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PR19 Risks and Uncertainties

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1. Introduction

In preparing our business plan, we have reviewed, at an individual and a programme level, the risks and uncertainties which the company and the services that we provide will potentially face over the course of the next price control period and beyond. This builds on our assessment of the long-term challenges and opportunities that underpinned our Welsh Water 2050 strategy.

This document provides an overview of the risks and uncertainties affecting our PR19 business plans, and the mitigations we have in place, in the following categories:

- delivery risks;
- economic and financial risks; and
- legal and regulatory uncertainty.

In addition, we provide an overview of how, as a business, we manage all the risks that we face within a unitary coherent risk management framework.

As separate but related exercises, we have also conducted an assessment of the financial resilience of the company to a set of adverse scenarios and the impact of a range of outcome uncertainties on our regulatory equity returns. These analyses are explained in detail in document 4.3: “PR19 Financial Resilience”, and document 5.6: “PR19 Risks and Return” respectively.

2. Plan delivery risks

Each part of our business has reviewed the issues that could put at risk its ability to deliver on the commitments set out in our PR19 plans. These can be categorised as technical, performance, and cost. Whilst facing with such risks and managing them as effectively as possible is a core ongoing responsibility for the company, the AMP7 period offers the prospect of particular challenges, which are highlighted below.

2.1. Technical delivery risks

As with any major capital projects, there are a number of uncertainties around the delivery of some of the major investment schemes on which we are relying to deliver performance, resilience and cost improvements in the next AMP. In the time remaining before the start of the AMP we will continue to work to mitigate these risks wherever possible.

Examples include two of our major investment schemes, the large new water treatment works near Merthyr Tydfil, and the new wastewater treatment works in the Gwili/Gwenraeth area. Delivery of these will rely on us obtaining the required planning permissions from the authorities, with whom we are already in discussion. However, we cannot rule out the possibility that drawn out negotiations will result in delays, which could have knock-on effects on several performance measures, including tap water quality, acceptability of water, and wastewater compliance.

There are also some significant engineering challenges that we will be tackling in AMP7, which themselves raise risks to the delivery of our plans. Parts of our dam safety programme in AMP6 have already thrown up some major challenges, and some of the dam repair work we have carried out is, we believe, the first time it has been attempted anywhere in the world. There are inherent risks with this kind of pioneering engineering work. We believe that we have costed for these projects in AMP7 appropriately, and we are rapidly gaining expertise on this kind of scheme, working closely with our capital alliance partners and other specialists.

Other schemes will face different kinds of challenges and uncertainties. Our new leakage strategy depends on the cooperation of customers to work with them on reducing leakage and consumption inside the home. We will need to pilot these approaches carefully and ensure that colleagues are properly trained and prepared to work alongside customers, building trust and providing a valued service.

2.2. Operational and performance risks

Water and wastewater operations are always subject to environmental conditions that are beyond the control of management, especially climate and weather-related factors. However, the experience of 2018 reinforces the fact that we will need to be prepared for the increased frequency of extreme weather events that has been predicted by climate experts. We have seen in 2018 how our performance measures and costs can be severely impacted by weather conditions, whether from a freeze/thaw event (Storm Emma), or extended dry weather. We are confident that over the five years, during which we will have some 'good' and some 'difficult' years, our water and wastewater performance targets are achievable. But there will probably be years in which we fall short, and in which financial penalties (ODIs) will apply.

The conditions experienced in 2018 have in fact provided some helpful new lessons for how to minimise the impact of adverse weather (from an operational standpoint). We will relentlessly learn from these experiences, building our resilience in terms of our operational performance. Ongoing research, investigations and innovation is creating a stronger base of knowledge and understanding of how our networks and our assets perform when under pressure. Our investment programme for AMP7 will also help strengthen the resilience of our assets and insulate our customers, whether from the impact of challenging conditions or from other risks such as cyberattacks.

2.3. Customer service risks

As with operational performance, our customer-facing functions face particular risks in AMP7. Although we work hard to build and maintain a strong relationship with our customers based on two-way trust, customers' attitudes can be influenced by external circumstances that are beyond our control. These include negative publicity arising because of events occurring elsewhere in the sector and the effect of political campaigns. As the use of social media that can exacerbate the effects of such developments continues to grow, there is greater risk to customers' satisfaction with our services and their trust in us.

Through our proposed Outcome Delivery Incentives we have a significant amount of value at risk, and could face large under-performance payments solely as a consequence of events that are outside our control. However, we work hard to ensure that our relationship with our customers is based on strong foundations. We emphasise openness and transparency and seek to maximise the availability of information about us and our services so that customers and other stakeholders are able to form a balanced view.

2.4 Cost/expenditure risks

As set out in document 5.1: PR19 Investment Planning Process, all our investment schemes are subject to optioneering and the detailed scrutiny of costs to ensure best value for customers. Nevertheless, at this stage, there is some residual uncertainty in the final design (and hence costs) of some of the schemes in our plan. To mitigate this risk we will work closely with our Capital Alliance to incentivise and deliver low cost solutions so that any unexpectedly costly schemes can be accommodated without causing overspends at the aggregate level.

It should be noted, in this context, that not all capital cost risks in AMP7 are symmetrical. Under the proposed arrangements for the National Environment Programme (NEP) it is intended that any savings in the programme will be re-deployed on other projects. The cost risk to us is therefore asymmetrical. Details are set out in Appendix 2 to document 5.8P: "PR19 IC: Wastewater NEP".

As set out in document 3.6: PR19 Costs: efficiency, benchmarking and recovery, we have set ourselves stretching cost efficiency targets for AMP7. The size and complexity of the change programme required to deliver these savings, while maintaining the highest standards of service, will be a genuine challenge, raising the risk that efficiencies will not be realised as early as envisaged. However, the plans are detailed and have been discussed and analysed at length by business heads. We will have in place a framework of specialist delivery partners, and a comprehensive governance process for change management across all affected areas.

Finally, all of these cost risks are further exacerbated by the tighter price indexation arrangements that will be built into price controls from 1st April 2020 onwards. Hitherto, with price movements being driven by changes in RPI, this has been the benchmark that we have had to “beat” in order to deliver reductions in “real” expenditures. With the shift in 2020 to the CPIH index, which tends to rise by approximately 1% less than RPI from year to year, that benchmark is commensurately tighter. This, in turn, will shift our cost and expenditure risks towards the downside by the equivalent of 5% of totex by the end of the period. We aim to mitigate this by strengthening further our focus on driving down costs by implementing the efficiency strategy set out in document 3.6: PR19 Costs: efficiency, benchmarking and recovery.

3. Economic and financial risks

We face a number of economic and business risks, such as fluctuations in input prices, the impact of inflation, and movements in financial markets, all of which may lead to financial performance that is materially better or worse than projected. The principal risks, and our approach to managing them, are set out in this section.

3.1. Financial risks

With over £3 billion of debt, future movements in interest rates and inflation rates will have a significant potential impact on our interest costs in AMP7 and beyond. Interest rates in the UK remain at historically low levels, and the possibility of significant movements in the coming years represents a major risk for us. Document 5.6: “PR19 Risks and Return” analyses the effect on regulatory equity of movements in the cost of debt.

We are able to manage these risks in a number of ways. We seek to address the effects of market movements through our hedging strategy. In addition, Ofwat has proposed a new mechanism for AMP7 which will provide some protection in respect of future movements in the cost of debt. However, this only applies to new debt that is raised after the beginning of the period, details of exactly how it will work are not yet available, and the mechanism is not due to be implemented until the end of the AMP7 period.

3.2. Relative input prices

Over a third of our costs is accounted for by three cost categories which are subject to the fluctuations of national or international markets: energy, chemicals, and “materials, plant and equipment”. At the time of plan preparation there is considerable uncertainty regarding the future trading arrangements between the UK and the rest of the world, and there is a realistic prospect that significant shifts in relative prices will occur. Our revenue allowance for AMP7 will be indexed to CPIH inflation, so any cost increases in these areas above the outturn CPIH rate will have a negative impact on our financial position.

However, as noted in document 3.6: PR19 Costs: efficiency, benchmarking and recovery, we seek to manage our cost base so as to mitigate the effects of potential adverse movements in input prices. In particular we are constantly looking for better ways of procuring – and make extensive use of – hedging strategies where appropriate.

3.3. Economic activity

Economic developments could also have a material impact on our customers and, thereby, an indirect impact on our business finances. For example, an acceleration of economic growth could result in demand from housebuilders and businesses in excess of the projections allowed for in our business plan, requiring us to carry out and fund additional investment schemes. This is a particular risk for us along the M4 corridor in south Wales and in areas around Hereford and Chester.

Alternatively, an economic recession, potentially combined with changes to the social benefits system, could result in many more households and businesses struggling to pay their bills. This could lead to increased bad debt and debt recovery costs, which form a significant proportion of our household retail business’s ‘cost to serve’.

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It could also lead to an increase in unbilled properties if the pressure on incomes causes a rise in property re-possession. This, in turn, puts upwards pressure on household bills, because the same revenue is being spread over a smaller customer base. This would be exacerbated by the effect of recession on demands from businesses.

Whether dealing with rapid economic growth or periods of recession, we will use the means at our disposal to manage the risks and mitigate the consequences. For example, our affordability strategy contains a degree of flexibility that could be used to limit the effects on bad debt.

4. Legal and regulatory uncertainty

We bear a number of mainly asymmetrical risks associated with changes in legal and regulatory obligations. Items of particular note are set out below.

4.1. Environmental and drinking water standards

The possibility of future changes in environmental or drinking water standards remains a material risk. For example, the implementation of the Water Framework Directive could impact on the National Environment Programme, in the same way that Infraction Proceedings by the European Commission resulted in major and unexpected changes to discharge permits at the Loughor Estuary in west Wales soon after the finalisation of PR14. In addition, the European Commission is considering recasting the Drinking Water Directive to focus more on health protection, and there are concerns that this may add significant additional costs on water companies. Another example of potential regulatory change is the Industrial Emissions Directive, and the uncertainty over whether its applicability will be extended to sludge, which could have a significant impact on our bioresources costs.

4.2. Wales Act

With the coming into effect of the Wales Act provisions after 2020, there could be further divergence in regulatory rules between our activities in Wales and those in England. For example, there is ongoing consideration of a transfer of customer supply pipes to water companies and of changes to the rules for water abstractions, which could materially affect our cost base in either or both jurisdictions. Similarly, the Act is likely to bring some 10,000 non-household customers in the areas of England that we serve into the competitive retail market, which would have a material effect on our non-household retail business.

4.3. Business rates

Business rates are one of the largest operating costs of the business and are set periodically (at 'revaluations') by the Valuation Office Agency (VOA). Following recent Government announcements there will be two revaluations in AMP 7 – in April 2021 and April 2024. Predicting the outcome of revaluations is very difficult. We have carefully analysed the variables that underlie these revaluations, and considered the implications of a Welsh Government consultation on the topic in April 2018. The results of this analysis have been factored into our plans. However, there still remains considerable uncertainty over the potential effects of the revaluations, and regulatory changes in business rates more widely.

4.4. Brexit

The UK Government continues to negotiate its withdrawal from the European Union, which is due to take place in March 2019. The outcome of those negotiations is subject to considerable uncertainty, but the form and details of "Brexit" could have far-reaching effects on our business. These include potential macro-economic "shocks", but there is also wider unpredictability regarding the wide range of regulatory requirements that currently emanate from EU directives. The UK and/or Welsh Government may choose to remove or modify existing quality obligations, but they may also choose to strengthen them or create new ones, which could have a significant impact on our business.

4.5. Mitigations

Given the significant uncertainties regarding the scope of statutory obligations during the AMP7 period, we have given careful consideration to what process for managing change best meets customer priorities and provides an appropriate balance of risk. We have a good track record of dealing with such changes in the past. During AMP6, we have been able to defer passing on to customers the very significant costs of the new sewerage system permits at the Loughor estuary, with the understanding that these will be allowed for in full at the subsequent periodic review in 2019. However, whilst we would wish to avoid unexpected changes to customers' bills ("Interim Determinations") between regulatory reviews, the reduced profitability of companies post 2020 and the generally tighter financial environment for the sector may mean that it will be increasingly important to have the options of "logging up" and "Interim Determinations" available to companies, to ensure their financial resilience given the risk of unexpected, new regulatory requirements.

Most of the risks identified above can be accommodated within the general definition of a "Relevant Change of Circumstance". However, we are proposing that the PR19 determination include a Notified Item to cover changes to local authority rates arising out of the Valuation Office re-valuations that are due to take place during AMP7.

5. How we manage risk and uncertainty

The management of the risks that we face is one of our highest priorities. Accordingly, it receives considerable attention at board level and throughout the rest of the organisation, supported by systems and processes that allow us to identify, manage, mitigate and review our risks. The approach that we apply can be summarised as follows:

- individual teams within the business take responsibility for managing risks within their areas of responsibility;
- each business unit feeds into a “bottom up” risk management system, escalating risks through our governance structure of committees and team meetings. Risks recorded through that process are discussed during a more “top down” discussion of risk every month at a meeting of the Executive team;
- the Executive team’s update on strategic risks affecting the business is reviewed at every Board Meeting and the Board carries out an in-depth review of strategic risks twice every year. The Board assesses both the current and target level of each risk, as well as potential mitigation measures;
- the Audit Committee has accountability for overseeing the risk management processes and procedures and reports to the Board on the adequacy of internal controls (see below);
- this “bottom up” and top down approach to risk management provides assurance that risks are being effectively managed by the business and identifies those areas where further mitigation steps are needed;
- the Board and its Committees review a summary of strategic risks facing the business at every meeting.

Our approach to the management of risk is supported by established systems of internal control, which are designed to identify, evaluate and manage the risks affecting the business. These systems of internal control are regularly reviewed and monitored by the Audit Committee of the Board.

Finally, our risk management strategies and their implementation are subject to external assurance, as part of the preparation of the Annual Performance Report.