This decrease of £293.9 million was principally the result of the transfer of a Class A loan of £300 million to current liabilities, together with the revaluation of our derivative financial instruments which fell by £46.3 million. These reductions were offset by the current year indexation charge of £38.8 million which increased the value of our loans and an increase in the value of other non-current liabilities resulting from sewer and pumping stations adoptions totalling £23.5 million.

Overall, net assets increased from £954.1 million to £1,062.8 million.

Dividend policy

Our dividend policy takes into account the interests of all stakeholders to ensure that while shareholders are fairly rewarded for their continued investment and confidence in our company, the business can maintain its long-term capital structure and improve the services it offers to its customers.

When determining whether to make a dividend payment the following steps are followed:

1. A holistic view of company performance in the year is considered which forms a 'gateway' to the proposal of a dividend. This gateway includes how well we have delivered the promises and performance commitments we made as part of agreeing to the charges Ofwat allows us to make for our services, known as our price determination.
2. If it is agreed that a dividend will be paid, we start with a base level of dividend appropriate to our price determination and our actual level of gearing.
3. We then take into account financial performance during the year. Where we have performed better than would be reflected in the base level of dividend, we consider whether it is appropriate to increase it while also taking into account how an equitable share of our profits can be passed on to customers and other stakeholders.
4. It is important to note that we do not automatically pay the full amount of the calculated level of dividend. We may retain dividend in the business, or defer them to a future period, to maintain financial resilience, a sustainable long-term capital structure, and give due regard to employee and other stakeholder interests.

Our dividend policy is intended to support the credit ratings of the business and ensure continued access to diversified sources of finance. As part of step four we carry out an assessment of:

- i. headroom under debt covenants
- ii. the impact on the company's credit rating
- iii. the liquidity position and ability to fulfil licence conditions
- iv. key areas of business risk.

In light of Ofwat's recent publications regarding governance in the water sector and its proposals for the next business plan for 2020–25 we will be reviewing our dividend policy to ensure that it strikes the right balance between the interests of customers and investors.

For the current financial year to 31 March 2018 a portion of the dividend is being retained in the business in order to support financial resilience as we make preparations for our next price determination (the five years from 2020 to 2025). The dividend for 2017–18 amounts to £8.0 million of ordinary share dividend plus £13.1 million of preference share dividend, which is significantly below the base level dividend of £45 million plus a further £40 million deferred from the previous period due to a revenue shortfall.

These tests are not applied to the interim dividends of £46.1 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).

Further details are shown on page 75.

Taxation strategy

We have a low risk approach to our management of tax. The foundation of our tax strategy is to comply fully with tax legislation, to focus upon maintaining a strong tax compliance culture, and to manage our tax affairs in the best interest of our customers, and stakeholders.

Our Tax Policy

Our Tax Policy is consistent with the overall values and corporate strategy of the company and considers 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 to be fully compliant with tax laws, rules, regulations and reporting requirements in all of its operations. This extends to following both the letter of the law as well as the spirit of the law. We also use the expertise of professional tax advisors to ensure we maintain best practice in our approach to compliance and in circumstances when additional advice is deemed appropriate.

We are open and transparent and we do not use tax avoidance schemes or take an aggressive stance on our interpretation of tax legislation when tax planning.

Our management of tax risk

We adopt a conservative approach to tax risk and our tax management focus is on compliance. Furthermore, our tax planning is always aligned with our commercial and economic activity where decisions are made in the best interests of customers and stakeholders.

We do not use tax avoidance schemes or take an aggressive stance on our interpretation of tax legislation when tax planning. All companies within the Southern Water group are subject to UK tax, and all companies are UK tax resident irrespective of their place of incorporation, ensuring that each company is subject to UK tax.

Tax risk primarily emanates from the evolution and complexity of the Southern Water business along with the ever changing regulatory and legislative environment. We manage this risk by having an experienced tax team dedicated to tax compliance and the identification of tax risks in our business. Our tax team works with the wider business to ensure there are sufficient processes and controls in place and to determine what level of risk is acceptable. We also have a support network of industry tax experts who provide specialist tax services, check what we are doing, and provide advice and guidance on new tax compliance challenges. Our internal audit team also carries out assurance on the control environment relating to the transactional processes underpinning our payments to the Exchequer and our collection of taxes on behalf of the Exchequer.

Our relationship with Her Majesty's Revenue and Customs (HMRC)

A key factor in our management of our tax affairs 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 which goes beyond the normal filing of statutory returns, such as the sharing of internal audit findings so that we can be open and transparent in our approach to managing tax risk. 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.

Maintaining public trust

As previously stated, we are committed to complying fully with tax legislation and on maintaining a strong culture of compliance as well as having open and constructive relationships with tax authorities.

We apply government and fiscal authority tax incentives and exemptions, where they exist. For example, the UK tax system recognises the benefit to the economy of investment in infrastructure and environmental protection which reduces the corporation tax Southern Water pays. Any benefits of this are passed to our customers.

Southern Water and all Southern Water group companies pay taxes in the UK and have never used offshore companies to avoid tax or levies. We have a Cayman Islands registered subsidiary company which was set up to issue debt in the UK. However, we know that this company has contributed to misconceptions about our business practices which is why we are working towards closing it.

Understanding our taxable profits and our corporation tax

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 amounts 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 72. 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.

Our tax charge is reduced by our large capital expenditure programme and the interest we are charged on borrowings. The benefit of this 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 63.

Our tax contribution

Our contributions to the Exchequer amounted to £69.7 million. These are explained below:

- Business rates of £26.8 million paid to local authorities (2017: £26.0 million) and payments to the Environment Agency of £8.5 million (2017: £7.6 million) for abstraction licences and discharge consents, which reduce profits chargeable to corporation tax.
- Employment taxes of £31.3 million (2017: £28.3 million) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions.
- Carbon Reduction Commitment of £3.1 million (2017: £3.3 million) levied on our power costs, which reduces profits chargeable to corporation tax.

Payments have also been made to other group companies of £10.8 million for tax losses surrendered to the company. These were paid to SWSG and then repaid to us as interest. Overall, Southern Water pays 8.2 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 2017–18.

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 our initial market value plus subsequent 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	%	Senior adjusted cash interest cover	Times
2014–15 performance	78	2014–15 performance	1.6
2015–16 performance	79	2015–16 performance	1.9
2016–17 performance	77	2016–17 performance	1.9
2017–18 performance	77	2017–18 performance	1.8
Covenanted lock-up level	<85	Minimum target trigger level	1.1

Credit rating	As at 31 March 2018
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 have a Stable Outlook and the credit ratings for Moody's have a Negative Outlook. We are currently engaging with financial stakeholders as part of our financing plans to improve the financial resilience of Southern Water in preparation for the next five-year business plan for the period 2020–25.

Capital structure

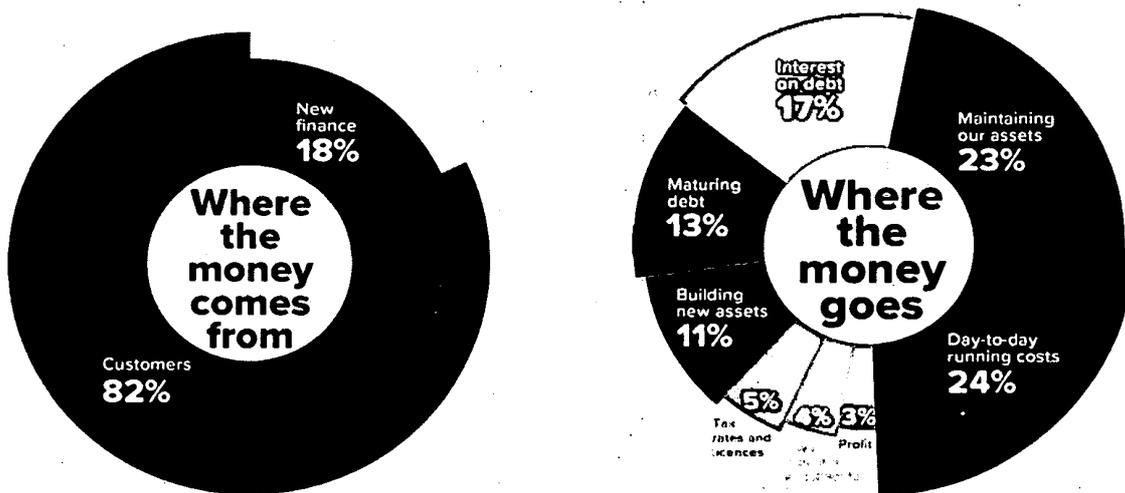
Why Southern Water raises finance

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 cubic metres 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 £82 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 bills 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 Business Plan 2015–20, 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 bills 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.

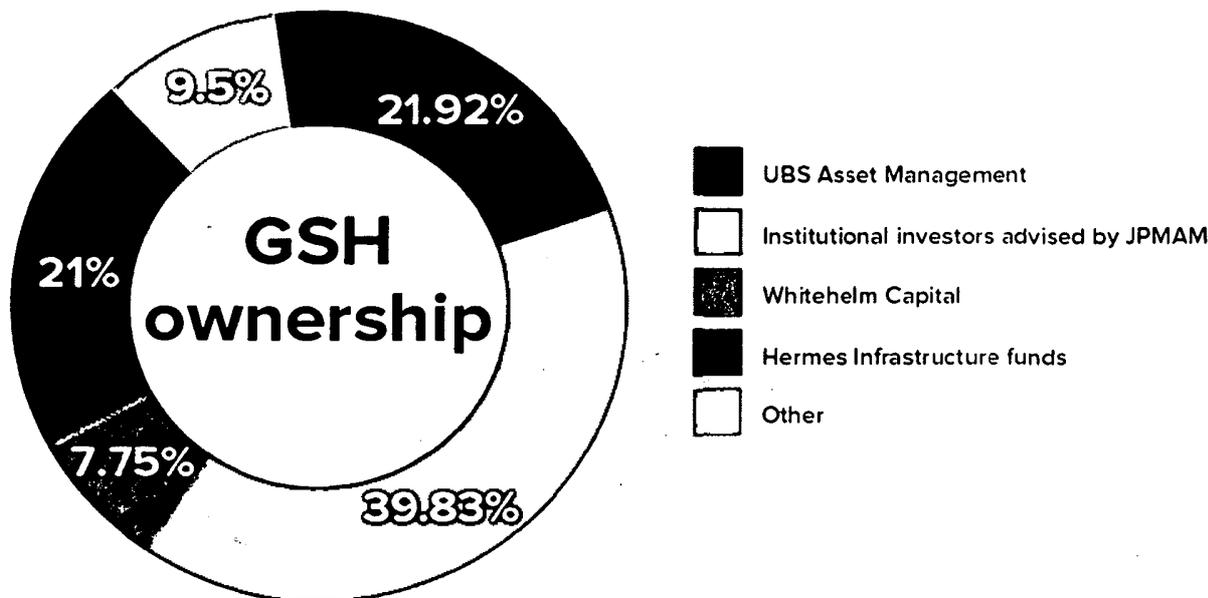
Profit – the return earned on shareholders' investment in the business.

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 £4.1 billion 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 directors. Three of those members, including, with effect from 1 May 2018, the Chair, are appointed by a shareholder represented by JP Morgan Asset Management; one director 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 GSH Board meetings.

The previous Chairman of Southern Water, Robert Jennings was a member of the GSH Board. However, following a review of Southern Water's and Greensands' governance arrangements, it was decided that the Chairman of Southern Water, Bill Tame, would not be a member of the GSH Board and so no independent members of our Board sit on the Board of GSH.

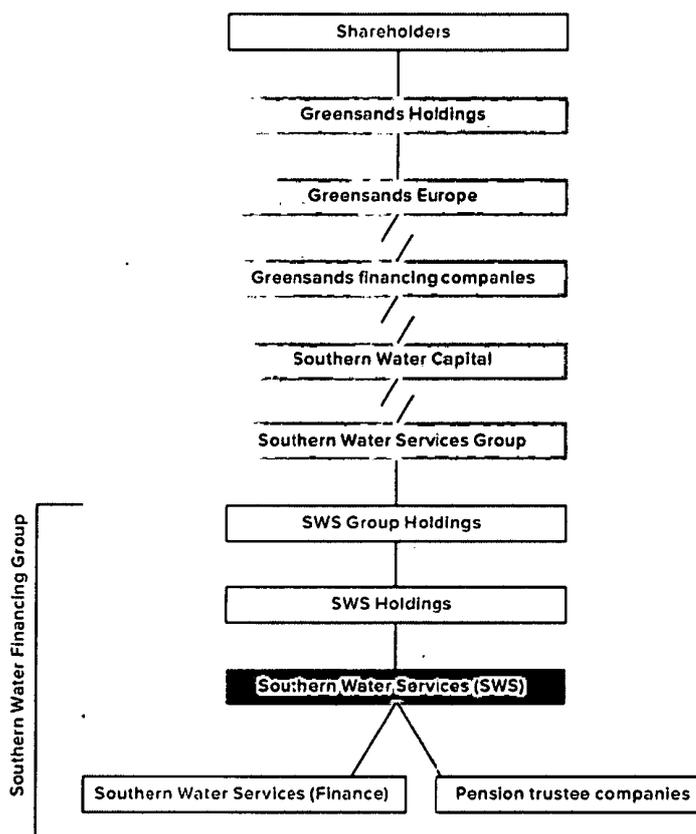
The purpose of GSH is to act as a single-purpose entity as the ultimate holding company for Southern Water and to provide the financing structure for the group. As a consequence, the GSH Board complements and supports the aims of Southern Water for its long-term success. Whilst certain matters are reserved to the GSH Board and/or shareholders, these matters do not impact the day-to-day operations of Southern Water and nor do they materially affect Southern Water's ability to function as an independent company in providing an essential public service.

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) – The ultimate parent company within the group. GSH was established in 2007 for the acquisition of the Southern Water Capital group, from RBS, by the shareholders. The company is Jersey registered, but it is UK tax resident and, as such, is liable for tax in the UK. The company was incorporated in Jersey because Jersey law allows greater choice than the UK as to the way distributions can be made to shareholders. 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 at southernwater.co.uk/greensands-ownership-of-southern-water.

Greensands Europe (GSE) – A subsidiary of GSH incorporated in England and Wales and resident for tax in the UK. GSE was established to issue bonds as part of the financing for the acquisition of the Southern Water Capital group in 2007. GSE has issued debt, Eurobonds, which are held by our shareholders in proportion to their respective shareholdings. This bond debt meets the eligibility requirements of the ‘quoted Eurobond exemption’ for tax purposes. The Eurobonds are listed on the International Stock Exchange in the Channel Islands which is a recognised stock exchange for the purposes of the quoted Eurobond exemption by HMRC. The bonds were issued on this stock exchange for ease of administration, as they are issued to the shareholders of the group and are not traded.

Greensands financing companies – A number of companies, all incorporated in England and Wales and resident for tax in the UK, were established to provide additional external financing for the acquisition of the Southern Water Capital group in 2007. 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 ScottishPower in 2002. SWC is incorporated in England and Wales and resident in the UK for tax. It 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 in 2003. SWSG is incorporated in England and Wales and resident in the UK for tax.

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 WBS sets strict rules which demonstrate to investors that Southern Water is a safe and reliable business in which to invest. This structure helps to reduce our financing costs and improves access to long-term and secure sources of finance. Reducing financing costs ultimately benefits customers in the form of lower bills.

The WBS works by creating a ring-fence around the Southern Water business in the form of a financing group. 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, Southern Water would continue to operate as usual. Debt providers are not permitted to either break up or interrupt the 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 the 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 the payment of 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.

SWS Group Holdings – An intermediate holding company forming part of the securitised group. The company is incorporated in England and Wales and resident for tax in the UK.

SWS Holdings – The immediate holding company for Southern Water, forming part of the securitised group. The company is incorporated in England and Wales and resident for tax in the UK.

Southern Water Services – This is the only operating company within the group, providing water and wastewater services to customers across Kent, Sussex, Hampshire and the Isle of Wight. Southern Water is incorporated in England and Wales and resident for tax in the UK. It is the company that this Annual Report and Financial Statements relates to.

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 and we are planning to close this company.

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 this company 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 2018 and 31 March 2017. 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 currently have £177.2 million of inflation-linked swaps with a legal maturity of March 2037 which include a mandatory break at March 2019. These are in the process of being extended to 2025 and are not expected to be a draw on our liquidity.

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 2018, the dividend was £46.1 million and the tax payment, in respect of the taxable losses incurred by SWSG, amounted to £10.8 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 dividend payments 2017–18

Fig 1

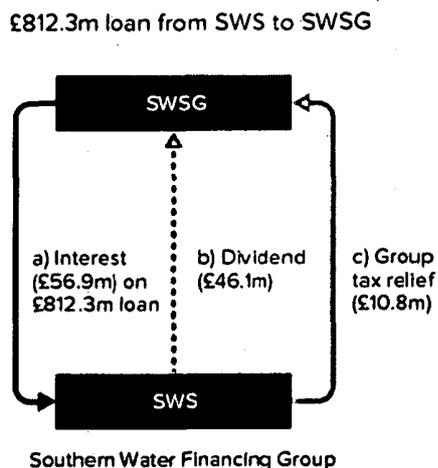
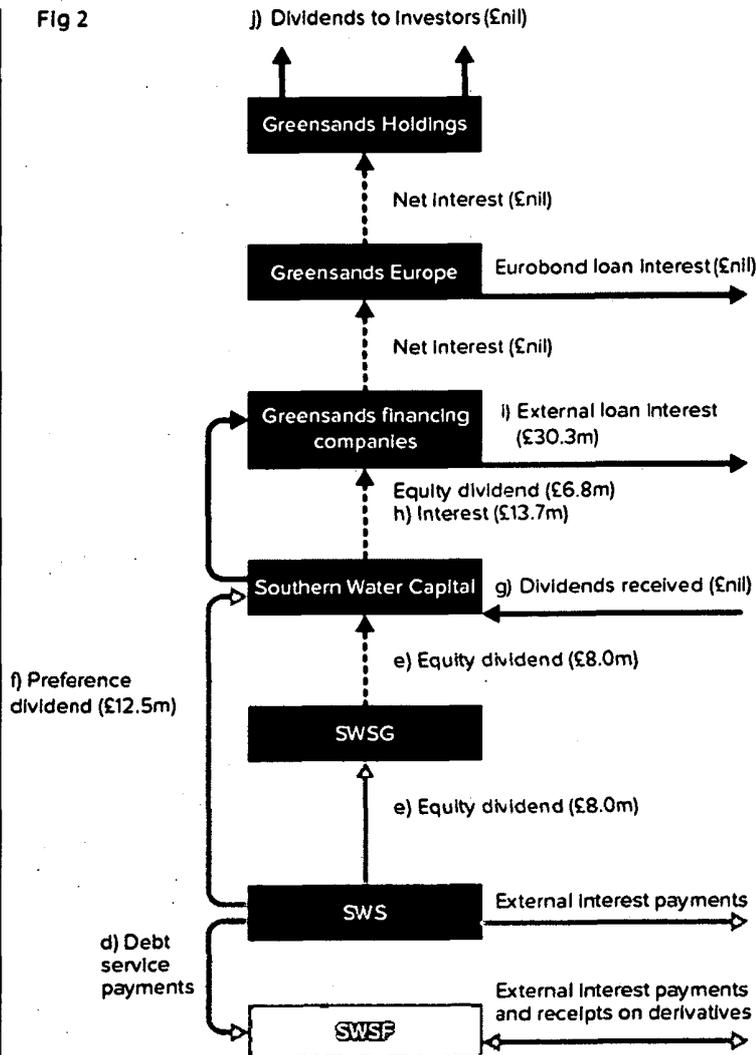


Fig 2



In summary, SWS have paid £20.5m to internal companies. Greensands companies have paid external loan interest payments of £30.3m. No interest or dividends have been paid to investors.

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 £nil was ultimately paid to investors (see j).
- f) Interest payments on the preference shares.
- g) Dividends received from other group companies.
- h) Interest payable on inter-company loans.
- i) External interest payable, funded from interest receivable and cash held in the Greensands financing companies.
- j) Dividends paid to investors.

Viability statement

Details of our Code of Board leadership, transparency and governance are set out in the corporate governance section of the Annual Report on page 95. 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 which it is assumed will not be revoked.
- 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. We are also preparing our next business plan for the period through to 2025.
- iii. The long-term financing of the business, including the maturity profile of existing debt, bearing in mind foreseeability of revenues reflecting the five-year price review.
- iv. Additional protection is afforded between price controls by Ofwat's primary legal duty to ensure that water and wastewater companies can finance their functions.
- v. Under the Water Act 2014 Ofwat has a further primary duty to ensure that water and wastewater companies have the long-term resilience to meet the needs of customers.

In assessing the viability of Southern Water over a five-year period to March 2023, the directors have taken into account current performance and the financial and operational impacts, in severe but plausible and reasonable scenarios, of the principal risks documented in the Strategic Report on page 78. 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
- exceptional items, for example regulatory fines or legal claims based on historical instances in the sector
- potential Outcome Delivery Incentive (ODI) penalties, associated with our current business plan performance commitments
- the overall group structure and its impact on the regulated business
- a deterioration in the defined benefit pension scheme deficit requiring additional contributions.

The principal risks have been monetised with reference to our risk weighting of likelihood and financial impact.

We have also tested specific business risk scenarios across the five-year period relating to higher or lower inflation than assumed in our forecasts, higher interest rates, higher expenditure and additional regulatory penalties.

Our regulator, Ofwat, has also provided regulatory guidance on financial resilience for the business planning process for 2020–25 including some common risk scenarios. These are:

- Totex under-performance (15% of totex)
- ODI penalty (3% of Return on Regulatory Equity (RoRE)) in one year
- Increase in the level of bad debt (20%)
- Financial penalty (3% of turnover) in one year
- New debt interest (2% above forward projections)
- Inflation (+/- 3%)
- Any relevant intercompany financing scenarios

We have tested these in addition to our more specific business scenarios. The most severe of the Ofwat scenarios is a combined risk scenario for each year of the period 2020 to 2025 comprising a 10% wholesale total expenditure (totex) and retail overspend plus 1% revenue penalty and 15% ODI penalty in each year.

We have tested all specific business risk scenarios separately and in combination and tested the combined Ofwat scenario. For each of these scenarios we have assumed a successful conclusion to our financing plan intended to support financial resilience into 2020–25 and beyond. The financing plan comprises a reduction to Southern Water's gearing and interest cost.

Many of these scenarios are significantly more severe than historic precedent and could be considered to go beyond what is plausible. The directors, however, concluded the viability of Southern Water was not compromised by the individual or combined scenarios over the five-year assessment period. When arriving at this conclusion the directors anticipate the successful completion to the financing plan, the ability to efficiently raise new finance, a

stable and supportive regulatory environment and the opportunity to mitigate financial risk by measures such as restricting non-contractual payments.

Southern Water is part of a group of companies but the financing and regulatory protection afforded to it results in there being no guarantees or contractual obligations between the Southern Water financing group and other group companies, see page 73 for more details.

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 in particular an advanced plan to refinance certain aspects of our financing will complete during the financial year ending March 2019.
- The weighted average cost of capital (WACC) for the next AMP period, commencing April 2020, will be sufficient to enable us to finance our functions. Ofwat published a draft WACC in December 2017 as part of their final methodology publication. We have used this WACC in our financial scenarios but we expect Ofwat to update this WACC for the Final Determination.
- Capital markets will be available for the refinancing of debt, credit facilities and financial derivative maturities when they fall due (see note 19 for details of our borrowings), given our sector and historical performance.

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 2023.

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.
- 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), which remains undrawn at 31 March 2018.
- 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, see above.

The approach to the long-term viability was reviewed internally and presented to the Board in May 2018 in order to agree the scenarios to be assessed. The results of the review were then reviewed by the Audit and Risk Review Committee in June 2018 as part of the process of recommending the accounts for approval. In addition, to support the Board in its assessment, third party assurance was obtained over the supporting calculations and sensitivities applied to the financial projections for the viability statement.

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 'principal risks'. Our Executive Leadership Team and Board consider these to have the greatest potential to stop us achieving our strategic objectives, based on outputs from 'top down' and 'bottom up' risk assessments and the review and monitoring process.

Changes to principal risks

Throughout the year, we make an assessment of how the regulatory and physical environment has changed, and what impact it has had on our principal risks. This year no new principal risks have been recognised, although the scope of two risks has been expanded as set out in the table below.

Principal risk 2016–17	Principal risk 2017–18	Rationale for change
Cyber security	Information security and Governance	New Data Protection standards (GDPR) came into effect in May 2018. We have therefore recognised the increased scope of our responsibilities for handling personal data in a compliant manner.
Regulatory reform	Future price limits and regulatory reform	In September 2018 we must submit a five-year business plan to Ofwat covering the period 2020–25. Much of the preparatory work for the business plan occurred during 2017–18. If Ofwat does not believe that our business plan is high quality this may materially affect the revenue we can earn in the period 2020–25. During the past year there has also been heightened political focus on the sector. The policy of the official opposition is renationalisation of the sector. Fundamental changes to the regulation of and structure of the sector could materially affect our business.

Our Board is responsible for determining the nature and extent of the principal risks it is willing to take in order to achieve the strategic objectives of the company.

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 senior management promote a culture that encourages a routine consideration of principal risks in decision making and supports the integration of risk management within our critical processes and ways of working. Risk management and internal control systems are monitored by the Audit and Risk Review Committee on behalf of 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 adopt those risks that deliver 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 exposure to these risks and for 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 those considered most critical 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 high score are passed to a director and Chief Executive Officer for immediate review.

Risk appetite

The amount of risk the Board is willing to take to achieve our strategic objectives is referred to as the risk appetite. We are in the process of identifying a risk appetite for each of our principal risks. It will then form a key element of our governance and reporting framework and will be reviewed annually by the Board.

We operate a complex infrastructure of water and wastewater assets, from pipelines to processing sites, over a broad geographical area and we recognise that extreme weather conditions and failure of our assets can have a negative impact on our customers. As a result we have clearly defined operating processes, procedures and control frameworks, including incident management, to mitigate our compliance and operating risks. In doing so we acknowledge that we also have to prepare for the unexpected and where some risk emerges that was not anticipated, we deal with it accordingly.

We employ sound enterprise risk management principles, transparent decision-making, and effective communication to prioritise risk. We aim to minimise our exposure to compliance, operational and regulatory risk, while accepting and encouraging more risk in pursuit of our mission and objectives. Our acceptance of risks is subject to ensuring that potential benefits and risks are fully understood before developments are authorised, and that sensible measures to mitigate risk are established.

This means we will not seek to intervene in all situations; rather our approach is based on judgement and the circumstances of each potential intervention and an assessment of its impact. We prioritise our actions in terms of risk, cost and perceived benefits in a consistent and transparent way, choosing the most appropriate course of action.

The principle risks we face are disclosed below:



Unchanged in the year



Risk reduced in the year



Risk increased in the year

Customer

Customer service

(Industry risk)

Outcomes affected



Responsive customer service



Better information and advice

Further information on our performance and strategy:

Working for our customers (page 28 to 40)

Better information and advice (page 35 to 40)

ODIs (pages 12 to 15)

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. Rewards and penalties will be assessed by Ofwat for each company based on relative performance across the four year period from 2015 to 2019.

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: This year we implemented an organisational restructure to help deliver our improved strategy for customer service. We plan to use more insight into customer trends to design a broader range of tailored services and training for our employees.

Improvements to customer service are being made continually. Our next step in improving our service is to change the way we work with outsourced partners. We have identified how working with a number of different companies, has caused customer issues. Consequently we are in the process of appointing a new, single outsourced partner.

We continue to actively engage with our customers and stakeholders 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. We are also re-designing our bills to make them easier to understand. Additionally, we are using software to identify customers who are still dissatisfied after they have spoken to us and taking recovery actions to turn around their experience.

Movement in risk exposure since 2017



Performance in 2017–18:

We have seen an improvement in our customer service risk since 2017. In the last year there was a 21% reduction in the number of written complaints. We are also dealing with 85% of all complaints received within three days, with the majority being responded to within 24 hours.

During the year we implemented an organisational restructure in our Customer Services department. During this period of transition we delivered an enhanced service for our customers that resulted in an improvement in our qualitative SIM ranking from 16th to 15th in the industry. While our performance is improving, we recognise that we remain behind many of our peers and, based on our relative performance over the last three years, we expect that Ofwat will impose a financial penalty in 2020. Our relative performance in 2018–19, the final year of assessment, will increase or decrease the level of penalty that we face.

Bad Debt

(Industry risk)

Outcomes affected



Responsive customer service



Affordable bills



Having a firm financial footing

Further information on our performance and strategy:

Affordable bills (page 32 to 34)

ODIs (pages 12 to 15)

Movement in risk exposure since 2017



Commentary: The level of customer debt which cannot be collected and has to be provided for as a bad debt charge 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.

Although we only operate in the south east of England we note that the ongoing Brexit process may have an adverse economic effect on our customers and their ability to pay for our services. While there are no signs that this has affected our bad debt position to date it is a risk that we continue to monitor and review.

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 help those in difficulty we offer a range of flexible instalment plans and tariffs, including a social tariff that was introduced in April 2015.

In addition we have partnered with Orbit, a company that provides specialist doorstep Debt Advice to customers in financial difficulty (to date over 95,000 customers have been referred).

We are proactive in collecting payment from our customers and in helping households pay any outstanding bills. Where necessary, should internal contact strategies fail, we may refer customer accounts to a panel of debt collection agencies. This helps us to control our bad debt position and the associated cost to serve our customers. As a final course of action, litigation may be considered where we believe customers have the financial means to pay any outstanding arrears.

We will shortly be enhancing our customer data to enable us to tailor the experience that our customers receive from us. This will enable us to more quickly identify and support customers who may be in financial hardship. We are overhauling our debt recovery strategies to be more responsive to individual customers' circumstances and are committed to ensuring that our service partners use systems and behaviours that accord with our values.

Performance in 2017–18:

This year, through using different engagement methods, we have been able to reduce our bad debt provision charge to £21.8 million (2017: £25.3 million).

We are aiming to improve on this performance further in the financial year for 2018–19.

Climate

Resilience to drought

(Industry risk)

Outcomes affected

-  A constant supply of high-quality drinking water
-  Looking after the environment

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 access to adequate water resources so we can supply customers and support the economy.

Further information on our performance and strategy:

A constant supply of high-quality drinking water (pages 41 to 44)

Protecting our natural resources (pages 48 to 55)

ODIs (pages 12 to 15)

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 ensure we have a secure supply of water. These measures include schemes such as: leakage reduction, strategic transfers and the development of new resources. As a result of our Universal Metering Programme, nearly 90% of customers now have a meter.

Should a drought occur 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.

During 2017–18 we applied for and were granted a drought permit to help resupply Bewl Reservoir. We also began a campaign to increase customer awareness about the current state of water availability and the actions we have been taking to protect water supplies.

Movement in risk exposure since 2017



Performance in 2017–18:

Last year we reported how the lack of rainfall we received in 2016–17 had increased this risk. Lower than average rainfall continued through much of 2017 and as a result, groundwater levels and the level of our Bewl Water reservoir were very low at the end of 2017. As a result, the EA declared Kent (among other areas of the country) to be in a drought position.

In December 2017 and the early months of 2018 higher than average rainfall was received. This resulted in an improvement in the level of water in our boreholes which are now either at, or slightly above, the position this time last year. In addition, we continue to improve supply resilience and drive water efficiency measures in our vulnerable areas. Such areas of concern include the Kent Thanet region where we witnessed extremely low groundwater levels at the end of 2017.

This improvement in groundwater levels, together with pumping to re-fill Bewl Water, now means that restrictions will not be needed in 2018–19.

Resilience to flooding

(Industry risk)

Outcomes affected



Removing wastewater effectively



Looking after the environment

Further information on our performance and strategy:

Removing wastewater effectively (pages 45 to 47)

Protecting our natural resources (pages 48 to 55)

ODIs (pages 12 to 15)

Commentary: Changing rainfall patterns, more frequent and intense storms and rising sea levels, could all lead to an increased risk of flooding if volumes overwhelm our assets. Excessive rainfall can result in high groundwater levels which are not possible to control. This leads to flooding to private land and property, possible contamination of water supply, and infiltration/inundation of sewers. 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.

Mitigation: To help combat this risk, we have prioritised schemes for investment in 2015–20. We are investing over £400 million during this period to provide a reliable and effective wastewater service, part of which will be used to keep over 39,500 kilometres of sewers and 3,321 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.

We are working collectively with other Water and Sewerage Companies in collating information for the national picture of headroom capacity and flood risk, as part of the 21st Century Drainage project for which UKWIR (UK Water Industry Research) are project managing the delivery.

In addition we are running our hydraulic models to determine properties and areas at risk of flooding in severe weather that national sewer design standards cannot cope with, to assist in building our five-year business plan from a resilience perspective.

Movement in risk exposure since 2017



Performance in 2017–18:

We have met all of our business targets this year for sewer blockages, sewer collapses, external flooding, and internal flooding incidents. While this risk has remained the same as last year, we continue to focus on reducing this further and improving the resilience of our network.

Operational

Resilient Supply of good quality water

(Industry risk)

Outcomes affected

-  A constant supply of high-quality drinking water
-  Looking after the environment

Further information on our performance and strategy:

A constant supply of high-quality drinking water (pages 41 to 44)

Protecting our natural resources (pages 48 to 55)

ODIs (pages 12 to 15)

Commentary: We must ensure we can supply enough drinking water to cater for a growing population of more than 2.5 million people. Should operational treatment processes fail, the water supply becomes contaminated, or our water distribution network fails:

- there is a risk that water could be supplied to customers that is unfit for consumption, and would require a widespread 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 in the Risk and Compliance section of our Annual Performance Report 2017–18 which is available on our website southernwater.co.uk/our-reports.

Mitigation: To avoid such incidents we prioritise investment in the maintenance of critical assets and technology. We also ensure all our employees are trained appropriately to perform their roles well.

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.

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.

Movement in risk exposure since 2017



Performance in 2017–18:

During the year we experienced some challenging circumstances, in particular the extreme freeze and thaw in February and March 2018, which resulted in an increase in the number of bursts in our own network and customer pipes.

While we achieved drinking water quality compliance of 99.96%, we missed our annual targets for minutes without supply for customers and leakage. However, leakage remains in line with our target for the five-year regulatory period.

As a result we have increased the risk in this area this year.

We have done much to improve our future position, including strengthening our resilience in high risk areas such as Thanet and the Isle of Wight. Delivery of nitrate removal and UV capital schemes also contribute to this. Following the severe weather event this winter we have also enhanced our contingency and incident management plans.

Information Security and Governance

(Southern Water specific risk)

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

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 information security threats which could have a significant impact on our business reputation, ability to operate, and the resilience of our operational assets.

Additionally, because of the nature of our activities, we hold and process large quantities of personal and payment data about our customers and employees. It is important that we treat this information with respect and in accordance with the requirements of information governance. Information governance brings together Data Protection (GDPR) and Information/Cyber Security (NIS) directives under one umbrella as part of an overall information governance framework. The main objective of this is to be able to manage risks and issues holistically across the organisation. Information governance also incorporates physical security as part of its scope.

Further information on our performance and strategy:

Mitigation: We manage this risk through IT security standards and ongoing monitoring of our IT infrastructure to identify risks and threats. Where needed we use incident management processes and business continuity plans.

Working for our customers (page 28 to 40)

We continue to invest in cyber threat mitigation strategies in response to the ever-changing risk landscape and we work with the National Cyber Security Centre. Over the past 12 months we have used industry experts to review our cyber security and help develop improvement plans.

ODIs (pages 12 to 15)

We undertake regular testing to assure our security measures during the year or whenever we make improvements to our IT systems.

We have policies in place identifying the need to have in place safeguards surrounding the collection, handling, use, storage and destruction of personal data, and ensuring our compliance with GDPR. This policy is supported by data protection training which is mandatory for all staff. We have established an Information Governance Council and a GDPR programme in preparation for the new GDPR legislation. NIS-related risks are also being assessed. Our information security, information governance and data protection training, policies and processes are currently being updated to ensure we comply with our obligations under the new legislation.

Movement in risk exposure since 2017



Performance in 2017–18:

During 2017–18 we continued to develop our Information Security resilience to protect our infrastructure and the information we hold, as well as ensure we were prepared for GDPR and NIS regulations which came into effect from May 2018.

In addition we have created a new Data Team to help ensure that the integrity of, and controls around, the data we hold are in place and are investing in significantly upgrading the backbone of our IT infrastructure to ensure that it meets the needs of the organisation.

Wastewater treatment works failures and pollution incidents (Industry risk)

Outcomes affected



Further information on our performance and strategy:

Removing wastewater effectively (pages 45 to 47)

Protecting our natural resources (pages 48 to 55)

ODIs (pages 12 to 15)

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.

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 (EA) and cause damage to our reputation.

We are continuing to assist Ofwat and the EA with some ongoing investigations in relation to the operation of some of our wastewater treatment works and reporting processes. The investigations are still evolving and no clarity of their findings or further action and associated financial impact, if any, can be quantified at this time.

We have significantly improved the level of internal assurance which has enabled the independent external assurance of 2017 data. We have also carried out this improved assurance on 2016 data which has identified a need to correct previously reported performance for Wastewater Treatment Works – population equivalent, and Wastewater Treatment Works – number of failed works. We are currently reviewing the 2015 data and it appears that Ofwat Outcome Delivery Incentive penalties may have been applicable in respect of the 2015 calendar year. The additional technical assurance that we have carried out on wastewater treatment performance data is now being rolled out for the years 2014 to 2010.

It is likely that we will be required to make future revenue adjustments and/or pay penalties and fines in relation to any restated figures. The Ofwat investigation could result in Ofwat taking enforcement action which may include the imposition of a financial penalty, which could be material in nature as Ofwat can impose a financial penalty of up to 10% of turnover for each breach. Any penalty or fine will be dependent on a consideration of the severity of the findings of the investigations. These will be subject to ongoing discussion and agreement reflecting, amongst other matters, the mitigating actions being taken by the company to respond to these matters after review.

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

We monitor the function and performance of our assets on a continuous basis through a central control room and we have formed a data analytics and reporting team to review pollution-related data. We also monitor any instances when our Combined Sewer Overflow (CSO - back-up over-flow pipes) are used, to proactively identify infrastructure under stress. This, together with our new works management system has significantly improved the way 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 our networks to reduce the risk of asset failures and asset-related incidents. This investment allows us to ensure a resilient wastewater service while accommodating increases in demand as a result of population growth, new environmental standards and climate change.

In the financial year 2017–18 we invested £144.7 million at our wastewater treatment works and pumping stations to reduce risks at critical sites. We also invested £46.3 million in our sewer networks.

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.

Movement in risk exposure since 2017



Performance in 2017–18:

As a result of the ongoing investigations by Ofwat and the EA in relation to the operation of some of our treatment works this risk has increased this year.

Health and Safety

(Southern Water specific risk)

Outcomes affected



Further information on our performance and strategy:

Our Southern Water (pages 56 to 60)

ODIs (pages 12 to 15)

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

Emotional wellbeing is an important part of caring about health and safety and the company recognises that wellbeing has a major impact on all aspects of our work.

Mitigation: We have taken all necessary steps to ensure the potential health and safety risk is suitably mitigated and controlled. We have a clearly defined strategy, safety protocols and standards that are set. 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.

All employees receive suitable health and safety training, and we have a campaign to encourage employees 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.

Wellbeing was a central part of our 2017 Health and Safety conference and Southern Water is committed to the 'Time to Change' programme to raise awareness and understanding of mental health issues.

Movement in risk exposure since 2017



Performance in 2017–18:

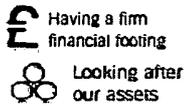
We have maintained a consistent high standard for health and safety throughout the 2017–18 year, recording two periods of more than 100 days without a reportable injury to a member of our own staff or those of our supply chain. Our health and safety record has been recognised again by RoSPA which awarded us an Order of Distinction in April 2018.

Financial

Financing our business

(Southern Water specific risk)

Outcomes affected



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. Maintenance of specified credit ratings is required as a condition of our regulatory licence and our borrowing covenants. 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.

Further information on our performance and strategy:

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.

Financial performance (pages 61 to 94)

During the year, Moody's updated the outlook on the credit ratings of Southern Water from Stable to Negative. The change to outlook reflected 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 are considering this as part of our five-year business plan for 2020–25.

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 the planning process for 2020–25, albeit the key value for the weighted average cost of capital (WACC) is uncertain. Financial risk is stable for the current regulatory period 2015–20, in part supported by our stated gearing targets. Operational risk is supported by our annual improvement since 2011.

Movement in risk exposure since 2017



Performance in 2017–18:

We are expecting a material reduction in the funding for interest and returns (i.e. the 'WACC') for the next price review commencing 2020. Our plans for 2020–25 (the next price review period) are being finalised and we will submit them to Ofwat in September 2018. An important part of this plan will be to reduce leverage and improve interest cover ratios at Southern Water in order to maintain a robust long-term capital structure.

Defined benefit pension scheme

(Southern Water specific risk)

Outcomes affected

 Having a firm financial footing

 Having great people

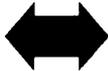
Commentary: We operate a defined benefit pension scheme which has been closed to new entrants from 1 April 2005. We remain liable for rights earned by past and present members of the scheme. Changes in demographics and fluctuations in investment markets may affect the cost of funding pension promises. 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. The company has been in discussion with the Trustees and The Pensions Regulator on the details of an appropriate long-term funding solution for the scheme.

Further information on our performance and strategy:

Financial performance (pages 61 to 94)

Mitigation: We agreed a long-term funding and risk management strategy with the Trustees in relation to the 2013 valuation. This is monitored regularly by us and the Trustees, and mitigating actions are reviewed and implemented as appropriate. The process of agreeing the 2016 valuation and funding plan has consequently been delayed by The Pensions Regulator since querying the pace of funding adopted to address the deficit.

Movement in risk exposure since 2017



Performance in 2017–18:

We have been monitoring the deficit in our defined benefit pension scheme carefully. We are confident the deficit will be reduced over the next five years, and have the financial agility to adjust our financing strategy accordingly.

Strategy and Regulation

Compliance with regulations and legislation

(Industry risk)

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

Further information on our performance and strategy:

Working for our customers (page 28 to 40)

A constant supply of high-quality drinking water (pages 41 to 44)

Removing wastewater effectively (pages 45 to 47)

Protecting our natural resources (pages 48 to 55)

ODIs (pages 12 to 15)

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. As with all companies we are also required to comply with legislation for example Competition Law and the Bribery Act.

As reported last year, this risk remains high as a result of certain regulatory compliance issues, described below, which have been raised by our regulators.

We are continuing to assist Ofwat and the EA with some ongoing investigations in relation to the operation of some of our wastewater treatment works and reporting processes.

The DWI has maintained an enforcement action 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 face investigations from the Environment Agency regarding the performance of certain wastewater sites and an investigation by Ofwat into the performance of our wastewater treatment sites and the reporting of relevant compliance information. The investigations are still evolving and no clarity of their findings or further action and associated financial impact, if any, can be quantified at this time.

We have significantly improved the level of internal assurance which has enabled the independent external assurance of 2017 data. We have also carried out this improved assurance on 2016 data which has identified a need to correct previously reported performance for Wastewater Treatment Works – population equivalent, and Wastewater Treatment Works – number of failed works. We are currently reviewing the 2015 data and it appears that Ofwat Outcome Delivery Incentive penalties may have been applicable in respect of the 2015 calendar year. The additional technical assurance that we have carried out on wastewater treatment performance data is now being rolled out for the years 2014 to 2010.

It is likely that we will be required to make future revenue adjustments and/or pay penalties and fines in relation to any restated figures. The Ofwat investigation could result in Ofwat taking enforcement action which may include the imposition of a financial penalty, which could be material in nature as Ofwat can impose a financial penalty of up to 10% of turnover for each breach. Any penalty or fine will be dependent on a consideration of the severity of the findings of the investigations. These will be subject to ongoing discussion and agreement reflecting, amongst other matters, the mitigating actions being taken by the company to respond to these matters after review.

From 2016–17, Ofwat has also made an annual assessment of our assurance as part of its company monitoring framework (CMF), publishing a report on its website.

Note – further details are included in our updated statement of Risks, Strengths and Weaknesses, March 2018, available on our website at southernwater.co.uk/our-reports.

Mitigation: We have continued with our work to improve our internal assurance capabilities, focusing on those processes that result in reporting to our regulators. This has included setting up a separate compliance directorate, detailed mapping of our processes, stabilisation and improvement of our systems and the development of a robust compliance framework. Additionally we are developing a culture transformation programme to embed a compliance culture into the organisation.

We have developed a transformation programme for our water business that we are calling 'Water First' and have made significant progress on rectifying any issues found following a series of compliance related field audits at our wastewater treatment sites. We are

continuing to improve the traceability and auditability of the sampling programme and as part of this we are rolling out a handheld GPS system to all samplers. We have rolled out technical training on critical compliance issues for water operatives and wastewater operatives.

We have responded to the comments raised by Ofwat in its Company Monitoring Framework assessment and have met Ofwat to discuss its concerns about our wastewater reporting. 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 non-technical 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.

Movement in risk exposure since 2017



Performance in 2017–18:

During 2017–18 we have continued to work hard to respond to areas where our regulators had expressed concerns. Although we have made progress, we recognise that there is still further work to do in order to deliver the regulatory compliance expected of us.

In November 2017 Ofwat published its latest CMF report. Overall, Ofwat said that it had seen some areas of significant improvement from Southern Water in 2017 as compared to the previous year.

However, overall Ofwat found a number of minor concerns in our reporting and with our data assurance. This included reporting of our outcomes and the fact that we were unable to provide assurance over three of our wastewater metrics, a few minor errors in our financial information and the quality of our casework responses. As a result, Ofwat concluded that we had not yet made enough of an improvement to lift us out of the 'prescribed' category.

Delivery of our capital investment programme *(Southern Water specific risk)*

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

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.

Mitigation: We are transforming 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.

Further information on our performance and strategy:

A constant supply of high-quality drinking water (pages 41 to 44)

Removing wastewater effectively (pages 45 to 47)

Protecting our natural resources (pages 48 to 55)

ODIs (pages 12 to 15)

Movement in risk exposure since 2017



Performance in 2017–18:

Capital expenditure in the first two years of the programme was behind that set out in the business plan, increasing the risk in this area. We have accelerated the programme in 2017–18 in order to recover this position and remain on track to deliver our required outcomes by the end of the investment programme in 2020.

PR19 price review and regulatory reform

(Industry risk)

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

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.

Our current business plan and approved pricing structure runs until 2020. The next period runs from 2020–25 and we have begun work on our new business plan. This must be submitted to Ofwat by 3 September 2018. If Ofwat do not believe that our business plan is of high quality, this may affect materially the revenue we can earn in the period 2020–25.

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.

Further information on our performance and strategy:

ODIs (pages 12 to 15)

Mitigation: We have established a programme for the 2020–25 business plan to ensure that we are able to deliver a high quality submission to Ofwat, by their deadline. Development of the plan includes significant engagement with our customers and stakeholders, as well as detailed costing of options to deliver service improvements and improve the resilience of the services we provide.

We have continued to respond to all Ofwat’s consultations on price review methodology and will maintain close dialogue with Ofwat and other regulators on key issues. We closely monitor developments in the requirements from our regulators Ofwat, The Drinking Water Inspectorate and the Environment Agency. To anticipate changes we have proactively initiated programmes of investment in our infrastructure that will help us to be prepared and resilient to their changes.

Movement in risk exposure since 2017



Performance in 2017–18:

This risk has increased during the year as a result of the further detail provided by Ofwat on the approach to our five-year business plan for 2020–25, including the level of detail and quality of evidence they expect to see in our business plan. Our programme to deliver our business plan to Ofwat by September remains on track.

The level of risk has also increased as a result of the level of political focus on the sector. There is a risk that this focus results in either significant changes to the structure of the sector or new regulatory requirements placed on water companies.

The Strategic Report was approved by the Board of Directors on 5 July 2018 and signed on its behalf by Joanne Statton, Company Secretary.

Joanne Statton
Company Secretary
5 July 2018

Corporate governance

Chairman's overview

Introduction

Southern Water is a provider of an essential public service to its customers and communities in the South East. We therefore put the customer at the heart of everything we do as a company. We are, as directors, required in law to promote the success of the company for the benefit of our shareholders, taking into account the interests of wider stakeholders in doing so. The importance of the services the company provides means that the interests of stakeholders beyond simply shareholders must be taken into account in a more material way than is perhaps the case in a more traditional corporate model. Hence, the Board ensures that the decisions we make consider the impact on our customers, the local community and the environment as well as the impact on our shareholders.

As has been highlighted earlier in the report, this has been a time of change for the company, for both the Board and the Executive, and throughout we have remained committed to providing high standards of leadership, transparency and governance. We continue to apply the provisions of our code, which was reviewed and updated during the year, and reflect the Ofwat principles of board leadership, transparency and governance. As the Board, we fully accept our responsibility and accountability to stakeholders, including our customers, 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, all its stakeholders, including customers, employees, key partners, contractors 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, including its customers
- 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 to provide an essential public service to our customers
- ensure that appropriate and effective processes and controls are in place to assess and manage risk.

Governance structure

The Board is aware of the need to demonstrate the highest standards of corporate governance and for the company to be a trusted provider of an essential public service. To improve transparency and accountability, a new governance structure has been introduced in the year, which separates the board meetings of Southern Water and our ultimate parent company Greensands Holdings Limited. In addition, a decision was made that I, as Chairman of Southern Water, would not be a member of the Greensands Holdings board, unlike my predecessor. We believe that these changes further demonstrate that Southern Water continues to operate as an independent company.

Southern Water Code of Board leadership, transparency and governance

In the Southern Water Code of Board leadership, transparency and governance, we have fully reflected Ofwat's principles and have 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 Limited (GSH), has committed to assist us. We reviewed and updated the Southern Water Code, not only to reflect the changes in the governance structure, but also to further emphasise the Board's commitment to considering the interests of all its stakeholders, balancing the needs of customers and the environment as well as the Board's role in governing for the achievement of long-term sustainable operations of the company. The Board is aware of the proposed changes to the UK Corporate Governance Code, which are expected to be finalised in 2018, and a further review of the Southern Water Code will then be undertaken.

The Southern Water Code is published on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

Board membership

Having been appointed to the position of independent non-executive chairman of the Board on 1 March 2017, my first full year as Chairman has seen significant change for the company. As I reported last year, the Nomination Committee was leading the recruitment for the vacancy left following my appointment as Chairman and we were pleased to welcome Mike Putnam to the Board in September as an independent non-executive director. In addition, Sara Sulaiman was appointed to the Board as a shareholder non-executive director, following the resignation of Mark Walters. Finally, Wendy Barnes was appointed as a shareholder representative non-executive director to the Board, having been nominated by Greensands Holdings following a process led by Southern Water's Nomination Committee.

During 2017–18 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. At all times during the year the majority of non-executive directors have been independent, with independent directors (including the independent non-executive Chairman) being the largest single group on the Board, in line with the Southern Water Code and Ofwat's principles. I believe that, during the year, we continued to comprise a balanced and rounded Board, giving independent support and advice as well as providing new ideas and healthy challenge. The members of the Board, their biographies and descriptions of their complementary skills and extensive experience are on pages 102 to 105.

Lisa Harrington resigned from the Board, effective 31 March 2018. The Nomination Committee, having reviewed the skills and experience of the Board, has commenced the process for the recruitment of two further independent non-executive directors. This process is being led by myself and the senior independent non-executive director.

The company published its gender pay gap report which showed that Southern Water is in line with the national average median. Our report at April 2017 showed a mean gap in favour of male employees of 9.5% and median gap in favour of male employees of 9.0%. In terms of bonus recipients, 84.0% of female employees and 87.4% of male employees received a bonus. We are committed to supporting the aspirations of our talented female workforce and are implementing plans to address the gender pay gap. Further information can be found in our gender pay gap report. On gender diversity, as at 31 March 2018, women made up 44% of the Board. We support diversity in its widest sense and want to attract employees and Board members with a diverse range of backgrounds, as we recognise the significant benefits of a diverse Board and workforce.

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, chairs 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.

As previously reported, I am not the Chairman of Greensands Holdings following a decision that this will ensure that the Chairman will remain independent of the company's shareholders in line with our Code.

Investor representation

Our investors comprise the Greensands Consortium, the membership of which is explained on page 71 and on our website at southernwater.co.uk/greensands-ownership-of-southern-water.

One investor is directly represented on the Board and the shareholders of Greensands Holdings are represented by their own appointed non-executive director. 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 four years and brings with him considerable experience in

construction and engineering. Paul also leads the process for the search for new non-executive directors to be appointed to the Board.

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 decisions and reporting 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, cyber security, regulation, transformation and finance, and for the range of their experience of general corporate management.

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 independent non-executive directors also meet without the Chairman to appraise his performance.

The standard terms and conditions of the appointments of independent non-executive directors are published on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

Shareholder representative non-executive directors

There is currently one non-executive director, Sara Sulaiman, who is nominated to the Board by one of our three major investors. She brings the extensive knowledge, skills and resources of her nominating investor and employer as well as her own personal skills, experience and knowledge of businesses and business sectors similar to our own. On our Board, she has all the duties, obligations and rights of a director of Southern Water and acts in the best interests of the company. She does not receive any remuneration from Southern Water. As reported earlier in this report, Wendy Barnes was appointed to the Board in September as a representative of the Greensands Holdings Board, following a process led by the Southern Water Nomination Committee. She brings with her experience of both the water sector and particularly, cyber security. On our Board, she has all the duties, obligations and rights of a director of Southern Water and acts in the best interests of the company.

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 judgment, are reasonable within the Chief Executive Officer's limits set out in the company's internal controls. The non-executive directors, led by the Chairman, appraise his performance annually.

Chief Financial Officer

The Chief Financial Officer, 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 for managing the company's financial affairs and assisting the Chief Executive Officer in the delivery of the company's strategy. His 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, 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, development and information

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: Cyber Security and the EU General Data Protection Regulation (GDPR); the company's water resources position; water resource management planning and drought plan; the opening of the non-household retail market; the company's culture programme; and Ofwat's methodology for the next business plan submission for 2020-25 (2019 price review). The Board also has access to professional development provided by external bodies and our specialist advisers, which this year included presentations on directors' duties, both generally and in respect of health and safety. The Board also received regular updates on regulatory matters, and matters raised by Ofwat, the Drinking Water Inspectorate and Environment Agency in particular.

Engaging with stakeholders

Engagement and listening to our stakeholders – particularly our customers and the communities we serve – is vital to delivering our vision and improving performance for our customers. I, and members of the Board, have actively engaged with the company's regulators and stakeholders at both formal meetings and events, including with Ofwat. In addition, we invited the Chief Inspector of the Drinking Water Inspectorate to visit our Board, and the Chair of the Consumer Council for Water. The Chair of our Customer Advisory Panel, now the Customer Challenge Group, for 2020–25, Anna Bradley, has an open invitation to attend our Board meetings, attending at least twice a year, to provide challenge and feedback on the company's engagement with customers, as well as the company's delivery against our business plan promises for 2015–20.

2019 price review

Throughout the year the Board has been actively engaged in the company's business planning process for Ofwat's 2019 price review. In addition to regular updates and presentations at Board meetings, the company has held stand-alone Board and shareholder engagement sessions. These sessions have enabled the directors to shape and challenge the plan in readiness for its submission in early September 2018.

Board evaluation

The assessment of the Board was conducted in accordance with the Southern Water Code and was facilitated by Ffion Hague of Independent Board Evaluation, with Ffion presenting her findings to the Board at its meeting in November. The review recognised that the company had undergone significant change, within both its business and its Board and that, overall, the Board was found to be effective. Following the review, the Board agreed a number of objectives to address matters raised during the review which will be tracked throughout the coming year. It is our intention to report on these matters and the Board's progress in respect of the agreed objectives in next year's annual report.

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. In line with the review of our governance structure, we published an updated schedule of those matters reserved to Greensands Holdings on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

During the year 2017–18 no matters required Greensands Holdings board or shareholder approval.

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 at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

Board meetings

The Board held 10 scheduled monthly meetings during the year and an additional meeting was held in December 2017. The agenda and papers are sent to Board members in advance of each meeting. The monthly financial and performance reports are also distributed for the other months when there is no scheduled meeting (August and December).

The Board holds its meetings at its principal office in Worthing and in London and this year the Board also held a meeting at Testwood Lakes, and undertook a visit to the company's adjacent Testwood Water Supply Works.

In addition to the scheduled Board meetings, the Board, the company's Executive Leadership Team and shareholders met in August, to discuss strategic considerations of the company for the 2019 price review. It was agreed that the Board would meet regularly for the purpose of monitoring, challenging and influencing the development of our plans. Five Board engagement meetings, including one two-day session and four sub-committee meetings were held up to the year end and further meetings are planned up to the submission of the Business Plan scheduled for September 2018.

The Board has overseen a year of change and challenge for both the company and the water industry. Notwithstanding this 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.

Directors have access to the advice and services of the Company Secretary and are able to obtain appropriate independent professional advice in connection with 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.

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 2017–18 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 on its remit. These terms of reference are published on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

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

Attendance at Board and committee meetings

Attendance at scheduled meetings in 2017–18	Board meetings	Audit and Risk Review Committee	Health and Safety Committee	Remuneration Committee	Nomination Committee
Bill Tame ¹	10/10	4/4	-	4/4	4/4
Ian McAulay	10/10	-	3/3	-	-
William Lambe	10/10	-	-	-	-
Paul Sheffield ²	9/10	4/4	3/3	4/4	4/4
Rosemary Boot	10/10	4/4	3/3	4/4	4/4
Lisa Harrington (resigned 31 March 2018)	10/10	4/4	-	4/4	4/4
Mike Putnam ³	5/5	2/2	-	2/2	2/2
Wendy Barnes ³	6/6	2/2	-	2/2	2/2
Sara Sulaiman ³	6/6	2/2	2/2	2/2	2/2
Mark Walters (resigned 26 September 2017)	3/4	1/1	1/1	1/2	1/1
Andrew Truscott (as alternate)	1/1	-	-	1/1	-

Note – Attendance includes attendance in person and by phone.

¹ Although not a member of the ARRC, the Chairman attends by invitation.

² An additional Board meeting was added for December and, as a result of a prior engagement, Paul Sheffield was not able to attend.

³ While not formally appointed to the ARRC until the Board meeting in September, Mike Putnam, Wendy Barnes and Sara Sulaiman attended the September ARRC meeting.

Remuneration

The directors' remuneration report is set out on pages 111 to 122.

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 following good corporate governance to underpin business strategies and plans. This ensures 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.

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.

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 and 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 previously served on the CBI Infrastructure Board and the Greater Brighton Economic Board. Ian currently chairs the Greater Brighton Economic Board and Infrastructure Panel and is a member of the CBI Infrastructure 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.

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.

Paul Sheffield

Senior independent non-executive director

Paul Sheffield joined the Board in June 2014 and was appointed as Senior Independent Director in July 2015. He is a Fellow of the Institution of Civil Engineers and is also a member of the Supervisory Board of BAM Group in the Netherlands. Paul is also a specialist adviser to Manchester Airport Group, working on their £2 billion capital programme at Manchester and Stansted Airports.

In his executive career, he spent over 32 years with Kier Group plc — the construction, services and property group. Graduating as a Civil Engineer in 1983, Paul spent 15 years working on major capital projects around the world, before taking responsibility for a number of business units within the Group. Paul was on the Group Board for 10 years and served 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, such as Crossrail, Hinkley Point C Nuclear Power Station and major capital projects in the water industry.

Through his various roles in business leadership, Paul has gained significant experience of strategy, productivity and efficiency – key facets of any successful organisation.

Rosemary Boot

Independent non-executive director

Rosemary Boot joined the Board in March 2015 and was appointed as Chair of the Audit and Risk Review Committee in July 2017, having previously served as the interim Chair since March 2017.

Since March 2017 she has been a non-executive director of Impact Healthcare REIT plc, a UK care home real estate investment trust that is listed on the Specialist Fund Segment of 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.

Mike Putnam

Independent non-executive director

Mike Putnam joined the Board in September 2017.

A Chartered Engineer and a Fellow of both the Institution of Civil Engineers and Royal Institution of Chartered Surveyors, Mike has over 25 years' experience leading and managing multiple businesses across development and construction. He is known for his values-based approach to leadership. Mike has since successfully transitioned to a plural career with a portfolio of Non-Executive Directorships.

Mike was President and CEO of Skanska UK between 2009 and 2017, responsible for a business with circa £1.8 billion revenues and 6,000 employees. Prior to this, he was Executive Vice President and main Board Director from 2001, as well working across the group as a non-executive director on some of the international boards. Throughout Mike's career he has been closely involved with the successful delivery of many high-profile projects and programmes.

Externally, Mike has been very active on the built environment change agenda, working with government and industry as a member of the Construction Leadership Council on the Industrial Strategy & Sector Deal. He has also been chair of the Green Construction Board; a member of the CBI Construction Council, influencing the future

direction of the industry and linking into Government; and a non-executive director of the Association of Consulting Engineers.

With proven all-round business and operations capability, Mike has particular strengths in: strategy development and deployment; results delivery; inclusive people and values-based leadership and transformational change.

Wendy Barnes

Non-executive director

Appointed to Southern Water in September 2017, Wendy Barnes, a portfolio non-executive and an independent consultant in cyber security, has wide experience in utilities, security and defence sectors. Having started her career as a statistician with British Nuclear Fuels, Wendy went on to have an executive career in customer service and business development with United Utilities.

In recent years, Wendy has been a non-executive director in the MOD, government security departments, Met Office and Ofwat. She is currently a non-executive director at the National Crime Agency, OCS Group, BMT Group and Scottish Power Networks and an Associate Director of Templar Executives. Wendy has chaired, and been a member of, several Audit and Remuneration Committees and has a particular focus on developing risk management and good governance, as well as helping organisations take on change in challenging environments.

In 2011–12, Wendy was a Director General in the Department of Energy and Climate Change (DECC) where she was responsible for Corporate Services and legacy nuclear policies.

Wendy runs a consultancy business with her husband, and is also a non-executive director of Chester Cathedral Enterprise Board and Finance Committee.

Sara Sulaiman

Non-executive director

Appointed in September 2017, Sara Sulaiman is an investment principal at the Infrastructure Investments Group of JP Morgan Asset Management.

Before joining JP Morgan, Sara was an investment director at Arle Capital Partners, a London based mid-market private equity firm. Prior to that she worked on corporate finance transactions both within Simmons & Company International, a specialist energy investment bank, and KPMG's Global Infrastructure and Projects Group (within the Energy & Natural Resources team).

Sara started her career in industry working as a finance analyst in Petroleum Development Oman and Shell Chemicals in London. She holds a Bachelor of Arts in Economics from Yale University, an MPhil in Economics from the University of Cambridge, and is an Associate of the Chartered Institute of Management Accountants.

In addition to her board role on Southern Water, Sara currently serves as a non-executive director on the board of Nature Investments SARL.

Joanne Statton

Company Secretary

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

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

Other Board members who served in 2017–18 were:

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. He served as a non-executive director until his resignation on 26 September 2017.

Lisa Harrington – Independent non-executive director

Lisa Harrington joined the Board in April 2015. She served as an independent non-executive director until her resignation on 31 March 2018.

Executive Leadership Team

Reporting to Ian McAulay, the Executive Leadership Team in 2017–18 consisted of:

William Lambe – Chief Financial Officer

Philip Barker – Director of Operations (to June 2017)

Rob Barnett – Director of Transformation and People

Simon Oates – Chief Customer Officer

Richard Price – Director of Engineering and Construction (to January 2018)

Alison Hoyle – Director of Compliance and Asset Resilience (from April 2017)

Craig Lonie – Director of Strategy and Regulation (from April 2017)

Helen Simonian – Director of Wholesale Water Services (from July 2017)

Simon Parker – Director of Wholesale Wastewater Services (from July 2017)

Jamie Ford – Commercial Director (from December 2017)

Neil Colman – Director of Engineering and Construction (interim from February 2018, permanent from April 2018)

Audit and Risk Review Committee

Message from the Chair

It has been a busy year for the Audit and Risk Review Committee. The committee has been overseeing the changes to processes, systems and training being led by the new Compliance and Asset Resilience Directorate to improve our non-financial information and reporting in water and wastewater, following concerns raised by our regulators. We have also monitored, at each meeting, the programme of actions being taken prior to the introduction of the new data protection and information security laws in May 2018. We have been assisting in the development of a risk appetite framework for approval by the Board.

The committee reviewed the approach to assurance being taken to support the Annual Performance Report as well as the five-year Business Plan being developed for 2020–25 to be submitted to Ofwat in September 2018.

Rosemary Boot, Chair of the 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.

Rosemary Boot was appointed as the Chair of the committee in July 2017, having previously served as the interim Chair. The other members of the ARRC are all other non-executive directors of the Board.

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, Chief Financial Officer, Director of Compliance and Asset Resilience 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 2017–18 and details of attendance are provided on page 100. During the year 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
- Compliance with the company's legal and regulatory obligations
- Regulatory reporting obligations
- Annual risk review
- Risk Appetite framework
- Speak Up
- EU General Data Protection Regulation and EU Network and Information Systems Directive

The terms of reference of the ARRC are published on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

As a customer-focused business, we have a significant amount of data on individuals, including names, addresses, payment information and in certain instances, more sensitive information where customers are vulnerable. Therefore, the ARRC has reviewed the impact of the EU General Data Protection Regulation (GDPR) and assessed the improvements required to the company's processes and controls to ensure that any personal data is protected and that the company would be in a position to comply with the GDPR when it came into force on 25 May 2018.

Following the creation of the Compliance and Asset Resilience Directorate, the ARRC has monitored the company's regulatory compliance activity and compliance improvement programmes throughout the year. In preparation for the submission of the company's business plan, the ARRC approved the company's approach to its assurance for Ofwat's 2019 price review.

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 referenced thereafter from that note and the external audit report from Deloitte regarding the year-end financial statements, considering any items of significant judgment that have been made and comments on the control environment, including general IT controls and contingent liabilities, before making a recommendation to the Board to approve the annual results. There were no significant issues to be addressed. However, it was noted that improvements to increase the reliability of the company's IT controls were required and that this would be addressed in 2018–19.

Our Ofwat Performance Commitments

We appoint a certifier to independently confirm that we have a robust system of internal controls in place for non-financial 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. In their report this year the certifier highlighted issues of data quality, data reporting accountability and issues relating to organisational change in our end of year non-financial reporting. The management team acknowledge these issues and have committed to tackle them in the coming year as part of its long-term compliance improvement programmes. This will include additional assurance in the autumn to help prepare for year-end reporting next year.

Internal controls

The ARRC receives regular reports from Internal Audit in respect of its work on internal controls and reviews any internal control findings identified by 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. This year was the first full year of the company's new Speak Up policy, which was launched in January 2017. The ARRC receives updates on those matters received through Speak Up and there were no material incidents reported during the year.

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 78.

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 Chair 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 Chair 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.

During the year the committee has considered and agreed the framework for the development of the company's approach on risk appetite to be approved by the Board.

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 25 September 2017 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 Chair of the ARRC provided a report to the Board of the review undertaken.

External auditor

Following a tendering process in 2011, Deloitte LLP was appointed our auditor for the year ended 31 March 2012. The ARRC considers the auditor's effectiveness each year and would report to the Board any concerns over the auditor's continuing appointment.

The current audit partner, Anthony Matthews, rotated onto the audit for the 2016–17 Annual Report.

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

Message from the Chair

The health, safety and wellbeing of the company's employees is a priority for the Board. The Health and Safety Committee has continued to monitor and review the health and safety arrangements within the company to ensure that we continue to provide a safe environment for employees, our supply partners and the wider public. We endeavour to continue to improve health, safety and wellbeing in our operations and as such during the year, we carried out an in-depth review of our contractors' performance and reviewed progress on our employee wellbeing initiatives. The Committee was pleased to see Ian McAulay, Chief Executive Officer, sign the Time to Change employer pledge that focuses on addressing Mental Health issues and eliminating the stigma and discrimination surrounding mental health.

Paul Sheffield, Chair of the 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, particularly on the capital programme and the company's progress on wellbeing. The Committee held its June 2017 meeting at the company's Hardham Water Supply Works and visited the Uckfield Water Treatment Works in March 2018, enabling the Committee to see first-hand the delivery of schemes on site. The H&SC also agreed the company's health and safety targets which were formally approved by the Board at its meeting in June 2017.

The H&SC was pleased to see that for the 19th consecutive year the company received a Gold Award from RoSPA.

Members of the H&SC also attended the company's annual Health, Safety and Wellbeing Conference, which attracted 214 people from across the company and its partners.

The members of the H&SC are Paul Sheffield (Chair of the Committee), Ian McAulay, Rosemary Boot, Sara Sulaiman (appointed November 2017). Mark Walters also served on the H&SC until his resignation in September 2017.

The H&SC met on three occasions in 2017–18 and details of attendance are provided on page 100.

The terms of reference of the H&SC are published on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

Nomination Committee

Message from the Chair

We have seen a number of significant changes to the composition of the Board over the last 12 to 18 months, including a new executive team and my own appointment as the company's Chairman. In addition, three directors have been appointed as non-executive directors. The Nomination Committee has participated in the recruitment of non-executive directors, taking into account the need to ensure an appropriate mix of skills, knowledge and diversity on the Board.

Bill Tame, Chair of the 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 recruitment of non-executive directors to the Board, supported by The Zygos Partnership. The Nomination Committee also reviewed the Executive Leadership Team succession plan and discussed diversity.

The members of the Nomination Committee are Bill Tame (Chairman), Paul Sheffield (senior independent non-executive director) and all other non-executive directors.

The Nomination Committee met on three occasions in 2017–18 and details of attendance are provided on page 100.

The terms of reference of the Nomination Committee are published on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

Directors' Remuneration Report

This report details the activities of the Remuneration Committee for the period to 31 March 2018. 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

I am pleased to present the Remuneration Committee's report for the year to 31 March 2018.

The key purpose of the Remuneration Committee is to develop and implement incentive and retention structures that allow Southern Water to drive performance improvement, align our employees to deliver the outcomes and expectations of our customers and create value for our shareholders. During the year, we felt it appropriate to introduce a new scheme which we felt was better able to meet these criteria. Later in the report, and below, we set out a summary of the new incentive scheme that we adopted and how we sought to implement it during the year.

Summary of the year

The last year has been one of significant change and challenge for Southern Water. We have seen many successes in the year but have faced significant costs associated with upgrading the backbone of our IT systems and investing in our customer relationship teams and processes across the whole company in order to provide a better service. A number of our achievements in the year were:

- a reduction in written complaints by 21%, adding to the 47% reduction we achieved in 2016–17
- implementation of joint billing with South East Water so that those customers whose water services are split between our two companies, now only receive a single bill
- further significant reductions in the number of sewer blockages, pollutions and internal and external flooding incidents caused by failures of our networks
- all 83 beaches in our area met the minimum standards required and 53 achieved 'excellent' status
- looking to the future, we have gained significant stakeholder support for a strategy that will see us waste less water through leakage and use less water by encouraging consumers to reduce daily average consumption rates.

These successes have been carefully weighed up against the challenges that we have been addressing which are largely historic in nature.

Remuneration outcomes for the year 2017–18

The Committee continues to advocate a clear link between performance and reward. As such the performance of the company as a whole has been reflected in the remuneration outcomes for the year with Directors receiving an annual bonus contribution of 54% of the maximum. Under the new incentive scheme, explained further below, half is paid out, with the remainder carried forward to future years.

On reviewing company performance against the Long-Term Incentive Plan (LTIP) criteria, none met the thresholds required to trigger a payment.

New incentive scheme

During the year, the Committee implemented a new Incentive and Retention Plan. The water industry is seeing an extraordinary amount of change and it was felt that the previous arrangement of Annual Bonus and LTIPs were not responsive enough to this changing environment. The Committee feels that this new Plan will enable us to respond to the needs and demands of customers and other stakeholders and to focus the Executive on their needs whilst delivering against a demanding business plan in a way that is visible to both management and stakeholders.

The Incentive and Retention Plan works by setting annual targets for a variety of short-term and long-term measures covering customers, financial, strategic and operational performance. At the end of the year, the performance for the year is assessed and a contribution is made into a 'bonus pool' for each participant. Each year half of the 'bonus pool' is paid out whilst the remaining half is retained in the 'bonus pool'. While in the 'bonus pool',

all unpaid contributions are subject to clawback and malus which help to inhibit excessive risk taking and further focus participants on long-term performance, providing an effective retention incentive for key executives. The Committee believes that this approach is in line with our remuneration philosophy of aligning remuneration to the performance of the company and the value delivered for our customers and stakeholders.

The Incentive and Retention Plan replaces future opportunities and grants from the previous Annual Bonus and LTIP and the total opportunity available to Executive Directors under the Incentive and Retention Plan is equal to the total opportunity under the Annual Bonus Plan and LTIP. The final LTIP award, granted in 2015, vested during the year. Following careful consideration of the performance of the company, against the criteria set out in the LTIP, which included SIM, delivery of the capital programme and total shareholder return, it was agreed that no payments would be made under this scheme. There will be no further grants or pay-outs under the LTIP.

Remuneration for 2018–19

For the next financial year the company will operate the Incentive and Retention Plan. However, performance measures and targets will be set specifically for the year in line with what the Committee considers to be challenging but achievable performance. Measures and targets will continue to be set by the Committee on an annual basis in order to ensure that the plan continues to be effective at driving performance improvement as well as aligning executives with outcomes for customers and shareholders.

The Remuneration Committee of Southern Water takes the views of customers, shareholders and regulators seriously and is committed to listening to the opinions of all of our stakeholders. I would like to take this opportunity to thank those of you who have taken the time to provide valuable input for the Committee.



Paul Sheffield
5 July 2018

The Remuneration Committee of Southern Water

The Remuneration Committee has the responsibility for setting the remuneration policy and structure of the executive directors and senior management. It is also responsible for setting the remuneration of the Chairman. The Committee has defined terms of reference, which are published on our website at southernwater.co.uk/about-us/about-southern-water/our-business/our-governance.asp.

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.

Only Committee members are entitled to attend meetings, with the Director of Transformation and People and the Chief Executive Officer, Ian McAulay, attending by invitation. The Company Secretary acts as secretary to the Committee.

No attendee participates in discussions regarding their own remuneration.

Committee activities and membership for the year

The table below sets out the members of the Committee for the year, attendance at meetings and the key activities undertaken at each meeting.

Members	Meeting 1 April 2017	Meeting 2 May 2017	Meeting 3 November 2017	Meeting 4 February 2018
Paul Sheffield (Chair)	●	●	●	●
Bill Tame	●	●	●	●
Rosemary Boot	●	●	●	●
Lisa Harrington	●	●	●	●
Mark Walters	●	Andrew Truscott as alternate	n/a	n/a
Mike Putnam	n/a	n/a	●	●
Sara Sulaiman	n/a	n/a	●	●
Wendy Barnes	n/a	n/a	●	●
Key activities undertaken	<ul style="list-style-type: none"> 2016–17 Management corporate objectives outturn 2017–18 Management corporate objectives 	<ul style="list-style-type: none"> 2017–18 Annual and long-term incentive targets Approved Incentive & Retention Plans and rules CEO and Executive Team remuneration review 	<ul style="list-style-type: none"> Remuneration benchmarking Reviewed medium-term incentive for senior management team 	<ul style="list-style-type: none"> Remuneration strategy Gender pay gap reporting 2018–19 Bonus metrics

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 2017.

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 and lower bills for customers, 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.

The table on page 115 summarises the elements of our executive directors' remuneration package and our policy for each item.

Our remuneration philosophy

Our philosophy is that the remuneration policy that will be most effective at doing this will be one where:

- a significant proportion of reward is based on performance against demanding targets
- targets are focused on delivering a high quality performance for our customers, stakeholders and the wider community
- remuneration strikes an appropriate balance between short-term and long-term success of the company
- remuneration should appropriately reward all employees who adhere to the company's values:

customers first – *we always put our customers first and do what we promise*

everyone matters – *we respect every individual, listen to their opinions and act on their ideas*

always improving – *we never stop working to make things better for our customers*

local pride – *we are proud of the essential work we do and the sustainable way we do it for the communities we serve*

taking ownership – *we take ownership and care about doing the right thing,*

succeeding together – *working as one team we will succeed in delivering our targets*

- the remuneration policy for our executive directors is aligned with that for other employees.

The 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 Committee 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 Committee is kept informed on a regular basis of the following which it uses to set remuneration policy:

- 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 Committee 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 Committee periodically calls upon experienced specialist consultants. During the year, the Committee also received some guidance and market practice from external, independent advisors, PwC.

Remuneration components

Element of remuneration	Purpose and link to strategy	Policy and approach	Maximum opportunity 2017–18
Base salary	<p>Takes into account experience and personal contribution to our strategy and performance.</p> <p>Attracts and retains executives of the quality required to deliver our strategy.</p>	<ul style="list-style-type: none"> • Reviewed annually with changes effective from 1 July if applicable. • Consideration given to individual and company performance. • General pay increases to all employees taken into consideration. • Aim to pay within a mid-market range, but may pay higher salaries to attract and retain executives of the right calibre or for out-performance by the individual or company. • Referenced against UK companies of a similar size, utility companies and other water companies. 	Base salary increases are applied in line with the annual review.
Incentive and Retention Plan	<p>Drives and rewards performance against financial, customer, and operational KPIs, which are directly linked to business strategy.</p>	<ul style="list-style-type: none"> • Details of the operation of the plan are shown on page 117. • Performance metrics and targets are established annually by the Committee, making sure they are sufficiently stretching while also recognising the nature and risk profile of the company. • Where applicable, between 60% and 80% of the opportunity available for each measure is created for achieving the mid-point target and 100% for achieving the stretch target. • The Committee has discretion to amend or withdraw payments based on the consideration of other factors which could significantly affect business performance. • Awards made under the plan are disclosed on page 120. 	<p>220% of salary for the CEO</p> <p>155% of salary for the CFO</p>
Long-Term Incentive Plan (LTIP)	<p>Aligns interests of executives, customers and shareholders.</p>	<ul style="list-style-type: none"> • The current LTIP plan was introduced on 1 April 2015 and outstanding awards vest after the 31 March 2018, subject to performance and continuing employment. 	<p>The annualised maximum award made at the beginning of 2015–16 and vesting at the end of 2017–18 for each director was:</p>

Element of remuneration	Purpose and link to strategy	Policy and approach	Maximum opportunity 2017–18
		<ul style="list-style-type: none"> • If the participant resigned during this period then participation in the scheme ceased. • The Committee has the discretion to allow vesting of awards for 'good' leavers as appropriate subject to performance. • Awards made under this plan are disclosed on page 120. • The LTIP has now been replaced by the Incentive and Retention Plan and no future awards will be made under this plan. 	CEO £504k CFO £188k
Pension	Defined contribution scheme minimises the risk to the company associated with defined benefit pension plans.	<ul style="list-style-type: none"> • A company contribution into a defined contribution scheme, or • A cash allowance in lieu of pension. 	Contribution of: CEO 18% of salary CFO 15% of salary
Other benefits	Provides market competitive benefits.	May consist of: <ul style="list-style-type: none"> • Car allowance • Health cover • Disturbance or relocation allowances. 	Based on individual circumstances.

Notes to the policy table

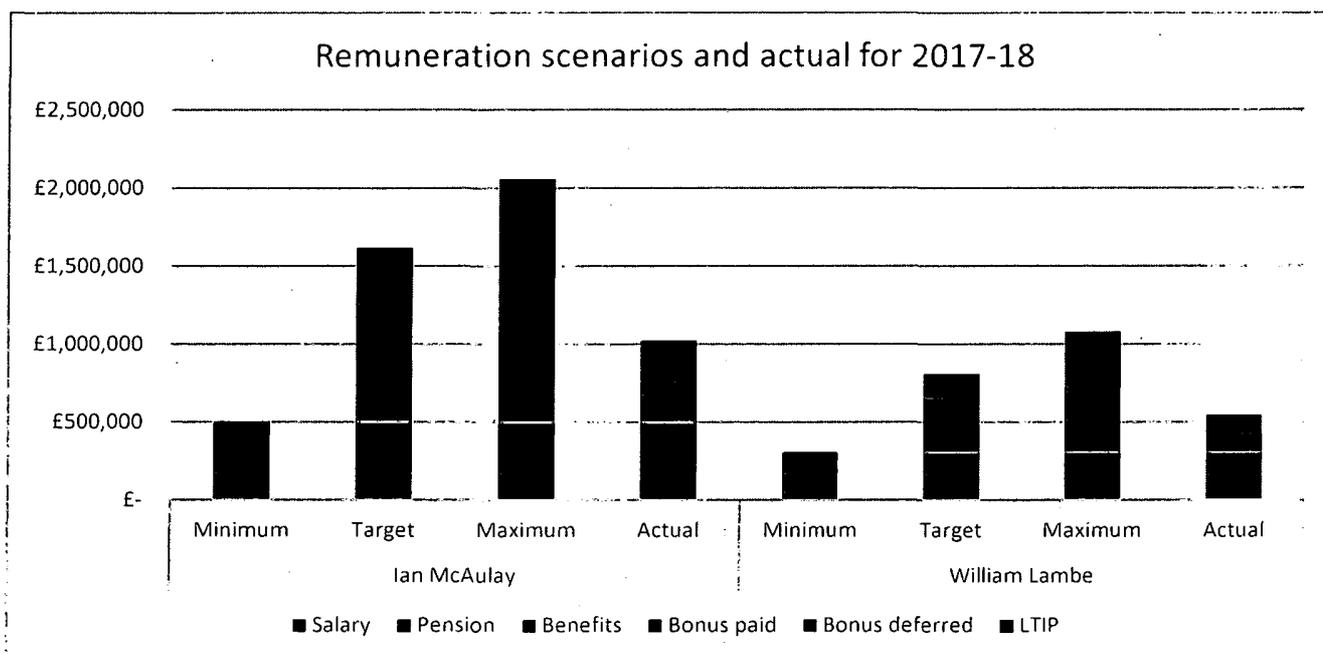
Directors' pay

Executive directors who served during the 2017–18 year are shown below:

Ian McAulay Chief Executive Officer (CEO)
 William Lambe Chief Financial Officer (CFO)

Details are given on page 119 of the amounts paid to them in the year ended 31 March 2018.

The following chart sets out the remuneration scenarios payable to the executive directors for various levels of performance as well as the actual remuneration for 2017–18. The figures shown for the LTIP reflect the vesting under the legacy LTIP, this plan is now closed and no further awards will be made under it.



Pensions

Executive directors are covered by four times death in service benefit within their contract of employment.

The company previously operated a defined benefit pension scheme, which was closed to new entrants on 1 April 2005. This scheme 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.

Operation of the Incentive and Retention Plan

The Incentive and Retention Plan operates as follows:

- Annual Contribution:** Each year, participants have the opportunity to earn an annual bonus contribution based on performance against targets pre-determined by the Board. This is then added to the 'bonus pool'.
- Annual Pay-out:** Each year, following the Annual Contribution, 50% of the total amount in the 'bonus pool' is paid out to participants in cash.
- Deferred value:** Each year, the remaining 50% of the 'bonus pool' is carried forward. These deferred amounts will therefore roll over to the next year.
- Repeat:** The following year, the process repeats, and continues for an indefinite period of time.

Why was the Incentive and Retention Plan introduced?

The Committee determined that there were a number of challenges when developing an appropriate and effective remuneration structure aligned to Southern Water's business model. Our business model, and hence our strategy, is perpetual in nature and therefore an arbitrary three-year performance period would neither be long-term enough nor align with the strategy of our business. The Committee therefore felt that the proposed approach should balance the short-term and long-term performance of the business and would also permit targets to be introduced each year that closely mirror current demands of various stakeholders and customers. Moreover, the Committee felt that the link between pay-out and performance should be sufficiently visible to management and shareholders. The Committee therefore sought an incentive structure which would make this link clearer, whilst aligning with the perpetual nature of our business.

Measures used in the Incentive and Retention Plan

During the year the Committee identified and operated both short-term and long-term performance measures in the Incentive and Retention Plan. Measures for the year were therefore split into two categories; short-term and long-term. Short-term performance measures for 2017–18 were focussed on issues that affect customers such as:

- customer satisfaction, as measured by our SIM performance
- delivery of our business plan commitments, as measured by our ODI performance
- reducing the level of bad debt costs
- improving cash collection
- delivery of our capital investment programme efficiently
- managing net operating costs.

Long-term performance conditions for 2017–18 included Total Shareholder Return and Total Costs to Serve reflecting both shareholders' and customers' long-term interests.

On leaving the company participants lose any deferred value and will not be eligible for any further annual pay-outs.

However, there are some circumstances where this is not the case; i.e. if the participant is classified as a 'Good Leaver'.

An individual is usually deemed to be a "Good Leaver" if they leave the company in the following circumstances:

- Death
- Disability
- Retirement
- Redundancy
- Other circumstances which the Committee deems appropriate.

If a participant is classified as a 'Good Leaver' then any deferred value will pay-out. 50% will be paid on the normal pay-out date following cessation of employment with Southern Water, and the other 50% will pay out on the next pay-out date.

Remuneration policy for joiners and leavers

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

Single figure of remuneration for 2017–18 (audited)

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

£'000		Base salary paid	Benefits	Relocation	Annual Bonus/ Incentive and Retention Plan	LTIP vesting	Total	Pension related benefit	Total including pension
Ian McAulay	2017–18	420.0	12.8	41.0	517.4 ¹	-	991.2	75.6	1,066.8
	2016–17	105.0	3.2	7.6	68.2	-	184.0	18.9	202.9
William Lambe	2017–18	265.5	7.5	13.6	238.3 ¹	-	524.9	39.8	564.7
	2016–17	227.9	6.8	5.6	119.2	-	359.5	34.2	393.7
Matthew Wright ²	2017–18	-	-	-	-	-	-	-	-
	2016–17	277.4	379.4	-	-	-	656.8	49.9	706.7

¹ The amount shown is 100% of the contribution into the bonus pool for the year as shown in the table under Incentive and Retention Plan below. Of this £258,720 was paid out in cash for Ian McAulay while £119,149 was paid out in cash for William Lambe. At the end of the year Ian McAulay and William Lambe have £258,720 and £119,149 retained in the bonus pool respectively which is to be carried forward for potential release in future years.

² The remuneration received by Matthew Wright for 2016–17 has been restated to reflect the decision of the Remuneration Committee not to award a bonus for performance in that year.

Notes to the single figure

Base salary

Base salary for the year for Ian McAulay was £420,000. Following a review of the market, the salary for William Lambe was reviewed in the year and was increased from £256,000 to £300,000 in January 2018. Salary was paid monthly via PAYE.

Incentive and Retention Plan

Details of the targets agreed by the Committee for 2017–18 together with the maximum bonus opportunity available to each executive director are shown in the table below. The performance for 2017–18 was assessed in May 2018 by the Committee and the achievement against each target is shown below.

Incentive and Retention Plan 2017–18	Threshold performance	Target performance	Stretch performance	CEO Weighting (% of salary)	CFO Weighting (% of salary)	Threshold	Target	Stretch	Performance for the year	CEO Pay-out (% of salary)	CFO Pay-out (% of salary)
Cash Collection (£m)	776.0	785.9	795.9	12.5%	10%	5%	60%	120%	764.1	0%	0%
OPEX (net operating costs; £m) Excluding approved one-off costs	306.2	298.2	285.2	12.5%	10%	10%	80%	120%	297.2	11%	9%
Bad Debt Provision (£m)	30.0	20.0	16.0	17.5%	14%	60%	100%	120%	21.7	16%	13%
Output Delivery Incentives (annual ODI penalty; £m)	1.0	0.5	0.0	20%	16%	30%	60%	100%	0.1	19%	15%
Service Incentive Mechanism (SIM qualitative ranking)	14 th	13 th	11 th or above	20%	16%	30%	60%	120%	15 th	0%	0%

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CAPEX	Subject to separate scorecard: 40% performance versus budget 40% regulatory dates 20% forecast accuracy										
	17.5%	14%	80%	100%	120%	11%	11%	9%			
Total Shareholder Return (TSR)	9.5%	10%	12%	60%	37.5%	80%	100%	120%	5.4%	0%	0%
Total Cost To Serve (£m)	75.8	72.2	68.6	60%	37.5%	80%	100%	120%	102%	61%	38%
Personal performance										5%	5%
Total										123%	89%

Incentive and Retention Plan Contribution 2017 - 18	Bonus pool brought forward (£'000)	Bonus awarded in year (£'000)	Bonus paid out (£'000)	Bonus pool carried forward (£'000)
Ian McAulay	0	517.4	258.7	258.7
William Lambe	0	238.3	119.2	119.1

Long-Term Incentive Plan

The LTIP for the period 1 April 2015 to 31 March 2018 was agreed by the Committee in June 2015, before Ian McAulay and William Lambe joined the company, and vested during the year. This Plan is now being replaced by the Incentive and Retention Plan and there will be no further awards or pay-outs under the LTIP. Ian and William have worked tirelessly to identify change that is needed and to implement plans to strengthen the long term performance of the company and a number of these plans have unfortunately had an impact on the near term performance as measured via the LTIP process.

Company performance was reviewed against the LTIP criteria set in 2015, at the Remuneration Committee meeting in April 2018. Recognising that the company's performance in the SIM rankings had been poor over a number of years, the Executives had been challenged to lift the company ranking to a median position (from a position well below that of other companies). Achieving a position of 15th this year was not sufficient to achieve this threshold target despite being only 0.06 SIM points away from threshold. During the year, the company put forward and implemented plans to invest significant additional Capex across a number of areas of the business to accelerate enhancements ahead of 2020–25 and this has had an impact on our cash flows (and hence total shareholder return) and the scale of our capital programme delivery, resulting in these elements failing to reach the threshold targets set in 2015.

As none of the thresholds required to trigger a payment were met, no payments have been made under this scheme.

Performance measure	Weight (% of max. LTIP)	Performance				Pay-out (% maximum)
		Threshold	Target	Max	Actual	
Total shareholder return	50%	9.5%	10%	12%	7.9%	0%
AMP6 Delivery Plan	25%	To deliver the Final Determination	To deliver the Final Determination + efficiencies of £62m	To deliver the Final Determination + efficiencies of £97m	Threshold not exceeded	0%
Service Incentive Mechanism 2016–17	12.5%	Median	>median <upper quartile	> upper quartile	16th	0%
Service Incentive Mechanism 2017–18	12.5%	Median	>median <upper quartile	> upper quartile	15th	0%
Total	100%					0%

Pension contributions

The pension contribution for the Executive Directors is set out in the table below:

Pension	Base salary (£'000)	Pension contribution as a % of base salary	Pension contribution (£'000)
Ian McAulay	420.0	18%	75.6
William Lambe	265.5	15%	39.8

Non-Executive Director fees for the year (audited)

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

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

£'000	2017–18			2016–17		
	Fees	Other	Total	Fees	Other	Total
Robert Jennings (Chairman to 28 February 2017)	-	-	-	206.2	76.3	282.5
Bill Tame (Chairman from 1 March 2017)	250.0	1.5	251.5	66.7	2.6	69.3
Paul Sheffield	60.0	10.1	70.1	60.0	1.4	61.4
Rosemary Boot	50.0	1.5	51.5	50.0	1.0	51.0
Lisa Harrington	50.0	1.5	51.5	50.0	1.5	51.5
Mike Putnam	25.7	1.3	27.0	-	-	-
Wendy Barnes*	30.8	13.0	43.8	-	-	-
Sara Sulaiman	-	-	-	-	-	-
Mark Walters	-	-	-	-	-	-

*The fees for Wendy Barnes include an amount for work undertaken on behalf of the company prior to her formal appointment to the Board.

The other amounts payable to the non-executive directors include taxable expenses incurred in the attendance at Board meetings. The other amounts for Paul Sheffield and Wendy Barnes include expenses for international travel in respect of a Board and shareholder event.

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.

Payments to past Directors for loss of office

Matthew Wright left his position of CEO on 31 December 2016 and the benefits disclosed for him for 2016–17 include a sum for loss of office of £369,822. After consideration by the Remuneration Committee, no performance bonus was paid to Matthew Wright for 2016–17.

Gender pay

Gender pay is an issue which we take very seriously. We are committed to supporting the aspirations of our talented female workforce and we are implementing plans to help us close the gender pay gap. On our Board, we already have a good balance of gender diversity, with women making up 44% of our Board as at March 2018. In terms of overall equality we've already taken steps to improve gender diversity at an executive level and we continue to focus and develop our succession plans and recruitment processes to strengthen gender equality across the business. For more information see the report on our gender pay gap on our website at southernwater.co.uk/gender-pay-gap.

Implementation of policy for 2018–19

Base salary

A basic salary increase of 3.57% for Ian McAulay for 2018–19 was approved in May 2018 and will be applicable to basic salary with effect from 1 July 2018. As the base salary for William Lambe was increased in January 2018 following a review of the market, no further increase is proposed for 2018–19. The revised base salaries for each Executive Director are as follows:

Base salary	Base salary 2017–18 (£'000)	Base salary increase (%)	Base salary 2018–19 (£'000)
Ian McAulay	420.0	3.57	435.0
William Lambe	300.0	0.00	300.0

Incentive and Retention Plan

As set out in our remuneration policy, the incentive and retention plan is designed to ensure that the executive is focused on delivering high quality performance for our customers in terms of the service they receive and for our wider stakeholders by enabling economic growth, supporting critical industries, supporting local communities, developing skills in our region, generating renewable energy and improving our environment. Delivery of these objectives will in turn generate returns for shareholders.

As a result the Committee has decided to use the measures below to assess performance for 2018–19:

- Achievement of a cash collection target
- Reducing the level of bad debt costs
- Delivery of our business plan commitments (ODI performance)
- Customer satisfaction (SIM performance)
- Delivery of an efficient capital investment programme
- Management of operating costs within budget
- Total Shareholder Return
- Total Cost to Serve

Weightings and targets, along with actual performance, will be fully disclosed in the 2018–19 Remuneration Report.

In recognition of Ofwat's consultation on director remuneration, we also intend to review the long-term measures used to assess performance during the year. Any changes made will be reported in the 2018–19 Remuneration Report.

Directors' report for the year ended 31 March 2018

The directors of Southern Water Services Limited (registered no. 02366670) present their report and the audited financial statements for the year ended 31 March 2018.

Principal activities

The principal activities of Southern Water Services Limited, herein after referred to as 'the company', also referred to as SWS, are the provision of water supply and wastewater services in the South East of England. The company is regulated by the Water Services Regulation Authority (Ofwat) and supplies water to over 2.5 million people and provides wastewater services to over 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 28 to 94.

Future developments

The information regarding future developments of the company can be found in our Annual Report on pages 28 to 94.

Post balance sheet events

On 6 April 2018, the company redeemed 12,892 of the A1 and A2 preference shares at nominal value plus the premium on issue, amounting to £12.9 million, plus an estimated amount for the A2 dividend that would have fallen due on 30 September 2018 of £0.6 million.

Results and dividends

The income statement on page 128 shows the company's results and profit for the year. Further details are also available in the Annual Report on pages 61 to 69.

Interim dividends of £822.52 per ordinary share (2017: £812.37 per share), totalling £46.1 million (2017: £45.5 million) were paid during the year to Southern Water Services Group (SWSG). These dividends, along with associated group tax relief of £10.8 million, enable SWSG to pay the interest of £56.9 million due to SWS on an inter-company loan as disclosed in note 13 to the financial statements.

Ordinary interim dividends totalling £8.0 million, equivalent to £142.86 per share, (2017: £61.0 million, equivalent to £1,089.29 per share) were declared and paid in the year. No final dividend has been declared or paid for the year ended 31 March 2018.

The final dividend for 31 March 2017 of £63.2 million (£1,128.57 per share) was paid in April 2017.

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 prior 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' report for the year ended 31 March 2018 (continued)

Directors and their interests

The directors who held office during the year ended 31 March 2018 and up to the date of signing the financial statements, unless otherwise stated, were as follows (further details can be found on pages 102 to 105):

Bill Tame	(Chairman)
Ian McAulay	(Executive director – Chief Executive Officer)
William Lambe	(Executive director – Chief Financial Officer)
Paul Sheffield	(Senior independent non-executive director)
Rosemary Boot	(Independent non-executive director)
Lisa Harrington	(Independent non-executive director) (resigned 31 March 2018) ✓
Michael Putnam	(Independent non-executive director) (appointed 26 September 2017)
Wendy Barnes	(Non-executive director) (appointed 26 September 2017)
Sara Sulaiman	(Non-executive director) (appointed 26 September 2017)
Mark Walters	(Non-executive director) (resigned 26 September 2017)

Alternate directors for the year were as follows:

Andrew Gilbert	(Alternate non-executive director for Sara Sulaiman) (appointed 26 September 2017)
Andrew Truscott	(Alternate non-executive director for Mark Walters) (resigned 26 September 2017)

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 charged to the income statement for the year amounted to £1.1 million (2017: £1.0 million).

Financial risk management

The Financial Risk Management Policy is included in the Strategic Report which can be found in the Annual Report on pages 78 to 94.

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.

In 2017, the company introduced the Gallup employee survey to reset its approach to employee engagement and to help develop management action plans.

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.

Directors' report for the year ended 31 March 2018 (continued)

Employees (continued)

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.

The company holds an annual Health and Safety Conference, which this year focused on wellbeing. It attracted 214 people from across the company and its partners. SWS is committed to the 'Time for change' programme to raise awareness and understanding of mental health issues.

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 48 to 55. 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.

Directors' report for the year ended 31 March 2018 (continued)

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 2018.

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 28 to 94.
- 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 61 to 94.
- The company has available a combination of cash and committed undrawn bank facilities totalling £514.4 million at 31 March 2018 (2017: £635.3 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 76 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' report for the year ended 31 March 2018 (continued)

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
- 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
5 July 2018

Financial statements

Income statement

For the year ended 31 March 2018

	Note	2018 £m	2017 £m
Continuing operations			
Revenue	4	829.7	809.7
Other operating income	4	2.4	1.3
Operating costs			
- before depreciation and amortisation		(336.0)	(306.9)
- depreciation and amortisation		(259.5)	(245.2)
Total operating costs		(595.5)	(552.1)
Operating profit	5	236.6	258.9
Other income	5	11.2	-
Profit on disposal of fixed assets	5	0.8	0.4
Finance income	8	57.9	58.1
Finance costs	8	(176.6)	(161.2)
Fair value gains/(losses) on derivative financial instruments	20	46.3	(416.8)
Net finance costs	8	(72.4)	(519.9)
Profit/(loss) before taxation		176.2	(260.6)
Taxation	9	(21.5)	84.9
Profit/(loss) for the financial year		154.7	(175.7)

The notes on pages 133 to 171 form part of these financial statements.

Statement of other comprehensive income

For the year ended 31 March 2018

	Note	2018 £m	2017 £m
Profit/(loss) for the year		154.7	(175.7)
Other comprehensive income/(loss):			
Items that cannot be reclassified to profit or loss:			
Actuarial gain/(loss) on pension scheme	22	9.8	(71.4)
Movement on deferred tax relating to retirement benefit obligations	21	(1.7)	12.8
Deferred tax movement due to rate change	21	-	(1.7)
Total other comprehensive income/(loss) for the year, net of tax		8.1	(60.3)
Total comprehensive income/(loss) for the year attributable to the owner of the company		162.8	(236.0)

Statement of financial position

as at 31 March 2018

	Note	2018 £m	2017 £m
Non-current assets			
Intangible assets	11	61.1	61.1
Property, plant and equipment	12	5,865.3	5,684.6
Other non-current assets	13	812.3	812.3
Investments	14	29.2	29.2
		<u>6,767.9</u>	<u>6,587.2</u>
Current assets			
Inventories	15	2.9	2.7
Trade and other receivables	16	323.1	197.3
Cash and cash equivalents	29	164.4	285.3
		<u>490.4</u>	<u>485.3</u>
Total assets		<u>7,258.3</u>	<u>7,072.5</u>
Current liabilities			
Trade and other payables	17	(368.1)	(310.1)
Borrowings	18	(352.4)	(39.4)
		<u>(720.5)</u>	<u>(349.5)</u>
Non-current liabilities			
Borrowings	19	(3,652.4)	(3,933.7)
Derivative financial instruments	20	(1,288.0)	(1,338.0)
Deferred tax liabilities	21	(270.0)	(257.6)
Retirement benefit obligations	22	(171.7)	(176.9)
Provisions for liabilities	23	(3.4)	(0.5)
Other non-current liabilities	24	(89.5)	(62.2)
		<u>(5,475.0)</u>	<u>(5,768.9)</u>
Total liabilities		<u>(6,195.5)</u>	<u>(6,118.4)</u>
Net assets		<u>1,062.8</u>	<u>954.1</u>
Equity			
Called up share capital	25	0.1	0.1
Share premium account	26	46.3	46.3
Revaluation reserve	27	-	-
Retained earnings	28	1,016.4	907.7
Total equity		<u>1,062.8</u>	<u>954.1</u>

The financial statements of Southern Water Services Limited (Registered no. 02366670) on pages 128 to 171 were approved by the Board and authorised for issue on 5 July 2018. They were signed on its behalf by:



William Lambe
Chief Financial Officer

Statement of changes in equity
 For the year ended 31 March 2018

	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
Balance at 31 March 2016	0.1	46.3	745.1	568.3	1,359.8
Loss for the financial year	-	-	-	(175.7)	(175.7)
Other comprehensive loss for the year	-	-	-	(60.3)	(60.3)
Total comprehensive loss for the year	-	-	-	(236.0)	(236.0)
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	-
Balance at 31 March 2017	0.1	46.3	-	907.7	954.1
Profit for the financial year	-	-	-	154.7	154.7
Other comprehensive income for the year	-	-	-	8.1	8.1
Total comprehensive income for the year	-	-	-	162.8	162.8
Equity dividends paid (Note 10)	-	-	-	(54.1)	(54.1)
Balance at 31 March 2018	0.1	46.3	-	1,016.4	1,062.8

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 previous 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 2018

	Note	2018 £m	2017 £m
Cash from operating activities	29	467.2	524.3
Tax paid		(14.1)	(11.4)
Net cash generated from operating activities		453.1	512.9
Investing activities			
Interest received		58.0	57.9
Purchase of property, plant and equipment		(373.5)	(246.7)
Purchase of intangible assets		(15.9)	(31.1)
Receipt of grants and contributions		6.5	3.1
Sale of property, plant and equipment		0.4	-
Movement on loan to subsidiary		(103.5)	(7.5)
Other income		11.8	-
Net cash used in investing activities		(416.2)	(224.3)
Financing activities			
Equity dividends paid		(117.3)	(106.5)
Interest paid		(23.9)	(136.8)
Preference share dividends		(12.5)	(13.4)
Payment of derivative accretion		(3.7)	(2.5)
Repayment of borrowings		(150.0)	(80.0)
Repayments of obligations under finance leases		(0.4)	(0.3)
Issue costs of new loans		-	-
Proceeds of new loans		150.0	318.3
Net cash used in financing activities		(157.8)	(21.2)
Net (decrease)/increase in cash and cash equivalents		(120.9)	267.4
Cash and cash equivalents at beginning of the year		285.3	17.9
Cash and cash equivalents at end of the year		164.4	285.3

Notes to the financial statements

For the year ended 31 March 2018

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 28 to 94.

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/greensands-ownership-of-southern-water.

As permitted by FRS 101, the company has taken advantage of the disclosure exemptions available under that standard in relation to standards not yet effective, impairment review, financial instruments, wholly owned related party disclosures and capital management. Where required, equivalent disclosures are given in the group financial statements of Greensands Holdings Limited.

Adoption of new and revised accounting and financial reporting standards

There were no new or revised significant accounting standards adopted in the current year.

Notes to the financial statements (continued)

For the year ended 31 March 2018

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 28 to 94.

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. As part of their review the directors have considered the need to refinance the Class A £300 million bond due for repayment in March 2019 and £177.2 million of inflation-linked swaps with a legal maturity of March 2037 which include a mandatory break at March 2019. The bond is in the process of being refinanced and the inflation-linked swaps are in the process of being extended to 2025 and are not expected to be a draw on our liquidity.

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 123.

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 76.

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.

For provisioning purposes, revenues and outstanding arrears are segmented based on customer characteristics. Should a group of customers attract a provision rate of 100%, i.e. assessed as not generating economic benefit, revenue would not be recognised. In 2017–18 no segment of customers met this criteria and so revenue has been recognised in full.

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 2018

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.

Property, plant and equipment

Property, plant and equipment comprises:

- i. Freehold land and buildings – comprising land and non-operational buildings.
- ii. 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.
- iii. Infrastructure assets – comprising a network of systems consisting of mains and sewers, impounding and pumped raw water storage reservoirs, sludge pipelines and sea outfalls.
- iv. Assets under construction.
- v. Other assets – comprising vehicles, computers, mobile plant and meters.

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.

Notes to the financial statements (continued)

For the year ended 31 March 2018

1 Accounting policies (continued)**Property, plant and equipment (continued)**

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. Assets are depreciated on a straight-line basis over their estimated operating lives, which are principally as follows:

		<u>Years</u>
Land and buildings:	- Land ¹	Not depreciated
	- Buildings	10-60
Plant and machinery:	- Operational structures ²	15-80
	- Fixed plant	10-40
Infrastructure assets:	- Water mains	100-120
	- Sewers	80-200
	- Reservoirs	200
	- Ancillary structures	10-70
Assets under construction:		Not depreciated
Other:	- Vehicles, computers and mobile plant	3-10

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.

¹ 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.

² Operational structures are assets used for wastewater and water treatment purposes. These include water tanks and similar assets.

Notes to the financial statements (continued)

For the year ended 31 March 2018

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 2018

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 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 2018

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 2018

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 2018

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 2018

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. The value of household billings raised in the year ended 31 March 2018 for consumption in prior years was £130.7 million, £1.7 million (1.3%) more than the accrual made at 31 March 2017. This difference is well within our view of acceptable tolerances for accounting estimates.

Allowance for doubtful receivables

The bad debt provision at each reporting date is calculated by segmenting customer debt based on historic debt collection and payment performance, demographic information and the age of debt outstanding. For each segment, forecast cash collection rates are determined which result in a corresponding provision percentage. The value of the provision for doubtful debts as at 31 March 2018 was £180.0 million (2017: £158.0 million). 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 2018

2 Critical accounting judgements and key sources of estimation uncertainty (continued)**Sources of estimation uncertainty (continued)**

Our sensitivity analysis suggests that the bad debt provision would vary between £1.8m and £5.3m if cash collections estimates were between 1% and 3% above or below those predicted.

Bad debt provision sensitivity analysis	31 March 2018	Sensitivity			
		1%	3%	-1%	-3%
Bad debt provision estimate (£m)	180.0	1.8	5.3	-1.8	-5.3

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 gain of £9.8 million (2017: loss of £71.4 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 2016 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 2018

4 Income

An analysis of the company's income is as follows:

Continuing operations	2018	2017
	£m	£m
Water and sewerage services	782.8	764.8
Other services	46.9	44.9
Total revenue	829.7	809.7
Other operating income	2.4	1.3
Other income (note 5)	11.2	-
Profit on disposal of fixed assets	0.8	0.4
Interest receivable (note 8)	1.0	1.2
Interest revenue from Southern Water Services Group Limited	56.9	56.9
Total income	902.0	869.5

Other operating income includes rents receivable.

Notes to the financial statements (continued)

For the year ended 31 March 2018

5 Profit for the year

Profit for the year has been arrived at after charging/(crediting):	2018 £m	2017 £m
Depreciation on		
- owned assets	243.5	229.6
- assets held under finance leases	1.0	0.7
	244.5	230.3
Amortisation of intangible assets	15.0	14.9
Other income (see note below)	11.2	-
Profit on disposal of fixed assets	0.8	0.4
Research and development expenditure	1.1	1.0
Rentals under operating leases:		
- Properties	1.9	1.7
- Vehicles	2.6	2.2
Employee costs (note 6)	63.9	56.5
Amortisation of grants and contributions (note 24)	(2.3)	(1.2)
Fees payable to the company's auditor in respect of:		
- statutory audit of the company's financial statements	0.2	0.3
- other services pursuant to legislation	0.1	0.1
- all other services	-	0.2

Audit-related and non-audit services primarily relate to regulatory assurance fees, and other taxation and professional fees.

Note On 1 April 2017 we completed the disposal of our non-household water and wastewater retail business, principally comprising billing and customer service activities, to Business Stream. This resulted in a £11.2 million profit after costs, which included a provision for unrecoverable debts of £2.1 million. Cash proceeds of £11.8 million are disclosed under other income in the cash flow statement on page 132.

Notes to the financial statements (continued)

For the year ended 31 March 2018

6 Employee information

	2018 £m	2017 £m
(a) Employee costs (including directors' emoluments):		
Wages and salaries	89.9	81.9
Social security costs	9.2	8.3
Pension costs - Defined contribution	3.0	2.6
- Defined benefit	6.7	5.1
Total employee costs	<u>108.8</u>	<u>97.9</u>
Less: charged as capital expenditure	<u>(44.9)</u>	<u>(41.4)</u>
Charged to the income statement	<u>63.9</u>	<u>56.5</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:

	2018 Number	2017 Number
Operations	1,160	1,298
Customer services	258	317
Corporate centre	871	505
	<u>2,289</u>	<u>2,120</u>

7 Directors' emoluments

	2018 £000	2017 £000 restated
Aggregate emoluments (including benefits in kind)	2,127	1,449
Compensation for loss of office	-	370
	<u>2,127</u>	<u>1,819</u>

No retirement benefits accrued to directors (2017: nil) under a Southern Water Services Limited defined benefit scheme. No retirement benefits accrued to directors (2017: nil) under a Southern Water Services Limited defined contribution scheme.

The prior year emoluments have been restated to reflect the decision made by the Remuneration Committee not to award a final bonus to Matthew Wright after he left the business in December 2016.

A long-term incentive plan (LTIP) was in operation for the three-year period from 1 April 2015 to 31 March 2018. The Remuneration Committee reviewed performance against the criteria included within the LTIP and no payments were made under this scheme.

Further details can be found in the Directors' Remuneration Report on pages 111 to 122.

Notes to the financial statements (continued)

For the year ended 31 March 2018

7 Directors' emoluments (continued)

Details of emoluments and benefits for the highest paid director:

	2018	2017
	£000	£000
		restated
Highest paid director's aggregate emoluments and benefits	1,066	337
Compensation for loss of office	-	370
	<u>1,066</u>	<u>707</u>

During the year the company made contributions of £nil (2017: £nil) to a money purchase pension scheme in respect of the highest paid director's qualifying services.

8 Net finance costs

	2018	2017
	£m	£m
Finance income		
Interest revenue from Southern Water Services Group Limited	56.9	56.9
Deposit income on short-term bank deposits	1.0	1.2
	<u>57.9</u>	<u>58.1</u>
Finance costs		
Interest payable on other loans	(6.0)	(6.8)
Interest paid to Southern Water Services (Finance) Ltd	(139.3)	(133.6)
Indexation	(38.8)	(20.9)
Amortisation of issue costs	(1.5)	(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	0.7
Other finance expense (note 22)	(4.9)	(3.7)
Dividends on preference shares – see note (a), (b) and (c) below	(13.1)	(13.4)
	<u>(193.1)</u>	<u>(169.8)</u>
Amounts capitalised on qualifying assets	16.5	8.6
	<u>(176.6)</u>	<u>(161.2)</u>
Fair value gains/(losses) on derivative financial instruments		
Derivative financial instruments not designated as hedges (note 20)	46.3	(416.8)
	<u>(72.4)</u>	<u>(519.9)</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 4.10% to expenditure on such assets (2017: 4.23%).

Dividends on preference shares

- Class A1 preference share dividends amounted to £40 per share and Class B £70 per share totalling £9.0 million (2017: £9.0 million).
- Dividends due to the Class A2 preference shareholders of £108.07 (2017: £134.73) per share totalling £3.5 million (2017: £4.4 million) were declared and settled in the year at base value plus an amount for out-performance and savings in the year ended 31 March 2017 (see note 19(ix)).
- After the year end, the company redeemed 12,892 of its Class A1 and Class A2 preference shares, at nominal value plus the premium on issue. As a result of the redemption, which was approved by the Board in March 2018, estimated dividends of £0.6 million (£46.97 per share) owing to the A2 preference shareholders on redemption have been accrued as at 31 March 2018. The redemption value plus the value for estimated A2 dividends totalling £13.5 million was paid on 6 April 2018.

Notes to the financial statements (continued)

For the year ended 31 March 2018

9 Taxation

	2018 £m	2017 £m
Current tax:		
Current year	10.8	11.4
Total current tax charge	<u>10.8</u>	<u>11.4</u>
Deferred tax:		
Origination and reversal of timing differences	17.1	(79.3)
Adjustment in respect of prior years	(6.4)	(0.1)
Effect of corporation tax rate change	-	(16.9)
Total deferred tax charge/(credit)	<u>10.7</u>	<u>(96.3)</u>
Total tax charge/(credit) on profit/(loss)	<u>21.5</u>	<u>(84.9)</u>

The tax assessed for the year is different to the standard rate of corporation tax in the UK due to the following factors:

	2018 £m	2017 £m
Profit/(loss) before tax	<u>176.2</u>	<u>(260.6)</u>
Tax at the UK corporation tax rate of 19% (2017: 20%)	33.5	(52.1)
Permanent differences	2.5	3.3
Group relief received for nil payment	(6.1)	(27.9)
Differences between current and deferred tax rates	(2.0)	8.8
Impact of tax rate changes	-	(16.9)
Adjustment in respect of prior years:		
Deferred tax	(6.4)	(0.1)
Total tax charge/(credit) for year	<u>21.5</u>	<u>(84.9)</u>

Factors that may affect future tax charges:

A reduction in the main rate of corporation tax to 17% from the 1 April 2020 was enacted in the Finance Bill 2016, and deferred tax balances at 31 March 2018 are calculated based on this rate.

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 2018

9 Taxation (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:

	2018 £m	2017 £m
Deferred tax		
Arising on income and expenses recognised in other comprehensive income:		
Tax charge/(credit) on actuarial gains/losses on defined benefit pension scheme	1.7	(12.8)
Deferred tax movement due to rate change	-	1.7
Total deferred tax charge/(credit) recognised in other comprehensive income/(loss)	1.7	(11.1)

10 Dividends

	2018 £m	2017 £m
Amounts recognised as distributions to equity holders in the year:		
Current year interim dividend of £822.52 (2017: £812.37) per share	46.1	45.5
Current year interim dividend of £142.86 (2017: £1,089.29) per share	8.0	61.0
Current year final dividend of £nil (2017: £1,128.57) per share	-	63.2
	54.1	169.7

The interim dividends of £46.1 million are paid to Southern Water Services Group Limited (SWSG). These dividends, along with associated group tax relief of £10.8 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 75 of the Annual Report.

In addition, a current year interim dividend of £8.0 million was paid in September 2017 (2017: £61.0 million). No final dividend has been declared for the year ended 31 March 2018 (2017: £63.2 million was declared in March 2017 and paid in April 2017).

Notes to the financial statements (continued)

For the year ended 31 March 2018

11 Intangible assets

	Externally generated		
	Assets under construction £m	Other £m	Total £m
Cost			
At 1 April 2017	20.1	90.1	110.2
Additions	15.0	-	15.0
Transfers	(6.2)	6.2	-
Disposals	-	(1.6)	(1.6)
At 31 March 2018	28.9	94.7	123.6
Amortisation			
At 1 April 2017	-	49.1	49.1
Charge for the year	-	15.0	15.0
Disposals	-	(1.6)	(1.6)
At 31 March 2018	-	62.5	62.5
Net book amount			
At 31 March 2018	28.9	32.2	61.1
At 31 March 2017	20.1	41.0	61.1

The company does not currently have any internally generated intangible assets.

Included within additions above is £0.3 million of interest that has been capitalised on qualifying assets in accordance with IAS 23 'Borrowing Costs', offset by corrections to previous years additions of -£0.5 million. The cumulative net book value of the borrowing costs capitalised amount to £1.4 million (2017: £1.8 million). The company has elected to apply IAS 23 from 1 April 2003, as permitted by the standard.

Other intangible assets include software, studies and research and development trials.

12 Property, plant and equipment

	Land & buildings £m	Plant & machinery £m	Infra- structure assets £m	Assets under construction £m	Other £m	Total £m
Cost						
At 1 April 2017	1,534.6	3,006.5	2,534.7	313.8	619.7	8,009.3
Additions	-	-	-	425.2	-	425.2
Transfers	3.1	112.6	84.0	(239.7)	40.0	-
Disposals	(0.5)	(2.0)	(0.8)	-	(31.5)	(34.8)
At 31 March 2018	1,537.2	3,117.1	2,617.9	499.3	628.2	8,399.7
Depreciation						
At 1 April 2017	682.2	1,165.0	84.5	-	393.0	2,324.7
Charge for the year	40.2	120.2	30.2	-	53.9	244.5
Disposals	(0.5)	(2.0)	(0.8)	-	(31.5)	(34.8)
At 31 March 2018	721.9	1,283.2	113.9	-	415.4	2,534.4
Net book amount						
At 31 March 2018	815.3	1,833.9	2,504.0	499.3	212.8	5,865.3
At 31 March 2017	852.4	1,841.5	2,450.2	313.8	226.7	5,684.6

Notes to the financial statements (continued)

For the year ended 31 March 2018

12 Property, plant and equipment (continued)

Freehold land is stated at a cost of £51.7 million at 31 March 2018 and 31 March 2017 and is not depreciated.

The company's interest in land and buildings are almost entirely freehold.

Included within additions above is £16.7 million (2017: £7.3 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 £177.3 million (2017: £167.4 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:

	2018 Other £m	2017 Other £m
Net book amount at 31 March	<u>4.5</u>	<u>5.3</u>

13 Other non-current assets**Non-current receivables**

Amounts owed by SWSG

	2018 £m	2017 £m
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**Shares in subsidiary Southern Water Services (Finance) Limited**

At the beginning and end of the year

	2018 £m	2017 £m
At the beginning and end of the year	<u>29.2</u>	<u>29.2</u>

The company has the following direct investments in subsidiary undertakings at 31 March 2018:

	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 2018

15 Inventories

	2018 £m	2017 £m
Raw materials	2.5	2.0
Work in progress	0.4	0.7
	<u>2.9</u>	<u>2.7</u>

16 Trade and other receivables

	2018 £m	2017 £m
Trade receivables	273.6	224.6
Provision for impairment	(180.0)	(123.3)
Net trade receivables	<u>93.6</u>	<u>101.3</u>
Loan to Southern Water Services (Finance) Limited	111.8	8.3
Amounts owed by other group undertakings	6.6	5.2
Other amounts receivable	16.7	9.7
Accrued income	74.2	53.1
Prepayments	20.2	19.7
	<u>323.1</u>	<u>197.3</u>

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

Accrued income as at 31 March 2018 includes water and sewerage income not yet billed of £53.3 million (2017: £50.2 million).

The directors consider that the carrying values of trade and other receivables are reasonable approximations of their fair values.

Provision for impairment

Movements on the doubtful debts provision were as follows:

	2018 £m	2017 £m
At 1 April	(123.3)	(111.9)
Amounts reinstated (see note below)	(34.6)	-
Charge for bad and doubtful debts	(21.8)	(25.3)
Charge for non-household bad debt	(2.1)	-
Amounts written off during the year	1.8	13.9
At 31 March	<u>(180.0)</u>	<u>(123.3)</u>

At each reporting date, the company evaluates the recoverability of trade receivables and records allowances for doubtful receivables based on experience.

The company does not include in revenue and trade debtors those accounts that are deemed irrecoverable. During 2017–18 the company completed a project to review the collectability of its debts. This has resulted in a restatement of debtors and the bad debt provision, with no impact on the net position.

Notes to the financial statements (continued)

For the year ended 31 March 2018

16 Trade and other receivables (continued)

The following table provides information regarding the ageing of receivables that are specifically provided for:

	2018 £m	2017 £m
Current	0.2	0.7
1-2 years	0.3	2.4
2-3 years	0.5	11.8
3-4 years	0.5	14.1
more than 4 years	0.7	39.8
	<u>2.2</u>	<u>68.8</u>

A collective provision is recorded against assets which are past due but for which no specific provision has been made. This is calculated based on historical experience of levels of recovery.

The aged analysis of receivables that were overdue at the reporting date but not individually provided for is as follows:

	2018 £m	2017 £m
Current	72.0	59.7
1-2 years	47.3	32.1
2-3 years	37.0	13.7
3-4 years	28.5	8.6
more than 4 years	58.4	6.4
	<u>243.2</u>	<u>120.5</u>

The amounts above are reconciled to gross and net debtors in the tables below:

At 31 March 2018	Gross £m	Provision £m	Net £m
Not due	28.2	-	28.2
Overdue not specifically provided	243.2	(177.8)	65.4
Overdue and specifically provided	2.2	(2.2)	-
	<u>273.6</u>	<u>(180.0)</u>	<u>93.6</u>
	Gross £m	Provision £m	Net £m
At 31 March 2017			
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>

Notes to the financial statements (continued)

For the year ended 31 March 2018

17 Trade and other payables

	2018 £m	2017 £m
Trade payables	21.0	18.9
Amounts owed to group undertakings	138.7	86.4
Capital creditors and capital accruals	107.1	96.8
Taxation and social security	2.8	3.0
Accruals and deferred revenue	98.5	105.0
	<u>368.1</u>	<u>310.1</u>

Amounts owed to group undertakings in the previous year included the final dividend declared of £63.2 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

	2018 £m	2017 £m
Debt issue costs (note 19 (iv))	(1.5)	(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
Class A £300m – 6.135% fixed rate 2019	299.5	-
Class A1 Preference shares	12.9	-
Other loans from subsidiary SWSF	30.3	30.3
Obligations under finance leases	0.7	0.5
	<u>352.4</u>	<u>39.4</u>

Notes to the financial statements (continued)

For the year ended 31 March 2018

19 Non-current borrowings

	Note	2018 £m	2017 £m
Loans from subsidiary SWSF:			
Class A £350m – 6.202% fixed rate 2029	19(i)		
Class A £150m – 3.716% index linked 2034	19(ii)	348.5	348.4
Class A £35m – 3.716% index linked 2034		229.7	221.7
Class A £350m – 6.650% fixed rate 2026		53.5	51.7
Class A £150m – 3.826% index linked 2023	19(ii)	348.7	348.6
Class A £350m – 5.010% fixed rate 2021		229.7	221.7
Class A £150m – 5.010% fixed rate 2041	19(ii)	348.6	348.2
Class A £200m – 4.510% fixed rate 2052	19(ii)	147.0	146.9
Class A £300m – 5.135% fixed rate 2056	19(ii)	197.2	197.1
Class A £300m – 6.135% fixed rate 2019	19(ii)	292.6	292.5
Class A £175m – 2.790% fixed rate 2031	18, 19(ii)	299.5	299.1
Class A £75m – 2.970% fixed rate 2036	19(ii)	174.0	173.9
Artesian £165m – 4.086% index linked 2033	19(ii)	74.5	74.5
Artesian £156.5m – 3.645% index linked 2032		252.8	244.0
Total Class A debt from SWSF		<u>233.9</u>	<u>225.8</u>
		3,230.2	3,194.1
Class B £250m – 4.510% fixed rate 2022	19(ii), (iii)	247.6	247.1
Debt issue costs	19(iv)	(14.6)	(16.1)
Bond premium deferred		9.5	10.2
Deferred gilt lock proceeds	19(v)	4.9	5.0
Deferred proceeds	19(vi)	95.6	105.3
Other loans from subsidiary SWSF	19(vii)	30.3	30.3
Total loans and other borrowings from SWSF		<u>3,603.5</u>	<u>3,575.9</u>
Class B, Term Facility Agreement 2017 £150m – 6-month Libor plus 1.550% 2022		150.0	-
Class B, Term Facility Agreement 2014 £150m – 6-month Libor plus 1.950% 2021		-	150.0
Class A £60m – 0.000% index linked 2025	19(viii)	64.6	62.1
Class A £40m – 0.000% index linked 2026	19(viii)	42.5	41.0
Class A1 Preference shares	19(ix)	32.6	32.6
Class B Preference shares	19(ix)	110.0	110.0
Obligations under finance leases		1.6	1.5
Total borrowings		<u>4,004.8</u>	<u>3,973.1</u>
Current borrowings	18	<u>352.4</u>	<u>39.4</u>
Non-current borrowings		<u>3,652.4</u>	<u>3,933.7</u>

Notes to the financial statements (continued)

For the year ended 31 March 2018

19 Non-current borrowings (continued)

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 refinancings do not take place when the underlying instruments mature in 2021 to 2029, the company will make good certain obligations of its subsidiary SWSF. The directors do not believe this to be likely and the liability, if any, cannot currently be quantified as it will depend wholly on the circumstances at the time of the maturity.

Notes 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 2018 debt issue costs amounted to £14.6 million of which £1.5 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) 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.
- (vii) 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.
- (viii) 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.

Notes to the financial statements (continued)

For the year ended 31 March 2018

19 Non-current borrowings (continued)

(ix) 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).

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 2018 for out-performance in the year ended 31 March 2018.

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.

On 6 April 2018, the company redeemed 12,892 of the A1 and A2 preference shares at nominal value plus premium, amounting to £12.9 million plus an estimated amount for the A2 dividend that would have fallen due on 30 September 2018. The total redemption value paid to shareholders including the estimated dividend was £13.5 million.

Notes to the financial statements (continued)

For the year ended 31 March 2018

19 Non-current borrowings (continued)

Repayments fall due as follows:	2018	2017
	£m	£m
Borrowings excluding finance leases:		
Between one and two years not by instalments	4.0	299.1
Between two and five years not by instalments	988.0	742.8
After five years not by instalments	<u>2,659.5</u>	<u>2,890.8</u>
	3,651.5	3,932.7
On demand or within one year not by instalments	351.7	38.9
	<u>4,003.2</u>	<u>3,971.6</u>
Finance leases:		
Between one and two years not by instalments	0.1	0.6
Between two and five years not by instalments	0.8	0.4
After five years not by instalments	<u>-</u>	<u>-</u>
	0.9	1.0
On demand or within one year not by instalments	0.7	0.5
	<u>1.6</u>	<u>1.5</u>
Borrowings including finance leases:		
Between one and two years not by instalments	4.1	299.7
Between two and five years not by instalments	988.8	743.2
After five years not by instalments	<u>2,659.5</u>	<u>2,890.8</u>
	3,652.4	3,933.7
On demand or within one year not by instalments	352.4	39.4
	<u>4,004.8</u>	<u>3,973.1</u>

It is the company's policy to lease its commercial vehicles 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 2018, the average effective borrowing rate was 4.61% (2017: 5.31%). 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.

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.

Notes to the financial statements (continued)

For the year ended 31 March 2018

20 Derivative financial instruments**Categories of financial instruments at fair value**

	2018 £m	2017 £m
Derivative assets carried at fair value through profit or loss (FVTPL):		
Interest rate swaps – not hedge accounted	4.2	9.3
Total derivative financial assets	<u>4.2</u>	<u>9.3</u>
	2018 £m	2017 £m
Derivative liabilities carried at fair value through profit or loss (FVTPL):		
Interest rate swaps – not hedge accounted	(1,292.2)	(1,347.3)
Total derivative financial liabilities	<u>(1,292.2)</u>	<u>(1,347.3)</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 £1,288.0 million (2017: £1,338.0 million) in the statement of financial position.

	2018 £m	2017 £m
Changes in value of financial instruments at fair value		
Profit for the year has been arrived at after charging/(crediting):		
Financial assets at fair value	(5.1)	(3.1)
Designated as FVTPL		
Financial liabilities at fair value	51.4	(413.7)
Designated as FVTPL		
Fair value gains/(losses) on derivative financial instruments	<u>46.3</u>	<u>(416.8)</u>

The derivative liability was reduced by £3.7 million in the year (2017: £2.5 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 2018

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 2016	551.9	(165.5)	(19.8)	(1.6)	365.0
(Credit)/charge to income statement	(11.4)	(67.5)	0.1	(0.5)	(79.3)
Prior year adjustment:					
- Charge/(credit) 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
At 1 April 2017	<u>510.8</u>	<u>(220.1)</u>	<u>(30.7)</u>	<u>(2.4)</u>	257.6
(Credit)/charge to income statement	(1.5)	19.5	(0.2)	(0.7)	17.1
Prior year adjustment:					
(Credit) to income statement	(6.4)	-	-	-	(6.4)
Charge to other comprehensive income	-	-	1.7	-	1.7
At 31 March 2018	<u>502.9</u>	<u>(200.6)</u>	<u>(29.2)</u>	<u>(3.1)</u>	<u>270.0</u>

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:

	2018 £m	2017 £m
Deferred tax liabilities	502.9	510.8
Deferred tax assets	<u>(232.9)</u>	<u>(253.2)</u>
	<u>270.0</u>	<u>257.6</u>

Notes to the financial statements (continued)

For the year ended 31 March 2018

22 Retirement benefit obligations

The deficit associated with retirement benefit obligations has decreased to £171.7 million (2017: £176.9 million). This has primarily resulted from a lower value of year end liabilities due to a change in the future mortality improvements from the 2015 projections to the 2016 projections, a reduction in the RPI inflation assumption, partially offset by a decrease in the discount rate used to calculate the value of the scheme liabilities.

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 90 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 2018

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 2018 amounted to £3.0 million (2017: £2.6 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:

	2013 SWPS % per annum (pa)
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 2018–19 are £6.4 million and £0.2 million respectively under the current Schedule of Contributions.

Notes to the financial statements (continued)

For the year ended 31 March 2018

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 2018 by a qualified independent actuary. The major assumptions used by the actuary are set out in the table below:

	2018	2017
	% pa	% pa
Price inflation (RPI)	3.2	3.3
Price inflation (CPI)	2.2	2.3
Rate of increase in salaries (plus an age-related promotional scale)	2.4	2.4
Rate of increase of pensions in payment (MIS* members only)***	2.2	2.3
Rate of increase of pensions in payment (Old section** members only)***	3.2	3.3
Rate of increase of pensions in payment (all other members)***	3.1	3.2
Rate of increase for deferred pensions (MIS* members only)***	2.2	2.3
Rate of increase for deferred pensions (all other members)***	3.1	3.2
Discount rate	2.7	2.8

* 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 2017–18, the company has used the post-retirement mortality assumptions based on the standard SAPS mortality tables together with future improvements in line with CMI 2016 improvements with a long-term improvement rate of 1.25% per annum.

	2018	2017
	Years	Years
Longevity at age 65 for current pensioners		
Male	22.4	22.7
Female	24.1	24.8
Longevity at age 65 for future pensioners		
Male	23.7	24.4
Female	25.5	26.7

The assets and liabilities in the schemes and the expected rates of return at 31 March 2018 and 31 March 2017 were:

	Value	Value
	at 2018	at 2017
	£m	£m
Equities	207.9	186.1
Government bonds	176.8	190.3
Non-government bonds	339.4	355.5
Cash	12.6	11.0
Total market value of plan assets	736.7	742.9
Total value of plan liabilities	(908.4)	(919.8)
Accrued deficit in the plan	(171.7)	(176.9)
Related deferred tax asset	29.2	30.7
Net retirement benefit obligations	(142.5)	(146.2)

Notes to the financial statements (continued)

For the year ended 31 March 2018

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.

Reconciliation of the present value of the scheme liabilities	2018	2017
	£m	£m
At 1 April	919.8	776.4
Current service cost	6.7	5.1
Interest expense	25.3	27.5
Member contributions	0.2	0.2
Experience gain on liabilities	5.3	(12.0)
Actuarial (gain)/loss on liabilities:		
- due to changes in demographic assumptions	2.7	(11.0)
- due to changes in financial assumptions	(13.9)	165.6
Benefits paid	(37.7)	(32.0)
Scheme liabilities at 31 March	<u>908.4</u>	<u>919.8</u>

Sensitivity analysis of the scheme liabilities

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

	Change in assumption	Impact on scheme liabilities (%)	Impact on scheme liabilities (£m)
Discount rate	+/- 1%	-/+ 18	-/+ 164
Rate of inflation*	+/- 1%	+/- 15	+/- 135
Rate of increase in pensions in payment	+/- 1%	+/- 12	+/- 113
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.

Reconciliation of the value of the scheme assets	2018	2017
	£m	£m
At 1 April	742.9	674.1
Interest income	20.4	23.8
Gain on assets above interest	3.9	71.2
Employer contributions	7.0	5.6
Member contributions	0.2	0.2
Benefits paid	(37.7)	(32.0)
Administrative expenses	-	-
Bid value of scheme assets at 31 March	<u>736.7</u>	<u>742.9</u>

The total return on scheme assets was £24.3 million (2017: return of £95.0 million).

Notes to the financial statements (continued)

For the year ended 31 March 2018

22 Retirement benefit obligations (continued)

Total cost recognised as an expense	2018	2017
	£m	£m
Current service cost	6.7	5.1
Net interest cost	4.9	3.7
Administration expenses	-	-
Total income statement expense before deduction for tax	11.6	8.8
Analysis of the amounts recognised in other comprehensive income	2018	2017
	£m	£m
Actual return less expected return on pension scheme assets	3.9	71.2
Experience (loss)/gain arising on scheme liabilities	(5.3)	12.0
(Loss)/gain due to changes in demographic assumptions	(2.7)	11.0
Gain/(loss) due to changes in financial assumptions	13.9	(165.6)
Total gain/(loss) recognised in OCI before adjustment for tax	9.8	(71.4)

The cumulative amount of actuarial losses recognised in other comprehensive income is £255.1 million (2017: £264.9 million).

Analysis of the movement in the schemes' deficit during the year	2018	2017
	£m	£m
Deficit in the scheme at 1 April	(176.9)	(102.3)
Employer's contributions	7.0	5.6
Employer's current service cost	(6.7)	(5.1)
Financing charge	(4.9)	(3.7)
Administration expenses	-	-
Actuarial gain/(loss)	9.8	(71.4)
Deficit in the scheme at end of year	(171.7)	(176.9)

23 Provision for liabilities

Environmental obligations	2018	2017
	£m	£m
At 1 April	0.5	0.5
Utilised in year	-	-
Increase in year	2.9	-
At 31 March	3.4	0.5

The environmental provision relates to management's best estimate for the decommissioning of abandoned sites and environmental commitments made for ecology work following the South Hampshire abstraction inquiry. 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 2018

24 Other non-current liabilities

	Deferred Revenue £m	Grants & contributions £m	Total £m
Balance at 1 April 2017	14.2	48.0	62.2
Receivable in year	-	30.0	30.0
Released to income statement	(0.4)	(2.3)	(2.7)
Balance at 31 March 2018	13.8	75.7	89.5

These grants and contributions relate to property, plant and equipment.

Deferred revenue £13.8 million (2017: £14.2 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

	2018 £m	2017 £m
Equity shares		
Authorised		
46,050,000 ordinary shares of £1 each	<u>46.1</u>	<u>46.1</u>
Allotted and fully paid		
56,000 ordinary shares of £1 each	<u>0.1</u>	<u>0.1</u>
Non-equity shares		
Issued		
Preference shares		
32,607 Class A1 shares of £1 each	0.0	0.0
32,607 Class A2 shares of £0.01 each	0.0	0.0
110,000 Class B shares of £1 each	<u>0.1</u>	<u>0.1</u>

The redeemable preference shares are presented as a liability (see note 19) at an amount of £142.6 million including share premium of £142.5 million and accordingly are excluded from called up share capital in the balance sheet. The total statutory company share premium of £188.8 million includes ordinary share premium of £46.3 million.

On 6 April 2018, the company redeemed 12,892 of the A1 and A2 preference shares at nominal value plus premium, amounting to £12.9 million plus an estimated amount for the A2 dividend that would have fallen due on 30 September 2018. The total redemption value paid to shareholders including the estimated dividend was £13.5 million.

26 Share premium account

	2018 £m	2017 £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 2018

27 Revaluation reserve

	£m
Balance at 1 April 2016	745.1
Capital reduction	(735.0)
Transfer to retained earnings	(10.1)
Balance at 1 April 2017	-
Balance at 31 March 2018	-

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 previous 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 2016	568.3
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
Balance at 1 April 2017	907.7
Equity dividends paid	(54.1)
Profit for the financial year	154.7
Other comprehensive income for the year	8.1
Balance at 31 March 2018	1,016.4

Notes to the financial statements (continued)

For the year ended 31 March 2018

29 Notes to the statement of cash flows

	2018 £m	2017 £m
Cash generated by operations		
Continuing operations		
Operating profit	236.6	258.9
Adjustments for:		
Depreciation of property, plant and equipment	244.5	230.3
Amortisation of intangible assets	15.0	14.9
Difference between pension charge and cash contributions	(0.3)	(0.4)
Amortisation of grants and contributions	(2.3)	(1.2)
Operating cash flows before movements in working capital	493.5	502.5
Increase in inventories	(0.2)	(0.3)
(Increase)/decrease in receivables	(23.6)	3.3
(Decrease)/increase in payables	(5.4)	18.8
Increase in environmental provisions	2.9	-
Cash from operating activities	467.2	524.3
Tax paid	(14.1)	(11.4)
Net cash generated from operating activities	453.1	512.9
Cash and cash equivalents	2018 £m	2017 £m
Cash and bank balances	164.4	285.3

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.

The table below details changes in liabilities arising from financing activities, including both cash and non-cash changes. Liabilities arising from financing activities are those for which cash flows were, or future cash flows will be, classified in the cash flow statement as cash flows from financing activities.

Analysis of net debt (including changes in liabilities from financing activities)	At 1 April 2017 £m	Cash flow £m	Fair value adjust- ments £m	New finance leases £m	Other non- cash changes £m	At 31 March 2018 £m
Cash and cash equivalents	285.3	(120.9)	-	-	-	164.4
Liabilities from financing activities:						
Term facilities/index linked loans (note 19)	(253.1)	-	(4.0)	-	-	(257.1)
Loans from subsidiary (note 19)	(3,575.9)	-	(36.6)	-	9.0	(3,603.5)
Finance lease liabilities (note 19)	(1.5)	0.4	-	(0.5)	-	(1.6)
Redeemable preference shares (note 19)	(142.6)	-	-	-	-	(142.6)
Interest rate swaps (note 20)	(1,338.0)	3.7	46.3	-	-	(1,288.0)
Total liabilities from financing activities	(5,311.1)	4.1	5.7	(0.5)	9.0	(5,292.8)
Net debt	(5,025.8)	(116.8)	5.7	(0.5)	9.0	(5,128.4)

Other non-cash changes of £9.0 million relate to the amortisation of loan issue costs, gilt lock proceeds and deferred proceeds.

Notes to the financial statements (continued)

For the year ended 31 March 2018

29 Notes to the statement of cash flows (continued)

Balances at 31 March 2018 comprise:	Current assets £m	Current liabilities £m	Non-current liabilities £m	Total £m
Cash and cash equivalents	164.4	-	-	164.4
Derivative financial instruments	-	-	(1,288.0)	(1,288.0)
Debt issue costs	-	1.5	13.1	14.6
Gilt lock proceeds	-	(0.1)	(4.8)	(4.9)
Borrowings due within one year	-	(353.1)	-	(353.1)
Borrowings due after one year	-	-	(3,659.8)	(3,659.8)
Finance leases	-	(0.7)	(0.9)	(1.6)
Net debt	<u>164.4</u>	<u>(352.4)</u>	<u>(4,940.4)</u>	<u>(5,128.4)</u>

Borrowings due within one year relate to amounts owed to group undertakings that are repayable on demand or within 12 months of the balance sheet date (see note 19).

30 Contingent liabilities

The company faces investigations from the Environment Agency regarding the performance of certain wastewater sites and an investigation by Ofwat into the performance of our wastewater treatment sites and the reporting of relevant compliance information. We are working proactively with the Environment Agency and Ofwat to resolve their investigations which are still evolving. At this time, no clarity of the findings of these investigations or further action and associated financial impact, if any, can be quantified.

The company has also revisited the reporting of the Wastewater Treatment Works number of failed works and population equivalent performance measures provided in previous years. The company is currently revisiting the 2015 data and it appears that Ofwat Outcome Delivery Incentive penalties may have been applicable in respect of the 2015 calendar year. The additional technical assurance that we have carried out on wastewater treatment performance data is now being rolled out for the years 2014 to 2010.

It is likely that we will be required to make future revenue adjustments and/or pay penalties and fines in relation to any restated figures. The Ofwat investigation could result in Ofwat taking enforcement action which may include the imposition of a financial penalty, which could be material in nature as Ofwat can impose a financial penalty of up to 10% of turnover for each breach. Any penalty or fine will be dependent on a consideration of the severity of the findings of the investigations. These will be subject to ongoing discussion and agreement reflecting, amongst other matters, the mitigating actions being taken by the company to respond to these matters after review. As a result, it is not possible to recognise an accounting provision at this time.

Our new Compliance and Asset Resilience directorate is leading improvements in data integrity and the planning, scheduling, monitoring and performance reporting to the Environment Agency and Ofwat. Further information on this programme can be found in our Final Assurance Plan 2018, which is available on our website southernwater.co.uk/our-reports.

Other contingent liabilities

Companies of the size and scale of Southern Water Services Limited 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.

Notes to the financial statements (continued)

For the year ended 31 March 2018

30 Contingent liabilities (continued)

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.

Following the South Hampshire abstraction inquiry Southern Water Services Limited has committed to undertake certain environmental work should a drought order be required on the rivers Itchen, Test or Candover Stream between 2018 and 2030. Details of the agreement are still being finalised, as a result it is not possible to provide an estimate of the potential financial effect of the agreement.

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 Services Limited's valuation.

The company had no contingent liabilities for capital claims at the year-end (2017: £nil).

31 Financial commitments

(a) Capital commitments are as follows:

	2018 £m	2017 £m
Contracted for but not provided for in respect of contracts placed in respect of property, plant and equipment	516.5	354.8
Contracted for but not provided for in respect of contracts placed in respect of intangible assets	9.7	9.7

(b) The company as lessee

	2018 £m	2017 £m
Lease payments under operating leases recognised as an expense in the year	<u>4.5</u>	<u>3.9</u>

As at 31 March 2018 and 2017, 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	
	2018 £m	2017 £m	2018 £m	2017 £m
Within one year	1.7	1.7	0.1	0.2
In the second to fifth years inclusive	7.0	6.2	-	0.3
After five years	13.2	13.0	-	0.1
	<u>21.9</u>	<u>20.9</u>	<u>0.1</u>	<u>0.6</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 ad hoc basis at the then prevailing market rate.

Notes to the financial statements (continued)

For the year ended 31 March 2018

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, which is the parent undertaking and controlling party of the smallest, largest and only group to consolidate these financial statements. Copies of the consolidated financial statements may be obtained from the registered office of GSH at Southern House, Yeoman Road, Worthing, BN13 3NX, or from the Southern Water website.

The largest shareholder in GSH as at 31 March 2018 is an institutional investment company advised by JP Morgan Asset Management owning 31.24%.

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

On 6 April 2018, the company redeemed 12,892 of the A1 and A2 preference shares at nominal value plus the premium on issue, amounting to £12.9 million, plus an estimated amount for the A2 dividend that would have fallen due on 30 September 2018 of £0.6 million.

Independent auditor's report to the members of Southern Water Services Limited

Report on the audit of the financial statements

Opinion

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 March 2018 and of its profit for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice including Financial Reporting Standard 101 'Reduced Disclosure Framework'; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements of Southern Water Services Limited (the 'company') which comprise:

- the income statement;
- the statement of other comprehensive income;
- the statement of financial position;
- the statement of changes in equity;
- the statement of cash flows; 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, including Financial Reporting Standard 101 'Reduced Disclosure Framework' (United Kingdom Generally Accepted Accounting Practice).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs(UK)) and applicable law. Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report.

We are independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, including the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of matter – contingent liability in respect of regulatory investigations

We draw attention to note 30 in the financial statements concerning the uncertain outcome of certain regulatory investigations regarding the performance of certain wastewater plants. The company faces investigations from the Environment Agency regarding the performance of certain wastewater sites and an investigation by Ofwat into the performance of wastewater treatment sites and the reporting of relevant compliance information. At this time, no clarity of the findings of these investigations or further action and associated financial impact, if any, can be quantified. As the ultimate outcome of the matter cannot presently be determined no provision for any liability that may result has been made in the financial statements. Our opinion is not modified in respect of this matter.

Conclusions relating to going concern

We are required by ISAs (UK) to report in respect of the following matters where:

- the directors' use of the going concern basis of accounting in preparation of the financial statements is not appropriate; or
- the directors have not disclosed in the financial statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the financial statements are authorised for issue.

We have nothing to report in respect of these matters.

Independent auditor's report to the members of Southern Water Services Limited

Other information

The directors are responsible for the other information. The other information comprises the information included in the annual report, other than the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and, except to the extent otherwise explicitly stated in our report, we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact.

We have nothing to report in respect of these matters.

Responsibilities of directors

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, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditor's report.

Use of our report

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.

Report on other legal and regulatory requirements

Opinions 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 or the directors' report.

Independent auditor's report to the members of Southern Water Services Limited

Matters on which we are required to report by exception

Under the Companies Act 2006 we are required to report in respect of the following matters 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.

We have nothing to report in respect of these matters.



Anthony Matthews FCA (Senior statutory auditor)
for and on behalf of Deloitte LLP
Statutory Auditor
London, United Kingdom

13 July 2018