Keeping it clear

A guide to how we are owned, run and financed

2019

At a glance...

On average, our customers currently pay just over 50p a day for their water services.

Like most companies, we are financed through a combination of shareholder capital and debt. Our shareholders have significantly lowered our debt by putting more of their own money into the Company.

We are jointly owned by two Japanese companies who have proved to be responsible and committed investors in our business.

Like any investors, our shareholders expect a return on the money they put into our business but these dividends are not guaranteed – our Board first considers how well we have delivered for our customers. Our dividends continue to be below the level of return that Ofwat has indicated as reasonable.

Similarly, the amount of money that is paid to senior directors needs to attract and keep people of a high calibre but also needs to reflect how well we are performing.

We have never operated any complex, international financing arrangements and our holding company is based in the UK, paying corporation tax to the UK Government.

Independent non-executive directors make up the biggest group on our Board, providing targeted challenge and support in their areas of expertise.

What the words mean

Fixed assets
Physical items used in running our business that we continuously invest in (called capital investment), such as our pipe network or reservoirs.

Bond
A type of long-term borrowing.

Corporation tax
A tax on a company's profits before dividends are paid to shareholders.

Debt
An amount of money that is borrowed by one party from another.

Dividends
Money that is given back to our shareholders in return for their investment.

Dividend yield
How much is paid out in dividends each year in relation to how much shareholders have put in.

Equity
Money from shareholders that is invested in our Company.

Gearing
Shows the balance between money we receive from our shareholders compared to lenders like banks.

Inflation
The rate at which the general level of prices for goods and services is rising. It is commonly measured by the Consumer Price Index (CPI) or the Consumer Price Index including owner occupiers' housing costs (CPIH).

Interest
Money that is paid regularly at a particular rate on debt.

Operating costs
The money we pay out to run our Company, such as wages, maintenance and electricity.

Profit
The difference between the money we receive, mainly from customer bills, and the money we spend on running and financing our Company.

Regulated Capital Value (RCV)
The total value of our Company calculated as required by our regulator Ofwat.

Retail Prices Index (RPI)
A measure of inflation published monthly.

Shareholders
Our owners who have shares in our Company.

Turnover
Another word for sales or income during a specific time period.

We provide 160 million litres of water each day to homes and businesses in parts of Surrey, south London, West Sussex and Kent.

I am pleased to present the second edition of 'Keeping it clear', intended to be an easy-to-read guide on our finances, structure and decision-making. Our first publication last year was met with very positive feedback from our customers and other stakeholders so we have maintained similar themes and focus this year, together with the latest financial information.

Providing transparency, both to our customers and employees, together with delivering great service, will hopefully continue to enhance the trust and confidence felt by everyone we engage with as part of delivering our essential public service.

This summary sets out our finances today and in the future, explains our bills and provides clarity on our financing structure and how we are governed so you can gain a good understanding of how we are owned and run, where we spend our money and the dividends and taxes we pay.

Paul Kerr
Finance and Regulation Director
SES Water

Our finances today

Average customer bill
£204 per year

Income & financing 2018/19

£66.8m
turnover

£6.5m
from other sources like new loans

Outgoings 2018/19

£37.6m operating costs
£25.3m investment in our assets
£10.6m financing costs and tax

£9.7m	£1.4m	£3.7m	c.61%
profit before tax	corporation tax	dividends to shareholders	gearing level (as at 31/03/19)

By 2020/21 we expect

Average customer bill
£200 per year

Income & financing 2020/21

£69.0m
turnover

£8.4m
from other sources like new loans

Outgoings 2020/21

£37.4m operating costs
£29.5m investment in our assets
£10.6m financing costs and tax

£7.5m	£1.0m	£4.0m	<64%
profit before tax	corporation tax	dividends to shareholders	gearing level (as at 31/03/20)

We are still awaiting Ofwat's final determination on our Business Plan for 2020 to 2025 and therefore our final revenues, costs and dividends are subject to some uncertainty. The figures above are based on 2017/18 CPIH.

Our income and expenditure

The majority of the income we receive comes from the water we provide.

The money we spend is split between four main areas – running our day-to-day operations, capital investment, costs associated with financing (interest repayments) and dividends to shareholders. We also pay corporation tax following UK tax rules.

Below you can see our main sources of income and what we spend our money on.

Income (£m)	2018/19 Actual
Household bills	52.3
Business retailers	9.7
Developers, builders and other	2.6
Non-appointed (unregulated) income	2.2
Turnover	**66.8**
New loans	3.0
Changes in bank balances	-1.7
Other	5.2
Net new financing	**6.5**
Total income	**73.4**

Outgoings (£m)	2018/19 Actual
Employees	14.1
Energy	5.6
Chemicals and materials	3.0
Rates	3.4
Insurance	0.8
Other e.g. contractors	10.7
Operating expenditure	**37.6**
Pipe replacement	14.2
Treatment works upgrades	5.6
Installing meters	2.7
Upgrading boreholes and reservoirs	1.1
IT, vehicles etc	1.7
Capital expenditure	**25.3**
Interest on loans	5.5
Dividends to shareholders	3.7
Financing costs	**9.2**
Tax	**1.4**
Total outgoings	**73.4**

Customer bills

Our household customers currently pay just over **50p per day** for their water services. Because we are a water only company, customers also pay a wastewater charge to either Thames or Southern Water. The average annual water bill in 2018/19 was £204, a 2.7% increase on the previous year.

We keep our bills low by:

- **Operating efficiently** – between 2020 and 2025 we plan to reduce our costs by 7% by buying goods and services more economically, reducing our energy use and making efficiencies across our operations
- **Financing efficiently** – while as a small company we can't access debt financing as cheaply as the larger water companies, our reduction in debt means lower interest costs to be borne by us and our customers
- **Growth in our customer base** – as more homes are connected to our network the costs will be spread across more customers which helps lower bills in the long-term
- **Providing extra support** – our Water Support Scheme helps those who genuinely can't afford to pay their bill. This discount is funded through a supplement from other customers, as well as money from our shareholders

We also receive income from:

Water retailers who pay us for the water we supply to their business customers who they provide billing and customer services to.

Housing developers who pay us to lay new pipes and connect new homes to our network.

Non-appointed income which is money we receive from other parts of our business not directly related to providing water to our customers, such as payments for issuing wastewater bills on behalf of Thames Water.

Setting bills

Because the water industry is a regionalised monopoly and household customers can't switch supplier, customer bills are set every five years through a rigorous price review process. We develop a Business Plan which sets out everything we plan to deliver and what it will cost. The plan is based on extensive engagement with customers to make sure that we are spending money in the areas that matter most to them and that they are willing to pay for the investment we make. This process is reviewed by our independent Customer Scrutiny Panel who ensure that our engagement is high-quality, and our plans reflect customer priorities. Our plan is then submitted to Ofwat, our economic regulator, who decides whether it offers good value for customers. Ofwat then determines how much we can charge over the five-year period.

We submitted our Business Plan for 2020 to 2025 in September 2018 and in January 2019 we received Ofwat's 'initial assessment' of our plan. Along with the majority of the industry, our plan was given slow-track status which meant we had to do further work and provide more evidence in a re-submitted plan in April 2019. On 18 July 2019 Ofwat published its 'draft determination' on our plan which is their view on the service levels we must deliver, together with the funding we will receive and the associated level of customer bills. We have responded to Ofwat on the changes we would like them to make in their final determination in December 2019, ahead of starting to deliver our plan in April 2020.

Debt, equity and gearing

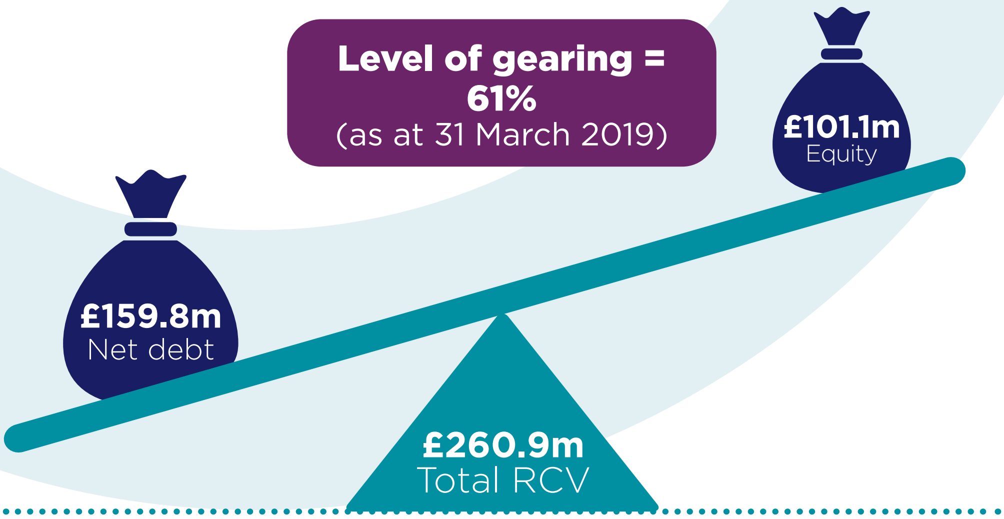
Like most companies we are financed through a combination of debt and shareholder equity. After deducting the cash we hold, the amount we have borrowed is referred to as our net debt.

NET DEBT (as at 31 March 2019)		
RPI-linked bond	£	160.0m
A revolving credit facility from the bank	£	13.5m
Debentures	£	0.1m
Cash	£	-13.8m
Net debt	£	**159.8m**

Net debt combined with shareholder equity equals our Regulated Capital Value (RCV), which is essentially the total value of our business as calculated by our regulator.

A good way to think about this is like a mortgage. The RCV represents the total value of your property (and increases in value in line with improvements and inflation over time), shareholder equity represents the deposit you put down and net debt represents what remains on your mortgage.

The proportion of the RCV that is funded by debt is commonly referred to as our level of gearing. Water companies operate with different levels of gearing, but historically it's not been unusual for gearing ratios to be above 75%. Our gearing at 31 March 2019 was 61% and while we expect this to increase over the next few years, we have committed to maintain our gearing below the levels considered reasonable by Ofwat for long-term financial resilience.



Money from the bank

As well as the availability of an overdraft and loans, we have a £35 million 'revolving credit facility' with our bank. This is a line of credit with an agreed maximum amount which can be drawn on at any time when needed. In July 2019 we agreed the terms of a new five-year facility at favourable market rates which demonstrates our credit worthiness and financial stability.

Our index-linked bond

In 2001, we took out a £100 million Retail Prices Index-linked (RPI) bond which has provided the bedrock for funding our capital investment programme and has meant that in the years since we have not needed to borrow a material amount of additional funds. The bond was issued at a rate of 2.87% interest. Because it is index-linked to RPI it means that both the capital sum and the interest payments will vary accordingly.

The charges associated with the indexation are treated as an interest cost but don't have any immediate impact on cash flow as no actual cash payments are needed until maturity. The fees associated with the issue of the bond are paid back over the life of the bond, plus interest.

In 2018/19 we paid £5.2m of interest on our bond.

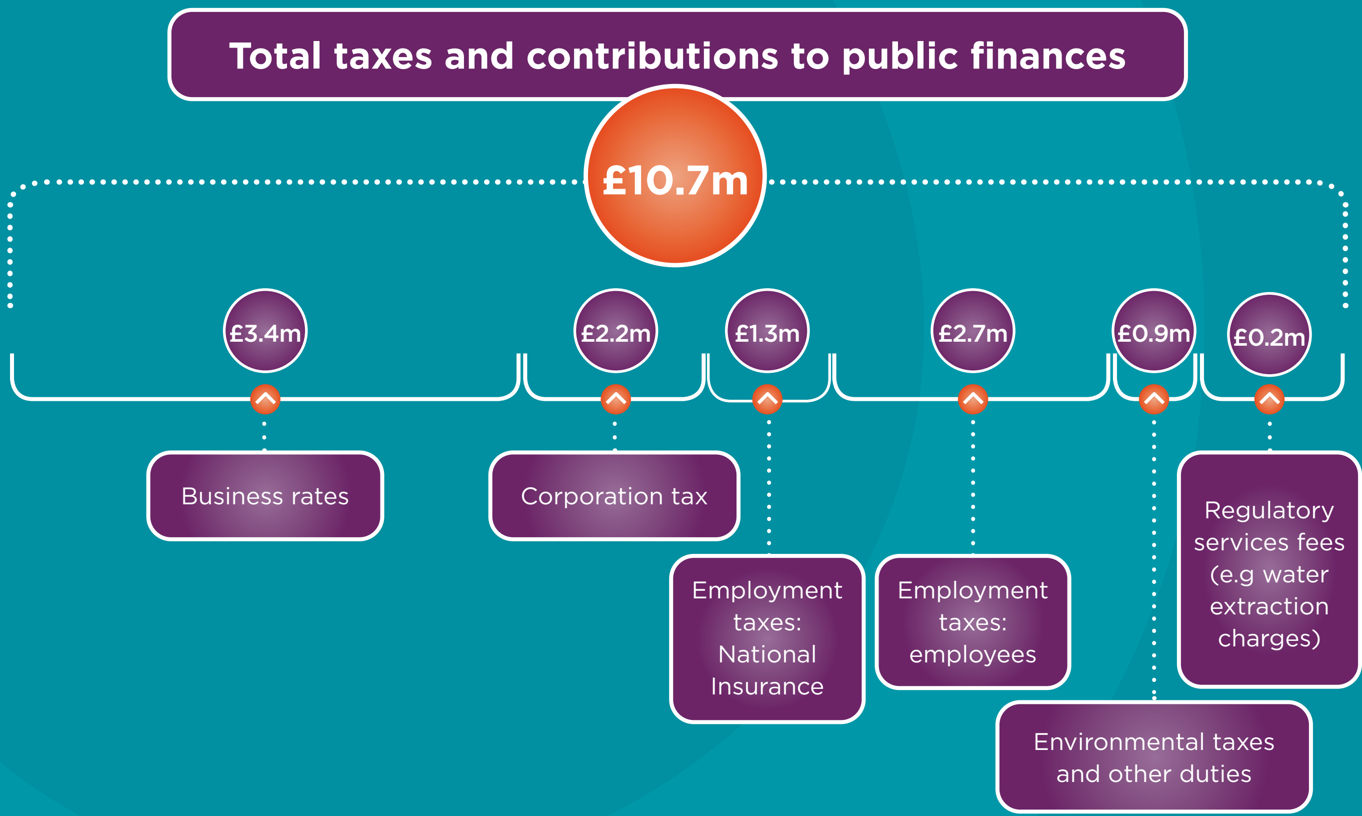
The bond will be repaid between 2027 and 2031. Ahead of this we will carry out a full assessment of the financing options available to replace it, to ensure our long-term borrowing is secured at the most efficient rate possible.

Profits and tax

In 2018/19 our profit before tax was £9.7m. This was the amount of profit left after taking into account our operating costs, investment and the interest we paid on our borrowing.

We deferred £1.4m in corporation tax to the UK Government, which is approximately 10% of our profit as under their rules our level of capital investment means that a portion of our taxes are paid in later years.

We also paid business rates, PAYE and national insurance contributions which help fund the vital services we all rely on. The below diagram illustrates the taxes and contributions we made to public finances in 2018/19.



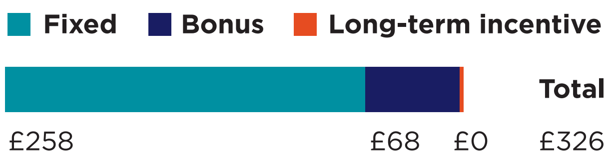
Executive pay

The amount of money that is paid to executive directors and senior managers is overseen by the Remuneration Committee. This includes making decisions around what is paid to new directors and the amount of money that senior executives receive through a bonus and long-term incentive plans. It is important that the Board strikes the right balance between attracting and retaining talented people with customers' interests. This is why each year executive directors have annual and longer term targets related to customer service, performance and sustainability, as well as personal targets, and the amount they receive is dependent on performance in all these areas.

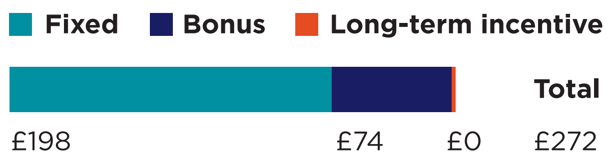
Single total figure of remuneration for executive directors for 2018/19

Fixed pay comprises base salary, benefits and pension.

Anthony Ferrar (£'000s)



Paul Kerr (£'000s*)



We are in the process of enhancing and updating our executive pay policy to include even stronger links with delivery for customers and more stretching targets. This will be published and come into effect on 1 April 2020.

**Paul Kerr's 2019 salary and benefit were prorated to his contract start date of 14 April 2018, including a payment of £33,000 for mitigation of loss of bonus and LTIP payments earned from his previous employment.*

Gender pay

We believe in creating a diverse and gender-balanced workforce which ensures equal opportunities for all employees and reflects the customers we serve. Most importantly, we are confident that men and women are paid equally for doing equivalent jobs, regardless of gender. Our gender pay gap of 17% is caused by having fewer women in senior roles and this is not uncommon in the utilities industry as the STEM (science, technology, engineering and maths) fields have been predominantly male occupations with historically low participation among women. In fact, just 23% of the core STEM workforce in the UK are women (WISE UK statistics 2017) and the UK has the lowest percentage of female engineering professionals in Europe.

Nevertheless, our figures highlight the need for us to ensure we are continually challenging ourselves to be more inclusive. Some of the actions we are taking include job grading so we have more effective career progression, transparency and clarity over pay bands and reviewing our recruitment processes and appraisal system to ensure capable employees can progress, regardless of gender.

Our ownership

We are jointly owned by Osaka Gas and Sumitomo Corporation. Both are Japanese companies that run UK-based operations, and each hold a 50% share in our ultimate UK holding company Sumisho Osaka Gas Water UK Limited.

Holding companies are recognised legal entities and exist to bring together the investment made by shareholders to own and control their interests in other companies.

In our case this enables Osaka Gas and Sumitomo Corporation to jointly own East Surrey Holdings Limited. It is the holding company for the trading companies of the group. A separate holding company, SESW Holding Company Limited, exists to control the funding associated with SES Water and protect the interests of bond holders.

The diagram below shows our ownership structure. All companies apart from those based in Japan are subject to UK tax laws. This has been the case since 2013 and we have not operated any complex, off-shore financing arrangements at any time during this period.

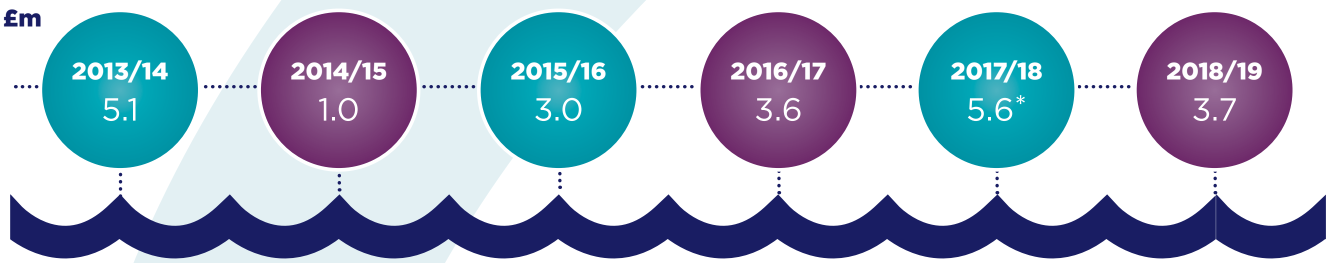
Dividends

Dividend levels are agreed each year by the Board and take into account how well we are performing against a range of targets. The Board also considers how well we are performing against our budget and the commitments made to customers. Only when all these factors have been considered are dividend levels agreed.

From our profits in 2018/19 we paid £3.7m of dividends to our shareholders from our regulated activities.

Like any investors, our shareholders expect a return on the equity they put into the business. Over time they have taken a fair and reasonable level of dividend, allowing more money to be reinvested in services or kept in reserve.

Below you can see the annual ordinary dividend paid to our shareholders. Dividends have been within the level of return which Ofwat has indicated as reasonable.

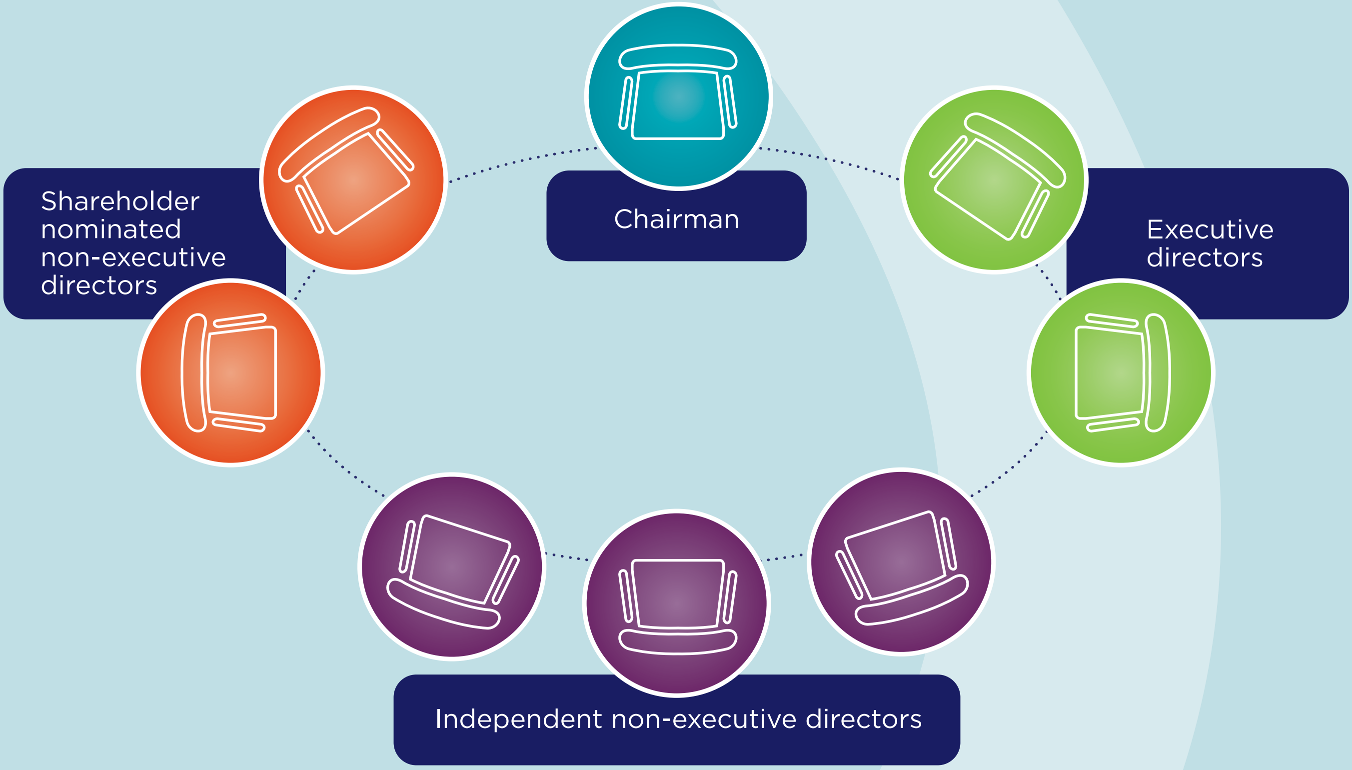


We are preparing to make changes to our dividend policy from April 2020, elements of which Ofwat has already highlighted as industry best practice. We want to ensure that our decision-making and payments to our shareholders are as transparent and accessible as possible, including explanations in this document and our Annual Report.

* The profit before tax figure includes a one-off gain of £2.0m from the sale of our right to trade with non-household customers to one of our group's associated companies, SES Business Water. The 2017/18 dividend to shareholders includes £2.0m reflecting that one-off profit.

Our Board

Our Board is made up of executive directors from SES Water, non-executive directors representing our shareholders and independent non-executive directors. It is led by a Chairman and is responsible for making decisions affecting the Company.



Our Board operates three main committees, each chaired by an independent non-executive director:

Audit Committee – responsible for making sure we follow robust and effective processes for financial and regulatory reporting, internal controls and risk management.

Remuneration Committee – responsible for our remuneration policy and its application, including levels of executive pay and the targets that are set as part of the performance-related employee bonus.

Nomination Committee – responsible for making sure the Board size, structure and membership is reviewed, succession planning for Board members and senior managers and reviewing Board performance.

Trust and confidence

It is essential that the water industry ensures that the right balance is struck between companies, shareholders and customer interests. There has been increased focus on how the sector operates for the wider public interest given the essential service provided. We welcome this scrutiny as we have always placed great emphasis on being an accountable, accessible local company.

In July 2019 Ofwat made it compulsory for all water companies to meet new objectives about Board leadership, transparency and governance (BLTG), including the need to establish a purpose, strategy and set of values. Company boards must also be satisfied that these, and its culture, reflect the needs of all those it serves. We are already meeting the updated requirements and our Annual Report includes a new statement from the Board explaining the actions taken for each objective.

Enhancing Board leadership, transparency and governance

Our Board works within a governance framework that is laid down by the UK Corporate Governance Code and the Companies Act. Members have been focused on enhancing their board leadership, transparency and governance for some time and recognise the importance of being open and accountable to both our employees and customers about how the business is run. Steps taken so far include:

- Publishing clear and accessible information through our annual report – including levels of executive pay and dividends.
- Recruiting high-calibre, experienced independent non-executive directors to challenge our activities and decision making.
- Establishing a strong succession planning process so we appoint individuals with the right mix and level of skills and experience.
- Reducing the number of shareholder representatives so our independent non-executive directors make up the single biggest group on our Board.
- Linking executive pay and dividend levels to performance and service to customers.
- Placing high importance on continuous training and development of our Board directors.
- Carrying out periodic reviews of Board member performance and Board effectiveness with the last one taking place in May 2019.

We are committed to enhancing our Board leadership, transparency and governance by:

- Ensuring we continue the high level of interaction amongst our independent non-executive directors, managers and stakeholders so that all views can be understood and represented.
- Appointing a designated independent non-executive director to work with our CEO on engagement with our workforce and help increase employee input through our Joint Negotiating and Consultative Committee.
- Inviting the Chair of our Customer Scrutiny Panel to attend one Board meeting per year.
- Publishing this document every year to explain our finances and governance.
- Introducing a new Environmental Scrutiny Panel to provide challenge on how we both maintain and improve the environment we rely on.
- Reviewing our executive pay policy so it gives appropriate weight to performance for customers.
- Publishing summary Board minutes.
- Explaining how we have reached decisions on the level of dividends, taking into account the delivery of our obligations and commitments to customers and other stakeholders.
- Using an independent facilitator to review Board effectiveness.

To follow our performance against our annual targets and find out more details about the work of our Board you can read our annual report on our website.

In this guide our aim is to explain our finances and governance in a clear and understandable way – but have we succeeded?

Let us know by contacting us through our website where you can also join our Talk on Water online community.

seswater.co.uk