Financial performance

Chief Financial Officer's review

I joined Southern Water as Chief Financial Officer in January 2023 to work alongside Lawrence and the rest of the Southern Water team to drive the transformation of the company, and improve performance for its customers and the environment. In my first months, I have focused on understanding the challenges we face, defining and putting in place the plan that will establish the foundation we need to deliver our ambitious turnaround.

A key element of this has been the development of a revised business plan for the current regulatory period, which is designed to significantly improve our operational performance, deliver on our regulatory obligations, meet additional cost pressures, increase resilience and deliver better outcomes for customers, communities and the environment. This Turnaround Plan includes significant additional expenditure, over that agreed in our final determination for 1 April 2020 to 31 March 2025 and represents a major milestone in our turnaround journey.

To maintain momentum on our turnaround plan we have engaged with shareholders to seek an additional £550 million of new equity funds for the group. We expect this process to conclude by the end of October 2023 with £375 million of that new equity being injected into Southern Water. For further information regarding this funding and its effect on the going concern assessment, including the related material uncertainty, see page 205.

We expect to complete the first phase of our Turnaround Plan by 31 March 2025. Our business plan for the five-year regulatory period starting April 2025, will be based on the final stage of the turnaround along-side the investments required to secure long-term water supplies for our customers and address the environmental impacts of water abstraction and treatment.

As a consequence of this initial period of additional spend and investment, our credit ratings and covenant ratios will be under pressure for the remainder of this regulatory period to March 2025. On 7 July, Fitch announced its decision to downgrade our credit rating to BBB (negative outlook) which has resulted in a Trigger Event. We expect to remain in Trigger for the remainder of this regulatory period.

We are fortunate to have shareholders that have consistently supported Southern Water by approving substantial investment in the business over and above regulatory allowances, while taking no dividends and expect to take no further dividends for the remainder of this AMP. For the sixth year in succession, our external shareholders did not receive a dividend as we prioritised the critical investment we need to make in our systems and assets to improve resilience for the benefit of our customers, communities and the environment.

This support has never been so important as we face the external challenges the world has been experiencing in the last few years, with climate change, increasing energy prices and rising inflation all having an impact on our customers and our business. The impact of these cost pressures is reflected in our financial results for the financial year ended 31 March 2023 which are summarised on the next page.

Stuart Ledger
Chief Financial Officer
7 July 2023

Read more in the Financial statements on pages 209 to 257

Financial performance

The financial results have been prepared in accordance with FRS 101 and the accounting policies of the company as set out in note 1 to the financial statements.

Financial performance

Income statement	Years ended 31 March 2023 £m	 2022 £m
Revenue	**792.5**	823.5
Amortisation of regulatory settlement payments	**23.2**	21.0
Total revenue	**815.7**	844.5
Other operating income	**1.8**	1.8
Operating costs before court fine and costs and charge for bad and doubtful debts	**(476.8)**	(384.7)
Court fine and costs	**–**	(91.5)
Charge for bad and doubtful debts	**(12.0)**	(29.9)
Depreciation, net of amortisation	**(347.1)**	(324.1)
Operating (loss)/profit	**(18.4)**	16.1
Profit on disposal of fixed assets and other income	**6.5**	1.5
(Loss)/profit before interest and tax	**(11.9)**	17.6
Net finance costs	**(278.6)**	(196.2)
Fair value gains/(losses) on derivative financial instruments	**659.1**	(669.0)
Profit/(loss) before tax	**368.6**	(847.6)
Tax	**(83.7)**	86.1
Profit/(loss) for the financial year	**284.9**	(761.5)

Revenue

Revenue decreased to £792.5 million (2022: £823.5 million). This is principally due to £63.6 million of net penalties for Outcome Delivery Incentives (ODI), £6.6 million reduced consumption by households during the drought and £3.3 million of generally lower consumption. Partially offset by £17.0 million increased business consumption and £36.7 million inflationary increases in line with the allowances set by Ofwat.

In 2022–23 ODI penalties, relating to performance in 2020–21, were applied to our water and wastewater revenue totalling £63.6 million representing penalties of £51.6 million and an element for tax of £12.0 million. We have subsequently confirmed with Ofwat that the tax element of this adjustment was incorrectly applied to reduce our tariff and revenues in 2022–23 and we will, therefore, recover the £12.0 million through revenues in 2023–24.

Details of the other significant movements affecting our revenues are described here and shown in the diagram on the following page:

- Revenue estimation – most of our customers are billed based on metered water usage. At each period end we make an estimate for water used but not billed. In the prior year, we billed an additional £13.0 million in relation to consumption to March 2021 and in the current year we billed a net £3.1 million less than we accrued at March 2022.
- Consumption – following the return to more normal usage patterns following the pandemic, we have experienced an increase in non-household consumption in the year, which increased revenues by £17.0 million. This was partially offset by reduced household usage in response to the drought, which reduced revenues by £6.6 million.

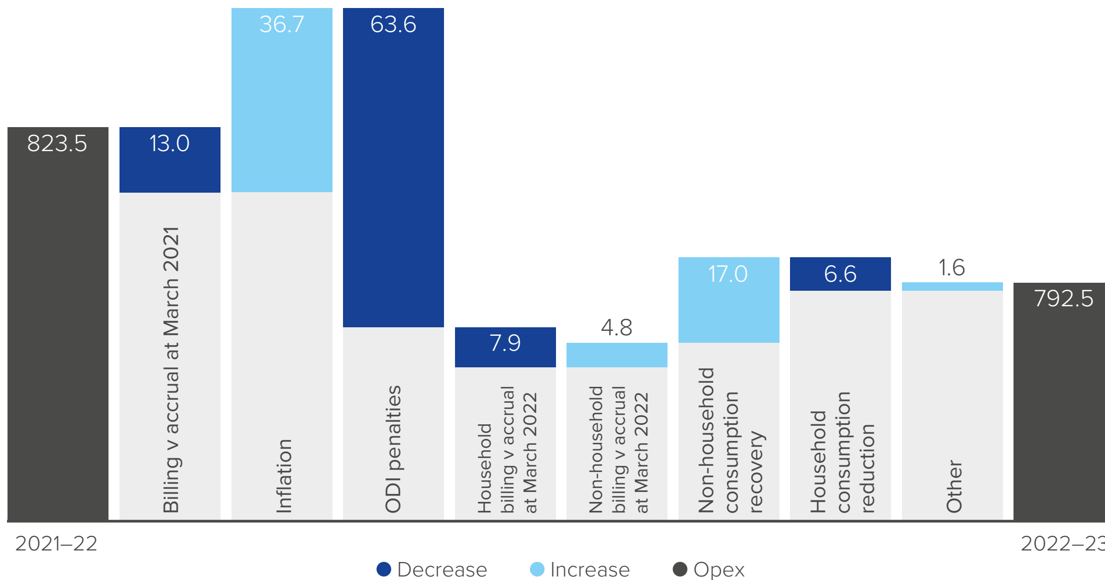
Financial performance continued

In 2018–19, we made provision for customer rebates, based on our regulatory settlement with Ofwat, to be provided to customers over the period from 2020–25. These customer rebates are now included within our tariffs and so part of the revenue reported in the income statement. The provision made in 2018–19 for these rebates is being released in line with the tariff adjustment over the same period, £23.2 million was released in 2022–23 a slight increase from the prior year, reflecting the impact of inflation on our revenues.

An analysis of revenue is provided in note 5 to the financial statements.

Read more in the Financial statements on pages 209 to 257

Movement in revenue £m



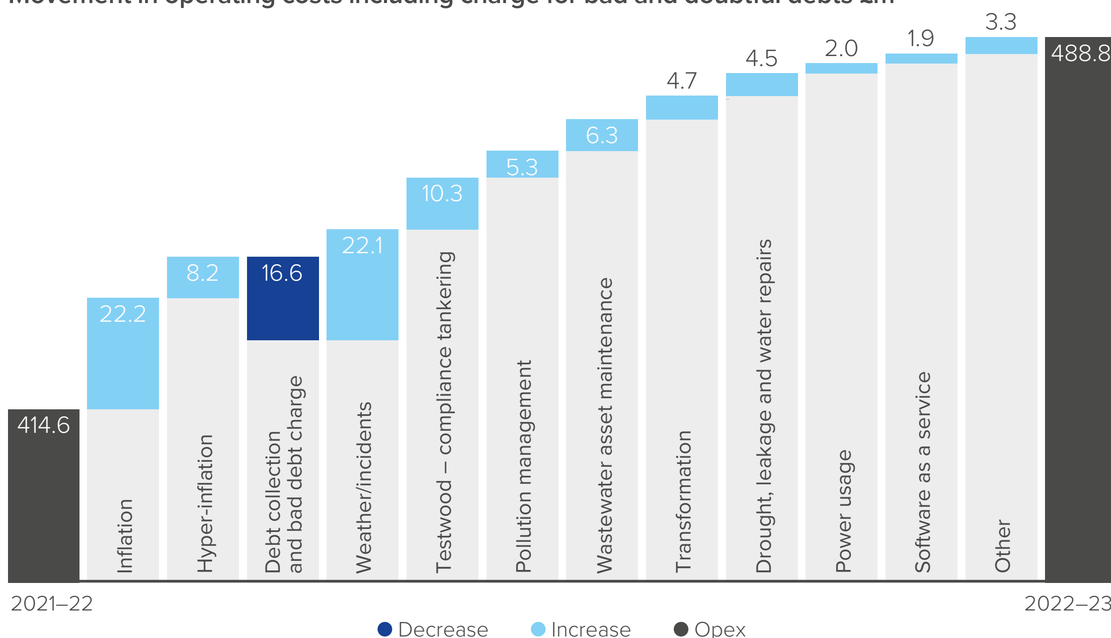
Financial performance continued

Read about our operational performance on pages 42 to 95

Operating costs and charge for bad and doubtful debts

Operating costs including the charge for bad and doubtful debts for the year increased by £74.2 million from £414.6 million to £488.8 million. This increase is explained in the chart below:

Movement in operating costs including charge for bad and doubtful debts £m



Over the course of the year the most significant cost increases were:

- **Inflation and hyper-inflation** – general inflation added a significant amount to our underlying costs, £22.2 million, with average inflation rates across most of our cost base lying between 4% and 7%. This included power costs, for which we had previously fixed prices. However, for certain chemicals and fuel we experienced inflation rates ranging from 14% to 200%, and these increased our operating costs by £8.2 million.
- **Debt collection and bad debt charge** – cash collection performance has been maintained as debt collection activities resumed post COVID–19, and with the support initiatives we have put in place to help customers facing financial difficulties in the current economic climate. As a result, our bad debt charge, which included an additional charge of £10.3 million in the prior year, for the potential impact of the economic pressure on customers, reduced by £17.9 million to £12.0 million (2022: £29.9 million). This reduction was offset by a small increase in our overall debt collection costs, resulting in a net reduction in operating costs of £16.6 million.
- **Weather/incidents** – As described in our strategic report, in 2022–23 we experienced loss of supply events in Kent and Hampshire which affected large numbers of customers. We would consider these events to be atypical due to the scale of the events which added £12.8 million to our operating costs.

  Since October 2022 we have experienced a prolonged period of extremely wet weather, with our region receiving 181% of the long-term average rainfall. Dealing with the high-ground water levels and infiltration cost a further £10.8 million. These increases were reduced in part by the costs incurred in the prior year for Storm Eunice which were not incurred in 2022–23 of £1.5 million.
- **Testwood compliance tankering** – at our Testwood Water Supply Works we have enhanced water quality performance through capital investment to replace all the chemical dosing equipment on site. Consequently, and in order to maintain compliance, this increased the amount of tankering and treatment required for the waste produced, so that it can be safely returned to the environment. This increased costs significantly by £10.3 million in the year and we are working hard to identify an alternative solution to mitigate and reduce these exceptional costs for the future.

Financial performance continued

- **Pollution management** – we increased proactive maintenance of our sewerage network by £5.3 million as part of our pollution reduction programme.
- **Transformation** – costs incurred during the year as part of our transformation programme to improve operational performance, these included the creation of a new logistics team, managing our own small fleet of water tankers as well as stores of spares for plant and equipment repairs, improvements to our control centre and alarm handling as well as production and publication of our overall transformation programme.
- **Drought, leakage and water repairs** – following the dry winter in 2021 and the hot summer water companies across the country faced the first nationwide drought for a decade, introducing a temporary usage ban for our customers in Hampshire. We incurred additional £4.5 million of operating costs in preparation for the drought and replenishing our reservoir at Bewl, along with additional leakage activity and water repairs to mitigate the effect on our overall water resources.
- **Power usage** – additional power consumption dealing with wastewater following the high levels of rainfall over the period from October 2022.
- **Software as a Service (SaaS)** – in 2021, the IFRS Interpretations Committee published its agenda decision regarding configuration and customisation costs in Cloud Computing Arrangements (SaaS). This has resulted in certain costs, that would have previously been capitalised as an intangible asset, being held on the balance sheet as a prepayment and recognised as an operating expense over the life of the contract. The impact on our operating costs is an increase of £1.9 million in 2022–23.

Court fine and costs

The company was subject to a detailed investigation by the Environment Agency (EA) regarding permit breaches at some of our wastewater treatment works during the period 2010 to 2015. On 9 July 2021, the company was sentenced and fined £90.0 million plus £2.5 million of costs for these historic offences. These costs, less the provision of £1.0 million made in 2019–20, were charged to the income statement in 2021–22.

Depreciation and amortisation

Depreciation and amortisation increased to £347.1 million (2022: £324.1 million) following the completion and commissioning of a large number of our capital investment schemes. This included a number of wastewater treatment schemes.

Operating loss/profit

As a result of the reduction in revenue and increased operating costs, we incurred an operating loss of £18.4 million (2022: profit £16.1 million).

Financing costs and profit before tax

Net finance costs increased by £82.4 million to £278.6 million (2022: £196.2 million). This increase is largely driven by higher indexation on our index-linked debt of £93.3 million, which, along with indexation form the prior year, increased the interest payable on loans by £3.9 million. These increases to our interest charge were offset by a greater level of interest capitalised during the year of £17.0 million.

The actual interest paid in cash on these loans was £176.8 million and this was offset by receipts from financial derivatives of £87.2 million.

The fair value gain on our derivative financial instruments amounted to £659.1 million reversing the loss experienced in the prior year, (2022: loss £669.0 million). The primary driver for changes in the valuation are the fluctuation in UK Government bond yields, which are used to discount the future cash flows and inflation which increases the liability associated with our index-linked instruments. As government gilt yields are constantly moving and inflation has increased significantly over the past year, the valuation of our derivative instruments is volatile. The balance sheet value represents the present value of future cash flows using financial market forecasts for inflation and interest rates. This balance sheet value does not, however, reflect the expected impact of inflation on future revenues and future Regulatory Capital Value (RCV) which is expected to more than offset the reported balance sheet value.

The profit before tax for the year amounted to £368.6 million (2022: £847.6 million loss).

Taxation

We have recognised a total tax charge to the income statement of £83.7 million (2022: £86.1 million tax credit). This differs from the charge that may be expected of £70.0 million, based on the profit before tax of £368.6 million and the current period tax rate of 19%, as described in note 10. The variance is primarily due to differences between the current and deferred tax rates.

Read about our drought response on page 57

Financial performance continued

Cash flow statement

Overall, cash and cash equivalents decreased in 2022–23 by £41.6 million (2022: £182.1 million decrease) and details of the principal movements in the cash flow are provided in the table below.

	Years ended 31 March			
	2023 £m	2022 £m	Movement £m	Explanation
Proceeds from share issues	**–**	391.3	(391.3)	In September 2021, funds managed by Macquarie Asset Management acquired a majority stake in Southern Water's ultimate parent company Greensands Holdings. As part of this investment new equity totalling £391.3 million was issued by Southern Water Services during 2021–22.
Settlement of loan to SWSG	**–**	130.0	(130.0)	As part of the investment into the group by funds managed by Macquarie Asset Management, the inter-company debtor issued to SWSG was repaid.
Net interest-related transactions	**(86.3)**	(123.0)	36.7	In total, the net cash outflow in relation to interest decreased by £36.7 million. The principal reasons were: There were no payments made in relation to accrued indexation on our index-linked loans (2022: £46.9 million). Lower interest received following the repayment of our intercompany debtor with SWSG, £8.6 million
Net movement on borrowings	**57.2**	(16.9)	74.1	During the year, we made loan and preference share repayments totalling £343.2 million (2022: £16.9 million); these were offset by the issue of a bridging loan £400.0 million (2022: nil).
Movements in short-term investments	**285.0**	(285.0)	570.0	Funds held on deposit for periods greater than three months decreased by £285.0 million in the year to support our capital investment programme.
Settlement of court fine and costs	**–**	(92.5)	92.5	Payment of the court fine and costs in 2021–22 relating to the Environment Agency prosecution.
Investment in subsidiary	**33.9**	–	33.9	In FY23 we closed our Cayman subsidiary, SWSF, resulting in the return of our investment of £29.2 million and a final dividend of £4.7 million.
Pension deficit repair	**–**	(77.3)	77.3	In FY22 we made lump sum pension deficit repair payments totalling £77.3 million which included the advance payment of £59.8 million previously scheduled to be made over the period to 31 March 2025. As a result, no further payments were made in the current year.
Other	**(331.4)**	(108.7)	(222.7)	The net cash movement from operating activities and our capital investment programme. Largely driven by the increase in our capital investment programme during the year which increased cash expenditure by £164.4 million and the increase in the cashflow associated with our higher operating costs as described above.
	(41.6)	(182.1)		

Statement of financial position

	31 March 2023 £m	31 March 2022 £m (Restated*)
Non-current assets	**7,297.8**	6,899.0
Current assets (excluding cash)	**263.8**	527.4
Cash and cash equivalents	**115.8**	157.4
Total assets	**7,677.4**	7,583.8
Current liabilities	**(530.4)**	(735.2)
Non-current liabilities	**(6,282.4)**	(6,259.6)
Total liabilities	**(6,812.8)**	(6,994.8)
Total net assets	**864.6**	589.0
Total equity	**864.6**	589.0

*The prior year has been restated following a re-analysis of prepayments from current to non-current assets

Financial performance continued

At the end of the year to 31 March 2023, we had non-current assets of £7,297.8 million (2022: £6,899.0 million), an increase of £398.8 million from March 2022. This increase largely results from our ongoing capital investment programme, which – after depreciation – increased the value of property, plant and equipment and intangible assets by £390.4 million.

Overall, during 2022–23 our capital investment in property, plant and equipment was £707.7 million (2022: £569.7 million). This step-up in expenditure was targeted at making refurbishments to our assets to improve operational performance as well as schemes to enhance the level of wastewater treatment we undertake, for example to reduce phosphorus levels.

In addition, we experienced an increase in the value of our non-current financial derivative assets of £38.3 million which was offset by a reduction in the value of investments held in subsidiaries of £29.0 million following the closure of our Cayman Islands registered subsidiary SWSF in October 2022.

Current assets decreased to £263.8 million (2022: £527.4 million). Most of this decrease resulted from the utilisation of the cash held in short-term investments at March 2022 during this financial year to finance the capital investment programme. At March 2023 there were no deposits held in short-term investments (2022: £285.0 million). This reduction was offset by increases in prepayments for interest and IT contracts of £9.2 million and a higher VAT debtor at the year-end of £7.9 million resulting from the increase in the capital investment programme.

Current liabilities decreased to £530.4 million (2022: £735.2 million). This was mainly caused by the movement on external loans due to be repaid in under one year, which decreased to £19.9 million (2022: £274.8 million), together with the repayment of an inter-company loan of £30.3 million following the closure of our Cayman Islands registered subsidiary SWSF. These reductions were offset by an increase in the level of trade and capital creditors and capital accruals of £56.8 million reflecting the increased expenditure in operating costs and the capital investment programme and an increase in deferred revenue mainly relating to payments in advance from customers of £16.3 million.

At 31 March 2023, non-current liabilities totalled £6,282.4 million (2022: £6,259.6 million). This increase of £22.8 million was principally the result of the following:

- An increase in borrowings of £485.2 million largely resulting from the issuance of a £400 million term loan facility and indexation on our inflation-linked bonds of £106.7 million offset by repayment of preference shares and loans totalling £24.1 million.
- A decrease in the derivative financial instrument liability of £533.6 million.
- An increase in the deferred tax liability of £81.5 million largely resulting from the fair value gain on derivatives recorded for the year.
- An increase in retirement benefit obligations of £13.1 million from the impact of movements in market conditions at 31 March 2023, which increased the deficit by £11.5 million, together with past service and financing costs of £1.6 million.
- The transfer of £25.6 million of the Ofwat regulatory settlement provision to short-term liabilities for rebates that will be applied through bills to customers' bills during 2023–24.
- Overall, net assets increased from £589.0 million to £864.6 million.

Financial performance continued

Dividend policy

Our dividend policy is formulated to ensure a fair balance of reward between customers and investors. To enable the successful delivery of our business plan for 2020–25, all stakeholders must share in success: customers benefiting through enhanced service and lower bills, and shareholders earning a fair return on the equity invested.

When proposing payment of a dividend, the directors of Southern Water Services Limited, acting independently in accordance with their directors' duties and in accordance with the company's licence, will apply the following principles:

1. Determination of a base level of dividend, based on an equity return consistent with our most recent Final Determination and our actual level of gearing. This recognises our management of economic risks and capital employed.
2. In assessing any adjustment to the base level of dividend, we will take into account all aspects of our performance. This would reflect our overall financial performance as compared to the final business plan as agreed by Ofwat and would explicitly consider a qualitative assessment of customer service levels and how customers share in our successes.
3. We will consider our financial resilience ahead of any dividend decision and whether any financial out-performance should be reinvested to benefit customers. This consideration will include taking into account the interests of our employees, other stakeholders, and our pension schemes.

   Our dividend policy is intended to support the financial resilience and investment grade credit ratings of the business and ensure continued access to diversified sources of finance. As part of step three, we carry out an assessment of:
   a. headroom under debt covenants
   b. the impact on the company's credit rating
   c. the liquidity position and ability to fulfil licence conditions
   d. key areas of business risk.
4. We will be transparent in the payment of dividends and will clearly justify the payment in relation to the factors outlined above.
5. We will publish our dividend policy annually (in the Annual Report) and highlight any changes.

No ordinary dividends were declared or paid in 2022–23 (2022: £nil).

On 26 July 2022, having undertaken a careful consideration of the company's financial position, progress in delivery for customers, and all other relevant factors, the Board approved the redemption of 5,164 of its Class B preference shares, at nominal value plus the premium on issue, including settlement for fixed value dividends due to that date. The total amount paid was £17.5 million, comprising principal redemption of £5.2 million and dividends of £12.3 million (2022: £nil).

Dividends on the preference shares accrue like interest and from an accounting perspective they are treated as interest, even though they are called dividends. The payment made in July 2022 was our first payment since 2020. These payments are made to a SWS group company and enable the payment of external interest on loans within the group. None of this money is paid to Southern Water shareholders.

An accrual totalling £4.5 million in relation to the cumulative liability of preference share dividends to 31 March is included within the financial statements as an inter-company creditor.

Tax strategy and policies

Southern Water and all group companies adopt the tax strategy and policies outlined below.

Our approach to the management of tax affairs is driven by our core values of succeeding together, always improving, doing the right thing and working with care, alongside the corporate strategy of the company. We have a low-risk tax appetite, and this is reflected in our management of tax.

The foundation of our tax strategy is to comply fully with tax legislation and to focus upon maintaining a strong tax compliance culture and an open and transparent relationship with HMRC.

To enable this, we undertake regular compliance reviews both internally and externally to ensure our tax policies are consistently applied. Our approach to tax planning is to align to business decisions made in the best interests of customers and stakeholders, rather than use tax planning to drive or determine business decisions. The very nature of our business means we always take a long-term view on all the activities we undertake. We therefore ensure our tax strategy, and approach to tax, is sustainable, ethical, considers both social and corporate responsibilities and can stand up to external scrutiny. When faced with a decision or business case, the ongoing tax impact is always considered as part of that decision-making process.

Financial performance continued

Our approach to tax management and governance

We ensure we are fully compliant with tax laws, rules, regulations and reporting requirements in all operations. This extends to following both the letter of the law as well as the spirit of the law. A culture of doing the right thing is embedded in our core values and our approach to tax embodies this by ensuring we pay the right amount, in the right place, at the right time. We also use the expertise of professional tax advisers to ensure we maintain best practice in our approach to compliance and in circumstances when additional advice is deemed appropriate.

The management of the tax affairs of Southern Water and all companies in the group is the responsibility of the Tax team. Roles and responsibilities within the Tax team are clearly defined. The Tax team reports to the Group Treasurer, who in turn reports to the Chief Financial Officer (CFO). The CFO is the Senior Accounting Officer (SAO) and has ultimate responsibility for the tax affairs for Southern Water and the Southern Water Group companies.

Our management of tax risk

As indicated above, we adopt a conservative approach to tax risk. Our tax management focus is on compliance, systems and governance and our tax planning is always aligned with our commercial and economic activity. All companies within the group are subject to UK tax and all companies are UK tax resident, irrespective of their place of incorporation, ensuring that each company is subject to UK tax.

Tax risk primarily emanates from the evolution and complexity of the business, along with the ever-changing regulatory and legislative environment. We manage this risk by having an experienced Tax team dedicated to tax compliance and the identification and management of tax risks in our business.

Our Tax team works with the business to ensure there are processes and controls in place and determine what level of risk is acceptable. We also work with industry tax experts who provide specialist services, check what we are doing and provide guidance on compliance requirements. Our Internal Audit team also carries out assurance on the control environment relating to the transactional processes underpinning our payments to the Exchequer and our collection of taxes on behalf of the Exchequer.

Our relationship with His Majesty's Revenue and Customs (HMRC)

A key factor in our management of our tax affairs is our relationship with HMRC.

We meet all statutory and legislative requirements and we manage our tax affairs in an open and transparent way. This extends to us sharing information with HMRC, which goes beyond the normal filing of statutory returns, such as the sharing of internal audit findings so that we can be open and transparent in our approach to managing tax risk. HMRC shares our view of our low-risk approach to the management of our tax affairs with the last HMRC assessment being that we were deemed to be a 'low-risk' company, and this was reaffirmed with HMRC in December 2022.

Maintaining public trust

As previously stated, we are committed to complying fully with tax legislation, maintaining a strong culture of compliance and having open and constructive relationships with tax authorities. We do not use tax avoidance schemes or take an aggressive approach on tax planning when interpreting tax legislation.

We apply government and fiscal authority tax incentives and exemptions, where they exist. For example, the UK tax system recognises the benefit to the economy of investment in infrastructure and environmental protection through the availability of capital allowances, which reduce the corporation tax Southern Water pays. Any benefits of this are passed to our customers through reduced bills.

Southern Water and all Southern Water Group companies pay taxes in the UK and have never used offshore companies to avoid tax or levies. In October 2022 all assets and liabilities from our Cayman Islands registered subsidiary were transferred to two new UK tax registered entities (both subsidiaries of Southern Water Services Limited) and this Cayman Islands-registered entity has now been dissolved effective at the end of June 2023. It was originally set up to issue debt in the UK (see page 119 for more information). Its Cayman Island registration did not have any impact on the tax due by the group.

The full amount of the court fine and the associated costs awarded to the Environment Agency that were incurred and recorded in the accounts for 2021–22 has been fully disallowed for tax, i.e. Southern Water does not receive any tax benefit for this deduction.

Although our tax strategy is reviewed and updated each year, it is not expected to significantly change from year to year.

We regard this publication as complying with our duty as required under paragraph 16(2) of Finance Act 2016 for the financial year ended 31 March 2023.

Financial performance continued

Understanding our taxable profits and our corporation tax

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

- **Capital allowances and depreciation** – capital allowances are a way of obtaining tax relief on certain types of capital expenditure. These are treated as a business expense and so reduce our taxable profit. Depreciation represents how much of an asset's value has been used up and reduces accounting profit. Capital allowances are applied at different rates than used for depreciation. As a result, there is a difference between capital allowance deductions made against our taxable profits and depreciation made against our accounting profits. The annual variance between capital allowances and depreciation results in a difference between our taxable profit and our accounting profit. Due to the large scale of our capital expenditure programme and the level of capital allowances available and utilised, our taxable profits are significantly reduced.
- **The treatment of interest costs** – we borrow money to finance our capital expenditure programme. The interest associated with this borrowing is recognised as both an accounting and tax expense, reducing profit and the amount of tax we pay. However, there are differences between the amounts of interest recognised for accounting profits and for taxable profits. Examples are that movements on the fair value of our financial derivatives are not recognised in our taxable profits, and interest that is capitalised in our financial statements is treated as an expense when calculating our taxable profits.
- **Group relief** – Southern Water is part of the Greensands Holdings group of companies as set out on pages 116 to 119. All of these companies are taxable as UK companies and profits or losses of the companies within the group can be set off against one another in the financial year. Group relief can be claimed by Southern Water Services Ltd where the standard rate of tax for the losses claimed is paid. For 2022–23, no tax for these losses was paid, therefore there was no group relief claimed.
- **Deferred tax** – the cumulative difference between taxable profits and accounting profits, which are expected to be temporary and reverse in future years, is presented as deferred tax on the statement of financial position. Changes to the future rate of corporation tax revise the carrying value of these differences.

Our tax charge is reduced by our large capital expenditure programme and the interest we are charged on borrowings. The benefit of this is passed to our customers through reduced bills. There is no corporation tax allowance within our customer bills for the regulatory period from April 2020 to March 2025.

Details of our tax charge for the current financial year are disclosed in note 10 to the financial statements and the current year charge to the income statement is also explained further on page 210.

Financial performance continued

Our other tax contributions

Our other contributions to the Exchequer amounted to £82.1 million. These are explained below:

- Business rates of £27.7 million paid to local authorities (2022: £27.8 million) and payments to the Environment Agency of £8.5 million (2022: £8.0 million) for abstraction licences and discharge consents, which reduce profits chargeable to corporation tax.
- Employment taxes of £45.9 million (2022: £40.6 million) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions.

No payments have been made to other group companies for tax losses surrendered to the company. As a result of capital allowances and interest charges, no corporation tax was paid by the company to HMRC in 2022–23.

Financial KPIs

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

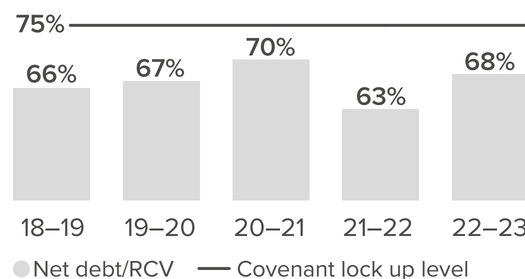
The net debt to RCV ratio is calculated as short and long-term senior borrowings less cash and short-term deposits, for the consolidated SWS group of companies, to the RCV. The RCV is set by Ofwat at each five-year review and reflects our initial market value plus subsequent capital investment and inflation. The RCV is adjusted at each periodic review for relevant changes to the level of expenditure or performance during the five-year period.

The adjusted cash interest cover is measured as the ratio of net cash inflow from operating activities less RCV depreciation to net cash interest expense for the consolidated group of SWS companies.

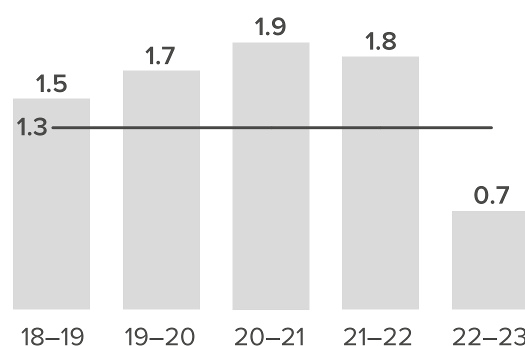
Credit ratings shown here are as at the date of publishing the accounts.

Debt covenant

Net debt/RCV



Adjusted cash interest cover ratio



The covenanted lock-up level/trigger level refers to debt covenants where payment of dividends by Southern Water is not permitted. These are structural buffers to protect against a default covenant, e.g. the covenanted default net debt to RCV level is at 95%.

Credit rating as at date of publishing the accounts

Standard & Poor's

Class A debt:

BBB+

Fitch

Class A debt:

BBB

Moody's

Class A debt:

Baa3

Notes: SWS is in a Trigger Event under our Common Terms Agreement which would restrict the payment of dividends and require the preparation of a remedial plan for our lenders. Southern Water has obtained a waiver from its lenders to continue to access permitted financial indebtedness to refinance the business in the event of a downgrade Trigger Event.

A further credit rating downgrade, or the assignment of a negative outlook, by Moody's would lead to a restriction on the payment of dividends under the terms of our Licence.

Under our Common Terms Agreement, a Trigger Event would occur if any two of the credit ratings fall to BBB (Standard & Poor's), BBB (Fitch) or Baa2 (Moody's) or below; and a Default would occur if any two of the credit ratings are less than the minimum rating required for the status of investment grade.

Capital structure

Read about our costs on pages 106 to 107

Why Southern Water raises finance

Significant capital investment has been a feature of our business since privatisation in 1989. We have invested in both maintaining our existing asset base and constructing new assets to improve the environmental quality of wastewater, improve the quality of drinking water and accommodate population growth in our area of operation.

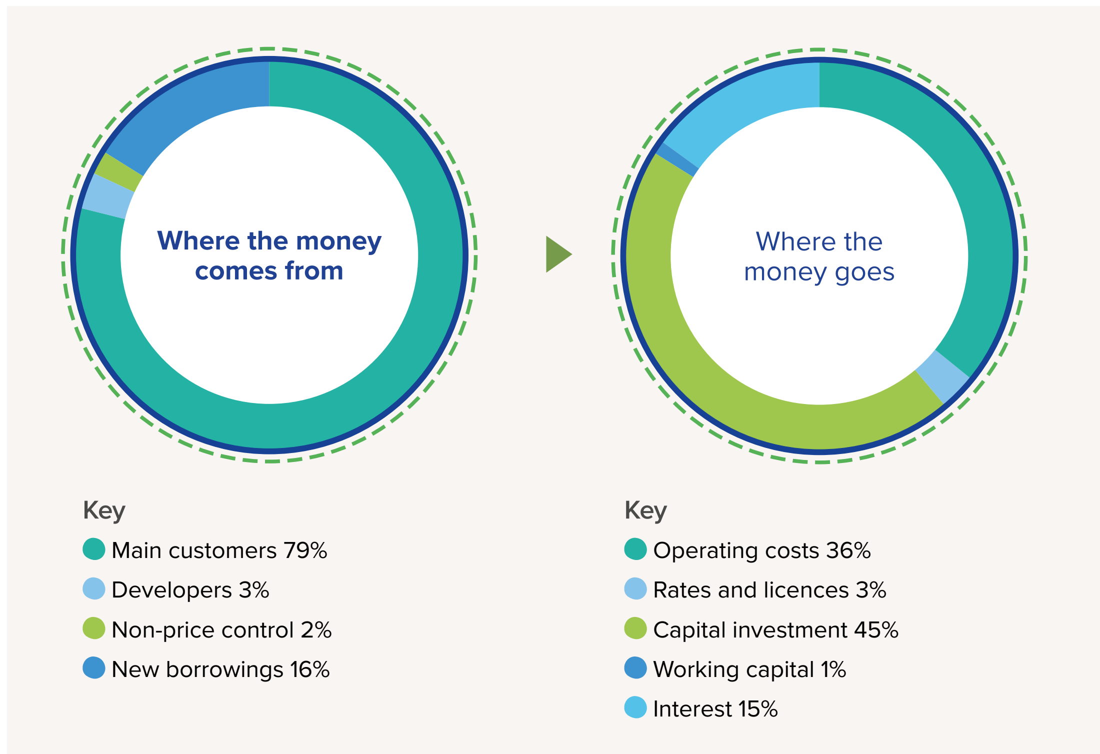
As an example, before privatisation, 350,000 cubic metres of wastewater per day was discharged into our coastal waters untreated, but the completion of our £300 million Cleaner Seas for Sussex scheme in 2013 marked the conclusion of a programme of capital investment to fully treat wastewater of the coastal towns and cities from Kent to Hampshire and the Isle of Wight. A further example is our £100 million construction project at Woolston, which has improved the quality of effluent discharged into the River Itchen and reduced odours.

We raise finance to pay for the construction of new assets and to repay loans taken out in previous years. We cannot rely wholly on raising new finance to pay for the construction of new assets. Our shareholders contribute approximately 30% of the funds we require towards this and to also provide the financial buffer we need to absorb financial risk.

Revenues from our customers are used to meet the costs of running the business (our operating expenditure), the cost of maintaining our assets, and to pay for the interest on the finance we raise and a return on the equity provided by our shareholders, to finance the capital investment programme. Our economic regulator, Ofwat, ensures that we can only charge our customers for an efficient level of cost, which is benchmarked against our peers.

The charts below illustrate the sources and uses of expected cash flows for the business plan 2020–25 and demonstrate our requirement to raise finance to fund our capital investment programme. The data is based upon the regulatory price determination for 2020–25, which sets out both our performance obligations and the limits on customer bills for this five-year price period.

Capital structure continued



Where the money comes from

Main customers – income for the provision of our core water and wastewater services.

Developers – income from the provision of services to developers for the provision of infrastructure and new connections to our network.

Non-price control – income from non-appointed activities.

New borrowings – additional financing raised to support delivery of our capital investment programme.

Where the money goes

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

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

Capital investment – includes investment to maintain our pipework and treatment works as well as the construction of new assets to enhance treatment standards and cater for growth.

Rates and licences – business rates on buildings, wastewater treatment and water supply works and Environment Agency licences.

Working capital – the timing and growth of the difference between expenditure and receipts.

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

Capital structure continued

GSH ownership

MSCIF Wight Bidco Ltd
Funds managed by Macquarie Asset Management on behalf of long-term investors including pension funds and insurance companies.

IIF Int'l SW UK ParentCo Ltd
A constituent entity of the Infrastructure Investments Fund, a fund advised by JP Morgan Asset Management (JPMAM), a large-scale global asset manager advising institutional investors.

UBS Asset Management
Shareholding advised by UBS Asset Management, a large-scale global asset manager, offering investment capabilities across all major traditional and alternative, asset classes

Hermes Infrastructure funds
Hermes Infrastructure is part of Federal Hermes International and is a specialist infrastructure manager operating a diversified, well-established, UK-focused shared investment platform.

Other
Minor shareholdings held by infrastructure investment companies

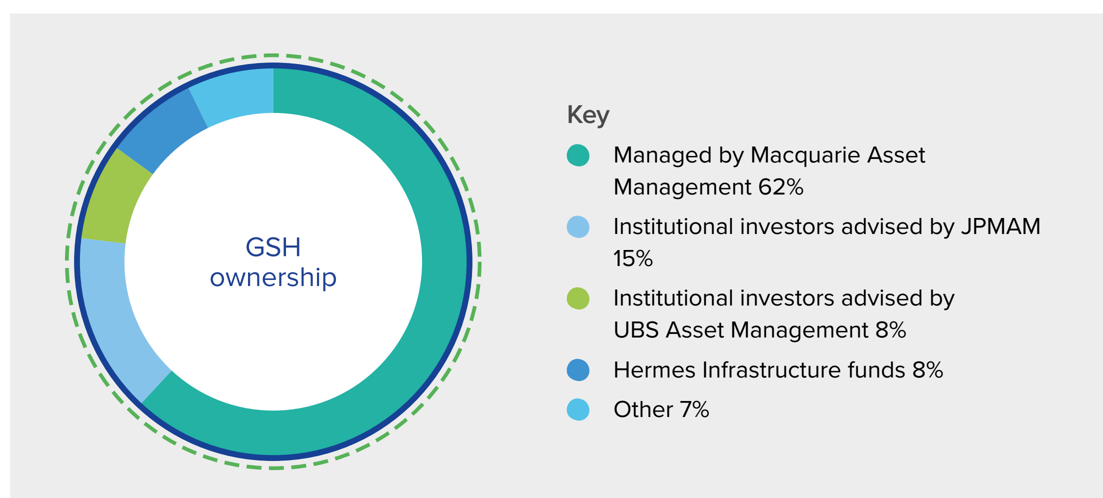
Ownership and structure

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

Ownership

GSH is owned by a consortium of long-term investors representing infrastructure investment funds, pension funds and private equity.

In September 2021, funds managed by Macquarie Asset Management (MAM) acquired a majority stake in GSH, with an investment of over £1 billion of new equity into the group. This new equity was used to recapitalise the ownership structure and improve the financial resilience of Southern Water. None of the proceeds were paid to the existing shareholders of GSH.



GSH Board

The GSH Board comprises three directors, appointed by GSH's majority shareholder.

The purpose of GSH is to act as a single-purpose entity as the ultimate holding company for Southern Water and the other companies within the group. The GSH Board complements and supports the aims of Southern Water for its long-term success. While certain matters are reserved to the GSH Board and/or shareholders in GSH, they do not impact the day-to-day operations of Southern Water and nor do they materially affect Southern Water's ability to function as a company in providing an essential public service.

Group structure

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

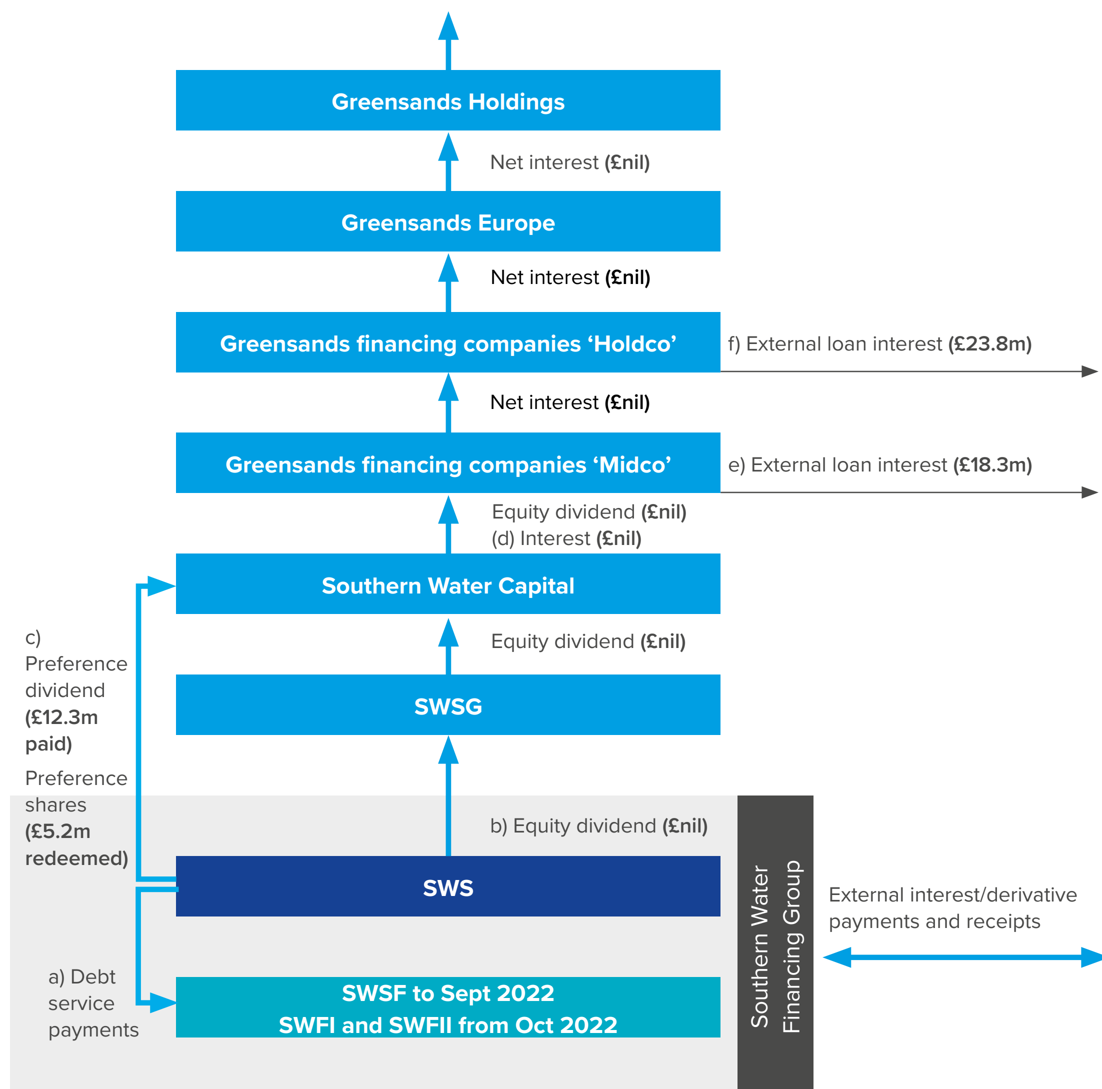
During 2018–19, additional Greensands financing companies were added to the group structure as part of a financing plan to improve financial resilience of Southern Water ahead of the five-year price review period starting April 2020.

As mentioned above, funds managed by Macquarie Asset Management acquired a majority stake in the Greensands group in September 2021. This investment was used by the group to repay external debt totalling £476.0 million and make a cash injection into Southern Water Services totalling £529.9 million from the settlement of an inter-company loan and the issue of new equity.

Capital structure continued

A summarised group structure, together with details of the interest and dividend payments between companies are shown in figure 1 below.

Fig. 1



In summary, SWS has paid £nil to internal companies. Greensands companies have paid external loan interest payments of £42.1 million.

No interest or dividends have been paid to investors in Greensands Holdings.

Footnote:

a. Interest payments from SWS to SWSF to September 2022 and SWSF I and SWSF II from October 2022 on the loans taken out by these companies on behalf of SWS.
This is then used by SWSF, SWF I and SWF II to pay the interest on these external loans.

b. There were no ordinary dividends during the year.

c. Dividend payments made on the preference shares issued by SWS of £12.3 million in relation to dividends accrued at March 2022.
In addition, preference shares totalling £5.2 million were redeemed and dividends of £4.5 million accrued for 2022–23.

d. Interest payable on inter-company loans from Southern Water Capital to Greensands Investments.

e. External interest paid by GSF Ltd, funded from interest receivable and cash held at 'Midco'.

f. External interest paid by SWGF, funded from interest receivable and cash held at 'Holdco'.

g. Dividends paid to investors.

Capital structure continued

Corporate Level	Companies	Description
Greensands Holdings	Greensands Holdings Limited (GSH)	The ultimate parent company for the group.
Greensands Europe	Greensands Europe Limited (GSE)	Intermediate holding company. Listed (Jersey) Eurobonds held by shareholders in proportion to their equity were converted to an inter-company loan with GSH in June 2021.
Greensands financing companies 'Holdco'	Greensands UK Limited (GSUK) Greensands Junior Finance Limited (GSJF) Southern Water (Greensands) Financing plc (SWGF) Greensands Senior Finance Limited (GSSF) Greensands Investments Limited (GSI)	A group of companies established to provide additional external financing for the acquisition of the Southern Water Capital group of companies in 2007 plus a further £250 million of additional finance raised in 2019, the proceeds of which were invested into SWS. The security granted to the lenders of this financing is limited to the share capital of GSH. There are no debt guarantees in place between the Greensands financing companies and the Southern Water Financing Group, with the result that SWS is fully protected, and fully isolated, from a default at any Greensands company.
Greensands financing companies 'Midco'	Greensands Finance Holdings Limited (GSFH) Greensands Finance Limited (GSF Limited) Greensands Financing plc (GSF plc)	A group of companies incorporated in 2018 as part of a financial restructuring exercise to improve the financial resilience of Southern Water. The objective of the restructuring was to reduce the total leverage within the Southern Water Financing Group. There are no debt guarantees in place between the Greensands financing companies and the Southern Water Financing Group, with the result that SWS is fully protected, and fully isolated, from a default at any Greensands company.
Southern Water Capital	Southern Water Capital Limited (SWC) Southern Water Investments Limited (SWI)	Intermediate holding companies established 2002 as part of a previous ownership structure.
Southern Water Services Group	Southern Water Services Group Limited (SWSG)	Intermediate holding company established as part of a previous ownership structure.
Southern Water Financing Group	SWS Group Holdings (SWSGH) SWS Holdings Limited (SWSH) **Southern Water Services Limited (SWS)** Southern Water Services (Finance) Limited (SWSF) SW (Finance) I plc (SWFI) SW (Finance) II Limited (SWFII)	SWS is the regulated water and wastewater company. It is the company that this Annual Report and financial statements relates to. SWSF was incorporated to raise finance on behalf of SWS and was closed in October 2022 and dissolved in June 2023. SWFI and SWFII have been incorporated to replace SWSF. The Southern Water Financing Group was established in 2003 and comprises a legal framework where each company guarantees the obligations of others within the group. Security granted to the lenders within this group is limited to the share capital of SWS Group Holdings Ltd. This structure ensures that SWS can continue to operate as a regulated water and wastewater company in the event of a default by any group company.

Capital structure continued

All companies are UK tax resident and therefore subject to UK taxes.

Most companies within the group are incorporated in the UK. The exceptions are:

- Greensands Holdings Ltd is incorporated in Jersey, but UK tax resident. The company was incorporated there because Jersey law allowed greater choice than the UK about the way distributions can be made to shareholders while treating UK and non-UK investors equally.
- Southern Water Services (Finance) Ltd was incorporated in the Cayman Islands, but was UK tax resident. SWSF was established for the express purpose of raising debt finance on behalf of SWS. Due to administrative reasons applicable at the time of forming the Southern Water Financing Group, it was necessary for SWSF to be registered in the Cayman Islands to raise debt listed on bond markets. This original requirement is no longer necessary, and in October 2022 we replaced SWSF with two new UK incorporated companies, SW (Finance) I plc and SW (Finance) II Limited and the company is now closed.

How we finance the business

In note 20 to the financial statements, we provide an analysis of our outstanding debt at 31 March 2023 and 31 March 2022. Our loans comprise: sterling bonds, issued by our financing subsidiaries SWFI and SWFII and listed on the UK Stock Exchange; other loans, including loans from US insurance companies; bank loans; and a loan from the European Investment Bank.

The regulatory framework under which revenues and the RCV are indexed exposes us to inflation risk. This risk is managed through the use of inflation-linked loans and derivatives within the overall debt portfolio. We do not intend to access future inflation-linked debt through the use of derivatives, but will instead seek such debt from natural sources, such as public and private bond markets. As a consequence, we expect the proportion of the RCV and debt that is currently linked to inflation through the use of derivatives will decrease over time. We are not restricted to issuing only sterling debt, but will ensure any other currency loans are fully hedged back to sterling. We also hedge our exposure to interest rate volatility by ensuring that at least 85% of our outstanding debt liabilities (in respect of Class A and Class B debt) is either inflation-linked or fixed rate for the current five-year regulatory period and at least 70% in the next period (on a rolling basis).

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

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

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

The Greensands companies also have their own loans:

- Loans issued by Greensands Finance Limited and Greensands Financing Plc, represented in the diagram above as part of the 'Midco' financing companies.
- Eurobonds issued by Greensands Europe, which were converted to an inter-company loan with GSH in June 2021.
- The Greensands financing companies also maintain liquidity facilities (£40.0 million at Greensands Midco financing companies to October 2027), which can provide a source of finance to pay interest on loans.

Risk management approach

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

Risk management is a core component of our governance and internal control framework, which provides the structure through which we conduct business.

Risk is inherent in our business and we face a diverse range of risk and uncertainties that cannot be completely eliminated. The purpose of our approach to risk management is to support better decisions through an improved understanding of risk. Those risks that have the potential to have a material impact on our company and our ability to deliver on our strategic objectives are our principal risks. Our risk governance model ensures that we can manage, monitor and report on our principal risks to maintain a resilient business. These risks are described on pages 127 to 130.

Managing risk

Our approach to risk management is designed to provide a clear and consistent framework for managing and reporting risks associated with our operations, to executive management and to the Board.

Our risk management framework is the totality of systems, structures, policies, processes and people that identify, measure, monitor, report and control or mitigate internal and external sources of risk.

The framework seeks to promote better decision-making, to strengthen our operational resilience and support the best outcomes and opportunities for the company and our customers through effective:

- **Risk identification and ownership**: understand the risk environment, identify the specific risks we face and assess potential exposure.
- **Risk assessment**: determine how best to manage identified risks to balance exposure.
- **Risk response**: take action to manage the risks we do not want to be exposed to, ensuring our resources are effectively and efficiently prioritised and used.
- **Risk monitoring, reporting and escalation**: report on a quarterly basis to the Executive Risk Committee, Audit Committee, and the Health and Safety and Operational Risk Committee and to the Board on a periodic basis on how significant risks are being managed, monitored, assured and the improvements that are being made.
- **Risk appetite and communication**: use our analysis to support the Board's determination of risk appetite and to monitor and report against it.

Across the company our risk management approach is embedded within the business directorates and their business processes. We have established a risk management approach that provides a consistent basis for measuring risk to:

- establish a common understanding of risks on a like-for-like basis, taking into account potential impact and likelihood,
- report risks and their management to the appropriate levels of the company,
- inform prioritisation of specific risk management activities and resource allocation.

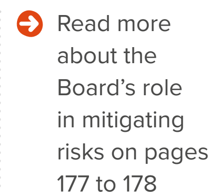
All areas of the company review significant risks and business processes to help inform and enable risk-based decision-making. As part of our annual planning process, the Executive Team and Board review the company's principal and emerging risks.

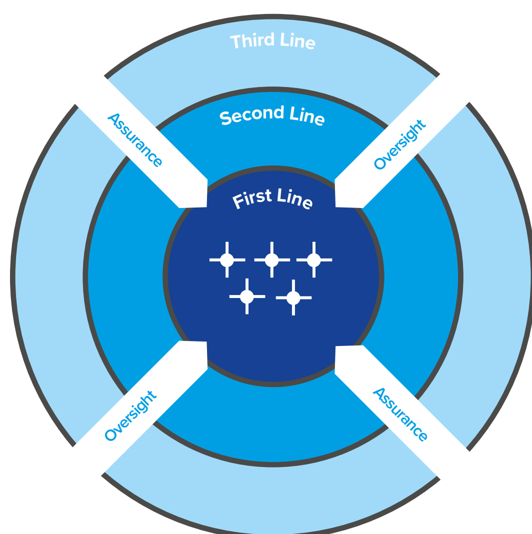
Risk management approach continued

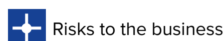
Three lines of defence

Our approach to risk management adopts the 'three lines of defence' model in which risk ownership responsibilities are functionally independent from oversight and assurance:

- Primary responsibility for risk management lies with the business. The risk owner is the first line of defence. An important part of the role of all employees is to ensure they manage risks appropriately.
- The Risk Management function forms the second line of defence and provides independent and objective review and challenge, oversight, monitoring and reporting in relation to material risks.
- Independent External Assurance and the Internal Audit function act as the third line and provide independent assurance on the business control environment and the effectiveness of the wider system of internal control.


Read more about the Board's role in mitigating risks on pages 177 to 178





First line
- The functions that own and manage risk.

Second line
- The internal functions that oversee risk and regulatory compliance activities.
- Provide guidance, direction and oversight.
- Develop the related assurance frameworks.

Third line
- Provides independent assurance on the business control environment, and the effectiveness of the wider System of Internal Control.

The next 12 months

The coming year will see continued integration of our risk management framework and approach. This will see risk management efforts focused on maturing our activities in a number of areas, including:

- Advancing a dynamic risk-aware culture throughout the company.
- Enhanced risk reporting to the Board, Board Committees and Executive Team.
- Continued training across the company to embed our business partnering model and to develop their enterprise risk profiles and support risk-based decision-making.
- Strengthening our analytical risk management capabilities through use of our Governance, Risk and Compliance (GRC) system to utilise enhanced risk management data and insights to facilitate risk-based decision-making and deliver business intelligence reporting.

The continuous improvements that we are making with our risk management approach are setting the company up for future success. As we further embed these improvements, we will be able to demonstrate to our customers and external stakeholders that the decisions we make are considered, well thought through, and demonstrate continued commitment to our values.

Risk oversight and governance

Risk oversight and governance

To successfully embed risk management, the process is supported by a governance structure that defines roles and responsibilities at each level of the company. The Board has overall accountability for risk management but discharges this role through the Audit Committee. It oversees and advises on enterprise and corporate risks, while the Health and Safety and Operational Risk Committee oversees and advises on operational risk.

Role of the Board

The role of the Board is to promote the long-term sustainability of our company and our responsibilities to shareholders, customers, employees, and the communities in which we operate. It has overall responsibility for risk management within the company.

The Board is responsible for maintaining an effective risk culture and is committed to:

- reviewing, endorsing and monitoring our approach to risk culture and conduct
- forming a view on our risk culture and the extent to which it supports our ability to operate consistently within our risk appetite.

The Board defines our risk appetite, enabling the company, in both quantitative and qualitative terms, to judge the level of risk it is prepared to take in achieving its overall objectives.

Our risk appetite is directly aligned to our principal risks. The risk appetite for each of these underpins our governance and reporting framework and is subject to regular review by the Board. The alignment of our principal risks with risk appetite allows for an informed analysis and discussion of our risk position and provides the Board with the insight to make key-decisions.

As a company we are tolerating a level of risk which is outside our current risk appetite and is reflected in the review of our principal risks in the coming pages. This can result in more focus on short-term issues than longer-term resilience.

The Board ensures the oversight and monitoring of our risk culture, risk appetite and risk management activities through the Audit Committee.

Role of the Audit Committee

The Audit Committee is responsible for the review of the company's internal financial controls systems that identify, assess, manage and monitor financial risks, and other internal control and risk management systems. It advises the Board on the company's overall risk appetite, tolerance culture and strategy, taking into account the current and prospective regulatory, legal, political, macroeconomic and financial environment with the Board retaining overall ownership and approval.

The Audit Committee oversees and advises the Board on current risk exposure and longer-term strategic risks to determine our future risk strategy. It also has a key role in risk assessment:

- reviewing the company's overall risk assessment processes for enterprise and corporate risks that inform the Board's decision-making, ensuring qualitative and quantitative metrics are used;
- reviewing regularly and approving the parameters used in these measures and the methodology adopted; and
- setting a standard for the accurate and timely monitoring of large exposures and corporate risk types of critical importance.

In addition, the Audit Committee reviews the company's capability to identify and manage new and emerging risk types and reviews reports on any material breaches of risk limits and the adequacy of proposed action.

Role of the Health and Safety and Operational Risk Committee

The Health and Safety and Operational Risk Committee is responsible for the oversight and assessment of the overall adequacy and effectiveness, of the health, safety and wellbeing policies, strategies; processes and controls; operational risk management and compliance with relevant legal and regulatory requirements, with the Board retaining overall ownership and approval.

The Health and Safety and Operational Risk Committee has a key role in:

- reviewing the areas of significant corporate and individual health, safety, wellbeing and operational risk whether the executive is managing these risks effectively, including via the supply chain;
- reviewing the company's health, safety, security and wellbeing performance;
- reviewing operational risk and risk management of information security, information governance, water, wastewater and customer services;
- reviewing of the scope, and results, of any: health, safety, wellbeing, information security, information governance, water, wastewater and customer operational risk audits; and
- considering the findings of internal and external investigations and executives' response.

Risk oversight and governance continued

Role of the ESG Committee

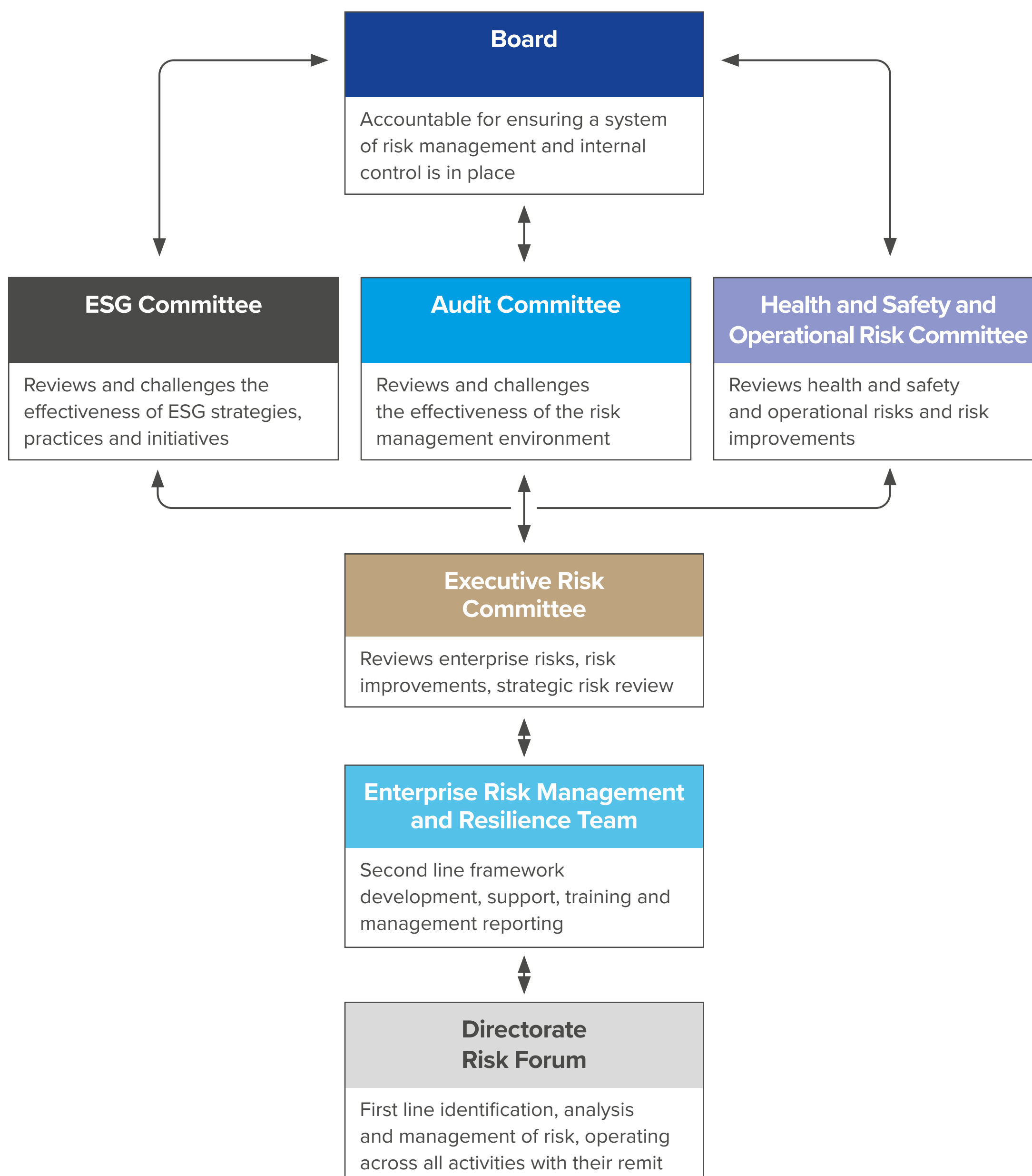
The ESG Committee was formed in 2022 to provide greater oversight and consideration of the material environmental, social and governance matters relevant to the company's activities.

ESG Committee is responsible for the review of the risks related to our environment, social, and governance practices, commitments, policies, and strategies.

The ESG Committee has a key role in:

- reviewing our progress and performance on Net Zero Plan delivery;
- ensuring the effective operation and delivery of our annual Climate Change Action Plan;
- providing oversight on the adoption and implementation of climate related disclosure regulations.

Key risk and governance responsibilities include:



Emerging and principal risks

Read more on our principal risks on pages 127 to 132

Emerging risks

We regularly consider new, changing, or emerging risks that could affect our ability to achieve long-term objectives. We define emerging risks as uncertain future events that are challenging to assess due to their unpredictable nature or lack of reliable information. We undertake regular horizon-scanning exercises to identify and monitor emerging risks. Our risk assessment process monitors available management information from a wide variety of internal and external business and environmental sources and analyses potential causes, impacts, likelihood, and the time frame over which a risk could occur. Our immediate horizon scan reviews possible emerging risks and their potential impact on the company within the next five years. These include:

Emerging risk	Description	Relevant activity
DWI enforcement regime	In early 2021, the Drinking Water Inspectorate (DWI) began work to change its method of regulatory enforcement to consider a new approach to include a punitive financial penalty regime within its regulatory framework. Southern Water is currently subject to a number of DWI notices; this could lead to a risk of additional financial penalties.	We continue to work closely with the DWI to respond and resolve our open notices in a timely manner. We are committed to reform and improve our performance related to our business operations and our provision of a sufficient supply of high-quality drinking water.
Escalating global conflicts	In 2022, war broke out in Europe between Russia and Ukraine. Tensions continue to escalate between the United States and China, Iran and Israel and in the Korean peninsula.	We are monitoring the potential expansion of global unrest to include new areas of conflict or types of conflict, resulting in new types of or expanded risk consequences, especially in relation to our supply chain and IT network.
Rainfall patterns and extreme weather	The changes in rainfall patterns and extreme weather resulting from global warming are creating a wider impact on our natural environment, including drought mitigations, flood defences and land erosion.	Associated risks are assessed and mitigated within our wider climate change strategies, our published Drought Plan and in our Drainage and Wastewater Management Plan (DWMP) to specifically address storm overflow reform and the Flood Action Plan.
Climate action failure	Climate action failure is defined by the failure by governments, corporations and businesses to take up active climate change mitigation measures and help protect ecosystems and livelihoods around the world.	We are committed to understanding the evolution and impact of climate change on our business and on the natural water supply and ecosystems. Associated risks are assessed and mitigated within our wider climate change strategies and we use our insight and knowledge to help policymakers craft their strategies and legislation to support and advance climate effective change solutions.

Emerging and principal risks continued

Principal risks

Those risks that have the potential to have a material impact on our company are our principal risks. We manage, monitor and report on the principal risks that can impact our ability to deliver our objectives. As part of our annual planning process, the Executive Team and the Board review the business's principal risks. These may be updated during the year in response to changes in internal and external circumstances.

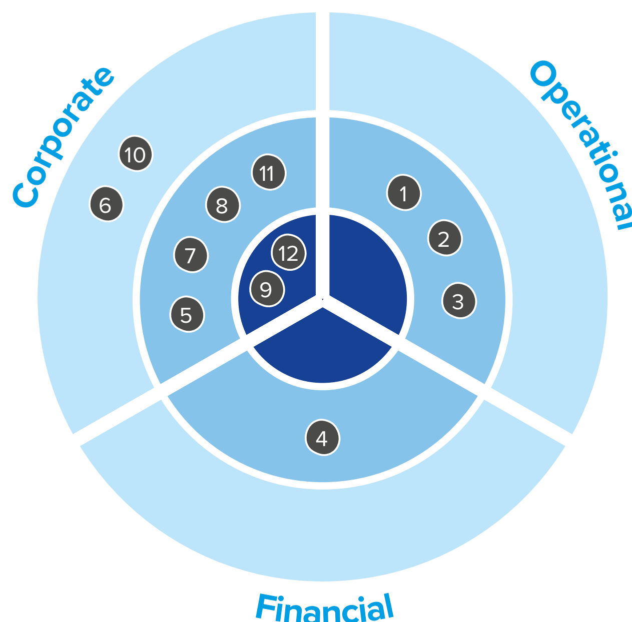
We currently have 12 principal risks. These are a key feature of our risk taxonomy and risk appetite. Our principal risks reflect our commitment to our values: doing the right thing, succeeding together, always improving and working with care. We review our principal risks and their risk components on an annual basis, ensuring emerging risks are reflected and that the current structure adequately reflects the risk context in Southern Water.

In 2022, our business was challenged by the impact of the ongoing war in Ukraine that intensified supply chain delays and failures, fuelled inflation and energy price increases, and had a deteriorating effect on our principal risks. We had to rapidly adapt to this changing operational environment to mitigate these accelerating macro-environmental influences.

Principal risks

Principal risk radar

The principal risk radar provides an indicative view of the current risk position of each of the principal risks, relative to each other.



- Improving
- Stable
- Deteriorating

Risk		Category	Risk climate	Commentary
1	Water	Operational	▶◀	We are challenged by several significant water supply disruption events on key operational sites which have resulted in an increased interruption of supply to our customers.
2	Wastewater	Operational	▶◀	We are challenged to manage an increase in capacity demand and extreme weather events while meeting our regulatory targets.
3	Customer	Operational	▶◀	We continue to support our customers through supply and service events and the challenges of the current cost of living crisis.
4	Financial	Financial	▶◀	We are working with Shareholders to bring in additional finance to the company to support long-term financial resilience, in addition to strengthening our internal financial control environment.
5	Compliance	Corporate	▶◀	We remain under continued scrutiny by our regulators as we transform and deliver on our business plan.
6	Climate Change	Corporate	▲	Planning and mitigation for climate change is embedded in our long-term strategic plans e.g. DWMP, WRMP, WINEP).
7	Delivery	Corporate	▶◀	We are challenged to deliver our capital investment delivery programme and Opex funded strategic projects due to prolonged macroeconomic conditions.
8	Information Technology (IT)	Corporate	▶◀	The global heightened cyber security threat has increased risk in this area. Our IT estate requires continual monitoring and improvement to maintain resilience.
9	Resources	Corporate	▼	Global inflationary pressures and disruption in goods or services availability has delayed supply and significantly increased our operational and capital costs.
10	Health, Safety, Security & Wellbeing	Corporate	▲	Our Health and Safety Transformation Programme is designed to improve our operations, comply with regulations and embed our Safety-First culture across the business.
11	Corporate Affairs	Corporate	▶◀	We have increased our communications in relation to service event management and recovery and work closely with our communities and regulators to support and influence the protection of our natural environment.
12	People	Corporate	▼	We are challenged to manage and develop our workforce in a competitive employment environment that has been strongly influenced by rising inflation and the current cost of living crisis.

Risk climate ▲ Improving ▶◀ Stable ▼ Deteriorating

Principal risks and uncertainties

Risk Climate Key:
▼ Deteriorating
▲ Improving
⧓ Stable

Operational risk

1 Water

We must make sure we can supply enough good quality drinking water to cater for a growing population of more than 2.7 million people across the region. Warmer summer weather and colder winters over the past two decades impact our supply/demand balance and increase our risks in relation to drought or significant water source depletion. Should we experience, water contamination, water treatment or distribution network failures, there is a risk that water may be unfit for consumption or customers may experience disruption to their water supply.

Executive accountability:

Director – Wholesale Water

Risk climate: ⧓

Following one of the driest summers on record in 2022, we have experienced a winter season that has seen higher than average rainfall which has replenished our groundwater sources, reservoirs and rivers.

Aside this, we continue to work hard at reducing leakage, which was impacted by the hot summer of 2022 and cold winter of 2022–23. We have employed digital technology to address network leakage performance, increased our field resource, continue to invest in pressure calming solutions, and have expedited speed of repair by a factor of 2.

During the year, we were challenged by several significant water supply disruption events on key operational sites which have resulted in an increased interruption of supply to our customers. We are continuously working to improve the reliability of our water supply works by putting in place new assets and improving maintenance. Our event management and operational control teams deployed immediate response and repair plans, along with establishing bottle water stations and issuing up to date communications across several media platforms to keep customers informed.

We have improved our logistics capability so we can move people and materials around faster, 24/7. This includes a new tanker fleet, storage of critical spares and an overhaul of our work management processes. We have also, improved the management and control of our sites and networks and our core systems and processes

Mitigating strategy:

- Water for Life – Hampshire, a programme of significant capital and asset improvements to provide long-term resilience.
- Water First, our improvement programme strengthening internal processes and asset performance.
- Improving the reliability of our water supply works by undertaking a complete overhaul of our four main sites, benefiting 62% of our customers.
- Investing to improve our leakage position with installation of more loggers, new data points and pressure management calming tools.
- Upgrading our logistics capability.

Cross reference:

Read more about how we are understanding and supporting our customers and communities on pages 42 to 51.

Read more about how we ensuring a supply of high-quality water for the future on pages 52 to 58.

Operational risk

2 Wastewater

We are committed to provide our customers with reliable wastewater services essential to maintain public health and protect the environment.

Periods of excessive rainfall or extreme weather may cause drainage and flooding issues. If operational wastewater treatment assets, our wastewater network or processes fail, we may discharge non-compliant sewage. These events may cause risks to the environment or public health from pollution and/or sewer flooding.

Executive accountability:

Director – Wastewater

Risk climate: ⧓

Our performance has been significantly challenged, specifically in light of increased capacity demand, fluctuations in extreme weather events and challenging regulatory targets. Improving our pollution performance is a key focus for the business and is supported by our strategic Turnaround Plans and our Pollution Incident Reduction Plans. We are building capacity and resilience at our wastewater treatment works and system networks to reach 99%+ compliance with treatment and permit standards to reduce pollution occurrences and the impact our operations might have on the environment. This means making sure our pumping stations and networks continue to operate effectively as our climate changes. We have established a dedicated Clean Rivers and Seas Task Force to enhance our network assets and reduce blockages, including an investment of £5 million to implement our Pathfinder projects to tackle the root cause of the storm overflows. We continue to work closely with our customers, the general public and stakeholders with respect to our impact on the environment; with a key focus on spills to the environment in rivers, chalk steams and bathing waters.

Mitigating strategy:

- Over £1.5 billion investment to 2025 to improve the capacity, capability and resilience of our wastewater network across the region to ensure our pumping stations and networks continue to operate effectively as our climate changes.
- Increased investment in Storm Overflow programme.
- Updated and enhanced Pollution Incident Reduction Plan.
- Updating our maintenance standards and proactive control to stop assets failing and developing an improved emergency response.
- Digitalisation of our sewer network to reduce pollutions and flooding, using industry-leading monitors, artificial intelligence for prediction and maintenance.
- Effective Event Duration Monitoring (EDM) and the expansion of EDM coverage on Beachbuoy, our online tool for information on storm release activity near coastal bathing waters.
- Improving training, development, and productivity by upskilling our front-line colleagues.

Cross reference:

Read more about how we protect and improve the environment on pages 59 to 68.

Principal risks and uncertainties continued

Risk Climate Key:
▼ Deteriorating
▲ Improving
⧓ Stable

Operational risk

3 Customer

We are committed to providing an excellent customer experience, as expected by our customers and regulators. We are prioritising our customer experience by ensuring that every colleague understands and responds to our customers and their unique needs.

When we experience interruption to services there is a risk that we are not able to deliver the standard of service expected by our customers. During these periods, we seek to address and rectify the cause of the underlying issues while also proactively managing our customers concerns in a timely manner.

Executive accountability:
Chief Customer Officer

Risk climate: ⧓

During the year, our service delivery has been challenged by a number of significant supply events that have resulted in a customer supply disruption, prolonged outage and it has negatively impacted our customers view of our performance and reputation. This was reflected in our annual customer satisfaction (C-MeX and D-MeX) performance metric measures and is a key area for our focused rebuild and improvement. In response, we enhanced our customer communications by implementing customer text messaging during incidents to keep them informed and up to date on our repairs and return to service timelines. We are also developing a new customer website which will enhance our customer service and experience.

To manage current economic pressures, household bills were increased in line with inflation. However, we continue to support our most vulnerable customers who have been most impacted by this cost of living crisis. We increased our social tariff cross-subsidy from £6.00 (for a dual service customer) to £8.50. This will allow us to increase the minimum discount offered from 20% to 45% and will support a further 21,000 customers in addition to the 107,000 who could be supported through the lower subsidy amount.

Mitigating strategy:

- Improving the digital customer experience including video assistant, a new website, improving customer journeys, data quality and complaints process.
- Enhancing our Customer Culture through customer promises and customer service training for all colleagues and partners.
- Better engagement with our communities through improved multi-channel and direct communications, education programmes and regular stakeholder forums.
- Supporting customers in vulnerable situations by improving our priority services during incidents and our social tariff offering.

Cross reference:

Read more about how we are understanding and supporting our customers and communities on pages 42 to 51.

Read more about how we ensuring a supply of high-quality water for the future on pages 52 to 58.

Financial risk

4 Financial

We are committed to managing the financial position of the company to ensure sufficient liquidity to meet our funding requirements and maintain service delivery for our customers. In the past two years we have been challenged by sustained macroeconomic volatility, leading to prolonged financially uncertain outlook. This is impactful to our ability to raise finance to fund the capital investment programme and to refinance debt maturities. Our internal cost control remains a key focus for all teams across the business.

A failure to maintain certain credit ratings could lead to an increase in interest cost, reduced availability of new capital and breach of our license conditions.

Executive accountability:
Chief Financial Officer

Risk climate: ⧓

Sustained macroeconomic volatility has increased pressure on our operating and capital budgets and created significant cost control issues. Additional cost control pressures have arisen from our response activities to our water supply outages and pollution events. This has resulted in some delays and impacted our current business plan, delivery plan and funding. We are working to strengthen our financial controls and to implement systems and processes to reduce these operational events. We are currently preparing our Business Plan 2025–30, which will outline our ambition and determine our future funding.

We have engaged with our shareholders to seek an additional £550 million of equity funding for the group, of which £375 million would be injected into the regulated entity, SWS, to allow it to invest even further above its regulatory funding for this regulatory period; we anticipate this process to conclude later in 2023.

We completed some financing activity in 2022–23 and expect to secure additional external financing in the year ahead to support our business plan ambitions and delivery. We continue to be at risk of a credit rating downgrade as a result of our poor operational performance and rapidly rising inflation. Our credit ratings are provided on page 128.

Mitigating strategy

- Liquidity testing and reporting is carried out on a regular basis, forming part of the 'going concern' assessment
- Sufficient cash and facilities are maintained to mitigate such risks as bond market closures
- Flexible dividend policy supports management of financial risk
- Detailed budgetary scrutiny of operational spend
- Improved operational performance.

Cross reference:

Read more about our financial performance on pages 102 to 119.

Principal risks and uncertainties continued

Risk Climate Key:
▼ Deteriorating
▲ Improving
⧓ Stable

Corporate risk

5 Compliance

As a regulated industry, we are committed to meeting an expected high standard of compliance with regulatory and corporate legislation.

Failure to comply can result in regulatory enforcement, fines, legal action and, in the worst case, the loss of our licence to operate as a water and wastewater company. Existing and changing legal and regulatory requirements encourage the business to operate in an agile way to ensure continued compliance with our obligations.

Executive accountability:

General Counsel

Risk climate: ⧓

We remain under continued scrutiny by our regulators. We are continuing our work to resolve a number of prior years prosecutions by the Environment Agency (EA) for wastewater permit breaches, sampling processes and governance approach. We continue to assist the EA with its ongoing investigations into these legacy issues and with their national investigations into flow compliance. The Drinking Water Inspectorate (DWI) and the EA continue to monitor our delivery of regulatory schemes (outputs) and this is likely to continue in the future.

During the year we received six Final Enforcement Orders in relation to delays in the delivery of our key capital works for the current business plan. We are working with our regulators to prioritise the delivery for those key sites, and have detailed supporting work plans in place.

Mitigating strategy:

- Delivery of key transformation and training programmes in both water and wastewater parts of the business.
- Ensuring appropriate governance through the embedding of a robust Three Lines of Defence compliance model.
- A compliance framework with internal monitoring and assurance and an ethical business framework.
- Compliance with company procedures is reviewed through our Statement of Compliance self-assessment every six months.
- Transparent communication with our various regulators.

Cross reference:

Read more about our three lines of defence on page 121.

Corporate risk

6 Climate change

We are committed to understanding the impacts of climate change and appropriately adapting our business operating model to ensure reliable continuity of service to our customers while protecting our natural environment and resources.

Failure to improve our resilience to the effects of climate change will impact our ability to deliver a sustainable supply of water to meet the growing demands of our customers and our ability to effectively manage the capacity and capability of our assets and sewer network. We must be resilient to both the physical effects, from extreme or prolonged weather events that could lead to flooding, pollution or damage to operational sites from coastal erosion or subsidence, and from transition risks including changes in policy, regulation and markets.

Executive accountability:

Chief Executive Officer

Risk climate: ▲

Extreme weather events are becoming more frequent. Severe winter storms and heavy rainfall impact our ability to effectively manage flooding and pollution events. Extended periods of dry weather greatly reduces the reliable availability of our water supply. We are challenged to balance the limitations of our stringent abstraction licences with our ability to meet customer demand while protecting our natural resources and the environment.

We are a long-term business and as such we are required to produce a number of strategic plans that include consideration of the long-term management of our water and wastewater assets to ensure that they continue to be available to provide services to customers and adapt to the changing environment we live in.

These include our published draft Water Resources Management Plan, which sets out how we will balance supply and demand for water over the next 80 years, and our first ever draft Drainage and Wastewater Management Plan, which analyses the key wastewater challenges and solutions in each of our drainage catchments over the next 25 years. We are currently in the process of producing our business plan submission for 2025–30 which will outline the investment we need to make to our assets, including mitigating and adapting to climate change risk.

Mitigating strategy:

- Annual Climate Change Adaptation Report.
- Net Zero Plan.
- Water Industry National Environment Programme (WINEP).
- 50-year Water Resources Management Plan (WRMP).
- Target 100 water efficiency programme.
- Drought Plan.
- Investment in new infrastructure.
- Drainage Wastewater Management Plans (DWMP).
- Operational resilience plans.
- Bioresources strategy.

Cross reference:

Read more about our approach to tackling climate change on pages 75 to 95.

Read our Climate Adaptation Report: **southernwater.co.uk/our-performance/reports/climate-adaptation-consultation**.

Principal risks and uncertainties continued

Risk Climate Key:
▼ Deteriorating
▲ Improving
⧓ Stable

Corporate risk

7 Delivery

We are committed to the delivery of our business plan 2020–25. We have significantly invested in upgrading our existing operational sites and sewer networks and developing our capital programme. We have also increased our investment in technology to advance our ways of working to deliver a more responsive customer experience. In the past 12 months we have developed a long-term strategy and plans for significant improvements and upgrades to our four large water treatment plants at Testwood, Otterbourne, Hardham and Burham between now and 2032. We are currently preparing our business plan (2025–30) for submission to Ofwat in October 2023.

Failure to deliver significant parts of the programme on schedule, will impact our ability to provide an excellent service to our customers, compromising or preventing us from fulfilling the commitments that we have made in our business plan and to our regulators.

Executive accountability:

Chief Operating Officer

Risk climate: ⧓

The ambition of the current capital investment delivery programme combined with the current macroeconomic environment has increased pressure on our ability to deliver on time and within budget. We have launched four key strategic plans to focus our delivery for the remainder of our current business plan around water quality and security of supply, pollutions and environment, trusted and easy customer service and health and safety. Their delivery is supported by three enablers which prioritise financing and efficiency, people and IT/digitalisation.

We are currently in the process of producing our business plan submission for 2025–30 which will be our most ambitious to date. This reflects our long-term commitment to our customers and the protection of our natural environment.

Mitigating strategy:

- We have brought significant investment capability in house including:
  - An in-house engineering and capital delivery function
  - An established long-term delivery partner supply chain.
- Risk and value are considered at each step of the investment cycle to provide best value for money to our customers
- Monitoring the delivery of our Final Determination obligations, continually assessing our financing status.
- Procurement and planning process are underway and on track to support the 2025–30 business plan delivery.

Cross reference:

Read more about our Long-Term Priorities and how they inform our five-year delivery strategy on pages 42 to 95.

Corporate risk

8 Information Technology (IT)

We are committed to providing IT services, capability and support to the business and improve our ways of working. We maintain the essential resources and processes to protect the company from external or internal attack, both physical and virtual and to protect our IT network, systems and data in accordance with our obligations under relevant regulations and legislation.

Failure to maintain the resilience of our operational and corporate IT networks and systems could have a significant impact on our business continuity, and the resilience and capability of our operational assets.

Additionally, we hold and process personal and payment data about our customers and employees. Failure to properly protect the data we hold could lead to reputational damage and loss of confidence from our customers, as well as significant fines under Data Protection (GDPR) and the Network and Information Systems (NIS) Directive.

Executive accountability:

Chief Information Officer

Risk climate: ⧓

The sustained conflict between Russia and the Ukraine has increased the disruptive and destructive attacks on global organisations IT networks and systems by cyber hacktivists. This has escalated risks associated cyber security across all businesses. We have adopted the National Cyber Security Centre's (NCSC) Cyber Assessment Framework (CAF) to achieve and demonstrate an appropriate level of cyber resilience. We are continually reviewing and adapting the resilience of our approach to cyber security to ensure we are adequately protected from potential cyber threats.

As a mature company, our IT estate requires continual maintenance and improvement to deliver the required capability across the business. We are also challenged to manage the volume of demand from across the company for IT solutions and expertise for digital technologies to advance our various projects and programmes, and to meet customer and regulatory expectations.

Mitigating strategy:

- Business continuity processes reducing impact on IT systems.
- Active programme for migration of services off legacy infrastructure and onto new fully-managed infrastructure.
- Migration of existing critical and core service applications into the new data centres.
- Enhanced suite of IT general controls identified following alignment to the Network and Information System (NIS) – Cyber Assessment Framework.
- Continued investment in cyber threat mitigation strategies in response to the ever-changing risk landscape.

Principal risks and uncertainties continued

Risk Climate Key:
▼ Deteriorating
▲ Improving
⧓ Stable

Corporate risk

9 Resources

We are committed to establishing a sustainable, resilient, outcome-based supply chain for the provision of essential goods and services to support the delivery of our business plan that can adapt to market shocks. These include the supply of Engineering, Construction and Asset Management Advice to support our capital delivery programme and repair & maintenance services, chemicals, fuel, and spare parts to ensure continuity of service across our network and operational sites, as well as the energy required to power our operational equipment on a continuous basis, at a commercially viable price. We use long-term contracts for the provision of critical goods, services and works, as well as outsourced activities. In the past year, global inflationary pressures and disruption in goods or services availability has continued to delay supply of some commodities and services, and increased our operational and capital costs.

Failure to appropriately protect the resilience of our supply chain could lead to significant business interruption and result in an inability to deliver our commitments to our customers and stakeholders.

Executive accountability:

Chief Financial Officer

Risk climate: ▼

During the year we have continued to be challenged by the rising costs of goods and services due to rapid inflation and delays or failures in the global supply chain. This has caused a significant impact on both our operational costs as well as the ability to deliver on our capital programmes and projects within scope and budget. In response, we have commenced a significant review of our operational supply contracts and have focused on establishing new supply chain frameworks for a wide variety of operational site services, using category spend management to drive opportunities, mitigate risk, benchmark prices, and achieve savings and efficiencies. We have also implemented an improvement in our contract management system and processes, and are looking at how we simplify our contracting approach to create the right conditions for improved supplier relationships that better position us as an 'attractive client' to secure best rates, resources and innovation. While our operating model employs several mitigation strategies to hedge the effect of these type of market events, it has not been possible to completely mitigate the current unprecedented economic conditions.

Recent macroeconomic influences have impacted capacity throughout our supply chain. This significantly impacts our external third party suppliers ability to deliver timely and cost effective goods and services and has created many challenges with managing performance, quality and consistency.

As part of our Business Plan submission for 2025–30, the procurement process for key contractors and suppliers for our capital delivery programme and network maintenance is underway. We have established a balanced scorecard to better align our supply chain to our strategic themes, this will be a core part of our supplier selection, tender evaluation, and supplier performance management. A Market Engagement Event was held on 7 February 2023 to outline the vision and strategy to the market.

Mitigating strategy:

- Hedging strategy is in place for energy cost fluctuations/ increases to manage impact to end customers.
- An enhanced Contract Management framework was implemented to effectively work with suppliers.

Corporate risk

10 Health and safety

We are committed to ensuring that the health, safety, security and wellbeing of our employees and the public is of the highest priority. The nature of our work requires that our employees and contractors undertake activities or use equipment which, if uncontrolled, have the potential to cause significant harm. Failure to comply with our Health and Safety Management System and associated procedures could result in death, serious injury or adverse health effects.

Executive accountability:

Chief Executive Officer

Risk climate: ▲

The safety of our communities, colleagues, and supply chain partners remains our highest priority. Our recently launched Health and Safety Transformation Programme includes our new corporate value, Working with Care. Together they are designed to improve safety standards, establish a robust system of operational process reviews and inspections, comply with governing regulations and legislation and support our colleagues and contractors in their day-to-day work to embed our Safety First culture across the business. The results of this are already being seen in the 20% reduction in our Lost Time Incident Accident Frequency Rate experienced in the financial year 2022–23.

Mitigating strategy:

- A review and update of all our safety policies and procedures, including a new policy statement and the issuing of CEO empowerment cards to encourage adherence and challenge in the business.
- The rollout of a new, app-based, online Safety Reporting System to improve information flow, awareness and the management of hazards and incidents.
- Upgrading the capacity (by 50%) and capability of the H&S team to enhance investigations and deliver better support to frontline teams.
- Improving the safety of our colleagues when conducting physical work through the introduction of a new mobile AI based risk safety app.
- The allocation of ring-fenced monies to repair hazards identified by the workforce.
- Delivery of a behavioural change project, including an immersive actor led away day, a revised site audit and inspection plan, enhanced manager health and safety training and a mandated Senior Leadership Visit programme.
- Enhanced communications, including the launch of the fourth Corporate Value, Working With Care, our "Stop, Think, Act" campaign and target local initiatives.
- A new induction strategy, to update our existing training requirements and expand their application to cover our supply chain workforce to ensure that all personnel are aware of the potential dangers specific to each operational site.
- A continued focus at Board level with a Health and Safety and Operational Risk Committee.
- The integration of SafetyFirst in every meeting or activity, including at the Executive Safety Committee which has been expanded by 33% to cater for the growth in reporting.
- Enforce suppliers and delivery partner safety standards.
- Strategic Reviews of Security and Wellbeing.
- Managing our compliance through new systems, inspections and assurance.

Principal risks and uncertainties continued

Risk Climate Key:
▼ Deteriorating
▲ Improving
⧓ Stable

Corporate risk

11 Corporate affairs

We are committed to engaging in regular and transparent communication with our customers and stakeholders. We appropriately monitor and adapt to any changes in our political and regulatory frameworks, or take a lead role to advocate and influence positive change to the political or regulatory landscape impacting both our industry and our natural environment.

Failure to do this may impact our relationships and reputation with our customers and stakeholders and may result in business disruption or regulatory fines.

Executive accountability:

Director of Corporate Relations

Risk climate: ⧓

Our relationships with customers and stakeholders is strongly connected to our operational performance. During the year we were challenged by several significant service disruption events and noncompliant spills, which have resulted in an increase in customer complaints and negative media coverage. We understand that increased monitoring is essential to improve our wider environmental performance and to achieve a significant reduction in the use of storm overflows. We continue to invest in improvements to the timeliness and accuracy of our data. We have engaged in open conversations with our customers, community leaders and regulator and provide timely reporting of events to share causes, impacts and future mitigation to prevent re-occurrence. We are committed to improving our performance and accountability to rebuild our trust and connection with our communities.

Mitigating strategy:

- Work with our customers to understand their service delivery needs and expectations.
- Monitor developments in the requirements from all of our regulators on key issues.
- Maintain close dialogue with Government, Ofwat and other regulators on key issues.
- Continue to engage constructively with all of our regulators in regards to the water scarcity challenges.
- Investment Pathfinder projects to improve CSO performance.
- Investment in Event Duration Monitoring (EDM) and the expansion of EDM coverage on Beachbuoy, our online tool for information on storm release activity near coastal bathing waters.
- Work with our regulators on how we better understand and address our customers' needs to enable successful outcomes in the next business plan period 2025–30.

Cross reference:

Read more about our Long-Term Priorities and five-year delivery strategy on pages 42 to 95.

Corporate risk

12 People

We are committed to attract, retain, and establish succession planning to maintain a workforce of the right people, with the right skills for the role. This is a central part of our long-term strategy and our ability to ensure the company is agile and adaptable to change.

We have designed our people risk framework to support a diverse and inclusive culture that promotes employee engagement and demonstrates the desired conduct and behaviours that align with our values. It includes building and retaining an industry-leading workforce and managing our people to upskill and develop our talent. This means we can ensure that we have the right resources to support our operations while implementing HR processes and procedures that support, protect and manage our people, and provide a fair and transparent reward and recognition programme.

Failure to develop our workforce and implement a successful succession planning programme across the business can significantly impact our service delivery and result in business interruption and our ability to meet our customer and regulatory commitments.

Executive accountability:

Chief People Officer

Risk climate: ▼

We continue to manage challenges in relation to talent attraction and retainment especially in the Technical and STEM roles. Our recruitment efforts are also impacted in part by our geographic location. In the past year, the already competitive employment environment has been strongly influenced by rising inflation and the current cost of living crisis. We have established industry relationships with specialty recruitment partners to help us manage our talent attraction strategy. We are committed to supporting an empowering and collaborative work environment that recognises performance and facilitates career progression and development.

Mitigating strategy:

- Ongoing workforce planning analysis and high-level strategic talent reviews take place across the business to assess capability and capacity needs
- Development of a Talent Acquisition Strategy
- Our internal INSPIRE Academy supports in-role development and career progression
- Our recruitment strategy streamlines our best route to market
- Our annual engagement surveys assess our employee satisfaction with remedial action plans developed by teams
- Strong inclusion and diversity culture.

Cross reference:

Read more on our people on pages 69 to 74.

Viability Statement

Southern Water Services (SWS) is a regulated utility which is characterised by a long-term investment horizon, over multiple-price control periods with stable revenues. Ofwat sets price controls for five-year periods, which reduces the potential for variability in revenues from the regulated business. The company benefits from a rolling 25-year operating licence.

Ofwat regulates the water industry in England and Wales and has a statutory obligation to ensure that water and wastewater companies can finance their functions. In addition, the regulator has a primary duty (under the Water Act 2014) to ensure that water and waste companies have the long-term resilience to meet the needs of customers.

In preparing the long-term viability statement (LTVS), SWS has included an expected equity receipt of £375 million (£550 million into the group). The proceeds are expected to be received by the end of October 2023, and to be used to invest in the operational turnaround plan of SWS. The equity was not committed at the date of signing the accounts and therefore considered to be a material uncertainty for the going concern statement (see page 205). This expected equity receipt is in addition to the £529.9 million received by SWS in September 2021.

SWS has conducted an assessment covering the period up to March 2030, which aligns to the price control cycle and covers the current and next cycle. The analysis has taken into account current performance, planned performance improvements, funding of the defined benefit pension scheme and the principal risks that affect the business as documented in the Strategic Report on pages 120 to 132. Scenarios were developed with reference to a quantification of financial effects of specific risks incorporated in the principal risks faced by the business, as well as consideration of the gearing sharing mechanism relating to gearing in the current five years period to 2025, and the recovery in the next five years period of additional expenditure incurred during the current five years period. These risk scenarios were then tested both individually and in combined scenarios. An overview of this analysis is provided on page 134. Mitigating actions and the effectiveness of these actions were also considered.

The analysis has also considered the long-term financing needs of the business, including the maturity profile of existing debt, which extends to 2056. Future financing plans assumed for the long-term viability statement includes £825 million of new finance to be raised by March 2025, £400 million of which is to repay existing debt; plus £4.5 billion of projected new finance used for the capital investment programme and the repayment of £2.2 billion of debt maturities and inflation-linked accretion repayments during the period 2025 to 2030.

Assessment period

For the LTVS, the Board continues with a forward-looking term up to 31 March 2030:

- SWS has accepted the commitments and customer promises in the Final Determination for 2020–25 and the SWS Board has agreed a business plan for the period to March 2025, albeit there is a material uncertainty regarding the expected equity receipt of £375 million by the end of October 2023.
- The Board notes that analysis of financial resilience over the period 2025 to 2030 is uncertain given a plan for this period will not be agreed with Ofwat, our regulator, until at least February 2025. SWS will, however, be producing a plan for the period from 2025–30 as part of the business plan submission to Ofwat in October 2023, following which there will be a period of review by Ofwat, leading to a final determination in December 2024. SWS will have the right to appeal the final determination which will extend the period of uncertainty into 2025. A preliminary view of the SWS plan submission has been used for the long-term viability assessment. However, cost allowances, performance challenges and returns are yet to be set, implying a wide range of potential outcomes, which have been taken into account in the stress tests below.
- It is not considered practicable to extend the period beyond 2030 given the inherent uncertainties already present in the forecasts used to 2030.

Viability statement continued

Stress tests

The ‘principal risks’ identified (pages 120 to 132) are recognised as the key risks facing SWS and those that will have the potential greatest impact on the business. These are regularly reviewed by the Board. Based on the principal risks, the following risk factors are considered to have the potential for a negative impact on the financial position of SWS.

- **Outcome Delivery Incentive (ODI) penalties:** These may materialise as a result of under-performing on performance commitment targets set by Ofwat, which are significantly more challenging compared to the previous price control.
- **Increased expenditure:** Increased expenditure has been considered in light of the challenging cost allowances set in the PR19 Final Determination as well as unexpected costs arising from high energy prices, high inflation, operational incidents, and maintaining service during periods of severe weather.
- **Outturn inflation is different to forecast:** SWS’s financial projections are sensitive to inflation scenarios given the index-linked nature of business cash flows and a number of credit metrics which include inflation adjustments (SWS uses inflation forecasts published by HM Treasury). SWS has in place inflation linked debt and derivatives to mitigate some of this risk.
- The likely financial impact of these risks has been estimated and used in the construction of severe, but plausible, downside scenarios. In developing these scenarios, we have considered combinations of risk factors and the potential correlations between risk factors.

Stress test	Link to principal risks	Specification of stress test
ODI penalty	Operational risks	ODI penalties resulting from failing to deliver on performance commitments due to operational failures. (RORE -2.0% to 2025 and -0.4% to 2030).
Increased expenditure	Operational risks Corporate risks	Increased expenditure resulting from the principal risks (see pages 120 to 132) over and above the costs already in the plan which are £1.2 billion more than the PR19 Final Determination). (Sensitivity +3.7% of each year to 2030).
Macroeconomic shock – low inflation	Financial	Inflation forecasts to 2030 -1%.
Macroeconomic shock – high inflation	Financial	Inflation forecasts to 2030 +1%.
Combined operational scenario	Operational risks Corporate risks	+4.3% overspend to 2030 combined with the ODI penalties, and high inflation.
Combined operational scenario	Operational risks Corporate risks	+4.3% overspend to 2030 combined with the ODI penalties, and low inflation.

Viability statement continued

Assessment of results and mitigating actions

There is limited financial flexibility within the assessment period to 2030. Primarily the result of a significant level of planned expenditure to improve resilience of SWS assets, to accommodate population growth in the Southeast, and to reduce the impact on the environment from the treatment and processing of water and wastewater.

For the period to March 2025 SWS is planning to spend an additional £1.2 billion to improve asset resilience whilst also incurring unexpected costs arising from high energy prices, high inflation, operational incidents, and maintaining service during periods of severe weather. Should a severe weather event occur (or a greater number of severe events in close succession), management believes that the costs of this can therefore be accommodated, although it (or any other significant one-off cash cost) may require rephasing of borrowing and spending plans. ODI penalties incurred during the period and customer reparation to 2025 also reduce customer receipts. Significant resource has been invested in a turnaround plan for SWS, which is expected to achieve demonstrable improvement in performance by the end of current five-year period to 2025

The additional investment to 2025 is expected to improve operational resilience for the period 2025 to 2030. The demand for further investment will, however, result in limited financial flexibility as the 2025 to 2030 investment plan is expected to be around 50% larger than the plan determined for the period to 2025.

A consequence of the significant increase to planned spend is that dividends are retained in SWS to finance enhancement expenditure, in addition to the expected receipt by October 2023 of £375 million of new equity. Restricting dividends is, therefore, not available as a mitigation to increased expenditure.

SWS is in a credit rating Trigger Event as a result of current credit ratings. There is a risk of a further credit rating downgrade if SWS is unable to deliver its planned improvement to operational performance and business efficiency for the remainder of the current regulatory period to March 2025. SWS also expects be in a debt covenant Trigger Event for the remainder of the current period to 2025 as a result of the impact on financial ratios of significant additional expenditure.

Credit ratings are expected to recover during the period from 2025 to 2030 as a result of improved operational performance from the significant additional expenditure in the period to 2025, plus the natural reset associated with a new five-year regulatory period, including the cessation of customer reparation in 2025.

Therefore, SWS is expected to be out of Trigger for the period 2025 to 2030. There is, however, a risk of a Trigger Event during the period 2025 to 2030 if operational performance does not adequately recover by 2025 and if increased expenditure cannot be effectively mitigated within planned expenditure to 2030.

A Trigger Event (see page 113 for further explanation) would result in restrictions on the payment of dividends and for SWS to prepare a plan, for the Security Trustee, of how it plans to recover from Trigger. Southern Water obtained a waiver from its lenders in 2021 to permit continued access to financial indebtedness, and to also continue to finance the business in a credit rating downgrade Trigger Event or the breach of interest cover ratio to March 2025. A further waiver to extend this period to March 2035 is expected to be secured as part of the planned new equity process.

A Default Event (see page 113 for further explanation) is considered unlikely and did not materialise in any of the scenarios tested. Financial forecasts include an expected equity receipt of £375 million by the end of October 2023. This is a material uncertainty for the going concern assessment (see page 205).

For each of the scenarios tested, we have identified appropriate mitigating actions if stress tests would result in projected metrics deteriorating materially. These mitigating actions are set out in the table on the following page.

Viability statement continued

Description of risk	Scenario	Potential mitigating actions
Costs incurred are higher than planned	Increased expenditure	Utilise contingency in AMP7. Re-prioritisation of expenditure, increase expenditure within debt covenants.
Underperformance on ODIs and totex	Combined operational scenario	Re-prioritisation of expenditure, increase expenditure within debt covenants.
Combined event – totex overspend, ODI penalty and high inflation	Combined scenario (high inflation)	Re-prioritisation of expenditure, increase expenditure within debt covenants.
Combined event – totex overspend, ODI penalty and low inflation	Combined scenario (low inflation)	This is the most severe scenario. Re-prioritisation of expenditure, increase expenditure within debt covenants. Risk of Trigger Event by 2030.

Viability

The Board has assessed the viability of SWS to the period March 2030. In doing so, it has considered SWS's current position, the principal risks facing the company and resulting stress tests, and the impact of mitigating actions.

The other companies in the wider Greensands group are principally in place to support the viability of the regulated business. The Board has taken into consideration the activities of other group companies (pages 116 to 119) as well as the overall group structure and is satisfied that it poses no additional risk to the financial flexibility of SWS.

In making their assessment, the directors have assumed that the planned equity injection will be successful, and capital markets will be available to provide funding for the significant ongoing capital investment programme as well as for the refinancing of debt, credit facilities and financial derivative maturities when they fall due. The directors anticipate the ability to efficiently raise new finance and a stable and supportive regulatory environment, but recognise that there is a material uncertainty relating to the £375 million equity raise not committed at the date of signing the financial statements that may cast significant doubt on the company's ability to continue as a going concern as detailed on page 205.

The Board is satisfied that it has sufficient information to judge the viability of the company and has a reasonable expectation, based on the assumption that it will be possible to raise additional debt and, subject to the material uncertainty as noted above, that the company will be able to continue to operate and meet its obligations over the period to March 2030.

Governance and assurance

The Board has reviewed the medium-term plan and reviews the company's principal risks from a strategic perspective, which form the basis of the stress tests modelled.

The Audit Committee supports the Board in reviewing the results of the analysis as part of its normal procedures. To support the Board in its assessment, a third-party assurance was obtained over the calculations applied to the financial projections for the LTVS in 2021.

The Strategic Report, including the directors' Section 172(1) Statement on pages 15 to 136, was approved by the Board of Directors and signed on its behalf by:

Richard Manning
General Counsel and Company Secretary
7 July 2023