

AFW

Company response

30 August 2019

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1 CEO letter



Rachel Fletcher
Chief Executive
Ofwat

29th August 2019

Dear Rachel,

We have worked intensely as an Executive team, with our Board and with our shareholders, to develop the best possible response to Ofwat's Draft Determination.

We are determined to deliver the best outcomes for our customers and our communities; we have stretched ourselves with our Performance Commitments and with our Efficiency targets further than ever before and more than we originally thought possible.

Our Board has challenged us to do more for less, whilst ensuring we appreciate and balance the associated risks.

Our shareholders, with long-term holding plans, seek investments which deliver reasonable, stable returns. They have now agreed to re-invest all of their dividends back into the business for the duration of the AMP, to enable this plan.

Across Affinity Water, our teams have started on the journey to improving how we work, to enable us to reach our challenging targets.

In the attached document we make proposals and representations for change in a few critical areas where we believe the risks would be too great for the business and for our customers, under the draft determination conditions.

I hope that Ofwat will accept our arguments and supporting evidence, so that we can now focus on getting ready for and delivering, our very challenging plan for AMP7.

A handwritten signature in blue ink that reads 'Pauline'.

Pauline Walsh,
Chief Executive

2 Shareholders note

Dear Affinity Water Customers and Stakeholders

Affinity's supply area is unique – it supplies an area which is an engine room for the UK economy, with very large population and housing growth, internationally important infrastructure such as Heathrow, Luton, Stansted airports and the Port of Dover. The communities in our supply area are amongst the fastest growing of any region in the UK. Affinity Water, alongside the regulator and the government, supports that growth.

We are proud of our role as shareholder directors of Affinity Water and this plan is a reflection of our long-term commitment to Affinity Water.

We are committed to helping Affinity Water to act as more than just a steward: Affinity will invest to improve the environment, the service offered to customers, the long-term resilience of water supply, and the communities which the company serves.

A handwritten signature in blue ink, appearing to read 'Jaroslava Korpanec'.

Jaroslava Korpanec
Allianz Capital Partners

A handwritten signature in blue ink, appearing to read 'A. C. Roper'.

Tony Roper
InfraRed Capital Partners

A handwritten signature in blue ink, appearing to read 'Angela Roshier'.

Angela Roshier
DIF

3 Company response

When responding to Ofwat's Initial Assessment of Plans we took on board the feedback, challenges and information Ofwat shared to prepare an even more ambitious and efficient plan. We are pleased by Ofwat's recognition of the progress we have made.

The Draft Determination (DD) agrees with many areas of our plan and sets out clear expectations for further progress described in 62 interventions. Using the detailed information published by Ofwat, we examined the scope for additional opportunities to unlock more for our customers, with a constructive and open mindset hopefully reflective of the manner of our engagement with Ofwat.

In that spirit, we have taken on board most of the DD interventions and have focused our response on areas where we believe a different balance of risk, cost and performance is required to deliver good outcomes for our customers. We have grouped our responses under the heading below of 'Delivering Outcomes for Customers', 'Cost Efficiency', and 'Financing and Resilience'

Our response, set out in this document, aligns with Ofwat's strategic objectives of putting the sector back in balance and delivering more of what matters. Our response also describes the necessary balance of risk and return and the conditions for financeability including the third-party assurance as required.

Delivering outcomes for customers

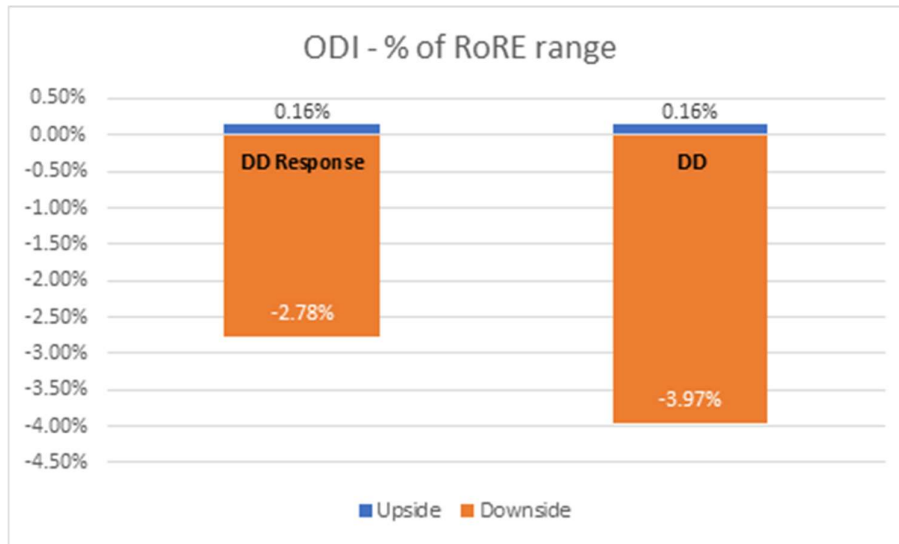
Our response on delivering outcomes covers the 31 interventions made in the DD. We acknowledge and firm up our intent to progress 24 interventions. We propose changes to the DD through representations in 5 cases and provide additional information as requested in 4 actions.

As a company operating in a water-stressed area, we welcome particularly the acknowledgement of our leading ambition in leakage reduction and PCC, which are necessary for the sustainable management of water resources.

The key points of our response are:

1. We acknowledge the more progressive path Ofwat has set to achieve an ambitious PC for interruptions to supply over 3 hours and the increase in the dead-band for the CRI reflecting the uncertainty of the new measure. We limit our response to 3 areas where we raise issues because they are material in risk. These areas are mains repairs, pressure (DG2) and interruptions to supply over 12 hours. For these PCs we present the changes required to either the PC targets or incentive rates and we provide evidence that the ambition of the DD intervention is either unachievable in the timeframe considered or creates disproportionate risk. For interruptions to supply over 12 hours, where customers interests are already protected by other means, including compensation payments, we represent our incentive as reputation only. This is supplemented by our commitment to action in system-thinking as detailed in our response to action AFW.LR.A2 submitted on 22 August.
2. In line with the DD interventions we acknowledge the removal of the majority of outperformance payments. We restate an outperformance for the River Restoration PC, for which we provided additional information showing customers support for environmental commitments and incentives.
3. We propose a revised performance commitment by extending the PC for customer contacts for discoloured water to include contacts for taste and odour and appearance. For this revised PC, we set a challenging target coupled with the more stretching incentive Ofwat has determined in the DD.
4. We have used the values of P10 and P90 derived from the information provided by Ofwat in the DD and guidance documents and we find that incentives are very asymmetrical and, out of all companies, our DD framework provides the lowest opportunity for outperformance payments. The DD ODI

exposure to RORE range is disproportionate (3.99%). We respond to the DD with changes that create a framework of ODI risk on the RORE range of 2.78%, which aligns with Ofwat's methodology.



Striking the right balance of commitment and incentive is a key factor to the successful delivery of outcomes and the protection of interests of our customers. In our response to the DD we include stretch in performance and increased incentives to perform. Our response shows progress in our commitments and defines the more proportionate balance of performance and risk required to secure sustainability in our operations.

Detailed information, including performance statistical analyses and industry comparison, is provided in the document AFW Company response: outcome delivery, reference AFW-OD.

Cost efficiency

Our response on cost efficiency covers the 4 interventions made in the DD. We acknowledge 2 interventions and propose changes to the DD through representations in 2 cases. We have appreciated Ofwat's consultative approach throughout the development of the PR19 methodology and open engagement in the assessment of our plan.

The key points of our response are:

1. We welcome Ofwat's recognition of the cost efficiency of our plan in the level of Botex set at DD. The methodology used by Ofwat has been subject to extensive consultation over a long period of time and has enabled the selection of a robust model. We understand that, at the time of DD, the assessment of allowance for growth was preliminary only and not recognising funding requirements in full. Ofwat has issued additional information and a call for data that will enable to firm up costs at FD. This should have no impact on the methodology used for Botex modelling. In our response, we also acknowledge the further efficiency challenge on some of our enhancement costs in the DD.
2. With increasing uncertainty in climate change and related extreme weather events we are very supportive of Ofwat's commitment to provide a dynamic and collaborative framework and to allow the expenditure required for the delivery of new strategic supply options in the South East of England.
3. We have examined carefully the make-up of implicit funding allowances included in base expenditure from past continuous improvement and enhancement programmes. For leakage, we have built a 30%

cost efficiency challenge in our base programme and we have included the benefits realised from a calm network and pressure management. We have used cost data curves to determine the remaining transitional costs of £12.9m required, in addition to base costs, to achieve our performance commitment of 20% reduction on a 3-year rolling average.

4. The DD calculation of Upper Quartile for retail is largely skewed by the use of one company's cost. We believe strongly that the cost model should exclude this outlier and use the remaining cost average to determine the cost needed for the funding of our retail costs.
5. We have identified two specific risks (potential investment in treatment for metaldehyde and a potential sustainability reduction in our Brett Region). We consider uncertainty is such that additional protection is needed. We include bespoke uncertainty mechanism for metaldehyde, such that there is an adjustment made at PR24 for costs incurred during AMP7. We have considered carefully Ofwat's approach in the DD to the bespoke uncertainty mechanism we sought in respect of potential sustainability reduction of up to 20 MI/day in the Brett Region. We are not persuaded that the unit cost approach to funding implementation of the potential sustainability reductions is a satisfactory allocation of risk. We include an appraisal of alternative funding mechanisms to mitigate this risk.

We support Ofwat's drive to move all companies towards operational excellence and greater cost efficiencies. We have embraced that challenge and are committed to delivering significant improvements to our cost performance.

Detailed information, including cost breakdowns and cost comparative analyses is provided in the document AFW Company response: cost efficiency, reference AFW-CE.

Financing and resilience

Our response on financing and resilience covers the 23 interventions made in the areas of risk and return, past delivery, long-term resilience and confidence and assurance. We acknowledge 17 interventions and propose changes to the DD through representations in 6 cases. We also provide information as requested in response to 6 actions.

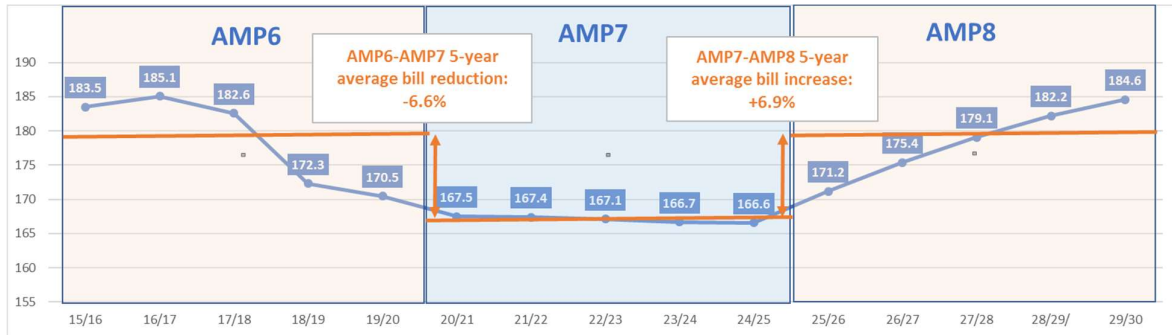
The key points of our response are:

1. The Board has agreed with the Company's shareholders to reduce the regulatory gearing ("the gearing") of the Company to 76.8% over the course of AMP7. We have agreed with our shareholders to restrict their dividends for AMP7 and that all returns from the appointed business and the returns from the non-appointed business (after servicing group financing needs) will be reinvested into the company to reduce gearing levels during the AMP. This means that:
 - no dividend will have been paid from the appointed business for seven years (2018/19 to 2024/25)
 - equity will have been invested into the appointed business in each of the 6 years from 2019/20 to 2024/25, and
 - £35m of additional equity and £8m of retained dividends (a total of £43m) will be invested into the appointed business in addition to the equity used to fund the investment programme

We have reviewed our dividend policy and executive remuneration policy to bring them more explicitly in line with Ofwat's expectations of fairness, transparency and financial resilience.

2. We propose a bill reduction of 2.3% over AMP7 which compares with a DD reduction of 5.4% after methodology and Totex allocation corrections. We propose a bill profile delivering the largest customer benefit in the first year (1.8%). The main differences relate to our representations on transitional costs of leakage, WRFIM and the PAYG adjustment required to make the plan

financeable. PAYG requires an uplift of 3.4% from the DD level, to achieve the necessary ratios such as maintaining the credit rating of the notional company. Delivering immediate customer benefit drives a higher RCV in the longer term and the forecast bill for AMP8 shows an increase of 10.8%. This is a difference from our response to IAP, which showed a reduction of 2% and is explained by the balance of PAYG and RCV run off over the 10 year-period. We continue to consult with our customers on what matters. They express a clear preference for a stable bill over the long-term in the latest research findings (August 2019).



3. We highlight our concerns about the 21bps reduction in the WACC in the DD and the further signalled 37bps reduction. The DD reduction has placed strain on the financeability of the plan and requires a higher PAYG rate for the notional company to remain financeable. Further reductions will put at risk the financeability of the company on both the notional and the actual structures.

We appreciate that as a water company, we are trusted to deliver essential services, vital for public health, the environment and the economy. We support Ofwat’s objective of putting the sector back in balance, making sure that the interests of customers are aligned with the interests of our company management and investors in delivering those services. Our response in financing and resilience demonstrates our strong commitment to responding constructively within the necessary boundaries of financeability.

Detailed information, including third-party assurance, options considered and findings, is provided in the document AFW Company response: financing and resilience, reference AFW-FR.

In conclusion, we acknowledge Ofwat’s interventions to our plan and their intent to drive the sector to excellence and fair sharing of benefits. We believe we have answered all actions effectively and we have progressed further in taking up the challenge and offering solutions where the DD compromises the balance of risk and benefits. To facilitate the PR process in the short time given to FD, we have restricted our representations to a limited and targeted number of areas where risk is material.

We recognise the challenges and opportunities of the areas we serve. We know first-hand of the benefits of collaboration to secure sustainable water resources and of innovation to maintain efficient costs amongst powerful neighbours. We believe that our plan, underpinned by the required financial ratios and responses to DD, provides a great framework to deliver for our customers and the environment and we look forward to delivering it.