Financial oversight responsibilities of the board

Audit, risk and internal control

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Principle M:
The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.

Our application of principle M is formalised in our non-audit services policy and terms of engagement with the auditor as agreed by the committee. The head of internal audit and risk reports to the committee and to the CFO but only on a functional basis, thereby ensuring a direct line of communication between internal audit and the committee. In accordance with provision 25, an explanation of the independence and effectiveness of the external audit process can be found on pages 148 to 149, and the reappointment of the statutory auditor on page 150. The board considered and was satisfied on the integrity of the financial and narrative statements, as advised by the audit committee in accordance with DTR 7.1.3(5).

Principle N:
The board should present a fair, balanced and understandable assessment of the company's position and prospects.

We have applied principle N, as confirmed by our disclosure against provision 27, which can be found on page 198 and is supported by our disclosure against provision 25 on pages 147 to 148.

Principle O:
The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

Our risk management framework and principal risks are on pages 100 to 109. Further information on the company's internal audit function and controls can be found on pages 153 to 154 and together set out our application of principle O.

Board's responsibility for financial oversight
One of the fundamental roles of the board is to oversee the financial performance of the business. The board is supported in this role by the audit committee whose activities are described on pages 143 to 154. The board reviews the financial performance of the company at every scheduled board meeting, receiving a report from the CFO which provides the board with the up-to- date position of the consolidated financial statements, interpretative analysis and other key performance indicators, metrics and ratios. The board takes into account the review by the audit committee of the financial and narrative statements, and the auditor's views on the key risks and judgements identified and given particular focus in their audit work and set out in their report (see pages 202 to 209), and the information and explanations provided by management in relation to their key judgements and adjustments to APMs (see page 82). The board considered the review and assurance process undertaken by management, and considered by the audit committee to support the application of principle N. The board concluded that in the 2021/22 annual report and financial statements it had presented a fair, balanced and understandable assessment of the company's position and prospects, and the board was satisfied on the integrity of the financial and narrative statements. Furthermore, the board approved the accounts and provision of the directors' responsibility statement at its meeting on 25 May 2022, see page 198.

Oversight of financial aspects of ESG
ESG, and behaving responsibly, has been a long-term commitment and part of the board ethos for many years and is embedded throughout the business. It naturally flows through into the board's approach to the integrity of the group's financial reporting. Recognising that climate change is a key risk to the group's provision of water and wastewater services (see page 102), 2021/22 is the third year that the group has reported against the TCFD recommendations. As part of the processes supporting the provision of the 'fair, balanced and understandable' statement, the board took into account the existing processes of review and assurance of the TCFD and wider narrative reporting. Management reviewed the assurance processes relating to narrative reporting and ESG matters, particularly those relating to TCFD reporting, and determined that the levels of assurance provided by the combination of the work by internal audit and of the various third parties was satisfactory at this time – a stance endorsed by the audit committee. The TCFD report addresses the TCFD recommendations and includes, for the second year, scenario analysis (see page 92). Inclusion of climate-related information in accordance with the TCFD is mandatory for the company in its 31 March 2023 annual report.

Board's approach to risk management and internal control
The board discharges its responsibility for determining the nature and extent of the risks that it is willing to take to achieve its strategic objectives through the risk appetite framework. As a key part of the risk management framework, risk appetite (see page 100) captures the board's desire to take and manage risk relative to the company's obligations, stakeholder interests and the capacity and capability of our key resources.

The board is responsible for ensuring that the company's risk management and internal control systems are effectively managed across the business and that they receive an appropriate level of scrutiny and board time. The risk profile is reviewed in conjunction with the full and half-year reporting cycle alongside deep dives and routine performance reviews.

The group's risks predominantly reflect those of all regulated water and wastewater companies. These generally relate to the failing of regulatory performance targets or failing to fulfil our obligations in any five-year planning cycle, potentially leading to the imposition of fines and penalties, in addition to reputational damage. Climate change is a causal risk theme that underpins our core operations and provision of water and wastewater services to customers (see page 102).

Review of the effectiveness of the risk management and internal control systems
During the year, the board reviewed the effectiveness of the risk management systems and internal control systems, including financial, operational and compliance controls. Taking into account the principal risks and uncertainties set out on pages 100 to 109, the ongoing work of the audit committee in monitoring the risk management and internal control systems (see pages 153 and 154) on behalf of the board, (and to whom the committee provides regular updates), the board:

- was satisfied that it had carried out a robust assessment of the emerging and principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity; and

- had reviewed the effectiveness of the risk management and internal control systems, including all material financial, operational and compliance controls (including those relating to the financial reporting process) and no significant failings or weaknesses were identified.

After review, the board concluded that through a combination of the work of the board, the audit committee and the UUW board (which has particular responsibility for operational and compliance controls), the company's risk management and internal controls were indeed effectively monitored throughout the year.

The board's review of the effectiveness of risk management and internal control systems took into account:

- the biannual review of significant risks and emerging risks (see pages 100 to 109);
- the assurance (both internal and external) of the most significant business and operational risks of the group;
- the review of matters correlating to specific event based operational risks (see pages 106 to 107);
- the outcome of the biannual business unit risk assessment process (see page 100);
- the activities and review of the effectiveness of the internal audit function (see page 153);
- the opinion provided by internal audit in relation to their work, that "the governance, risk management and internal control framework was suitably designed and effectively applied within the areas under review";
- the self-assessment provided by management confirmed compliance with a range of key internal policies, processes and controls (see page 154);
- the review of reports from the group audit and risk board (see page 101);
- the oversight of treasury matters, in particular debt financing and interest rate management (see page 155); and
- the review of the business risk management framework and management's approach and tolerance towards risk (see page 100).

Going concern and long-term viability

The following section sets out the company's compliance with part of provisions 30 and 31.

The board, following the review by the audit committee, concluded that it was appropriate to adopt the going concern basis of accounting (see page 217). Similarly, in accordance with the principles of the code, the board concluded, following the recommendation from the audit committee, that it was appropriate to provide the long-term viability statement based on an assessment period of seven years. Assurance supporting these statements was provided by the review of: the group's key financial measures and contingent liabilities; the key credit financial ratios; and the group's liquidity and ongoing ability to meet its financial covenants. As part of the assurance process, the board also took into account the principal risks and uncertainties facing the company, and the actions taken to mitigate those risks, and include emerging and more topical risks.

These principal risks and uncertainties are detailed on pages 100 to 109, as are the risk management processes and structures used to monitor and manage them. Biannually, the board receives a report detailing management's assessment of the most significant risks facing the company. The report gives an indication of the level of exposure, subject to the mitigating controls in place, for the risk profile of the group, while also highlighting the reputational and customer service impact. This provides the board with information in two categories: group-wide business risks; and operational risks. The board also receives information during the year from the treasury committee (to which the board has delegated matters of a treasury nature – see page 155), including such matters as liquidity policy, the group's capital funding requirements and interest rate management.

Long-term viability statement

The directors have assessed the viability of the group, taking account of the group's current position, the potential impact of the principal risks facing the business in severe but reasonable scenarios, and the effectiveness of any mitigating actions. This assessment has been performed in the context of the group's prospects as considered over the longer term. Based on this viability assessment, the directors have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the seven-year period to March 2029.

Basis of assessment

This viability statement is based on the fundamental assumption that the current regulatory and statutory framework does not substantively change. The long-term planning detailed on page 46 assesses the group's prospects and establishes its strategy over a 25-year time horizon consistent with its rolling 25-year licence and its published long-term strategy. This provides a framework for the group's strategic planning process, and is key to achieving the group's aim of providing the best service to customers at the lowest sustainable cost and in a responsible manner over the longer term, underpinning our business model set out on pages 20 to 83.

In order to achieve this aim and promote the sustainability and resilience of the business, due consideration is given to the management of risks over the long term that could impact on the business model, future performance, credit ratings, solvency and liquidity of the group. Specifically, risks associated with current levels of economic uncertainty and climate change have been incorporated into the baseline position and factored into the various scenarios modelled as part of the group's assessment. An overview of our risk management approach that supports the group's long-term planning and prospects, together with the principal risks and uncertainties facing the business, can be found on pages 100 to 109. This approach considers the full range of categories of risk that could impact the company, such as financial, operational and regulatory risks. In addition, consideration is given to the adequacy of workforce policies and practices, all liabilities including pension liabilities, any exposure to revenue variations, and expectations of future performance taking account of past performance in delivering for customers.

Within the context of this long-term planning and management of risks, the group's principal business operates within five-year regulatory price control cycles. Medium-term planning considers the current price control period, over which there is typically a high degree of certainty, and looks beyond this in order to facilitate smooth transitions between price control periods. This results in the board concluding a recurring period of seven years to be an appropriate period over which to perform a robust assessment of the group's long-term viability.

Viability assessment: resilience of the group

The viability assessment is based upon the group's medium-term business planning process, which sits within the overarching strategic planning process and considers:

- the group's current liquidity position – with £1.1 billion of available liquidity at March 2022 providing a significant buffer to absorb short-term cash flow impacts;
- the group's robust capital solvency and credit rating positions – with a debt to regulatory capital value (RCV) ratio of circa 60 per cent, a robust pension position and current credit ratings of A3/BBB+/A- with Moody's, S&P and Fitch respectively, this provides considerable headroom supporting access to medium-term liquidity where required;
- the group's expected performance, underpinned by its historical track-record; and
- the current regulatory framework within which the group operates – which provides a high degree of cash flow certainty over the regulatory period and the broader regulatory protections outlined below.

The group has a proven track-record of being able to raise new finance in most market conditions, and expects to continue to do so into the future. This is despite the group no longer having access to future EIB funding following the UK's exit from the EU.

From a regulatory perspective, the group benefits from a rolling 25-year licence and a regulatory regime in which regulators – including the economic regulator, Ofwat – are required to have regard to the principles of best regulatory practice. These include that regulation should be carried out in a way that is transparent, accountable, proportionate, consistent and targeted. Ofwat's primary duties provide that it should protect consumers' interests, by promoting effective competition wherever appropriate; secure that the company properly carries out its statutory functions; secure that the company can finance the proper carrying out of these functions – in particular through securing reasonable returns on capital; and secure that water and wastewater supply systems have long-term resilience and that the company takes steps to meet long-term demands for water supplies and wastewater services.

In addition, from an economic perspective, given the market structure of water and wastewater services, threats to the group's viability from risks such as reduced market share, substitution of services and reduced demand are low compared to those faced by many other industries.

Viability assessment: resilience to principal risks facing the business

The directors have assessed the group's viability based on the resilience of the group and its ability to absorb a number of 'severe but reasonable' scenarios, derived from the principal risks facing the group, as set out on pages 100 to 109. The baseline plan against which the viability assessment has been performed incorporates the estimated impact of current high levels of inflation which are expected to endure in the near term before falling to more normal levels. This baseline plan is then subject to further stress scenarios and reverse stress testing that takes into account the potential impact of the group's principal risks. Such risks include: environmental risks such as the occurrence of extreme weather events and other impacts of climate change, further details of which are included in the group's TCFD disclosures on pages 86 to 94; political and regulatory risks; the risk of critical asset failure; significant cyber security breaches; current economic uncertainties including high levels of inflation and a squeeze on the cost of living impacting the group's customer base; and the potential for a restriction to the availability of financing resulting from a capital markets crisis.

The scenarios considered are underpinned by the group's established risk management processes, taking into account those risks with a greater than 10 per cent (1 in 10) cumulative likelihood of occurrence. Risks associated with current economic conditions are reflected within the baseline position, with further potential downside risks (most notably in relation to bad debt and low inflation) covered by the individual scenarios modelled, and collectively within a combined scenario.

Read more about **significant issues** on pages 151 to 152

Read more about **relations with banks and credit investors** on page 128

Read more about **our principal risks** on pages 104 to 109

Read more about **going concern basis of accounting** on page 217

Based on these risks, the following six largest impacting scenarios were identified and applied as downside stress scenarios to the group's baseline plan:

Scenario modelled	Link to risk factors
Scenario 1: Totex £500m one-off impact in 2022/23	Broadly representing the largest 'severe but reasonable' risk which is a critical asset failure, all assumed to be operating costs
Scenario 2: Totex underperformance of 10% (c£120m–c£140m) per annum for 2022/23–2028/29	Representing more than the cumulative total expected NPV totex impact of the remaining top 10 'severe but reasonable' risks (including environmental, cyber security and network failure risks)
Scenario 3: CPIH inflation of 2.0% below baseline plan for 2022/23 and 2023/24, and 1.0% below baseline plan for 2024/25–2028/29	Consistent with quantum of inflation impacts modelled within top 10 severe but reasonable risks
Scenario 4: An increase in bad debt of £15m per annum from 2022/23 to 2028/29	Aligned to internal risk factor on debt collection.
Scenario 5: Additional ODI penalty of c£50m per annum	Assumes mid-point of UUW's baseline and final determination P90 ODI position
Scenario 6: Combined scenario – 50% of scenarios 2-5	50% of scenarios 2-5

Example mitigations (of which none are required to remain viable under the scenarios modelled):

- Issuing of new finance
- Reduction in discretionary totex spend
- Capital programme deferral
- Closing out of derivative asset position
- Restriction of dividend
- Raising of new equity

The assessment has considered the impact of these scenarios on the group's business model, future performance, credit ratings, solvency and liquidity over the course of the viability assessment period. This assessment has demonstrated the group's ability to absorb the impact of all severe but reasonable scenarios modelled, without the need to rely on the key mitigating actions detailed below.

The most extreme of the severe but reasonable scenarios modelled, without any mitigating action, resulted in: the group comfortably retaining investment grade credit ratings; liquidity of more than one year; and no projected breaches of financial debt covenants.

Viability assessment: reverse stress testing

As part of the assessment, reverse stress testing of two extreme theoretical scenarios focusing on totex overspend and persisting low inflation have been performed to understand the extent to which the group could further absorb financial stress before it reaches a sub-investment grade credit rating. This reverse stress testing demonstrated that these extreme conditions would have to be significantly outside what would be considered 'severe but reasonable' scenarios before the group's long-term viability would be at risk.

Viability assessment: key mitigating actions

In the event of more extreme but low likelihood scenarios occurring, there are a number of key mitigations available to the group, the effectiveness of which are underpinned by the strength of the group's capital solvency position.

As well as the protections that exist from the regulatory environment within which the group operates, a number of actions are available to mitigate more severe scenarios, which include: the raising of new finance, including hybrid debt; capital programme deferral; reduction in other discretionary totex spend; the close-out of derivative asset positions; the restriction of dividend payments; and access to additional equity.

Governance

The analysis underpinning this assessment has been through a robust internal review process, which has included scrutiny and challenge from the audit committee and board, and has been reviewed by the group's external auditor, KPMG, as part of their normal audit procedures.

Going concern

The directors also considered it appropriate to prepare the financial statements on the going concern basis, as explained in the basis of preparation note to the accounts.