

SOUTH WEST WATER

JUNE RETURN 2011

REPORTER'S REPORT

17 June 2011

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Our report is addressed to the directors of the Water Services Regulation Authority and the directors of South West Water only. The work we have undertaken is private and confidential, and we do not accept or assume responsibility to any other party for our work, for the report or for the opinions we have formed. Unless stated otherwise, all matters and issues referred to in our report arise from our work on the June Return 2011. Our report should not be used or relied upon for any other purpose or by any third party.

Reporter's Report

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REPORTER'S REPORT

Executive Summary

Strategic Management Consultants (SMC) has reviewed the annual return (the June Return) submitted by South West Water to the Water Services Regulation Authority (Ofwat). SMC undertook this in its capacity as independent Reporter approved by Ofwat.

June Return process

This is SMC's first report as Reporter for South West Water. We have had the benefit of direct access to the Company's Sharepoint system in which the Company has made available copies of appropriate documents such as methodologies and procedures. We have also been given unrestricted access to copies of the master spreadsheets through which the Company ensures that its submitted data is clearly derived from corporate data systems, is consistent between tables in the June Return and also consistent with earlier submissions (Business Plans, Principal Statements and previous June Returns).

We have vigorously challenged the Company's data and methodologies where appropriate. In key areas we have reached agreement with South West Water on the comments we have made; there remain a small number of outstanding matters which the Company has undertaken to review before JR12. From our experience to date we have seen a willingness to make improvements and to focus attention on both numerical accuracy and compliance with reporting guidelines

We have benefited from a high level of support from the Company. We have been given access to the Company's senior management. We attended the South West Water Board meeting on 18 May having previously met with management to review findings on 16 May.

We have co-ordinated our work with the Company's financial auditors, PricewaterhouseCoopers, whom we contacted during the course of our work.

No director has provided information directly to us or directly made us aware of any relevant audit information.

Key findings and conclusions

We have referred to and, to the extent we are reasonably able, followed up on all the points covered by the Ofwat reporter guidance. We have used our judgement when deciding the appropriate level of scrutiny. To the extent we have been able to determine from the review we have undertaken we have the following points to bring to Ofwat's attention:

- We consider that the Company's Overview is well-founded and consistently supported by the numerical information in the June Return and the reports of the quality regulators relating to the quality enhancements programme
- As far as we are able to establish the statements made by the Company are accurate. The Company has countered most challenges with justification for statements and we have not identified any unsupported statements.
- We do not consider that there are any material weaknesses in the effectiveness of the Company's June Return process and we have not identified any material areas where it has not been followed

- From our detailed review of methodologies and information supplied by the Company we have reported separately to Ofwat some changes in methodology and explanatory factors not included in the company Executive Overview because they are not material in the context of the company's overall business.

We are satisfied that:

- the Company's methods and procedures in providing the data that Ofwat is seeking in JR11 are adequate
- the Company has prepared its JR11 data in accordance with its stated methods, procedures, policies and assumptions
- there are coherent links between the current and earlier relevant Company assumptions
- the methods and procedures are adequate for producing estimates of expenditure needs or records of costs incurred
- the Company's June Return methods and procedures provide a credible system of quality assurance
- the Company has complied with the process of submissions document
- there are no material changes to Company systems, processes and models which have not been highlighted to Ofwat by the company
- the confidence grades provided by the Company in the ICS are not inappropriate

1 Introduction

Background to the JR11 submissions

South West Water has submitted to Ofwat an Executive Overview for JR11. As in previous years, the Overview includes an Executive Summary which demonstrates how performance in 2010-11 supports the Company's vision of 'Pure Water, Pure Service, and Pure Environment'. We understand that the practice in recent years has been for the Executive Summary to mirror closely the Chief Executive's Review that appears in both the South West Water and Pennon Annual Reports.

In view of the revised Ofwat requirements for JR11, the Company has explained that "it has attempted to re-position itself away from a detailed description of outputs towards a greater concentration on KPIs and explanations that focus on the outcomes of what it is achieving as a business, the impact on customers and other stakeholders and the relationship with its long-term strategy". We have reviewed several drafts of the Overview, and we consider that it meets the Ofwat requirement to demonstrate to its stakeholders how the Company has met its statutory obligations and customers' expectations. The Overview covers a wide range of outputs, activities, indicators and governance processes which address stakeholders' interests.

Drafts of the Overview were tabled by the Finance & Regulatory Director at Board meetings in April and May. At the April Board meeting the revised approach described above was explained in the covering Board paper. We were given the opportunity to comment initially on the version of the Overview that had been tabled at the April Board meeting and subsequently, in advance of the meeting, on the version that had been prepared for the May Board meeting. On each occasion, we focused on how the document complied with the Ofwat reporting requirements. We provided written comments to the Finance & Regulatory team. The responses to our comments were positive, and amendments were made to the draft Overviews accordingly.

The Company placed drafts of the Overview in the JR11 folder on Sharepoint, the Company's electronic document management system, to which we have access. Downloads of the ICS showing the JR data tables and other supporting information for the Overview, including quality regulators' reports, were also placed in the JR11 folder. We were sent e-mails giving details of any new items entered on Sharepoint. The availability of the latest versions of the tables and supporting information on Sharepoint facilitated our review of the Overview, and we support fully this approach.

Structure of Reporter's report

SMC has examined the information that South West Water has presented in its Executive Overview. This report includes our review of that information and our own observations on the Company's performance at this high level.

Our report initially considers key points from the Company Executive Overview and then provides key findings from our review of the Company information prepared to support the Company submission of data to Ofwat.

2 Reporter review of Executive Overview

2.1 Executive Overview process

Review and identify any shortfalls in the process established by the company to ensure that the Board Overview is well founded and consistently supported by the numerical information in the June return and the reports by the quality regulators relating to the quality enhancements programme.

The South West Water Overview is drafted by the Finance & Regulatory team with contributions from functional experts across the Company. The structure of the Overview is different from previous years because Ofwat has withdrawn the requirement for five specific data tables and prescribed chapters of text.

For our Overview audit meeting, as described in the relevant sections below, we prepared queries and challenges on the June Return process and the numerical information and statements included in the latest draft Executive Overview. On the updated version of the Overview placed on Sharepoint after the audit meeting, we saw evidence of the changes made as a result of our queries and challenges. We also saw evidence of comments and amendments made by Directors.

In the 'Processes and Systems of Control' section of Ofwat's Board Overview reporting requirements, certain assurances are required from the Board in respect of the provision of data and the inclusion of material issues in the Overview. We can confirm that these have been met.

Ofwat also requires an annual statement from each Director of the Company about the provision of information to the Auditor and Reporter. We can confirm that this has been met through the individual Director sign-offs which are new for JR11 and provided at the end of the Company's Overview.

2.2 June Return process

Draw attention to any weaknesses in the effectiveness of the company's June return process and identify any material areas where it has not been followed.

The Company's June Return process is outlined in the Overview. This includes Reporter and Auditor access, allocation of responsibilities for data, availability of detailed guidance, and addressing issues arising from audits. We comment on the effectiveness of the Company's process below.

Ofwat has changed the reporting requirements for JR11, and commentaries for individual tables are generally no longer required. However, the Company considers that it is important for responsible managers to continue to address a list of questions to help explain methodology, processes and performance to the Reporter and to give assurance to the Company's Board that sufficient detailed analysis has been undertaken of information that is to be submitted to Ofwat and may be used in the Overview. We fully support this approach.

For JR11, the Regulatory reporting manager has introduced table specific commentary templates in which he has entered Company and Ofwat targets (where available), inter-company performance comparisons, and statements from the Reporters' commentaries from the previous reporting years.. This has improved the quality and relevance of the information entered on the templates by Responsible

Managers. We have reviewed completed commentary templates as part of our individual table audits and found them very helpful.

At the audit meeting we requested explanations of activities included in the Company's June Return process that we had identified from reviewing the descriptions in the Overview and Guidance Note. The Company provided detailed explanations at the audit meeting which clarified the activities. We also asked to see documentary evidence to confirm that activities we had identified had been undertaken. We can confirm that the Company has provided all the documentary evidence requested.

We reviewed a sample of six table/line quality procedures included in the June Return business area on Sharepoint. We found that the overall Quality Management System (QMS) structure had been used for all six procedures. There were some minor inconsistencies in the contents of the procedures, which we have discussed with the Company and which will be addressed in updating of the procedures for the future. Our auditors were able to establish the status of relevant documents through questioning in the course of the review meetings.

We discussed our findings at the Overview audit meeting. We suggested that for future June Returns more guidance should be given to responsible managers on what to include under the standard QMS headings in June Return procedures. We further suggested that for future June Returns auditees be required to produce an audit file (electronic or hard copy) containing all the documentation necessary to demonstrate the audit trail from source data to table entries.

2.3 Executive Overview commentaries

Comment upon any inconsistencies in the Board Overview commentaries with the numerical information drawn from the annual return tables and from any quality regulators' reports.
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As explained in the 'Board Overview process' section above, we were given the opportunity to comment initially on the version of the Overview that had been tabled at the April Board meeting and subsequently, in advance of the meeting, on the version that had been prepared for the May Board meeting. On each occasion, we focused on how the document complied with the Ofwat reporting requirements and we provided written comments to the Finance & Regulatory team. The Overview was updated following the May Board meeting and we carried out our numerical information checks on this version.

We checked that the numerical information included in the Overview was supported by the JR tables, quality regulators' reports or other supporting information on Sharepoint or by information on the Ofwat website. We also checked that statements made in the Overview about the Company's performance and activities were fair and reasonable on the basis of the information available to us.

Primarily because we were given access to drafts prior to the Company's quality checks being completed, there were several instances where as a result of our queries and challenges the Company changed numerical information and statements in the Overview. We can confirm that the Company has responded satisfactorily to all the queries and challenges we raised at the audit meeting.

At the audit meeting we discussed the financial performance information in the Overview. The Company advised that there were no plans for this to be reviewed

by the Auditor, so we undertook to check after the audit meeting that the financial performance information in the Overview was numerically consistent with the latest version of the JR11 tables. We can confirm that the Company has responded satisfactorily to the queries and challenges we raised on financial performance following the audit meeting.

3 Reporter's key findings

We have completed our reviews for all tables, taking into account the guidance given by Ofwat both generally and for specific tables.

We have referred to and, to the extent we are reasonably able, followed up on all the points covered by the Ofwat reporter guidance. We have used our judgement when deciding the appropriate level of scrutiny. To the extent we have been able to determine from the review we have undertaken we have nothing material to bring to Ofwat's attention.

We have concluded that the methodologies and processes employed are fit for purpose. The Company has an extensive quality assurance system and our comments on this are given in the previous section on the June Return process.