

IAP Technical Annex 9

# Confidence and Assurance



# 1. Securing Confidence and Assurance

“Securing Confidence and Assurance” was assessed as grade “C” overall in Ofwat’s IAP. However, test question 5 was assessed “D”, largely due to the results of the 2017 and 2018 Company Monitoring Framework (CMF) and the fact that we continue to be in the “prescribed” category. We are committed to addressing Ofwat’s feedback, both in relation to the IAP and the CMF. The paragraphs below briefly explain what we are doing to address this feedback, though this was not specified as a formal action by Ofwat.

Following the 2017 CMF we updated our action plan. The 2018 CMF assessment confirmed that as a result of our activity, two areas had improved from ‘minor concerns’ to ‘met expectation’ (Financial Monitoring Framework and Outcomes). However, the 2018 CMF also identified new assessment areas where improvement activity is required. These are set out in our Final Assurance Plan (published on 31 March 2019) and will also be added to our CMF action plan. We will be assessing progress to ensure actions are completed.

We have included areas where Ofwat highlighted specific minor concerns and serious concerns in our Final Assurance Plan to ensure that we have specific assurance activity designed to address Ofwat’s concerns. Additionally, in response to Ofwat’s assessment we will continue to:

- Review and address each point raised by Ofwat to create an action plan for improving the quality of our reporting, learning from industry best practice
- Meet regularly with Ofwat to understand its concerns and provide updates on our improvements
- Ensure we make effective use of our technical assurance partners to review specific actions taken in response to Ofwat’s concerns
- Ensure we are fully conversant with all existing Ofwat requirements and ensure that we respond appropriately
- Identify and respond in a timely manner to all new requirements.

## 1. Current Investigations

Ofwat raised a serious concern in the area of “Casework”. In particular they commented that we had not responded fully to requests for information (missing pages and/or text), not responded in a timely manner and provided information that was unclear to them. This affected Ofwat’s ability to rely on the information to progress our investigation and required Ofwat to take steps to seek further clarifications.

As disclosed in our Annual Report for 2018–19 and our Business Plan 2020-25, the company faces investigations by the Environment Agency (EA) regarding the performance of certain wastewater sites, and an investigation by Ofwat into the performance of our wastewater treatment sites and the reporting of relevant compliance information, focused on the years from 2010 to 2017.

We have revisited the reporting of the Wastewater Treatment Works (WwTW) number of failed works and population equivalent performance measures provided in previous years. We have reviewed the relevant reported WwTW data for the years 2010 to 2017. We have engaged in a discussion with Ofwat regarding the initial findings from the review and the consequences in relation to potential serviceability and Outcome Delivery Incentive penalties that should have been applicable in respect of AMP5 and AMP6. We are working closely with Ofwat to resolve this matter in the coming months. The Ofwat investigation could result in Ofwat taking enforcement action. It is possible that other investigations may also result in other enforcement actions and fines being imposed.

As we have also reported to our regulators elsewhere, during the year 2018 we undertook a very significant amount of work in relation to resolving long standing issues with the reporting of spill data. The details of the

steps that have been taken and that continue to be taken, to improve the robustness of the spill data collection and data processing systems and the assurance of that data, have been shared with the EA and Ofwat, and we have also been sharing the progress of the resolution of those issues. As those steps have not yet reached completion, the data supplied would continue to have an error band of +/- 10%.

Our new Risk and Compliance (formerly Compliance and Asset Resilience) directorate is leading improvements in our business processes and systems, governance and controls as well as data integrity and the planning, scheduling, monitoring and performance reporting to the Environment Agency and Ofwat. In our 2019 Final Assurance Plan we have detailed our approach to assurance in relation to our performance information and acknowledged the importance of accurate information in building trust and confidence.

We are committed to driving structural and cultural change to support the development of a modern, transparent and ethical compliance framework. We have adopted the 'three lines of defence' framework for our reporting governance and assurance activity. This helps to assure performance information by applying multiple levels of control. We apply internal controls and have processes in place to mitigate the risk of supplying incorrect or inaccurate information on all our non-financial regulatory reporting, with ultimate oversight from the Board and Audit Committee.

We have significantly strengthened our performance monitoring capability, which underpins the completeness and accuracy of our performance data and provides more confidence in the reporting we publish. This leads to improved assurance with fewer issues being identified and increased trust and confidence in our data. Our end-to-end process work is being undertaken by our internal assurance specialists, with independent external assurance of our reported data. This will ensure our regulators are provided with an independent third line assurance opinion of our data returns, as currently required by Ofwat.

Further information on this programme can be found in our Final Assurance Plan 2019, which is available on our website [southernwater.co.uk/our-reports](https://southernwater.co.uk/our-reports).

2. Our approach to responding to the IAP

We have taken a risk based approach to assurance of our IAP response with higher risk items being reviewed by external third parties. Our assurers targeted their activity in the areas that had been revised following Ofwat’s IAP feedback (see below at CA.A6. Table 1 – Details of Third Party Assurers supporting our re-submission).

**CA.A6. Table 1 – Details of Third Party Assurers supporting our re-submission:**

Third Party Assurer	Activity	New/Repeat Activity
PwC	IAP actions review	New
	Assessment of PCs/ODIs	Repeat
	Amended data tables (non-financial)	Repeat
	Legacy performance	Repeat
	Board Statements	Repeat
Deloitte	Amended data tables (financial)	Repeat
Jacobs	Cost estimation/investment plan (and associated data tables)	Repeat
	Amendments to cost adjustment claims	Repeat
KPMG	Financeability	Repeat
	Value for Money assessments	Repeat

## 2.SRN.CA.A1

Ofwat action	How we have responded
Provide a restated and compliant Board assurance statement. (Statement 10 - Cost assessment)	Accepted

### Our detailed response

The Board has carefully considered the results of the IAP and has been actively engaged in the process of responding to Ofwat’s feedback. As part of this, the Board has revised its statement regarding cost assessment. We consider this be compliant with Ofwat’s requirement, see SRN\_IAP Board Statements – Resubmission.

## 3.SRN.CA.A2

Ofwat action	How we have responded
Provide a restated and compliant Board assurance statement. (Statement 11 - Risk and return)	Accepted

### Our detailed response

The Board has carefully considered the results of the IAP and has been actively engaged in the process of responding to Ofwat’s feedback. As part of this, the Board has revised its statement regarding risk and return. We consider this be compliant with Ofwat’s requirement, see SRN\_IAP Board Statements – Resubmission.

## 4.SRN.CA.A3

Ofwat action	How we have responded
Provide a restated and compliant Board assurance statement. (Statement 11 - Risk and return; risk management plans)	Accepted

### Our detailed response

The Board has carefully considered the results of the IAP and has been actively engaged in the process of responding to Ofwat’s feedback. As part of this, the Board has revised its statement regarding risk and return and risk management plans. We consider this be compliant with Ofwat’s requirement, see SRN\_IAP Board Statements – Resubmission.

## 5.SRN.CA.A4

Ofwat action	How we have responded
<p>On dividend policy the company is required to confirm that it is committed to adopt the expectations on dividends for 2020-25 as set out in 'Putting the sector in balance' to include:</p> <ul style="list-style-type: none"> <li>• Clear Board commitment to publish detail on dividend policies in the APR and to signal changes to stakeholders; and</li> <li>• Commitment to transparency about how the dividend policy in 2020-25 takes account of obligations and commitments to customers for the dividend policy that is applied in 2020-25 and when determining dividends.</li> </ul> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.</p>	<p>Accepted</p>

### Our detailed response

We confirm that the company is committed to adopting the expectations on dividends for 2020-2025 as set out in the "Putting the sector back in balance" outcomes document. We note that in your IAP assessment our dividend policy proposals as submitted reflected all the "required elements" but we fell short in evidencing how these would be taken into account when determining dividends.

We are confident this response can give you and our customers the detail and transparency required to ensure that we will provide all stakeholders with a fair deal.

In answering the two specific points:

- Our Board has committed to publish our dividend policy annually as part of the APR with any changes clearly signposted to stakeholders; and
- We commit to being transparent about how the dividend policy in 2020-25 takes account of obligations and commitments to customers, for the dividend policy that is applied in 2020-25 and when determining dividends.

#### 1. Putting the Sector Back in Balance Principles

##### P1 – "Dividend policies will take into account delivery for customers over the period 2020-2025"

Our business plan is underpinned by a commitment to ethical business practices. On dividend policy this includes a commitment to transparency that will allow our customers to assess the service levels they receive against the returns of our investors. We believe our business plan strikes the right balance between customers and investors to ensure that both will share in our success.

Our proposed base level of dividend is consistent with the real cost of equity funded via the WACC. This is adjusted to ensure it reflects our capital structure, and ensures that no customer pays any more as a result of our financing choices. In fact, as a result of our capital structure choice we have leverage higher than the notional structure (reducing bills) but the protections we afford to our creditors allow us to maintain strong investment grade credit ratings.



This base level of dividend is calibrated to be consistent with our overall financial and non-financial performance commitments to our customers over the period 2020-2025. Any deviations in this performance will result in changes to our forecast cash flows available for dividends and as such will reduce (under performance) or increase (out performance) dividend potential. Whilst the ultimate impact our holistic performance has on dividends is not entirely mechanistic, the regulatory mechanisms that hold us to account for our performance are very clearly defined. These include:

- Wholesale cost performance – “Wholesale Totex Menu” – Customer and Investor’s shared risk
- Retail cost performance – “Efficient Cost to Serve” – Investor risk
- Customer Service Levels – “Outcome Delivery Incentives” – Investor risk and reward

**P2 – “We expect companies to explain clearly for customers and wider society how the dividend policy and actual dividends paid reflect performance delivery to customers.”**

We are aware that not all of our customers will want the “n<sup>th</sup>” degree of detail (although that will be available via the APR too). We can commit to a plain English summary as to how our overall performance in any financial year has given rise to the determined level of dividend as compared to our base level. In the unlikely scenario that the company has significantly benefitted from something outside our control that is not picked up by existing regulatory mechanisms, we would consider how best to utilise that windfall to ensure customers share the benefit.

Consistent with our Ethical Business Practices, our dividend policy will be simple and concise. We will not create a complex set of rules that our customers will not follow, rather we expect to embody through our decisions the principles of trust, legitimacy, and fairness.

**P3 – “Factors which companies should consider for dividend policies include delivery of obligations and promises to customers, service and cost performance, employee interests, financial resilience.”**

We can specifically commit to including each of these factors in our determination of the appropriate dividend amount. These will be considered as part of our cash flow forecasts as impacted by customer service levels, and changing investment needs, and our qualitative assessment of our overall customer service levels.

## 2. Next Steps

We intend to publish our dividend policy consistent with these principles as part of our 2018/19 APR. We are in the process of consulting our Board and shareholders on these proposals, who are supportive in principle.

## 6.SRN.CA.A5

Ofwat action	How we have responded
<p>On executive pay the company is required to confirm that it committed to adopt the expectations on performance related pay for 2020-25 as set out in 'Putting the sector in balance' to include:</p> <ul style="list-style-type: none"> <li>• Visibility and evidence of substantial linkage of executive remuneration to delivery to customers</li> <li>• Clear explanation of stretching targets and how they will be applied</li> <li>• Clearer explanation of how the policy will be rigorously applied and monitored.</li> <li>• Commitment to report how changes, including the underlying reasons, are signalled to customers</li> <li>• Commitment to publish the executive pay policy for 2020-25 once it has been finalised.</li> </ul> <p>Please provide an update on the steps you are taking to fully meet the expectations as set out in our putting the sector in balance position statement.</p>	<p>Accepted</p>

### Our detailed response

## Alignment of executive remuneration with delivery for customers

Southern Water commits to publishing the executive pay policy for 2020-25, once it has been finalised by the Remuneration Committee. The company has embraced the expectations set out in 'Putting the sector in balance' with regards to Executive performance related pay for 2020-2025 and is bringing forward much of this commitment into 2019. As such, we are committed to being totally transparent in respect of our Remuneration Policy and we set stretching and relevant targets, which clearly link Executive remuneration with the delivery of exceptional performance for our customers. Our Board Remuneration Committee ensures that our Remuneration Policy is rigorously applied and monitored.

### 1. Transparency

Southern Water is required under the terms of its licence to operate as if it were a listed company. Accordingly, the company complies with appropriate sections of the UK Corporate Governance Code and applies the Board leadership, transparency and governance principles produced by its regulator, Ofwat. Governance of Southern Water's Executive pay policies and practices are a matter for the Southern Water Board, subject to appropriate oversight by the Remuneration Committee in line with its Terms of Reference. Following a recent review, new Terms of Reference were approved by the Southern Water Board on 27 February 2019. A copy of these are provided Annex 11: *IAP\_TA11\_CA\_Remuneration Committee terms of reference*. For transparency, the Terms of Reference will be published on our website.

Our Executive pay and remuneration policies are disclosed annually in the Remuneration Report within the Southern Water Annual Report and Financial Statements. Incentive metrics, target ranges and weightings are clearly disclosed, along with the performance outcome against each measure. This includes transparency about the link between pay and performance and disclosure of bonus including in-year and long-term incentive measures, targets and outcomes and any changes from year to year. This enables all stakeholders to clearly understand the basis of rewards and the development of policies and metrics. Changes in remuneration policy will be signalled to customers in the Annual Report and Financial Statements.



## 2. Stretching performance delivery for customers – 2019/20

A substantial proportion of Executive pay will be linked to performance (64% of pay is variable for the CFO and 68% for the CEO).

72.5% of annual bonus targets for Executives are directly linked to delivering a high quality performance outcome for customers, stakeholders and the wider community and 100% of our long term measures underpin a resilient business. This includes financial resilience and transformation activity, performance commitments and a highly engaged workforce.

In line with best practice, annual targets have a minimum threshold, a target level and an additional stretch. The stretch applied to each budgeted target and a performance range established around that, in line with the extremely stretching performance improvement requirements set out in our Business Plan. Failure to reach a threshold performance level results in no payment being made. As a result, the Remuneration Committee rigorously applies this principle when targets are not met, as evidenced in the Remuneration Report for 2018/19.

Some targets, which may on their face appear to be not directly linked to delivery for customers do, in fact, support the delivery of customer outcomes. For example, long term financial resilience, including the delivery of transformation activities, builds the business capability that underpins the delivery of service and commitments to our customers.

## 3. Rigorously applying and monitoring our policy

The Remuneration Committee consists of a majority of Independent Non-executive Directors, to avoid any conflict of interest. No Director or Executive is involved in any decisions as to their own remuneration.

In setting the Remuneration Policy for Executive Directors, the Remuneration Committee is required, under its Terms of Reference, to take into account “all factors which it deems necessary, including relevant legal and regulatory requirements and the provisions and recommendations, of, among others, the UK Corporate Governance Code and any corporate governance principles issued by Ofwat from time-to-time”. The Board is kept up to date with regulatory developments and best practice.

The Remuneration Committee has taken other steps to ensure that the Remuneration Policy will be rigorously applied. For example, in 2017, the Committee introduced new incentive scheme rules, giving them absolute discretion to adjust bonus incentive outcomes where appropriate and it has a track record of doing so. In May 2017, the Committee made the decision to withhold a bonus payment in respect of the 2016/17 financial year for a previous member of the Executive team.

The incentive scheme rules contain other examples where policy can be rigorously applied such as:

- 50% bonus deferral so that performance has to be sustained over the longer term.
- Bonus recovery terms, through malus and clawback provisions, which allow for the possibility of a reduction or clawback of bonuses already earned, or those deferred.
- A clear definition of ‘good’ and ‘bad’ leavers.

The Remuneration Committee periodically reviews its own performance and, at least annually, reviews its constitution and Terms of Reference to ensure it is operating at maximum effectiveness. The Committee has also, on occasions, taken independent advice from PwC remuneration advisors.

The remuneration committee's effectiveness is externally and independently evaluated every three years. The last evaluation was undertaken in 2017 with the next evaluation scheduled for 2020.

These mechanisms combine to ensure that our Remuneration Policy is rigorously applied.

#### 4. Evidence

The information set out in this document demonstrates that performance pay for Southern Water Executives:

- Includes bonus metrics that are relevant and provide a substantial link with delivering for customers.
- Sets stretching targets, not all of which have been met – as evidenced by non-payment for historical SIM performance and non-payment of long term incentives.
- Sets targets that are customer focused and reviewed annually to ensure relevance and that stretch is maintained. In 2019 the proportion relating to customer outcomes will increase further.
- Southern Water has a longstanding track record of reflecting customer metrics in performance pay arrangements. This is not a recent innovation, and bonus metrics are regularly reviewed for relevancy.

#### 5. Application of stretching targets linked to customer outcomes

Our short term and long term bonus targets are substantively linked to quality outcomes for customers. For 2019/20 the Remuneration Committee intends to extend the number of short term metrics even further to demonstrate Southern Water's commitment to providing a substantial link to stretching performance delivery for customers. The new Customer Experience Delivery metric, which accounts for 30% of the bonus on its own, includes elements on C-MeX, D-MeX, written complaints and affordability/vulnerability performance. It should be noted that the short term bonus metrics are also used throughout the organisation so that all company employees are incentivised to achieve stretching levels of customer service.

#### 6. 2019/20 Short term bonus metrics

(Percentages shown are % of maximum bonus potential)

Customer experience *	30.0%
Customer commitment delivery**	20.0%
Efficient delivery of customer service	15.0%
Cash collection	7.5%
Transparent and open data quality	7.5%
Totex	20.0%

\* This metric includes C-MeX, D-MeX, written complaints and affordability / vulnerability performance

\*\* This metric includes ODIs and delivery of regulatory dates

#### 7. 2019/20 Long term bonus metrics

(Percentages shown are % of maximum bonus potential)

TSR*	50.0%
Creating long term resilience**	50.0%

\* TSR aligns shareholder value with business performance. Value is only created when the business performs.

\*\* Underpinned by engaged people who live the company values, improvements in efficiency and delivering longer term customer commitments.

We are committed to customer outcomes and to continuous improvement and have historically included transparent metrics based on customer outcomes. In 2017/18 our short term targets were as follows:

**CA.A5.Table 1 – 2017/18 short term targets**

Area	Target
Customer	SIM 20%
Focused	ODIs 20%
	Regulatory dates 10%
	Forecast accuracy 5%
Other	Bad debt provision 10%
	Operational expenditure 15%
	Cash collection 20%

## 8. Directors' Remuneration Policy for AMP7

We have already consulted with shareholders on determining performance pay arrangements for AMP7 and are implementing many of these developments in the final year of AMP6.

Southern Water's current Remuneration Policy reflects the Board's objectives for good corporate governance, high quality of service to customers as well as sustained and long-term value creation for shareholders and lower bills for customers. The policy focuses on ensuring sound and effective risk management, including alignment with our business strategy, values, key priorities and long-term goals.

Any increases to base pay are entirely dependent upon the individual's performance and 100% of variable pay is performance related. For Executive Directors, this equates to 64% - 68% of total pay.

Southern Water is committed to complying with the Executive remuneration requirements of 'Putting the Sector back in balance' and is migrating significantly already in 2019/20 to comply with these standards.

## 9. Commitment to publishing the executive pay policy for 2020-25

The Remuneration Committee will further develop the Remuneration Policy over the coming year to ensure continued compliance with these standards. Southern Water commits to publishing the executive pay policy for 2020-25, once it has been finalised.

## 7.SRN.CA.A6

Ofwat action	How we have responded
Provide a revised financial model (based on version 16z released on 31 January 2019) and data tables on 1 April 2019.	Accepted

### Our detailed response

Alongside our IAP response, we have provided a revised set of data tables and a revised financial model based on version 17z, communicated to companies in letter 'Ofwat\_Letter to Regulatory Directors\_Financial Model\_6 March 2019'. This supersedes version 16z, released on 31 January 2019.

The model and tables reflect the updates we have made to our plan in response to Ofwat's feedback. The revised data tables have been assured in line with our risk-based assurance framework (which requires higher risk items to be reviewed by external third parties). Please see below *CA.A6.Table 1 - Data tables assurance for details of the scope of this assurance and also Annex 11 Supporting documents: IAP\_TA11\_CA\_PWC letter of assurance, IAP\_TA11\_CA\_Jacobs letter of assurance – Data Tables, IAP\_TA11\_CA\_Deloitte letter of assurance, IAP\_TA11\_CA\_Deloitte PR19 Post IAP final Report and IAP\_TA11\_CA\_Deloitte Release Letter.*

#### Consistency with business plan tables

Prior to our IAP submission we have conducted a final check and confirmed that the F\_Inputs worksheet of the financial model is consistent with our data tables.

### CA.A6.Table 1 – Data tables assurance - Deloitte Assurance

Deloitte Assurance	
App7 - Proposed price limits and average bills	App8 - Appointee financing
App9 - Adjustments to RCV from disposals of interest in land	App10 - Financial ratios
App11 - Income statement based on the actual company structure	App11a - Income statement based on the notional company structure
App12 - Balance sheet based on the actual company structure	App12a - Balance sheet based on the notional company structure
App13 - Trade receivables	App14 - Trade and other payables
App15 - Cashflow based on the actual company structure	App15a - Cashflow based on a notional company structure
App16 - Tangible fixed assets	App18 - Share capital and dividends
App19 - Debt and interest costs	App22 – Pensions
App23-Inflation measures	App24 - Input proportions
App26 - RoRE Scenarios	App28 - Developer services (wholesale)
App29 – Wholesale tax	WS1 - Wholesale water operating and capital expenditure by business unit
WS1a - Wholesale water operating and capital expenditure by business unit including operating leases reclassified under IFRS16	WS2 - Wholesale water capital and operating enhancement expenditure by purpose
WS2a - Wholesale water cumulative capital enhancement expenditure by purpose	WS5 - Other wholesale water expenditure
WS7 - Wholesale water local authority rates	WS8 - Third party costs by business unit for the wholesale water service

Wr2 - Wholesale water resources opex	Wr3 - Wholesale revenue projections for the water resources price control
Wr4 - Cost recovery for water resources	Wn3 - Wholesale revenue projections for the water network plus price control
Wn4 - Cost recovery for water network plus	WWS1 - Wholesale wastewater operating and capital expenditure by business unit
WWS1a - Wholesale wastewater operating and capital expenditure by business unit including operating leases reclassified under IFRS16	WWS2 - Wholesale wastewater capital and operating expenditure by purpose
WWS2a - Wholesale wastewater cumulative capital enhancement expenditure by purpose	WWS5 - Other wholesale wastewater expenditure
WWS8 - Third party costs by business unit for the wholesale wastewater service	WWn1 - Wholesale wastewater sewage treatment operating expenditure
WWn2 - Wholesale wastewater large sewage treatment works explanatory variables and operating expenditure	WWn5 - Wholesale revenue projections for the wastewater network plus price control
WWn6 - Cost recovery for wastewater network plus	Bio3 - Wholesale wastewater sludge opex
Bio4 - Wholesale revenue projections for the wastewater bioresources price control	Bio5 - Cost recovery for bioresources
R1 - Residential retail	R3 - Residential retail ~ further information on bad debt and customer services
R7 - Revenue and cost recovery for retail	

#### CA.A6.Table 2 – Data tables assurance - PwC Assurance

PwC Assurance	
App1 – Performance commitments (PCs) and outcome delivery incentives (ODIs)	App1a - ODI Additional Information
App1b - PC and ODI Supplemental Measurement Information	App2 – Leakage additional information and old definition reporting
App4 – Customer metrics	App5 – PR14 reconciliation ~ performance commitments
App25 - PR14 reconciliation adjustments summary	App27 - PR14 reconciliation - financial outcome delivery incentives summary
WS4 - Wholesale water other (explanatory variables)	
WS13 - PR14 wholesale revenue forecast incentive mechanism for the water service	WS15 - PR14 wholesale total expenditure outperformance sharing for the water service
WS18 - Explaining the 2019 Final Determination for the water service	Wn2 - Wholesale water distribution (explanatory variables)
WWS13 - PR14 wholesale revenue forecast incentive mechanism for the wastewater service	WWS15 - PR14 wholesale total expenditure outperformance sharing for the wastewater service
WWS18 - Explaining the 2019 Final Determination for the wastewater service	WWn4 - Wholesale wastewater sewage treatment (potential explanatory variables)
R9 - PR14 reconciliation of household retail revenue	R10 - PR14 Service incentive mechanism

CA.A6.Table 3 – Data tables assurance - Jacobs Assurance

Jacobs Assurance	
WS1 - Wholesale water operating and capital expenditure by business unit	WS2 - Wholesale water capital and operating enhancement expenditure by purpose
WWS1 - Wholesale wastewater operating and capital expenditure by business unit	WWS2 - Wholesale wastewater capital and operating expenditure by purpose

CA.A6.Table 4 – Data tables assurance – Internal Assurance

Internal Assurance	
App3 – Abstraction Incentive Mechanism - surface and ground water abstractions under the AIM threshold	App6 – PR14 reconciliation ~ sub-measures
App21 - Direct procurement for customers	App24a - Real price effects (RPEs) and efficiency gains
App28 - Developer services (wholesale)	App30 - Void properties
App32 - Weighted Average Cost of Capital for the Appointee	Wr5 - Weighted average cost of capital for the water resources control
App33 - Wholesale Operating Leases Reclassified Under IFRS16	Wr6 - Water resources capacity forecasts
WS3 - Wholesale water properties and population	Wr7 - New water resources capacity ~ forecast cost of options beginning in 2020-25
WS10 - Transitional spending in the wholesale water service	Wr8 - Wholesale water resources special cost factors
WS12 - RCV allocation in the wholesale water service	Wn1 - Wholesale network plus raw water transport and water treatment (explanatory variables)
WS12a - Change in RCV allocation in the wholesale water service	Wn5 - Weighted average cost of capital for the water network plus control
WS17 - PR14 water trading incentive reconciliation	Wn6 - Wholesale water network plus special cost factors
Wr1 - Wholesale water resources (explanatory variables)	WWS3 - Wholesale wastewater properties and population
WWS4 - Wholesale wastewater other (explanatory variables)	WWn2 - Wholesale wastewater large sewage treatment works explanatory variables and operating expenditure
WWS7 - Wholesale wastewater local authority rates	WWn3 - Wholesale wastewater network (explanatory variables)
WWS10 - Transitional spending in the wholesale wastewater service	WWn7 - Weighted average cost of capital for the wastewater network plus control
WWS12 - RCV allocation in the wholesale wastewater service	WWn8 - Wholesale wastewater network plus special cost factors
Bio1 - Wholesale wastewater sludge (explanatory variables)	Bio7 - Wholesale wastewater bioresources special cost factors
Bio2 - Wholesale wastewater sludge treatment process and disposal routes	R2 - Residential retail special cost factors
Bio6 - Weighted average cost of capital for the bioresources control	App17 – Appointee Revenue Summary
R8 – Net Retail Margins	



## 8.SRN.CA.A7

Ofwat action	How we have responded
Provide an external data assurance statement for App1 and ensure consistency of unit and measure reporting for PCs.	Accepted

### Our detailed response

We have appended a letter from our technical assurers (PwC) to our re-submission see Annex 11: *IAP\_TA11\_CA\_PWC Letter of Assurance*, which includes a statement regarding the assurance of data table App1 and specifically the consistency of unit and measure reporting for PCs.

## 9.SRN.CA.A8

Ofwat action	How we have responded
<p>The company should explain the assurance process it has taken to develop its tax forecasts to demonstrate that amounts proposed for tax take account of customer interests, in particular to clarify the scope of the assurance work that was undertaken and the outcome of that work. Whilst the business plan included a reference that the capital expenditure allocations were externally reviewed, there was no mention of any other tax information.</p>	<p>Further information provided</p>

### Our detailed response

Assurance of our tax forecasts was undertaken by Deloitte for the September Business Plan submission. However, the scope of this assurance was not fully articulated in our submission. As part of their review of our revised data tables, Deloitte has more clearly articulated the scope of their assurance of tax forecasts. Their report and summary letter are appended to this response, see Annex 11: *IAP\_TA11\_CA\_Deloitte PR19 Post IAP Final Report, IAP\_TA11\_CA\_Deloitte Letter of Assurance and IAP\_TA11\_CA\_Deloitte Release Letter*.

Deloitte’s assurance approach aligned to our tax policy, which states “Southern Water’s approach to tax is to support our business and reflect commercial and economic activity and the interests of our customers, stakeholders and the environment”.

No issues were identified as part of their assurance. The scope of work that was undertaken by Deloitte, and the outcome of that work is summarised below.

Four procedures were applied to the assurance of App29. These procedures were completed by members of Deloitte’s tax practice that specialise in the water sector. We asked Deloitte:

- To confirm that historical balances have been apportioned across the different controls on the basis of the RCV split, unless it has been apportioned in a more accurate manner and explanations provided.
- To examine the supporting calculations for brought forward capital allowance pools as at 31 March 2020, to be included in data table block A and B, against underlying data sources including the tax return submitted for the period to 31 March 2017. Consider the reasonableness of assumptions made in estimating pool movements for 2017/18 to 2019/20 and the consistency of approach with Ofwat’s prescribed methodology.
- To examine the supporting calculations for percentage splits to be included in data table block C, to be applied to determine the tax treatment of new capital expenditure, including assessment of key assumptions made for tax treatment of major capital expenditure projects in the price review period, and consideration of consistency with percentage splits for capital expenditure in the historical tax returns.
- To consider the tax adjustments to disallowable expenditure, allowable expenditure and other taxable income included in data table blocks D, E and F for consistency with adjustments made in the historical tax returns.

Deloitte performed top up procedures prior to the April re-submission, to confirm that changes to totex resulted in changes to App29, using the same methodology that they had previously assessed.

## 10. SRN.CA.B1

Ofwat action	How we have responded
Provide an updated financial model that is consistent with business plan tables e.g. addresses differences in capex creditor days and uses dividend yield and growth rates as advised in the guidance.	Accepted

### Our detailed response

The financial model submitted with our IAP response is based on version 17z, communicated to companies in 'Ofwat\_Letter to Regulatory Directors\_Financial Model\_6 March 2019'. This supersedes version 16z, released on 31 January 2019.

#### Use of input overrides

Following the publication of the IAP we engaged with Ofwat to understand the specific reference to 'differences in capex creditor days'. The F\_Inputs sheet of the financial model was populated consistently with data tables, but we had used the model functionality on the InpOverride worksheet to override the F\_Input assumption.

We adopted this approach in order to capture in our modelling the impact of our cashflows – particularly with respect to working capital - driven by development of our forecast of financial statements, as reflected in data tables A11 to A15. The approach accounted for differences in treatment between the financial model and our actual accounting disclosures. It was also a practical way to iteratively update the financial model without requiring updates of data tables to feed the F\_Inputs worksheet.

We understand Ofwat's views on the use of the override functionality, and have worked to minimise their use in the model resubmitted in our response to the IAP. We have continued to make use of this functionality for a number of entries - predominantly working capital - where the calculations in the financial model differ slightly from those in the data tables and we need to compensate for this difference. We have also used the override functionality for the 'Other liabilities b/f balance (e.g. long-term trade and other payables, deferred income, grants and contributions and adoptions), which does not appear in data tables and is otherwise unmodelled.

We also note the requirement to use some elements of the InpOverride worksheet to allow the financial model to operate under the notional structure, as documented in the User Guide.

### Dividend yield and growth rates

In IAP Technical Appendix 3: Aligning Risk and Return, Ofwat states: 'In our financeability assessment, we will limit the dividend yield plus growth assumption to be consistent with the blended cost of equity on a real basis (4.52% on a 50:50 blended CPIH:RPI basis).'

We understand that the initial dividend yield plus subsequent growth combines multiplicatively, rather than additively, and have confirmed this application in the financial model.

Our September 2018 submission included dividend assumptions in the notional company of 3.57% initial yield plus 2.00% growth. This assumption generated a dividend which was less than the 4.52% limit proposed by Ofwat.

**CA.B1.Table 1 – Dividend yield (Sept 2018 submission)**

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Dividends	65.0	67.6	70.3	73.2	76.1	79.2
Average RCV	5,064.9	5,213.9	5,492.6	5,865.0	6,171.3	6,373.8
Notional equity (%)	35.99%	40.00%	40.00%	40.00%	40.00%	40.00%
Notional equity (£)	1,822.7	2,085.6	2,197.0	2,346.0	2,468.5	2,549.5
<b>Dividend yield</b>	<b>3.57%</b>	<b>3.24%</b>	<b>3.20%</b>	<b>3.12%</b>	<b>3.08%</b>	<b>3.11%</b>

Our IAP submission includes a revised dividend assumption in the notional company of 3.22% initial yield plus 1.3% growth, also comfortably within the proposed 4.52% limit.

**CA.B1.Table 2 – Dividend yield (IAP submission)**

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Dividends	55.9	57.8	59.7	61.7	63.7	65.8
Average RCV	5,023.4	5,161.0	5,389.4	5,681.8	5,922.7	6,078.2
Notional equity (%)	34.57%	40.00%	40.00%	40.00%	40.00%	40.00%
Notional equity (£)	1,736.4	2,064.4	2,155.8	2,272.7	2,369.1	2,431.3
<b>Dividend yield</b>	<b>3.22%</b>	<b>2.80%</b>	<b>2.77%</b>	<b>2.71%</b>	<b>2.69%</b>	<b>2.71%</b>

### Average Bills

Financial model 17z included an update (new 'Bill Module' and additional 'F\_Inputs' rows) to reflect revised allocation of retail residential costs by customer type, giving more weight to company cost forecasts in table R1. This revised approach results in a higher retail bill component in our financial modelling.

Data table App7 requires very few manual inputs, with the retail bill components in Block G and average bills in Block H being calculated based on embedded, protected formulas in the data table cells. The data tables were not re-issued following the release of Financial Model 17z, and therefore the revised approach to retail cost allocation is not reflected in the data tables. This causes an inconsistency between the average bills reported in our updated plan (output from financial model) and those calculated in data table App7.

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