AFW

Board Assurance Statement

30 August 2019

1. INTRODUCTION

1.1 As a Board, we are, and have been, fully engaged in the design, development and preparation of our representations on Ofwat's Draft Determination (our "Represented Plan"). We own the strategy and have provided strategic direction to management on our Represented Plan.

1.2 Since publication of the Draft Determination, we have met formally and informally as a Board on a number of occasions specifically to discuss and set the strategy for and to oversee the development of our Represented Plan. This has allowed us to scrutinise and challenge our Represented Plan.

2. ASSURANCE

2.1 Pricewaterhouse Coopers LLP and Atkins Limited have provided assurance of the data tables and commentaries for our Represented Plan. KPMG have reviewed our internal financial model to provide assurance of its consistency with the Ofwat model. KPMG also undertook technical assurance of financial ratios, pay as you go and RCV run-off rates and their supporting explanations.

2.2 Subject to any limitations identified in the data table commentaries and third-party assurance reports, we are satisfied as to the accuracy, completeness and quality of the data, estimates and forecasts provided in the Represented Plan.

2.3 We have engaged Evercore Partners International LLP ("Evercore") to provide financial assurance in respect of:

- expected credit ratings implied by our Represented Plan based on our actual capital structure;
- the financeability of our Represented Plan on an actual and notional capital structure basis;
- our Represented Plan's compliance with financial covenants under our whole business securitisation; and
- the long-term viability of our Represented Plan based on an actual capital structure.

3. GEARING

3.1 In our Board Assurance Statement (September 2018), we confirmed our intent and the intent of our shareholders to reduce the gearing of Affinity Water Limited to 75% in AMP7 and our ambition to reduce gearing to an actual reported level of 70% in the same period. We reported that our shareholders were minded to modify the capital structure of the Daiwater Investment Limited group to meet this intent and to pursue this ambition. We also reported that we were working on a plan to enable this.

3.2 In our Supplemental Board Assurance Statement (March 2019), we re-confirmed this intent and ambition and explained the work being undertaken to consider options to modify the capital structure of the Daiwater Investment Limited Group to achieve our intent. Having completed the evaluation of these options, the shareholders have concluded that modifying the capital structure of the Daiwater Investment Limited Group at this time is not the most effective means of implementing a reduction in the gearing of Affinity Water Limited.

3.3 We have now agreed with the Company's shareholders to reduce the gearing of the Company over AMP7. This will result in the regulatory gearing level of our Represented Plan reducing to 76.8% by the end of AMP7. This will be achieved by investing all the planned earnings from the non-appointed business (after satisfying any financing needs of the Daiwater Investment group) along with retaining all the earnings from the appointed business. This is in addition to the returns generated by the appointed business being used to fund the significant investments the company will make to secure supplies for our customers today and in the future.

3.4 We, and the Company's shareholders, share the intention of reducing gearing levels even further, to 75% or lower in the AMP and we are continuing to explore options to achieve that. Any changes to the Represented Plan at Final Determination would require further consideration before this approach could be confirmed.

3.5 Overall, this approach will mean:

- no dividend would be paid to shareholders from the appointed business for the 7-year period from 2018/19 to 2024/25;
- equity would be invested into the appointed business from the non-appointed business in each of the 6 years from 2019/20 to 2024/25, and
- £35m of additional equity along with £8m of retained dividends (a total of £43m) would be invested into the appointed business in addition to the equity used to fund the significant investment programme.

3.6 Our shareholders have also engaged Evercore to continue to develop the capital restructuring plans of the Daiwater Investment Limited Group as a means to further reduce the gearing level at Affinity Water Limited. These plans involve additional debt at holding company level resulting in further equity being made available to the appointed business. Evercore has presented options to the shareholders that could be executed post the Final Determination if the Final Determination is in line with the Represented Plan, the financial markets are calm after Brexit and the risks to the plan become more certain. The risks to the plan have increased with the Draft Determination, particularly due to the reduction in the WACC and the indication of potential further reductions.

3.7 In preparation for the capital restructuring plans and in order that the group financing needs can be serviced, the Affinity Water Limited dividend policy has been amended to allow group debt service costs to be financed. This amendment does not change how dividends are assessed and paid by the appointed business.

3.8 Our Represented Plan includes the full default "benefit sharing mechanism" as per Ofwat's "Putting the sector in balance; position statement on PR19 business plans". This has been calculated in line with the gearing declining to 76.8% and is reflected in the data table Wn3 line 10. Our previous PR19 Business Plan submission also included this mechanism in full.

4. FINANCEABILITY

4.1 On the basis of Affinity Water Limited's actual capital structure, taking account of the analysis undertaken by Evercore, we consider that Affinity Water Limited, with our Represented Plan is financeable and that Affinity Water Limited should maintain a credit rating of A-/ A3 on its Class A Bonds and BBB / Baa3 on its Class B Bonds. We have formed this view based on the assumption that the credit rating agencies (S&P and Moody's) do not change their guidance, the level of target ratios, or the method in which they evaluate our business plan.

4.2 On the basis of Ofwat's notional capital structure, taking into account the analysis undertaken by Evercore, we consider that our Represented Plan is financeable and implies a credit rating of A-/ Baa2.

4.3 We have applied to our Represented Plan a series of stress tests (including Ofwat's stress tests) which are aligned to the stress tests applied in our annual viability statement tests. These have been applied to both the actual capital structure of Affinity Water Limited and Ofwat's notional capital structure.

4.4 Applying these stress tests to our Represented Plan, we consider that:

- based on its actual capital structure, Affinity Water Limited remains financeable, maintaining an investment grade credit rating and sufficient covenant headroom to continue operations and the financing of its Represented Plan; and

- a company with Ofwat's notional capital structure would remain financeable, maintaining an investment grade credit rating.

4.5 Evercore has provided independent assurance of Affinity Water Limited's long-term viability on its actual structure by assessing a combined downside scenario which, in our view, represents a reasonable, yet severe, downside case over AMP7 and AMP8. Based on this assessment, we consider that Affinity Water Limited would:

- remain compliant with its financial ratio covenants; and

- maintain its investment grade ratings with Moody's and S&P on its Class A and Class B bonds.

4.6 We have assessed the Draft Determination for financeability on the basis of both the actual capital structure of Affinity Water Limited and Ofwat's notional capital structure. In our view, the annual cash flows allowed by the Draft Determination are insufficient in both cases to conclude that the Draft Determination plan would be financeable.

4.7 As explained above, we have tested a reasonably foreseeable range of plausible outcomes for our Represented Plan and have provided assurance of Affinity Water Limited's financeability and its long term financial resilience. At Final Determination, we will undertake an assessment of the financeability of the determined plan. This will allow us to assess the impact (if any) on financeability and long-term viability of any change in the allowed cost of capital.

4.8 We are concerned about the 21bps reduction in the WACC in the Draft Determination and a signalled further 37bps reduction. The reduction in the Draft Determination has placed strain on financeability and requires a higher Pay As You Go rate for Affinity Water Limited to remain financeable on Ofwat's notional capital structure. Further reduction would put at risk the financeability of Affinity Water Limited on both its actual capital structure and Ofwat's notional capital structure.

5. MANAGING UNCERTAINTY

5.1 In our September 2018 plan, we identified two specific risks (potential investment in treatment for metaldehyde and a potential sustainability reduction in our Brett Region) where we considered uncertainty was such that additional protection was needed to maintain an appropriate balance between customers and shareholders. We included bespoke uncertainty mechanisms for these two risks, such that there would be an adjustment made at PR24 in respect of costs incurred by the Company during AMP7.

5.2 In our Supplemental Board Assurance Statement, we stated that:

- we were satisfied that the risk of the potential need for investment in treatment for metaldehyde had been mitigated by the ban on sale and use announced in December 2018 by Defra. We therefore confirmed that this bespoke uncertainty mechanism was no longer required; and

- we considered it appropriate to retain the bespoke uncertainty mechanism for the potential sustainability reduction in the Brett Region. The EA has stated in correspondence that a sustainability change of up to 20 Ml/day may be required but did not include it in its Water Industry National Environment Programme ("WINEP3") document. If this sustainability change were included in WINEP, it would be included as "amber". The PR19 methodology requires companies to include the cost of 'amber' schemes in their investment programmes so the bespoke uncertainty mechanism we are proposing provides equivalent protection.

5.3 In light of the ban on the sale and use of metaldehyde being set aside in July 2019, there remains uncertainty as to the need in AMP7 for investment in treatment for metaldehyde. As our Represented Plan does not include costs for the treatment of metaldehyde, we remain of the view that additional protection is needed to maintain an appropriate balance of risk between customers and shareholders. We have therefore reinstated to our Represented Plan the bespoke uncertainty mechanism for this risk and request that this risk is included as a Notified Item in the Final Determination.

5.4 We have considered carefully Ofwat's approach in the Draft Determination to the bespoke uncertainty mechanism we sought in our September 2018 plan and in our Revised Plan in respect of potential sustainability reduction of up to 20 Ml/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. Our Represented Plan therefore includes an appraisal of alternative funding mechanisms to mitigate this risk.

6. SUMMARY

6.1 We have led and overseen the preparation of our Represented Plan to ensure that it effectively addresses the issues raised by Ofwat in its Draft Determination. We have challenged management's proposals and, where appropriate, directed changes to those proposals.

6.2 We believe that our personal and collective Board leadership in respect of our Represented Plan demonstrates our commitment to producing a well evidenced Represented Plan of the highest quality. We are satisfied that the assurance we provided in our September Board Assurance Statement, as supplemented by our Supplemental Board Assurance Statement and this Assurance Statement provides assurance that all the elements of our Represented Plan add up to a plan that is of high quality, stretching and deliverable and will deliver financial resilience over AMP7 and the long term.

6.3 We have considered the risks of delivering our Represented Plan, balancing the management of those risks with delivering stretching targets for our customers, communities and the environment. We are satisfied that our Represented Plan is both stretching and deliverable and we have confidence in the leadership team's ability to deliver it.

Tony Cocker
Chairman

Pauline Walsh
Chief Executive Officer

Stuart Ledger
Chief Financial Officer

Chris Bolt
Independent non-executive director

Patrick O'D Bourke
Independent non-executive director

Trevor Didcock
Independent non-executive director

Susan Hooper
Independent non-executive director

Chris Newsome
Independent non-executive director

Jaroslava Korpanec
Non-executive director

Tony Roper
Non-executive director

Angela Roshier
Non-executive director