# Welcome to the Severn Trent Annual Report 2018

## OUR PURPOSE IS TO SERVE OUR COMMUNITIES AND BUILD A LASTING WATER LEGACY. THIS DRIVES OUR VISION TO BE THE MOST TRUSTED WATER COMPANY BY 2020, DELIVERING AN OUTSTANDING CUSTOMER EXPERIENCE, BEST VALUE SERVICE AND ENVIRONMENTAL LEADERSHIP.

This report highlights the progress we have made over the past year in achieving that vision through our strategic objectives and absolute focus on delivering value for all of our stakeholders.

We're committed to keeping your water flowing clearly and making your waste water clean again, so you can carry on enjoying this force of nature in your very own home, for generations to come.

**WONDER**FUL ON TAP

# 20 MINUTES
# OF TRANQUILITY...

# MADE BY **DECADES** OF CONTINUED INVESTMENT

We have always been committed to investing for the benefit of our customers and future generations. This year we invested a total of £855 million across our business, including in renewable energy and the resilience of our networks.

See more on page 38

**WONDER**FUL ON TAP

# 1 MINUTE NURTURING...

# MADE BY 100% COMMITMENT

**We are proud of the fact that we have outperformed against our commitments that our customers most care about. Our customer service and operational improvements have contributed to customer ODI rewards of £80.2 million.**

See our 'ODIs' on page 32

**WONDER**FUL ON TAP

# 240ml OF PURE QUALITY...

# DELIVERED BY 49,000 km OF PIPES

Our drinking water is rated at 99.96% for quality. We distribute 1.6 billion litres of quality drinking water through 49,000 km of pipework. This, combined with 94,000 km of sewage pipework, is enough pipes to go around the world three and a half times.

See more on page 36

**WONDER**FUL ON TAP

# What we do

We provide clean water and waste water services and develop renewable energy solutions through our businesses:

## Regulated Water and Waste Water

Our Regulated Water and Waste Water business includes the wholesale and household retail activities of Severn Trent Water and Dee Valley Water.

### The primary markets we focus on

- Wholesale operations and engineering
- Household customer services

**About us**
We are one of 10 largest regulated water and waste water businesses in England and Wales. We provide high quality services to more than 4.3 million households and businesses in the Midlands and Wales.

**Where we operate**
Our region stretches across the heart of the UK, from the Bristol Channel to the Humber, and from North and mid-Wales to the East Midlands.

**Turnover**
£1,574.6m

**Households and businesses served**
4.3m

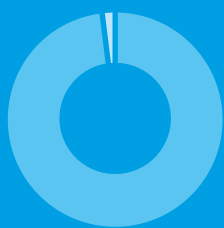
**Profit before interest and tax**
£503.8m

**Litres of drinking water supplied each day**
1.6bn

**Underlying profit before interest and tax[1]**
£514.9m

**Litres of waste water treated per day**
2.77bn

**Revenue split**



- Severn Trent Water **98.2%**
- Dee Valley Water **1.8%**

Read more on page 34

**Employees**
5,660
average during 2017/18 (see page 157)

1 Alternative Performance Measures are defined in Note 46 to the group financial statements on pages 192 to 194

# Severn Trent Business Services

## The markets we focus on

- Operating Services
- Renewable Energy

### Where we operate
Business Services operates in the UK and Ireland.

## There are two parts of Business Services:

### UK Operating Services (including Ireland)
UK Operating Services provides contract services to municipal and industrial clients in the UK and Ireland and the UK Ministry of Defence ('MOD') for design, build and operation of water and waste water treatment facilities and networks, and services to developers.

### Renewable Energy
Business Services generates renewable energy from anaerobic digestion, hydropower, wind turbines and solar technology.

### Turnover
**£138.7m**

### Profit before interest and tax
**£34.2m**

### Underlying profit before interest and tax[1]
**£36.0m**

### Employees in continuing operations
**596**

average during 2017/18 (see page 157)

Read more on page 42

1 Alternative Performance Measures are defined in Note 46 to the group financial statements on pages 192 to 194

# Our business model

## Running an efficient water business

**Severn Trent provides clean water every time our customers turn on the tap and removes their waste water in an affordable, sustainable and reliable way.**

It does so through its regulated subsidiaries and draws upon its skills in water and waste treatment to provide services to other organisations through its Business Services division.

## Critical inputs

**Natural resources**

Water from reservoirs, rivers and underground aquifers

Read more on page 45

**Power**

The treatment and distribution of clean and waste water consumes significant energy.

Read more on page 43

## The Water Cycle

### Water is collected

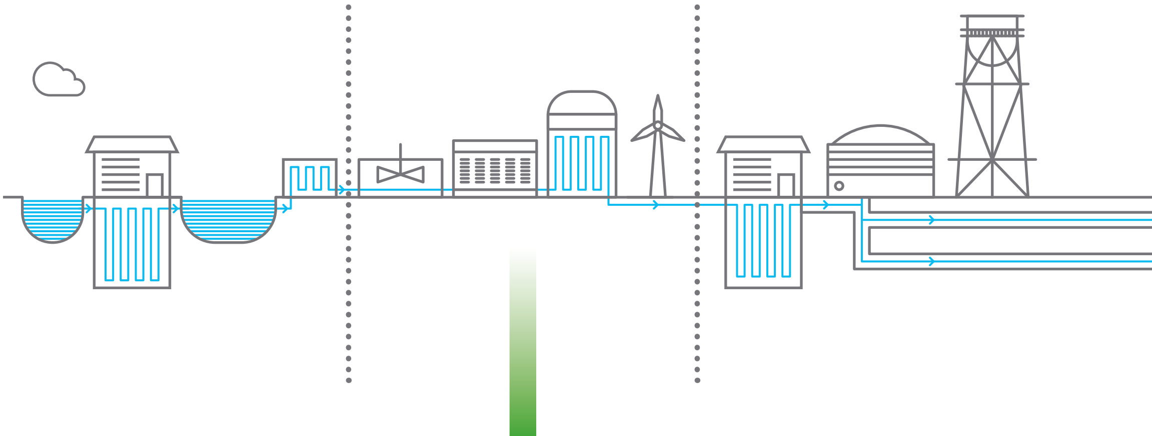
We pay the Environment Agency and Natural Resources Wales for the water we collect from reservoirs, rivers and underground aquifers across our region.

### Water is cleaned

Our 116 groundwater and 23 surface water treatment works clean raw water to the highest standards, making it safe to drink.

### Clean water is distributed

Our 49,167 km network of pipes and enclosed storage reservoirs bring a continuous supply of clean water right to our customers' taps.



## Our investments in renewable energy production

**Cleaning waste water is an 'energy hungry' process so we are utilising waste and renewables to help us power our operations.**

We are on track to produce 50% of our own energy needs by 2020

### Food waste anaerobic digestion plants

## Outcomes

**Natural resources**

- Clean water for 4.3 million homes and businesses
- Clean gas produced from anaerobic digestion plants, contributing to the decarbonisation of the UK economy

**Physical assets**

- Efficient and reliable services: 1.6 billion litres of drinking water supplied each day and 2.8 billion litres of wastewater treated each day

**Physical assets**
A resilient, well maintained network of clean water pipes and reservoirs, sewers and pumping stations
Read more on page 47

**Our people**
We look to attract, develop and retain talented people, and to bring the next generation of water experts into the industry
Read more on page 48

**Relationships**
- **Our suppliers and partners**
  Joint ventures and strong supplier relationships
- **Our customers and communities**
  The heart of our business
- **Our regulators**
  Our industry is regulated by Ofwat and several other regulators and public bodies

Read more on page 50

## Customers enjoy our services

We serve 4.3 million businesses and households with a safe, reliable supply of water and collect waste water 24 hours a day, 365 days a year.

## Waste water is collected

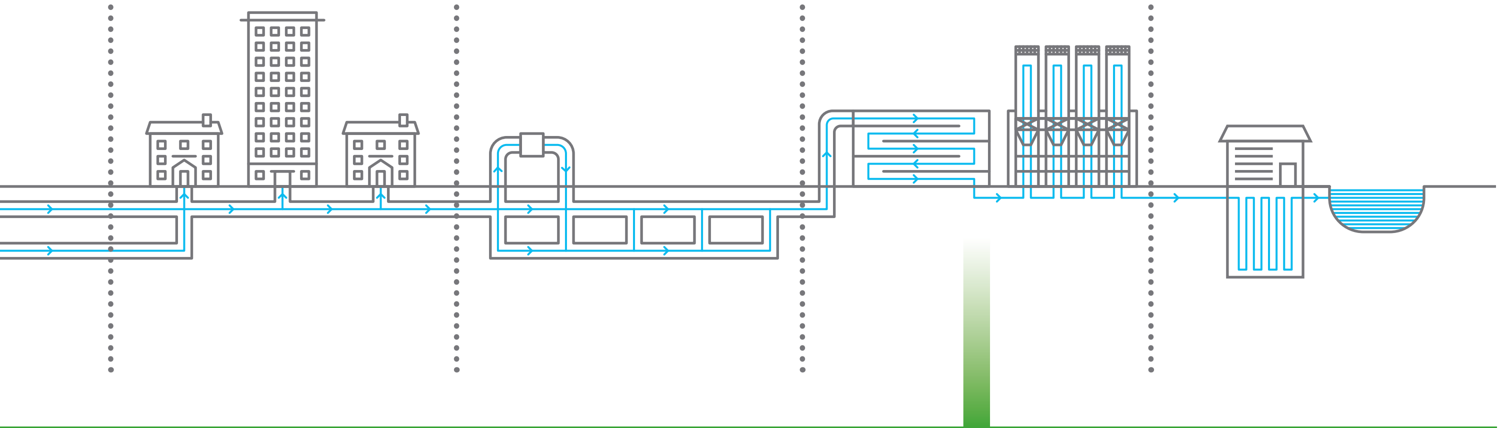
Our 94,027 km of sewers and pumping stations collect waste water from homes and businesses and take it to our treatment works.

## Waste water is cleaned

Waste water is carefully screened, filtered and treated in our 1,010 sewage treatment works to meet stringent environmental standards.

## Water is recycled to the environment

We pay the Environment Agency and Natural Resources Wales annual consent fees to return the treated water to the water system.



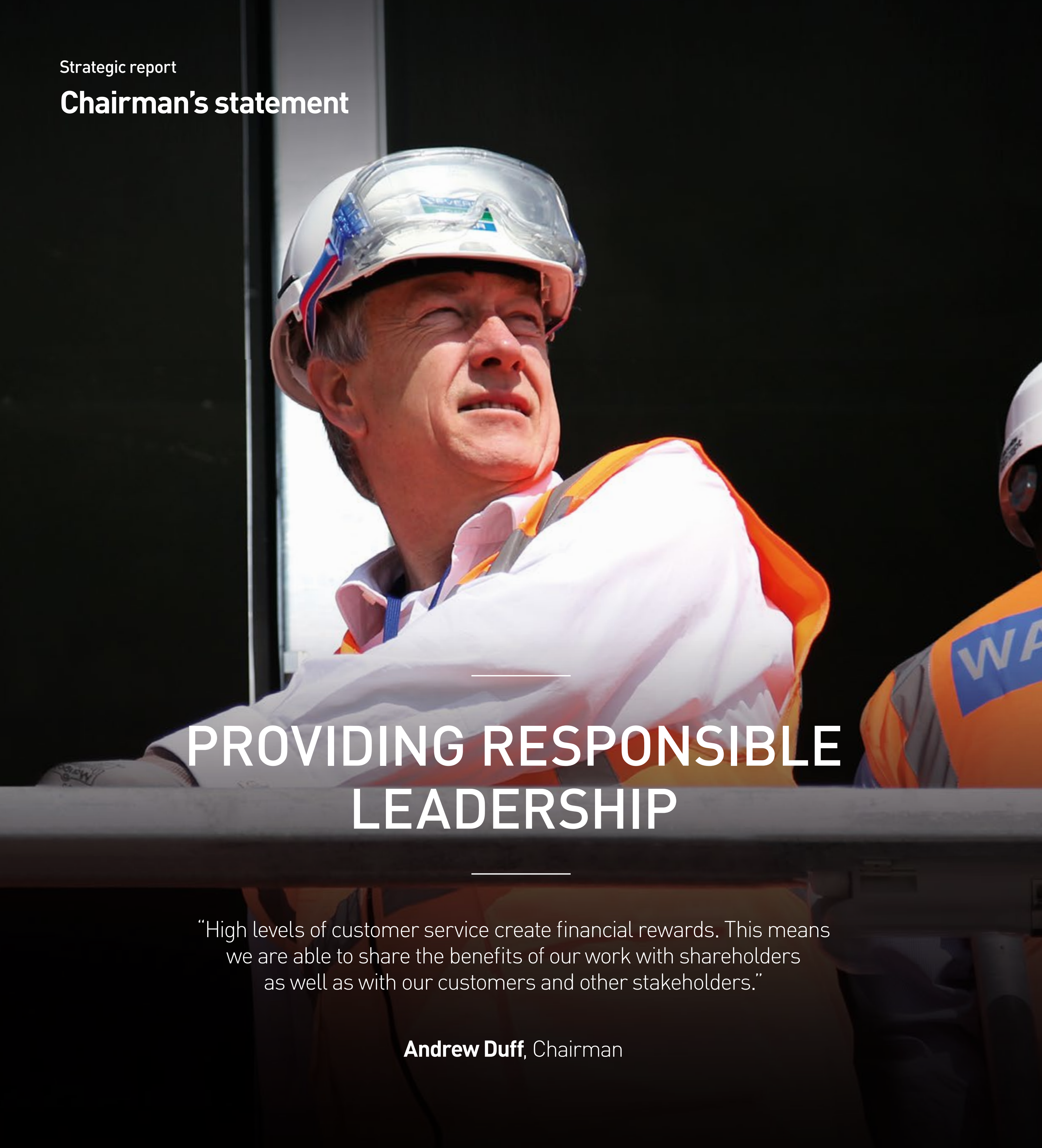
## Solar and wind turbines

## Clean gas from our sludge anaerobic digestion plants

**Our people**
- An awesome place to work
- A diverse, skilled and talented workforce

**Relationships**
- **Our suppliers and partners**
  A robust supply chain. We work with partners over the five years of an AMP, which means more competitive pricing
- **Our customers and communities**
  The lowest average combined water and waste water bills in Britain. Educational visits on water efficiency and being sewer savvy
- **Our regulators**
  Positive and constructive relationships and industry-leading ODIs and KPIs

# Chairman's statement



## PROVIDING RESPONSIBLE LEADERSHIP

"High levels of customer service create financial rewards. This means we are able to share the benefits of our work with shareholders as well as with our customers and other stakeholders."

**Andrew Duff**, Chairman

**Dividend per share**

**86.55p**

2017: 81.50p

**Group turnover**

**£1,694.1m**

2017: £1,638.0m

**Group profit before interest and tax**

**£528.4m**

2017: £536.7m

**This has been a good year for our customers and therefore for Severn Trent. Our operational performance is discussed in detail in our Chief Executive's statement. Here, I want to take the opportunity to look at the bigger picture by highlighting the improvements we have made to customers' lives in the last 25 years – and to underline our commitment to running a responsible business.**

Water services in England and Wales have been transformed for the better over the last 25 years – leakage is down by over a third since its peak in 1994/95, service quality is up, as evidenced by a 65% reduction in written complaints since its peak in 2007/08 and environmental performance is unrecognisable from that which we inherited from the nationalised industry in 1989, with an 86% reduction in serious pollution incidents in England and Wales. These changes have not happened by accident; they are the direct result of the near doubling of investment that has been pumped into the sector since privatisation.

At Severn Trent, we have played a major role in this step-change, investing £21 billion in today's money in infrastructure improvements over the last quarter of a century. We are proud of the achievements that this investment has generated for our customers. They drink and wash in cleaner water, experience fewer supply interruptions and floods, and enjoy healthier and more pleasant surroundings, all thanks to our work. At the same time, and despite the huge capital investments we have made, we have been able to keep prices down. This last year, as in the previous seven years, the average price paid by a customer in the Severn Trent region was the lowest anywhere in England or Wales.

Our team is absolutely committed to continuing this good work – and a key aspect of that is demonstrating the highest standards of governance and behaviour. Our values of: putting customers first; creating an awesome place to work; being passionate about what we do; acting with integrity; and protecting our environment sit right at the heart of our decision making. We fully support the governance changes that the regulator and Government wish to see – indeed, as a listed company these standards of transparency and responsible behaviour are already in place at Severn Trent: we are prudent in how we manage financial risk and even-handed in the way we share the returns from our outperformance with customers and shareholders; we pay our taxes in full and on time; we pay dividends and executive salaries that are reasonable and sustainable and linked to the delivery of outcomes to customers; avoid complex offshore financial vehicles; and we communicate progress on all of these matters in the Annual Report which we provide to stakeholders and to the public at large on our website every year.

Having strong and transparent corporate governance is the right way to carry out our activities. It will ensure the long-term sustainability of our business and reinforce our legitimacy in the eyes of the communities we serve.

## Sharing the rewards

Under our industry's regulatory regime, high levels of customer service create financial rewards. This means we are able to share the benefits of our work with shareholders as well as with customers and other stakeholders. In this five year period we are reinvesting £220 million of Totex outperformance back into our business, with a further £120 million of outperformance being shared with customers in the form of lower bills in AMP7.

Our investors too have benefited through our base dividend commitment of growth at RPI+4%, and this has all been achieved whilst maintaining a sustainable, resilient financial structure.

We delivered a 3.4% increase in Group turnover to £1,694.1 million, Group PBIT of £528.4 million, down 1.5% from the prior year, and underlying basic earnings per share of 121.0 pence, up 4.6% from the prior year.

We are therefore proposing a final dividend of 51.92 pence per share to be paid on 20th July 2018. This will take the total dividend for the year to 86.55 pence.

## Your Board

Emma FitzGerald stepped down from her position as a Director during the year. On behalf of the Board, I thank her for her insight, professionalism and dedication. It has been a privilege to work alongside her.

We have worked with regulators to successfully realign our English and Welsh licences along national boundaries. From 1 July 2018, all our Welsh interests will sit under a single licence, and we will rebrand Dee Valley Water as Hafren Dyfrdwy after the two main rivers which supply the region. Hafren Dyfrdwy will serve the interests of all our Welsh customers, and we are pleased to have made positive progress to ensure the robust governance of that company through the appointment to its Board of three new independent non-executive directors with a wealth of experience in business, public services and Welsh public policy. I am delighted that they all enhance the already diverse make up of our business.

## A diverse team doing great work

Severn Trent's people are a significant asset. We have a fantastic team here who worked tirelessly through the year, often in severe weather conditions, to deliver extraordinary service. They are rightly proud of both their efforts and the outcomes.

It is important that the makeup of our workforce is representative of the communities we serve. So I am pleased to report that 21% of the 124 graduates, placement students and apprentices who joined us during the year came from black or minority ethnic backgrounds. We are also mindful of the role that gender diversity plays in supporting a successful team. The representation of women on our Board led to us again being recognised by the Hampton-Alexander Review in 2017, which placed us second among FTSE 100 companies for representation of women on boards and in leadership. In addition, 40% of the members of our Executive Committee are female and, at 2.4%, our mean hourly pay gap is one of the lowest in the FTSE index.

## Looking ahead

We are now working hard to continue to position the business for success during the next regulatory period. Our draft business plans are well advanced and will be submitted to Ofwat in September 2018. We look forward to continuing to outperform against our service commitments through the rest of this AMP and into the next.

**Andrew Duff**, Chairman

# Market and industry overview

## Our context and peers

A total of 17 regional businesses supply water services to 50 million household and non-household customers in England and Wales. Ten of these, including our regulated business Severn Trent Water Limited, also provide waste water services. The remaining seven, including our regulated business Dee Valley Water Limited, provide water only.

## Over 25 years of continuous improvement...

Water services in England and Wales have been transformed in recent years, with a total investment of around £130 billion driving significant increases in reliability, efficiency and quality.

We're very proud of our industry's achievements. For example, whilst adverse weather such as that encountered last winter and spring can skew the picture, customers are still five times less likely to be without water than they were 25 years ago and eight times less likely to be affected by sewer flooding. Leakage has fallen by 35% since the mid-1990s, and 99.6% of drinking water as well as 98.6% of bathing waters now meet EU standards.

As discussed below, our regulatory framework is continuing to evolve. We believe that improving this existing mechanism, for example, by encouraging lower gearing and greater openness and transparency, is a more viable way forwards than embarking on a disruptive course of action that would distract attention from our industry's core priorities.

## ...but there's still more to do

We're excited about the opportunities to continue the good work the industry has recorded so far. But although we've taken huge strides in embedding customers right at the heart of what we do, we recognise that there's still room for improvement. Customers rightly expect the highest standards of water quality and waste water treatment, 24 hours a day and seven days a week, and while these are continuing to move in the right direction there's absolutely no room for complacency. We have to target capital investment programmes wisely in order to make sure our network – parts of which originate in the late 19th Century – is equipped to meet the demands of 21st Century living. That's no easy matter, in light of an increasing population and more housing, as well as all the challenges to water supplies and drainage caused by the droughts and floods associated with climate change. It requires experience, expertise and a great deal of money – in fact Severn Trent alone will have invested some £3,000 million in assets over the five years to March 2020.

Customers also want to be able to contact us whenever and however they want, whether that's to ask for advice, question a bill or notify us of a leak. Digital technology is playing a major role here at Severn Trent, helping us interact with customers via nine different channels, ensuring we are always there to talk to in person over the phone, or in writing.

Regional businesses

**17**

Number of households and non-household customers

**50 million**

Total investment for transformation

**£130 billion**

**"Water quality... waste water treatment... reliability and efficiency... service and support... all delivered with great value... these are the things our customers expect."**

And, of course, customers rightly expect all this while enjoying great value for money. Bills matter to everybody – and while we're pleased that yet again Severn Trent Water's customers benefited from the lowest bills in England and Wales over the last year, we're also committed to doing even more to support those vulnerable members of our local communities who struggle to pay.

Water quality… waste water treatment… reliability and efficiency… service and support… all delivered with great value… these are the things our customers expect. We've made terrific progress in the last quarter of a century and we know there's more to do – and we're committed to working with our peers in the industry and with our regulators to give our customers a service to be proud of.

## Our regulatory framework

The Government's approach to our industry is set by the Department for the Environment, Food and Rural Affairs ('Defra') in England and the Welsh Government in Wales. Ofwat is the industry's economic regulator. This means it sets limits on the prices we can charge our customers over five year Asset Management Plan ('AMP') cycles. This financial year was the third of AMP6, which runs from April 2015 to March 2020.

We also work closely with a variety of other regulators and public bodies:

- The Drinking Water Inspectorate ('DWI') independently checks that water supplies in England and Wales are safe and that drinking water quality is acceptable to consumers. Its work includes assuring water quality, ensuring companies make the changes necessary to improve, developing new regulations to further improve water quality, and science and policy.
- The Consumer Council for Water ('CCW') speaks on behalf of water consumers in England and Wales. It advises consumers and takes up complaints on their behalf.
- The Environment Agency ('EA') allows us to collect water from reservoirs, rivers and aquifers and return it to the environment after it's been used by our customers and treated by us.
- Natural Resources Wales is the environmental regulator in Wales. It oversees how the country's natural resources are maintained, improved and used now and in the future.
- Natural England advises the Government on the natural environment in England and helps to protect nature and the landscape, especially for plant and animal life in fresh water and the sea.
- The Health and Safety Executive helps us to reduce the health and safety risks faced by our employees, customers and visitors.

# **Market and industry overview** continued

## Moving into the next phase of regulation

Every five years, our regulator Ofwat reviews industry pricing. The most recent price review – known as PR14 – was in 2014 and heralded sweeping changes. PR14 gave customers a greater voice in setting our priorities and also introduced a performance-related reward and penalty system, called Outcome Delivery Incentives (ODIs). We welcomed these initiatives and believe they're playing an important part in driving greater efficiency across the industry.

Now we're moving towards the next price review, which will take place in 2019. In December 2017, Ofwat published its methodology for the 2019 price review, known as PR19. This provided us with guidance on expectations for our business plans, which we'll submit in September 2018. In our view, the methodology sets out a challenging environment, but also one where high performing companies can succeed. We're fully supportive of Ofwat's reform agenda, which includes stronger ODIs – and although they're currently still in development, our business plans will lay out our ambitions in four key areas:

### Customers

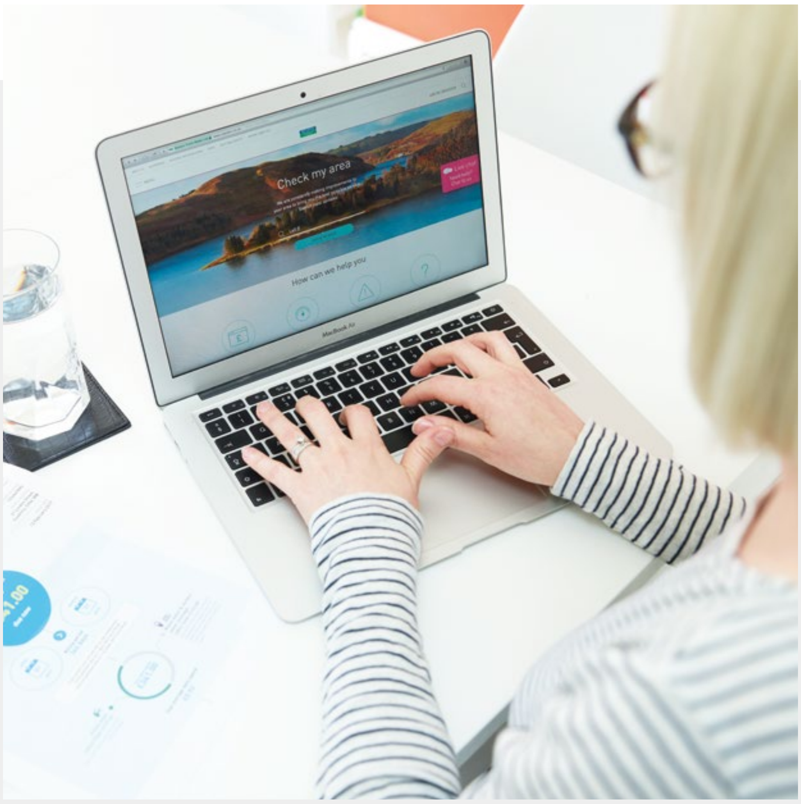
Our preparation work for PR19 has included the most comprehensive customer engagement activity and research programme in our history, in conjunction with insight from our everyday interactions with them. The result is a new level of understanding about the issues that are most important to our customers. In brief, they want us to go beyond just balancing supply and demand, providing clean drinking water and taking waste water away. They see us as key influencers in the everyday lives of their local communities. And they want us to step up and play our role to the full.

So, among other initiatives, we're investing in better communications and also redoubling our efforts around customer education, especially of children – for example on what not to put down their toilets – as well as supporting our people to do more volunteering to benefit the communities which we serve.

### Affordability

In 2017, and for the 8th year running, Severn Trent Water's customers had the lowest bills in England and Wales. That's an achievement in its own right, but we're committed to making sure that those bills are affordable for all our customers – including the most vulnerable. Struggling to pay a water bill can be an indication of other issues in a customer's life, so we're working with partners in local communities to identify those who may need some extra help.

**"Reliable supplies and services depend on reliable infrastructure. But to us 'resilience' is a broader issue than just having good quality pipes, reservoirs and treatment works. It means being operationally resilient, so our people are sufficiently well trained to carry out the tasks we need them to do."**



### Resilience

It goes without saying that reliable supplies and services depend on a reliable infrastructure. But to us 'resilience' is a broader issue than just having good quality pipes, reservoirs and treatment works. It means being operationally resilient, so our people are sufficiently well trained to carry out the tasks we need them to do, both in a steady state and in an emergency. And it means financially resilient, with a stress-tested capital structure to maintain an investment-grade rating for our regulated business and the appropriate equity strength to effectively manage risks. It also means having corporate resilience, with the right governance processes ensuring that we're fair and transparent at all times, and recognised as a responsible and trusted business by society at large. We're rightly regarded as a public service company and we'll do everything in our power to deliver a service that the public can be proud of.

### Innovation

You can't deliver outstanding customer service, keep bills affordable or run a resilient business without innovation. We're pleased to see that Ofwat's PR19 methodology embraces the role of markets, not only in bioresources but also in water resources through water trading.

In fact we're working with United Utilities to engage with Thames Water on the evaluation of a project to build a super interconnector that would enable us to transfer and trade water between the Severn and Thames catchment areas.

## What happens next?

Ofwat's timetable for PR19 is as follows:

Submission of business plans – 3 September 2018

Initial assessment of plans – late January 2019

Fast-tracked draft determinations – March/April 2019

Remaining draft determinations – July 2019

Final determinations – December 2019

## Playing our part in the debate

We agree with the general direction in which Ofwat is taking the industry and have continued to add our voice to the debate wherever and whenever possible.

For example, in addition to evaluating the possibilities of water trading, we worked with a number of our peers and the Social Market Foundation to publish a report into the likely implications of renationalisation on public sector debt levels.

We've also stepped up our consumer-facing communications, including launching our new brand – 'Wonderful on tap' – to improve understanding of what we do and how we do it. Please see our website for more details.

## How our market environment influences our five strategic priorities

**Embedding customers at the heart of all we do**
we'll continue to anticipate and to meet changing customers' and wider societal needs (see page 22)

**Driving operational excellence and continuous innovation**
innovation helps us to deliver the services customers need and keep bills affordable (see page 24)

**Investing responsibly for sustainable growth**
we invest to make sure we continue to benefit from a resilient, well-maintained network that meets the demands of a growing population and a changing climate (see page 26)

**Changing the market for the better**
we work constructively with regulators, helping to prepare the industry for the opportunities and challenges of the future (see page 28)

**Creating an awesome place to work**
we can only succeed if we have the support of inspired, talented, diverse and engaged people (see page 30)


# GETTING THE BALANCE RIGHT

"What truly matters is balance… balance between today and tomorrow, between making improvements where customers value them most, keeping bills affordable and providing a fair return to our investors."

**Liv Garfield**,
Chief Executive

**Times have changed. Today, all of us, across all walks of life expect the companies that serve us to be socially responsible. It's time for leading businesses to step up to the challenges of running a sustainable operation and to embrace all aspects of their performance: social and environmental as well as financial.**

Success is not as easy to quantify as it was in the past. Gone are the days when a company was judged purely on its balance sheet and income statement. At Severn Trent, this is a change we welcome wholeheartedly.

That's not to say that financial performance no longer matters. It does, and we're extremely proud of our track record in that respect, as you can see from the figures for 2017/18 that you'll find elsewhere on these pages, notably in James' financial report. What truly matters is balance… balance between today and tomorrow, between making improvements where customers value them the most, keeping bills affordable and providing a fair return to our investors.

We can debate what has caused this shift of opinion well into the early hours; whether it's the financial crisis or global political unrest, government action or the poor behaviour of a handful of companies, or something else entirely. What is undeniable is that this change has happened. And that the new world it's ushered in is here to stay.

So, instead of a traditional CEO review, I want to use these 1,500 words or so to tell you what I'm really proud of and what makes Severn Trent different, through the lens of social responsibility. I want to show you how have we performed when the metrics of success are extended beyond financial returns.

## Our environment: everybody's most important priority

Climate change has focused everybody's minds on the need to look after the planet we call home. At Severn Trent we're fortunate that our estate, which is one of the largest corporate land-holdings in the UK at over 53,000 acres, includes several Sites of Special Scientific Interest ('SSSIs') as well as many other areas that are important for plants and wildlife. But with great fortune comes great responsibility – more than most companies, we're in a position to have significant impacts on these wonderful environments.

So we work very hard to make sure that these impacts are as positive as possible. That means encouraging greater biodiversity by working with groups such as The Wildlife Trust and farmers. Over the last year, we improved biodiversity on 9.86 hectares of SSSIs and are targeting many more by 2020. We also encourage and empower our people to focus their volunteering efforts on local rivers and other habitats near their homes. And last year, 40% of our colleagues chose to clean up 50 km of riverbank through our volunteering scheme.

Environmental responsibility also means reducing sewer flooding – where we reduced the number of external flooding events by around 2,000, which is a 49% outperformance against our target – and serious pollution incidents, which came down from seven to two. We continued to improve the quality of water entering our rivers, for example by working in partnership with farmers and rewarding them for using less metaldehyde on their fields. It was great to see all these achievements come together and we believe they will help us regain the mark of exceptional environmental performance in our sector, the coveted 4* status from the Environment Agency.

Looking to the long-term future of the environment, we're continuing to invest heavily in renewable energy – and I was delighted that we generated the equivalent of 38% of the energy we consumed last year, and also sold green gas back into the grid.

**Group PBIT**
**£528.4m**
2017: £536.7m

**Group turnover**
**£1,694.1m**
2017: £1,638.0m

**Underlying Group PBIT**
**£541.0m**
2017: £520.1m

**Dividend increase**
**6.2%**
2017: 1.0%

**Net ODI outperformance payment**
**£80.2m**
2017: £47.6m

# Chief Executive's review continued

## Our customers: the reason why we're all here

There are two ways of behaving when you're a natural monopoly. You can simply take advantage of the opportunities your situation presents, or you can work night and day to create a service that's so good that your customers would still choose you, if they had the choice. We firmly believe that this is vital for any business that wants to still be a business in the years ahead.

So how do we do that? Firstly by striving to give customers what they tell us they want – low bills, less sewer flooding and high quality water at the turn of a tap. Our Upper Quartile positioning in the UK Customer Service Index and our Customer ODI performance show that we're making good progress.

Affordability is right at the top of our agenda and I'm delighted to report that at an average of £348 in 2018/19, Severn Trent Water's bills will once again be the lowest in England and Wales. That's £57 lower than the average household bill, £35 lower than the next cheapest and – if we look beyond the UK – half those in Berlin and a quarter of those in Copenhagen.

We're also increasing our efforts to support the most vulnerable people in our communities. As well as providing discounts to customers who are struggling to pay their bills, we've started to work more closely with other agencies and use our close relationship with local communities to identify where a little bit of extra understanding and financial help can go a long way to easing pressure on customers facing difficulties. This isn't the best way to improve our bottom line – but it is demonstrably the right thing to do.

As I've already mentioned, the number of sewer floodings are one of a number of measures in which we have outperformed, but it is disappointing when our customers are left with nothing coming out of their taps, as happened too often this year. Our performance on supply interruptions was our worst performance in five years and the first time we've missed our target on that measure during that time. Some of these interruptions to supply can be explained away by the extreme freeze-thaw-freeze cycles of the bitter winter, which also meant that we missed our challenging target on leakage – despite strong performance for 11 months of the year. But the fact remains that we know we have let some of our customers down in an area that really matters to them. Although small succour for these performance failures, customers are rightly compensated for them through compensation when our performance falls below regulatory standards and by virtue of the ODI penalty system, through reductions in future bills.

We're working really hard to improve our ability to cope with extreme weather, as this is a fact of life for us all now, through initiatives like leakage detector robots and other high tech tools that can give us extra 'eyes' on the network.

Customers also tell us that it's important that we're available for them when they need to talk to us. We all lead busy lives, and we all know how frustrating it is when you can't talk to somebody when you need to in the five minute slot that you have in between dealing with more important work or family matters. So we've extended and improved our contact channels. We're now the only water company that customers can contact at any time of day or night, on any issue – not just for emergencies.

We need to help our customers understand what they should and shouldn't put down the loo or the sink, and how to use water more efficiently. While I passionately believe that most people want to do their best for the environment, they don't always have the right knowledge to do so. That's why we spend so much time and effort on education, particularly in schools. If we can get young people to value water and support what we're doing to preserve and supply it, then we will all be in a much better place as well as our children and grandchildren in years to come.

## Our people: the assets that make it all happen

Severn Trent is its people. They're the ones on the front line, the ones who talk to customers, the ones who innovate and implement the bright ideas that help us deliver a service you would choose to have.

To be your best, you have to be happy and supported in your workplace. So we're constantly looking for new and better ways to help them thrive, fulfil their potential and show them how much we value their expertise and commitment. Over the last year we've increased our focus on training. Ours is a technical, engineering-led industry where there's absolutely no substitute for the right expertise. Of course, investing in training is good for our business, because it helps us be more technically competent. But it's also good for our colleagues, because it gives them a platform for growth, promotion and more rewarding careers – and it's good for local communities and industry too, because it improves the skills base across the Midlands. This is what businesses like Severn Trent can and should be doing... building our employees' talents and playing our part as members of society to benefit everybody.

As a significant employer in our region and presence in local communities across the Midlands, we can also do a lot to help change general attitudes towards issues that affect individuals everywhere. For example, according to the World Health Organization, one in four people in the world will be impacted by mental or neurological disorders at some point in their lives. So last year we decided that we needed to remove the stigma associated with mental health, particularly for men. We now have over 400 qualified mental health first aiders at Severn Trent, who have undertaken formal training programmes and also listened to first-hand stories of how mental health can affect lives – including personal contributions from my senior team. Now we're turning our attention to the menopause, which is another area that is a bit of a taboo in society at large but which can have a massively detrimental impact on women and their families.

Our employee engagement score rose by a full six percentage points last year, proving that the things we're doing for our people are appreciated, and we are turning Severn Trent into an even better place to work. Our teams respond to the sense of belonging and community that we're trying to create here – and an incredible 40% of them turned out to volunteer their time to improve their local environment during the last 12 months.

Dee Valley Water is now substantially integrated, and the people there are already a vital part of the Severn Trent family. I'm so proud of the fact that they haven't missed a beat in delivering a great year from an operational perspective, with zero coliforms (an important feature of water quality) at their sites probably being the standout achievement. We're learning from each other and adopting each other's best practices in order to provide better services to our customers and the environment.

I'd like to thank all 6,000 of our people for the passion they've applied to all they do over the year, sometimes in difficult circumstances, but always with a smile on their faces. They make it an honour to have my job. Thank you!

## Our outlook: lots to look forward to, but more hard work lies ahead

In September, we'll submit our plans to Ofwat for our next five year business plan. Make no mistake, from an industry perspective this is going to be tough.

But for customers, this is the right thing at the right time. Putting the focus fairly and squarely on customer service, affordability and long term resilience is absolutely the correct thing to do and we fully support Ofwat's goals.

We've been working hard over the last few years to make sure we're in good shape to rise to these challenges. As this report highlights, Severn Trent Water's customers again had the lowest bills in England and Wales, and we're making good progress in most other areas of the business. Are we getting it right all the time? No. But we know where and how we can improve – and we have a total determination with our people's support to get there.

**Liv Garfield**
Chief Executive

# How we are doing against our strategic objectives

## Embed customers at the heart of all we do

### What do we mean by this?

We'll improve the way in which customers engage with us through improved insight and understanding of what's important to them.

### What we said we would do in 2017/18

- Make a step change in customer service.
- Continue to deliver on the things that matter most to our customers to achieve a substantial reward of around £23 million in customer ODIs.
- Provide a service that is affordable for all and support our financially vulnerable customers by assisting 50,000 customers with their bills.
- Be recognised as an upper quartile wholesaler in the new non-household retail market.
- Provide an industry leading experience for property developers and customers who need new water and waste connections.

## Lowest bills in the land – yet again

Research tells us that with so many competing demands on household budgets, affordability is one of the biggest concerns for our customers. Which is why it was great to see that our efforts to keep water bills down yet again proved so worthwhile.

For the 8th year running, Severn Trent Water's customers have the lowest bills in England and Wales. Our average combined bill for 2018/19 will be £348. That's £57 below the average across the two nations and £35 less than the next cheapest.

Nevertheless, we know that some vulnerable customers still struggle to make ends meet – so over the last 12 months, we used our Big Difference scheme to give discounts of up to 90% to 36,000 people.

## Protecting the interests of our customers

From investing in robotic leakage detectors to encouraging farmers and fast food chains to be more careful about what they put on fields or down drains, we work tirelessly to make Severn Trent water as clean, available and affordable as possible.

Although customers certainly appreciate what we do – in fact water quality complaints are down 12% year-on-year – not everybody buys into the need to look after this precious resource. We don't enjoy taking people to court, but sometimes it's the only way to protect the interests of all those who pay their bills and play by the rules. Since the start of 2016, we've successfully prosecuted over 50 companies that have been caught illegally using hydrants to access our network. And to prevent future misuse, we've now fitted 30,000 locking caps to hydrants across our network.

## Our progress 2017/18

- Achieved upper quartile position in the UK Customer Service Index and reduced customer written complaints by 17%.
- Achieved better outcomes for customers on a number of measures including external and internal sewer flooding, and achieved ODI outperformance payments of £80.2 million.
- Maintained the lowest bills in England and Wales, and assisted more than 50,000 vulnerable customers with their bills.
- Developer Services team recognised by Ofwat as 1st for Water and 2nd for Waste in its SLA compliance comparison tables.

## Areas of focus for 2018/19

- Build greater capability in incident management focusing on continuous improvement.
- Develop the use of the 'Wonderful on tap' brand to increase the focus of all colleagues on enhancing the quality of our products and customer service, and make our customers aware of what we do for them and our connection with their daily lives.
- Deliver on the things that matter most to our customers as measured in Customer ODIs.
- Provide a service that is affordable for all and support our financially vulnerable customers by assisting 50,000 customers with their bills.

## Improving our performance for developers

Every year, we connect around 20,000 new properties and install and adopt around 100 km of new water and waste water pipes. And whether we're working with an individual doing a self-build, a national housebuilder constructing a new 200-home estate or office block, or a farmer wanting a new water supply for a distant drinking trough for his cattle, we aim to make this process as simple and cost-effective as possible.

By reorganising our Developer Services business around our three main customer segments – small and first time developers, large developers and self-lay providers – we evolved our approach over the last year to meet the needs of our customers more precisely.

The result? The best customer service within our sector – finishing 1st for water and a close 2nd for waste water as measured by the Ofwat customer service KPI. We also saw a 29% reduction in customer complaints compared to the previous year.

**"We continue to maintain the lowest bills in England and Wales, and assisted more than 50,000 vulnerable customers with their bills."**

# How we are doing against our strategic objectives continued

## Drive operational excellence and continuous innovation

### What do we mean by this?

We'll build a smarter water and waste water network, develop our business intelligence and simplify our cross business processes.

### What we said we would do in 2017/18

- On track delivery of our plans to be Upper Quartile for Retail, Water and Waste.
- On track delivery of Upper Quartile financing performance by the end of 2019.
- Continue to provide environmental leadership as evidenced by EA 4* status.
- Develop the profitability of our US and UK Business Services operations.
- Deliver budgeted benefits from implementing 10 innovation projects and 10 digital projects, and developing a sustainable pipeline and process for innovation.
- Drive innovative developer solutions to deliver a step-change in the new connections service to customers.
- Reduce the number of water quality complaints.


## Seeking out best practice, wherever in the world it lives

Our teams are constantly coming up with brilliant ideas on how we can do things better, faster or cheaper for our customers – and the Bike on a Boat project gives them all the support they need to become even more innovative.

Named after a clever idea developed by an America's Cup yacht racing team, Bike on a Boat is all about learning from each other as well as from best practice around the world. Towards the end of 2017, we took Bike on a Boat on tour, holding 64 roadshows at 10 different venues over six weeks and generating over 6,200 ideas from our people.

In October 2017, we launched a £100,000 Bike on Boat fund to enable any of our people to apply to travel anywhere in the world in order to learn more about how other companies are reducing water usage and leakage.

We have received over 30 applications and approved 13 trips as far afield as Australia and Singapore.

## Our progress 2017/18

- Achieved Upper Quartile performance in key waste measures including external sewer flooding.
- Delivered sector leading environmental performance, which we expect to lead to EA 4* status.
- UK Business Services profit increased, and US business sold.
- Expanded our search globally for innovative solutions to deliver the highest standards and greatest efficiency for our customers.
- Achieved 1st and 2nd place in Ofwat's water and waste rankings respectively for new connections SLA compliance.
- Delivered our best water quality performance in five years, reducing water quality complaints by 12%.
- Deployed innovative solutions, such as the addition of bio-augmentation to prevent the build-up of fatbergs, to deliver higher standards and greater efficiency.

## Areas of focus for 2018/19

- Deliver our plans to be Upper Quartile for Retail, Water and Waste.
- Continue to provide environmental leadership.
- Regain self-assured status for our English business.
- Make further progress on the quality of our water as measured by the DWI's Compliance Risk Index.

Customer water quality complaints

↓12%

Trialling the use of augmented reality technology at one of our operational sites.

# How we are doing against our strategic objectives continued

## Invest responsibly for sustainable growth

### What do we mean by this?

We'll develop an effective strategy which optimises our regulated asset base, whilst creating new growth opportunities for the future.

### What we said we would do in 2017/18

- On track to delivering on our PR14 commitments and make appropriate targeted investments for the future.
- Integrate and deliver the benefits of the Dee Valley acquisition, combining the strengths of the two companies to create a strong Welsh entity focused on delivering local priorities.
- Complete the transfer of our non-household customers to our joint venture business Water Plus.
- Generate the equivalent of 38% of our energy needs from renewable sources.
- Achieve material improvements in some of our key Enterprise Risk Management risks.

## Bringing new resilience to local infrastructure

The market town of Newark in Nottinghamshire has survived everything from the black death to the civil war. But an expanding population coupled with an ageing, inadequate sewer network was challenging the town's resilience. The infrastructure was at breaking point, with 400 properties regularly at risk of sewer flooding – after fire, the worst thing that can happen to a property.

We're currently investing £60 million in a three year project to replace more than 20 km of pipes, including a 2.8 metre diameter tunnel running 15 metres below Newark's streets. Despite short term disruption, the end results will be welcomed by all. The town will have a sewer and water pipe network fit for its future population. And for the 400 households at the heart of the project, a drop of rain will no longer raise the fear of sewage flooding their homes and gardens.

## Our progress 2017/18

- Embraced Totex, identifying a further £100 million of efficiencies which will be re-invested in the business to further improve customer service and ensure we're in the best possible position for AMP7.
- Substantially completed the integration of Dee Valley Water into the Severn Trent Group, allowing the two companies to learn and share best practice with each other for the benefit of their customers.
- Well advanced in realigning the boundaries of Severn Trent Water and Dee Valley Water along English and Welsh national borders.
- Generated the equivalent of 38% of our energy needs from renewable sources, and made good progress on the construction of new renewable energy plants.
- Delivered key milestones in major capital schemes, including the Birmingham Resilience Programme and the Newark waste and water improvement project. Major capital schemes are on track to meet any associated ODI commitments.

## Areas of focus for 2018/19

- Deliver fully on our PR14 (AMP6) investment commitments, being confident that we are able to deliver against our current plans and make appropriate investments for the future.
- Achieve material improvements in some of our key ERM risks.
- Drive a focus on efficiency across all business areas including central functions to support frontline investment.
- Continue to embed innovation across the Company, making it part of every team's way of working.

## The end of an era

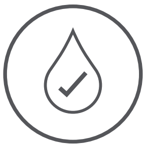
Customers in North Wales are now enjoying higher quality water, thanks to the completion of a complex scheme to close an old treatment works and instead supply water from a more resilient and efficient facility.

Constructed in the 1920s, the works at Legacy on the outskirts of Wrexham was licensed to abstract water from nearby former lead mines. This water was then treated through a series of pressure filters and chlorination plants before being held in a 350,000 gallon tank. However, despite regular upgrades, the facility was nearing the end of its useful life and some customers were experiencing occasional discolouration problems.

In March 2018, following several years of hard work by the team at Dee Valley, a project to transfer the raw water to Llywn Onn was completed – including a new distribution water pipe – and the Legacy treatment works was finally closed.

# How we are doing against our strategic objectives continued

## Change the market for the better



### What do we mean by this?

We'll embrace market opening in the UK and explore opportunities for growth in new water markets.

### What we said we would do in 2017/18

- Have a clear PR19 outline plan in place that evidences our leading status.
- Produce compelling cases for investment that customers want to see, at PR19, that enables strong RCV growth over AMPs 7 and 8.
- Design and implement the Bioresources change programme and business model.
- Be seen as the water sector's thought leader.
- Create a strong Welsh entity focused on delivering local priorities.

Tanker arriving at our sludge treatment centre at Worksop, north Nottinghamshire.

## Preparing for competition in new markets

During the year we commenced preparations for the separation of our Bioresources activity from our Regulated Water and Waste Water business into Business Services to ready ourselves for competition. We have created regional treatment hubs; streamlined logistics; optimised treatment strategy and rationalised sites. We are already active in the market having completed our first trial trade with Yorkshire Water in April 2018.

## Our progress 2017/18

- Our PR19 plans are coming together well, co-creating them with our largest ever customer engagement programme, and we are in a good position to submit in September 2018.
- Restructured our waste business to create a stand-alone Bioresources team, identifying opportunities for operating efficiencies and trading with our companies.
- Worked with the Social Market Foundation to assess the likely costs associated with renationalising the water and sewerage industry in England.
- Worked with United Utilities to engage with Thames Water on the construction of a super interconnector to transfer and trade water between the Severn and Thames catchment areas.
- Integration of Dee Valley Water is well advanced, and plans to realign the boundary of the Company wholly within Wales will take effect in July 2018.

## Areas of focus for 2018/19

- Produce compelling cases for investment at PR19 that enable strong RCV growth over AMPs 7 & 8.
- Deliver phase two of the energy and renewables strategy to achieve 50% self-generation.
- Build a sector leading approach to Bioresources.
- Finalise the creation of Hafren Dyfrdwy and deliver a great first year.

Integration of Dee Valley Water is well advanced, and plans to realign the boundary of the Company wholly within Wales will take effect in July 2018.

# **How we are doing against our strategic objectives** continued

## Create an awesome place to work

### What do we mean by this?

We'll create a culture of empowerment and accountability with a focus on skills, talent and career development.

### What we said we would do in 2017/18

- Deliver a step change in our safety performance.
- Improve the wellbeing of our colleagues.
- Deliver a further uplift in our employee engagement scores.
- Progress our talent agenda.
- Continue to strive for the most diverse and inclusive business with increasing numbers of Black, Asian and Minority Ethnic ('BAME') talent in our business.
- Further improve employee engagement by resolving the top 10 issues identified by our employees.

## Opportunity and support for all

We're striving to make Severn Trent an awesome place to work – where anybody who wants to reach their potential can thrive.

Graduates already recognise the opportunities we offer – and apprentices are continuing to follow suit, with another increase in their numbers over the last year. We're also succeeding in attracting a more diverse workforce – BAME employees on our graduate programmes were up 12.74% during the year. Now we're redoubling our efforts to encourage people from less socially mobile populations to join us, removing artificial barriers to entry and working with more schools in disadvantaged areas. For example, for the year ahead we've ring fenced 25 work experience opportunities at five schools across five social mobility 'cold spots' in our region.

Once they're part of our team, we provide all our people with a range of training programmes. We've committed to invest in technical skills and will create a new Severn Trent Training Academy, focused on delivering tailored programmes for staff across our region, with the aim of making our workforce the most technically skilled in the industry.

We recognise the importance of supporting people in all aspects of their lives. During the year, we continued our major programme to improve our employees' understanding of mental health issues, as well as encouraging greater awareness of cancer and menopause. In April 2018, we also signed up to the TUC's Dying to Work charter which aims to protect employees with a terminal diagnosis.

## Our progress 2017/18

- Achieved a 23% reduction in lost time injuries, resulting in an LTI rate of 0.17, through an enhanced focus on safety culture, standards compliance and training.
- Continued our focus on mental and musculoskeletal health to drive an improvement in employee wellbeing and reduce absences.
- Achieved a six percentage points improvement in our employee engagement survey, demonstrating improvement in all areas, and achieving an upper quartile position relative to our peers.
- Continued investment both in our graduate and apprentice schemes, as well as innovative investment in the ongoing training and development of our broader employee population.
- Focused efforts on further improving social mobility within our region, through targeted recruitment from social mobility cold spots.
- Delivered solutions for two of the top 10 issues identified by our employees, and made progress to resolve the remaining issues.

## Areas of focus for 2018/19

- Deliver a further step change in our safety performance and support the wellbeing of our colleagues.
- Continue to build on our strong volunteering performance and drive the CR agenda.
- Continue our focus on improving overall Quest engagement scores.
- Deliver the foundations of the new Academy, to make a positive contribution to technical development.


## Supporting clean, safe water and sanitation

**As a founding member and long term supporters of WaterAid, we've raised over £450,000 for the charity over the last two years. We believe that our continued support can help WaterAid realise our shared ambition for clean water, decent toilets and hygiene for everyone everywhere by 2030.**

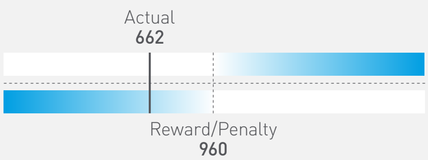
# ODIs and KPIs

We continue to make progress against our customer ODIs and financial KPIs.

## Progress against our Outcome Delivery Incentives[2]

### 1. Embed customers at the heart of all we do

#### Internal sewer flooding



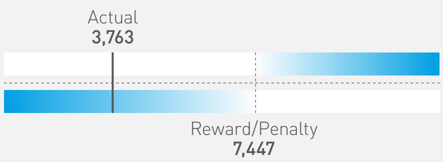

Rate of Reward/Penalty (per incident)

£42,820[1]

**Why we measure it**
To ensure we do everything we can to prevent flooding of customers' homes or businesses. It is one of our customers' most important priorities.

**Progress in the year**
We are reporting a performance of 662 internal incidents, ahead of our committed performance level of 960 incidents.

#### External sewer flooding



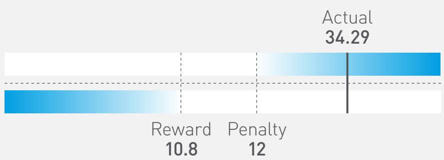

Rate of Reward/Penalty (per incident)

£19,779[1]

**Why we measure it**
To ensure we do everything we can to prevent flooding of customers' homes or businesses. It is one of our customers' most important priorities.

**Progress in the year**
We are reporting a performance of 3,763 external incidents, ahead of our committed performance level of 7,447 incidents.

#### Minutes without supply




Rate of Reward/Penalty (per minute)

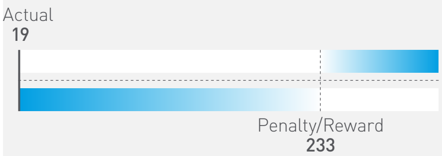
£1.10m[1]

**Why we measure it**
Our customers value water being there when they need it. This performance commitment ensures we are driving down the impact of any interruptions to supply across our network to minimise the impact on customers.

**Progress in the year**
We interrupted customers' supplies for an average of 34.29 minutes in 2017/18, well behind our performance commitment of 10.8 minutes.

### 2. Drive operational excellence and continuous innovation

#### Improvements to river water quality



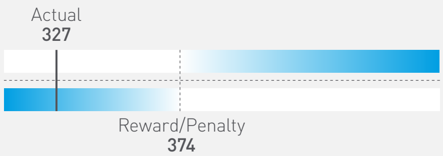

Rate of Penalty/Reward (per unit)

£150,000[1]

**Why we measure it**
We have statutory obligations to deliver, but our customers told us that we should do more where we can. This performance commitment ensures we meet our obligations and drives us to deliver more where it is possible.

**Progress in the year**
There were 19 individual points completed in 2017/18, bringing our cumulative total to 34 points, and we are on track for our end of AMP target.

#### Number of category 3 pollution incidents



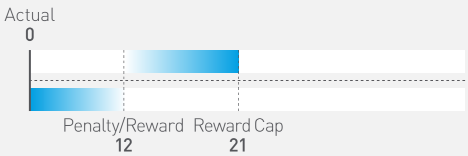

Rate of Reward/Penalty (per incident)

£53,900[1]

**Why we measure it**
Minimising the impact our activity has on the environment is a key concern for our customers. This performance commitment ensures we drive to improve performance in this area.

**Progress in the year**
We are reporting 327 category 3 incidents against a committed performance level of 374; this is 47 ahead of target and our reward dead-band.

#### Successful catchment management schemes




Rate of Penalty/Reward (per scheme)

£1.03m[1]

**Why we measure it**
Our customers want us to look for new and innovative ways to improve water quality, whilst working in partnership with other stakeholders to deliver wider benefits. This performance commitment focuses on how our approaches are encouraging farmers and land owners to change their behaviour and practices.

**Progress in the year**
Over the last year, we have undertaken a review of our schemes and processes and optimised our approach based on previous years' experience. We are on track to deliver more than our performance commitment of 12 catchments in 2018/19.

### 3. Invest responsibly for sustainable growth

See our Regulated Water and Waste Water performance review on pages 34 to 41.

### 4. Create an awesome place to work

#### Lost time incidents per 100,000 hrs worked

Severn Trent Water Limited

0.17 2016/17: 0.22

Severn Trent Business Services

0.15 2016/17: 0.04

## SIM – Customer experience

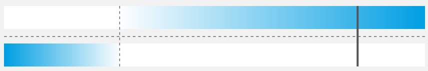
Not yet defined by Ofwat

83.2 SIM score

**Why we measure it**
Providing good quality service to our customers is key and the Service Incentive Mechanism ('SIM') provides us with a regular opportunity to understand our performance and implement initiatives to improve the quality of service we provide, but also deliver value for money.

**Progress in the year**
We have seen a slight decline in our quantitative areas of our business and maintained our qualitative scores which has meant that we have reported a SIM score of 83.2 for 2017/18, behind our original upper quartile target.

## Complaints about water quality




Rate of Reward/Penalty (per complaint)

£900[1]

**Why we measure it**
Customers value the aesthetic quality of their water. This performance commitment is designed to ensure we manage our network to minimise the number of events that cause discolouration, taste or odour problems.

**Progress in the year**
In 2017, the number of drinking water quality complaints decreased from 14,461, to 12,687, but we did not achieve our committed performance level of 9,992.

# Progress against our financial KPIs[4]

## Group turnover

£1,694.1m

2016/17: £1,638.0m

## Group underlying PBIT

£541.0m

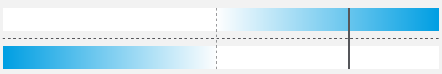
2016/17: £520.1m

## Underlying earnings per share

121.0p

2016/17: 115.7p

## Asset Stewardship – coliform failures



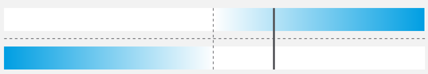

Rate of Penalty

£463,000[1]

**Why we measure it**
The presence of coliforms in our drinking water is unacceptable as it is an indicator of poor quality so we continually monitor our works to ensure they are not being detected.

**Progress in the year**
During 2017, we detected coliforms at eight water treatment works sites, which is worse than our committed performance level of seven or fewer works with coliform detections.

## Leakage




Rate of Reward/Penalty (per megalitre per day)

£123,000[1]

**Why we measure it**
Customers see leakage as a waste of a key resource; our customers want us to reduce our level of leakage as a priority.

**Progress in the year**
Our outturn position for 2017/18 was a total of 443 Ml/day, which was behind our committed performance level of 434 Ml/day.

## Severn Trent engagement score improvement[3]

6 percentage points

**Notes**

1 In 2012/13 prices after tax.

2 These are also key measurements used to assess our Corporate Responsibility performance.

3 Engagement index used for the Group since 2015/16 to support benchmarking and gain better insight about us as an employer.

4 Alternative Performance Measures are defined in Note 46 to the Group Financial Statements on pages 192 to 194.

**Key**

Actual
| Severn Trent Actual Performance 2017/18

# Regulated Water and Waste Water

Our Regulated Water and Waste Water business performed well during the year, as we continued to deliver our five strategic priorities.

Here, we provide greater detail on the achievements and challenges we encountered while delivering our five strategic priorities over the last 12 months – and also identify some of the areas where there's still more to do.

Litres of drinking water supplied each day
**1.6bn**

Kilometres of sewerage pipes in our network
**94,027**

Households and businesses served
**4.3m**

We aim to educate and inspire an entire generation, not just about water conservation and environmental protection, but also by emphasising the importance of hydration to their health and wellbeing.

## Embedding customers at the heart of all we do

Serving our 4.3 million customers and doing our best for their local communities sits right at the very centre of everything we do.

During the year, we carried out the most intensive customer engagement activity in our history. This included a range of in-depth, deliberative sessions with customers to get right to the heart of their needs, and close collaboration to explore how those needs – and our service – could evolve in the future.

The customer engagement confirmed that the priorities for our customers are consistent and simple – including less sewer flooding and lower bills. Simple to understand, of course, but not so simple to achieve. So it's extremely pleasing to report that this was the third consecutive year where we outperformed on the measures that our customers care most about.

### Less sewer flooding

An improved record on sewer flooding sits right at the top of our list of achievements. There's been a 35% reduction in the number of customers affected by external sewer flooding, largely due to our continued focus on prevention.

With many blockages caused by wipes and other non-degradable items, we've continued to use a wide range of initiatives to educate our customers about what they can and can't put down toilets and drains. Among households, wipes are the main culprits and during the year we interacted with 200,536 customers to help them to improve their understanding of how sewers work and to be careful around how much water is consumed. We're paying particular attention to the customers of the future, and engaged with 156,102 schoolchildren during the year. We aim to educate and inspire an entire generation, not just about water conservation and environmental protection, but also by emphasising the importance of hydration to their health and wellbeing.

In the non-household sector, we followed up last year's pioneering agreement with McDonald's by engaging with more fast food restaurants. In Gloucestershire, for example, we worked with companies including YO! Sushi, J D Wetherspoon and The Mayflower to help prevent fatbergs by educating staff about what they shouldn't be pouring down sinks and drains, and advising them on what grease containment and treatment is needed.

We're the first water company to provide a 24/7 service for non-emergencies, so customers can contact us to discuss anything they want in the middle of the night, if that's what fits in with their lives.

## Lower bills

For the 8th consecutive year, Severn Trent Water's customers paid the lowest bills in England and Wales, with our average combined bill for the year being £341. We're proud of this record – but we're even more proud of our continuing efforts to do more every year to help vulnerable customers who are struggling to make ends meet. In its third year, our Big Difference scheme helped 36,000 customers access discounts of between 10% and 90%, which is a critical part, along with other tailored schemes, to ensure we deliver on our commitment to help at least 50,000 customers with bills every year. Experience tells us that financial difficulties can often indicate issues in other areas of a customer's life, so we've expanded our care and assistance team to give us the capacity to engage with agencies such as housing associations, the NHS, Citizens Advice and charities including MIND, Samaritans and local food banks, as well as other utility companies. By working together, sharing appropriate information and adopting a holistic approach to vulnerable people, we believe we'll be able to do even more to play a key role at the heart of local communities.

## More ways to contact us

It's important to our customers that they can get in touch with us how they want, when they want. We now maintain nine different customer communication channels, including webchat which saw an increase in traffic during the year. We're the first water company to provide a 24/7 service for non-emergencies, so customers can contact us to discuss anything they want in the middle of the night, if that's what fits in with their lives. The value of round-the-clock availability can be seen in the fact that on most nights, more people contact us with questions about payment of their bills and other issues than about emergencies.

Although our customer Service Incentive Mechanism ('SIM') score – which Ofwat uses to measure how well and how quickly we put things right when our service fails to meet customers' expectations – is disappointing, we are working hard to improve the consistency of our customer experience. There's still more to do, and we're going to focus extra effort in areas such as the time we take to respond when customers inform us of a leak. But it's encouraging to see that our drive to embed customers at the centre of all we do is paying off where it matters most – in the hearts and minds of customers themselves. Customer written complaints for the year are down 17%.

We continued to perform well on the Institute of Customer Service's UK index, which measures customer satisfaction across the utilities sector, achieving upper quartile position for customer satisfaction, equivalent to fourth position in the Utilities sector. We look forward to the introduction of Ofwat's new C-MeX measure; currently in development, we believe that this measure will provide a truer reflection of our relative performance.

# **Performance review** continued
# Regulated Water and Waste Water


We've outperformed our internal sewer flooding regulatory target by 31% and our external target by 49%.

## Driving operational excellence and continued innovation

We're fully supportive of the incentive environment that Ofwat has created. The clear linkage between performance and reward has encouraged us to think differently about how we work and to develop a sharper focus than ever on improving customer service. The result has been a good performance which has generated significant ODI outperformance payments of £80.2 million. We've decided to defer these earnings and access them in the years to come, when they'll help us to smooth future customer bills.

Nowhere is our performance better demonstrated than on our waste measures, including sewer flooding. As reported above, we achieved a significant reduction in the number of customers affected by such incidents over the last year. In fact we've outperformed our internal sewer flooding regulatory target by 31% and our external target by 49%. How have we achieved this? By continuous investment supported by leading edge technology. At a macro level, we're using sophisticated data and analytics to predict the areas at greatest risk and then addressing these with targeted capital investment. At a more micro level, we're carrying out root cause analysis of incidents when they do occur and putting measures in place to prevent reoccurrence – whether caused by geographic factors or customer behaviours.

### Regaining 4* status

Pollution is an area where the investments made since privatisation are really paying off – and we're delighted to report that our environmental performance should enable us to regain coveted 4* status from the Environment Agency.

Our number of serious pollution incidents (categories 1 and 2) decreased to two from seven the previous year while category 3 performance again improved, with 327 incidents against a regulatory target of 374. At the same time, we worked hard to improve the quality of the water entering our rivers and reservoirs. Metaldehyde is an effective pesticide against slugs, snails, and other gastropods – but once it runs off fields and enters the watercourse, it's extremely expensive to remove. We continued to use financial incentives to encourage farmers to pursue different and less environmentally damaging alternatives, with considerable success.

The Drinking Water Inspectorate ('DWI') plays a key role in our regulatory environment, and we continued to fulfil our commitment to carry out diagnostics at our 16 largest sites. Our performance is measured by a metric known as mean zonal compliance, and during 2017/18 we improved our performance compared with the prior year at 99.96% (2016/17: 99.94%).

### Scope for improvement

Unfortunately, our performance on supply interruptions was less pleasing, with a two-fold year-on-year deterioration. Due to a number of significant bursts some of our customers were left without water. The major burst at Tewkesbury in December, which affected many thousands of people, was challenging both to locate and isolate. Although we worked tirelessly to reconnect our customers and provided 100,000 litres of bottled drinking water, we recognise that our performance was unacceptable.

Then, in March 2018 the very rapid thaw following 'The Beast from the East' led to a substantial increase over a seven day period in the number of burst pipe notifications we would typically receive during that period, followed by complications caused by airlocks, further snowfall and then further bursts. We were incredibly disappointed that homes and communities were left without water as a result of the unprecedented weather. We know how difficult everyday life was for our customers until we could restore supplies – and we decided immediately to pay £30 compensation, roughly equivalent to our average monthly combined bill for water and waste, to any who were without water for more than 12 continuous hours, or experienced intermittent supply for more than 15 hours. We also worked with business customers and their retailers who were affected. With around 70% of issues occurring on private property, we know we need to do more to advise customers better on how to prepare for winter.

The quality of our drinking water is constantly monitored and strictly regulated. Our strategy for the year was to focus more efforts on our surface water treatment works – and while this generated good results it was accompanied by a slight dip in performance at our ground water sites. For example, the number of sites where coliforms were detected rose from five to eight. While coliforms are harmless bacteria, their presence can be an indication that water quality is not as high as it should be.

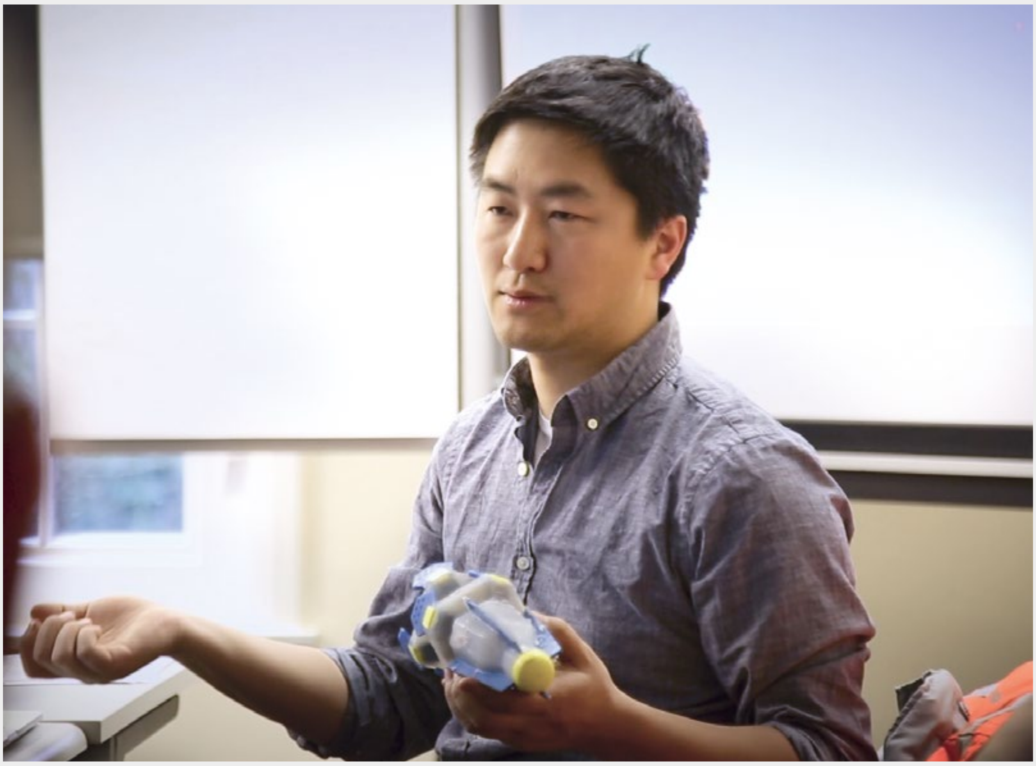
Overall, we received 12,687 complaints about water quality during the year, down by 12%. This was our best performance for six years, and sustained the prior year's improvements. We're committed to further improvement and acknowledge that the number of complaints in 2017/18 is still significantly above our regulatory target of 9,992. We're targeting improvements in many ways, including adopting the water flushing programme initiatives in place at Dee Valley Water which helped the team there achieve 100% compliance during the year.

One of the Dee Valley Water teams is currently leading the Severn Trent water quality improvement programme – a good example of how we're sharing best practice and learning from each other's experiences.

**Investing in innovation**

We continue to seek out innovative ideas that can transform our performance, no matter where they originate. For example, our commitment to remove phosphorus from our sewage treatment works has seen our innovation team evaluate technologies from across the world. Following intensive £2 million trials at our Packington site over the last two years, we're now commencing the roll-out of five different and highly advanced technologies. These include a magnetite ballasted coagulation process pioneered in the US. At one site this technology has replaced our original solution, which was costed at £21.1 million. The new solution reduced the cost to £12.5 million and will lead to a total expenditure (Totex) saving of £8.7 million – a return on investment of 218% on one scheme alone.

We're also seeking to improve our performance on leaks through innovative projects, such as the introduction of detector robots into the pipe network. This innovative solution uses small touch sensors to spot the nature and exact location of leaks rather than the current visual and acoustic techniques. Based on technology first used in North America, we were the first test case in Europe and only the third test case globally with very encouraging early results.



We're also seeking to improve our performance on leaks through innovative projects, such as the introduction of detector robots into the pipe network.

# Performance review continued
## Regulated Water and Waste Water continued

### Investing responsibly for sustainable growth

At Severn Trent, we've been responsible for £21 billion of the £130 billion invested by our industry since privatisation – and our capital programme continued at pace through 2017/18, as we invested £855 million across our estate. Last year, we committed to investing a further £120 million in AMP6 in order to make sure we're in the best possible shape for AMP7, and we've increased our forecast Totex efficiencies by £100 million. These now stand at £870 million. This additional £100 million of Totex efficiencies, which is in addition to the £120 million previously announced, will also be reinvested in our business, for the benefit of customers.

**Delivering our capital programme**

Looking at our major capital projects, we started work on a £60 million project to protect 400 homes and businesses at Newark in Nottinghamshire from sewer flooding, and provide the town with a more reliable water supply. On track for completion in 2019, the project will see us install 4 km of new sewers and 10 km of new water mains, and also build a 3 km, 2.8 metre diameter, tunnel 15 metres below Newark.

The £300 million Birmingham Resilience Project is the largest capital project undertaken in the industry during AMP6. Due to be completed in 2020, this will create a second major source of water for Birmingham. Progress during the year included preparatory works for the Lickhill to Frankley pipeline comprising the laying of 17 km of pipework and major tunnelling operations.

Meanwhile, the £40 million investment to replace an ageing reservoir with two new ones at Ambergate was completed a year early in February 2018. This project will lower the risk to drinking water quality while improving our storage capacity resilience at the same time.

Our capital programme is delivering rewards in many areas of the business. We've retained our Upper Quartile position in waste and are moving in that direction on water. In terms of ODIs, we've significantly outperformed our targets and our ODI outperformance payments have exceeded £80 million.

**Building a sustainable business**

It's important to balance capacity-building projects with the need to create a sustainable business that's able to deliver customer benefits in the long term – not just next year but over the coming decade and beyond.

For example, we carried out 15,367 home water efficiency checks during the year. These help customers save money by using water more efficiently – and that means less pressure on water resources in the future. We're now using demographic data such as socioeconomic profiling, to target customers who we believe stand to gain most from a visit by our team. In total, our education programmes helped over 171,469 customers use water more wisely in 2017/18.

We're fortunate that the Severn Trent estate is home to a diverse array of species of plants and animals. During the year, we improved biodiversity at Sites of Special Scientific Interest ('SSSIs') covering 9.86 hectares, representing good progress against our 2020 target of 75 hectares – and we also improved almost 120 km of rivers as part of the Water Framework Directive. We continue to focus on exploring innovative ways to generate renewable energy from waste, and last year self-generated the equivalent of 38% of our energy needs. Please see the Business Services performance review on page 42 for more details.

On a more negative note, our emissions performance was disappointing as we failed to achieve our Water carbon ODI due to higher than expected energy use. In response, we've introduced new energy management initiatives for the coming year. We've also agreed to help the National Grid balance energy supply and demand by turning some of our operational sites off at certain times.

We know that our own efforts to become more sustainable become even more effective when we're joined by others – and in May 2017, we were delighted to see our supply chain partners stepping up to support our ambitions. At an event in Coventry, senior delegates from our top suppliers engaged with our management team to explore opportunities to work together for mutual benefit. The outcome included a series of pledges from these influential suppliers to work on improving sustainability in areas relevant to their business. For example, embedding carbon and water reductions in their processes and pledging to work closely with us on mitigating the risks of modern slavery.

Closer to home, we are working with PwC and Hope for Justice to provide our people with bespoke training on modern slavery. This programme raised awareness of the issue and how to identify it, particularly among our suppliers – and it's encouraged our people to become advocates of our zero tolerance approach to modern slavery.

## Changing the market for the better

Severn Trent Water and Dee Valley Water are very active players in the water industry across England and Wales. We're keen to play our part to the full – promoting the industry and the positive influence it has had on life in the UK since privatisation, and encouraging greater awareness among regulators and others of the issues we face.

During the year, we supported the Social Market Foundation in publishing a report into the likely implications of renationalising the water industry on public sector debt levels. With some commentators estimating the cost of such a development to be in excess of £90 billion, our view is that the public should be fully aware of the facts around all aspects of renationalisation. We also collaborated with Thames Water and United Utilities to publish a thought leadership document on how water companies could create and manage a systems operator for water trading in order to drive greater efficiency.

### Encouraging new ideas

We have a track record of embracing markets where we believe we can create value for our customers. For example, our Water Plus joint venture with United Utilities is enabling us to take advantage of the opportunities presented by the opening of the non-household retail market in April 2017.

We continued to engage with our industry peers on a wide range of issues throughout 2017/18, in order to identify and evaluate new and better ways of working. Our draft Water Resources Management Plan outlines a range of potential trading options to help meet future demand pressures and to secure supplies for the long term. We've already worked with Thames Water and United Utilities to investigate the benefits that a super interconnector could bring to our respective regions, by enabling us to move and trade water. Additional future options include bio-resources trading – and we've taken part in trials to make sure we're ready for the opportunity when it arises.

We also worked closely with the Water Forum, which not only gave us valuable customer insights but also helped guide the new and deeper approach we're taking to supporting vulnerable members of our local communities.

Acquired in 2017, Dee Valley Water has now been substantially integrated into the Group, and we've been busy sharing ideas between the businesses. The acquisition gave us the opportunity to realign both Dee Valley Water and Severn Trent Water around national boundaries. Once the realignment is complete in July 2018, Dee Valley Water will be answerable to the government in Wales, while Severn Trent Water will be answerable to the government in England.

We recognise the importance of leading by example, and aim to help our industry regain public trust and legitimacy by demonstrating the highest standards of governance. Our Board leads from the front and is responsible for the oversight of all aspects of the business, including culture. During the year, the Directors continued to evaluate a broad set of cultural indicators, such as exit interviews and external stakeholders' perceptions, in order to ensure that our values remain central to everything we do.

# Performance review continued
## Regulated Water and Waste Water continued

### Creating an awesome place to work

Our people are key to the success of our business – and we want to make sure we motivate, reward and support them accordingly. It was very encouraging to see our efforts reflected by a six percentage points improvement in our annual employee engagement survey in 2017. The increased score builds on the positive momentum of recent years as our culture matures, and was achieved across the board – people in every part of the business support what we're doing.

We're creating an awesome place to work by focusing on a broad set of projects and initiatives. Recruitment and career paths clearly play an important role – graduates continue to be attracted to the challenges and opportunities we offer, and our apprentice intake increased yet again. In fact during 2017/18 we were delighted to see four experienced employees start on our first ever Masters level apprentice programme.

**Celebrating diversity**
The last 12 months saw the establishment of our first LGBT+ inclusion group. The mission of this team was to create a proud and inclusive culture for our LGBT+ community, supporting our colleagues and ongoing commitment to being recognised as a diverse and inclusive business.

**Helping people progress**

We invest in skills and development at all levels of the business, doing all we can to provide people with progressive, successful careers. A number of our current senior managers started in junior positions. We aim to provide great opportunities for all, regardless of gender, race or background. We continually strive to be a diverse, inclusive business that reflects the demographics of our region, and achieved a 13% increase in the numbers of Black, Asian and Minority Ethnic ('BAME') employees on our graduate programmes during the year. The population in the East and West Midlands is among the least socially mobile groups in the UK – but as a major employer we can help change that and enable people to realise their potential. To this end, we've removed barriers to entry such as the requirement to have a degree for some of our programmes and we have changed our selection process to focus on potential rather than experience.

Our gender diversity performance improved during the year and we now have a mean gender pay gap of just 2.4%. However, we're working hard to reduce it still further. We benefit from high female representation at executive level and were pleased to be placed second among FTSE 100 companies for representation of women on boards and in senior leadership roles by the 2017 Hampton-Alexander Review. The last year also saw the creation of our first LGBT+ inclusion group. The mission of this team was to create a proud and inclusive culture for our LGBT+ community, supporting our colleagues' ongoing commitment to being recognised as a diverse and inclusive business.

We encourage all our people, across all roles and age ranges, to be creative and put forward their ideas for innovations that can improve customer service. We repeated the all-employee staff roadshow, following its success in 2015. The 'Bike on a Boat' tour, inspired by the innovative approach of the New Zealand America's Cup-winning team of 2017, captured and shared a wide range of brilliant ideas. Since its launch we have funded 13 ideas, including sending employees to evaluate initiatives in Singapore, Australia, Denmark and USA that could be adopted in our business.

We also restructured the business during the year. This brought a renewed emphasis on our core work in water and waste water, it's also improved our customer focus and, crucially, brought a new level of clarity to our employees on roles and responsibilities. We all know what's expected of us, and we all know that the business will do its best to support us by giving us the tools we need – whether that's a robot leakage detector, an innovative agreement with a farmer or a day of intensive management training.

Pay and conditions are high on everybody's list of priorities, and we've made good progress here too. We provide jobs that are well paid and with excellent pensions. Our bonus scheme also embraces everybody, ensuring that the rewards of a good year's work are shared among us all. The annual employee engagement survey identified pay transparency and relativity as two of the top 10 issues where our people thought we could improve. We're now addressing this by clarifying pay rates and being more thorough in the way we explain career opportunities.

### Promoting health, safety and wellbeing

We pay particular attention to the health, safety and wellbeing of our teams, and in 2017/18 continued our major initiative around mental health. Our aim is to remove the stigma around mental health, for example by creating a workplace where people can talk about problems with depression or stress. To date, we've trained over 400 mental health first aiders to spot the signs of a possible issue, while a number of senior managers have brought mental health more into the open by talking frankly about their own experiences. During the year, we held an initiative on the menopause and other areas that people can be uncomfortable discussing, including cancer, and we signed up to Dying to Work, which supports employees with a terminal diagnosis.

We're committed to the highest standards of behaviour at all times, not only in our own business but also among our suppliers, who are required to sign up to our Code of Conduct, anti-corruption and bribery policy and our sustainable supply chain charter to illustrate that they share our values and are committed to helping us achieve our goals. We audit suppliers as part of our tendering process for large contracts, and they must demonstrate full compliance with our standards at all times.

Over 40% of employees volunteered during the year, a huge increase on the 11% that took part in 2016/17.

During the year, we worked with Hope for Justice to develop a training package, including upskilling our contract managers on how to spot the signs of slavery and human trafficking and the steps they should take if any concerns are raised. We have clear policies and training in place – and these are supported by an independent and confidential whistleblowing service which we actively promote via communications such as messages on payslips. Every report of possible corruption or bribery, from any source, is investigated and reported to both the Corporate Responsibility and Audit Committees of the Board.

We want our people to feel part of a progressive company that plays its part to the full – and the record level of employee volunteering is another positive sign of this. Over 40% of employees volunteered during the year, a huge increase on the 11% that took part in 2016/17. Most volunteering was through our new Community Champions programme, working alongside key partners such as The Wildlife Trust to improve 50 km of riverside environments in our regions. Our volunteers also helped our corporate charities, Comic Relief, Sport Relief and Children in Need, as well as continuing our long term support for WaterAid. In addition to raising nearly £300,000 during the year, our people also drew on specific industry skills to give practical help to WaterAid, for example by supporting the charity's campaign to improve water quality in Cambodia.

# Business Services

We have transformed Business Services during the year: divesting our overseas operating services businesses and increasing our focus in the UK; expanding our energy production capacity and establishing our Bioresources business; and setting up our Property division.

## Focusing on the domestic UK market

Following the sale of our Italian business in the previous year, in June 2017 we sold the Operating Services' US business to Public Pensions Capital for $62 million. This enabled us to sharpen our focus on our core UK and Ireland domestic market, in line with our strategy.

Our UK contracts business again provided a solid foundation for the year's performance. The 25 year operating and maintenance contract with the Ministry of Defence ('MOD') has now reached the halfway point. We're delighted to continue to receive positive feedback from our customers regarding the service we're delivering and we've continued to see strong returns from project work across the MOD estate.

We continue to grow and value our close working relationships with customers. For example, this was demonstrated to good effect on our Coal Authority contract. Our team is now co-located in the customer's Mansfield office, from where we manage the contract to prevent flooding and pollution issues at disused mines.

## Seizing new opportunities

We've completed the integration of our non-household retail operation into Water Plus. This joint venture with United Utilities is focused on the opportunities created by the opening of the non-household retail market to competition in April 2017. Water Plus is working well, maintaining its share of a growing market by winning several major contracts. The emphasis for the year ahead will be on driving improvements in the market and improving our service to meet customer needs, as we strive to be recognised as a leader in this new market.

In a move that will help us extract maximum value from our estate, we created a new property division during the year. The Property Development business unit aims to develop land previously used for operations through the planning process for onward sale to developers to enable new homes and commercial premises to be built, creating new homes, communities and jobs. Our experienced, dedicated team has significant property expertise and will assess the potential in our surplus land. Together with Severn Trent Water's Estates Management Team, our aim is to deliver £100 million profit over the next decade.

Construction of our third food waste plant is also progressing well. Sited in Derby, this new plant is the first in the UK to incorporate advanced thermopressure hydrolysis, which will enable us to generate more energy and take in waste from the broader waste market.

## Generating our own energy

Our sewage sludge anaerobic digesters, food waste and crop digestion plants, two wind turbines and solar PVs generated the equivalent of 38% of our energy during the year – and we remain on track to achieve our target of increasing that percentage to 50% by 2020.

In pursuit of that goal, we took steps to expand our renewable activities by announcing a new Bioresources business unit. Set to begin operations in April 2018, the new unit will manage all bio-resource activities within our regulated business, in preparation for the opening up of the bio-resource market in 2020.

Our crop digestion plant near Nottingham will play an important role in achieving our 50% target. The plant produces gas by digesting maize that's been grown on contaminated land around our treatment works. Construction of a new biogas facility to expand capacity by 50% completed in December 2017 and delivers biomethane directly into the National Grid.

Food waste plants – which take waste food from restaurants, supermarkets and other facilities – are another way in which we're turning waste into renewable energy. Our second food waste plant at Stourbridge opened for business in June 2017. It will produce enough green gas to power around 3,000 homes and help the Government meet its objective to decarbonise the environment. Construction of our third food waste plant is also progressing well. Sited in Derby, this new plant is the first in the UK to incorporate advanced thermo-pressure hydrolysis, which will enable us to generate more energy and take in waste from the broader waste market.

# Managing our critical resources and relationships

## Every day, we rely on six key resources and relationships to support the long-term sustainability of our business.

On these pages we explain these resources and relationships in detail, and showcase a number of practical examples of how we managed them over the last year.

This year we have integrated our CR metrics among our commentary on managing our critical resources and relationships.

Positive engagement with land managers

**85%**

2017: 44%

Water Framework Directive classification improvement points

**19**

2017: 15

Hectares improved from unfavourable or deteriorating condition using Natural England's database of SSSIs

**9.86**

2017: 29.74

Expected EA rating

**4***

2017: 3*

Number of Environment Agency Category 1 & 2 incidents (calendar year metric)

**2**

2017: 7

Reduction in Group carbon emissions

**4.4%**

(scope 1 and 2) – our direct emissions and those from the energy we use

2017: 8.3%

# Our natural resources

## Maintaining our reservoirs, rivers and underground aquifers

**We're fortunate to be responsible for some of the UK's most impressive natural resources. From the chain of man-made lakes created by damming the Elan and Claerwen rivers in Wales, which provide clean water to Birmingham, to stunning stretches of rivers such as the Severn, the Dee and the Trent, these wonderful resources provide the raw materials for our services.**

Despite the relatively dry winter, our reservoirs were full at the end of the financial year, and we're in a strong position to ensure a reliable supply to customers during the year ahead.

### Working with landowners...

Prevention is better than cure, so we work hard to make sure that the water entering our watercourses is as clean as possible. Supported by the skills of a dedicated team of agricultural advisers, the Severn Trent Environmental Protection Scheme ('STEPS') aims to improve watercourses and the wider environment.

STEPS provides grants of up to £5,000 for infrastructure improvement and land management changes in our target areas. This is part of our plan to invest £21 million by 2020 to help farmers improve water quality – an investment that will pay off several times over by protecting the environment and reducing treatment costs.

For example, we continued to recompense farmers prepared to switch from metaldehyde to less invasive alternatives for the control of slugs. Once in the watercourse via field run-off, metaldehyde is extremely expensive to remove – and the scheme has again delivered excellent value while helping us achieve our catchment management target.

We improved biodiversity on 9.86 hectares of Sites of Special Scientific Interest ('SSSIs') during the year, and have a target of improving 75 hectares of SSSIs by 2020.

### ...and ensuring long term supply

As the financial year closed, we published our draft Water Resources Management Plans ('WRMP'). Our long term view on supply availability, the WRMP articulates the need to make significant investments in water supply and demand management schemes, particularly in light of the Government's requirements for the industry to reduce levels of water abstraction. For example, Severn Trent Water has targeted a 15% reduction in leakage over the next five years, and we plan to increase the use of water meters, in addition to stepping up our home water efficiency checks. We carried out 15,367 checks during the year – helping customers save money and protect future supplies by using water more efficiently.

### Helping farmers step up to the challenge

**Prevention can be more cost-effective than treatment, particularly when it comes to pesticides which can enter our rivers from surrounding fields. Through STEPS we offer farmers grants of up to £5,000 per year to undertake works which will help reduce pollution.**

CARBON TRUST STANDARD
REDUCING CO2 YEAR ON YEAR

### Retaining the Carbon Trust Standard

**We were proud to once again be reaccredited with the Carbon Trust Standard during the year. This achievement verifies that we have sound carbon management processes in place and are reducing absolute carbon emissions year-on-year. In fact, we've reduced our GHG emissions by 17% since 2014.**

# **Managing our critical resources and relationships** continued

### Cleaning our rivers

Under the EU Water Framework Directive ('WFD'), we're charged with achieving 'good status' for all watercourses. We continued to support the aims of the WFD during 2017/18 and again made significant progress towards achieving our ambitious target of improving the health of 1,800 km of river by 2020. We completed 10 WFD sewage treatment projects during the year which improved almost 120 km of river – an increase of around 650% over the previous year – and we're now approximately 15% of the way to reaching our objective. River health is assessed by the Environment Agency and measured against a set of criteria including oxygen levels and the presence of fish and invertebrates.

### Managing our environmental impact

During 2017/18, we outperformed our internal sewer flooding regulatory target by 31% and our external target by 49% – and these have been key factors that should help us regain a 4* rating from the Environment Agency.

We also achieved all of our regulatory targets relating to pollution incidents, reducing serious category 1 and 2 pollutions to two events during 2017/18, down from seven in the prior year.

We failed to reach our water ODI carbon emissions target for 2017/18, primarily due to greater energy consumption as we need to meet increases in demand for water production. Efficiency measures now in place are expected to drive the required reduction in the coming 12 months. Meanwhile, we continue to increase the amount of renewable energy we generate. During the year, we produced the equivalent of 38% of Severn Trent Water Limited's energy needs and are on track to increase this to 50% by 2020.

## Using technology to prevent pollution

**Combined sewer overflows ('CSOs') are susceptible to pollution if they block or stop working properly. So over the last year we've invested in monitors at over 70% of our CSOs. We're also installing over 1,000 monitors in manholes where there's a high risk of internal flooding or pollution.**

## 40% of employees volunteer to clear 50 km of rivers

**Our volunteering scheme continues to go from strength to strength. During the year, over 40% of our people worked with partners such as local Wildlife Trusts to help clean up the environment alongside 40 km of rivers in England and a further 10 km in Wales.**

# Our physical assets

Ensuring a resilient and well-maintained network

**Our physical assets include over 49,000 km of water mains, 27 dams, 139 water treatment works and a vast range of equipment, sites, offices and other structures across an estate that covers more than 53,000 acres. While a significant number of these assets are over 100 years old and of historic importance, many are among the most technologically advanced examples of their type in the water industry – not only in the UK but worldwide.**

We're committed to ensuring that our assets are in optimum condition at all times, able to deliver the high quality services that our customers depend on. At dams and reservoirs, for example, we carry out regular checks to identify any remedial actions that need to be undertaken – and every year, the Board receives a full report on the condition of each dam and reservoir in our portfolio.

Security is an increasingly important issue for all key UK infrastructure. Mindful of our role and responsibilities, we co-operate closely with the Government on potential terrorist targets and provide physical security at all major sites. At the same time, our cyber security team constantly monitors our IT assets, identifying and addressing any vulnerabilities in order to protect our data and that of our customers.

## Improving our portfolio to improve efficiency...

Since privatisation, the water industry has invested some £130 billion in assets to improve services for customers, with our own capital programme involving an investment of around £3 billion over the five years to March 2020.

The major projects currently underway include the £300 million Birmingham Resilience Project – the largest ongoing capital project in the industry – and a £60 million scheme to improve sewers and water mains at Newark in Nottinghamshire. We also have a continuous investment programme to improve the effectiveness of our sewage treatment works, including a £12.5 million project to remove phosphorus.

## ...and reduce interruptions and leakage

While our capital programme is delivering rewards in many areas of the business, we recognise that our customers experienced too many supply interruptions during the year. Some of these caused major hardships, notably at Tewkesbury in December 2017, when we took too long to locate, isolate and rectify a burst main, and in March 2018 when the countrywide freeze and subsequent thaw contributed to some customers being left without water or with only intermittent water supplies for extended periods of time.

We're working hard to improve our performance, including investing in robot leakage detector technology which we believe would have been invaluable at bursts such as the one at Tewkesbury.

The time we take to respond when customers tell us about a leak is another area where we need to improve. However, this is not as clear cut as it appears. Our performance commitment target is to respond within 24 hours, but, this may not be the most operationally effective way to provide a good service to customers or manage our network efficiently. We're currently evaluating our response capabilities in order to assure ourselves and our customers that our current approach is appropriate.

## **Managing our critical resources and relationships** continued

# Our people

## Creating a place where people enjoy coming to work – where they're safe, well rewarded and treated with respect

**The Group employs around 6,000 people at locations primarily across the East and West Midlands as well as in North and mid-Wales. We know that we're only as good as our people. So we strive to create a workplace that's welcoming, safe and well-rewarded – and where they're treated with respect. This year's employee survey showed a six percentage points increase in engagement, clearly demonstrating that we're on the right path to making the Group an awesome place to work.**

### Health, safety and wellbeing

The health and safety of our people is a core aspect of how we work, and we ensure that they're provided with the training and resources to follow our safety rules. Our Lost Time Injury ('LTI') frequency rate for the year was 0.17 per 100,000 hours worked, a significant decrease of 23% over the previous year. Our rigorous approach to safety has led to this improvement over the last three years, from 0.21 in 2015. However, there's no room for complacency and we'll continue to promote safe working practices through initiatives including training and regular communications.

We also made good progress in ensuring our people's wellbeing during the year. We continued our mental health programme and now have over 400 trained mental health first aiders across the Group. This is part of our drive to promote greater awareness of some of the more challenging issues that people can face in their everyday lives – for the year ahead we're continuing to focus on the menopause and cancer.

### Pay and career paths

We aim to provide people with careers, not just jobs. Pay scales are relatively high for our Midlands heartlands, and we work hard to make sure that our people can see how and where they can progress up through our organisation – regardless of their starting point.

Attracting high quality people is a challenge for all employers, so we're pleased to see the high numbers of graduates that apply to Severn Trent. Our apprentice programme expanded yet again during the year and for the first time included a Masters level option.

Over the next 12 months we're going to respond to issues raised in the employee survey, including greater clarification on pay rates and extra focus on how we explain career opportunities.

### Diversity and inclusion

We're already a diverse, inclusive business – but we know there are opportunities to do even more to reflect the demographics of our region.

The year saw a 13% increase in the numbers of Black, Asian and Minority Ethnic ('BAME') employees on our graduate programmes, and we've introduced new ways of working designed to drive a further increase in future years. These include removing barriers to entry such as the requirement to have a degree for some of our programmes and improving the way we target recruitment activities at schools.

Gender diversity is another area where we're performing well. Our mean gender pay gap for the year was 2.4% – and we're committed to reducing it still further. Our executive team has particularly high female representation, which is why we were placed second among FTSE 100 companies by the 2017 Hampton-Alexander Review.

DYING TO WORK

### Signing up to help those with a terminal illness

**We were proud to sign up to the TUC's Dying to Work charter during the year, which aims to protect employees with a terminal illness. We believe that nobody should have to worry about keeping their job if they have a terminal diagnosis.**

### Raising awareness of mental health

**Since 2015, 19% of our employees have taken part in mental health awareness training. We're going to continue to focus on this issue during the year ahead – while also expanding our efforts to embrace other aspects of wellbeing such as physical health, nutrition, exercise and sleep.**

# Our suppliers and partners

## Building strong relationships that provide mutual benefit

**We rely on a pool of suppliers that use their expertise and resources to maintain and improve our infrastructure. Through the One Supply Chain programme, we agree long term contracts that give suppliers greater certainty of workflow and revenue, while the benefit to Severn Trent lies in the opportunity to negotiate more competitive prices. The long term nature of the contracts also enables both parties to build stronger relationships, work more closely together and explore more efficient ways of working.**

In addition to achieving operational excellence and meeting our efficiency targets, our contracts also stipulate that suppliers must adhere to our own high safety standards and sign up to our policy on bribery and corruption and our sustainable supply chain charter. We ensure compliance with these requirements through a comprehensive audit during the tendering process, and through regular communications and meetings. For example, a number of our suppliers have signed up to corporate responsibility targets agreed with us, and we review progress against these monthly. Through our supplier events, we have set out our plans and expectations, and have invited delegates to contribute their own ideas on how we could work better together. We also took the opportunity to underline the role that safety and ethics play in creating enduring supplier relationships.

### Partnering with others

We're keen to work with partner organisations from both inside and outside our industry, combining their specialist knowledge with our own in order to address some of the challenges and opportunities we face.

For example, during the year we extended our drive to support vulnerable customers – and have now formed deeper relationships with bodies including MIND, Samaritans, Citizens Advice, local food banks, the NHS and other utility firms. By sharing our knowledge, we aim to build a holistic view of people who are potentially vulnerable and to put measures in place to help them at an earlier stage.

We've continued to collaborate with our peers in the industry. We engaged with Thames Water to evaluate a project to build a super interconnector that would enable water trading, and with the Social Market Foundation to publish a report into the possible financial implications of renationalisation. In partnership with Thames Water and United Utilities, we also published our joint ideas on how the creation of a systems operator could support greater efficiency.

Inspecting the condition of our waste water assets at Packington treatment works.

**Suppliers signed up to sustainable supply chain charter**

**211**

Introduced in May 2017

**Suppliers paid on time**

**96%**

2017: 97%

# Managing our critical resources and relationships continued

## Our customers and communities

### Improving the customer experience

**We're responsible for meeting the needs of 4.3 million household and business customers, across an area stretching from the Bristol Channel to the Humber, and from North and mid-Wales to the East Midlands. We provide these customers with around 1.6 billion litres of high quality drinking water every day and treat around 2.77 billion litres of waste water, which we clean and return to the system.**

Everything we do is to the benefit of our customers and their communities – and during the year we carried out our most extensive research project ever, to make sure that we're addressing the issues that matter most to them.

### Making a difference

Communication is the key to managing expectations, and we work hard to keep customers and communities informed and to minimise disruption when we carry out planned work on our network. Through our education programme, we help people save water and prevent blockages in our sewers and drains, supporting the long term integrity of the network and protecting water supplies for future generations.

The scale of our operations and the nature of our assets means we have a great opportunity to be a positive influence on the environment in local communities. We're continuing to implement initiatives – and working with local businesses, including farmers – to improve important habitats such as rivers, for the ultimate enjoyment of all. Our 17 visitor sites host a total of 4 million visits a year, and provide access to water for a range of leisure facilities, as well as customer education facilities.

Many of our people continued to play their part in the lives of their local communities during 2017/18. In fact more of our people than ever before took the chance to join in some form of volunteering or fundraising activity.

Customers who rate our service value for money in an independent quarterly survey

**59%**

2017: 58%

Customers we help each year through social tariffs and assistance schemes

**51,716**

2017: 50,903

## Regulators

### Working with the authorities to shape our industry

**We maintain positive and constructive relationships with Ofwat and other regulatory bodies. Complying with their requirements at all times isn't just the right thing to do – it's essential to our licence to operate and our ability to meet our commitments to our customers and other stakeholders.**

We engage with regulators on a regular basis in order to share our knowledge and promote developments which could lead to improved services for customers across the industry.

Our 17 visitor sites host a total of 4 million visits a year, and provide access to water for a range of leisure facilities, as well as customer education facilities.

# Chief Financial Officer's review

We have delivered a good financial performance in 2017/18, absorbing the upward pressures from sector-wide changes in business rates and energy pass-through costs. In our Regulated Water and Waste Water business, a full year's contribution from Dee Valley Water and higher revenues more than offset the impact of these pressures on our operating costs. In Business Services we have delivered good growth both in revenues and PBIT.

Underlying basic earnings per share increased by 4.6% to 121.0 pence per share in the current year. Reported basic EPS from continuing operations was 102.2 pence.

Our Return on Regulated Equity ('RoRE') at 11.5% is 1.5 percentage points higher than the previous year, driven by a strong performance across all three levers – Totex, customer ODIs and financing. Last year our RoRE was amongst the best in the sector and we expect to be in a similar position when this year's results for all companies are published in July.

In line with the revised dividend policy announced last year of growth of RPI plus at least 4% per annum, the proposed dividend for the year has increased by 6.2%.

On financing, we have a strong funding position, with all our projected investment and other cash flow needs covered by cash or committed facilities through to March 2020. This year saw the first rate increase from the Bank of England in more than 10 years. We actively monitor and manage our interest rate exposure and took steps to hold our proportion of debt at floating rates at 26% through the year end. We are also preparing for the introduction of CPIH indexation in AMP7, entering into CPI/RPI swaps with a notional value of £100 million in the second half of the year, which increased the total amount of these swaps to £150 million at 31 March 2018. And we have entered into a further swap for £100 million since the year end.

We are committed to paying the right amount of tax at the right time. In addition to the corporation tax, which is included in our tax charge in the income statement, we also pay business rates, employers' national insurance and environmental taxes such as the Climate Change Levy and the Carbon Reduction Commitment. In 2017/18 we incurred £146.5 million in these taxes, charges and levies (2016/17: £147.2 million). Our corporation tax charge for the year was just above the statutory rate of 19% with our cash tax payments reduced by the benefit of allowances on our capital programme, contributions to our pension schemes and by the timing of instalment payments to HMRC under the current rules.

A brief overview of our financial performance for the year is as follows:

- Group turnover from continuing operations was £1,694.1 million (2016/17: £1,638.0 million), an increase of 3.4% as Regulated Water and Waste Water revenue increased by 3.0%, mainly due to the RPI-linked tariff increases and a full year of Dee Valley Water, and Business Services' external turnover grew by 9.2%.
- We increased underlying PBIT by 4.0% to £541.0 million (2016/17: £520.1 million). The first full year of Dee Valley Water contributed an additional £5.7 million and, excluding Dee Valley Water, underlying PBIT in our Severn Trent Regulated Water and Waste Water business grew by £14.5 million. Business Services underlying PBIT grew by £3.8 million, offset by a reduction in corporate and other PBIT of £3.7 million.
- We recorded net exceptional costs of £12.6 million (2016/17: credit of £16.6 million). Costs to prepare our Bioresources business for the introduction of the competitive market in 2020 were £20.9 million, partially offset by a credit from the Pension Exchange Arrangement reported at the half year. Reported Group PBIT was down as a result by 1.5% to £528.4 million (2016/17: £536.7 million).
- Net finance costs were £219.5 million (2016/17: £205.1 million). Our effective interest rate of 4.5% was up only marginally from 2016/17 (4.4%) despite the impact of higher RPI on our index-linked debt.
- Our full effective tax rate was 20.5% and our underlying effective tax rate was 12.7%, down from 16.6% in 2016/17 largely due to higher capital allowances from the larger capital programme in the year.

## Regulated Water and Waste Water

Turnover for our Regulated Water and Waste Water business was £1,574.6 million (2016/17: £1,528.8 million) and underlying PBIT was £514.9 million (2016/17: £494.7 million).

| | **2018** | | | 2017 | | | Better/(worse) | |
|---|---|---|---|---|---|---|---|---|
| | Excluding Dee Valley £m | Dee Valley £m | **Total £m** | Excluding Dee Valley £m | Dee Valley £m | Total £m | Excluding Dee Valley £m | % |
| Turnover | 1,546.7 | 27.9 | **1,574.6** | 1,526.6 | 2.2 | 1,528.8 | 20.1 | 1.3 |
| Net labour costs | (136.4) | (5.4) | **(141.8)** | (139.8) | (1.0) | (140.8) | 3.4 | 2.4 |
| Net hired and contracted costs | (145.8) | (1.9) | **(147.7)** | (144.6) | – | (144.6) | (1.2) | (0.8) |
| Power | (93.6) | (2.3) | **(95.9)** | (86.7) | (0.1) | (86.8) | (6.9) | (8.0) |
| Bad debts | (25.1) | (0.6) | **(25.7)** | (20.4) | (0.2) | (20.6) | (4.7) | (23.0) |
| Other costs | (188.1) | (4.8) | **(192.9)** | (187.7) | (0.6) | (188.3) | (0.4) | (0.2) |
| | (589.0) | (15.0) | **(604.0)** | (579.2) | (1.9) | (581.1) | (9.8) | (1.7) |
| Infrastructure renewals expenditure | (134.4) | (0.8) | **(135.2)** | (136.2) | – | (136.2) | 1.8 | 1.3 |
| Depreciation | (314.3) | (6.2) | **(320.5)** | (316.7) | (0.1) | (316.8) | 2.4 | 0.8 |
| Underlying PBIT | 509.0 | 5.9 | **514.9** | 494.5 | 0.2 | 494.7 | 14.5 | (2.9) |

# Chief Financial Officer's review
continued

Dee Valley Water was acquired on 15 February 2017 so this is its first full year in the Group. It contributed £27.9 million to turnover and £5.9 million to underlying PBIT in the year. The following commentary on the Regulated Water and Waste Water business excludes Dee Valley Water and is therefore on a like-for-like basis.

Turnover increased by 1.3%, as higher tariffs, including the impact of the annual RPI increase on prices, increased revenue by £33.8 million. Customer ODI rewards earned in 2015/16 increased turnover by £25.8 million but this was offset by a reduction from the Wholesale Revenue Forecasting Incentive Mechanism of £24.5 million arising from revenue billed in excess of the wholesale price control also in 2015/16. Our successful drive to help more vulnerable customers reduced revenue by £4.6 million due to greater take-up of social tariffs. Other movements of £10.4 million (net) including the impact of customers opting for metered status, offset by consumption increases further reduced turnover. In the current year our billed revenue was around £3 million below the wholesale price control and this will be added to revenue to be billed in 2019/20.

Net labour costs were £3.4 million (2.4%) lower. Gross employee costs increased by 5.3%, due to the annual pay award and our strategy to bring more work in-house. The increase in activity on capital projects resulted in an increase in the level of own labour capitalised, up £16.0 million on the previous year.

Net hired and contracted costs were up £1.2 million (0.8%).

Power costs were £6.9 million higher year-on-year driven as forecasted by higher pass through costs, greater consumption from a higher volume of water produced and the costs of responding to incidents. The Group manages its power costs through a combination of demand management, self-generation and forward price contracts.

Our bad debt charge increased by £4.7 million this year, and represented 2.2% of household revenue (up from 1.8% last year). In the year we improved cash collections on our current debt, but saw a decline in the amounts collected on older debt – both in accounts collected by us and by other water companies on our behalf. The prudent provisioning we apply to this older debt increased both our charge and the level of bad debt as a percentage of household revenue for the year.

Other costs increased by £0.4 million in total after higher profits on disposal of fixed assets (up £5.8 million) offset by higher business rates of around £3 million and other cost increases.

Infrastructure renewals expenditure was £1.8 million lower in the year, at the lower end of our guidance range; we expect to see growth in the programme next year.

Depreciation of £314.3 million was £2.4 million lower than the prior year. Our underlying depreciation rate increased in line with our asset base, but the change was lower year-on-year due to impairments recorded in 2016/17.

## Return on Regulated Equity ('RoRE')

RoRE is a key performance indicator for the regulated business and reflects our combined performance on Totex, customer ODIs and financing against the base return allowed in the Final Determination.

Severn Trent Water's RoRE for the year ended 31 March 2018 and for the three years ended on that date is set out in the following table:

| | 2017/18 % | AMP6 to date % |
|---|---|---|
| Base return | 5.6 | 5.6 |
| Totex outperformance | 0.8 | 1.3 |
| ODI outperformance | 2.3 | 1.5 |
| Financing outperformance | 2.8 | 0.9 |
| **RoRE[1]** | **11.5** | **9.3** |

1 Calculated in accordance with Ofwat guidance set out in RAG 4.07.

We have delivered strong returns across the board – with outstanding Customer ODI performance, improved operational and investment efficiency driving Totex savings, and continuing outperformance on financing.

## Business Services

| | **2018 £m** | 2017 (restated) £m | Increase £m | Increase % |
|---|---|---|---|---|
| **Turnover** | | | | |
| Operating Services | **78.3** | 74.4 | 3.9 | 5.2 |
| Renewable Energy | **60.4** | 54.0 | 6.4 | 11.9 |
| | **138.7** | 128.4 | 10.3 | 8.0 |
| **Underlying PBIT** | | | | |
| Operating Services | **15.9** | 12.8 | 3.1 | 24.2 |
| Renewable Energy | **20.1** | 19.4 | 0.7 | 3.6 |
| | **36.0** | 32.2 | 3.8 | 11.8 |

Our Business Services division delivered good growth in revenues (up 8.0%) and underlying PBIT (up 11.8%).

In our Operating Services business, turnover and underlying PBIT increased by £3.9 million and £3.1 million respectively, due in part to higher income from our new contract with plumbing and drainage insurers.

In the Renewable Energy business, turnover increased by 11.9% largely driven by increased generating capacity in the non-regulated business from our new food waste plant at Roundhill. Underlying PBIT increased by 3.6%, with our operating margin impacted by start-up costs in the new plant.

The results above exclude the US Operating Services business, which was sold on 30 June 2017; the Italian Operating Services business (sold on 23 February 2017); and the non-household Retail business (transferred to the Water Plus joint venture during the prior year). All of these businesses have been classified as discontinued operations in the current and previous periods and the results for the previous period have been restated to reflect this.

## Corporate and Other

Corporate overheads were £8.9 million (2016/17: £6.9 million) and our other businesses generated a net loss of £0.8 million (2016/17: profit of £0.9 million).

## Exceptional items before tax

We recorded a net exceptional charge of £12.6 million (2016/17: credit of £16.6 million).

We have made an early start in preparing our Bioresources business for AMP7. We have developed our business model and identified the actions that we need to take to compete effectively in the new market, determining the lowest cost structure from our existing network of sites, optimising our tanker fleet operations and identifying opportunities for trading in the new market. We have implemented a programme to reorganise the business to deliver our business model, reducing from 20 sites to 12, and as a result incurred exceptional costs of £20.9 million as follows:

- Set up and restructuring costs £2.1 million;
- Write-off of assets that will not be used in the new business £16.8 million; and
- Provision for costs to decommission these assets of £2.0 million.

An exceptional gain of £8.3 million arose (2016/17: gain of £16.6 million) from the net benefit, after implementation costs, of a Pension Increase Exchange arrangement, under which members of the defined benefit schemes will be offered the opportunity at retirement to exchange future non-statutory inflationary increases in a portion of their pensions earned prior to 1997 for a higher pension payment now. In the prior year the exceptional gain arose from a similar exercise for existing pensioners.

## Net finance costs

Our net finance costs for the year were £219.5 million, up £14.4 million on the prior year. Our effective cash cost of interest (excluding the RPI uplift on index-linked debt and pensions-related charges) was 3.4%, 40 basis points lower than 2016/17. Higher RPI inflation on our index-linked debt (up £23.9 million) and pensions-related charges meant our overall effective interest rate increased marginally year-on-year to 4.5% (2016/17: 4.4%), but still compares favourably to our position at the start of AMP6 (5.4%).

Capitalised finance costs were higher than the prior year due to the increased level of capital activity in the year.

Our earnings before interest, tax, depreciation and amortisation ('EBITDA') interest cover was 4.3 times (2016/17: 4.3 times) and PBIT interest cover was 2.7 times (2016/17: 2.7 times). See note 46 for further details.

## Gains/losses on financial instruments

We use financial derivatives solely to hedge risks associated with our normal business activities including:

- Exchange rate exposure on foreign currency borrowings;
- Interest rate exposure on floating rate borrowings; and
- Exposure to increases in electricity prices.

Accounting rules require that these derivatives are revalued at each balance sheet date and, unless the strict criteria for cash flow hedge accounting are met, the changes in value are taken to the income statement. If the risk that is being hedged does not impact the income statement in the same period as the change in value of the derivative, then an accounting mismatch arises and there is a net charge or credit to the income statement.

During the period a counterparty requested to terminate four interest rate swaps with a notional principal of £150 million. The fair value of the swaps at termination was a £42.6 million liability and the termination payment was £40.0 million. The gain on termination has been included in finance income.

We hold interest rate swaps with a net notional principal of £251.3 million, fixed to floating, and cross currency swaps with a sterling principal of £98.3 million, which economically act to hedge exchange rate risk on certain foreign currency borrowings. However, the swaps do not meet the hedge accounting rules of IAS 39 and so the changes in fair value are taken to gains/(losses) on financial instruments in the income statement. During the year there was a loss of £12.6 million (2016/17: gain of £11.1 million) in relation to these instruments.

Note 12 to the financial statements gives an analysis of the amounts charged to the income statement in relation to financial instruments.

As part of our power cost management strategy, we have fixed around 95% of our estimated wholesale energy usage for 2018/19.

## Taxation

We are committed to paying the right amount of tax at the right time. As well as corporation tax on profits, which is included in the tax charge in our accounts, we incur a range of taxes, charges and levies imposed by government agencies:

| | 2018 £m | 2017 £m |
|---|---|---|
| **Tax borne:** | | |
| Corporation tax | **26.7** | 32.4 |
| Business rates and property taxes | **82.4** | 78.8 |
| Employer's National Insurance | **23.2** | 21.6 |
| Climate Change Levy | **4.0** | 3.2 |
| Carbon Reduction Commitment | **5.9** | 6.3 |
| Other taxes | **4.3** | 4.3 |
| | **146.5** | 146.6 |

# Chief Financial Officer's review
continued

The corporation tax charge for the year recorded in the income statement was £61.9 million (2016/17: £6.5 million) and we made net corporation tax payments of £6.5 million in the year (2016/17: £21.8 million). The difference between the tax charged and the tax paid is summarised below:

| | 2018 £m | 2017 £m |
|---|---|---|
| Tax on profit on ordinary activities | **61.9** | 6.5 |
| Tax effect of timing differences | **(29.0)** | (26.4) |
| Current tax credits recorded in Other Comprehensive Income or Equity | **(10.1)** | (14.9) |
| Overprovisions in previous years | **3.9** | 27.4 |
| Impact of rate change | **–** | 39.8 |
| Corporation tax payable for the year | **26.7** | 32.4 |
| Payable by instalments next year | **(12.2)** | (18.0) |
| Instalments paid in the year | **14.5** | 14.4 |
| Repayments received | **(8.0)** | (20.6) |
| Payments relating to prior years | **–** | 28.0 |
| Net tax paid in the year | **6.5** | 21.8 |

Tax payments were reduced by £29.0 million (2016/17: £26.4 million) as a result of capital allowances and other timing differences where tax relief is given ahead of the cost being recognised in the income statement.

The total tax incurred was further reduced by £10.1 million (2016/17: £14.9 million) representing tax credits that we receive on charges that are shown in the statement of comprehensive income or equity – the tax for these items is also shown in the statement of comprehensive income or equity so is not included in the income statement charge.

The tax charge includes a credit of £3.9 million (2016/17: £27.4 million) for amounts overprovided in prior years. In 2016/17 there was also a credit of £39.8 million from the impact of adjusting our deferred tax liability to reflect the tax rate reductions announced by the Government to take effect in 2020. These accounting adjustments do not impact the amount payable to HMRC.

Together these amounts represent the corporation tax payable for 2018 of £26.7 million (2016/17: £32.4 million).

Corporation tax liabilities are currently settled in four instalments, two in the year of assessment and two in the following year. In the current year we have paid instalments on this year's tax amounting to £14.5 million (2016/17: £14.4 million) and received repayments of tax overpaid in previous years of £8.0 million (2016/17: £20.6 million), net of the instalments due from 2016/17, resulting in a net tax payment of £6.5 million (2016/17: net payment of £21.8 million including payments of £28.0 million relating to prior years).

Instalments of £12.2 million (2016/17: £18.0 million) are due to be paid to HMRC next year in respect of the current year's liability.

Note 13 in the financial statements sets out the tax charges and credits in the period, which are described in more detail below.

The current tax charge for the year was £32.9 million (2016/17: £19.9 million). In the previous year there was an exceptional credit of £16.4 million from adjustments following agreement with HMRC of prior years' tax matters.

The deferred tax charge before exceptional tax was £29.0 million (2016/17: £22.4 million). In the previous year there was an exceptional deferred tax credit of £35.8 million comprising an exceptional charge of £4.0 million following agreement with HMRC of prior years' tax matters and an exceptional credit of £39.8 million arising from a reduction in the corporation tax rate, enacted in that year, to 17% with effect from 1 April 2020.

Our full effective tax rate this year was 20.5% (2016/17: 2.0% after the exceptional tax credits described above). We expect this rate to be close to the corporation tax rate in the UK of 19% (2016/17: 20%) because substantially all of our business is in the UK and the profits of these businesses are chargeable to UK corporation tax.

UK tax rules specify the period over which tax relief can be obtained for capital expenditure. Typically this is a shorter period than that over which the assets are depreciated in the accounts and this tends to reduce the corporation tax charge in the year and the Group underlying effective current tax rate. We make provision for tax that will be paid in future periods when the tax relief on the capital expenditure has been received and we receive no allowance for the depreciation charge arising from that expenditure. This is the most significant component of our deferred tax position.

Our underlying effective current tax rate was 12.7% (2016/17: 16.6%).

## Profit for the year and earnings per share

Profit for the year from continuing operations decreased by 25.2% to £240.5 million (2016/17: £321.5 million).

The profit for the year from discontinued operations was £13.2 million (2016/17: £21.1 million).

Total profit for the year including discontinued operations was £253.7 million (2016/17: £342.6 million).

Basic earnings per share from continuing operations decreased by 25.3% to 102.2 pence (2016/17: 136.8 pence). Underlying basic earnings per share was 121.0 pence (2016/17: 115.7 pence). For further details see note 15.

## Cash flow

| | 2018 £m | 2017 £m |
|---|---|---|
| Cash generated from operations | **773.3** | 851.0 |
| Net capital expenditure | **(591.0)** | (501.3) |
| Net interest paid | **(182.1)** | (177.0) |
| Purchase of subsidiaries net of cash acquired | **(0.2)** | (77.7) |
| Proceeds on disposal of subsidiaries net of cash disposed and disposal costs | **25.1** | (19.2) |
| Proceeds on maturity of forward contracts | **–** | 4.3 |
| Swap termination payment | **(40.0)** | – |
| Tax paid | **(6.5)** | (21.8) |
| Free cash flow | **(21.4)** | 58.3 |
| Dividends | **(197.0)** | (190.4) |
| Issue of shares | **5.6** | 6.1 |
| Change in net debt from cash flows | **(212.8)** | (126.0) |
| Non-cash movements | **(61.4)** | (133.0) |
| Change in net debt | **(274.2)** | (259.0) |
| Opening net debt | **(5,082.4)** | (4,823.4) |
| Closing net debt | **(5,356.6)** | (5,082.4) |

| | 2018 £m | 2017 £m |
|---|---|---|
| Net cash and cash equivalents | **38.5** | 44.6 |
| Bank loans | **(1,217.4)** | (1,073.3) |
| Other loans | **(4,223.9)** | (4,090.0) |
| Finance leases | **(113.9)** | (115.7) |
| Cross currency swaps | **24.5** | 43.4 |
| Loans due from joint ventures | **135.6** | 108.6 |
| Net debt | **(5,356.6)** | (5,082.4) |

At 31 March 2018 we held £38.5 million (2017: £44.6 million) in net cash and cash equivalents. Average debt maturity was around 14 years (2017: 15 years). Including committed facilities, our cash flow requirements are funded until March 2020.

Net debt at 31 March 2018 was £5,356.6 million (2017: £5,082.4 million) and balance sheet gearing (net debt/ net debt plus equity) was 84.4% (2017: 84.6%). Group net debt, expressed as a percentage of estimated Regulatory Capital Value at 31 March 2018 was 60.6% (2017: 61.6%).

The estimated fair value of debt at 31 March 2018 was £1,184.3 million higher than book value (2017: £1,444.0 million higher). The decrease in the difference to book value is largely due to the increase in the discount rates applied, driven by higher prevailing market interest rates.

## Treasury management and liquidity

Our principal treasury management objectives are:

- To access a broad range of sources of finance to obtain both the quantum and lowest cost compatible with the need for continued availability;
- To manage our exposure to movements in interest rates to provide an appropriate degree of certainty as to our cost of funds;
- To minimise our exposure to counterparty credit risk;
- To provide an appropriate degree of certainty as to our foreign exchange exposure;
- To maintain an investment grade credit rating for our regulated subsidiary Severn Trent Water Limited; and
- To maintain a flexible and sustainable balance sheet structure.

We invest cash in deposits with highly rated banks and liquidity funds. We regularly review the list of counterparties and report to the Treasury Committee.

Our policy for the management of interest rates is that at least 40% of our borrowings in AMP6 should be at fixed interest rates, or hedged through the use of interest rate swaps or forward rate agreements. At 31 March 2018, interest rates for 48% (2017: 51%) of our net debt of £5,356.6 million were fixed.

Our long term credit ratings are:

| Long term ratings | Severn Trent Plc | Seven Trent Water | Outlook |
|---|---|---|---|
| Moody's | Baa1 | A3 | Negative |
| Standard & Poor's | BBB | BBB+ | Stable |

## Treasury policy and operations

Our treasury affairs are managed centrally and in accordance with our Treasury Procedures Manual and Policy Statement. The treasury operation's role is to manage liquidity, funding, investment and our financial risk, including risk from volatility in interest and (to a lesser extent) currency rates and counterparty credit risk. The Board determines matters of treasury policy and its approval is required for certain treasury transactions. The Board has established a Treasury Management Committee to monitor treasury activities and to facilitate timely responses to changes in market conditions when necessary.

Our strategy is to access a broad range of sources of finance to obtain both the quantum required and lowest cost compatible with the need for continued availability. Our principal operating subsidiary, Severn Trent Water, is a long term business characterised by multi-year investment programmes. Our strategic funding objectives reflect this and the liquidity position and availability of committed funding are essential to meeting our objectives and obligations. We therefore aim for a balance of long term funding or commitment of funds across a range of funding sources at the best possible economic cost. The Group also seeks to maintain an investment grade credit rating and a flexible and sustainable balance sheet structure.

# Chief Financial Officer's review
continued

We use financial derivatives solely to manage risks associated with our normal business activities. We do not hold or issue derivative financial instruments for financial trading.

Except for debt raised in foreign currency, which is fully hedged, our business does not involve significant exposure to foreign exchange transactions.

The Group issues notes in foreign currency under its EMTN programme and uses cross currency swaps to convert the proceeds to sterling. The effect of these swaps is that interest and principal payments on the borrowings are denominated in sterling and hence the currency risk is eliminated. The foreign currency notes and the cross currency swaps are recorded in the balance sheet at their fair values and the changes in fair values are taken to gains/(losses) on financial instruments in the income statement. Since the terms of the swaps closely match those of the underlying notes, such changes tend to be broadly equal and opposite.

## Pensions

We have three defined benefit pensions arrangements, two from Severn Trent and one from Dee Valley Water. The Severn Trent schemes closed to future accrual on 31 March 2015.

Formal three-yearly actuarial valuations have been completed as at 31 March 2016 for the Severn Trent schemes ('the Schemes') and we have agreed the future funding plan for the Schemes with the Trustee. The agreement reached with the Trustee for the STPS, which is by far the largest of the schemes, includes:

- Deficit reduction contributions of £25 million paid in the year ended 31 March 2017 and payments of £10 million for each of the subsequent financial years ending 31 March 2019.
- Inflation-linked payments of £15 million per annum through an asset-backed funding arrangement, potentially continuing to 31 March 2031, although these contributions will cease earlier should a subsequent valuation of the STPS show that these contributions are no longer needed.
- Payments under another asset-backed funding arrangement of £8.2 million per annum to 31 March 2032.
- In addition to these payments, the Company will directly pay the annual PPF levy incurred by the STPS (£1.1 million in 2017/18).

The Schemes have entered into additional hedging arrangements to reduce the impact of fluctuations in interest rates and inflation on the Schemes' liabilities without adversely impacting the expected return from the Schemes' assets.

Dee Valley Water participates in the Dee Valley Water Limited Section of the Water Companies Pension Scheme ('the Section'). The Section funds are administered by trustees and are held separately from the assets of the Group.

On an IAS 19 basis, the net position (before deferred tax) of all of the Group's defined benefit pension schemes was a deficit of £519.8 million (2017: £574.6 million). To calculate the pension deficit for accounting purposes, we are required to use corporate bond yields as the basis for the discount rate of our long-term liabilities, irrespective of the nature of the Scheme's assets or their expected returns.

The movements in the net deficit during the period were:

| | Fair value of plan assets £m | Defined benefit obligations £m | Net deficit £m |
|---|---|---|---|
| At start of the period | 2,352.8 | (2,927.4) | (574.6) |
| Amounts credited/(charged) to income statement | 60.2 | (69.7) | (9.5) |
| Actuarial (losses)/gains taken to reserves | (1.3) | 30.4 | 29.1 |
| Net contributions received and benefits paid | (71.9) | 107.1 | 35.2 |
| **At end of the period** | **2,339.8** | **(2,859.6)** | **(519.8)** |

On an IAS 19 basis, the funding level has improved to 82% (2017: 80%).

## Exchange rates

The trading results of overseas subsidiaries are translated to sterling at the average rate of exchange ruling during the period and their net assets are translated at the closing rate on the balance sheet date. The impact of changing exchange rates on the subsidiaries' trading results was immaterial.

## Dividends

In line with our policy for the remainder of AMP6 announced last year to increase the dividend by at least RPI+4% each year, the Board has proposed a final ordinary dividend of 51.92 pence per share for 2017/18 (2016/17: 48.90 pence per share). This gives a total ordinary dividend for the year of 86.55 pence (2016/17: 81.50 pence). The final ordinary dividend is payable on 20 July 2018 to shareholders on the register at 15 June 2018.

## Accounting policies and presentation of the financial statements

Our consolidated financial statements are prepared in accordance with International Financial Reporting Standards that have been endorsed by the European Union. The Company financial statements are prepared in accordance with FRS 101.

# Risk management

## Our approach to risk:

Risk is all about uncertainty and risk management describes the activities performed within our organisation to identify, assess, and control events which may impact on our ability to achieve our aims and objectives. We also recognise that uncertainty can manifest itself as both negative and positive impacts, hence our goal is to minimise these threats and maximise the opportunities for the benefit of our customers, people, contractors and key stakeholders.

The Board has overall accountability for ensuring that risk is effectively managed across the Group. The Board's mandate includes defining risk appetite and monitoring risk exposure to ensure significant risks are aligned with the overall strategy of the Group. The management of risk is embedded in our everyday business activities, with employees encouraged to play their part.

On behalf of the Board, the Audit Committee assesses the effectiveness of the Group's Enterprise Risk Management ('ERM') process and internal controls to identify, assess, mitigate and manage risk. Internal Audit supports the Audit Committee in evaluating the design and effectiveness of internal controls and risk mitigation strategies implemented by management.

The Executive Committee reviews strategic objectives and assesses the level of risk taken in achieving these objectives. This 'top down' risk process helps to ensure the 'bottom up' ERM process is aligned to current strategy and objectives.

Across the Group, we manage risks within the overall Governance Framework which includes clear accountabilities, delegated authority limits and reward policies. These are designed to provide employees with a holistic view of effective risk management.

Within Severn Trent Water Limited, our approach reflects our status as a regulated utility providing essential services and operating as part of the Critical National Infrastructure for the UK. The nature of our Severn Trent Water Limited business is such that there are some significant inherent risks, as illustrated on pages 60 to 65. We aim to have a strong control framework in place to enable us to understand and manage these risks in accordance with our risk tolerance and appetite.

In our non-regulated businesses we take a more commercial approach to risk. However, we recognise that we provide products and services for clients who operate in regulated environments. As a result, for risks that could impact on our clients' regulated services, we take a similar approach to risk as in our own regulated business. The risks inherent in our non-regulated business are illustrated on pages 60 to 65.

## Our Enterprise Risk Management process

We use an established ERM process across the Group to assess and manage our significant risks, which are linked to our corporate objectives, core processes, key dependencies, stakeholder expectations and legal and regulatory obligations. The process is controlled by the central ERM team and underpinned by standardised tools and methodology to ensure consistency. ERM Champions and Co-ordinators operate throughout the business, with support and challenge from the ERM team, to identify and assess risks in their business units quarterly against a defined set of criteria that consider the likelihood of occurrence and potential financial and reputational impacts. The potential causes and subsequent impact of the risks are documented to enable mitigating controls to be assessed. This assessment allows us to put in place effective strategies to remediate defective controls or implement additional controls.

This information is combined to form a consolidated view of risk across the Group and allows the risks to be prioritised. Our significant risks, in terms of likelihood and impact, form our Group risk profile which is reported to the Executive Committee for review and challenge ahead of final review and approval by the Audit Committee and Board half-yearly. The report provides an assessment of the effectiveness of controls over each of those risks and an action plan to improve controls where this has been deemed necessary.

To further enhance our ERM information, we now report 'risk flightpaths'. These graphically demonstrate the level of risk the Group faces and the timeline for the key risk mitigation steps to manage the risk to the target position. The flightpaths help to facilitate a more thorough review of the target risk positions, considering risk appetite and whether improvement actions to achieve these are on target with the correct prioritisation in place.

In addition, individual risks or specific risk topics are also discussed by the Board during the year.

On a monthly basis, the status of open risk mitigation actions across the Group risk profile is reported into the Executive Committee by the central ERM team. The level of ERM maturity in each business unit is assessed half-yearly and reported to the Executive Committee. Improvement plans are agreed to ensure ERM is fully embedded and effective. An overview of accountability for our ERM process is illustrated in the diagram opposite.

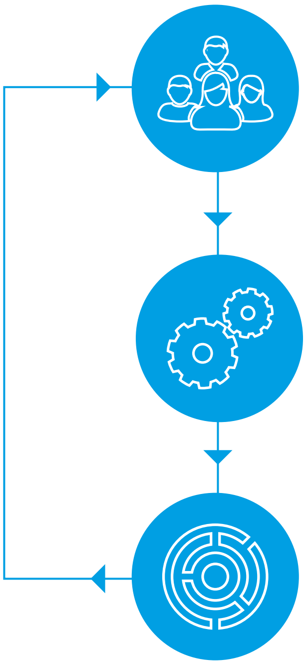
## Risk appetite

The Board keeps under ongoing review the relationship between our strategic ambitions and the management of risk.

The ERM process establishes target risk positions for each of our significant risks. The Board formally discusses the progress towards this position and the mitigating actions being undertaken every six months.

# Risk management continued

## The ERM process



### The Board

- Sets strategy and determines regulatory outcomes
- Sets business plan objectives
- Defines risk appetite

### Operational teams

- Identify and assess risks
- Set risk target position
- Identify risk improvement actions

### ERM team

- Monitors performance
- Assesses ERM maturity across the Group
- Provides challenge and insight
- Reports to Executive Committee, Audit Committee and Board

## Financial risks

Like all businesses, we need to plan future funding in line with business need. This is part of our normal business planning process (see Principal Risk 2).

The Board receives regular updates relating to funding, solvency and liquidity matters through the Treasury Committee so we can respond quickly to any changes in our ability to secure financing (see Principal Risk 10). The pension fund Trustees and Company regularly monitor our pension deficit, with advice from investment managers and actuarial advisers. An annual pension fund review paper is produced for the Board to apprise them of fund performance and proposed initiatives to manage down pension liabilities and further balance pensions risk (see Principal Risk 9).

The ERM process and relevant risk assessments are factored into the 'stress testing' to assess the Group's prospects as part of our Long-Term Viability Statement.

## Sustainability risks

Sustainability risks are treated in the same way as all our other Company risks, captured at a local level by responsible teams and managed centrally through our established ERM process. By the nature of what we do, several of our principal risks have a Sustainability focus, and we monitor our social and environmental impacts in line with our broader performance.

### Long-Term Viability Statement

Assessment of current position and long term prospects

The Directors' assessment of the Group's current financial position is set out in the Financial review on pages 51 to 56.

The Group's principal operating subsidiary is Severn Trent Water Limited, which is a regulated long term business characterised by multi-year investment programmes and stable revenues. The water industry in England and Wales is currently subject to economic regulation rather than market competition and Ofwat, the economic regulator, has a statutory obligation to secure that water companies are able to finance their appointed activities. Ofwat meets this obligation by setting price controls for five year Asset Management Periods ('AMPs'). This mechanism reduces the potential for variability in revenues from the regulated business. The current AMP runs until March 2020. Ofwat has published its Final Methodology for assessing companies' business plans and setting price controls for the AMP period 2020 – 2025 and Severn Trent Water Limited has made significant progress in developing its business plan, which is due to be submitted to Ofwat in September 2018.

The Group has significant investment programmes that are largely funded through access to debt markets. The Group's strategic funding objectives reflect the long term nature of the Severn Trent Water Limited business and the Group seeks to obtain a balance of long term funding at the best possible economic cost. The Group's Treasury Policy requires that it maintains sufficient liquidity to cover cash flow requirements for a rolling period of 18 months in order to mitigate the risk of restricted access to capital markets. The Group's debt maturity profile is actively managed by the Group Treasury department to spread the timing of refinancing requirements and to enable such requirements to be met under most market conditions. The weighted average maturity of debt at the balance sheet date was 14 years.

The Group has an established process to assess its prospects. The Board undertakes a detailed assessment of the Group's strategy on an annual basis and the output from this assessment sets the framework for the Group's medium term plan, which is updated annually.

The plan assesses the Group's prospects and considers the potential impacts of the principal risks and uncertainties. Stress tests are performed to assess the potential impacts of combinations of those risks and uncertainties. The plan also considers the mitigating actions that might be taken to reduce the impact of such risks and uncertainties and the likely effectiveness of the mitigating actions.

### Period of assessment

The Directors considered a number of factors in determining the period to be covered by the assessment. The long term nature of the Group's principal business together with relatively stable revenues and a model of economic regulation that places a duty on the regulator to secure that water companies can finance the proper carrying out of their functions support a longer period of assessment.

However, the changing nature of regulation of the water industry increases the uncertainty that is inherent in the Group's financial projections. The Group has an established planning and forecasting process and the Directors consider that the assessment of the Group's prospects is more reliable if it is based on an established process. The Group's latest medium term plan extends to the end of the next AMP period in 2025 and the Board of Severn Trent Water Limited will make an assessment of viability covering that period in its business plan submission to Ofwat in September 2018.

A longer period of assessment introduces greater uncertainty as the variability of potential outcomes increases as the period considered extends.

Bearing in mind the long term nature of the Group's business; the enduring demand for its services; the nature of the Group's established planning process and the changing nature of the regulation of the water industry in England and Wales, the Directors have determined that seven years is an appropriate period over which to assess the Group's prospects and make its viability statement this year.

## Assessment of viability
In assessing the future prospects the Group has considered the potential effect of risks that could have a significant financial impact under severe but plausible scenarios. The risks considered were identified from the Group's ERM process, which is described on pages 57 to 58, and from the key assumptions in the financial model. The scenarios tested are described below.

The Directors have identified actions, including reducing discretionary outflows of funds and working with providers of finance, that would be available to the Group to mitigate the impact of adverse outcomes.

The Group has significant funding requirements to refinance existing debt that falls due for repayment during the period under review and to fund the Group's capital programme. Under all scenarios considered the Group would remain solvent and have access to sufficient funds in normal market conditions. The Group's Treasury Policy requires that it retains sufficient liquidity to meet its forecast obligations, including debt repayments for the next 18 months. In making its assessment the Board has made the following key assumption:

- Any period in which the Group is unable to access capital markets to raise finance during the period under review will be shorter than 18 months.

On this basis, the stress tests indicated that none of these scenarios, including the combined scenario, resulted in an impact to the Group's expected liquidity, solvency or credit metrics that could not be addressed by mitigating action and hence were not considered to be threats to the Group's viability.

## Governance and assurance
The Board reviews and approves the medium term plan on which this viability statement is based. The Board also considers the period over which the assessment of prospects and viability statement should be made. The Audit Committee supports the Board in performing this review. Details of the Audit Committee's activity in relation to the Viability Statement are set out in the Audit Committee report on pages 83 to 89.

This statement is subject to review by Deloitte, our External Auditor. Their audit report is set out on pages 136 to 140.

## Assessment of viability
The Directors have assessed the viability of the Company over a seven year period to March 2025, taking into account the Company's current position and principal risks.

Based on that assessment, the Directors have a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the period to 31 March 2025.

## Going Concern Statement
In preparing the financial statements the Directors considered the Company's ability to meet its debts as they fall due for a period of one year from the date of this report. This was carried out in conjunction with the consideration of the Long-Term Viability Statement above.

On this basis the Directors considered it appropriate to adopt the going concern basis in preparing the financial statements.

| Scenario tested | Related principal risk |
|---|---|
| **1. An increase in the funding deficit of the Group's defined benefit pension schemes**<br>The planned funding for the Group's defined benefit pension arrangements is based on assumptions on future inflation, asset returns and members' longevity. Underperformance against these assumptions might result in additional cash contributions being required during the period under consideration. Contributions are reviewed and agreed with the scheme trustees on a triennial basis with the next valuation of the main scheme due as at 31 March 2019. | Risk 9: Increased funding for pension schemes |
| **2. A severe climate event, operational failure or other exceptional event with a very significant financial impact**<br>The Group's Enterprise Risk Management process has identified a number of risks including cyber security, failure of key assets and severe weather events that might have a significant impact on the Group's operational and financial performance. | Risk 4: Cyber security<br>Risk 6: Failure of key assets<br>Risk 7: Health and safety and environmental impact<br>Risk 8: Impact of extreme weather/climate change |
| **3. A reduction in inflation and increase in interest rates for the duration of the period under consideration**<br>Severn Trent Water Limited's revenues are linked to inflation. Low or negative inflation tends to adversely impact profits and cash flows if increases in costs exceed revenue. | N/A – key assumption in financial model |
| **4. Underperformance against performance commitments**<br>Severn Trent Water Limited operates under a regulatory model which encourages companies to deliver what customers want using performance related rewards and penalties. Failure to deliver performance at the committed level can lead to significant penalties. | Risk 1: Failure to deliver what our customers want |
| **5. Higher costs than planned that are not funded**<br>Significant overspending could result in a deterioration in financial metrics and performance, which might adversely impact the Group's solvency. | Risk 2: changes in the regulatory environment for the UK water industry |
| **6. A combination of scenarios 2, 3 and 4**<br>It is unlikely that scenarios 1 and 3 would occur simultaneously since lower inflation and higher interest rates would tend to reduce the pension deficit. Therefore scenario 3, which has a great individual impact has been included. | See above |

# Principal risks

The Directors have carried out a robust assessment of the principal risks facing the Company, including those that would threaten its business model, future performance, solvency or liquidity. These have been categorised across:

- Customer perception;
- Legal and regulatory environment;
- Operations, assets and people; and
- Financial risks.

For each risk we state what it means for us and what we are doing to manage it.

## Customer perception

### 1 What is the risk?

We may be unable to improve or maintain our levels of customer service sufficiently to deliver what our customers tell us they want.

#### Which part of Severn Trent is affected?

Regulated Water and Waste Water businesses

#### Link to how we're achieving our strategy (page 22)

Embedding customers at the heart of all we do

#### Link to our values

We put our customers first

We are passionate about what we do

We act with integrity

#### ODIs

ODIs 24-27

#### What does it mean for us?

We are a regulated utility providing essential services to our customers. We recognise that our customers increasingly expect more from us and demand an improved and more consistent experience. As other industries improve their levels of service, the bar continues to be raised.

Failure to deliver the service that customers expect will lead to customer dissatisfaction. This may result in financial penalties under Ofwat's Service Incentive Mechanism ('SIM') and associated ODI outturn.

#### What are we doing to manage the risk?

The three upper quartile ('UQ') programmes in Retail, Water and Waste are key to SIM improvement. Whilst Retail has a number of transformation actions in flight there are further actions to be delivered which will improve customer experience, for example website transformation. Customers tell us they are delighted when we are able to complete billing issues for them at Point of Contact so the retail programme is looking at how to improve our Point of Contact resolution to improve the overall experience.

The Waste UQ programme is focusing on both the work of our supply partner Amey in our day-to-day customer offering and also how Severn Trent supports them in complex cases. The Waste UQ programme has identified some key areas to drive and improve performance in order to improve our SIM score.

The Water UQ programme is at an early stage. The rapid action team pilot that is currently ongoing in our Derbyshire area is showing fantastic customer benefit. The programme is currently developing a rollout plan to all other areas. The E2E customer communications workstream is looking at the expectation that we set when a customer contacts us through their channel of choice and how we keep the customer informed along the journey. An element of this workstream is a review of our Track my Job customer communication tool that we use to keep customers informed.

#### Movement in net risk exposure

⇔

Key:

- ↑ Increase in net risk exposure
- ⇔ No change in net risk exposure
- ↓ Decrease in net risk exposure

# Legal and regulatory environment

## 2

### What is the risk?

We may be unable to effectively anticipate and/or influence future developments in the UK water industry resulting in our business plans becoming unsustainable.

### Which part of Severn Trent is affected?

Regulated Water and Waste Water businesses

### Link to how we're achieving our strategy (pages 26 to 29)

Changing the market for the better

Investing responsibly for sustainable growth

### ODIs

N/A

### What does it mean for us?

Severn Trent Water operates in a highly regulated environment. Whilst we are broadly content with the direction of changes proposed for our industry, there remains a risk that future changes could have a significant impact on Severn Trent Water.

### What are we doing to manage the risk?

Severn Trent has always contributed to the debate about our industry's future, including through our series of Changing Course publications. We will continue to be an active participant in these conversations, so we can help shape thinking about how to best serve our customers in the future.

We have contributed to embedding the role of Market Operator Services Ltd (the body which oversees the non-household retail market) and contributed towards the success of competition in the non-household market.

We continue to participate in discussions with Ofwat on the development of the future regulatory environment and since publication of Ofwat's final methodology in relation to Water 2020 we are developing our business plan. We are actively participating in discussions on the opening of the competitive market for bioresources.

Engagement with our peers, other regulators, UK Government departments and other stakeholders, including the Welsh Government, helps us to influence the direction of regulatory policy where possible and put forward our own case for change in a constructive way.

We continue to engage constructively with stakeholders following Labour's 2017 manifesto commitment to re-nationalise the water sector. We are encouraged that both the benefits to customers of the current model and the cost to taxpayers of re-nationalisation are now being better understood.

### Movement in net risk exposure

↑

## 3

### What is the risk?

The regulatory landscape is complex and subject to ongoing change. There is a risk that processes may fail or that our processes may not effectively keep pace with changes in legislation leading to the risk of non-compliance.

### Which part of Severn Trent is affected?

Group-wide

### Link to how we're achieving our strategy (pages 24 to 29)

Driving operational excellence and continuous innovation

Changing the market for the better

Investing responsibly for sustainable growth

### Link to our values

We act with integrity

We protect our environment

### ODIs

ODIs 1-4, 19-23, 30-43

### What does it mean for us?

Our policies and processes must reflect the current legal and regulatory environment and all relevant employees must be kept aware of new requirements. The Group as a whole may face censure for non-compliance in an individual group company or a specific region in which we operate.

### What are we doing to manage the risk?

Our Governance Framework, transparency, engagement with customers and stakeholders, policies and internal controls ensure our ongoing compliance with all applicable laws and regulations.

For the operation of separate Wholesale and Retail business we have a control framework of protocols, policies, systems, guidance and training to ensure ongoing compliance with the relevant legislation including Competition Law.

Following the integration of Dee Valley into the Severn Trent Group we have refreshed our policy framework and are updating our systems, protocols and policies in readiness for the boundary realignment of our regulated businesses.

Ensuring readiness for the General Data Protection Regulation ('GDPR') coming into effect on 25 May 2018 has also been a key area of focus for us.

Changes to the legal and regulatory environment are captured as 'emerging risks' through our ERM process with the necessary owners and actions identified to ensure compliance when the changes come into effect.

### Movement in net risk exposure

↔

# Principal risks continued

## Operations, assets and people

### 4

#### What is the risk?

We may experience loss of data or interruptions to our key business systems as a result of cyber threats.

#### Which part of Severn Trent is affected?

Group-wide

#### Link to how we're achieving our strategy (pages 22 to 25)

Embedding customers at the heart of all we do

Driving operational excellence and continuous innovation

#### Link to our values

We put our customers first

#### ODIs

ODIs 1-4, 5-18, 19-23, 24-37

#### What does it mean for us?

The risks arising from loss of one or more of our major systems or corruption of data held in those systems could have far reaching effects on our business. We have recognised the increasing threats of cyber attacks on our systems and data. Whilst this threat can never be eliminated and will continue to evolve, we are focused on the need to maintain effective mitigation.

#### What are we doing to manage the risk?

We continue to follow guidance from the National Cyber Security Centre ('NCSC') to improve our defences against cyber attacks and have focused this year on more layered-security controls to protect sensitive data in readiness for the introduction in May 2018 of the GDPR.

We have also completed risk assessments of cyber threats to our water supply systems for the introduction in May 2018 of the Network and Information Systems Directive ('NISD').

We have participated in a number of Government led and internal cyber incident exercises to test our response capability to cyber attacks.

Although not directly impacted by significant recent cyber incidents (e.g. WannaCry and NotPetya), we did review our security controls and response plans to ensure we are prepared for future attacks of this type.

#### Movement in net risk exposure

### 5

#### What is the risk?

We may fail to meet our regulatory targets including targets from Ofwat for operational performance of our assets resulting in regulatory penalties.

#### Which part of Severn Trent is affected?

Regulated Water and Waste Water businesses

#### Link to how we're achieving our strategy (pages 22 to 27)

Embedding customers at the heart of all we do

Driving operational excellence and continuous innovation

Investing responsibly for sustainable growth

#### Link to our values

We put our customers first

We are passionate about what we do

We protect our environment

#### ODIs

ODIs 1-45

#### What does it mean for us?

If we are unable to meet operational performance targets, we may be subjected to significant regulatory penalties either within the current price review period, or applied to the next price review.

Regulatory targets apply to all of our water treatment, distribution, sewerage and sewage treatment assets. Measures are in place in relation to water quality, continuous supplies, sewer flooding, sewer collapses and pollution events.

#### What are we doing to manage the risk?

Our business plan for 2015-2020 includes considerable investment in our assets to improve the resilience of our networks, reduce interruptions and improve the service that our customers receive. We recognise there are areas where our performance is not as consistent as we would like and we are committed to improving these.

We are continuing our Cleanest Water Plan which drives the inspection, cleaning and repair of storage tanks, increasing our capital maintenance interventions, optimising our operation and maintenance tasks and formalising our processes, standards and operating procedures involved in delivering clean water.

We use leading measures on our comm cells and performance meetings to track delivery against customer ODIs and performance commitments so that we can intervene in a timely fashion if performance is drifting.

The three UQ programmes in Retail, Water and Waste are key to us delivering our targets for the remainder of this business plan.

#### Movement in net risk exposure

Key:

- Increase in net risk exposure
- No change in net risk exposure
- Decrease in net risk exposure

## 6

### What is the risk?

Failure of certain key assets or processes may result in inability to provide a continuous supply of clean water and safely take waste water away within our area.

### Which part of Severn Trent is affected?

Group-wide

### Link to how we're achieving our strategy (pages 22 to 31)

Embedding customers at the heart of all we do

Driving operational excellence and continuous innovation

Investing responsibly for sustainable growth

### Link to our values

We put our customers first

We are passionate about what we do

### ODIs

ODIs 1-4, 5-18, 19-23

### What does it mean for us?

Some of our assets are critical to the provision of water to large populations for which we require alternative means of supply.

Examples include our reservoirs and water treatment works. These assets are regularly inspected and maintained and our assessment of the overall condition of these assets is good.

Other examples are our IT, telephony systems and remote monitoring systems which are also key to our operations.

### What are we doing to manage the risk?

We included substantial investment in our AMP6 plan to reduce the likelihood of failure of strategic assets that supply Birmingham and to provide the city with a second source of water. We are ahead of delivery on the improvements to our strategic assets and on track with the provision of a second source.

We continue to maintain and test our 'Being prepared framework' to ensure our business continuity arrangements are fit for purpose and the Group can react quickly to safeguard our critical operations.

In addition to investing in resilience improvements to our network we also have assurance plans in place to monitor, inspect and maintain our most critical assets and to ensure clean water is always available to our customers and we will always be able to safely take their waste water away.

We will continue to make significant investment into our network and processes but we accept there is always a risk of unexpected failures. For example, we experienced a number of trunk main bursts in 2017 which led to supply interruptions to our customers and in March 2018 the very rapid thaw following 'The Beast from the East' resulted in a substantial increase in pipe bursts. Our incident response helped to mitigate the impact of these failures. During the bursts we worked with local resilience forums and other agencies and had great community engagement to return suppliers back to normal as quickly as possible. We are taking the learnings from the incidents to expand our network condition monitoring programme to detect vulnerabilities before failures occur and to ensure that our incident response procedures are as good as they can be.

### Movement in net risk exposure

## 7

### What is the risk?

Due to the nature of our operations we could endanger the health and safety of our people, contractors and members of the public as well as negatively impact our local and wider environment.

### Which part of Severn Trent is affected?

Group-wide

### Link to how we're achieving our strategy (pages 24 to 27, and pages 30 to 31)

Driving operational excellence and continuous innovation

Investing responsibly for sustainable growth

Creating an awesome place to work

### Link to our values

We protect our environment

We act with integrity

### ODIs

ODIs 30-41, 42-43

### What does it mean for us?

The nature of our assets, operations and business are such that threats to the safety of our employees, contractors, customers and the wider public exist. Operational failures or negligence could result in damage to the environment.

We are responsible for a large estate of assets and have to secure these from unauthorised access to ensure our operations are not impacted nor the safety of the public compromised.

### What are we doing to manage the risk?

Our 2015-2020 business plan includes substantial investment in community schemes to ensure the risk of failure at key points along our Elan Valley Aqueduct, that could cause substantial damage and endanger the safety of the public, is further reduced.

We have a well-established Health, Safety & Wellbeing framework to ensure all operations and processes are conducted in compliance with Health and Safety legislation and in the interests of the safety of our people and contractors. Our Goal Zero initiative clearly establishes our target that no one should be injured or made unwell as a result of what we do. We've continued to reduce total injuries to staff and contractors through the application of the Goal Zero plan and we work collaboratively with our supply chain and other key stakeholders to continue to seek improvements.

There are a number of ODI commitments we have made to protect our local environment, including river water quality, pollution incidents, biodiversity improvements and environmental compliance. In AMP6 we will be delivering our largest ever environment programme, spending over £300 million to deliver improvements to rivers throughout our region, a programme which is supported by our customers who want to see us do more to improve river water quality. This year we expect to regain our 4* Environmental Performance Assessment status from the Environment Agency.

We recognise the impact our operations have on the wider environment and we want to reduce our carbon footprint by seeking lower carbon ways of operating our business, driving energy efficiency and generating renewable energy. We aim to increase the amount of renewable energy we generate and to invest in ways to make our processes more energy efficient, and our target is to generate the equivalent 50% of Severn Trent Water's energy needs by 2020.

### Movement in net risk exposure

# **Principal risks** continued

8

## What is the risk?

We are unable to deal with the impact of extreme and unpredictable weather events on our assets and infrastructure and/or are unable to successfully plan for future water resource supply and demand due to climate change.

### Which part of Severn Trent is affected?

Group-wide

### Link to how we're achieving our strategy (pages 24 to 27)

Driving operational excellence and continuous innovation

Investing responsibly for sustainable growth

### Link to our values

We protect our environment

### ODIs

ODIs 1-4, 5-18, 19-23, 42-43

### What does it mean for us?

Climate change (hotter and drier summers, wetter winters and increased frequency of storms) could result in an inability to meet customer demand, lower river levels, decreased raw water quality, flooding of our water or waste works, sewer capacity being exceeded and increased land movement. Climate change could also be a contributing factor for principal risks 1, 5, 6 and 7 detailed above.

There are also some potential opportunities that climate change presents for us, including aquifer recharge and increased biological treatment. It is important that we understand these opportunities to maximise the benefits.

### What are we doing to manage the risk?

Our climate change adaptation report sets out our strategy for coping with future changes to our climate.

In February 2018, we published our draft water resources management plan for the next 25 years. The plan includes a detailed assessment of climate change impact for our region and our demand management and proposed new sources are designed to offset any supply risk resulting from climate change.

Our analysis for the National Flood Resilience Review ('NFRR'), that was instigated by Defra/the Cabinet Office after the flooding of winter 2015/16, identified our non-infrastructure (overground) sites that could be at risk from river or surface water flooding using a new higher standard called the 'Extreme Flood Outline'. This has informed our contingency plans and future investment plans.

We don't consider climate change risks in isolation and we view them alongside all the challenges we face. To that effect a large number of our current objectives and targets agreed as part of our ODI commitments will increase our resilience from climate change, including reducing leakage, improving water efficiency, reducing properties prone to low pressure, protecting prone properties/areas from sewer flooding and increasing the resilience of our water supply and water/waste works.

Our own impact and contribution to climate change cannot be ignored and, as outlined in principal risk 7 overleaf, there are a number of ways in which we are addressing our impact on the environment.

### Movement in net risk exposure

Key:

- Increase in net risk exposure
- No change in net risk exposure
- Decrease in net risk exposure

## Financial risks

### 9

#### What is the risk?

Lower interest rates, higher inflation or underperforming equity markets may require us to provide more funding for our pension schemes.

#### Which part of Severn Trent is affected?

Group-wide

#### Link to how we're achieving our strategy (pages 26 and 27)

Investing responsibly for sustainable growth

#### What does it mean for us?

We already provide significant funding but could be called upon to provide more money to reduce pension deficits in our defined benefits schemes.

#### What are we doing to manage the risk?

Following the Brexit vote, our main defined benefit pension scheme has seen a significant growth in the accounting value of liabilities due to the fall in long term interest rates. Volatile financial conditions are likely to remain for the foreseeable future. The growth in the accounting deficit has adversely impacted the headroom on some of our credit ratios, such as gearing, which are relevant for debt covenant and credit ratings purposes. It also has a reputational impact that could have a bearing on investment and distribution decisions.

We have completed the process of immunising our bank financial covenants from adverse movements in the accounting deficit, gaining approval from relevant banks and the European Investment Bank ('EIB'). We have worked with the ratings agencies to focus on the impact of our repair payments on credit ratings, rather than movements in the accounting value of the deficit. Importantly, we have agreed cash repair payments with the Trustee until the next Triennial Valuation at 31 March 2019. We have also completed, with Trustee agreement, additional inflation and interest rate hedging and introduced downside protection to the fund's equity holdings. The Pension Regulator has confirmed that the March 2016 actuarial valuation will not be subject to further review. However, the Regulator has stated that it believes that the current repair period, to 2032, is very long and in the event of a further deterioration in deficit does not see an extension of the recovery plan end date an appropriate solution.

#### Movement in net risk exposure

### 10

#### What is the risk?

We are unable to fund the business sufficiently in order to meet our liabilities as they fall due.

#### Which part of Severn Trent is affected?

Group-wide

#### Link to how we're achieving our strategy (pages 26 and 27)

Investing responsibly for sustainable growth

#### What does it mean for us?

We must ensure sufficient liquidity is available to meet our near term financial commitments. We have a significant funding requirement in AMP6, to fund our investment programme and refinance maturing debt. This is a well-controlled risk, but it is important that we maintain these high standards to mitigate this risk.

#### What are we doing to manage the risk?

Whilst Brexit may impact our access to funding from the EIB, an attractive source of finance, we have other sources of funding we can call upon. In November 2015, we raised £471 million through a US Private Placement debt issue and in November 2016 to December 2017, we raised £900 million through three sterling bond issues. Despite some initial volatility following the Brexit vote, global debt capital markets continue to deliver substantial levels of liquidity.

See our Long-Term Viability Statement on pages 58 and 59.

#### Movement in net risk exposure

The Strategic report, as set out from page 1 through to page 65, has been approved by the Board.

By order of the Board

**Bronagh Kennedy**
Group General Counsel and Company Secretary
22 May 2018