

## PRINCIPAL RISKS AND UNCERTAINTIES

We manage risk to help us achieve our strategic objectives and protect our reputation.

The Audit Committee is responsible for overseeing the Group's risk management processes and the Board is responsible for the appropriate identification of risks and the effective implementation of mitigating activities.

Internal Audit provides independent assurance to management and the Audit Committee as to the effectiveness of mechanisms put in place to mitigate risks. This process explicitly recognises the relationship between Internal Audit and Risk Management. The Audit Committee is satisfied that the processes are adequate and appropriate. Further details are set out in the Corporate Governance Report on pages 35 to 44.

The Group Risk Register is compiled in two stages. Central, demand and supply risks are identified separately by members of the Management Board and senior managers and consolidated into an initial register that is then reviewed and refined by the Management Board as a whole to create the Group Risk Register. The Board formally reviews the Group Risk Register annually when the budget is set. The Company Secretary and General Counsel is responsible for highlighting to the Board any changes to the Group Risk Register identified during the intervening periods.

The principal risks and uncertainties facing the Group are set out in the table below. This is not intended to be an exhaustive analysis of all risks facing the Group.



### Commercial risks

#### Reduced profitability

##### Risk area and potential impact

We operate in extremely competitive markets. If we fail to compete effectively or are subject to higher input prices that cannot be recovered by raising selling prices without losing volumes we could lose sales and profits.

##### Mitigating controls

We set ourselves the target of continually reducing our cost base and are able to invest in our supply chain to help achieve this.

No one customer accounts for more than 15% of total revenues and we continually strive to widen our customer base. Despite challenging trading conditions we continue to invest in marketing our key brands. Our innovation programme continues to generate new products that reinforce our appeal to customers. We recognise the importance of strong customer relationships and the executive team plays an active part in maintaining and developing these. They are also involved in major customer negotiations. We conduct customer surveys to benchmark our performance and we continuously monitor the service and quality levels provided to our customers and consumers, and have procedures in place to react quickly to any issues. Our commitment to corporate responsibility is an important part of our overall proposition to some customers.

#### Reduced demand from consumers

##### Risk area and potential impact

Consumers could move away from dairy products for economic, health, ethical, or other reasons leading to lower sales and profits.

##### Mitigating controls

Consumers are at the heart of our business and we regularly monitor consumer trends. We continue to promote the health benefits provided by dairy products and develop healthier products. We also continue to maintain our focus on developing a compelling new product development pipeline, enabling us to react to consumer trends, for example with more environmentally-friendly packaging, and healthier variants of our key brands. We have a direct involvement with government to understand and influence future legislation that could affect future consumer demand.

#### Input cost volatility

##### Risk area and potential impact

Volatile milk and non-milk costs (vegetable oils, diesel, electricity, gas and packaging) could reduce margins unless we can manage cost risk, find other cost efficiencies elsewhere or increase selling prices.

Milk prices could remain volatile as European milk production quotas have been abolished from April 2015.

##### Mitigating controls

This area is closely reviewed by the Management Board which has established a risk committee to monitor and hedge forward non-milk commodity prices as appropriate. The risks associated with purchasing large volumes of milk have been reduced by establishing milk pools linked to major customers. We seek to absorb short term cost movements through supply chain efficiencies. Our purchasing and commercial teams have clear lines of communication between them to ensure customers are kept aware of changes to our cost base and requests for price increases can be fully justified.

We have reviewed the effect that we believe the abolition of milk quotas will have on our business. We believe it is commodity cheese markets, in which we don't operate, that are most likely to be affected, but we will continue to monitor this closely.

## Operational risks

### Inability to source milk

#### Risk area and potential impact

Without milk we would not have a business. Restricted milk supply due to economic factors, weather, fuel availability or an epidemic which affects dairy cows could restrict milk supply. This in turn could lead to lower sales and profits. Consumer confidence in dairy products could also be adversely affected.

#### Mitigating controls

We invest significant resources in maintaining strong relationships with our milk suppliers by attending forums and discussing current issues and pressures that affect both the farms and our business. The majority of our milk comes directly from farms on contracts that include a notice period of between three months and one year. Our experienced milk procurement team understand milk production and are alert to changes in supply. We aim to pay a fair, market related milk price and closely monitor the milk price we pay to suppliers in order to ensure we can purchase the right quantity of milk to meet demand forecasts and have established procedures for allocating milk between our businesses if a short-term shortfall in supply does arise. We have contingency plans established for major incidents and work closely with DEFRA and industry bodies to ensure these are appropriate. These plans are regularly tested and reviewed with the Management Board.

### Failure of a key supplier

#### Risk area and potential impact

We are dependent on key suppliers and could lose sales and face financial penalties from customers if suppliers' failure leaves us unable to supply. Failure of key information technology suppliers could adversely affect our financial systems.

#### Mitigating controls

Our purchasing team regularly monitors suppliers' ability to supply and puts in place alternative arrangements, including dual purchasing, if appropriate. We have taken specific actions to reduce our dependency on information technology suppliers.

### Other operational risks

#### Risk area and potential impact

An accident, a fire, product contamination, the failure of equipment or systems or deliberate act could disrupt production, affect food safety, cause injury, and/or cause reputational damage with adverse consequences. We are also reliant on information technology and exposed to losses in the event that systems fail.

#### Mitigating controls

Plans are maintained to respond quickly to incidents and minimise any impact to the Group. Our business is committed to the health and safety of all our employees and maintains systems aimed at ensuring everyone is able to work safely. All of our manufacturing sites have a trained engineering resource, are supported by our major equipment suppliers and hold appropriate stocks of spare parts. They also all have fire protection systems and regular fire drills. Our information technology systems are regularly backed up and duplicated in the majority of areas. We also maintain insurance cover for property damage and business interruption risks.

#### Risk area and potential impact

Failure to maintain product quality could lead to reputational damage and loss of sales and profits. As we start to manufacture ingredients for infant formula this risk could increase.

#### Mitigating controls

We have well established supply chains and a close working relationship with our milk suppliers. We have an independent quality team, including experienced cheese graders. Customer and consumer complaints are monitored and acted upon. Our contractual relationship with Fonterra, who will sell the infant formula ingredients we will produce, allows us to utilise its experience in this field.

## People risks

### Disease epidemic

#### Risk area and potential impact

A disease epidemic such as swine flu could adversely affect the health of our employees and prevent them working, leaving us unable to service customers.

#### Mitigating controls

Contingency plans which include working with industry bodies are in place for known epidemic risks.

### Recruitment and retention

#### Risk area and potential impact

We need to retain high quality employees to provide customers and consumers with safe, high quality products and services.

#### Mitigating controls

We carry out rigorous selection procedures and benchmark pay and benefits to ensure we can attract and retain the best people. We have a wide bonus scheme and a range of other incentives to reward good performance. Our Long Term Alignment Plan aligns the interest of management to shareholders and helps to retain key senior employees. There is a performance review and talent management scheme to identify and develop our own people. We undertake regular surveys to monitor the relationship with our employees and their engagement, communicate with them regularly and encourage them to ask questions.

## Financial risks

### Pension scheme

#### Risk area and potential impact

Despite the action we have taken to reduce the risks associated with our pension scheme, including closing the scheme to future accrual in 2010 and buying insurance to meet the liabilities associated with many of our retired members in 2008 and 2009, the deficit could continue to increase and we may then have to increase our contributions.

#### Mitigating controls

We continue to work closely with the Trustee of the Pension Fund to improve the Fund's financial position at an acceptable cash cost to the business. We have recently reduced the scheme's exposure to equities and other higher-risk asset classes and aim to further do so.

## Legal and compliance risks

#### Risk area and potential impact

Our sector is subject to a number of complex statutory requirements. There is a risk of fines or lawsuits and reputational damage if we fail to comply.

#### Mitigating controls

We have a strong in-house legal function supported by external advisers. We have undertaken Group-wide training in respect of competition law and actively monitor and adjust to on-going legal and regulatory changes. We have a Business Conduct Policy, and a programme designed to ensure that all relevant employees understand what is and is not permissible under the UK Bribery Act.

## Major project risk

#### Risk area and potential impact

To remain competitive we periodically undertake major transformational projects following strategic reviews. Successful execution of these projects is often key to delivering strategic objectives. At the same time we have to ensure that major projects do not divert from the on-going day-to-day delivery of products and services to our customers.

#### Mitigating controls

We have a good track record of managing projects and use experienced and appropriately skilled senior managers to lead these. Supervisory governance structures are also put in place to help successful delivery. We are aware that too much change concentrated in too short a timescale can be detrimental and manage this by ensuring key project resource is full time with appropriate backfilling and use of third parties.