

Southern Water: June Return 2011 Reporter's Report by Halcrow Management Sciences Limited

Summary

Our audit has followed Ofwat's requirements and included checks on Southern Water's processes, controls and assurance of the data and reports.

We have challenged the Company on areas of materiality and taken account of the responses in making our assessments and consider that in preparing its June Return, Southern Water's processes and controls are appropriate.

We summarise our findings as follows:

Preparation of the 2011 June Return

- Southern Water has appropriate assurance and controls with robust data trails and sign-offs from management and directors. Data has been subjected to internal audit and Southern Water has again commissioned PricewaterhouseCoopers (PwC) to audit two tables to identify gaps in controls and to provide assurance that the procedures are satisfactory. The Return has been reviewed and endorsed by Southern Water's Board;
- Southern Water has provided full access to staff and data for our audits, we received all information and documents we requested and are not aware of any information being withheld;
- The June Return has been prepared following Southern Water's internal procedures, which to the extent possible reflect the regulatory reporting requirements;
- In certain areas (water efficiency, customer contacts, vulnerable customer applications, HH/NHH billing, meter under-registration, sewage treatment data) Southern Water has enhanced its reporting processes and improved the quality of the submitted data. In other areas (DG2 exclusions, DG3 >3hrs reviews, mains activities and NHH domestic sewage) the confidence in the data has temporarily reduced pending completion of investigations and process reviews;
- In the area of telephone contacts Southern Water has enhanced its reporting processes and improved the quality of the submitted data.

Operational Performance

- In the Water Service, water quality compliance remained very high with a significant improvement in the number of water supply works with coliform failures. This level is below the Ofwat reference level for the first time since 2001. The key indicator of properties experiencing low pressure also improved on the prior year. The Company's region experienced another severe winter and the number of properties affected by unplanned supply interruptions >12 hours was increased as a consequence, not aided by a particularly major event where a whole roadway collapsed taking out the utilities' services, which had to be repaired before the water main could be repaired. The cold weather coupled with the increased leakage activity resulted in an elevated number of burst mains, although this was lower than that reported for the prior year. Southern Water did not meet its leakage target in spite of the on-going focus on leakage reduction and advanced preparedness for extreme winter events. We note that Southern Water has deployed considerably higher levels of resources to meet the leakage target, which has similarly resulted in expenditure during the year that is double that funded in the AMP5 Final Determination.
- In the Sewerage Service, compared with the prior year sewage treatment works compliance and the number of properties affected by flooding from overloaded sewers remained stable. The number of sewer collapses is the lowest figure reported over the last decade. However, the number of properties flooded internally by sewage from other causes significantly increased and the Company has instigated an action plan, including additional sewer cleaning, aiming to improve performance in this area. Additionally, the number of Category 3 pollution incidents has increased (the most severe Category 1 and 2 incidents are the same as those reported last year).
- In the area of Customer Service, the number of complaints and billing contacts received were significantly lower than the prior year. The response times for billing contacts, complaints telephone contacts also showed an improvement from the prior year's levels, although the number of estimated bills is similar to that reported last year. The introduction of the Universal Metering Programme will begin to increase its impact on the

Southern Water: June Return 2011 Reporter's Report by Halcrow Management Sciences Limited

figures in 2011/12, as the first reading (for billing purposes) of meters installed under the programme during 2010/11 has not yet been completed.

Asset Serviceability

- Ofwat assesses asset serviceability for each of the four services (Water Infrastructure (WI), Water Non-Infrastructure (WNI), Sewerage Infrastructure (SI) and Sewerage Non-Infrastructure (SNI)) as being either "*deteriorating*", "*marginal*", "*stable*" or "*improving*" from worst to best performance. The aim is for performance in all four services being at least "*stable*".
- Using key asset performance data in the current year, Southern Water has assessed that the serviceability of its assets in all services, except SI, is "*stable*". The Company has assessed SI as being "*marginal*". This assessment, driven largely by the primary serviceability indicators of compliance and unplanned maintenance for non-infrastructure assets and by bursts, flooding and collapses for infrastructure assets has been derived using Ofwat's assessment guidelines, as presented at a Serviceability Workshop held in April 2010. This compares with Ofwat's assessment last year of "*stable*" for all services, except for WNI, which was assessed as "*deteriorating*".
- We have carried out our own assessment using the same guidelines, but cannot fully endorse the Company's assessment, as set out below.
- The Company has assigned WNI serviceability as "*stable*", whereas the Reporter has adopted a more cautious approach and considers that "*marginal*" would be more appropriate, on the basis that we would like to see a second year of sustained good performance. We note that performance in the current calendar year to date has remained very good with only one failed sample.
- Whilst our assessment of WI serviceability now agrees with that of the Company (i.e. "*stable*"), this has been derived using analyses relating to the number of burst mains impacted by cold weather events in the winter and additional leakage activity throughout the year. Without taking these effects into account the serviceability would be "*marginal*".

Investment

- During the year Southern Water invested £128m in the water service and £278m in the sewerage service compared with respective figures of £48m and £184m in the prior year, a net increase of £175m;
- In the Water Service, the increased investment reflected completion of quality schemes and the River Arun storage scheme, whilst investment in maintenance of both infrastructure and non-infrastructure assets substantially increased reflecting the ongoing leak detection and mains renewals together with asset refurbishment programmes relating to the WNI serviceability action plan aimed at achieving "*stable*" status;
- In the Sewerage Service, there were substantial increases over prior year on quality enhancements (162% over the 2009/10 expenditure) mainly due to the Cleaner Seas for Sussex scheme and increasing maintenance on infrastructure renewals (123% higher) and non-infrastructure (43% higher). Investment in new development and enhancing service levels was significantly lower than in the prior year.

Operating Expenditure

- Total operating expenditure of £271m (comprising £88m in the water service and £182m in the sewerage service) was about 37% higher than the comparable figures in 2010. A significant proportion of this increase (53%) was in relation to the exceptional item of £38.5m for historic bad debt provision. An additional £7.7m is attributable to bad debt during the Report Year. More use of contractor services was made during the year and hence there was an increase in hired and contracted services.

Carbon Accounting

- In JR11 Southern Water has increased the amount of in-house generation of renewable energy by 26.8 million KWh (representing a 30% increase over the JR10 figure); operational emissions were marginally lower than the prior year due largely to offsetting of decreased grid electricity use and process and fugitive emissions and increased outsourced activities and direct emissions from fossil fuels;

Southern Water: June Return 2011 Reporter's Report by Halcrow Management Sciences Limited

- Southern Water has continued to improve its collection of emissions data, having installed 1,700 AMR devices to monitor energy use. The JR10 commentary stated that a total of 2,000 AMR's were to be installed during the Report Year and the Company has confirmed that the remaining 300 will be installed by July 2011.

Material changes in methodology or confidence grades

- With the commencement of the Universal Metering Programme, Southern Water has revised some of its methodologies to reflect new processes or information arising during the year. These particularly impact on Water Efficiency in **Table 1** and increase the confidence in the reported data and whilst not material, we are required to identify methodological changes.
- In several areas the Company has adopted methods to transpose data in order to minimise errors due to manual data input.
- In reporting operating costs of the disaggregated business areas, the Company has adopted different cost allocation methodologies from those proposed by Ofwat in the reporting requirements. This particularly relates to several lines in the Activity Costing analysis for the Retail Services in **Table 21b**. However, the deviation in methodology only impacts upon the household/non-household split and is not considered to be material, with the total retail service costs unaffected.
- Certain elements of mains activity reporting in **Table 11** have been assigned a lower confidence grade this year as the Company has not been able to verify some of the data provided by contractors. The Company is carrying out on-going investigations to ensure that the processes are improved for the current year. Similarly, further verification work is being carried out on exclusions in **Table 2**.
- The confidence grades for supply interruptions >3hrs have been downgraded from A2 to A3 as detailed reviews are only carried out on incidents >6 hrs and typically these result in a 10% reduction in properties affected.
- The volume of measured non-household domestic sewage in **Table 14** has been downgraded following recognition of deficiencies in the method of apportioning values between households and non-households.
- Investigations into the disparity between sludge production and disposal that we reported in our JR10 commentary to **Table 15** are still underway and are expected to be completed during the current year.
- An improved data handling process has resulted in a better confidence grade for telephone contact data in **Table 5**.

Material exceptions

To assess material exceptions we adopted a risk-based approach to their identification and importance in terms of economic regulation.

Whilst a small number of methodological changes, which are not considered to be material, were noted, we have not observed exceptions apart from in the following areas:

- In **Lines 7, 12, 15 and 19 of Table 21b** the Company has not adopted Ofwat's preferred allocation method.
- The Company has assigned WNI serviceability as "*stable*", whereas the Reporter has adopted a more cautious approach and considers that "*marginal*" would be more appropriate, on the basis that a second year of sustained good performance would be preferred to produce a "*stable*" trend.

Southern Water: June Return 2011
Reporter's Report by Halcrow Management Sciences Limited

Conclusion

To the extent that the statements included in the 2011 Annual Return Board Overview are derived from the 2011 June Return data, in our opinion:

- the information in the Board Overview is consistent with June Return and other regulatory submissions,
- the information fairly represents the Company's progress as at 31st March 2011,
- the information has been properly prepared in accordance with the regulatory reporting requirements,
- appropriate assurance, controls and internal checks have been applied.

I further confirm that in preparing its 2011 June Return and 2011 Annual Return Board Overview, Southern Water has used appropriate data and methods with demonstrable control and assurance processes and has:

- Fully cooperated in our audit and made available all relevant information to us,
- Disclosed all material assumptions,
- To the extent possible, maintained processes throughout the year that follow Ofwat's Reporting Requirements,
- Established suitable control, assurance and approval processes to ensure effective reporting consistent with the confidence grades assigned.

I confirm that the 2011 June Return has been considered and endorsed by the Board and jointly signed by the Chief Executive Officer and one of the Non-Executive Directors (David Golden) on 9th June 2011.

Paul Pinard

Reporter to Southern Water Services Ltd
Halcrow Management Sciences Limited.
Burderop Park, Swindon, SN4 0QD
17th June 2011

Southern Water: June Return 2011 Reporter's Report by Halcrow Management Sciences Limited

Appendix 1: Basis of Opinion

A full description of the scope of the June Return and the reporting requirements is given on Ofwat's website at <http://www.ofwat.gov.uk/regulating/junereturn/>. The scope of Reporters' audit of June Return is given on <http://www.ofwat.gov.uk/regulating/junereturn/reportingreq/>.

We have audited data submitted to Ofwat by Southern Water in its 2011 June Return for the year ended 31st March 2011 comprising the: June Return Information Capture System, 2011 Annual Return Board Overview and the Water Resources Management Plan 2011 Annual Review.

Our report is made to Ofwat and Southern Water in accordance with Ofwat's statutory duties and the audit has been undertaken to report on those matters that we are required to report to Ofwat in a Reporter's report and for no other purpose. To the extent permitted by law, we do not accept or assume responsibility to anyone other than Ofwat or Southern Water for our audit, for this report or for the opinions we have formed.

The role of Ofwat

Ofwat is the economic regulator of the water industry in England and Wales and aims to make sure that water companies provide good quality service at a fair price.

Ofwat collects information to monitor progress towards achieving:

- environmental and drinking water quality objectives;
- compare performance and costs;
- ensure that customers' bills avoid undue preference and undue discrimination and are in line with the price limits;
- approve charges schemes;
- make sure standards of service are protected; and
- to prepare for price reviews.

Southern Water's 2011 June Return

All appointed water companies are required to make an annual return sent each June covering their activities in the previous financial year (ending on 31st March). The June Return is the primary source of monitoring and provides information in the following key areas:

- **Key outputs (levels of service indicators)** comprising performance reports on:
 - restrictions on water use;
 - low pressure;
 - interruptions;
 - flooding from sewers;
 - responses to billing queries and written complaints;
 - the answering of telephone calls; and
 - frequency of meter reading.
- **Company performance under the Guaranteed Standards Scheme (GSS)** relating to:
 - interruptions to the water supply, flooding from sewers;
 - written account queries;
 - making and keeping appointments; and
 - responding to account queries and complaints.
- **Non-financial measures** comprising:
 - data on population, households and non-households receiving both measured and unmeasured supplies of water and sewerage services, new connections, meter installations;
 - supplies to non-households;
 - volumes of water affected by undertakings and relaxations, volumes of water delivered (including leakage), volumes of sewage and effluent collected, treated and disposed, lengths of water mains and sewers and water sources;

Southern Water: June Return 2011 Reporter's Report by Halcrow Management Sciences Limited

- treatment needs; and
 - types of water and sewage treatment works.
-
- **Regulatory accounts** comprising profit and loss accounts and balance sheets (on historic cost and current cost basis) for the regulated business, cash flow statement for the regulated business, operating costs analysed by types of direct cost, maintenance and other expenditure for water and sewerage services, revenue from measured and unmeasured supplies of water and sewerage services and other sources, values and types of assets; movements in working capital and transactions with associated companies.
 - **Financial measures:** comprising additions to the asset base, maintenance and depreciation by type and asset life, expenditure by purpose for water and sewerage services (base service, quality enhancements, enhanced service levels and improvements to the supply/demand balance) and proceeds from land disposals.

Ofwat's monitoring is based on data that has been scrutinised by independent professionals, Reporters and Auditors who examine, test and report on the reliability of the information provided by the companies.

Basis of the Reporter's assessment

For the 2011 June Return, Ofwat has extensively revised the guidance and whilst Ofwat expects Reporters to continue to examine the Company's information and data, there is no longer a requirement for commentaries on each of the tables as in previous years. For the 2011 June Return, Ofwat requires a report setting out material issues and changes in methodology and data that the Reporter has found during the audit.

Reporters are required to:

- check that Companies have complied with the process of submissions or has included a commentary as to why the guidance has not been followed or where the underlying methodology has changed from the previous year;
- Identify material changes to Company systems, processes and models that have not been highlighted by the Company;
- report by exception; and
- comment on confidence grades provided in the ICS, where the Reporter feels the grade is inappropriate.

Respective responsibilities of Directors and Reporters

The Directors are responsible for the preparation of data in the June Return and associated statements. The Reporter's responsibility is to audit and provide independent commentary on data submitted by the Company in accordance with the relevant Ofwat reporting requirements.

Matters which the Reporter is required to report by exception

We are required to report on exceptions from the general procedures above in all areas of the Company's June Return, apart from:

- Response to written complaints (**Table 5a**) and consumer experience measures (**Table 5b**);
- Bad debt (**Table 6a**);
- Regulatory Accounts: Historical Cost Accounting (**Tables 18, 18c, 18d and 19**);
- Regulatory accounts: Current Cost Accounting (**Tables 20, 23, 24, 26, 27, 28 and 29**);
- Regulatory Accounts: Transactions with Associated Companies (**Tables 30 and 31**);
- Proceeds from disposal of protected land (**Table 39**); and
- Health and Safety (H&S) activity (**Table 41**).