Appendix 7

Securing Long Term Resilience

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1.1 7.5 Financial resilience

Long term financial viability and planning

As part of our process for financial viability statement testing for the 2017/18 financial year, we have modelled the scenarios set out in the Ofwat consultation paper published in April 2018 (‘Putting the sector back in balance: Consultation on proposals for PR19 business plans’), along with further scenarios developed from the principal risks included in our Enterprise Risk Management (ERM) process. The period of assessment for the stress testing was 7 years through to the end of 2025.

We have detailed below the scenarios we modelled and the link to our principal risks.

Ofwat consultation:

	Scenario tested	Related principal risk
A.	Totex underperformance (15% of totex).	Risk 1: Ongoing regulatory reform
B.	ODI penalty (3% of RORE) in one year.	Risk 2: Failure to meet targets for regulatory performance and customer service
C.	Inflation set 3% above the independent forecasts in one year for the UK economy as published by Treasury.	N/A – key assumption in financial model
D.	Inflation set 3% below the independent forecasts in one year for the UK economy as published by Treasury.	N/A – key assumption in financial model
E.	Increase in level of bad debt (20%).	N/A – key assumption in financial model
F.	Debt refinanced as it matures, and new debt financed as required at 2% above the forward projections.	N/A – key assumption in financial model
G.	Financial penalty – equivalent to 3% of one year Appointee turnover.	Risk 3: Failure to comply with regulatory requirements
H.	Combined scenario – cost underperformance in both totex and retail expenditure of 10% in each year of the price control along with an ODI penalty equivalent to 1.5% of RORE in each year and a financial penalty equivalent to 1% of revenue in one year.	See above

Additional scenarios relating to our principal risks:

	Scenario tested	Related principal risk
I.	A severe climate event, operational failure or other exceptional event with a very significant financial impact.	Risk 4: Business interruption and/or data loss resulting from cyber threats Risk 5: Health and safety impact
J.	Over-collection of revenue resulting in one year impact of 3% of appointee turnover.	Risk 3: Failure to comply with regulatory requirements

Mitigating actions

We identified actions, including reducing discretionary outflows of funds and working with providers of finance, including other Group companies, that would be available to the Company to mitigate the impact of adverse outcomes. None of the scenarios tested resulted in an impact to the expected liquidity, solvency or ability to service debt that could not be addressed by mitigating action and hence were not considered to be threats to the company's viability. The results of the scenario modelling and the mitigating actions is further described in the section below in the 'Results of scenario testing'.

Further modelling

Following Ofwat's publication of their summary of decisions on the 'Putting the sector back in balance' consultation on 3 July 2018, we have also modelled the following revised scenarios:

- Totex underperformance (10% of totex).
- Inflation scenario (high inflation scenario RPI 4%, CPIH 3%; low inflation scenario RPI 2%, CPIH 1% for each of the five years of the price control.
- Increase in the level of bad debt (5%) over current bad debt levels.

Taking into consideration the mitigating actions identified as part of the viability statement stress testing, none of these additional scenarios resulted in an impact to the expected liquidity, solvency or the ability to service debt that could not be addressed and hence were not considered to be threats to the company's viability.

Governance and assurance

As noted in the Viability Statement in Hafren Dyfrdwy's Annual Report & Accounts, the Board has reviewed and approved the medium term plan on which the statement is based. The Board also considers the period over which the assessment of prospects and viability statement should be made. The Audit Committee supports the Board in performing this review. This statement is subject to review by Deloitte, our External Auditor.

Results of stress testing

We have summarised the impact of our stress tests on the ability to maintain financial metrics (including gearing and profit after tax), hypothetical credit ratings and the ability to service debt in the table below. HD does not have any external debt and so there are no debt covenants in place.

We have shown the potential mitigating actions we could take and both the impact pre and post implementation of those actions on the metrics, ratings and ability to service debt.

Scenario	Impact (pre-mit. actions): Key financial metrics	Credit Metrics	Ability to service debt	Potential mitigation actions: Re-profile capital investment programme	Significant cost reduction	Securing additional finance within Group	Impact (post mit. actions): Key financial metrics	Credit Metrics	Ability to service debt
A. Totex underperformance (10%)	Red	Red	Red		✓	✓	Green	Green	Green
B. ODI penalty in one year (3% of RORE)	Amber	Green	Green		✓		Green	Green	Green
C. Inflation high scenario (RPI 4%; CPIH 3%)	Green	Green	Green						
D. Inflation low scenario (RPI 2%; CPIH 1%)	Amber	Green	Green		✓	✓	Green	Green	Green
E. Increase in level of bad debt (5%)	Green	Green	Green						
F. New debt financed 2% above forward projections	Amber	Amber	Amber		✓	✓	Green	Green	Green
G. Financial penalty (3% of appointee turnover)	Amber	Green	Green		✓		Green	Green	Green
H. Combined scenario	Red	Red	Red	✓	✓	✓	Green	Green	Green
I. Extreme one-off event in one year	Amber	Red	Amber		✓	✓	Green	Green	Green
J. Adjustment of 3% of revenue due to over-collection	Green	Green	Green		✓		Green	Green	Green

Key
Green – limited impact on financial metrics, credit ratings and ability to service debt
Amber – pressure on financial metrics, credit ratings and ability to service debt
Red – significant impact on financial metrics, ability to service debt or potential downgrade to below investment grade

In the table below, we have provided further detail of the mitigating actions we would take in each scenario.

	Scenario tested	Mitigating actions
A.	Totex underperformance (10%)	As the scenario considers underperformance over a prolonged period, we would look to implement a significant cost reduction programme. We may look to secure additional finance from within the Group.
B.	ODI penalty in one year (3% of RORE)	In the year of impact, we would look to reduce costs and working capital to manage the short term cash impact. We may also look to secure additional finance from within the Group, if required.
C.	Inflation high scenario (RPI 4%; CPIH 3%)	Although financial metrics, ratings and the ability to service debt would not be significantly impacted in this scenario, we would look to manage our cost base closely over the period.
D.	Inflation low scenario (RPI 2%; CPIH 1%)	We would look to reduce costs and working capital to manage the cash impact across the period. We would also look to secure additional financing from within the Group.
E.	Increase in level of bad debt (5%)	Although financial metrics, ratings and the ability to service debt would not be significantly impacted in this scenario, we would look to manage this situation closely and offer support to our customers who are unable to pay over the period.
F.	New debt financed 2% above forward projections	In this scenario we would seek efficiencies in our cost base over the period and look to reduce our working capital.
G.	Financial penalty (3% of appointee turnover)	As with scenario B, we would look to reduce costs and working capital to manage the short term cash impact. We may also look to secure additional finance from within the Group, if required.
H.	Combined scenario	As with scenario A, we would look to implement a significant cost reduction programme and re-profile our capital programme. We may look to secure additional finance from within the Group.
I.	Extreme one-off event in one year	In the year of impact, we would look to reduce costs and consider re-profiling our capital programme. We may look to secure additional finance from within the Group.
J.	Adjustment of 3% of revenue due to over-collection	In the year of impact, we would look to reduce costs and working capital to manage the short term cash impact.

Summary

In support of our overall assessment of financial resilience of the company, we have considered the principal short and longer term risks relevant to the company and modelled scenarios to stress test the business plan for the period through to 2025. Specifically, we have:

- Modelled the impact of the scenarios proposed in the ‘Putting the sector back in balance’ consultation on our key financial metrics, credit ratings and the ability to service debt;
- Confirmed the relevance of those scenarios to the company through linking to the principal risks in our ERM process;
- Identified and modelled the impact of additional scenarios for those principal risks not covered by the minimum suite of scenarios;
- Explained the impact of the scenarios and identified realistic mitigating actions for each scenario that we would be able to take; and
- Concluded that under each of the scenarios, the mitigating actions would allow the company to remain viable for the 7 year period under review.