



AFW Supplemental Board Assurance Statement

March 2019

SUPPLEMENTAL BOARD ASSURANCE STATEMENT

1. INTRODUCTION

1.1 As a Board, we are very disappointed that our PR19 Business Plan (“September Plan”) has been classified by Ofwat in its Initial Assessment of Plans (“IAP”) as requiring significant scrutiny. We have taken steps to appraise ourselves of where, as a business, we have fallen short in meeting Ofwat’s expectations and to seek to ensure that our September Plan (as updated by this submission) (our “Revised Plan”) provides the evidence and assurance that our plans for AMP7 are of high quality, robust, supported by customers and are stretching and deliverable.

1.2 We remain committed to ensuring our AMP7 Business Plan delivers for customers and the environment for the period 2020 to 2025 and in the longer term. We have been ambitious in addressing the issues identified by Ofwat in its IAP and welcome Ofwat’s commitment to consider whether, in light of the changes to our September Plan reflected in our Revised Plan, it remains appropriate to allocate lower cost sharing rates as a ‘significant scrutiny’ company.

1.3 We have led and overseen the preparation of our Revised Plan, in particular by:

- making ourselves even more visibly accountable to the communities we serve by increasing the number of our performance commitments from 19 to 28;
- stretching ourselves further through our performance commitments, including on leakage where we have increased our reduction target from 15% to 18.5% (equivalent to a 30 Ml/d reduction over AMP7);
- developing additional bespoke performance commitments dedicated to: (a) the longer-term provision of resilience in our supply area; (b) the sustainability of asset health; and (c) supporting the resilience of our service for customers in vulnerable circumstances;
- responding to Ofwat’s cost efficiency challenge which brings us to upper quartile on cost and reducing our retail cost to serve from 22% to 5%;
- reducing the average household bill (before inflation) by 1.6% in AMP7 and planning to reduce it by a further 2% in AMP8;
- widening the RoRE range to +0.33% and -2.61%;
- ensuring our Revised Plan continues to align with our revised draft Water Resources Management Plan (rdWRMP) published for consultation on 1 March 2019; and
- re-confirming our intention 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.

1.4 In this Supplemental Board Assurance Statement, we provide:

- details of how we, as a Board, have led the development of our Revised Plan and its assurance;

- the assurance requested by Ofwat with respect to the robustness of our large investment proposals (action reference AFW.CA.A1);
- assurance of other matters where we have fallen short of Ofwat's expectations; and
- an update on a number of matters relating to board leadership, governance and transparency.

2. LEADING THE DEVELOPMENT OF THE REVISED PLAN AND ITS ASSURANCE

- 2.1 We are, and have been, fully engaged in the design, development and preparation of our Revised Plan. We own the strategy and have provided strategic direction to management on their responses to the actions required by Ofwat. We have supplemented our regular meetings with a number of PR19-specific Board meetings to support our oversight, scrutiny and challenge of our Revised Plan.
- 2.2 We have re-visited the assurance we provided in respect of our September Plan and considered the changes within our Revised Plan and any implications they may have for the assurance provided.
- 2.3 As a Board, we have:
- reviewed the findings of an external review into data quality;
 - scrutinised and informed the scope of the assurance programme for our Revised Plan and approved the appointment of PricewaterhouseCoopers LLP and Atkins Limited to provide strategic and technical assurance as well as assurance of our data tables and commentaries;
 - reviewed, challenged and approved the methodology for assuring the accuracy and quality of our data tables and commentaries;
 - reviewed third party assurance reports on the data tables and commentaries provided by PricewaterhouseCoopers LLP, Atkins Limited and ChandlerKBS and KPMG with respect to the accuracy of our financial model; and
 - met with the Chair of our Customer Challenge Group to discuss the findings of its assurance of relevant aspects of our Revised Plan.
- 2.4 Since publication of the IAP, 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 Revised Plan.
- 2.5 We will continue, as a Board, to provide leadership and oversight of the further work we are undertaking and further submissions in respect of our AMP7 Business Plan, and are committed to overseeing and monitoring the delivery of our Revised Plan.

3. ROBUSTNESS OF LARGE INVESTMENT PROPOSALS

- 3.1 In our September Board Assurance Statement we provided assurance that:
- we had reviewed expenditure forecasts included in the September Plan to satisfy ourselves that they were robust, reliable and efficient, taking account of benchmarked cost data. In this regard, we took into account the Atkins Limited *PR19 Assurance Report*;

- we had challenged management about their plans to achieve the operating and capital cost efficiencies within the September Plan so that we were assured they were both stretching and deliverable;
- we had reviewed how the wholesale investment programme had been developed and the process by which options were assessed;
- we had reviewed the scope and deliverability of the investment programme and, where uncertainties in scope or cost had been identified by our assurance providers, we had satisfied ourselves that those risks and uncertainties were appropriate and that the relevant investment remained the best one for customers; and
- our September Plan was aligned with the revised draft Water Resources Management Plan we were preparing and that we did not envisage there would be any change to the investment programme included in the Business Plan for AMP7.

3.2 The Atkins Limited *PR19 Assurance Report* classified a number of our large AMP7 investment areas 'amber', highlighting uncertainties with respect to these investment areas. Since our September Plan, further work has been undertaken by management on the business cases for these investment areas and for the Supply 2040 scheme. We asked Atkins Limited to revisit these seven investment areas and the Supply 2040 scheme, in particular to provide assurance with respect to:

- their technical suitability;
- the robustness of the challenge and decision-making process;
- their consistency with proposed Performance Commitments; and
- confirming that uncertainties either in relation to the quantum of activities or the costs were not material.

3.3 Atkins Limited has prepared a further assurance report which re-classifies each of the seven 'Amber' investment areas and the Supply 2040 programme 'Green'. The 'Green' classification indicates that these investment areas have clear drivers and that optioneering and costs are underpinned by an appropriate evidence base.

3.4 We recognise that investments driven by our Water Resources Management Plan form a substantial part of our AMP7 enhancement programme. We therefore established a Water Resources Management Plan Committee, chaired by Tony Cocker, to provide oversight and scrutiny of the preparation of our revised draft WRMP, to ensure it represents the most cost effective and sustainable long-term solution and meets legal requirements and relevant guidelines. As part of its duties, the Committee reviewed:

- technical assurance from Atkins Limited with respect to preparation of our rdWRMP and its adherence to the Water Resources Planning Guidelines and the Water Resources Management Plan (England) Direction 2017;
- reviewed technical assurance from Ricardo Energy & Environment of our Strategic Environmental Assessment ("SEA"), Habitats Regulations Assessment ("HRA") and Water Framework Directive Assessment; and
- legal assurance, with specific reference to the requirements of the SEA and HRA.

- 3.5 The Committee provided the following assurance in Chapter 8 of the revised draft Water Resources Management Plan:

“We have reviewed this rdWRMP and the assurance reports provided by Atkins Limited and Ricardo Energy & Environment and comments and views provided by Counsel following legal review.

We are satisfied that the rdWRMP represents the most cost effective and sustainable long-term solution for managing and developing water resources so as to be able, and continue to be able, to meet the Company’s water supply obligations under Part III of the Water Industry Act.

We are further satisfied that our rdWRMP takes account of all statutory drinking water quality obligations, and that it includes plans to meet our statutory obligations in this respect in full. We approve the rdWRMP on behalf of the Board.”

- 3.6 Taking all of these matters into account, we can provide assurance that our large investment proposals for AMP7 are robust and deliverable, that a proper assessment of options has taken place, and that the option proposed is the best one for customers.

4. DATA QUALITY

- 4.1 We acknowledge that the data forming part of our September Plan fell significantly short of Ofwat’s expectations for consistency and accuracy, including the allocation of costs between business units, information on corporation tax, and the assurance and commentaries provided. As a ‘prescribed’ company under the Company Monitoring Framework, we are committed to making the improvements necessary to restore Ofwat’s confidence and our ambition is to become a ‘self-assured’ company. We have appraised ourselves of the risks and weaknesses identified in our revised *Risks, Strengths and Weaknesses* statement and endorsed the actions to address those risks and weaknesses set out in our *Final Assurance Plan 2018/19*.

- 4.2 We have carried out a thorough review to understand why the above approach did not operate as effectively as it should have done and the changes needed to remedy this. The review identified that we needed to:

- enhance our control environment, in particular by enforcing single sources of data and strengthening our lock down and change control processes;
- improve understanding of how data informs our business planning processes and how data inter-relates; and
- improve our overall framework for data governance and adherence to regulatory reporting guidelines.

- 4.3 We are committed to taking the necessary steps to implement these improvements and our Audit Committee will oversee this work. For our Revised Plan, we have strengthened the assurance of our data and commentaries by reinforcing the “three lines of defence” approach, strengthening our processes for change control and providing further advice, guidance and support to those responsible for providing data and preparing commentaries.

- 4.4 Pricewaterhouse Coopers LLP and Atkins Limited have provided assurance of the data tables and commentaries for our Revised Plan. KPMG have reviewed our internal financial model to correct errors identified from the September Plan and 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.

4.5 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 Revised Plan.

5. CUSTOMER CHALLENGE GROUP

5.1 We greatly value the work undertaken by our Customer Challenge Group in challenging the quality of our customer engagement for our September Plan. We recognise that the timetable envisaged for some of our engagement activities supporting the September Plan was not met and became compressed, causing significant time pressures for and a draw on the resources of the CCG. We fully accept the criticisms made by the CCG in its report in this regard.

5.2 For our September Plan, we engaged extensively with our CCG to obtain feedback on the quality of our customer engagement and to seek assurance that the outcome from that engagement had informed our plan. The CCG confirmed this was the case.

5.3 We were pleased that for our September Plan the CCG assessed 15 of its 18 test areas for engagement on our Business Plan 'Green'. While disappointed that our customer engagement did not fully meet the CCG's tests for effective customer engagement on long term risks, the performance commitment framework as a whole and resilience, we fully accept the shortcomings identified.

5.4 For our Revised Plan, our CCG has provided assurance that we have effectively engaged with customers on:

- the affordability and acceptability of our proposed bill profile for the 2020 to 2025 period; and
- long-term bill profiles for the 2025-30 period and customer support for each of the profiles tested.

5.5 In addition, the CCG has reviewed our response to fourteen other actions which relate to our performance commitments and customers in vulnerable circumstances and provided assurance in its report that our approach is appropriate.

5.6 We take this opportunity to thank the CCG and its chair, Teresa Perchard, for the further work done in reviewing the work we have undertaken (and are continuing to take) with respect to customer engagement on our AMP7 Business Plan.

6. AFFORDABILITY AND VULNERABILITY

6.1 In our Board Assurance Statement we provided assurance that we were satisfied from research that the small increase proposed in average bills over AMP7 would represent a declining share of our customers' projected disposable income (allowing for housing costs) over that period.

6.2 For our Revised Plan, we are proposing a 1.6% reduction in clean water bills (before inflation) across AMP7, with a reduction in each year and an anticipated further 2.0% reduction in clean water bills (before inflation) in AMP8.

6.3 We have considered the further consultation undertaken with customers on these final bill profiles, noting high levels of acceptability and affordability. We note that we will be undertaking further quantitative and qualitative research during May and June 2019. On the basis of the consultation undertaken to date we provide assurance that our final bill profiles for AMP7 and AMP8 are supported by customers.

6.4 In our Board Assurance Statement we also provided assurance that our September Plan included appropriate assistance measures for those struggling, or at risk of struggling, to pay their bills. Our plans to increase the reach of our social tariff to a further 25,000 customers have

now been tested with customers and we have provided evidence of their support for increasing the current level of cross subsidy from £3.00 to £4.50 per customer, per annum.

- 6.5 Our Revised Plan includes a further performance commitment to secure and maintain accreditation to BSI 18477 for Inclusive Services and confirms our commitment to increase the number of customers on our priority services register to 7.22% of total customers by the end of AMP7.

7. ACCOUNTING FOR PAST DELIVERY

- 7.1 We continue to monitor closely our performance against the challenging performance commitments we set ourselves for AMP6, which include some of the biggest reductions in leakage, demand and water abstraction of any company in the industry. In our September Board Assurance Statement, we acknowledged that:

- our performance on supply interruptions greater than 12 hours had fallen short of the commitment we made in the first three years of AMP6 and that we were continuing to challenge and monitor the robustness of management's plans to meet this performance commitment for the remainder of AMP6; and
- we had continued to rank in the lower quartile for performance against the Service Incentive Mechanism.

- 7.2 We confirmed that we would continue to monitor the progress of the business in meeting all our performance commitments and our legal and regulatory obligations, and would oversee and challenge management's plans to achieve them.

- 7.3 In October 2018, we considered the risks to achieving the 2018/19 performance commitments for leakage reduction and per capita consumption. We noted that performance during the Spring of 2018 had been satisfactory but that recorded leakage rose substantially over the hot summer but had not declined as expected as we moved into late summer and early autumn. We scrutinised and endorsed management's plans to secure and deploy additional resources to detect more leaks and repair those leaks more quickly to meet the performance commitment for leakage reduction. We have since monitored performance against these plans on a monthly basis.

- 7.4 During January 2019, it became apparent that, notwithstanding the measures taken under the action plan we would not meet our leakage reduction performance commitment for 2018/19. Our CEO, Pauline Walsh, informed Ofwat's CEO, Rachel Fletcher, of this on 28 January 2019 and outlined the actions we had taken and are continuing to take to be in the best position we can at the end of 2018/19 to achieve our performance commitment for 2019/20.

- 7.5 We remain acutely conscious of the public focus on industry performance and we understand the importance of meeting leakage reduction and per capita consumption performance commitments in this context. We remain fully committed to maintaining our track record of delivery this AMP and plan to achieve our overall targeted reductions in leakage and per capita consumption by March 2020.

8. RESILIENCE

- 8.1 We confirm our commitment by 22 August 2019 to prepare and provide an action plan to develop and implement a systems-based approach to resilience in the round to ensure we can demonstrate in the future an integrated resilience framework that underpins our operations and future plans, showing the connections between risks to resilience, planned mitigations, our package of outcomes and our corporate governance framework.

- 8.2 Our Revised Plan includes common and bespoke performance commitments associated with operational resilience which are clearly defined, demanding for AMP7 and the long term, and which are supported by the right incentives. We have ensured that there is a clear link to our

long term risks, as well as our near term operational risks around the performance of our network and our increasing dependency on cyber and digital technology.

9. GEARING

- 9.1 We re-confirm 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. In our September Plan, 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.
- 9.2 Following our September Plan, we have worked with our external financial advisers to refine the analysis of the options that we have considered. Through this work we have ruled out the option of repaying existing debt, as our existing borrowings are at rates that are efficient and therefore any repayment would be at a significant premium.
- 9.3 Our Revised Plan will require £120m of new financing. We also have £14m of existing debt maturing during AMP7. If these funding requirements remain in our final determination, we plan to modify the capital structure of the Daiwater Investments limited Group to reduce the gearing level in Affinity Water limited, possibly ahead of AMP7. A further capital injection could then be made at the Affinity Water limited level later in the AMP to keep the gearing at 75% or below.
- 9.4 We continue to expect to confirm implementation once the AMP7 price controls are finally determined, when the investment and funding needs of the business are finalised. We have assumed in our planning that the fundamentals of our September Plan (as updated in our Revised Plan) are maintained (including Ofwat's initial assessment of the WACC). We have also assumed that current market conditions will continue to prevail. If either of these were to change significantly, our plan to reduce gearing would need to be reconsidered. The change to our Group capital structure could trigger a change in our Dividend Policy.
- 9.5 There also remains some uncertainty about timing of implementation. We therefore believe it is right for our customers and our assessment of financeability, to base our AMP7 plan at the top level of our current target range of gearing of 80%, for each year of AMP7. We remain satisfied that this level of gearing would be appropriate and that our Revised Plan will facilitate Affinity Water Limited maintaining an investment grade credit rating, as set out in the Risk and Return section of our Revised Plan.

10. FINANCEABILITY

- 10.1 We recognise that, due to an error in the financial model we used to populate the Ofwat financial model, the ratios we reported in respect of Ofwat's indicators of financeability did not match those in the Ofwat Model. Our model has been reviewed independently by KPMG and fully reconciled to Ofwat's financial model 17z.
- 10.2 We have assessed the financeability of our Revised Plan on the notional company basis, using the financial ratios produced by the Ofwat model and using Ofwat's early view of the cost of capital.
- 10.3 Our Revised Plan enables Affinity Water Limited to maintain its Baa1 credit rating based on Moody's current assessment, process and guidance. We expect to meet our covenants and maintain headroom against those covenants. When Ofwat's stress tests are applied, we will continue to be able to meet our covenants and maintain an investment grade credit rating (based on Moody's current assessment process and guidance). Taking these matters into account, we are satisfied that our Revised Plan will enable our appointed business to remain financeable throughout AMP7. Accordingly, we are satisfied of Affinity Water Limited's financeability for AMP7.

11. ALIGNING RISK AND RETURN

11.1 In our September Board Assurance Statement we stated:

- we had considered carefully whether our September Plan represented an appropriate balance of risk between our investors and customers;
- we acknowledge that the regulatory framework provides a number of significant protections for companies with respect to revenue and costs;
- we had taken steps to appraise ourselves of the risks associated with delivering our Plan and reviewed and challenged the work undertaken by management to mitigate those risks;
- we were satisfied that management's risk and mitigation plans were appropriate; and
- that delivery of the September Plan would be stretching, with significant cost efficiencies needing to be achieved to facilitate a fair return to our investors.

11.2 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 investors. 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.

11.3 We are satisfied that the risk of the potential need for investment in treatment for metaldehyde has been mitigated by the ban on sale and use announced in December 2018 by Defra. Accordingly, this bespoke uncertainty mechanism is no longer required.

11.4 We consider 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 MI/day may be required but did not include it in its Water Industry National Environment Programme ("WINEP3") document. If this sustainability change is included in WINEP, it would be included as "amber". The PR19 methodology requires companies to include the cost of 'amber' schemes in its investment programme so the bespoke uncertainty mechanism we are proposing provides equivalent protection.

12. BOARD LEADERSHIP, GOVERNANCE AND TRANSPARENCY

12.1 In our Board Assurance Statement, we explained that we consider our Board is made up of directors with key relevant skills and experiences, who are able to challenge and support the executive management team and focus on customer, operational, regulatory and sector priorities. We stated that we wished to make some further improvements, including:

- ensuring that at least half our Board (excluding the Chairman) are independent;
- appointing a Senior Independent Non-Executive Director; and
- undertaking an externally-facilitated board effectiveness review.

We have implemented each of these changes, as explained below.

- 12.2 Simon Cocks stepped down as non-executive director on 1 October 2018. In January 2019, Chris Newsome was appointed an independent non-executive director. Chris has extensive experience in the water sector, most recently as Director of Asset Management and Executive Director at Anglian Water Services Limited and previously as Head of Investment and Capital Development at Yorkshire Water. He has a strong track record in asset management and capital delivery. His skills and experience complement those of existing Board members.
- 12.3 Following these changes, half our Board (excluding the Chairman) is independent. Our Board comprises:
- a non-executive chairman, who is independent;
 - five independent non-executive directors;
 - two executive directors; and
 - three non-executive directors who are affiliated to shareholders, therefore not independent;
- 12.4 We have appointed Chris Bolt as Senior Independent Non-Executive Director, to provide a sounding board for the Chairman and to serve as an intermediary for the other directors, shareholders and regulators.
- 12.5 We have recently undertaken an externally-facilitated review of our effectiveness as a Board. We have considered the review's recommendations and we are making improvements in the following areas: the induction and development of directors; succession planning; stakeholder management; board administration; and informal interactions between directors. We will report progress against these actions in our Annual Report.
- 12.6 Affinity Water Limited has recently been awarded the Fair Tax Mark and we have removed the Cayman Islands subsidiary from our financing structure.
- 12.7 We welcome Ofwat's revised Board Leadership, Governance and Transparency principles which will apply from 1 April 2019 and the approach Ofwat has outlined to embedding the core objectives in the licence conditions. We have confirmed to Ofwat we are minded to consent to a change of our licence conditions to reflect this approach.

13. SUMMARY

- 13.1 We have led and overseen the preparation of this Revised Plan to ensure that it effectively addresses the issues raised by Ofwat in its IAP assessment of our September Plan. We have challenged management's proposals and, where appropriate, directed changes to those proposals.
- 13.2 We believe that our personal and collective Board leadership in respect of our Revised Plan demonstrates our commitment to producing a well evidenced Revised Plan of the highest quality. We are satisfied that the assurance we provided in our September Board Assurance Statement, as supplemented by this Supplemental Board Assurance Statement, provides assurance that:
- all the elements of our Revised Plan add up to a plan that is of high quality, stretching and deliverable;
 - the overall strategy for data assurance and governance processes has delivered data for this Revised Plan which is high quality;

- our large investment proposals for AMP7 are robust and deliverable, that a proper assessment of options has taken place, and that the option proposed is the best one for customers;
- this Revised Plan will allow Affinity Water Limited to meet its statutory and licence obligations, now and in the future, taking account of the UK Government's strategic policy statement;
- this Revised Plan will deliver financial resilience over AMP7 and the long term; and
- this Revised Plan will enable customers' trust and confidence through high levels of transparency and engagement on issues such as governance, transparency and the resilience of our corporate and financial structure.

13.3 We have considered the risks of delivering our Revised Plan and satisfied ourselves that it continues to be both stretching and deliverable.



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