



TA 2.4 Trust and Transparency Technical Annex

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TA 2.4 – Trust and Transparency

Purpose: Our Board is committed to continuing to build trust, confidence and legitimacy. This annex provides further detail on our approach to developing customer trust and confidence, and how we will ensure a fair balance between customers and investors. We have undertaken specific research with customers and stakeholders to understand how to engender trust, and have developed future plans based on this insight. We have also provided further details on our approach to sharing the benefits of financial outperformance, our dividend policy, and our executive pay policy going forward. This annex should be read in conjunction with Chapter 2 - Trust, Confidence and Assurance

The table below summarises the Ofwat tests that are addressed by the evidence in this Annex.

Table 1: Relevant Ofwat tests

Ref	Ofwat test	Comment
Primary Focus Areas		
CA3	To what extent has the company's full Board provided assurance that the company's business plan will enable customers' trust and confidence, through appropriate measures to provide a fair balance between customers and investors (which include outperformance sharing, dividend policies and any performance related element of executive pay) and high levels of transparency and engagement, on issues that matter to customers (which extends to their ability to understand corporate and financial structures and how they relate to its long-term resilience)?	<p>In a high quality plan:</p> <ul style="list-style-type: none"> The Board will also provide assurance that it will enable its customers' trust and confidence through high levels of transparency and engagement with customers. <ul style="list-style-type: none"> This annex details research we have undertaken in order to understand how to build trust with our customers. It includes information on our approach going forward, alongside specific proposals in relation to dividend policies and executive pay. This supports Board Assurance Statement 6 on Trust and Transparency.
Secondary Focus Areas		
CE1	Engaging Customers	

About this annex

Our Board is committed to continuing to build trust, confidence and legitimacy. This annex sets out the work we have been doing to increase the trust we receive from our customers, and to improve the transparency of our communications. It describes independent research we have carried out into the factors that increase or reduce trust from our customers' point of view. It also sets out our approach to our proposed policies on dividends and executive pay.

On 11 July 2018 Ofwat issued its consultation on revised Board leadership, transparency and governance principles, as part of its wider drive to rebuild trust and confidence and “put the sector back into balance”. The consultation set out the following expectations in relation to executive pay and dividend policies:

- “Companies must publish in a form and level of detail that is accessible and clear for customers and stakeholders:
 - i. An explanation of the company’s executive pay policy and how the criteria for awarding short and long-term performance related elements are substantially linked to stretching delivery for customers and are rigorously applied. Where directors’ responsibilities are substantially focused on the regulated company and they hold responsibilities elsewhere in the group, pay policies should be fully disclosed at the regulated company level;
 - ii. An explanation of dividend policies and dividends paid, and how these take account of delivery for customers and other obligations (including to employees);

Our response to the July consultation was supportive of much of Ofwat’s proposals for water companies to apply ever higher standards of governance in accordance with generally accepted best practice.

Transparency and engagement

We already provided a high level of transparency on our structure, governance and performance, but know there is more we can do to ensure customers confidence and trust. Our Board is overseeing the development of a **five-pronged approach** to improving our transparency and trust in us, and to ensuring we put customers at the heart of everything we do. This involves:

- 1. Creating a new and genuinely effective customer engagement strategy;**
- 2. Creating a customer experience that is refreshingly easy to deal with;**
- 3. Developing principles on how we communicate with customers in future on the issues that matter to them, and in ways that will engender trust;**
- 4. Developing a performance commitment on trust, based on our research into what matters to our customers when they think about trusted companies they use**
- 5. Responding to financial and structural issues that are identified as reducing trust.**

This section provides further details on our current approach to providing transparency to customers, and how we intend to further improve customer confidence and trust through ensuring we engage with customers on issues that matter to them – including our financial structure.

What we already do

We understand the importance of providing our customers and stakeholders with insight into how we operate and perform. We currently maintain a high degree of transparency, and provide a range of information on our plans, and the policies that underpin how we operate. Two key publications form the basis of our existing disclosures:

- **Annual Report¹**: We provide information on our operational and financial performance each year in our Annual Report. We are transparent about our governance and financial structures, and provide customers with complete information around our ownership. The annual report contains a simplified version of our ownership structure, and a complete version is on our website.² The annual report also includes specific information on both our existing dividend policy and executive pay policy.
- **Annual Performance Report³**: As part of our regulatory reporting, we annually provide a detailed update on our performance against the commitments in our existing business plan, and our financial performance. We also publish details on our data assurance plan related to this disclosure.

Alongside these disclosures, we also provide a range of information on our performance and activities⁴, and policies⁵ for how we operate. The purpose of each is outlined in the table below:

Table 2: Our existing publications

Our reports	Overview
Our taxes explained	A description of our total tax contribution, and on maintaining public trust
Statement on our financial structure	Announcement of our commitment to close our subsidiary finance company in the Cayman Islands
WRMP	Our draft WRMP for consultation with the public.
Drought Plan	Our draft Drought plan for consultation with the public, alongside our statement of response to the feedback we received.
Our annual accounts	A central library of our financial reports.
Final Assurance Plan	Our approach to assuring information in our annual performance

¹ https://annualreport.southernwater.co.uk/media/1792/annualreport_2017_18.pdf

² https://www.southernwater.co.uk/media/default/pdfs/3968_Ownership_structure.pdf

³ https://annualreport.southernwater.co.uk/media/1784/annualperformancereport_2017_18.pdf

⁴ <https://www.southernwater.co.uk/our-reports>

⁵ <https://www.southernwater.co.uk/key-policies>

	report.
Statement on Risks, Strengths and Weaknesses	Identified Risks, Strengths and Weaknesses in relation to performance reporting.
Network Access Code	The basis on which we allow alternative suppliers to access our network
Bioresources RCV	Our approach and initial allocation for bioresources RCV
Our key policies	Overview
Gender Pay Gap	Key data relating to salary, bonus and the distribution of pay within the organisation, in accordance with gender pay gap legislation
Health and Safety	Principles that guide the way that we work, and areas that we place special emphasis on in relation to health and safety.
Corporate Responsibility	Policy for integrating our business values and operations of our customers, employees, regulators, investors, supplies, communities and the environment.
Asset Management	Policy for asset management to deliver outcomes in our PR14 plan.
Environment	Approach to continually improve our environmental management system to enhance our performance in line with customer expectations.
Corporate Lobbying	Principles guiding corporate lobbying: to be open and honest; to be accountable; to focus on customers; to treat each other with respect; to act as one team; and to partner for best performance
Sustainable and Ethical Trading	Policy on sustainable and ethical trading, which ensures that we and our supply chain partners continually raise the bar in meeting the social, economic and environmental challenges we face together.
Employee Volunteering	Policy committing to support and make a positive difference to the communities we serve by behaving in a socially responsible manner
Carbon Emissions	Policy on reporting our emissions, and our commitment to mitigate increases in energy usage and emissions through improved operational efficiency and increased renewable generation.
Compensation due to works in highways	Approach to claims for loss caused or damage done when we undertake works to our water mains and sewers in the public
Plastic	Commitment to minimising our use of plastics, to reducing the environmental impact of waste plastics and to beating the national target of eliminating avoidable plastic waste before the end of 2042.

Research informing our customer communications

We sought to gain a greater understanding amongst our customers and stakeholders on how we can present information in a way to support the development of trust. To do this, we commissioned YouGov to undertake three strands of research to explore the issues of trust, financial transparency and financial structures. This was carried out independently, and involved:

- **Deliberative workshops** (May 2018) – two 2 ½ hour workshops with representative groups of customers were carried out in May 2018.
- **In depth stakeholder interviews** (July 2018) – anonymous interviews with c.12 stakeholders chosen by YouGov from a long list we provided, to cover a diverse range of interests represented.
- **Online survey** (July 2018) – Over 1,000 customers, chosen by YouGov with a mix of age, gender, region and social grade, representative of the demographic of our region.

Full findings⁶ from this research were shared with the CCG, and provided a rich baseline of insight for the types of information that can help to engender trust and transparency, and the appropriate ways to present this information. It also provided us with tailor insight from both customer and stakeholders.

From the online survey, we developed a clear understanding of what is important to our customers, and what we can do to promote trust. Figure 1 below summarises customers' responses.



Figure 1: Factors that positively influence trust

⁶ The full findings from YouGov's research are appended to this Technical Annex: TA.2.4

For each of the components of trust tested by YouGov, each was found to be at least “important” to over 65% of those surveyed. Many elements relating to honesty and fairness were identified as critical in promoting trust between us and our customers.

This research also provided an understanding of what can reduce levels of trust. Figure 2 below summarises our customers’ responses. As show, at least 70% of customers involved in the survey identified the presented factors as reducing trust.

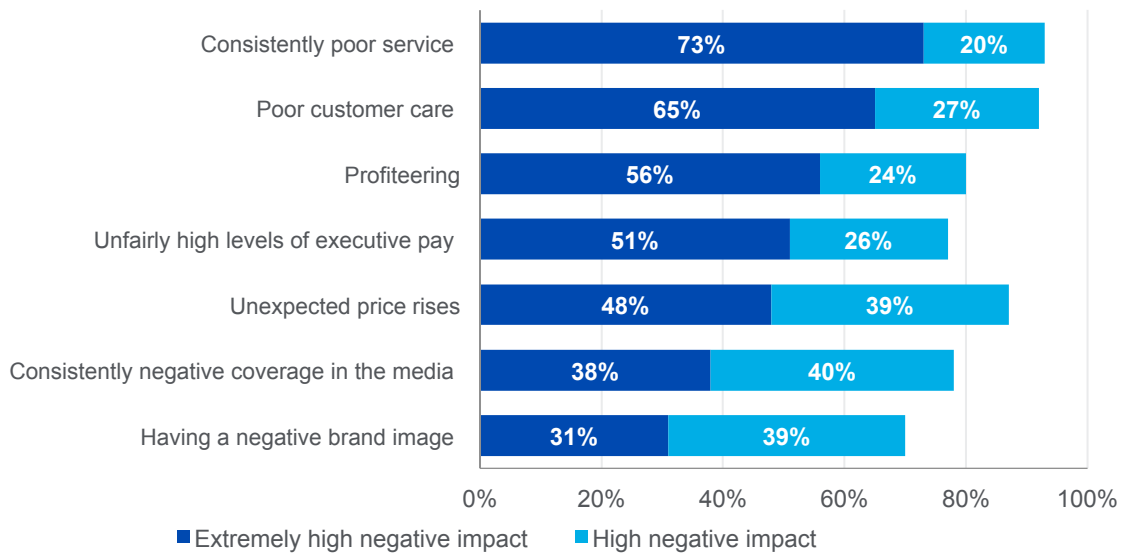


Figure 2: Factors that negatively influence trust

How we are going to do more

We know we can go further than our existing approach to ensure customers and stakeholders trust and confidence through transparency and engagement. This section gives further details of our five pronged approach, outlined in turn below. This includes a focus on how we interact with and share information going forward, including on our financial structure.

Creating a new and effective customer engagement strategy

We understand the importance of engaging with customers and stakeholders on issues that matter to them in order to promote trust and confidence. In Chapter 5 -Future Customer Participation and Engagement Strategy, we explain our new customer engagement strategy, and how it is being delivered. This strategy responds to the fact that our customers have high expectations that change over time, so our approach needs to be able to evolve in order to respond to these changes, alongside political, social and regulatory trends.

We are putting customers at the heart of everything we do by actively collaborating to create a resilient water future for the South East. This is being achieved by extensive insight and engagement functions, which are helping to drive a principles-based way of working. It also involves the introduction of a new engagement model and framework throughout the company based on collaboration and participation with our customers and stakeholders. Crucially, we are



taking action to create a customer-focused and collaborative culture internally, and have established strong governance to ensure our future engagement is customer focused.

Creating a customer experience that is refreshingly easy to deal with

Our insight identified the importance of delivering great customer service in building trust, and the negative impact from failing to do so. In Chapter 9 - Great Customer Service, we outline our approach to delivering great customer service. This is underpinned by a set of customer principles approved by our Board, ensuring customers are at the heart of everything we do:

- a. Our company strategy is customer led and focused on delivering outcomes for all our customers. This will be delivered through our customer experience propositions.
- b. Customer benefits will be embedded into our decision making across the business. We have developed a Customer Policy, endorsed by the Board, to drive this from the top and a process for project evaluation which considers the customer outcomes.
- c. Our processes will be customer-insight led. (We have set out our approach to embedding customer insight into the way we do things in Chapter 5 - Customer and Stakeholder Engagement and Participation. Our policies, decision making and evaluation processes require customer insight and support for programmes of work.

Developing principles on how we communicate with customers

We have developed four principles based on the insights from the YouGov research to guide our approach to customer communication going forward. This includes how we design our customer-facing publications to ensure they provide information in an accessible way. We have started by producing a customer-friendly version of our plan, published on our website alongside our full submission. Below, we outline our principles for improving trust in our communications with customers:

- **Being open and upfront:** We will be honest with our customers, and be open and upfront when things go wrong. Whenever we update or change our policies, we will explain why we have made a decision so that customers understand how it impacts them.
- **Clarity:** We will use clear and accessible language that speaks to the customer in a simple way about what it means for them, so our communications are easy to understand.
- **Timeliness:** We will communicate with our customers promptly on any changes to our services.
- **Financial information:** We will be open and transparent about our financial performance and ownership. We will use plain language and focus on the issues that we know matter to our customers.

Developing a trust performance commitment

We want to use the insight we have gathered to develop a focused measure of trust, and have received positive support from our CCG to do this. We are working to develop a reputational PC, involving the use of an external agency to benchmark our performance. Our intention is to conduct a baseline survey using the insights obtained from the YouGov research and to target how we

communicate our performance and how we manage the company to deliver on customers' needs. When we have established a reliable baseline we will consider how to set a reputational performance target.

We intend to develop a measure in such a way that other water companies and other utility companies could join the same process.

Responding to financial and structural issues that reduce trust

The last element of our approach is to address financial and structural issues. These actions were taken independently of and prior to the research we commissioned, and show our commitment to tackling wider issues on our financial structure:

- We are in the process of simplifying the holding company structure and refinancing of the company. By 2020 we anticipate this will have reduced gearing to about 70%, funded at a significant cost to our investors. This involves replacing the existing complex holding structure with a simple three-tier structure.
- We announced the closure of the offshore financing subsidiary in April 2018.
- We committed to making our tax structure and UK tax status more transparent and easier to understand. We have published on our website a simple leaflet in May 2018 that explains our tax policy and position.

We will continue to explain our ownership structure in simple ways that are easy for customers to understand.

A fair balance between customers and investors

Executive Pay

We are proposing:

- **to build on our existing remuneration policy** which already considers performance measurement across a balanced set of outcomes for stakeholders, including a significant element linked to customer outcomes and areas of financial performance that underpin lower bills. Scheme rules give the Remuneration Committee significant control over bonus payments, based upon the quality of performance delivery, including:
 - Complete discretion to reduce variable pay
 - Short and long term measures
 - A 50% bonus deferral
 - Malus and clawback provisions, which allow the possibility of a reduction or clawback of bonuses already earned
 - A Clear definition of 'good' and 'bad' leavers
- **to maintain a link to things our customers value.** Bonus performance criteria already underpin stretching outcomes for customers. We will maintain this link:

- 40% of current bonus earnings potential in respect of annual measures are directly driven by customer outcomes (SIM performance and ODI performance), with the remaining 60% underpinning lower bills for customers.
- Our long term measures are designed to incentivise the delivery of a long-term, sustainable business
- Stretching targets are set directly from the Business Plan / annual budget and executives only benefit where there is a significant performance improvement
- Measures and targets are reviewed annually to ensure they remain both stretching and relevant and as we move into PR19 will be further substantially linked to customer outcomes
- We will continue with the rigorous application of our policy which rules out a bonus for failure to meet specific criteria hurdle rates
- **to continue to report transparently the performance** against bonus metrics in the remuneration report in our annual report and accounts
- **to formally review our policy annually**, setting this out transparently with outcomes in our annual remuneration report as part of the Annual Report and Accounts.

We operate within a competitive market and the company's chosen position (market median) will remain unchanged, particularly given our focus on improving the business. The business will continue to need to recruit and retain talent so may, from time to time, need to put in specific arrangements for certain individuals, albeit these will also include substantial links to customer outcomes.

We show below an extract from our 2017/18 Annual Report and Financial Statements, setting out our current policy. We believe that it is flexible and can be readily adapted to link performance-related pay to our performance on customer outcomes.

Extract from Southern Water's Current Remuneration Policy

Purpose

The remuneration policy of SWS applies to all its employees. The Board of Directors has adopted the remuneration policy at the recommendation of the Remuneration Committee. The policy applies to remuneration earned from 1 April 2017.

The policy reflects the Board's objectives for good corporate governance, high quality of service to all our customers, as well as sustained and long-term value creation for shareholders and lower bills for customers. In addition, it ensures that:

- SWS is able to attract, develop and retain high-performing and motivated employees in a competitive market
- employees are offered a competitive and market median-aligned remuneration package which balances the fixed and variable remuneration components according to job role



- employees feel encouraged to create sustainable results and that a link exists between shareholders/customers and employees' interests.

The policy focuses on ensuring sound and effective risk management through:

- a stringent governance structure for setting goals and communicating these goals to employees
- alignment with our business strategy values, key priorities and long-term goals
- alignment with the principle of protection of customers and investors ensuring prevention of conflict of interests.

Our remuneration philosophy

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

- a significant proportion of reward is based on performance against demanding targets
- targets are focused on delivering a high quality performance for our customers, stakeholders and the wider community
- remuneration strikes an appropriate balance between short-term and long-term success of the company
- remuneration should appropriately reward all employees who adhere to the company's values. They are:
 - customers first** – we always put our customers first and do what we promise
 - everyone matters** – we respect every individual, listen to their opinions and act on their ideas
 - always improving** – we never stop working to make things better for our customers
 - local pride** – we are proud of the essential work we do and the sustainable way we do it for the communities we serve
 - taking ownership** – we take ownership and care about doing the right thing
 - succeeding together – working as one team we will succeed in delivering our targets
- the remuneration policy for our executive directors is aligned with that for other employees.

The aim is that executive directors' remuneration should be market-competitive relative to other comparable companies, with a significant proportion being variable and performance related. The performance-related element is only paid out if stretching short-term and long-term targets are achieved that benefit both customers and shareholders. In setting the remuneration policy for executive directors, the Committee takes into account the remuneration practices found in other UK companies of a similar size or operating in the same sector. It also ensures that the remuneration arrangements for the executive directors are appropriate when compared with those for other senior executives and the wider workforce.

To ensure that our remuneration practices remain competitive, the Committee periodically calls upon experienced specialist consultants. During the year, the Committee also received some guidance and market practice from external, independent advisors, PwC.

Dividends

The Board has started a process to refine its existing dividend policy. That existing policy, which was set out in our 2017/18 Annual Report, and which is repeated at the end of this Dividends section, was a development of the previous policy. The proposed future changes referred to here will aim to go further to meet Ofwat's 31 July 2018 position statement.

We expect to publish the revised dividend policy in our 2018/19 Annual Report and Annual Performance Report.

Dividend Policy governing principles

Our revised dividend policy will aim to ensure that we maintain our corporate, operational and financial resilience in order to sustainably deliver the needs of our customers, investors, employees and local communities/wider stakeholders.

Accordingly, in further refining our revised dividend policy, we will consider incorporating a wide range of measures, including financial measures, customer performance measures and public service value measures that apply to our wider stakeholders and gauge our contribution to society at large, so that we are always accountable for our performance.

In keeping with the current dividend policy, the level of any dividend will:

1. Satisfy the Directors' duties under law; and
2. Meet the conditions of Southern Water's Licence;

A description of the measures is summarised below. However these will be described in further detail as part of our published revised Dividend Policy in our 2018/19 Annual Report and Annual Performance Report.

Financial measures

The Board of Southern Water will only consider payment of a dividend where certain financial, commercial and legal conditions are met based on a review of the areas in the following table:

Assessment	Description
Cash flow	Assessment of the stability of future cash flows.
Business risk	Assessment of the key areas of business risk.
Cash security	Assessment of security over cash balances.
Retained profit	Assessment of current year and forecast distributable reserves.
Liquidity test	Assessment of the Company's liquidity position and facilities available to meet cash requirements to fulfil our Common Terms Agreement, Licence and going concern obligations.
Covenant test	Assessment of headroom to the debt covenant levels of dividend

	lock up and default.
Credit rating	Review of the current credit ratings and assessment of the impact of the dividend on our credit rating.
Directors' duties	Satisfaction that the payment of a dividend is in line with directors' legal and regulatory obligations.

In addition, the company will necessarily take account of the dividend yield assumptions made in its forecasts, consistent with the Ofwat nominal base dividend yield referenced in its 31 July 2018 position statement.

Customer performance measures

If the decision to pay an external dividend has been made in principle, and it satisfies the financial tests, we will test our performance against customer commitments. In particular, we will test our performance against performance commitments and the associated outcome delivery incentives.

Any material under or over performance against a broadly defined set of measures, representative of what is important to our customers, will be taken into account when setting the level of any dividend paid.

Stakeholder measures

We will seek to set out criteria to ensure that the Board can satisfy itself that the payment of a dividend will not materially jeopardise our commitments to the wider stakeholder universe, including employees and pensioners.

Measures of our contribution to wider society

We will seek to formulate our revised dividend policy so that it is underpinned by our study of best practice in terms of Ethical Business Practices and Regulation (EBPR) and Public Service Value (PSV), as we believe that the payment of dividends should reflect our contribution to wider society.

In the spirit of these principles, we also intend to make commitments to invest in and deliver benefits across a number of areas which may include:

- **Skills and education**, including apprenticeship schemes, a regional skills academy and STEM schools programmes
- **Community contribution schemes**, particularly focusing on the Target 100 water efficiency programme
- **A ground breaking “Water Levels”** programme tying together for the first time new build and retrofit water efficiency measures alongside a twinning programme with WaterAid projects to bring fresh water supplies to communities
- Beauty of the Beach, **extending our award winning education and beach improvements programme**
- Learn to Swim, **continuing our partnership programme with Swim England** which celebrated its 25th anniversary last year and has helped 750,000 youngsters learn to swim.

Refill and plastics, significantly **increasing our commitment to the provision of water refill outlets** and the reduction of single use plastics across all of our operations.

- Innovation, **committing to the development of innovation partnerships on a cross sectoral basis** dealing with water, energy and agriculture.
- Formalising our commitment to each of our Executive having a non-remunerated role in a body or programme which helps delivers value in public service
- **Formalising a commitment to staff volunteering days**, on a paid basis, to support community based schemes
- **Reach and Support, our recently launched collaborative programme to improve processes to identify vulnerable customers**, simplify access to support and providing appropriate assistance.

We will commit to funding a selected set of such programmes and to measuring and identifying the benefits which derive from their delivery.

Review Parameters

Once finalised and approved, the dividend policy will be reviewed regularly to ensure that it continues to reflect our performance and delivery of our commitments to our customers and stakeholders.

Southern Water's Current Dividend Policy

As noted above, we set out below the current Dividend Policy of Southern Water published in our 2017/18 Annual Report. This existing policy was revised in 2018 to start what we consider is a continuing process to align the interests of all our stakeholders:

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

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

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

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

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

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

Throughout the plan we have taken decisions to ensure a fair balance between customers and shareholders.

The key proposals within our plan have been designed to provide a fair balance between customers and investors, and go beyond the proposals outlined above. Examples include:

- **PCs and ODIs:** As outlined in Chapter 6 - Outcomes, Performance Commitments and ODIs, the PCs in this plan are underpinned by a set of stretching targets. With increasing service performance and falling bills, our Plan delivers greater value for money for customers. Our plan includes a P10 / P90 range of +1 to -3%. This range reflects our customer's priorities, including their strong desire for us to deliver high quality water at all times delivery of water services, and to avoid any deterioration in our wastewater services or the environment.
- **Bill reductions:** The plan has been designed to deliver an average bill reduction of c3.0% in real terms over AMP7, whilst also creating a resilient water future for the South East. Further information is presented in Chapter 8 - Helping customers who need our support – our response to the challenges of affordability and vulnerability.
- **Acceptability testing:** We tested the acceptability of the plan directly with our customers. 78% of customers found our plan acceptable. Further information is presented in Chapter 4 - Customer and Stakeholder Engagement and Participation.
- **Governance:** We have responded to the current Ofwat consultation on Board leadership, transparency and governance principles; we are supportive of much of Ofwat's proposals for water companies to apply ever higher standards of governance. Whilst it is not known what the final changes to Ofwat's principles will be, the Board remains fully committed to maintaining high standards of leadership, transparency and governance, and the company's governance structure will be modified as appropriate to the revised principles.