# Financial performance

# Contents

# 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 results

The financial results are summarised in the table below:

| | Years ended 31 March | |
|---|---|---|
| Income statement | 2021 £m | 2020 £m |
| Revenue | 784.2 | 878.0 |
| Amortisation of regulatory settlement payments | 35.6 | 0.0 |
| Total revenue | 819.8 | 878.0 |
| Other operating income | 1.7 | 1.4 |
| Operating costs before charge for bad and doubtful debts | (360.0) | (373.5) |
| Charge for bad and doubtful debts | (34.8) | (29.6) |
| Depreciation, net of amortisation | (287.9) | (264.0) |
| Operating profit | 138.8 | 212.3 |
| Profit on disposal of fixed assets | 0.8 | 0.9 |
| Profit before interest and tax | 139.6 | 213.2 |
| Net finance costs | (51.6) | (119.2) |
| Fair value (losses)/gains on derivative financial instruments | (444.8) | 339.9 |
| (Loss)/profit before tax | (356.8) | 433.9 |
| Tax | 64.8 | (105.2) |
| (Loss)/profit for the financial year | (292.0) | 328.7 |

## Revenue

Revenue decreased to £784.2 million (2020: £878.0 million). This decrease in revenue was expected and principally results from the changes to our inflation-linked water and wastewater tariffs, which were agreed as part of our business plan for 2020–25. Our revenues were also affected by COVID-19, which reduced the level of trade effluent and developer income we received as well as reducing our main water and wastewater income.

As a result of COVID-19, we experienced a significant change in the mix of that revenue between household and non-household customers.

The national lockdown resulted in a large increase in household demand, with many customers spending more time at home. As a result, our household revenues for 2020–21 were £22.2 million above expectations. The increased household revenue was more than offset by a reduction in non-household revenue, resulting from the restrictions on businesses, which were £30.8 million below expectations.

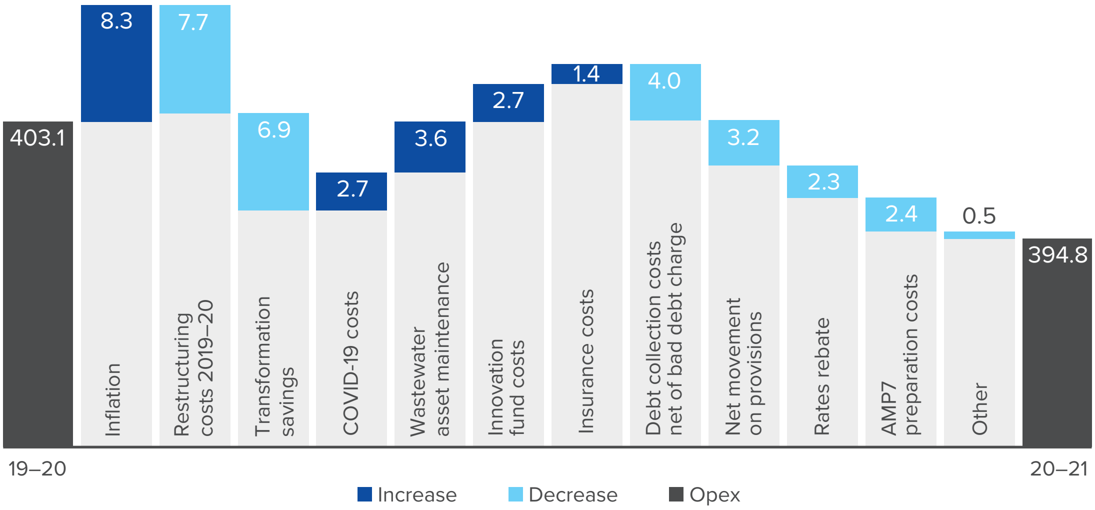
In 2018–19, we made provision for rebates, based on our regulatory settlement with Ofwat, to be provided to customers over the period from 2020–25. These rebates are now included within our tariffs and so part of the revenue reported in the income statement. The provision made in 2018–19 for these rebates is being released in line with the tariff adjustment over the same period.

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

## Operating costs and charge for bad and doubtful debts

Operating costs including the charge for bad and doubtful debts for the year decreased by £8.3 million from £403.1 million to £394.8 million. This decrease is explained in the chart below:

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




In order to prepare for the challenge of this five-year period, improve our services and reduce costs, we undertook a number of restructuring activities during 2019–20. These included transferring the majority of our customer services activities to Capita, closing our final salary pension scheme and reshaping a number of teams across the business. As a result, we incurred a number of one-off restructuring costs, totalling £7.7 million in the prior year.

These transformation activities resulted in a reduction of £6.9 million in our ongoing operating costs for 2020–21 as a result of lower employee and pension costs.

Over the course of the year, we have experienced a number of cost increases, the most notable of these being:

- The impact of COVID-19 – excluding the impact on debt collection, the net impact of COVID-19 was £2.7 million. This increase largely resulted from additional costs to ensure the health and safety of employees and contractors and facilitate remote working for our office-based staff, the treatment and water supply costs to meet the significant increase in customer demand for water, in particular during the first lockdown in May, and support for our supply chain to cover additional operating costs as well as extended vehicle hire costs. These increases were partly offset by some cost reductions, most notably regarding travel and expenses as well as the deferment of some training activities.
- Wastewater asset maintenance – we increased maintenance expenditure on our wastewater assets by £3.6 million in order to improve our wastewater operational performance and reduce the risk of equipment failures.
- Innovation fund costs – for the current five-year regulatory period, Ofwat introduced an innovation fund to drive innovation across the water industry through a series of competitions to select projects to progress. There is an allowance within the revenues we collect from customers for the cost of this fund and this income is ring-fenced for use on the schemes selected through the competition. Our operating costs for 2020–21 include a provision of £2.7 million for the liability for our contribution to the fund.
- Insurance costs – during 2020–21, we have experienced an increase in insurance premium costs of £0.6 million together with higher insurance losses, following a higher number of claims, of £0.8 million.

# Financial performance continued

The impact of these cost increases has been offset by a number of cost reductions:

- Debt collection costs – in response to COVID-19, and in order to support customers in financial hardship as a result of the pandemic, we suspended our debt collection activities during the year, which resulted in lower debt collection costs of £9.0 million. These savings were offset by an increase in our overall provision for bad debt of £5.0 million, reflecting the fact that the likely recovery of debt that has reached the end of the recovery process has worsened and the impact of the pandemic on our outstanding debt.
- Provisions – as reported in our Annual Report last year, we made provisions in 2019–20 of £3.0 million for historic guaranteed standards of service (GSS) payments for missed appointments and £1.0 million in relation to the charges presented by the Environment Agency to the court regarding historic wastewater performance. No additional provisions were made for these matters during 2020–21, resulting in a reduction in operating costs of £4.0 million offset by an increase of £0.8 million to the environmental provision held in respect of work to improve the resilience of the Rivers Test and Itchen in Hampshire for periods of severe drought. Further details regarding the Environment Agency investigation can be found on page 31 and in note 26 to the accounts.
- Rates rebate – following a successful appeal, we received a net reduction in our Business Rates charges of £2.3 million.
- AMP7 preparation costs – during the prior year, we incurred costs in relation to our business plan submission to Ofwat and our preparations for delivering our plans for this regulatory period. As a result, our operating costs fell by £2.4 million for this year.

## Depreciation and amortisation

Depreciation and amortisation increased to £287.9 million (2020: £264.0 million) as a result of the completion and commissioning of a large number of our capital investment schemes. The most significant of these were our new wastewater treatment works at Woolston, which increased depreciation by £4.0 million, and a number of short-life IT and system related assets, which added over £4.0 million.

## Operating profit

As a result, operating profit decreased to £138.8 million (2020: £212.3 million), a 35% reduction, the majority of which relates to the reduction in our revenues that was agreed as part of our business plan for 2020–25.

## Financing costs and profit before tax

Net finance costs decreased by £67.6 million to £51.6 million (2020: £119.2 million). This reduction is largely driven by the refinancing activities undertaken in the prior year, which have resulted in a reduction in net interest payable of £51.2 million. There was also lower indexation on our index-linked debt of £8.8 million and a lower financing charge associated with our pension deficit of £2.9 million.

The fair value loss on our derivative financial instruments amounted to £444.8 million (2020: gain £339.9 million). The primary driver for changes in the valuation is the fluctuation in UK government bond yields, which are used to discount the future cash flows. As government gilt yields are constantly moving, the valuation of our derivative instruments can be volatile. This is particularly evident over the past year, largely as a result of the pandemic, and the gain experienced at March 2020 has reversed as markets have recovered. These changes do not represent cash flows.

The loss before tax for the year amounted to £356.8 million (2020: £433.9 million profit).

## Taxation

We have recognised a total tax credit to the income statement of £64.8 million (2020: £105.2 million tax charge). This differs from the credit that may be expected of £67.8 million, based on the profit before tax of £356.8 million and the current period tax rate of 19%, as described in note 10. The difference is primarily due to the company receiving group relief losses surrendered by other companies in the Southern Water group for nil payment, and the announcement made in the Government's Budget Statement in March 2020 that the rate of Corporation Tax would not be reducing to 17% as announced and would remain at 19%. As a result, a charge of £40.3 million has been recognised in the income statement for the impact of this change on our deferred tax balance.

## Cash flow statement

Overall, cash and cash equivalents increased in 2020–21 by £210.2 million (2020: £242.7 million decrease). This movement of £452.9 million principally results from the refinancing activities that we undertook during the year. Further details of the year-on-year movements are provided below.

| | Years ended 31 March 2021 £m | 2020 £m | Movement £m | Explanation |
|---|---|---|---|---|
| Net interest related transactions | (201.1) | (175.0) | (26.1) | In total, the net cash outflow in relation to interest increased by £26.1 million. The principal reasons were as follows.<br>A payment of £194.5 million was made in 2020–21 (2020: nil) in relation to accrued indexation on our index-linked loans. This payment was offset by lower net interest payable in the year, following the refinancing activities completed in 2019–20 of £68.1 million.<br>In 2019–20, net interest payments also included interest of £107.2 million in relation to 2018–19 as the 31 March 2019 fell on a weekend. |
| Net movement on borrowings | 411.0 | (202.8) | 613.8 | During the year, we made loan and credit facility repayments totalling £696.2 million (2020: £417.8 million); these were offset by proceeds from new bonds issued under our Sustainable Finance Framework in May 2020 and March 2021 totalling £1,107.2 million (2020: £215.0 million). |
| Payments on restructure of derivative instruments | – | 140.0 | (140.0) | During 2019, we restructured the cash flows associated with an existing financial instrument, which brought forward a cash receipt of £140.0 million at present value. |
| Equity dividends paid | (4.0) | (7.1) | 3.1 | In FY21 we have made lower dividend payments to SWSG.<br>These dividends are used by SWSG to make interest payments back to SWS on an inter-company loan. Dividends for the second half of the year have not yet been approved or made; as a result, the interest due for the second half year has not been received and has been accrued. |
| Other | 4.3 | 2.2 | 2.1 | The net cash movement from operating activities and our capital investment programme. A reduction in cash received from operations, resulting from the reduction in our revenues, was offset by lower capital expenditure. |
| | 210.2 | (242.7) | | |

## Statement of financial position

| | 31 March 2021 £m | 31 March 2020 £m |
|---|---|---|
| Non-current assets | 6,862.1 | 6,721.3 |
| Current assets (excluding cash) | 220.5 | 278.3 |
| Cash and cash equivalents | 339.5 | 129.3 |
| Total assets | 7,422.1 | 7,128.9 |
| Current liabilities | (354.4) | (1,017.5) |
| Non-current liabilities | (6,166.9) | (4,857.9) |
| Total liabilities | (6,521.3) | (5,875.4) |
| Total net assets | 900.8 | 1,253.5 |
| Total equity | 900.8 | 1,253.5 |

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At the end of the year to 31 March 2021, we had non-current assets of £6,862.1 million (2020: £6,721.3 million), an increase of £140.8 million from March 2020. This increase results from our ongoing capital investment programme, which – after depreciation – increased the value of property plant and equipment and intangible assets by £266.9 million. This Included the recognition of an intangible asset of £131.1 million, comprising payments of £6.5 million and a long-term liability of £124.6 million, for the future right to a bulk supply of water associated with a new reservoir at Havant Thicket, which is being constructed by Portsmouth Water. These increases in asset values were offset by a decrease in the value of our non-current financial derivative assets of £126.1 million.

Current assets decreased to £220.5 million (2020: £278.3 million). Following the reduction in our tariff, which reduced revenues, there was a reduction in our accrued income as well as a higher level of provision made against our outstanding historic gross receivables. The combined impact of these was a reduction in the value of our net receivables by £22.4 million. In addition, there was a reduction in the balance on our inter-company debtor with Southern Water Services (Finance) Limited of £39.4 million. This inter-company arrangement is used to pay the interest on our loans. The balance reduced this following the restructuring activities undertaken in the prior year, which reduced our net interest payable.

Current liabilities decreased to £354.4 million (2020: £1,017.5 million). This is mainly caused by loans of £679.5 million, which were repaid during the year, offset by additional accrued interest at March 2021 from refinancing activities and on our preference shares totalling £24.2 million.

At 31 March 2021, non-current liabilities totalled £6,166.9 million (2020: £4,857.9 million). This increase of £1,309.0 million was principally the result of the following:

- An increase in borrowings of £1,107.2 million as a result of new bonds issued under our Sustainable Financing Framework.
- An increase in the derivative financial instrument liability of £124.2 million.
- A decrease in the deferred tax liability of £79.0 million as a result of the loss recorded for the year and the increase in the retirement benefit obligation.
- An increase in retirement benefit obligations of £54.0 million. The final salary pension scheme was closed to future accrual on 31 March 2020. During the year, a lump sum deficit payment of £17.5 million was made, but this was offset by the movement in market conditions at 31 March 2021, which increased the deficit by £70.0 million, together with past service and financing costs of £1.5 million.
- The transfer of £24.2 million of the regulatory settlement provision to short-term liabilities.
- The recognition of a liability totalling £124.6 million for future capacity charge payments, to be made to Portsmouth Water in relation to the Havant Thicket reservoir scheme, mentioned above, over the period to 2100.

Overall, net assets decreased from £1,253.5 million to £900.8 million.

## Dividend policy

Our dividend policy is formulated to ensure a fair balance of reward between customers and investors. To deliver on our vision for 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 near £2 billion of 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 (as part of the Annual Report) and highlight any changes.

These tests have not been applied to the interim dividends of £4.0 million paid in 2020–21 to Southern Water Services Group (SWSG) as this dividend payment is instantly offset by a corresponding interest receipt from SWSG and is therefore immediately repaid to the company in a 'dividend loop' (see page 117), resulting in no net cash outflow for the company. The dividends to enable SWSG to pay the interest for the second half of 2020–21 have not yet been approved. This interest has been accrued in the financial statements at March 2021.

The Board has resolved that the company will not pay dividends, other than those associated with the 'dividend loop' mentioned above, until it is clear that to do so would not be detrimental to the company's financial position.

The Board has not approved the payment of preference share dividends for 2020–21 (2020: £9.0 million dividends and £50.1 million redemption). Preference share dividends are disclosed as interest in the financial statements and an accrual for £4.9 million in relation to this liability is included within the financial statements.

## Tax strategy and policies

Southern Water and all Southern Water 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 and doing the right thing, 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.

To enable this, we undertake regular compliance reviews 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 and considers both social and corporate responsibilities. When faced with a business decision or business case, the ongoing tax impact is always considered as part of that decision-making process.

## Our approach to tax management

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 of tax, 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.

## 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 Southern Water 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 Southern Water 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 wider business to ensure there are sufficient processes and controls in place and determine what level of risk is acceptable. We also have a support network of industry tax experts who provide specialist tax services, check what we are doing and provide advice and guidance on new tax compliance requirements. Our Internal Audit team also carries

# Financial performance continued

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 Her Majesty's Revenue & 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 an HMRC assessment of us as a 'low-risk' company.

## 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. We have a Cayman Islands-registered subsidiary company, which was set up to issue debt in the UK (see page 116 for more information). Its Cayman Island registration does not have any impact on the tax due by the group. However, we know that this company has contributed to misconceptions about our business practices, which is why we are working towards closing it. We hope to complete this process shortly.

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

We regard this publication as complying with our duty under paragraph 16(2) of Finance Act 2016 for the financial year ended 31 March 2021.

## 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 scale of our capital expenditure programme and the level of capital allowances 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 page 115. 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.

- 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 222.

## Our other tax contributions

Our other contributions to the Exchequer amounted to £70.0 million. These are explained below:

- Business rates of £25.2 million paid to local authorities (2020: £27.5 million) and payments to the Environment Agency of £8.3 million (2020: £8.3 million) for abstraction licences and discharge consents, which reduce profits chargeable to corporation tax.
- Employment taxes of £36.5 million (2020: £36.1 million) paid to the Exchequer under PAYE (Pay As You Earn) and National Insurance contributions.

Payments have also been made to other group companies of £0.9 million for tax losses surrendered to the company. These were paid to SWSG, allowing SWSG to make interest payments back to Southern Water. Overall, Southern Water pays 2.4 pence in the pound for losses surrendered from group companies. As a result of capital allowances and interest charges, no corporation tax was paid by the company to HMRC in 2020–21.

## 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.

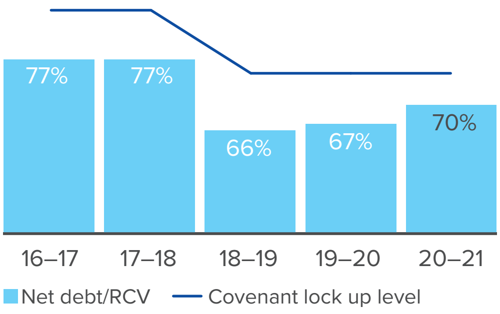
The net debt to RCV ratio is calculated as short and long-term senior borrowings less cash and short-term deposits to the RCV (all values taken from our Regulatory Accounts). The RCV is set by Ofwat at each five-year periodic review and reflects our initial market value plus subsequent capital investment 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.

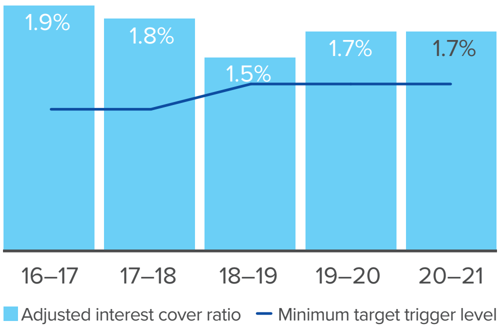
The credit ratings are shown in the table above and the outlook for Standard and Poor's is Negative Outlook, the outlook for Fitch is Ratings Watch Negative, and the outlook for Moody's is Stable.

## 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 signing date of accounts

Standard & Poor's
Class A debt:
**BBB+**

Fitch
Class A debt:
**BBB+**

Moody's
Class A debt:
**Baa3**

A further credit rating downgrade by one or more Rating Agencies would result 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.