

JUNE RETURN - 2011

SOUTHERN WATER SERVICES

2011 Annual Return

Board Overview

10th June 2011



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BOARD'S OVERVIEW - EXECUTIVE SUMMARY

2010-11 marks the first year of the new regulatory period, following the price review in 2009. During this period we are committed to improving our key processes to deliver better services for customers, protecting the environment and providing safe and reliable services in the most efficient way. In particular we are focused on transforming our asset management capabilities. Our goal is to be recognised as the UK's leading water company by 2015.

Everything we do will ensure we are:

- Working for our customers and using their insight to develop and deliver excellent services
- Protecting the environment and striving to mitigate our impact on it
- Safer and more efficient, through a continued focus on our operating model, processes and ways of working
- Creating an exciting, healthy and rewarding place to work, which attracts and retains great people who are passionate and empowered to deliver their best
- Understanding and investing in our assets to ensure excellent services and serviceability
- Enhancing our capabilities by working with the very best service providers
- Delivering sustainable regulatory performance with good returns for our shareholders
- Being an integral, active and valued partner in the communities that we serve
- Positively shaping the industry agenda and actively engaging with key stakeholders and regulators

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

- Achievement of further improvements in customer services leading to a 19% reduction in complaints and a 12% reduction in billing contacts
- Early start made on the sewer flooding programme, with 13 properties removed from the register in the year through company action (of the 41 properties funded in the final determination)
- Award of our third "President's Award" by RoSPA to mark twelve years of 'Gold' level performance and a 33% reduction in RIDDOR accidents involving our employees
- Progress made on re-building our asset management capabilities, by bringing significant activities back in-house
- The start of our Universal Metering Programme, following extensive engagement with customers in order to ensure that the transition is as smooth as possible for customers
- Renewal of the senior management team
- Implementation of a new programme of operator training and monitoring ('passport' scheme) to drive improved compliance and performance

- Implementation of a number of other operating initiatives and re-phasing of the capital programme to improve serviceability, respond to exceptional events and deal with performance issues

There remain a number of key challenges for this period. We recognise that there is more to do in reshaping some of our key processes to drive out operating efficiencies, following a large increase in operating expenditure this year.

Similarly, delivering the capital programme in the face of significant capital price deflation of 9% since the price review (as measured by the Construction Output Price Index (COPI)), represents a major challenge. This is because, under Ofwat's methodology, the fall in COPI effectively reduces the value of the final determination capital allowance. However, the reduction in the index is not necessarily matched by a reduction in the real costs that we face in procuring our capital programme.

There are also significant challenges for us in managing our networks. Following three harsh winters, the resilience of our water infrastructure network has reduced and as a result we have been unable to achieve the challenging leakage targets that we set for ourselves, though we continue to have the lowest leakage levels of any of the ten water and sewerage companies in England and Wales. Customers expect us to manage our resources effectively, and we remain committed to leading the industry on leakage. We have in place an action plan to drive down leakage levels, on which we have updated Ofwat regularly through the year. As part of the plan we deployed record levels of resources on finding and fixing leaks and as a result we repaired an unprecedented 22,000 leaks during the year. However, we believe a re-profiling of our targets for this period, to reflect the impact of the unpredicted harsh winters is required.

On the sewer network, we believe serviceability, Ofwat's measure of the effectiveness of our maintenance activity in delivering services to customers, has this year fallen to 'Marginal' status. This follows increases in both pollution incidents and flooding and blockages. We have put in place an action plan to address these failures. This plan includes a 50% increase in our sewer jetting programme, reinstatement of a prioritised wet well cleaning programme, increased sewer replacement rates (60km planned for 2011-12), prioritised refurbishment of 100 pumping stations during 2011-12, increased use of real-time data on the sewer network and improved data analysis such as 'hot spot' analysis.

Serviceability across the other three sectors has been assessed as 'Stable'. This follows significant investment, above the levels reflected in price limits, on restoring the serviceability of our water (and in the last period, sewerage) above-ground assets (principally treatment works). Despite the trend in some of the key indicators on the water infrastructure network, we believe these are related to our increased leakage activity (which increases the reported mains burst indicator) and one exceptional event in Meopham, Kent, where the collapse of the whole road and disruption to other underground services resulted in a lengthy supply interruption. The extent of the damage meant that we could not safely repair the main and restore customers' supply more rapidly.

Finally, there is an urgent need to address the shortfall in our revenue base compared with the assumptions included in Ofwat's price limits. The ongoing element of this shortfall amounts to £24.5m in the report year and we believe it will remain at or above this level for the whole of the five-year period. While this shortfall can be recovered under the Revenue Correction Mechanism introduced at the last price review, this is likely to result in a significant bill spike in 2015-16. We believe it is prudent to take action to avoid this now and we have made some proposals to Ofwat to smooth these increases, by recovering part of the revenues in the current period and part in the next five-year period. We will continue to discuss the issue with Ofwat as well as consulting with customers on their preference between small steady bill increments immediately, or a much larger increase at some point in the future.

CHAPTER 1 DELIVERING FOR OUR CUSTOMERS

Central to our goal to be recognised as the UK's leading water company is delivering excellent services to all of our customers. In this section we describe our performance in the year in delivering for our customers and our progress with the customer-related elements of our five-year capital investment programme for the period 2010-2015.

PERFORMANCE IN THE YEAR

Customer contact

The ability of our customers to contact Southern Water in their preferred manner, to receive a timely response, and where we get things wrong, a full explanation, is crucial to ensuring our customers are satisfied with the services they are receiving.

During the year we have established a new company-wide programme under the 'Improving Customer Experience' banner, to co-ordinate and measure the impact of the suite of initiatives to drive improved performance against Ofwat's Service Incentive Mechanism (SIM), which is one of our top strategic objectives. In particular we will be improving the clarity of our billing and charges information, which significantly impacts on customers' need to contact us, as well as their perception of us. We also plan to further enhance the customer experience with a strengthened staff training programme, improving the skill levels of our staff as well as increasing the proportion of permanent employees rather than agency staff.

We are beginning to see these initiatives reflected in our SIM score, but there is more to do to improve satisfaction levels. While we met all of our internal targets on the quantitative element of the SIM, we fell short on the challenging qualitative target that we set ourselves (a level that was not achieved by any other company).

Table 1. Service Incentive Mechanism score

	2010-11 Actual	2010-11 internal target
QUANTITATIVE SCORE :		
All Lines Busy	7	7
Calls Abandoned	50	51
Unwanted Telephone Contacts	164	180
Written Complaints	31	33
Escalated Written Complaints	137	137
CCW Investigations	0	1.5
Total Quantitative Points	389	410
Converted SIM score	18	16
QUALITATIVE SCORE:		
Customer Experience Survey Results average (out of 5)	3.9	4.6
Converted SIM score	36	45
COMBINED SIM SCORE:	54	61

In terms of billing contacts (DG6), we have seen a further 12% fall in customer contacts, with 100% being responded to in the target of 5 days. (JR Table 4) 87% of these were responded to within 2 days. The number of written complaints has also fallen by 19% in the year, with 99.7% being answered within the target time of 10 days. (JR Table 5) This follows a 39% fall in complaints in 2009-10.

To help us learn from our complainants, we established our Customer Forums, which give customers who have complained the opportunity to understand more about the services we provide, through a tour of one of our works, while giving us excellent feedback. The innovative nature of these forums was recognised this year at the Water Industry Achievement Awards with the award of Customer Satisfaction Initiative of the Year.

As in 2009-10, 99.8% of customers received a bill based on an actual read during the year. (JR Table 5) Under our Universal Metering Programme we will be installing 486,000 new meters and 100,000 replacement meters with remote reading capabilities in the period to 2015. This will ensure that all measured customers receive a bill based on an actual read and estimated bills will disappear once all the current meter stock is replaced.

There was a slight increase from 9,830 to 12,841 in the number of customers receiving the engaged tone when attempting to contact us. This largely reflects an intermittent technical fault on one of our servers during March 2011, which affected 3,073 customers.

The improvements that we have made in our contact centre over the last few years were recognised during the year when we were included as one of the UK's top 50 call centres for Customer Service in an independent benchmarking programme.

The harsh winter conditions experienced in December 2010, led to an increase in the number of appointments that could not be kept. Of the reported 168 cases where there was a failure to correctly cancel the appointment, 165 of these occurred in December 2010. (Payments under the Guaranteed Standards Scheme (GSS) were not made under the severe weather exclusion.) (JR Table 6) The increase in supply interruptions during this period (see below) also led to an increase in GSS events.

Water supply

The key concerns of customers about their water supply are ensuring a safe and reliable service, at adequate pressure and with minimal interruptions. The issues of water quality and availability are covered in Chapter 3. Here we discuss performance on pressure and interruptions.

The number of customers at risk of receiving a water supply at inadequate pressure fell again by the year end to just 235. (JR Table 2) This is a reduction of 60 from 2009-10 and compares with the forecast made at the last price review of 315. Note that the number of properties reported as excluded from the DG2 indicator due to abnormal demand has increased. This increase includes 22,599 properties in the Fleete Gravity area in Kent - further verification work is being carried out on this data, which may overstate the total number of abnormal demand exclusions by the inclusion of properties affected by bursts or other maintenance work. (This does not impact on the DG2 register.) The confidence grade for this data has been amended to reflect this degree of uncertainty.

The extremely cold weather in December 2010 led to a number of significant interruptions to customers' supply, and a large increase in the number of unplanned interruptions lasting more than six hours. Of the total 7,554 properties, 3,467 relate to incidents in December 2010, when the most extreme weather conditions were experienced in the region. A further 2,156 relate to two major incidents – the first in Horsham, West Sussex involving 1,548 properties following failure of a 200mm main in July and 608 in Crawley, West Sussex, resulting from the failure of a reservoir outlet main. (JR Table 2)

We have also reported an increase in planned interruptions. (JR Table 2) This reflects the significant increase in mains activity at the start of the AMP5 capital programme, and our efforts to deliver Stable serviceability (mains replacement rates have increased from 3km to 56km in the year (JR Table 11)). As we continue our enhanced mains replacement programme we will continue to do all we can to minimise disruption to customers and local residents.

Sewerage Service

For most customers the sewerage system is largely invisible and that is how it should be. However, blockages in the network or a lack of hydraulic capacity can give rise to flooding from our sewers, particularly in the event of extreme rainfall. Where this flooding is in the street or customers' gardens (external flooding) this causes distress and inconvenience. Where raw sewage enters customers' homes this has a traumatic impact. We are working hard to reduce the number of properties at risk of flooding (see below).

During the year the total number of properties experiencing internal flooding was 483. (JR Table 3) This is an increase on last year where the number was 364. Most of this increase was due to an increase in blockages where the number of incidents increased from 286 to 351 and equipment failures which increased from 29 to 91. A similar pattern is evident on external flooding, where the number of incidents caused by blockages has increased from 4,878 to 6,120. (JR Table 3a) As a result we instigated a 50% increase in our programme of sewer jetting, which will reduce the incidence of blockages, and a prioritised programme of wet well cleaning at pumping stations to reduce equipment failures. We are also making greater use of 'real-time' data on the network which will provide early-warning of potential problems and have re-launched our fats, oils and grease campaign, to encourage customers not to put fat down the sink.

Where flooding does occur, we aim to provide customers with all the assistance they require and have established a Customer Service Incident Response Team, made up of some of our most experienced customer service staff, to co-ordinate our response and help mitigate the impact on customers. Feedback from customers who have been helped by the team has been overwhelmingly positive.

ENHANCING SERVICE LEVELS

As part of the price review, Ofwat sets price limits alongside a package of outputs that must be delivered. In this section we describe progress with delivering the specific outputs under the Enhanced Service Levels investment category.

Water supply

There are no specific regulatory outputs under the Enhanced Service Levels investment category for water for AMP5.

Wastewater service

The key outputs for the wastewater service are reductions in the number of properties on the DG5 flooding risk register, and mitigation of flooding problems.

We have taken the view that where funding has been made available as part of the determination, customers should not have to wait for resolution of problems. We have therefore fast-tracked all of the flooding schemes within our capital programme and schemes to reduce the number of properties on the (1:10 and 2:10) register have all now been placed with our capital delivery partners. As a result 13 properties of the 41 in the final determination have been removed during the year. (JR Table 3) The remainder should be removed during 2011-12. The rate of additions to the (1:10 and 2:10) register, at just seven, has been significantly below the expectations in the determination. The net change in the register is therefore a reduction of six.

The price limits also provided funding for removal of eight properties from the lower risk 1:20 flooding register. All eight properties have been removed during this first year of the five-year period. There have, however, been 32 additions compared with an expectation of 23 in the final determination. Schemes will be developed to remove these, or an equivalent number of properties, as soon as is practicable.

In terms of external flooding problems, we have removed seven areas from the external flooding register, meeting the regulatory output for AMP5. We have also removed three linked areas, compared with the total of 19 for the five-year period. There have been 368 additions in the year.

Because we have prioritised early delivery of the permanent solutions, we have made a slower start on the mitigation of flooding problems (where a capital solution would not be cost-beneficial). During the year we have delivered mitigation solutions to 11 properties on the internal flooding register (a total of 200 are required for the five-year period) and 19 areas at risk of external flooding (the five-year requirement is 100).

CHAPTER 2 PROTECTING THE ENVIRONMENT

The delivery of water and sewerage services can have a significant impact on the natural environment. In all that we do we aim to prevent pollution and to contain the environmental impact of our activities to a practicable minimum. In this section we describe our performance in the year in protecting the local environment and delivering enhancements under our five-year capital investment programme for the period 2010-2015.

PERFORMANCE IN THE YEAR

Pollution incidents

Over the last regulatory period we significantly improved our performance with respect to pollution incidents, particularly in reducing the numbers of the most serious Category 1 and 2 incidents. We have maintained this level of performance and the total number of Category 1 and 2 incidents at seven is below last year's total of nine.

We are extremely disappointed that in 2010 the level of Category 3 incidents has risen significantly from 278 to 462.

Table 2. Pollution incidents

	2009	2010
Pollution incidents		
Total Category 1 & 2 incidents	9	7
Total Category 3 incidents	278	462

Note: Includes water pollution incidents

Most pollution incidents result from either blockages or pump failures. To address the disappointing performance in the year, we have increased our activity on proactive sewer jetting by 50% and reinstated our targeted wet well cleaning programme. These initiatives, along with greater use of real-time data on the network, targeted cctv inspections, improved data analysis of 'hot spots' and pumping station refurbishment, are already delivering significant benefits in terms of reductions in equipment failures and will, in time, feed through to reductions in pollution incidents, though there will be a lag between activities and impact on reported incidents.

Wastewater treatment works compliance

Ensuring our wastewater treatment works comply with their discharge consents helps ensure that we minimise any harm to the environment from effluent discharges. During the year we had just four out of 370 works that failed to comply with their discharge consents, maintaining the excellent performance of 2009. However, the population equivalent served by non-compliant works has increased, due to the failure of one of our large treatment works (116,000 pe), at Eastbourne. A detailed action plan for this works has been put in place and significant capital investment is being made to attempt to ensure future compliance.

Table 3. Wastewater treatment works and bathing water compliance

	2009	2010
WWTW compliance		
Number of sewage treatment works failing their discharge consents	4	4
% total p.e. served by works failing consents	6.0	6.5
Bathing water performance		
Mandatory standard (%)	100	100
Guideline standard (%)	76.5	68.3

Bathing Water

Bathing Water compliance during 2010 was again at 100% against the mandatory standard. Performance against the tighter “guideline” standard was 68%, representing 56 out of 82 beaches. This is a slightly worse than 2009 when 76% met the higher standard reflecting, in large part, variations in rainfall levels.

Energy use

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

We have made significant investment in biogas-fuelled CHP and now have 13 operational units with the capacity to generate over 10% of our power demand. Opportunities for wind and solar energy are also being explored.

We are also making significant investment in improving management information on energy consumption. We are currently installing 2,000 smart meters at our smaller sites to provide accurate and timely consumption data. Another initiative is to install enhanced consumption monitoring at our top 20 power consuming sites to provide greater information on individual assets’ energy consumption.

Improved energy efficiency is also a key focus for the 2010-15 period and we have a range of initiatives including improved pump and blower efficiency monitoring, advanced aeration control and energy recovery through the installation of hydro turbines in outfall pipes. Detailed feasibility work on the hydro turbines has been completed and work is due to commence shortly on the development of our pump and blower efficiency monitoring strategy.

ENHANCING ENVIRONMENTAL QUALITY

As part of the price review Ofwat sets price limits alongside a package of outputs that must be delivered. A large part of this investment programme, some £500m over five years, is directed at delivering environmental improvements. In this section we describe progress with delivering the specific outputs under the Quality category.

Wastewater Service

Over the current five-year period Southern Water must deliver a total of 184 outputs under the wastewater 'Quality' programme. In the final determination, none of these outputs were due to be completed in 2010-11.

A number of outputs that were varied into the AMP4 (2005-10) programme at the end of that period, were not completed by March 2010 as originally planned. There are 28 event and duration monitoring schemes that were originally due to be delivered by March 2010. Due to unforeseen delays, these could not be completed as planned and a revised output date of March 2011 was agreed with the Environment Agency, and one scheme removed, under the Change Protocol process. All 27 remaining outputs have been delivered in the year. One other scheme at Kings Road, Emsworth was also delayed from AMP4, but was completed in the year by its revised date of January 2011.

We have made good progress on work to deliver outputs that are due in subsequent years, including the largest scheme in our programme, the Cleaner Seas for Sussex project to deliver a new wastewater treatment works in Peacehaven to meet the requirements of the UWWTD. One output has been delivered during the year, ahead of the required regulatory output dates.

Water Service

The water service Quality programme is significantly smaller than that for the sewerage service, with just 15 regulatory outputs over the five year period. These include drinking water quality as well as environmentally-driven outputs. Of these 15, two were due in 2010-11, and both were delivered on time.

One Security & Emergency Measures Directive scheme was carried over from AMP4. This remains outstanding at the year end, but is forecast to complete by the end of June 2011.

CHAPTER 3 DELIVERING SAFE AND RELIABLE SERVICES

Our customers consistently tell us that their principal requirement is a safe and reliable drinking water and an 'invisible' wastewater service. Reliable services depend on sustainable investment in maintaining our assets and investing to cater for growth. In this section we describe our performance in the year in maintaining our assets and ensuring availability of supplies through resource development and demand management.

PERFORMANCE IN THE YEAR

Serviceability

Over the five-year period 2010-11 we will be investing around £900m in maintaining our asset base. This investment is targeted to deliver Stable services to customers. Ofwat measure the efficacy of this investment through a 'serviceability' assessment, which looks at a range of key indicators of the service received by customers and the impact on the environment.

Our assessment of our serviceability within each of the four asset categories, using Ofwat's methodology is shown below.

Table 4. Serviceability assessment

	Infrastructure	Non- infrastructure
Water service	Stable	Stable
Sewerage service	Marginal	Stable

Water infrastructure

Water infrastructure is assessed as being 'Stable'.

Although two of the key indicators, mains bursts and interruptions greater than 12 hours are above the upper limits, both indicators are affected by exceptional events during the year.

The first indicator, mains bursts, reflects the efforts put in to pro-actively finding and fixing leaks on the network, which when identified on mains are recorded as mains bursts. Adjusting for the exceptional level of pro-active work this year would bring this indicator well within the tramlines and on a downward trend.

Our year-end assurance process has highlighted an issue with the reporting of our mains bursts, which, based on a sample audit of our records, we believe may be overstated. As a result we have reduced the confidence grade associated with this data (JR Table 11). We are putting in place an action plan to resolve the issue and restore the confidence grade associated with this data.

The second of these key indicators, interruptions greater than 12 hours, is affected by a single exceptional event at Meopham, Kent where the collapse of an entire road and disruption to other utilities, meant that repairs to the network were restricted until the area was made safe to work in. Excluding the impact of this exceptional event would bring the indicator comfortably within the tramlines.

Overall, taking into account these exceptional events and the performance against the other secondary indicators, our assessment is that water infrastructure serviceability is 'Stable'.

Water non- infrastructure

Water non-infrastructure is assessed as being 'Stable', having been assessed by Ofwat as 'Deteriorating' last year. The 'Deteriorating' assessment largely reflected our performance against the coliform failures indicator.

The compliance action plan that we agreed with Ofwat has been very effective and the results are reflected in a step change in performance, with only three failed works during 2010 compared with 13 in 2009. This significant improvement has continued in the current calendar year. To date we have recorded only one works failure up until the beginning of June 2011. Therefore the rolling 12-month position is well below our reference level of three works failures in a 12-month period. All the other serviceability indicators have showed either a continuation of or improvement on last year's performance and are significantly below the reference levels.

We believe the clear step change in performance and the continuation of this performance into the current calendar year means that an exceptional movement of two serviceability bands in one year, moving us to 'Stable', is warranted.

Wastewater infrastructure

Wastewater infrastructure is assessed as being 'Marginal'.

Serviceability for wastewater infrastructure was assessed by Ofwat as 'Stable' in 2009-10, but with a warning that a number of indicators were showing a worrying trend. We are disappointed that although we have achieved improvements in performance against some metrics, both the leading "other causes" flooding indicator and the pollution incidents and blockages indicators show a deteriorating performance (though the latter remains within the tramlines). We therefore can only conclude that the serviceability assessment should be 'Marginal'.

We already have the required activities in place and are investing substantially more than the final determination allowance in our efforts to achieve a 'Stable' performance assessment for 2011-12.

Wastewater non-infrastructure

Wastewater infrastructure is assessed as being 'Stable'.

The lead indicator for sewerage non-infrastructure is compliance against discharge consents. Performance against this metric has remained well within the control limits and continues at levels that represents a similar performance to recent years. Whilst the number of non-compliant works is the same as last year, the population equivalent served by a non-compliant works metric has increased, due to the failure of our large treatment works at Eastbourne. A detailed action plan has been developed to address performance issues at this site and significant investment has already been made at the site during the year.

Water resources

Despite the very hot and dry spring our current resource levels for this time of year are about average. All of our above-ground reservoirs were boosted by rainfall during the recharge season (October until March). We do not expect to have to impose any restrictions this summer.

Security of Supply Index (SoSI)

The security of supply index for the year is at 95% (critical period), better than the price review assumption, following completion of our River Arun abstraction scheme in March 2010, one year early.

Leakage

We are extremely disappointed that despite finding and repairing a record 22,000 leaks during the year, and dedicating unprecedented resources to finding leaks, we have not met our annual leakage target of 83 MI/d this year, with levels for the year being at 92 MI/d. This reflects both the starting point for the year which, following the harsh winter in 2009-10, was unusually high and was then followed another harsh winter in 2010-11.

However, even at the reported level, our leakage levels remain the lowest of the ten water and sewerage companies in England & Wales. Given the early delivery of our River Arun scheme, which means that the security of supply index is better than the level assumed in price limits, the leakage level will have no impact on customers.

Customers expect us to manage our resources effectively, and we are committed to continuing to lead the industry on leakage. However, having experienced three consecutive harsh winters, which are particularly unusual in this part of the country, we believe there has been an increase in the 'background' level of very small leaks that cannot be detected, which means the profile of leakage levels set out in our business plan is no longer realistic. We are discussing these issues with Ofwat and hope to agree a revised leakage target profile which will deliver long-term leakage levels consistent with our water resources plan. We will continue to report our leakage to Ofwat on a quarterly basis, so that they can be assured that satisfactory progress is being made.

Universal Metering Programme (UMP)

During the current five-year period, Southern Water will be installing 486,000 meters under our Universal Metering Programme. By 2015 92% of our customers will have a meter. This programme, which is expected to deliver a 10% reduction in demand from those customers who are metered, is critical to ensuring reliable supplies in future.

Our initial plan was to install and begin to charge 56,000 metered customers in the first year of the programme. The start of the programme was delayed to allow time to consult with Ofwat and customer representative groups and design tariffs and transitional measures to help smooth the move to metered charging for our customers.

We have now agreed these tariffs and will begin billing the first customers metered under the programme in June 2011. Meanwhile, during the year, 12,497 customers have opted to switch to a meter (JR Table 8). We have also installed, but not begun to charge on a further 38,000 meters, which will be 'switched on' in a phased manner during 2011.

Water efficiency

As part of the metering programme we have begun an extensive programme of water efficiency advice to customers, helping them to save water, money and energy. This means that we have comfortably met our water efficiency target for the year of a saving of 1.18 ML/d. The largest part of this saving (0.89 ML/d) is attributed to behavioural change, which Ofwat currently caps at 30% of the total savings. We will be providing Ofwat with evidence to support the lifting of this cap for us in due course.

Key to the success of the UMP will be the way in which customers with affordability issues are helped. These targeted customers are offered a free home energy and water audit, which couples advice with the fitting of water efficient devices to lower both energy and water bills.

Meanwhile we have continued with our wider educational activities. These include our popular water efficiency play, now in its twelfth year, featuring a family called the Drips. During the year this was seen by more than 4,000 children aged five to 11. Facepack Theatre visited 25 schools and gave performances of the show, which incorporates our water efficiency and water for health characters Mr Save-It and Mr Drink-It.

In conjunction with the Design Council, we also launched the Water Design Challenge, an innovative education programme for secondary school pupils that tasks them to come up with ways to save water. The challenge was successfully piloted in five schools and the winner, The World's Smallest Water Museum – designed by students at Sholing Technology College in Southampton – was built and is being showcased at a number of events. The programme will be rolled out to more schools in 2011.

Water quality

Drinking water quality for 2010 continues to show a very high level of compliance. The overall drinking water quality index was maintained at very high levels of 99.90% (99.97% in 2009). The slight drop in performance was due to a breach in a very small zone on the Isle of Wight, which disproportionately distorts the statistics compared with a breach in a larger zone.

Health and Safety

The health and safety of all employees, customers and contractors continues to be a priority for the company. Every employee can see and comment on the corporate policy statement on Health and Safety. There are regular meetings of employee representatives to consider all aspects of Health and Safety.

The total number of days lost to sickness, accidents and operational ill-health fell substantially, despite an increase in employee numbers. (JR Table 41) This is due to a number of initiatives introduced which include the better management of accidents at work (first day visiting of employees following lost time accidents by Line Manager and HR Business Partner) and increased Occupational Health referrals for individuals at four weeks. The number of RIDDOR incidents (those that must be reported to the Health and Safety Executive) fell to just eight in the year (from 12) for our employees and 12 (from 15) among our contractors.

In recognition of our Health and Safety performance we were awarded the Royal Society for the Prevention of Accidents (RoSPA) President's Award for the third year running in their International Occupational Health and Safety Awards, presented to companies who have achieved excellent Health and Safety performance over a number of years. Several of our key contractors were also recognised by RoSPA with a range of awards during the year.

CHAPTER 4 FINANCIAL PERFORMANCE

It is important that water companies are seen as low-risk investments in order to attract the external finance to fund capital investment on the scale that is required to deliver the environmental and other improvements that are required of us. In this section we describe our financial performance in the year including our capital investment compared with the levels assumed by Ofwat.

PERFORMANCE IN THE YEAR

Table 5. Historic Cost Profit and Loss Account

	2010-11 £m	2009-10 £m	Movement £m
Turnover	642.1	671.5	(29.4)
Operating expenditure	(232.1)	(197.9)	(34.2)
Exceptional items	(38.5)	(0.0)	(38.5)
Historic Cost Depreciation	(126.7)	(125.5)	(1.2)
Infrastructure Renewals Charge	(56.4)	(48.8)	(7.6)
Operating Income	0.1	1.0	(1.0)
Operating Profit	188.6	300.3	(111.7)
Other Income	0.1	0.2	(0.1)
Interest	(180.2)	(115.2)	(65.0)
Profit before Tax	8.4	185.3	(176.8)
Taxation	20.9	(59.5)	80.4
Profit for year	29.4	125.8	(96.3)
Dividends	(74.4)	(37.5)	(37.0)
Retained Profit	(45.1)	88.3	(133.4)

Turnover

Turnover decreased by 4.4% compared with an average tariff decrease of 0.4% (JR Table 23). The significant reduction over and above the tariff reduction reflects the outcome of a review of the method for estimating the amount of measured water and wastewater charges unbilled at the year-end. This review highlighted that an element of the previous year's estimated unbilled charges were not subsequently being billed and an adjustment to turnover has therefore been made to reflect the previously overestimated accrual. The review has also led to modifications to the method for estimating the level of unbilled charges for the current year, which affects the comparison with 2009-10. These issues have been discussed with Ofwat previously.

Water and sewerage revenues for 2010-11 are £47.6m below that assumed by Ofwat in the Final Determination. This shortfall can be split between a one-off adjustment of £23.1m to reflect the issues described above and an ongoing element of £24.5m. The ongoing element of the shortfall is expected to persist for the whole of the five year period. While this shortfall will be recoverable at the next price review under the Revenue Correction Mechanism, given the other pressures on future bills, such as the adoption of private sewers and meeting the challenges of climate change and population growth, we believe an earlier correction is sensible to avoid a sharp bill spike in 2015-16. We will continue to discuss with Ofwat the best way of avoiding this as well as consulting with customers on their preference between small steady bill increments immediately, or a much larger increase at some point in the future.

Operating expenditure

Operating expenditure increased in the year by 37% to £270.6m (a 17% increase, excluding the effect of the exceptional item). The principal elements of this movement are set out below.

Table 6. Movements in operating expenditure

	2010-11 £m
Exceptional items	38.5
Increased bad debt charge	7.7
Increased hired and contracted services	9.6
Inflation (5.3%)	9.5
Increase in general and support costs	7.0
Other direct costs increase	1.6
Reduction in employment costs	(3.8)
Other movements	2.5
Net increase	72.6

The largest movements relate to a review undertaken in the year of the level of collectability of outstanding measured and unmeasured income. This has resulted in significant increases in the level of provision for former debt and certain current debts which have been through the full recovery process. The exceptional item of £38.5m relates to the element of these changes that has arisen from pre 2010-11 charges. The increased bad debt charge of £7.7m relates to the 2010-11 element of the project described above.

The increase in hired and contracted costs arises from a project undertaken in the year to bring out of action plant items back in to service on a prioritised basis, along with the fact that all sewer activity in the year was undertaken by contractors, whereas for part of 2009-10 these activities were carried out by in-house teams. The latter change is reflected in the decrease in employee costs.

The additions to general and support costs reflect the ongoing transformation of the business and additional resources being brought in, in particular to our asset management and finance functions, as well as large insurance losses, significant actuarial adjustments and movements in VAT provisions.

The increase in Other Direct Costs relates to a non-recurring credit item in the prior year, additional Crown Estates invoices (some relating to previous years) and fewer capitalised costs in this category compared to 2009-10.

We recognise the need to reshape some of our key processes to drive our operating efficiencies following the large increase in costs in the year. In particular we are focused on driving down bad debt costs. During the year we have been piloting our Assist tariff in the Hastings area, to help customers with genuine affordability issues and will be rolling this out on a targeted basis during 2011-12. We have also set up an internal debt advice centre to act as a first point of contact for any customers in debt, ensuring that they receive the appropriate help, for example through our debt-matching scheme or by taking advantage of WaterSure, our charitable trust or WaterDirect schemes. Increased focus on early intervention through outbound calling and the profiling of debtors will ensure that we collect more income.

We are also putting in place a number of operational initiatives, including reviewing our sludge strategy, where our costs are above many of our peers, improving our end-to-end processes and contract management, including greater use of in-house resources to carry out routine maintenance tasks and a number of people initiatives. Our energy strategy will deliver reduced consumption and lower power costs.

Finally, our focus on delivering an improved customer experience will help reduce the costs associated with failure demand and further investment in customer-facing systems will reduce costs by both ensuring agents are able to resolve customer issues rapidly and enabling customers to access more self-service.

Capital charges

The Infrastructure Renewals Charge (IRC) has been increased from £48.8m to £56.4m this year. This reflects the reprioritisation of our capital maintenance expenditure in the current period to reflect the risks around the serviceability of our infrastructure assets and the need to maintain a long-term balance between the IRC and IRE.

Movements in Current Cost Depreciation principally relate to new additions and the impact of inflation at 5.3%.

Financial ratios

The impact of the revenue shortfall, along with the increases in opex and IRC has meant that our key financial ratios have fallen significantly.

Table 7. Key financial ratios

Key ratios	2008-09 (actual basis)	2009-10 (actual basis)	2010-11 (actual basis)
Adjusted cash Interest Cover	1.55	1.17	0.84
Gearing (Debt/RCV) (%)	95	89	90
Net Debt (£m)	3,190	3,189	3,373
Rate of Return on RCV (%)	6.72	5.00	1.80

Note: ratios shown above are calculated using Ofwat's June Return definitions. These are not consistent with the definitions used in our financing instruments and therefore differ from those reported in the Operating and Financial Review in our statutory accounts.

On the basis of the notional financial structure assumed by Ofwat in setting prices, key ratios are well outside the level assumed by Ofwat to be 'financeable'. The critical adjusted cash interest cover ratio falls to 1.59 when the revenue shortfall (excluding the one-off adjustment in 2010-11) is taken into account and deteriorates significantly over the remainder of the period, compared to an Ofwat benchmark level of 1.6 times. This underlines the need for early redress of the revenue shortfall

Dividends

Dividends paid for the year were £75m from the appointed business. This is made up of a £34m final dividend declared in 2009-10 and a £41m interim dividend for the year. No final dividend has been declared for 2010-11. The £41m interim dividend paid is returned in full to the regulated business as interest receivable on an inter-company loan. The directors do not intend to declare a final dividend for 2010-11.

CASH FLOW

Net cash inflow from operating activities (JR Table 28) increased to £468.9m for 2010-11 from £384.3m in 2009-10. This increase mainly reflects lower pension contributions and a reduction in working capital, offset by reduced operating profits as explained above. The decrease in pension contributions compared to the prior year of £68.8m mainly results from an exceptional one off lump sum payment of £56.1m made in 2009-10 by the company into the Southern Water Pension Scheme which covered future contributions for four years.

The net outflow of cash relating to the purchase of tangible fixed assets was £375.9m compared with £213.4m in the prior year and the net cash outflow before financing in 2010-11 was £102.9m compared with a net inflow of £12.8m in the prior year.

CAPITAL INVESTMENT

During the year we invested a total of £406m (gross of grants and contributions). This compares with an allowance in the final determination of £342m (including the CIS uplift to the baseline). (JR Table 35a/36a) This overspend partly reflects timing differences and increased investment on asset maintenance but also the challenges of significant reductions in the Construction Output Price Index (COPI) which are not reflected in lower delivery costs. The impact of COPI to date over the whole of the five year programme equates to a reduction of around £150m on a £1.7bn programme.

Compared to Ofwat's 'baseline' – their assessment of what we needed to spend – which was £320m, we spent £401m on an equivalent basis (net of grants and contributions from third parties). The reasons for the variance are shown below. (JR Table 35b/36b)

Table 8. Capital expenditure variance from final determination

	Water £m	Sewerage £m
Outputs underachieved	0.0	0.2
Timing	14.8	-35.5
Efficiency	31.8	56.4
AMP4 carryover	2.2	10.9
Total variance	48.8	32.1

The overspend on the water service (shown as negative efficiency) principally relates to the impact of COPI and acceleration of our non-infrastructure maintenance, which is £28.1m above the Ofwat determination. This additional expenditure is essential to address our historic serviceability issue. We have also spent an additional £12.6m on infrastructure maintenance in our determination to drive down our leakage levels and meet the challenges of a third very harsh winter. The larger part of the timing differences (£11.5m) also relate to advancement of maintenance expenditure.

At the same time we have achieved £9.1m of efficiency savings on the supply demand programme, principally as a result of delivering the River Arun scheme for less than the funding allowance.

On the sewerage programme, the overspend of £56.4m reflects the impact of COPI, additional quality enhancement expenditure of £32.6m (mainly on the Cleaner Seas for Sussex project) and an additional £17.5m invested in our infrastructure assets. The re-prioritisation of the maintenance programme towards the infrastructure assets, where serviceability challenges have been most acute over the last two years, is reflected in a £(46.7)m timing shortfall on sewerage non-infrastructure maintenance.

The introduction of a new risk framework across our asset base will help ensure that this additional investment delivers maximum benefits in terms of serviceability to customers.

Water capital maintenance

As highlighted above, both water infrastructure and non-infrastructure expenditure is above the levels allowed in the final determination (after adjustment for COPI). (JR Table 32)

Table 9. Water capital maintenance expenditure

	Final Determination 2010-11 £m	Actual 2010-11 £m	Variance £m
Infrastructure Renewals Expenditure	20.8	37.0	16.2
Maintenance Non- Infrastructure	30.3	64.1	33.8

Infrastructure renewals expenditure is significantly in excess of the determination for the report year. Mains renewal rates have increase and we have renewed 56km of the total 256km required over the five-year period. At the same time as renewing the mains, we have replaced 4,974 communication pipes in the year. (JR Table 11)

MNI for the report year is also well above the level of the determination due to the significant investment in our treatment works compliance programme, to achieve Stable serviceability.

Wastewater capital maintenance

Capital maintenance expenditure for the sewerage service is below the level of the determination, reflecting the reprioritisation of investment to reflect the changing risk profile of our assets. (JR Table 32)

Table 10. Wastewater capital maintenance expenditure

	Final Determination 2010-11 £m	Actual 2010-11 £m	Variance £m
Infrastructure Renewals Expenditure	21.1	25.5	4.4
Maintenance Non- Infrastructure	128.0	78.3	(49.6)

As for the water service, infrastructure investment is ahead of the determination, as we have striven to deliver 'Stable' serviceability in this category. Expenditure on sewerage non-infrastructure maintenance, which was the subject of significant investment in the last regulatory period, has become less of a priority within a constrained capital programme. Nonetheless we continue to deliver 'Stable' serviceability in this asset class.

CHAPTER 5 PROCESSES AND SYSTEMS OF CONTROL

INTRODUCTION

The Board is required by Ofwat to provide statements covering compilation and reporting of information contained within this June Return 2011. The Board considers that over the last five years continuous improvement has been maintained in the implementation of sound practices, procedures and systems of control of information within the June Return.

The Board Audit Committee has monitored throughout the year, the completion of a programme of assurance activities covering the practices, procedures and systems used for the June Return 2011. The Audit Committee considered at a meeting on 24 May 2011, the findings of the programme of assurance reviews completed by Internal Audit and PwC. The outcomes of the assurance programme were discussed at a meeting of the Board on 25 May 2011, with Halcrow (Reporter) and PwC in attendance, providing the opportunity for members to raise any concerns.

So far as the Directors are aware, there is no relevant audit information of which the Company's auditor or reporter are unaware; and that they have taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the Company's auditor and reporter are aware of the information.

PROCESSES

Southern Water recognises that it is essential to maintain embedded controls on data capture, collation and reporting within the business to ensure that information, on which compliance is measured, achieves the objective of completeness, accuracy and reliability. The following measures are applied within the Company.

- All senior managers and Directors on the Executive Management Team (EMT) are required to provide a declaration that they are fully compliant with Company procedures and controls, or otherwise record any areas of non-compliance for areas of the business where they are accountable. An action plan is required to address any areas of non-compliance.
- For all information and supporting data used in the June Return, there are documented processes, procedures and systems in place which are covered by an ISO9001 accredited quality management system. Procedures are reviewed annually, incorporating changes in regulatory requirements and improvements to address the findings of assurance audits.
- Awareness briefings are provided to all key individuals involved in providing information to this June Return. The purpose of the briefing is to ensure that individuals fully understand their responsibilities and have knowledge of the internal controls within their business area and the need to maintain effective operation of controls.
- A register of Data Providers, Subject Matter Experts, Senior Manager and EMT Director responsible for each reporting process within the June Return is maintained and updated on change of personnel.

- Data Providers are accountable for providing data to the required accuracy and timescales. Subject Matter Experts within the relevant business areas are accountable for ensuring that the data is in line with the Ofwat Reporting Requirements and that the business processes and procedures used in preparing the data comply with these reporting requirements.
- Senior managers and EMT Directors are accountable for the provision and sign off information within the June Return for their business areas. This includes ensuring adequate procedures processes are in place for data collection and reporting.
- Monthly reviews of approximately 60% of the non financial data lines are completed with review and feedback from senior managers and the Regulation department. Year-end forecasts and quarterly reports are provided to the Executive Management Team (EMT). These actions have increased the confidence in the accuracy and reliability plus raised awareness and the opportunity for questioning on a regular basis.

MONITORING AND AUDIT

During the period the Audit Committee has received regular updates on the audit programme for the June Return.

- a) A risk assessment was undertaken by management for the non-financial lines of the June Return to identify the areas requiring assurance this year. PwC completed a review of the approach taken and the outputs of the risk assessment. The risk assessment established the comfort required for priority tables.
- b) Assurance activities outlined below were completed.
 - Internal Audit completed a series of audits as part of the ongoing review of all the Southern Water June Return procedures. Following the risk assessment Internal Audit were asked to undertake reviews of the operating effectiveness of controls for 13 JR tables. A total of 172 controls were tested. No material weakness was found.
 - Following the risk assessment PwC were asked to complete agreed upon procedures on the design and operating effectiveness of controls for two non-financial JR tables, and operating effectiveness on a further table, together with common controls and IT controls. A total of 58 controls were tested and no material weakness was found.
 - PwC completed a series of design effectiveness workshops for selected tables based on the findings of the risk assessment. A total of 16 tables were assessed and all issues arising from the reviews have been remediated.

Findings of the audit were outlined to the Board on 25 May 2011.

- c) Halcrow has carried out their certification workplan, agreed by Ofwat. They have provided feedback to the Company on the results of their audits and all issues arising have been addressed. Findings were shared with the Board on 25 May 2011. There were no material issues, other than our Reporter expressing a different view of WI and WNI serviceability.

- d) PwC performed the audit of the regulatory accounts much of which is included in the June Return tables. They completed agreed upon procedures on behalf of Ofwat on the specific tables. There are no material issues arising from the audit.

BOARD INVOLVEMENT

The Southern Water Board:

- Receives monthly reports from Executive Management Team Directors on performance within the business;
- Reviews progress in relation to delivering regulatory outputs;
- Receives presentations from customer services, operations, asset management, and regulation directorate on key business issues;
- Reviews the governance, policy and strategy of decisions with regulatory implications;
- Reviews current, emerging and future regulatory matters;
- Oversees the preparation, and approve submission, of:
 - the June Return required by Ofwat including the Board Overview;
 - information relating to performance against the AMP Monitoring Plans.

BOARD STATEMENTS

The Board has considered all the factors arising in the activities referred to above.

Accordingly we have no reason to believe that the information included in this return in respect of the 2010/11 year is other than reliable, accurate and complete in all material respects within the bounds specified. We also confirm that, to the best of our knowledge and belief, the Company's processes and internal systems of control are sufficient to satisfy Ofwat's requirements in relation to the provision of information.

DIRECTORS' STATEMENT

The Directors have assessed the projected operating expenditure, capital expenditure and working capital requirements against the cash and bank facilities in place and confirm that the Company has adequate financial resources to fulfil its obligations and objectives.

The Directors believe, after considering the results of all of these exercises, that the data supplied reflects the position of the business. As indicated in MD209, some issues require an element of judgement and we believe that we have made appropriate use of confidence grades and supporting narratives in the provision of this information. The Directors plan to continue assurance work throughout the year ahead, maintaining continuous improvement to the design and operating effectiveness of the procedures in place.

BOARD ENDORSEMENT

I confirm that this overview of the 2011 June Return, submitted to Ofwat on the 10 June 2011, was endorsed by the Board of Southern Water Services Ltd on the 9 June 2011.

A handwritten signature in black ink that reads "Matthew Wright". The signature is written in a cursive style with a period at the end.

Matthew Wright
Chief Executive Officer

A handwritten signature in black ink that reads "David Golden". The signature is written in a cursive style with a period at the end.

David Golden
Non-Executive