Financial performance

Financial performance

Accounting policies

The accounting policies of the company, which are consistent with the prior year, are set out on pages 151 to 158.

Income statement

Our income statement is summarised in Table 1 below.

Table 1 – Income statement years ended 31 March

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

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

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

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

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

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

Unfortunately, during 2016–17 we were prosecuted for pollution incidents which occurred at Margate in 2012 and 2014. This prosecution resulted in a fine of £2.0 million, which increased our operating costs in this financial year. Since those incidents, we have also made considerable investment to mitigate

Table 2 – Year-on-year increase/(decrease) in operating costs

	£m
Inflation	5.7
Customer services improvement programme	4.0
Increased bad debt charge	3.8
Increased leakage detection and repair activity	0.9
Power efficiencies	(2.4)
Process efficiencies	(4.0)
Procurement savings	(1.4)
Lower costs from dealing with groundwater flooding	(0.8)
Margate – fine	2.0
Other	(0.5)
Movement in operating costs	**7.3**

the risk of future incidents, improve resilience at the site and to ensure that bathing water in the area is cleaner than ever.

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

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

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

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

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

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

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

Table 3 – Cash flow statement years ended 31 March

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

Cash flow statement – summary

Our cash flow statement is summarised in Table 3 above.

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

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

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

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

Table 4 – Statement of financial position years ended 31 March

	2017 £m	2016 £m
Non-current assets	**6,587.2**	6,491.0
Current assets (excluding cash)	**200.0**	194.7
Cash and cash equivalents	**285.3**	17.9
Total assets	**7,072.5**	6,703.6
Current liabilities	**(349.5)**	(277.0)
Non-current liabilities	**(5,768.9)**	(5,066.8)
Total liabilities	**(6,118.4)**	(5,343.8)
Total net assets	**954.1**	1,359.8
Total equity	**954.1**	1,359.8

Statement of financial position – summary

Our statement of financial position is summarised in Table 4 above.

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

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

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

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

The net increase in the liability associated with derivative financial instruments during the year was £414.3 million. During 2016–17 we repaid £2.5 million of accrued indexation associated with these instruments, which was offset by an increase in the liability due to the impact of market rates on the underlying instruments of £416.8 million. Further details can be found in note 20 to the financial statements.

Overall, net assets decreased from £1,359.8 million to £954.1 million.

Dividend policy

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

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

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

Distribution proposals submitted to the Board will also include an assessment of our performance against the business plan, including expected performance over the balance of the regulatory period.

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

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

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

Further details are shown on page 99.

Capital reduction

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

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

Taxation

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

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

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

Risk is managed by ensuring there are sufficient processes and controls in place. Internal assurance for the company is carried out by our Internal Audit team and we have also used the services of professional tax advisors to assist us with our of tax compliance. Our Tax Policy extends to the wider group and ensures all companies within the Southern Water and Greensands groups are subject to UK tax, and all companies are UK tax resident irrespective of their place of incorporation.

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

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

- **Capital allowances and depreciation** *– we have a large capital expenditure programme and this is charged against taxable profits as capital allowances. These are applied at different rates than the depreciation charged against profits in the financial statements. As a result, there is a timing difference between deductions made against our taxable profits and those made against our accounting profits. Due to the scale of our capital expenditure programme and the level of capital allowances utilised, our taxable profit is reduced.*
- **The treatment of interest costs** – *we borrow money to finance our capital expenditure programme. The interest associated with this borrowing is recognised as both an accounting and tax expense, so reducing profit and the amount of tax we pay. There are however, differences between the amount of interest recognised for accounting profits and for taxable profits. Examples are that movements on the fair value of our financial derivatives are not recognised in our taxable profits, and interest is capitalised in our financial statements, with no corresponding treatment in the calculation of our taxable profits.*
- **Group relief** – *Southern Water is part of the Greensands Holdings group of companies as set out on page 97. All of these companies are taxable as UK companies and profits or losses of these companies within the group can be set-off against one another in the financial year.*
- **Changes to future tax rates** – *The financial statements carry the temporary differences between our taxable profits and our accounting profits as a deferred tax balance on the statement of financial position. Changes to the future rate of corporation tax revise the carrying value of these differences.*

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

Details of our tax charge for the current financial year are disclosed in note 9 to the financial statements and the current year charge to the income statement is also explained further on page 89.

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

- *Business rates of £26.0 million paid to local authorities (2016: £25.7 million) and payments to the Environment Agency of £7.6 million (2016: £8.4 million) for abstraction licences and discharge consents, which reduce profits chargeable to corporation tax. In 2015–16, these payments were offset by a refund of historic rates charges totalling £13.3 million following an appeals process in relation to historic charges.*
- *Employment taxes of £28.3 million (2016: £26.7 million) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions.*
- *Carbon Reduction Commitment of £3.3 million (2016: £3.8 million) levied on our power costs, which reduces profits chargeable to corporation tax.*

Payments have also been made to other group companies of £11.4 million for tax losses surrendered to the company. These were paid to SWSG and then repaid to us as interest. Overall, Southern Water pays 5.8 pence in the pound for losses surrendered from group companies. As a result of capital allowances and interest charges, no corporation tax was paid by the company to HMRC in 2016–17.

Financial KPIs

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

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

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

Net debt/RCV	%
2013–14 performance	78
2014–15 performance	78
2015–16 performance	79
2016–17 performance	77
Covenanted lock-up level	<85

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

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

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

Capital structure

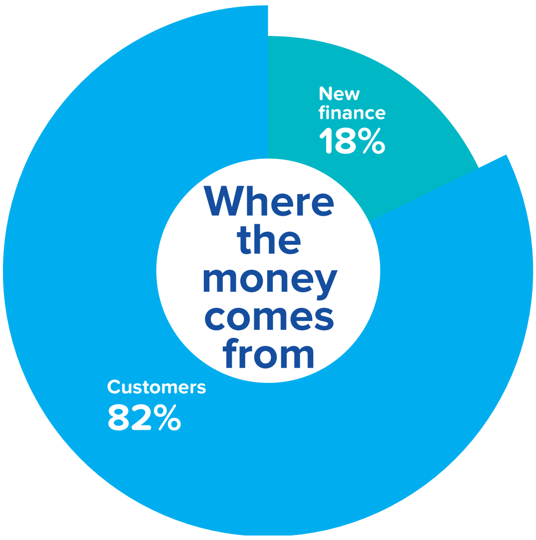
Why Southern Water raises finance

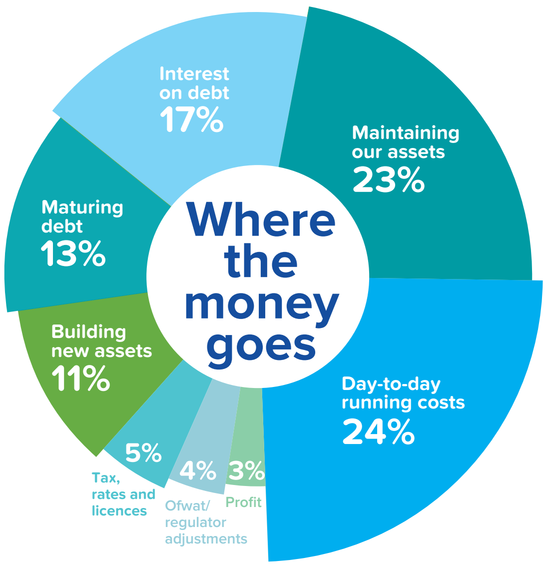
Significant capital investment has been a feature of our business since privatisation in 1989. We have invested in both maintaining our existing asset base and constructing new assets in order to improve the environmental quality of wastewater, improve the quality of drinking water and accommodate population growth in our area of operation. As an example, before privatisation, 350,000 m^3 of wastewater per day was discharged into our coastal waters was untreated, but the completion of our £300 million Cleaner Seas for Sussex scheme in 2013 marked the conclusion of a programme of capital investment to fully treat wastewater of the coastal towns and cities from Kent to Hampshire and the Isle of Wight. A further example is a current £63 million construction project at Woolston which will improve the quality of effluent discharged into the River Itchen as well as reduce odours.

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

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

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





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

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

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

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

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

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

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

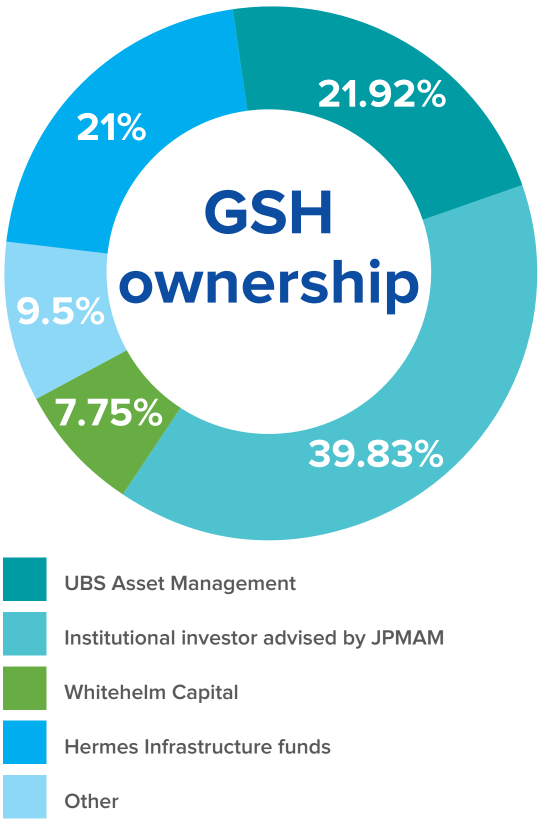
Profit
– the return earned on shareholders' investment in the business.

How we are structured

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

Ownership

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



UBS Asset Management

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

JP Morgan Asset Management (JPMAM)

– a large-scale global asset manager advising institutional investors

Whitehelm Capital

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

GSH Board

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

The former Chairman of Southern Water Services, Robert Jennings, was also independent Chairman of the GSH board, which meets four times a year. The purpose of GSH is to act as a single-purpose entity, being the ultimate holding company for Southern Water, providing the financing structure for the group. As a consequence, the GSH board complements and supports the aims of the Board of Southern Water for its long-term success. In his role as Chairman, Robert united the respective Boards in this common aim. Taking this into consideration it was felt that his cross directorship did not undermine his independence.

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

Hermes Infrastructure funds

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

Other

– other minor shareholdings held by infrastructure investment companies

Group structure

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

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

Southern Water ownership structure summary

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

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

Greensands financing companies – A number of financing companies were established as part of the acquisition in 2007 to provide additional external financing. Security granted to the lenders of this financing is limited to the share capital of Greensands Holdings Ltd. There are no debt guarantees in place between the Greensands financing companies and the Southern Water Financing Group, with the result that SWS is fully protected, and fully isolated, from a default at any Greensands company.

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

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

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

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

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

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

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

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

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

How we finance the business

In note 19 to the financial statements, we provide an analysis of our outstanding debt at 31 March 2017 and 31 March 2016. Our loans comprise sterling bonds, issued by our financing subsidiary SWSF, and listed on the UK Stock Exchange, other loans including loans from US insurance companies, bank loans, and a loan from the European Investment Bank.

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

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

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

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

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

In addition to our loans as analysed in note 19, we have in issue a loan of £812.3 million to SWSG which was put in place as part of the refinancing in 2003 (note 13). We receive £56.9 million annual interest on this loan from SWSG. In order to enable SWSG to make this payment, it receives dividend and tax payments from us. For the year ended 31 March 2017, the dividend was £45.5 million and the tax payment, in respect of the taxable losses incurred by SWSG, amounted to £11.4 million. This loan provides no tax benefit to either us or the Greensands Group, with the tax payment we make to SWSG simply negating any tax effect of this loan. This is illustrated in figure 1 of the diagram on page 99.

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 2016–17

Fig. 1

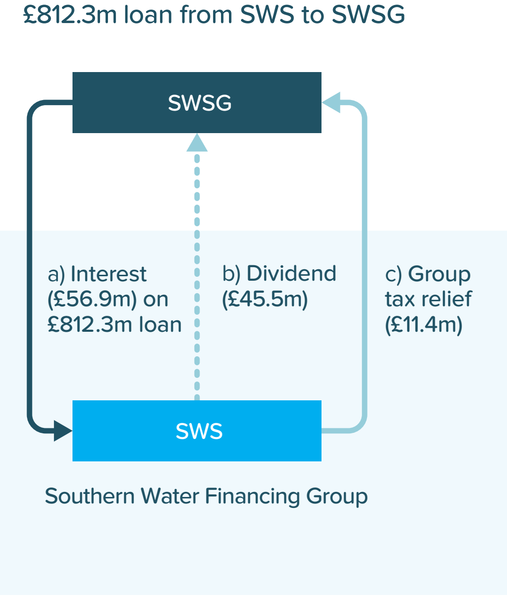
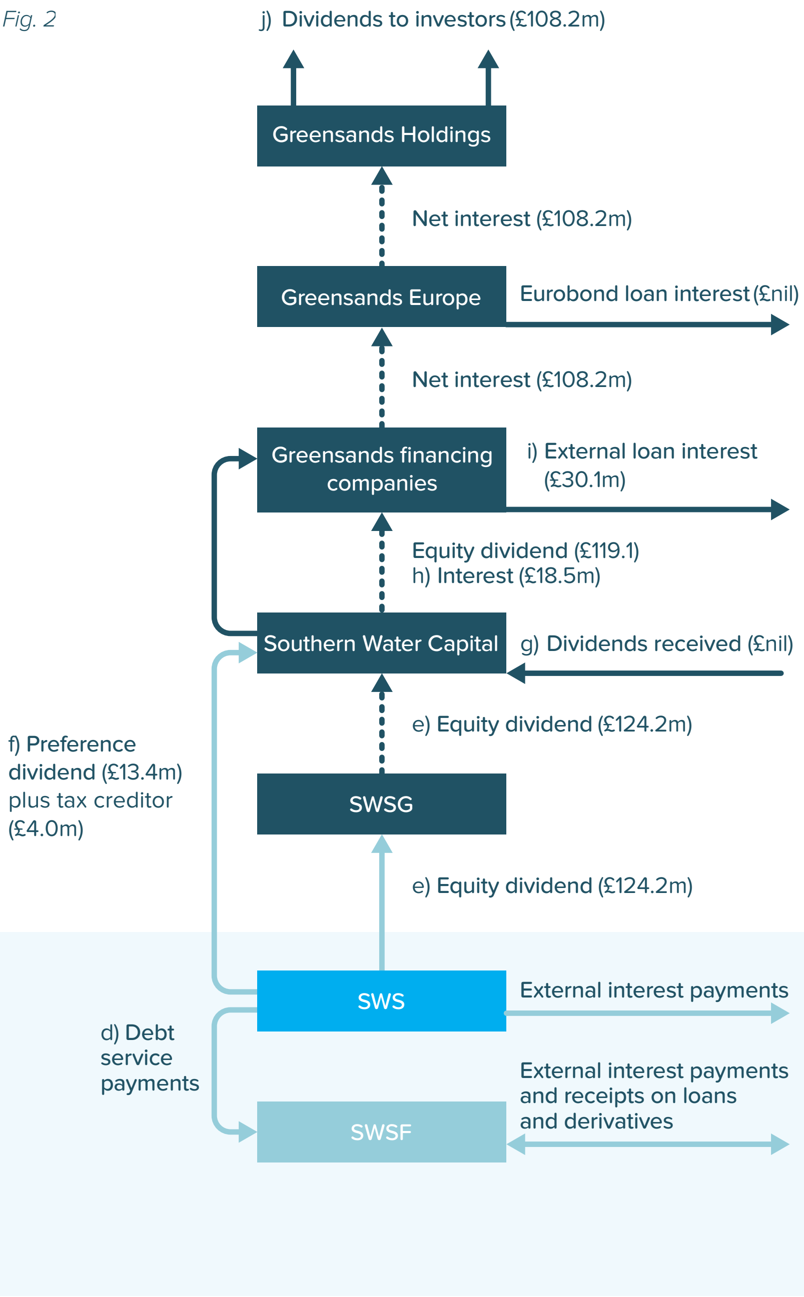


Fig. 2



Footnote:
a) Interest paid by SWSG to SWS on £812.3m loan.
b) Dividend paid by SWS to SWSG to facilitate the interest payment on the £812.3m loan.
c) Payment of group tax relief by SWS for the taxable losses at SWSG.
d) Interest payments from SWS to SWSF on the loans taken out by SWSF on behalf of SWS. This is then used by SWSF to pay the interest on these external loans.
e) Ordinary dividend of which £108.2 million was ultimately paid to investors (see j).
f) Interest payments on the preference shares and payment of tax creditor.
g) Dividends received from other group companies.
h) Interest payable on inter-company loans.
i) External interest payable, funded from interest receivable and cash held in the Greensands financing companies.
j) Dividends paid to investors.

Viability statement

Details of our Code of Board leadership, transparency and governance are set out in the corporate governance section of the Annual Report on page 115. In developing our code we drew on the appropriate principles of the UK Corporate Governance Code (UK Code). In accordance with provision C.2.2 of the UK Code, the Board has assessed the prospects of the company over a longer period than the 12 months required by the 'Going Concern' provision. The Board has selected to conduct this review based on a rolling five-year period for the following reasons:

i. The company benefits from a rolling 25-year operating licence.

ii. The wholesale and retail price controls set by Ofwat provide a high degree of certainty over cash flows through to the end of the current regulatory period, March 2020.

iii. Additional protection is afforded between price controls by Ofwat's primary legal duty to ensure that water and wastewater companies can finance their functions.

In assessing the viability of Southern Water over a five-year period to March 2022, the directors have taken into account current performance and the financial and operational impacts, in severe but plausible scenarios, of the principal risks documented in the Strategic Report on pages 23 to 86. These include the impacts of:

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

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

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

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

Based on this assessment, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period to March 2022.

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

- *The certainty of wholesale and household retail price controls to March 2020 provided by the 2014 Final Determination by Ofwat, following its acceptance by the Board.*
- *The financial strength of the company at the balance sheet date and the fact that it has arranged £350 million of five-year committed bank facilities as back up liquidity (maturing in 2019), of which £350 million remains undrawn at 31 March 2017.*
- *The company's annual budget and business plan projections, including stress testing reflecting plausible but severe combinations of the principal risks of the business.*
- *The company's formal risk and governance arrangements which are monitored by the Audit Risk and Compliance Committee and Board.*
- *The company's track record in being able to raise new forms of finance in most market conditions.*

Risks

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

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

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

Our strategy for risk management is that all principal risks are identified, assessed and managed to within acceptable levels. To achieve this, the Board and management promote a culture that encourages routine consideration of principal risks in key decisions and supports integration of risk management with our critical processes and ways of working. Risk management and internal control systems are monitored by our Board. This covers all material controls including financial, operational and compliance controls.

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

The objectives of our risk management strategy are to:

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

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

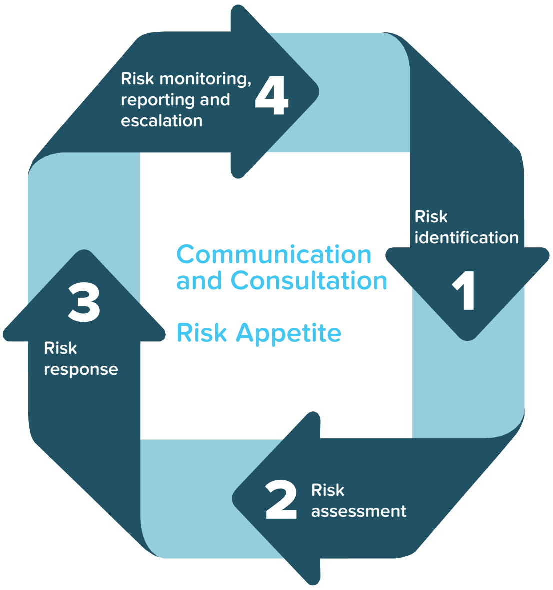


Figure 1: Southern Water Risk management process

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

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

The principal risks we face are disclosed below:

Risk unchanged in the year | Risk reduced in the year | Risk increased in the year

Customer

Customer service

Risk unchanged in the year

Commentary:

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

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

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

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

Mitigation:

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

We continue to actively engage with our customers and stakeholders in order to strengthen our links with local organisations such as councils and community groups.

We will continue to improve our customers' experience by providing enhanced online facilities for them to manage their accounts. Where customers do need to speak to us directly, we have ensured the opening hours of our contact centre are convenient and our bills will be redesigned to make them easier to understand.

Outcomes affected:

Responsive customer service

Better information and advice

Customer continued

Bad debt

Risk increased in the year

Commentary:

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

We note that the ongoing Brexit process may adversely affect the economic climate and customers' ability to pay.

In 2016–17, the bad debt charge to the income statement increased to £25.3 million (2015–16: £21.5 million)

Mitigation:

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

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

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

Outcomes affected:

Responsive customer service

Affordable bills

Having a firm financial footing

Climate

Resilience to drought

Risk increased in the year

Commentary:

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

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

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

Mitigation:

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

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

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

Outcomes affected:

A constant supply of high-quality drinking water

Looking after the environment

Climate continued

Preventing flooding of our sites and from our network

Risk reduced in the year

Commentary:

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

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

Mitigation:

To help combat this risk, we have prioritised schemes for investment in 2015–20. We are investing £426 million during this period to provide a reliable and effective wastewater service, part of which will be used to keep our 39,594 kilometres of sewers and 3,243 wastewater pumping stations well maintained. It will also fund our replacement or refurbishment of about 100 kilometres of sewers, with the parts of our network in most need of repair and of most structural use targeted first.

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

Outcomes affected:

Removing wastewater effectively

Looking after the environment

Operational

Resilient supply of good quality water

Risk unchanged in the year

Commentary:

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

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

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

DWI enforcement actions are referred to on page 51.

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

Mitigation:

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

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

We have provisionally achieved drinking water quality compliance of 99.97%. Our business plan 2015–20 includes schemes to add carbon filters and other more advanced filters at our water treatment works in high risk areas such as Hastings, to help improve the taste and smell of water. Our activities to improve water quality include upgrades to wells and boreholes, service reservoirs and water supply works, as well as flushing mains and cleaning service reservoirs, which store water underground before it is pumped to customers' taps.

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

Outcomes affected:

A constant supply of high-quality drinking water

Looking after the environment

Operational continued

Cyber security

Risk unchanged in the year

Commentary:

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

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

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

Mitigation:

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

We continue to invest in cyber threat mitigation strategies in response to the changing risk landscape and we work with the Centre for Protection of National Infrastructure. Over the past 12 months we have used industry experts to review our cyber security maturity and help develop an improvement plan.

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

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

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

Outcomes affected:

Responsive customer service

Better information and advice

A constant supply of high-quality drinking water

Removing wastewater effectively

Having a firm financial footing

Looking after our assets

Operational continued

Wastewater treatment works failures and pollution incidents

Risk unchanged in the year

Commentary:

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

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

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

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

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

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

Mitigation:

We continue to operate and maintain our assets effectively.

We monitor the functionality and performance of our assets on a continuous basis through a central control room. We also monitor any instances when our Combined Sewer Overflow (CSO – back up over flow pipes) are used, to proactively ensure we can identify infrastructure under stress. This together with our new works management system has significantly improved the way in which we dispatch work. We can respond quicker to asset-related events and deliver the required planned preventative maintenance more efficiently.

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

In the last year we have invested £45.2 million at our wastewater treatment works and pumping stations to reduce risks at critical sites, and invested £11.5 million in sewer maintenance and rehabilitation.

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

Outcomes affected:

Removing wastewater effectively

Looking after the environment

Operational continued

Health and safety

Risk unchanged in the year

Commentary:

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

Mitigation:

We have taken all necessary steps to ensure the potential health and safety risk is suitably mitigated and controlled. We have a clearly defined strategy, safety protocols and standards that are set. 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 staff receive suitable health and safety training, and we have a campaign to encourage staff to report ‘near misses’ or hazards at work to help further reduce the risk of injuries or ill-health. Additionally, every employee has ready access to a copy of the corporate policy statement and health and safety processes and procedures.

Outcomes affected:

Having great people

Working in partnership

Financial

Financing our business

Risk increased in the year

Commentary:

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

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

Our current credit ratings are:

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

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

Mitigation:

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

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

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

Outcomes affected:

Having a firm financial footing

Looking after our assets

Financial continued

Defined benefit pension scheme

Risk increased in the year

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 in recent years by The Pensions Regulator could result in a higher funding requirement for the final salary pension scheme in the future. Southern Water is currently in discussion with The Pensions Regulator regarding the current deficit.

Mitigation:

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

Outcomes affected:

Having a firm financial footing

Having great people

Strategy and Regulation

Compliance with regulations and legislation

Risk increased in the year

Commentary:

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

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

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

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

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

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

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

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

Mitigation:

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

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

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

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

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

Outcomes affected:

- Responsive customer service
- A constant supply of high-quality drinking water
- Removing wastewater effectively
- Looking after the environment
- Having a firm financial footing

Strategy and Regulation continued

Delivery of our capital investment programme

Risk increased in the year

Commentary:

We have a capital investment programme of £1.8 billion between 2015 and 2020. We have plans in place to ensure we will deliver this and we are working hard to ensure our focus is maintained to complete all works on time.

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

Capital expenditure in the early part of the programme is behind that set out in the business plan, increasing the risk in this area. We have worked this year to close this shortfall and we remain on track to deliver our required outcomes by the end of the investment programme in 2020.

Mitigation:

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

Outcomes affected:

- Responsive customer service
- A constant supply of high-quality drinking water
- Removing wastewater effectively
- Looking after the environment
- Having a firm financial footing

Strategy and Regulation continued

Regulatory reform

Risk unchanged in the year

Commentary:

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

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

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

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

Mitigation:

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

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

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

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

Outcomes affected:

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

The Strategic Report was approved by the Board of Directors on 27 June 2017 and signed on its behalf by Joanne Statton, Company Secretary.

J Statton.

Joanne Statton
Company Secretary

27 June 2017