

2014 Price Review
Business Plan Supporting Appendices
Risk

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Executive Summary

The creation of a five year business plan inevitably requires us to use assumptions where the future is not certain e.g. energy costs. If these assumptions prove to be incorrect this can create a risk that either customers' bills are higher than they need to be or we don't collect in prices sufficient expenditure to allow us to meet our obligations to our customers, shareholders, stakeholders and maintain our credit rating.

It is important therefore that we understand or mitigate the risks in our plan. We use a number of tools to achieve this:

- We ensure the original assumption is based on sound evidence;
- Where it is available we seek third party assurance of any key assumption;
- We measure the impact of a change in the assumption to better understand its impact; and,
- We benchmark our assumptions against our and other industries

Risks are also dealt with in other sections of the plan the other key area of risk assessment and balance relates to the assessment of required returns, this is dealt with in the financeability section of the plan.

Risks identified that may lead to a cost increase or decrease in 2015-20 include:

1. Energy
2. Business Rates
3. Efficiency
4. Pension Funding
5. Population Growth
6. Metering impact
7. Drought
8. Retail Margin

A summary of risks across retail and wholesale are presented in the below table.

	Potential increase over 2015-20 plan	Potential cost decrease over 2015-20 plan
Wholesale	£71.6m	£38.8m
Retail	£33.5m	£13.7m
Total	£105.1m	£52.5m

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Section 1. Introduction

The purpose of this paper is to outline identified risks that could vary cost in either direction. Risks have been identified for both retail and the wholesale function.

Assumptions used to balance risk are embedded in each area of our plan. Indeed risk assessments are the cornerstone of the processes we use to assess future investment needs e.g. capital maintenance planning based on the risk of service failures to customers, there are nevertheless key and material risk items that remain.

Table 1 summarises the key and material impacts on cost to the whole business and therefore potentially prices. The assumptions for potential increases and decreases in cost are included against each individual item.

Clearly it is unlikely that we will experience either the total potential increase or total decrease and that the likely outcome will be a mixture of both. The range of outcomes demonstrates that on balance the risk sits more with us than with our customers, this is deliberate, and represents another challenge we have set ourselves i.e. to mitigate the risk further or to seek new and innovative ways to offset these risks.

Section 2. Risk at the total company level

Inevitably risk and the assumptions used to balance risk are embedded in each area of our plan. Indeed risk assessments are the cornerstone of the processes we use to assess future investment needs e.g. capital maintenance planning based on the risk of service failures to customers. There are nevertheless key and material risk items that remain. Table 1 summarises the key and material impacts on cost to the business and therefore potentially prices at the company level.

Table 1 Company Level Risk Matrix

Item	Assumption in plan	Potential increase over 2015-20 plan	Potential cost decrease over 2015-20 plan	Comment / Mitigation
Changes in power costs	Power prices follow the DECC forecast	£6.0m	£4.0m	We have contracted prices in place until 2017-18 but are subject to market forces thereafter
Business rates	Third party estimate of rate change in 2017	£5.6m	£0.5m	Increases and decreases reflect upper and lower ends of estimated range.
Pension funding	Pension costs included in prices as per methodology	£14.8m	£0.0m	Extra efficiency will be required above the explicit targets

Population forecast	Forecast 17% increase by 2040	£3.9m	£9.0m	Costs relate to the timing of new schemes being fast-tracked to meet demand, or being pushed back post 2020 if demand is reduced
Drought – three consecutive dry winters	1 drought in 10 years is the current assumption in WRMP	£3.9m	£0.0m	Plan based on normal year, high rainfall years do not produce material benefits
Metering	Move from 158 litres per day per person to 141 by 2040	£2.6m	£9.7m	Challenging pcc target means less likely to outperform this target than underperform
Incentives (Wholesale)	Meet performance levels	£10.6m	£3.7m	Potential incentive range
Incentives (Retail)	Meet performance levels	£6.6m	£3.5m	Potential incentive range
Wholesale efficiency	Deliver Totex efficiency in plan	£30.4m (i.e. no efficiency)	£11.9m	Efficiency assessments used to create targets, tough targets mean outperformance is less likely than underperformance
Retail efficiency	Specified efficiencies plus CPI efficiencies	£5.2m (i.e. no efficiency)	£0.0m	Efficiency assessments used to create targets, tough targets mean outperformance is less likely than underperformance
Household retail margin	Risk within margin of 1.0% p.a.	£12.2m	£4.6m	Margin for households should be closer to business margin or indeed no material risk exists due to separation of retail cost control
Business retail margin	Risk within margin of 3.0% p.a.	£3.5m	£5.6m	Market does not open in 2017 as anticipated or margin should be closer to upper end of retail range at 5%
Risk Balance		£105.1m	£52.5m	

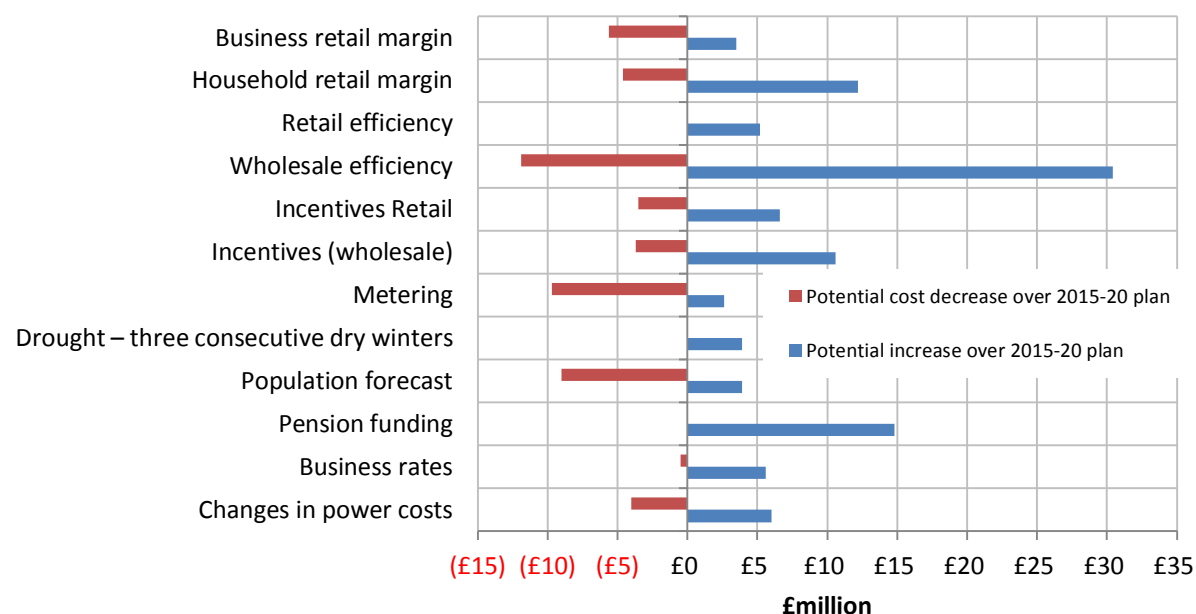
Figure 1 Whole Company Risk

Table 1 and figure 1 represents the material risks within the plans, in addition risks covered by existing adjustment mechanisms i.e. revenue related risks have not been included although any revenue shortfall creates cash flow risks until the Revenue Correction Mechanism is applied. Each relevant area of the plan describes how we have arrived at our key planning assumptions and the sensitivity around this decision this includes an assessment of the Weighted Average Cost of Capital which can be found in the Financing and Financial Modelling appendix.

We have used an analysis of key assumptions to generate this risk assessment.

1. Power Cost and Volume Risk

Energy prices are contracted to the end of March 2017. Where we are not contracted we have taken a consistent approach with Ofwat to use the DECC forecast to determine energy price. Ofwat have applied a high and low forecast around the DECC profile and we have utilised these profiles to calculate a high and low scenario. Anticipating a high price scenario potentially results in energy cost increases of £6.0m across the period, conversely should energy prices adopt the lower level of price forecast then potential savings of £4.0m could be achieved.

2. Business Rate Risk

The DTI has announced that the business rates revaluation will take effect from 1st April 2017. The current forecast is based on the advice of Colin Parsons of Jones Lang Lasalle, who has acted as our external adviser for previous rates revaluations. A low, mid and high value has been provided and varies according to rate of return and a forecast of uniform business rate (UBR).

We have opted to forecast the mid value within our plan, and therefore the low and high values represent our potential increase and decrease. A further review of business rates is offered within the Operating costs appendix.

3. Efficiency and Pension Funding Risk

Within our plan we have targeted tough efficiency challenges which we believe will continue to ensure we continue as an above average performing company. When considering a potential increase in cost this relates to no efficiency being delivered for Capex nor Opex. The subsequent increase in cost as a consequence of achieving no efficiency is £36m, across both retail and wholesale functions. Conversely a stretch target for efficiency would be to maintain 2010-15 performance level of efficiency, and achieving this would result in £11m of efficiencies being secured.

With regard to pension funding we have a committed recovery plan for the two defined benefit schemes for which we are the sponsoring employer, with annual payments of £6.8m (12/13 prices) committed until 2025.

We have undertaken significant risk management activity in relation to the scheme including agreeing the cessation of the accrual of any new liabilities from 31 March 2015, but this will have a negligible impact on the current deficit, and will have no impact on the committed pension deficit repair costs in the period to 2020. More detail concerning the schemes can be found in KPMG's report contained in Operating costs appendix.

In Information Notice 13/17 Ofwat has prescribed that only payments of £3.8m per annum will be allowed in prices going forward. This therefore generates a further efficiency requirement of £3m per annum which will need to be achieved. This amounts to £14.8m for 2015-20 and is therefore our potential risk increase in cost.

4. Population Forecast Risk

A higher than expected population growth by 2020 will require additional capital schemes to be implemented to ensure demand is met. Likewise, if population is below expectations then schemes may be deferred and cost saved.

High, central, and low population growth scenarios have been modelled within the Water Resource Management Plan (WRMP). For our plan the central approach has been adopted and has a growth of 3.7% over five years from 2014/15 to 2019/20. The upper sensitivity test had growth increasing by 4.6% over the same period. The lower sensitivity was for a growth rate of 95% of the plan, which results in a 5% lower increase in population.

Allowing for the upper sensitivity resulted in costs increasing by £3.9m. Conversely, the lower scenario of population growth would result in cost decreasing by £9.0m. Further detail can be found in the Water Resource Management Plan appendix.

5. Drought Risk

Our current drought assumption is for a one in ten year event, which has driven the current plan cost. As a high scenario we have modelled the cost impact of experiencing three consecutive dry winters as experienced in this five year period. The subsequent requirement to bring forward schemes increases 2015-20 cost by £3.9m.

6. Metering and Demand Reduction Risk

Metering and water efficiency initiatives are expected to reduce per capita consumption (PCC) from

165 to 158 litres per day by 2020. If the forecast impact of metering and water efficiency is not delivered then additional capital plan cost will be required to meet the shortfall. Conversely, if the impact of metering is greater than expected then an element of 2015-20 schemes may be deferred to the next period of investment.

We have modelled a low and high case of metering impact to anticipate any cost variance. A low case of metering is defined as metering having a greater impact of demand management and therefore reducing actual capital spend (i.e. deferral of schemes). A low impact is PCC reduced by 5.5% from our central view. The subsequent reduction in cost is £9.7m across 2015-20. A high case of metering impact is when PCC is 5.5% higher. The outcome is that capital plan costs will increase by £2.6m across 2015-20. Further detail can be found in the Water Resource Management Plan.

7. Incentive Risk

The incentive range from both the Outcome Delivery Incentives and the Service Incentive Mechanisms are equivalent to a potential increase in revenue equivalent to 1% of the five year revenue and the decrease is equivalent to 2% of the five year revenue. This incentive range was generated as a result of Return on Regulatory Equity (RORE) analysis and customer willingness to pay survey results. Further detail is included in our 'Outcome, Performance Commitments and Incentives' appendix.

8. Margin Risk

The use of margins to reflect risk is always a difficult area especially in a developing market arrangement. The assumptions used in this area relate to the margin either being insufficient to cover the risk that emerges or less or no risk occurs and therefore the margin is unnecessary.

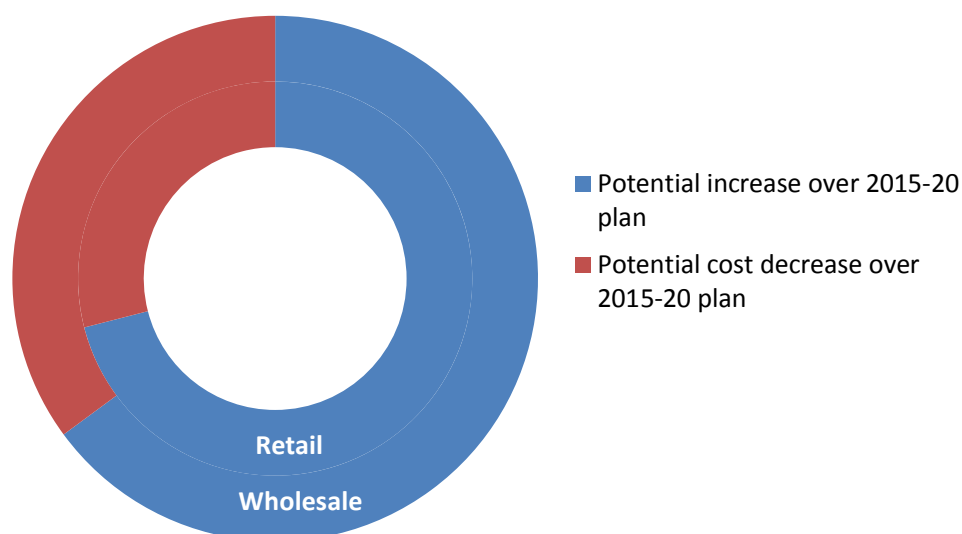
For household within the plan we have assumed a central value of 1% to reflect risk, with a low value of 0% and a high value of 3%. The respective change in cost is therefore a £4.6m decrease and £12.2m increase.

Similarly for non-household we have assumed in our plan a central view of 3.5% risk margin, with a low value at 0% and high value at 5%. The respective change in cost is therefore a £5.6m decrease and a £3.5m increase.

Section 3. Balance of risk between plans

Examining the above risks at the plan level it can be seen that the wholesale business carries a considerable proportion of the overall risk and if you consider the difference between the potential increases and the decreases to be the residual risk then wholesale carries 69 per cent of the residual risk. However, the wholesale business has a greater capacity to absorb risk as it has more flexibility in its operation it is also protected to some extent by the in period regulatory mechanisms e.g. IDoK. However the risks articulated here are not materially mitigated by our Change Protocol, see Change Protocol Appendix. These offer no protection for retail within the existing framework due to the current materiality threshold relating to the total business turnover.

Figure 2 Comparison of risk sharing



The residual risk in retail of £18m is equivalent to 13% of the retail turnover over the period demonstrating that the retail business is not as low a risk as might be expected driven in part by the change to pension funding arrangement.

Section 4. Wholesale risk

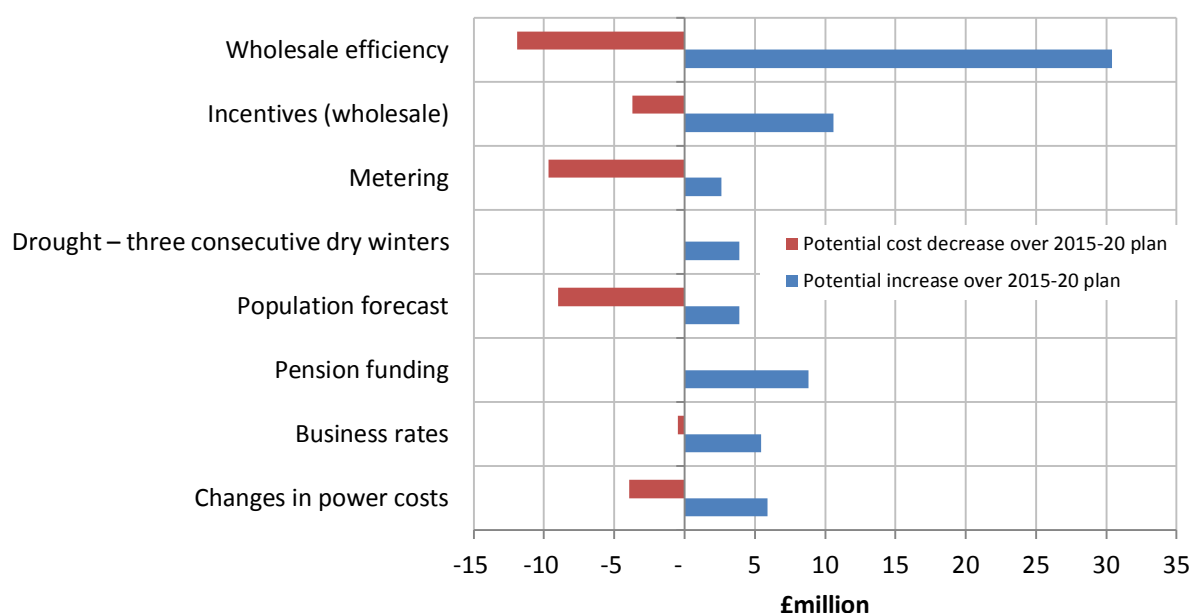
The same analysis is replicated but for the wholesale business only.

Table 2 Wholesale Risk Matrix

Item	Assumption in plan	Potential increase over 2015-20 plan	Potential cost decrease over 2015-20 plan	Comment / Mitigation
Changes in power costs	Power prices follow the DECC forecast	£5.9m	£4.0m	We have contracted prices in place until 2017-18 but are subject to market forces thereafter
Business rates	Third party estimate of rate change in 2017	£5.5m	£0.5m	Policy but not cost change included within the change protocol
Pension funding	Pension costs included in prices as per methodology	£8.8m	£0.0m	Extra efficiency will be required above the explicit targets
Population forecast	Forecast 17% increase by 2040	£3.9m	£9.0m	Central estimate based on latest census data

Drought – three consecutive dry winters	1 drought in 10 years is the current assumption in WRMP	£3.9m	£0.0m	Plan based on normal year, high rainfall years do not produce material benefits
Metering	Move from 158 litres per day per person to 141 by 2040	£2.6m	£9.7m	Challenging pcc target means less likely to outperform this target than underperform
Incentives (Wholesale)	Meet performance levels	£10.6m	£3.7m	Potential incentive range
Wholesale efficiency	Deliver Totex efficiency in plan	£30.4m (i.e. no efficiency)	£11.9m	Efficiency assessments used to create targets, tough targets mean outperformance is less likely than underperformance
Risk Balance		£71.6m	£38.8m	

Figure 3 Wholesale Risk



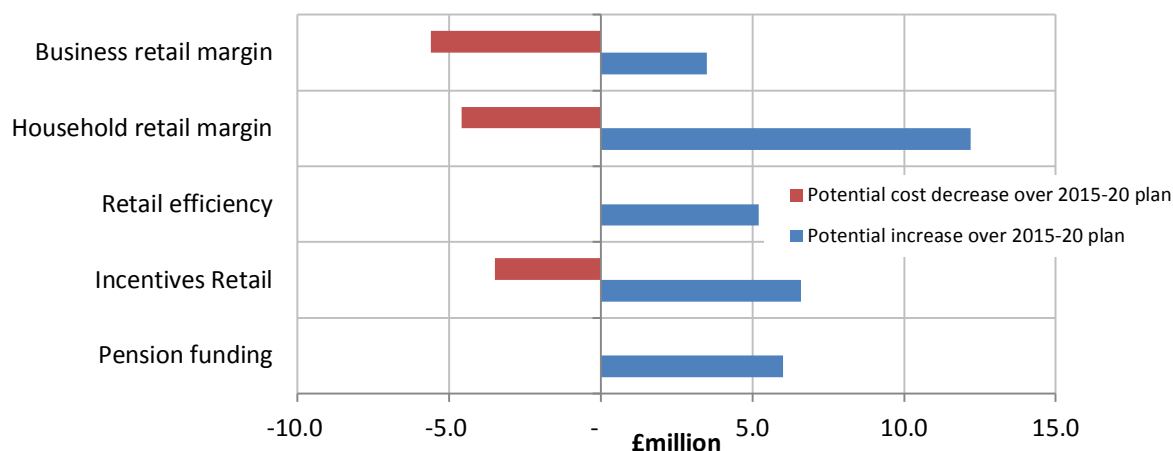
Section 5. Retail Risk

The same analysis is replicated but for the wholesale business only.

Table 3 Retail Risk Matrix

Item	Assumption in plan	Potential increase over 2015-20 plan	Potential cost decrease over 2015-20 plan	Comment / Mitigation
Pension funding	Pension costs included in prices as per methodology	£6.0m	£0.0m	Extra efficiency will be required above the explicit targets
Incentives (Retail)	Meet performance levels	£6.6m	£3.5m	Potential incentive range
Retail efficiency	Specified efficiencies plus CPI efficiencies	£5.2m (i.e. no efficiency)	£0.0m	Efficiency assessments used to create targets, tough targets mean outperformance is less likely than underperformance
Household retail margin	Risk within margin of 1.0% p.a.	£12.2m	£4.6m	Margin for households should be closer to business margin or indeed no material risk exists due to separation of retail cost control
Business retail margin	Risk within margin of 3.0% p.a.	£3.5m	£5.6m	Market does not open in 2017 as anticipated or margin should be closer to upper end of retail range at 5%
Risk Balance		£33.5m	£13.7m	

Figure 4 Retail Risk



Section 6. Overall Risk Position

Key points from the above analysis:

- We are carrying an amount of risk that looks challenging yet acceptable, and will benefit customers via lower bills and as a minimum maintenance of the existing service levels;
- There are a wide range of material risk areas the largest of which relate to efficiency challenges;
- The risks associated with meeting the water resource challenge is also significant again reflecting challenges we have set ourselves particularly to reduce pcc; and,
- The residual risk is largely in wholesale but a significant proportion remains in retail.

The balance clearly substantiates our position that we have challenged ourselves to create a plan that keeps bills low whilst setting ourselves challenging performance targets across a wide range of measures. Whilst challenging we believe the plan is deliverable and represent a balance between customers, shareholders and stakeholders