

Risks and resources



Waste water storm tank, South Shields, part of our £3.0 million flood alleviation scheme

The NWG Board requires all subsidiaries within the Group to identify and assess the impact of risks to their business. For each risk, the likelihood and consequences are identified, management controls and frequency of monitoring are reported and the scale of the risk is assessed. Apart from NWL, none of the subsidiaries has risks considered to be significant to the Group's short and long term value.

For NWL, the management team reviews the approach to risk management in detail every year and the Audit Committee considers the outcome. The NWL management team review the significant risks every month and summary reports on these reviews are submitted to the NWL board. This year, the Audit Committee commissioned an additional risk and assurance mapping report from Ernst & Young, to provide NWL's management and the Audit Committee with a view of the different assurance functions and the extent to which they provide assurance that the control activities mitigating the key business risks are working properly. In performing the review, Ernst & Young interviewed several of the managers most involved in the management of risk and, having done so:

- identified the main risks in NWL's existing risk register and additional risks that they would typically expect to be included based on their knowledge of the water sector;
- identified the main audit and assurance activities; and
- mapped the sources of assurance against the control activities and risks checking for gaps and duplication.

The main conclusions, which were reported by Ernst & Young to the NWL board, were:

- the mechanics of the risk assessment and the format of the risk register are typical of what Ernst & Young would expect to see within an effective risk management process;
- much of the content of the risk register is very typical of what they see within other companies operating within this sector; and
- there are many different sources of assurance across the business and the assurance coverage of key risks is reasonable.

Having received Ernst & Young's assessment of the current approach to risk and assurance, the board considered the documentation of risk appetite and the manner in which assurance is received. The board agreed that as well as ensuring that an effective 'bottom up' risk management programme is in place, they should also consider risks of a more strategic nature regularly. Subject to addressing Ernst & Young's points, the board considered the current approach to general business risk to be acceptable, although board papers could usefully make more explicit reference to how risks have been evaluated. However, a draft register of strategic risks will also be produced for discussion. As well as helping to identify these risks this should also help the board agree whether its appetite for risk should be documented formally.

Going concern and treasury risk

The financial ratios, financial results, liquidity position and credit ratings are described in the financial performance section on pages 22 to 25. In addition, note 20 to the financial statements includes details on the Group's strategy and treasury operations for managing its capital; its exposures to liquidity risk, interest rate risk, foreign currency risk and counterparty risk; and details of its financial instruments.

The Group has sufficient funding in place to finance all of its operations until the end of 2011, leaving it well placed to deal with continued volatility in capital markets.

The current economic climate is having an impact on revenues, particularly those from industrial and commercial customers and those associated with the housing market. We continue to monitor the uncertain situation very carefully and, in particular, the recovery of domestic revenue. We welcome the passing of the Flood and Water Management Act 2010, which will require landlords to disclose details of their tenants which will help improve debt collection.

Overall, industrial revenues are currently expected to be close to those assumed by Ofwat when setting prices for 2010-15. Our largest single customer, Artenius UK Limited, ceased production in 2009 and Ofwat assumed this plant would remain closed. However, in February 2010, it was bought by a Korean company, KP Chemicals, whose subsidiary Lotte Chemical UK Limited brought the plant back into operation in April 2010 (although NWL revenue will be slightly lower than under the previous Artenius contract). By contrast, a number of plants have closed which Ofwat had assumed would remain open. The most significant is Corus Cast Products where the blast furnace was mothballed in January 2010, although Corus has also announced that the South Bank Coke Ovens, which was also under threat of closure, will remain open for at least a further three years.

The directors believe that the Group is well placed to manage its business risks successfully despite the current uncertain economic outlook. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

Regulatory risk

The fact that NWL has been able to accept the outcome of PR09 reduces the main source of regulatory risk.

The Flood and Water Management Act 2010 also includes provisions to implement the recommendations of the 'Pitt Review' on flooding as well as a range of other measures to tidy up aspects of water related legislation. The flooding measures primarily relate to local authorities and the EA but also have implications for water companies, particularly with regard to how they interact and cooperate with those bodies.

Risks and resources continued

The Labour Government signalled its intention to proceed with the transfer of certain private drains and sewers into water company ownership, increasing the network owned and maintained by NWL by about 70%. The timetable is slipping and we have still not seen the implementing regulations. The earliest practical date of transfer is now October 2011, but further delay in issuing the regulations will result in a delay in the transfer date. The costs associated with the transfer were not included in the PR09 price review. It is, therefore, likely that all sewerage companies will see an adjustment to price limits in light of the transfer.

The full impact of another item of legislation, the Traffic Management Act 2004, is not yet clear, but the Labour Government indicated its desire to increase charges for disruptive roadworks.

The General Election has delayed Government measures in response to the 'Cave Review' (on competition) and the 'Walker Review' (on charges and metering). The new coalition Government has made some early statements about its desire to consider the Cave, Walker and Pitt reviews. We expect this to provide greater clarity to the future direction of the industry. If and when changes are proposed, NWL will work constructively to ensure that new legislation takes account of the practical needs of the industry.

Through 2007 to 2009, the company detected pesticides, metaldehyde and clopyralid, in its treated water at a number of sites, primarily in the Essex area. Whilst these pesticides are not of concern to human health, they were detected at levels in excess of the regulatory standard. As a result of this we agreed an undertaking with the DWI to carry out certain actions to mitigate the situation. This has predominantly involved proactive catchment management with the appointment of two catchment officers who have been working with farmers and regulators to advise on better use of such pesticides. Whilst this is likely to be a long term project, the early signs are very encouraging with the results detected this autumn and winter being significantly lower than the previous two years. This is also a much more sustainable solution than the alternative, which would be to construct major new treatment processes to remove any residual pesticides.

Environmental, social and governance risks

There are two environmental, social or governance risks considered to be significant to the value of the Group.

The first relates to the use of sewage sludge as a soil conditioner on agricultural land. If this disposal route was lost, the sector would need to find or develop alternative ways to re-use or dispose of its sewage sludge.

We will continue to play a leading role in the industry on water efficiency measures and to encourage customers to use water wisely.

This could mean higher capital and revenue costs to provide additional sludge processing facilities. The development of the 'Safe Sludge Matrix' and the proposed revision of the Sludge (Use in Agriculture) Regulations have reduced the immediate risk in this area. NWL is introducing advanced anaerobic digestion to both reduce sludge volumes and the carbon impact of its activities and provide a sustainable outlet for sludge. Advanced anaerobic digestion is already in operation at our Bran Sands site and plans to develop this at our Howdon site are well advanced.

The second is the potential for sewer flooding. As rainfall patterns become more variable and intense storms more frequent, localised heavy rainfall can result in sewers becoming overloaded. We welcome the focus on integrated flood management in the Flood and Water Management Act 2010.

Affordability and customer debt

Affordability is an issue for NWL with income deprivation levels in the northern area the highest of all water and sewerage companies and in the southern area, close to the national average.

Providing our customers with a range of payment facilities and frequencies that suit their individual circumstances is a critical element of successful income collection and debt prevention. We ensure that customers are aware of options which help reduce charges and ease the establishment of payment arrangements.

Customers who deliberately avoid paying charges are actively pursued and we continue to work with Ofwat and Defra to seek changes to legislation to assist the industry to impose and collect charges.

Water resources

The way we retain, recycle and distribute our water resources is a central part of our business. While NWL has sufficient water resources in the north east, we believe it is still important to manage the demand for water so that it does not exceed levels that can be supplied in a sustainable way.

In our Essex and Suffolk areas, however, water resource availability is a key issue. We have been successful over many years in encouraging our customers to use less water and in keeping leakage at or below the economic level. Nonetheless, we need to continue to invest to achieve our aim of ensuring our customers have a safe, secure and reliable supply of water well into the future. In January 2010, we published our final 'Water Resources Management Plan' having received approval from the Secretary of State.

Risks and resources continued



Weather radar at High Moorsley, near Durham City, with David Chapman NWL, Graham Butler Met Office, and Phil Marshall EA

Work is progressing on increasing the capacity of our Abberton Reservoir near Colchester by 58%. The one remaining part of the overall Abberton Scheme that requires permissions is the variation of abstraction licences at Denver and Blackdyke in Norfolk. We are working closely with the EA on progressing this. Once this scheme is in operation in 2014, it is unlikely we will need to develop major resources in Essex for the next 25 years.

We will continue to play a leading role in the industry on water efficiency measures and to encourage customers to use water wisely. We will work with other stakeholders to develop a coordinated strategy for reducing water use to sustainable levels.

In areas where water is scarce, water meters have a key role to play in reducing demand. We aim to achieve as near to universal metering as possible in Essex by 2020 and in Suffolk by 2023. On current policies it will take considerably longer to achieve full metering in the north east as there is no economic, environmental or social driver to move more quickly.

Changing weather patterns

The water cycle and the changing weather has a direct influence on the provision of water and waste water services. NWL's employees are experienced in managing the effects of too much or too little rainfall, but changing weather patterns will present a growing challenge for the business.

In past years, we have carried out research into the likely impact of climate change on all our assets and water resources and this has been incorporated in our climate change policy as part of our corporate responsibility work. This work is continuing, based on the latest UKCP09 projections published last year by the UK Climate Impacts Programme.

Over the course of the year we will be doing more work in this area as we respond to the new adaptation reporting power granted to the Government by the 2008 Climate Change Act. This will set out in the public domain the extent to which the changing climate is likely to impact on the business and what actions we are taking to meet the challenge it represents.

Employees

If we are to continue to optimise our assets, offer an excellent service to our customers, and achieve our regulatory obligations, we need to continue to recruit, retain and develop talented people as a leading employer in our regions. We will continue to offer all our employees terms and conditions at least commensurate with other major employers as well as appropriate training and development to support their ongoing performance and career progression. This includes the comprehensive management development framework, graduate and apprentice programmes, as well as initiatives such as the NVQ programme which reach many employees.

Directors' remuneration and interests

Information about directors' remuneration and their interests in the shares of the Company is contained in the directors' remuneration report.

Indemnification of directors

The Company has in place directors' and officers' insurance and, on 28 November 2005, entered into a deed of indemnity to grant the directors further protection against liability to third parties, subject to the conditions set out in the Companies Acts. Such qualifying third party indemnity provision remains in force as at the date of approving the directors' report and business review. The deed, together with directors' service contracts, will be available for inspection by shareholders at the AGM, or from the Company Secretary.

Annual general meeting

The notice convening the AGM, to be held on 29 July 2010, was sent to shareholders together with an explanation of the business to be conducted at the meeting and a form of proxy.

Auditors

Ernst & Young LLP has indicated its willingness to continue in office and a resolution proposing its re-appointment as auditors will be put to shareholders at the AGM.

Directors' declaration

As required under section 418 of the Companies Act 2006, so far as each current director is aware, there is no relevant audit information of which the Company's auditors are unaware and each director has taken all the steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

By order of the Board

Martin Parker

General Counsel and Company Secretary
1 June 2010

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