Your local supply, on tap

AFW Company response: reference AFW-FR

Financing and Resilience

30 August 2019

Table of Contents

1 Introduction 4

1.1 Purpose and structure of this document 4
1.2 Key conclusions 4
1.3 Supporting Documents and Information 5

2 Table of responses to interventions and actions 7

3 Representation: Bill reduction and customer support 9

3.1 Purpose of this section 9
3.2 Main conclusions 9
3.3 Table of relevant actions and interventions 9
3.4 Structure of this section 9
3.5 Bill reduction and profile 9
3.6 Customer Research Completed on Revised, DD and DD smoothed Bills 10

4 Representation: Risk and Return 13

4.1 Purpose of this section 13
4.2 Main conclusions 13
4.3 Table of relevant actions and interventions 14
4.4 PAYG and RCV Run-Off Rates 15
4.5 Financeability 18
4.6 Our View of the Weighted Average Cost of Capital (WACC) 26
4.7 RoRE Outcomes 27
4.8 WRFIM Adjustment 28

5 Representation: Sector back in balance 42

5.1 Purpose of this section 42
5.2 Main conclusions 42
5.3 Table of relevant actions and interventions 42
5.4 Structure of this section 43
5.5 Gearing 43
5.6 Dividend policy 44
5.7 Executive pay 46
5.8 Trust Fund 47
5.9 Company Structure 47
5.10 Cayman Registered Company and Fair Tax 47

Appendix A Dividend policy 48
Appendix B Executive pay policy 49
Appendix C Bill profile customer research 50
Appendix D Experian Report: P14 population property forecast 51
Appendix E Third party assurance 52
Appendix F PAYG and RCV run-off rates 53

1 Introduction

1.1 Purpose and structure of this document

The purpose of this document is to set out our response to Ofwat's draft determination (DD) actions and interventions in relation to '**financing and resilience'**. These interventions relate to our bill, financeability of the Company including third party assurance, the PAYG and RCV Run-Off rates, RORE outcomes, and representation on the WRFIM adjustment. It also reports on the actions and interventions relating to the 'sector back in balance including our plans to reduce the gearing level of the company, further refinement of our executive pay and dividend policies and updates on other actions we are taking in this area.

We list the individual interventions and the actions grouping them in three categories:

- 'Noted or acknowledged' where we do not seek a change to the interventions made at this stage of the determination process.
- 'Representation' where change to the DD is required to achieve the balance of performance and incentives that protects our customers, including where we introduce a new PC.
- 'Technical points' where we address technical issues by providing clarification or additional information.

We present, in 3 main sections:

- Section 3 Representation: Bill reduction and customer support
- Section 4 Representation: Risk and Return
- Section 5 Representation: Sector back in balance

Additional supporting information is presented in appendices which have been provided alongside this document and are listed in Table 1.

1.2 Key conclusions

Our Represented plan results in a bill that is lower than our previous plan submission with an overall bill reduction of 2.3% over AMP7. We are engaging with customers on this bill profile and will share the results of this with our CCG and Ofwat in September. This will test with and without inflation and also on natural rate to address the concerns raised by Ofwat in the Draft Determination. We have engaged with customers on the DD bill, with customers showing a strong preference for the bill from our March Plan over the Draft Determination bill due to the smooth phasing of the bill over AMP7 and AMP8. Adopting the phasing approach in the DD has prevented us replicating this smoothing in our Represented Plan.

The bill is higher than the DD bill, however when the DD bill is corrected for the method of calculating PAYG and our view of the phasing and allocation of totex the difference is much smaller. This difference can be explained by the need to uplift the PAYG to meet the financeability needs of the notional company, adjusting for our representation on WRFIM and our representations on totex.

We have worked with external regulatory experts to develop the representation for the PAYG. We believe that the notional company in the Draft Determination is not financeable with no financial headroom to manage cost shocks. The targeted ratio levels are not consistent with the target credit rating and the methodology applied in the calculation of the natural PAYG is not consistent with the methodology Ofwat has stated applies for Affinity Water. We have corrected these factors in our represented case.

Ofwat has disallowed our proposed adjustment to the revenues included within the WRFIM, while highlighting additional evidence that it would need to consider our case further. We maintain our claim for

WRFIM, reducing the value of the claim from £21.9m to £16.6m. The main adjustments are the following items:

- An adjustment to our 2019/20 forecast contributions to reflect new data on actual performance;
- An adjustment to the infrastructure charges component of the claim in response to Ofwat's challenge; and
- We have also made some very minor changes to the WRFIM Feeder Model we submitted on 15 July 2019 and table WS13 for our Representation, assuming that additional revenue has been allowed to compensate for the loss of price-controlled tariff revenue caused by excess growth in connections revenue.

We have assessed the financeability of the company with the represented plan on the notional and actual structure. We have assessed the financeability against our covenants, rating agency ratios and Ofwat ratios. In completing the assessment, we have applied the Ofwat stress tests. We have also considered our financing needs, current cash balances and the requirements of our bond documentation. We provide Board assurance that the Company is financeable with the Represented Plan on Ofwat's notional structure and the Company's actual structure. We have formed this view based on the assumption that 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.

We have engaged a third party to provide assurance of the financeability of the Represented plan and the longer-term viability of the Company with the Represented plan. We have summarised the assurance provided in our Board assurance statement.

In the financeability section of this paper we have set out the actions we have in place to support our long-term financeability. We re-confirm that we are and will continue to report our long- term viability in our Annual Report over a 10-year period.

We report on the development on our plans to reduce gearing with a commitment from our shareholder to invest £43m into the appointed business from reinvesting the dividends from the appointed business and £35m of dividends from the non-appointed business. This results in the shareholders planning to receive no dividend in AMP7. This delivers a reduction in our regulatory gearing to 76.8% by the end of AMP7. We restate the Boards and Company shareholders intent to reduce the gearing to 75% or lower.

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.

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 provide our support to Anglian Water's view of the WACC in their discussion document 'PR19 – Notional Company Financeability   A discussion paper: August 2019 Update Annex to our 2018 paper on Notional Company Financeability'.

1.3 Supporting Documents and Information

In addition to our company response to 'financing and resilience' in this document, we provide additional supporting appendices, either within this document or as standalone documents. These should be read in conjunction with the relevant representation and technical point.

A list of supporting documentation and their relevant representation/technical point are listed in the table below.

Table 1: Supporting documentation for our response to 'financing and resilience'

Document reference	Description	Standalone document	Associated representation/technical point
AFW-FR-Appendix A	Dividend Policy	Yes	**Section 5.6.** Dividend policy
AFW-FR-Appendix B	Executive Pay Policy	Yes	**Section 5.7** Executive pay
AFW-FR-Appendix C	Bill Profile Customer Research completed by Verve	Yes	**Section 3.6.** Customer Research Completed on Revised, DD and DD smoothed Bills
AFW-FR-Appendix D	Experian Report: PR14 Population Property Forecast	Yes	**Section 4.8.** WRFIM Adjustment
AFW-FR-Appendix E	Third Party Assurance on our financeability and long term viability	Yes	**Section 4.5**. Gearing
AFW-FR-Appendix F	PAYG and RCV run-off rates	Yes	**Section 4.4.** PAYG and RCV Run-Off Rates

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2 Table of responses to interventions and actions

The table below presents all actions and interventions relating to 'financing and resilience'.

- Column A sets out the action reference for the individual action.
- Column B sets out the intervention area relating to the individual Ofwat intervention.
- Column C sets out where we acknowledge the intervention or seek a change through a representation or technical point. This is denoted as follows:
  - 'A': Acknowledged or noted with no further commentary in this document.
  - 'R': A change is required to the DD and therefore we have provided a representation in this document.
  - 'T': Technical issues addressed by providing clarification or additional information as required.
- Column D provides the section reference in this document where we seek change through a representation or a technical point.

Table 2: Ofwat actions and interventions relating to 'financing and resilience'

Intervention reference	Intervention Area	Response	Page reference
AFW.AV.A1	Retail bill profile	R	**Section 3.5.** Bill reduction and profile
AFW.LR.A5	Reduction of gearing, maintenance of credit rating, and stress testing of long-term viability	A	**Section 5.5.** Gearing **Section 4.5.** Financeability
AFW.LR.C1	Board Assurance: Financial resilience	A	**Section 4.5.** Financeability Please also refer to our separate Board Assurance Statement.
AFW.RR.A3	Retail revenue risk	A	
AFW.RR.A5	Board Assurance: Long term resilience	A	**Section 4.5.** Financeability Please also refer to our separate Board Assurance Statement.
AFW.RR.A6	PAYG and RCV run off rate alignment	R	**Section 4.4.** PAYG and RCV Run-Off Rates
AFW.RR.A7	Third party assurance of business plan tables changes	A	**Section 4.5.** Financeability Please also refer to our separate Board Assurance Statement.

Intervention reference	Intervention Area	Response	Page reference
AFW.RR.A8	Board Assurance of financeability	A	**Section 4.5.** Financeability Please refer to the Company response (Shareholders note) and the Board Assurance Statement.
AFW.RR.A9	PAYG and RCV in the context of the TOTEX split	T	**Section 4.4.** PAYG and RCV Run-Off Rates
AFW.RR.A10	PAYG and RCV run-off rates in the context of the retail bill	R	**Section 3.5.** Bill reduction and profile
AFW.RR.C1	Alignment of PAYG rates to opex	R	**Section 5.5.** PAYG and RCV Run-Off Rates
AFW.RR.C2	Retail cost risk	A	
AFW.RR.C3	RoRE risk ranges: Alignment with ODIs	R	**Section 4.7.** RoRE Outcomes
AFW.RR.C4	RoRE risk ranges: Analysis update	A	**Section 4.5.** Financeability
AFW.PD.A3a	Data request: Unmetered water customers	A	
AFW.PD.A5	WRFIM	R	**Section 4.8.** WRFIM Adjustment
AFW.PD.C008.01	Modification factors	A	
AFW.PD.C008.02	Financing adjustment discount rate	A	
AFW.PD.C009.01	Household retail revenue	A	
AFW.PD.C011.01	Profile revenue adjustment discount rate	A	
AFW.CA.A2	Dividend policy	T	**Section 5.6.** Dividend policy
AFW.CA.A3	Executive Pay	T	**Section 5.7** Executive pay
N/A	Third party assurance of long term viability and equity investor support	T	**Section 4.5.** Financeability Please also refer to the Company response (Shareholders note) and the Board Assurance Statement.
N/A	PAYG and RCV in the context of the TOTEX split	T	**Section 4.4.** PAYG and RCV Run-Off Rates

Source: Ofwat PR19 draft determination, Affinity Water

3 Representation: Bill reduction and customer support

3.1 Purpose of this section

In this section, we present our response to the DD for the reduction in our customers' bill and its profile. We present the findings of additional customer research we have carried out to understand customers views on affordability and acceptability of bills now and in the longer term. We outline the further customer research planned to gauge support for the bills.

3.2 Main conclusions

Our represented plan results in a bill reduction of 2.3% over AMP7 with a 1.8% decrease in the first year. This compares to a 5.8% 'true' reduction in the DD. The main differences relate to our representations on totex, WRFIM and the PAYG adjustment required to make the plan financeable. We have aligned the profile as much as possible with the profile of the DD which also reflects customer preferences.

Our customers have shown a preference for the Revised plan bill and bill profile, submitted in March. This is because it spreads the bill reduction over the longer term. We have not been able to replicate this as Ofwat require the bill to be NPV neutral within the AMP. We believe that Ofwat should reconsider this decision in light of this customer research.

We confirm that we will complete customer research on the Represented plan bill and this will be shared with Ofwat and our CCG in September. Based on previous research we expect this to have a high level of acceptability and affordability. We will also test the Represented plan bill with the natural rate.

3.3 Table of relevant actions and interventions

The table below sets out those actions and interventions addressed in this representation.

Table 3: Ofwat actions and interventions for Bill reduction and customer support

Action reference	Intervention area
AFW.AV.A1	Retail Bill profile and customer engagement

3.4 Structure of this section

The structure of this section of the representation is:

- Section 3.5 sets out the bill profile and explains the difference in our bill against the bill proposed in the Draft Determination; and
- Section 3.6 sets out the customer engagement we have undertaken, how this has been accounted for in our bill, and our proposed customer engagement activities going forward.

3.5 Bill reduction and profile

The DD reduced the average bill for our customers by 11.9% over AMP7. This has been calculated using the PAYG natural rate excluding capital maintenance, which is not a methodology aligned with some other companies' DD that have similar accounting policies to us. Ofwat state in the main DD document for Affinity Water, section 5.4, "The adjusted cash interest cover ratio is affected by Affinity Water's Accounting Policy of capitalising part of its infrastructure renewals expenditure and the allocation of this to PAYG revenue as this is treated as fast money within the calculation of the ratio." When this calculation is applied, the reduction in bill changes to 7.6%. This reduction lessens further when we correct the totex mix that is applied to 5.8%. We believe that this 5.8% bill reduction represents the true DD position.

Our Representation on totex, retail cost to serve and WRFIM reduce this bill reduction to 3.0% and the uplift in the PAYG rate to 3.4% to address the financeability of the notional company along with the inclusion of the sharing mechanism results in a final represented plan bill reduction of 2.3%.

We explain in section 4.4 (PAYG and RCV Run-Off Rates) why the notional company is not financeable under the conditions of the DD and why an uplift of 3.4% of the PAYG ratio is required.

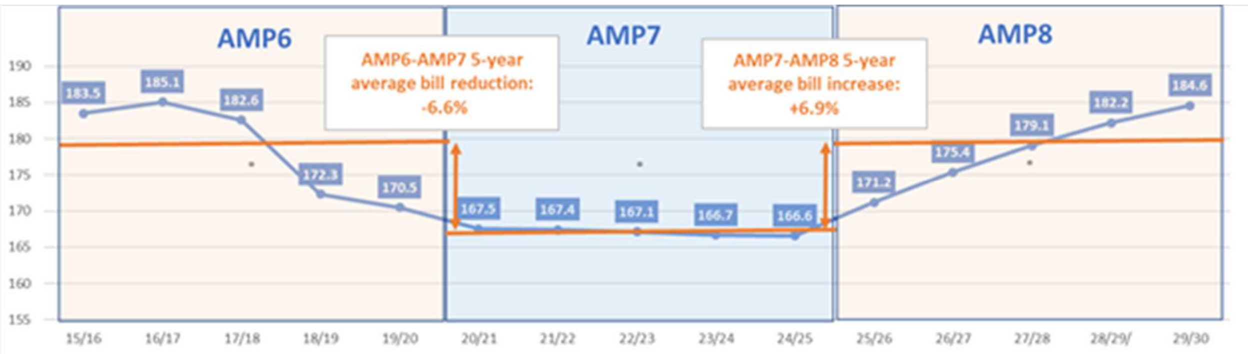
The Represented bill reduction is a change in the average bill from £170.5 to £166.6 over the AMP period. This follows a 7.7% bill reduction in AMP6 resulting in the 5-year average AMP7 bill being 6.5% lower than the 5-year average bill for AMP6.

We have aligned the profile of our bill, as much as possible, with the profile that Ofwat set in the DD. This results in the largest reduction (1.8%) in year 1 of AMP7, followed by small reductions in the remaining years, building on an overall 7.7% bill reduction we will have delivered in AMP6.

3.5.1 Long-term context

Following guidance from Ofwat and therefore using an RCV run-off which is NPV neutral, 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%. This is explained by the balance of PAYG and RCV run off over the 10 year-period. Seeking the meet Ofwat's expectations in delivering immediate benefit for customers, the lower PAYG rate in AMP7 drives a higher RCV in AMP8 thus a much-increased bill.

Figure 1: Forecasted bill profile for AMP7 and AMP8



We tested customers support for this approach and the results are presented below in section 3.6.

3.6 Customer Research Completed on Revised, DD and DD smoothed Bills

We have completed further testing of bills post the Draft Determination. The detail of this can be seen in AFW-FR-Appendix C (Customer Research). We have tested the following: the DD Bill, the Smooth Bill or the Revised Bill all with and without inflation. The purpose of the research was to understand if customers preferred one of the bills and their profile. The testing conducted follows the methodology of customer engagement previously agreed with our CCG.

The findings are that respondents expect and prefer for any changes to their water bill to be spread out over a 10-year period and to pay gradually over a longer period of time.

- Nearly two thirds (61%) expected any cost changes in their water bill to be spread out over the 10-year period and pay an increase gradually over time.
- Nearly half (49%) would prefer to pay cost changes in their water bill over a 10-year period and pay an increase gradually over time.

When looking at the 2020-25 Clean Water Bill Profiles, all three bill profiles (DD Bill, Smooth Bill and Revised Bill) perform similarly with no significant differences identified across acceptability, affordability and expectations.

- 74% rate the DD Bill profile as 'very or fairly acceptable', 71% rated the Smooth Bill profile as 'very or fairly acceptable' and 72% rated the Revised Bill profile as 'very or fairly acceptable'.
- 70% rate the DD Bill profile as 'very or fairly affordable', 67% rated the Smooth Bill profile as 'very or fairly affordable' and 66% rated the Revised Bill profile as 'very or fairly affordable'.
- 62% 'strongly agreed or slightly agreed' that the DD Bill profile was in line with their expectations, 60% 'strongly agreed or slightly agreed' that the Smooth Bill profile was in line with their expectations and 57% 'strongly agreed or slightly agreed' that the Revised Bill profile was in line with their expectations,

However, when looking at the 2025-30 Clean Water Bill Profiles, the Revised Bill emerges as the profile most acceptable, affordable and in line with expectations.

- 71% found the Revised Bill to be very or fairly acceptable compared to only 57% for the Smooth Bill and 58% for the DD Bill.
- 72% found the Revised Bill to be very or fairly affordable compared to only 58% for the Smooth Bill and 63% for the DD Bill.
- 62% 'strongly agreed or slightly agreed that the Revised Bill profile was in line with their expectations, significantly higher than the Smooth Bill (49%) and directionally higher than the DD Bill (58%).

After inflation is added, acceptability and affordability falls significantly across all three bills for both 2020-25 and 2025-30. However, this time, in order to observe and minimise any research ordering bias, the survey presented half of the participants (516) with the non-inflation bill profiles first and the inflation bill profiles second. The other half of the sample (508) saw the inflation bill profiles first, followed by the non-inflation bill profiles second. Among the customers who evaluated the inflation bill profiles first the negative impact of inflation, although still present, is reduced.

When forced to choose between all three bill profiles over a 10-year period the Revised Bill was the preferred profile both with and without inflation.

- 37% chose the Revised Bill profile as their preference without inflation, this is significantly higher than the other two bill profiles; Smooth Bill achieved 13% preference while DD Bill achieved only 3%. 47% selected 'don't mind' or 'don't know'.
- 45% chose the Revised Bill profile as their preference with inflation, this is significantly higher than the other two bill profiles; DD Bill achieved only 4% and the Smooth Bill achieved even less at 2%. 49% selected 'don't mind' or 'don't know'.

When looking at acceptable price point increases the Gabor Granger exercise determined that acceptability is highest at an increase of £2.50 (83% acceptability), but £12.50 may be considered the optimum price point as it provides the maximum yield.

3.6.1 Application of Customer Research in Setting the Bill

Although there is a preference for a bill profile that matches the Revised plan over AMP7 and AMP8, and spreads the changes in the bill over 10 years, we have not been able to replicate this in the Represented plan. This is due to the requirement set in the interventions in the Draft Determination to make the profile NPV neutral for RCV run off for the AMP7 period. This prevents the smoothing of bills across AMP7 and AMP8 by bringing forward revenues from AMP8 into AMP7. From the customer research conducted this is against the customers preference. We suggest that in light of this Ofwat reviews its intervention in setting the Final Determination.

Focusing on the AMP7 only preference, the research indicates that the DD bill and profile was slightly favoured over the Smooth bill. We have therefore adopted a similar profile to the DD bill with an initial big drop relative to the changes in the bill in the subsequent years of the AMP.

3.6.2 Planned Customer Research

We are testing the Represented bill with customers to assess its acceptability and affordability. This will be on both a pre and post inflation basis and with and without the sewage charges added to the bill and we will also test the natural rate. This will be shared with Ofwat post the submission of the Represented Plan but before the end of September. This has previously been flagged with Ofwat as it was not possible to test the Represented plan bill in the time allocated for preparing responses to the Draft Determination. We will also share the research with our CCG. We expect the research to show high levels of acceptability for the bill and bill prolife based on previous customer research on the bill.

4 Representation: Risk and Return

4.1 Purpose of this section

This section sets out our representation on financeability, and addresses the following key areas:

- Section 4.2 sets out our main conclusions on risk and return;
- Section 4.3 Table of relevant actions from Draft Determination;
- Section 4.4 Our view of the PAYG and RCV Run-Off Rates. This is presented in a report we have developed with the assistance of by the consultants Berkeley Research Group ("BRG"). We also present a table of totex on a combined wholesale basis in response to Ofwat' 23rd August 'Confirmation of expectations for 30 August 2019 representations';
- Section 4.5 Explains our assessment of the financeability including third part external assurance of the financeability of the Company with the Represented Plan
- Section 4.6 highlights our concerns of Ofwat's view of the Weighted Average Cost of Capital (WACC);
- Section 4.7 Sets out our RORE outcomes
- Section 4.8 Explains our WRFIM adjustment representation

4.2 Main conclusions

We have worked with external regulatory experts to develop the representation for the PAYG. We believe that the notional company in the Draft Determination is not financeable with no financial headroom to manage cost shocks. The targeted ratio levels are not consistent with the target credit rating and the methodology applied in the calculation of the natural PAYG is not consistent with the methodology Ofwat has stated applies for Affinity. We have corrected these factors in our represented case.

Ofwat has disallowed our proposed adjustment to the revenues included within the WRFIM, while highlighting additional evidence that it would need to consider our case further. We maintain our claim for WRFIM, reducing the value of the claim from 21.9m to £16.6m. The main adjustments are the following items:

- An adjustment to our 2019/20 forecast contributions to reflect new data on actual performance.
- An adjustment to the infrastructure charges component of the claim in response to Ofwat's challenge.
- We have also made some very minor changes to the WRFIM Feeder Model we submitted on 15 July 2019 and table WS13 for our Representation, assuming that additional revenue has been allowed to compensate for the loss of price-controlled tariff revenue caused by excess growth in connections revenue.

We have assessed the financeability of the company with the represented plan on the notional an actual structure. We have assessed the financeability against our covenants, rating agency ratios and Ofwat ratios. In completing the assessment, we have applied the Ofwat stress tests. We have also considered our financing needs, current cash balances and the requirements of our bond documentation. We provide Board assurance that the Company is financeable with the Represented Plan on Ofwat's notional structure and the Company's actual structure. We have formed this view based on the assumption that 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.

We have engaged a third party to provide assurance of the financeability of the represented plan and the longer-term viability of the Company with the Represented plan. We have summarised the assurance provided in our Board assurance statement.

In the financeability section of this paper we have set out the actions we have in place to support our long term financeability. We re-confirm that we are and will continue to report our long- term viability in our Annual Report over a 10-year period.

4.3 Table of relevant actions and interventions

The table below sets out those actions and interventions addressed in this representation.

Table 4: Ofwat actions and interventions for Risk and Return

Action reference	Intervention area
AFW.RR.A6	PAYG and RCV run-off rates
AFW.RR.A9	Method for calculation of RCV runoff
AFW.RR.A10	RCV run-off rates in relation to the bill profile
AFW.RR.C1	Alignment of PAYG rates to stated methodology
AFW.LR.C1	Board assurance that Affinity Water will remain financeable on a notional and actual basis, and that it can maintain financial resilience of our actual structure.
AFW.RR.A5	Board assurance on financeability and long-term resilience.
AFW.RR.A8	Board assurance to confirm how financeability and financial resilience of the actual structure will be maintained.
AFW.RR.A5	Evidence of support from its equity investors, including further evidence about its plans to restructure its financing arrangements and assurance on the long-term viability of the company. Third party assurance on financeability.
AFW.PD.A5	Ofwat are intervening to remove the full amount of the revenue claim in respect of higher revenue from new connections.
AFW.RR.A3	The company should amend its overall assessment of RoRE outcomes or provide convincing evidence to explain why it is reasonable to assume totex outcomes should be asymmetrically skewed to the downside for the notional company within an incentive-based regime.

4.4 PAYG and RCV Run-Off Rates

4.4.1 Purpose of this section

In this section, we present our view of PAYG and RCV-Run Off Rates. The main part of this section is formed by a report we have developed with the support We have been assisted in the preparation of this document by the consultants Berkeley Research Group ("BRG").

.We also present the table of totex on a combined wholesale basis in response to Ofwat' 23rd August 'Confirmation of expectations for 30 August 2019 representations';

4.4.2 PAYG and RCV Run-Off Rates Report and Conclusion

The report in AFW-FR-Appendix F sets out representation on the PAYG rates and RCV Run-Off Rates. The main conclusions form the report are that the 3.4% increase above the natural PAYG rate proposed by Affinity Water in its Representation is the minimum increase required to deliver financeability, given the natural PAYG rate and all other parameters in the Representation.

By contrast, the Draft Determination PAYG rates deliver financial ratios that suggest:

- the notional company would not be able to achieve a Baa1 credit rating (or even, in some years, a minimum investment grade Baa3 credit rating) under the central case; and
- the notional company would not be able to achieve a minimum investment grade Baa3 credit rating in any year under the downside scenario.

These outcomes appear incompatible with Ofwat's own guidance, as set out in Section 3 of the report, that target credit ratings should allow sufficient headroom for a company to absorb potential cost shocks and still retain investment grade.

4.4.3 Response to AFW Letter – Confirmation of expectations for 30 August 2019 representations dated 23rd August 2019

In this section, we present our analysis of totex on a combined wholesale basis for the amount shown in Table 3.2 of the Draft Determination along with the amount of totex that corresponds to our Representation Plan and supported by our WS1 data table submitted 30 August 2019. We have supplied further analysis giving detail of this amount by each Wholesale price control within the uploaded file 'AFW PR19 Totex split by opex and capex for Represented Plan and DD.xlsx'.

Figure 2: Natural PAYG Rate Calculation

Draft Determination	2020/21	2021/22	2022/23	2023/24	2024/25	AMP7
Total Opex (including third party and strategic regional solution)	142.864	142.302	140.782	152.051	147.726	725.725
Maintenance Capex:						
Capitalised Infrastructure Renewal Expenditure	12.670	14.609	15.129	17.129	17.230	76.765
Other	81.882	68.871	69.513	51.262	49.279	320.807
Enhancement Capex (including strategic regional solution)	48.474	69.524	60.290	61.967	40.866	281.121
Total Totex (Including Thrid party and Strategic regional solution)	**285.891**	**295.305**	**285.713**	**282.409**	**255.101**	**1,404.419**
Strategic regional solution (Included in the above figures)						
Opex	1.864	4.659	6.056	13.510	11.181	37.270
Capex	2.302	5.754	7.480	16.687	13.810	46.032
	4.165	**10.413**	**13.537**	**30.197**	**24.991**	**83.302**
Total Totex (excluding Strategic regional solution)	**281.726**	**284.892**	**272.177**	**252.212**	**230.111**	**1,321.117**
Additional Developer Services Expenditure (following supplementary information on G&C)						
Opex - New Connection	4.389	4.637	4.639	4.642	4.644	22.950
Maintenance Capex - New Development	5.156	5.232	5.232	5.233	5.234	26.086
Total Totex (incl additional DS expenditure & excl strategic regional solution)	**291.270**	**294.761**	**282.048**	**262.086**	**239.989**	**1,370.154**
Opex	147.254	146.938	145.421	156.692	152.370	748.675
Capex	148.182	158.235	150.164	135.591	112.609	704.781
Total Totex (Including Thrid party and Strategic regional solution)	**295.435**	**305.173**	**295.585**	**292.283**	**264.979**	**1,453.456**
Grants and contributions - Opex	9.059	9.570	9.575	9.580	9.585	47.369
Grants and contributions - Capex	6.620	6.732	6.734	6.736	6.737	33.559
Natural PAYG Rate Calucaltion	**53.9%**	**52.6%**	**54.1%**	**59.5%**	**64.4%**	**56.7%**

Representation Plan	2020/21	2021/22	2022/23	2023/24	2024/25	AMP7
Total Opex (including third party and strategic regional solution)	149.326	148.982	147.465	158.736	154.414	758.922
Maintenance Capex:						
Capitalised Infrastructure Renewal Expenditure	12.670	14.609	15.129	17.129	17.230	76.765
Other	86.442	73.498	74.140	55.890	53.908	343.879
Enhancement Capex (including strategic regional solution)	48.526	69.576	60.342	62.019	40.918	281.382
Total Totex (Including Thrid party and Strategic regional solution)	**296.964**	**306.665**	**297.076**	**293.774**	**266.470**	**1,460.949**
Strategic regional solution (Included in the above figures)						
Opex	1.864	4.659	6.056	13.510	11.181	37.270
Capex	2.302	5.754	7.480	16.687	13.810	46.032
	4.165	**10.413**	**13.537**	**30.197**	**24.991**	**83.302**
Total Totex (excluding Strategic regional solution)	**292.799**	**296.252**	**283.539**	**263.577**	**241.479**	**1,377.647**
Opex	149.326	148.982	147.465	158.736	154.414	758.922
Capex	147.638	157.683	149.611	135.038	112.056	702.027
Total Totex (Including Thrid party and Strategic regional solution)	**296.964**	**306.665**	**297.076**	**293.774**	**266.470**	**1,460.949**
Grants and contributions - Opex	9.059	9.570	9.575	9.580	9.585	47.369
Grants and contributions - Capex	6.620	6.732	6.734	6.736	6.737	33.559
Natural PAYG Rate Calucaltion	**54.4%**	**53.0%**	**54.5%**	**59.9%**	**64.8%**	**57.1%**

4.5 Financeability

4.5.1 Purpose of this section

In this section, we present the Board assurances of financeability and set out how the company has assessed its financeability. We also provide a view on the WACC response to the DD for the reduction in our customers' bill and its profile. We present the findings of additional customer research we have carried out to understand customers views on affordability and acceptability of bills now and in the longer term. We outline the further customer research planned to gauge support for the bills.

4.5.2 Main conclusions

We have assessed the financeability of the company with the represented plan on the notional an actual structure. We have assessed the financeability against our covenants, rating agency ratios and Ofwat ratios. In completing the assessment, we have applied the Ofwat stress tests. We have also considered our financing needs, current cash balances and the requirements of our bond documentation. We provide Board assurance that the Company is financeable with the Represented Plan on Ofwat's notional structure and the Company's actual structure. We have formed this view based on the assumption that 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.

We have engaged a third party to provide assurance of the financeability of the represented plan and the longer-term viability of the Company with the Represented plan. We have summarised the assurance provided in our Board assurance statement.

In the financeability section of this paper we have set out the actions we have in place to support our long term financeability. We re-confirm that we are and will continue to report our long- term viability in our Annual Report over a 10-year period.

We highlight our concerns about the 22bps 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.

4.5.3 Financeability Assurance

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.

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.

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.

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.

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:

- retain sufficient headroom to 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.

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.

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.

We have engaged PwC to assure the data tables including assuring the completed data tables reflect our representation models. We also engaged KPMG to assure the accuracy of our internal models in relation to the PR19 methodology and the published Ofwat financial model (version 18z).

4.5.4 Notional Structure Financeability

In AFW-FR-Appendix F we set out how the notional company is financeable on the Revised plan and that the ratios targeted of a Baa1 credit rating and a Baa3 credit (lowest rating for investment grade) under stress are achieved. This section explains that these are on the limits of financeability and therefore any reduction in these such as changes to the Cost of Capital or the PAYG will make the notional company unfinanceable.

Our analysis in the report in in AFW-FR-Appendix F leads us to conclude that the notional company with the Draft Determination is not financeable.

Evercore reports that the notional company achieved a lower rating of Baa2. This is assessed after the adjustments have been applied for performance in AMP6 and bill smoothing. This results in lower ratios and therefore a lower rating.

4.5.5 Actual Structure Financeability

Our overarching financeability objectives are retaining the Company's existing corporate family credit rating of Baa1 assessed by Moody's, maintaining the credit ratings of our class A debt of A3 from Moody's and A- from Standard and Poor's, and meeting our financial covenants relating to gearing and interest cover. We believe that our Represented Plan will enable these objectives to be met subject to the current target ratings and methodologies applied by the rating agencies.

The financeability of the Represented Plan and of the Company has been considered using our revised gearing level and the updated Cost of Capital from the Draft Determination.

We have considered the Represented Plan against the eight Ofwat stress tests, the Ofwat ratios as per the latest Ofwat model, the Company's covenant ratios and the credit rating tests applied to the company to maintain the Company's investment grade credit rating.

In assessing the financeability of the Represented Plan, we have also considered the ability of the Company to finance the Represented Plan and the level of cash reserves. We have considered the stress tests suggested by Ofwat and believe that they are appropriate stresses to assess the financeability of the plan. We believe that the 10% totex overspend, RoRE and combined scenarios are more appropriate for our Represented Plan due to the increased risk in the Represented Plan for ODI's and totex. These stress tests have been applied without management action or mitigations.

The same analysis has been completed for AMP8 as we also assess our financeability over the longer term. It should be noted that we now report our long-term viability over 10 years in our annual report published in July 2019.

4.5.6 Actual Structure Financeability Against the Ofwat Ratios

The tables below show the performance of the Ofwat ratios in delivering the Represented Plan.

Table 5: Performance of Ofwat ratios in delivering the Represented plan

Actual Structure Ratios				Base Case	+10% Totex	Financial Penalty (3% Revenues)	ODI Penalty (3% RORE)	Bad Debt Increase 5%	Inflation High	Inflation Low	Cost of New Debt +2%	Combination - +10% Totex, Financial Penalty 1% Revenues & ODI Penalty 1.5% RORE
Ofwat's Metrics	***Target***											
Cash interest cover	***Actual***	***Notional***	*Avr*	3.9	3.5	3.6	3.6	3.8	3.9	3.8	3.8	3.3
Adjusted cash interest cover ratio (Ofwat)	*1.2 to 1.5*	*1.5 to 2.5*	*Avr*	1.8	1.5	1.6	1.6	1.8	1.9	1.8	1.8	1.3
Adjusted cash interest cover ratio (Alternative)	*1.2 to 1.5*	*1.5 to 2.5*	*Avr*	1.0	1.1	1.1	0.8	1.0	1.1	1.0	1.0	1.0
Funds from operations / net debt (Ofwat)	*6% to 10%*	*10% to 15%*	*Min*	8.7%	7.3%	8.0%	7.7%	8.7%	8.9%	8.5%	8.6%	6.6%
Funds from operations / net debt (Alternative)	*6% to 10%*	*10% to 15%*	*Min*	7.2%	5.9%	6.5%	6.3%	7.2%	6.9%	7.5%	7.2%	5.2%
Return on capital employed (ROCE)			*Avr*	4.2%	3.3%	3.7%	3.6%	4.2%	4.3%	4.1%	4.2%	2.8%
Return on capital employed (ROCE) (building blocks)			*Avr*	2.5%	2.6%	2.5%	1.9%	2.5%	2.5%	2.5%	2.5%	2.5%
Return on regulatory equity (RoRE) (building blocks)			*Avr*	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%

Source: Affinity Water analysis

The target ratio has been adjusted to the Ba range in the Moody's tests as shown in AFW-FR-Appendix F. This is due to the notch uplift gain from our securitised capital structure. The exception is the Adjusted cash interest cover ratio (Alternative) which is not met. This ratio replicates the Moody's test, however, the Company does meet the Moody's ratio when being assessed on a corporate family basis and assuming its current methodology. Therefore, we believe no action is required to meet this test for the Ofwat metrics.

The tables also show that these metrics against the Ofwat stress tests are met. The boxes coloured red indicate where the ratios suggest the possibility of a downgrade but remain at levels necessary to maintain investment grade.

4.5.7 Actual Structure Financeability Against the Company's Covenants

Table 6: Covenant ratios

Actual Structure Ratios				Base Case	+10% Totex	Financial Penalty (3% Revenues)	ODI Penalty (3% RORE)	Bad Debt Increase 5%	Inflation High	Inflation Low	Cost of New Debt +2%	Combination - +10% Totex, Financial Penalty 1% Revenues & ODI Penalty 1.5% RORE
Covenants	***Trigger***	***Default***										
Class A Adjusted ICR	*1.3*	*1*	*Avr*	2.1	1.9	1.9	1.8	2.1	2.2	2.0	2.0	1.6
Senior Adjusted ICR	*1.1*	*n/a*	*Avr*	1.8	1.6	1.7	1.6	1.8	1.9	1.8	1.8	1.5
Class A RAR	*75%*	*n/a*	*Max*	71%	76%	71%	72%	71%	70%	72%	71%	77%
Senior RAR	*85%*	*95%*	*Max*	81%	85%	81%	81%	81%	80%	81%	81%	86%

Source: Affinity Water

Our bond programme is governed by Whole Business Securitisation (WBS) documentation, which encompasses a series of covenants that the Company must meet in addition to its regulatory requirements. The assessment of the ability to meet these covenants within the Represented Plan forms a significant part of the Boards assessment of the financeability of this plan. We set targets against the covenant ratios to maintain headroom against the lockup and trigger levels.

Table 6 above shows performance against the Company's covenant ratios. These covenants are set in our lending documents. The trigger level - if breached - would require increased reporting and would lockup dividend payments. If the default level were breached, the creditors take control of the holding company. The covenants are assessed at the AWL level, the same level as our corporate family credit rating is assessed. The table above shows that AWL meets its covenants with the Represented Plan for all four capital structures.

Under the stress tests, the covenants do breach the trigger levels for the 10% totex overspend scenario and the combined scenario. This is mainly on the gearing ratios and this would result in a high gearing. However, the default levels are not breached and therefore the Company is financeable with the Represented Plan.

4.5.8 Actual Structure Financeability by Maintaining an Investment Grade Credit Rating

Table 7: Credit rating ratios

Actual Structure Ratios			Base Case	+10% Totex	Financial Penalty (3% Revenues)	ODI Penalty (3% RORE)	Bad Debt Increase 5%	Inflation High	Inflation Low	Cost of New Debt +2%	Combination - +10% Totex, Financial Penalty 1% Revenues & ODI Penalty 1.5% RORE
Rating Agency	***Target***										
Moody's - Adjusted ICR	*1.4*	*Avr*	1.6	1.6	1.6	1.3	1.6	1.6	1.5	1.5	1.6
S&P - FFO/net debt	*7%*	*Avr*	7.9%	6.6%	7.2%	6.9%	7.9%	7.7%	8.2%	7.8%	5.9%

A key consideration in the Company assessing its financeability is its ability to maintain its credit ratings. The ratios and stress tests shown in the tables above demonstrate that the company meets the ratio levels currently required to maintain its credit ratings based on Moody's and S&P's current rating methodology for the actual capital structure. However, it should be noted that the ratios for Moody's make up 40% of the requirements of the credit rating. Other factors that make up the rating are Business Profile (50%) and Financial Policy (10%). There is also a one (1) notch uplift for Structural Considerations that is based on the Company's corporate structure, its regulatory licence or its financing arrangements. Moody's views structural enhancements in AWL's financing structure as credit positive as it provides protection to creditors. These enhancements are incorporated in our financing agreements and also in our regulatory licence. We confirm that we will maintain these structural enhancements in the long run. For S&P the weightings are based on business risk and financial risk with capital structure forming part of the anchors that modify the rating.

The performance of the credit rating ratios for the Company show that the ratios are satisfied with the credit rating agencies current process and methodology. Therefore, the Company's Represented Plan is expected to maintain its credit rating and is financeable.

4.5.9 Actual Structure Financeability by holding Sufficient Cash Reserves

The ability of the company to finance the plan and hold sufficient cash reserves in its financeability assessment, the Company has considered the requirements to fund the Represented Plan. Our objective is to ensure we have adequate funding arrangements, cash and standby facilities to enable us at all times to have the level of funds available for the achievement of our business and service objectives. At 31 July, we held cash balances of £114.9m and undrawn revolving credit facility of £100m, as well as debt service reserves which we plan to continue to hold. The high cash balance reflects the pre-funding of AMP7 undertaken to reduce the financing risk. A further £86m of Debt is required to fund the investments planned and £14m of our existing debt matures in AMP7. This assumes all appointee distributions are held for de-gearing and a further equity amount of £35m is injected in the AMP. Our Represented Plan assumes that the remaining cash need is funded through additional external debt with £43m (50%) raised as index linked

Interest rate exposure is primarily managed by using a mixture of fixed rate, floating rate, CPI and RPI linked to deliver the investment proposed in the Represented Plan. In August 2018, we put in place a swap to move £135m of bonds from fixed to be index-linked. This swap further supports the financeability of the Represented Plan.

4.5.10 Securitisation Requirement to Submit a Plan that Maintains the Current Credit Rating

The securitisation documents include a clause relating to price determinations (para 3 part 2 (*Financial Covenants*) schedule 4 of the CTA (the "**Price Determinations covenant**")). This requires AWL to apply for a price determination which, in the reasonable opinion of the AWL directors, would allow the current credit ratings of the applicable bonds to be maintained.

"At each Periodic Review and in making each IDOK application, AWL must apply to Ofwat for a price determination which, in the reasonable opinion of the AWL directors, would allow, at a minimum, a credit rating the same as the then current credit rating to be achieved and maintained for the Class A Bonds and the Existing Issuer Bonds from each of the Rating Agencies."

A breach of the Price Determinations covenant would lead to an event of default under the AWL group's debt arrangements.

In order not to breach the Price Determinations covenant, the AWL directors would need to reasonably form the opinion that the pricing AWL is applying for would allow the current ratings of the applicable bonds to be maintained.

The directors have reviewed the ratios in relation to current credit ratings and believe that the Represented Plan should enable the company to maintain its current credit rating based on the current methodologies and calculation methods applied by Moody's and S&P, the two agencies that provide the credit rating of the company. Evercore have completed a review of the financeability of the company based on model outputs provided by Affinity in respect of the Represented Plan and in their reasonable opinion they support this view.

4.5.11 Third Party Assurance of Our Financeability

AWL have engaged with Financial Advisors Evercore to undertake the third-party assurance work on the Represented Plan. On the actual capital structure, the financeability conclusions are:

- Evercore's reasonable view is that, based on the financial ratios on the actual capital structure under the Represented Case, Affinity will be able to maintain its current Moody's CFR of Baa1 and its Class A and Class B ratings of A3 and Baa3, respectively;
- Evercore's reasonable view is that, based on the financial ratios on the actual capital structure under the Represented Case, Affinity will maintain its current S&P Class A and Class B ratings at A- and BBB, respectively; and

The Long Term Viability conclusions are:

- Evercore's reasonable view is that Affinity's Represented Plan provides sufficient headroom to remain compliant with its financial ratio covenants under the Combined Downside case in AMP7/8;
- Evercore's reasonable view is that Affinity will maintain its investment grade rating with Moody's and S&P on its Class A and B bonds under the Combined Downside case; and

4.5.12 Financial Resilience

The Draft Determination requires that we provide further assurance on about how Affinity Water will maintain its long-term resilience. In the gearing section of this document, section 5.5.1 we explain our plans to reduce gearing. In this section, we list out the main principles we apply to maintain long-term financial resilience.

Maintenance of Financial Ratios to a minimum trigger and default level (below are the Trigger levels):

i. the Class A RAR is or is estimated to be more than 0.75:1;
ii. the Senior RAR is or is estimated to be more than 0.90:1;
iii. the Class A Adjusted ICR for any Test Period is or is estimated to be less than 1.3:1;
iv. the Senior Adjusted ICR for any Test Period is or is estimated to be less than 1.1:1;
v. the Class A Average Adjusted ICR for any Test Period is or is estimated to be less than 1.4:1;
vi. the Senior Average Adjusted ICR for any Test Period is or is estimated to be less than 1.2:1;
vii. the Conformed Class A Adjusted ICR for any Test Period is or is estimated to be less than 1.3:1;
viii. the Conformed Senior Adjusted ICR for any Test Period is or is estimated to be less than 1.1:1;
ix. the Conformed Class A Average Adjusted ICR for any Test Period is or is estimated to be less than 1.4:1; or
x. the Conformed Senior Average Adjusted ICR for any Test Period is or is estimated to be less than 1.2:1.

Maintenance of reserve bank facilities

We maintain a Debt Service Reserve requiring an amount equal to the next 12 months' interest and other finance charges forecast to be due Debt of the Company.

We hold an Operating and Maintenance Reserve bank facility requiring 10 percent of AWL's Projected Operating Expenditure and Capital Maintenance Expenditure for the next succeeding 12 months.

Financial Indebtedness

The company cannot incur any Financial Indebtedness other than Permitted Financial Indebtedness or, in the case of AWL, indebtedness under Permitted Volume Trading Arrangements.

Financial Indebtedness maturing does not exceed the greater of 20% of RCV or £250m within a 24 month period or 40% of RCV over a Price Review period.

Insurances

The company is required to maintain in full force and effect at all times insurances in respect of all risks which are required to be insured against under any applicable law or regulation and any additional risks which a prudent owner would insure against provided an appropriate insurance is available on reasonable commercial terms.

Cash Management

Maintain the following Accounts with the Account Bank, Operating Accounts, O&M Reserve Account and a Debt Reserve Account. The Debt Service account will accrue 1/12th of the Annual Finance Charge every month.

Authorised Investment Minimum Rating means, in respect of any person or investment, such person’s or investment’s short-term unsecured debt obligations being rated, in the case of:

(a) Moody’s, "P-1";

(b) S&P, "A-1"; and

(c) Fitch (to the extent the Fitch Appointment Right has been exercised by the Transaction Agent), "F1",

Hedging Policy

The Company is permitted from bearing currency risk in respect of foreign currency denominated debt instruments.

Hedging Counterparty Minimum Day 1 Rating Requirement means, in the case of Moody's: A3, in the case of S&P: A-, and in the case of Fitch: A-

If any Hedging Counterparty ceases to be rated Investment Grade by any Rating Agency, such Counterparty will be required to post the Credit Support Amount in accordance with the terms of the relevant Credit Support Annex entered into in respect of any relevant Hedging Agreement.

4.6 Our View of the Weighted Average Cost of Capital (WACC)

We are concerned by the low level of the WACC. In the Draft Determination, it reduced to 3.08% CPIH deflated (2.08% RPI deflated), a drop of 22bps mainly driven by a reduction in the cost of embedded debt, whilst assuming a higher proportion of embedded debt and a reduction in the assumed cost of equity. Ofwat has indicated a possible further reduction of 37bps could be implemented in the Final Determination.

We have explained in the PAYG report in In AFW-FR-Appendix F of this paper that the notional company is on the edge of financeability with the reduced WACC of 3.08% CPIH deflated (2.08% RPI deflated). We believe that the further reduction as indicated would mean that the notional company would not be able to achieve the target Baa1 rating and the Baa3 rating under stress. Our plan has already required an uplift in the PAYG to achieve the ratios required. If Ofwat's 'Early View' of WACC of 3.3% CPIH deflated (2.3% RPI deflated), as used in the IAP, had been used instead, the PAYG uplift would be 2.1% and not the 3.4% included in the Represented Plan. We are therefore compensating for the reduction in the WACC with an uplift in the PAYG to maintain the credit rating of the notional company.

The PAYG has limited use for improving the financeability of the company as Moody's have said they do not see the use of PAYG as a legitimate mechanism to bring forward revenues to improve financeability;

> *"The regulator views the adjustment of PAYG and run-off rates as economically equivalent to the change in indexation measures, because they involve a trade-off between fast money (received through revenue through the detriment of RCV growth) and slow money (increased RCV growth with lower short-term revenue). However, we believe that there is a key difference: the switch to CPIH is a permanent change that applies to all companies in a similar way, while PAYG and run-off rates are partly within companies' control and can change between periods, distorting comparability between companies and over time. We will continue to remove the regulatory depreciation as well as excess PAYG to calculate company-specific AICR ratios."*
> ***Source: Moody's (2019), 'Ofwat tightens the screws further, July 2019***

This means that it may not be possible to make the notional company financeable to achieve the interest cover ratio required by Moody's to achieve a Baa1 credit rating by further uplifting the PAYG.

A similar affect also applies to Affinity Water's financeability. Section 4.5.8 shows that the ratios are tight to maintain the current credit rating. A drop of 37bps would put this credit rating at risk. This is caused by lower annual cashflows and cannot easily be solved by changing the capital structure of the company.

We have reviewed Anglian Water's discussion document 'PR19 – Notional Company Financeability A discussion paper: August 2019 Update Annex to our 2018 paper on Notional Company Financeability' We fully support the paper and the arguments it makes relating to the WACC. We agree for the need for a higher WACC for the industry especially when taking into account the increased risks companies in the sector are facing from the challenges set in the Draft Determination and macroeconomic issues. We support the view set in the Anglian paper that the WACC should be increased.

The main points to the argument are listed below along with the amendments we believe should be made to the calculation of the WACC;

- We note that Ofwat has changed the methodology since its 'early view' on how it calculates the point estimate. We believe this should revert to the 'early view methodology';
- The WACC calculation does not take into account the assessment of the majority of swaps that companies hold, which were entered to efficiently finance investments;
- The current low interest rates that are factored into the calculation penalise companies that have longer dated debt. We believe the swaps should be reflected in the calculation;
- The risks of Brexit related currency and high inflation are not captured in calculation;
- Ofwat has assumed an increase to 25%bps from 15%bps for the Halo effect at a time that due to regulatory actions, credit rating agencies have strong negative views of the sector. This has been reflected in the value of the listed companies. We acknowledge that companies have outperformed debt costs in the past but the macroeconomic and regulatory condition that enabled this are no longer there. We believe the halo effect should be removed from the calculation; and
- Companies are unlikely to meet the A3 iBoxx non-financial index chosen by Ofwat in its WACC calculation. This underperformance is not captured in the WACC calculation

4.7 RoRE Outcomes

4.7.1 Our response

We have re-run our RoRE calculations having made adjustments to reduce downside retail cost risks. As a result, the negative skewness in RoRE arising from retail costs is diminished compared to our updated business plan.

Table 8: RoRE ranges for retail costs

	IAP response		DD reflecting interventions		Response to draft determination	
Retail costs	-0.97%	0.32%	-0.46%	0.30%	-0.32%	0.32%

Source: Affinity Water

There are two material interventions to RoRE ranges in the draft determination. First, Ofwat have reduced the downside risk for retail costs we projected, so that it is more closely aligned to industry comparators. We do not wish to make further representations on this intervention and have adopted it in our re-run of RoRE (see AFW.RR.C4 below)

Second, Ofwat have aligned RoRE risk ranges for outcome delivery incentives to those in its draft determinations. Elsewhere in our response to the draft determination, we are proposing certain alterations to the draft determination outcome delivery incentives, as below:

- Adjust the PC, collar & cap and underperformance penalties for the mains repair ODI;
- Reduce the underperformance penalty for the properties at risk of low pressure;
- Alter the ODI for unplanned interruptions > 12hrs so that it is non-financial; and
- Extend the discolouration ODI so that it includes other aesthetic parameters.

We have re-run RoRE risk ranges to be consistent with the outcome delivery incentive parameters we propose in our draft determination response. The contribution towards RoRE variation of our retail cost downside adjustments and the alterations to ODIs is tabulated below:

Table 9: Selected Affinity Water RoRE ranges

	IAP response		DD reflecting interventions		Response to draft determination	
Base RoRE	4.6%		4.3%		4.3%	
Outcome delivery incentives	-2.83%	0.27%	-3.15%	0.15%	-2.58%	0.09%
Retail costs	-0.97%	0.32%	-0.46%	0.30%	-0.32%	-0.32%

Source: Affinity Water

We confirm that our RoRE modelling demonstrates that we are able to achieve the base return on equity at the notional capital structure.

The RORE analysis and data supporting data table App26 has also been updated to include the changes made to uncertainty mechanisms, removing the previously proposed items and including the impact of a mechanism dealing with metaldehyde treatment.

As noted above we have re-run RoRE and included adjustments for retail cost downside relative to our revised plan, and for adjustments to ODIs relative to the draft determination.

4.8 WRFIM Adjustment

Ofwat has disallowed our proposed adjustment to the revenues included within the WRFIM, while highlighting additional evidence that it would need to consider our case further. In this representation, we:

- Set out the evidence Ofwat has asked for;
- Update our actual and forecast revenue variance for new information not available when we submitted our revised plan;
- Respond to Ofwat's challenges on justification of our 2019/20 forecast and inclusion of infrastructure charges in the claim; and
- Present our revised claim for a WRFIM adjustment, informed by the evidence presented.

4.8.1 Structure of the representation

We summarise the variance experienced in new connections in section 4.8.2, and the variance in grants and contributions revenue in section 4.8.4. We provide further evidence to support our forecasts for 2019/20 (section 4.8.3).

Ofwat states that we still need to provide the following:

- Sufficient explanation to support the level of our PR14 forecasts (provided in section 4.8.5).
- An explanation of the process we went through to assess our forecasts at PR14 and how we took account of these types of connections in our assessment (section 4.8.6).
- The reasons why these types of connections have increased so significantly from forecast (section 4.8.7).

We respond to Ofwat's other feedback, including:

- Ofwat's specific intervention on infrastructure charges in section 4.8.11.
- The extent to which this was within management control, and the mitigation actions we undertook (section 4.8.13)

Charges should be cost reflective and therefore we need to demonstrate that the revenues we received from infrastructure charges are linked to actual costs. We set out the evidence in Section 4.8.12.

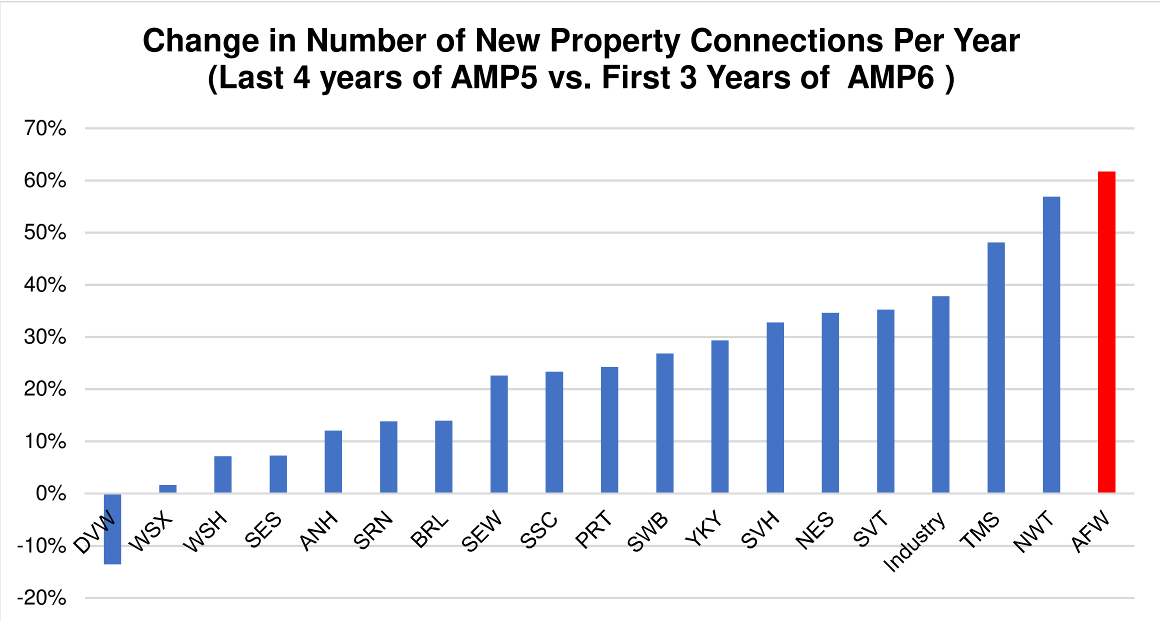
Finally, we summarise the WRFIM adjustment in our represented plan in Section 4.8.14.

4.8.2 Summary of the variance in new connections

As set out in our revised plan, the WRFIM adjustment is needed because our rate of new connections in AMP6 has been significantly higher than we forecast at PR14, making us an outlier. The main driver of this was that our forecasts (prepared by our expert advisers Experian and based on Local Authority projections at the time) took a view that the housebuilding forecasts would be flat in AMP6, whereas our outturn new connections show that the housebuilding market has recovered significantly in our operating area. Neither we, nor our advisors, nor property market experts at the time were able to predict that the market in our area would recover to the extent that it has (further evidence to support this is set out in sections 4.8.5-4.8.10).

Our average number of new connections between 2011/12 and 2014/15 was 10,993 per year. In the first three years of AMP6 this increased to 17,776 properties per year (a 62% increase). By contrast, over the same time period, industry total new connection activity (excluding AFW) was 137,485 properties per year, increasing by 36% to 186,803 per year in the first three years of AMP6. These results are illustrated on the following chart which shows that growth rate of new connections has been strongest in our area.

Figure 3: Change in number of new property connections per year



Source: Affinity Water analysis. Reproduced from our revised plan

As Ofwat has noted, the variance has been driven mainly by 'internal' connections indicating that a high proportion of new connections to individual properties fed off a large supply (e.g. a block of flats). We have also seen an increase in self-lay provision in our area from 0% forecast at PR14 to 16% in AMP6. This is set out in the table below.

We welcome Ofwat's statement that "Affinity Water has been able to demonstrate that there was a significant increase in new connections to individual properties fed off a large supply (e.g. a block of flats)[1]" compared with our forecasts. We also welcome that Ofwat sets out additional evidence that it requires[2].

Table 10: Drivers of the variance in number of new connections

Number of properties (000) (% of total)	Offsite (ad-hoc single supplies)	Onsite (single connections within a new development)	Internal (multiple connections fed from a large supply e.g. flats)	Self-lay	Total
PR14 BP (000 properties)	15.3	15.3	11.0	0.0	41.6
PR14 BP (%)	37%	37%	26%	0%	
Actual/ Forecast AMP6 (000 properties)	13.9	15.4	35.4	12.5	77.2
Actual/ Forecast AMP6 (%)	18%	20%	46%	16%	
Variance	**-1.3**	**0.1**	**24.4**	**12.5**	**35.6**

Source: Affinity Water analysis. Reproduced from our DD query responses

In our APR19, we reported 12,329 new connections in 2018/19 versus the 16,994 we forecast in our revised plan. The APR19 number is the number of new customers on our billing system rather than the number of new connections completed in our Developer Services department. The reasons for the variance are as follows:

- 14,000 new connections were actually completed during 2018/19. Therefore, 1,671 connections were completed during the year but not added to our billing system at the year end.

The MHCLG data for the local authority areas that we serve suggest that the number of new properties in 2017/18 and 2018/19 was very similar (with 2018/19 being 1.01x the 2017/18 number). This suggests that the remaining variance in connections could be due to timing (e.g. to settle charges with developers).

In the next section, we set out revisions to our 2019/20 projections. We have used actual run rates during 2019/20 rather than 2018/19 data to revise our forecasts as the actual data are more reflective of experience in the current year.

4.8.3 Further evidence to support our forecasts for 2019/20

In this section, we set out an assessment of our revised plan 2019/20 forecast. We understand the need to justify our 2019/20 forecast, given that the rate of new connections forecast is higher than we have seen in AMP6 actual performance to date.

We tested our revised plan forecast for 2019/20 of £17.060m contributions. We now have our quarter 1 actual data (which were not available to us during the DD query process). The table below shows our quarter 1 figures and the extrapolation to year end. Our internal forecasts are still tracking close to the revised plan, and we are still planning towards the revised plan forecast given that quarter 1 is within the normal range of variance that we might expect to see in a given quarter. However, we want to present a 2019/20 projection that is prudent for the purposes of our WRFIM claim. Making an extrapolation of the monthly actual data to the end of the year suggests that a £1.460m reduction to our claim might be reasonable to assume given the experience in quarter 1.

[1] Source: Ofwat, July 2019. "Affinity Water – Accounting for past delivery actions and interventions", p6, AFW.PD.A5.
[2] In AFW.PD.A4

Table 11: Analysis of our actual grants and contributions revenue from Q1 2019/20

£m	April 2019	May 2019	June 2019	Q1 total	2019/20 forecast
A. 2019/20 Forecast (IAP response)	N/A	N/A	N/A	N/A	**17.060**
B. Capital contributions (excluding diversions) Q1 actuals and Q1 total	0.543	0.557	0.684	1.785	N/A
C. New connections (excluding retail element) Q1 actuals and Q1 total	0.609	0.739	0.767	2.115	N/A
D. Q1 grants and contributions (B + C)	**1.152**	**1.296**	**1.451**	**3.900**	N/A
E. Total prudent projection for revised WRFIM claim (4 x the Q1 total from line D)	N/A	N/A	N/A	N/A	**15.600**
Variance (E – A)[3]	N/A	N/A	N/A	N/A	**(1.460)**

Source: Affinity Water analysis.

This has resulted in a data change in Table WS1 – we have reduced our 2019/20 connection charges revenue to £7.461m (we previously forecast £8.921m). We have also made a £1.460m reduction to our WRFIM claim and have adjusted our WRFIM model accordingly.

We have not, at this stage adjusted our property forecasts for the following reasons:

- We are seeing a strong pipeline of new development in the early months of 2019/20 which suggests that the rates of new connections we have seen during AMP6 so far could potentially be maintained in response to the market stimulus that is in place at the moment from Help to Buy (see section 4.8.9 for our analysis of the impact).
- We can adjust our WRFIM claim to a more prudent projection without changing our demand forecast.
- Changing the property numbers would mean we need to change multiple data across our plan because we would need to revise the demand forecast which is based on the property forecasts. It would also lead to inconsistency with our WRMP.

4.8.4 Summary of the variance in grants and contributions

Our PR14 allowance for grants and contributions was £45.713m, whereas, by the end of AMP6 we expect to have collected £66.910m. This is a variance of £21.197m which is detailed in the table below which is £1.460m less than the amount of £22.657m included in our submission of 15 July 2019.The expected amount is different from our revised plan because we now have an additional year of actual data.

- Our actual developer contributions for 2018/19 were £15.841m versus £17.011m forecast contributions. These were reflected in the WRFIM model we submitted on 15 July 2019.

Our revised assessment of the variance between actual and forecast is set out in the table below.

[3] This is the reduction we have applied to our WRFIM claim.

Table 12: Impact of adjustments for 2019/20 on revenue variance

£m	2015/16	2016/17	2017/18	2018/19	2019/20 (prudent projections)	AMP6 Total
FD14 allowed grants and contributions (2012/13 prices)	8.383	8.354	8.015	7.846	8.029	**40.627**
FD14 allowed grants and contributions (outturn prices)	9.037	9.100	8.922	9.073	9.581	**45.713**
Actual and prudent view of grants and contributions (outturn prices)	9.199	13.185	13.085	15.841	15.600[4]	**66.910**
Variance	0.162	4.085	4.163	6.678	7.571	**21.197**

Source: Affinity Water analysis.

We have not benefitted in any way from the increase in new connections above forecast because the contributions from developers are used to cover additional costs incurred in putting new infrastructure in place (evidence for this is presented in section 4.8.12). This new infrastructure connects the new properties to our network, funded through one off connection charges. It also contributes to reinforcing the network to support current and future growth, helping us maintain our service to customers.

4.8.5 Supporting the level of our PR14 forecasts

Our demand forecasts were prepared for our WRMP14, and followed the industry methodologies specified in the Environment Agency guidance[5]. The WRMP Guideline emphasised that "The main source of information for projecting current and future population and household numbers in England must be local authorities and local planning documents[6]". Experian undertook our property and population forecasts at PR14[7].

Experian also prepared forecasts for seven other companies, none of whom have had as extreme an issue with variance as we have (Wessex Water, Sutton and East Surrey Water, Southern Water, South East Water, and Portsmouth Water are all significantly below the industry average rate of change as shown in Figure 3).

Thames Water has a larger than average variance, which makes sense given the overlap of Affinity Water's area with parts of Thames Water's area. None of the other companies for whom Experian prepared forecasts have had cause to make a WRFIM claim, which reflects that the variance they experienced was significantly less than ours in most cases. Our analysis below shows that the Help to Buy scheme was slower to help bolster housebuilding recovery in London (and in our area more widely, see Figure 5 and Table 13).

Experian obtained data from local authorities on planned housing projections, from the Office for National Statistics (ONS) on population estimates and from analysis of the population census 2001. Experian prepared three forecasts based on:

- DCLG property forecasts available at the time;
- Local Authority plans; and

[4] This represents a prudent view and incorporates the adjustment to our WRFIM claim as set out in Table 11. As stated above we are still working to our revised plan forecast for our internal reporting
[5] Environment Agency, 2012 "Water Resources Management Planning Guideline"
[6] Environment Agency, 2012 "Water Resources Management Planning Guideline" p70
[7] Included as an appendix (AFW.Repr.Financial Resilience.WRFIM.1)

- Experian's view of the likely demand forecast (which assumed that the forecast population would be realised but at a lower rate of new property development).

None of these forecasts predicted the actual new connections realised during the AMP (they all predicted lower numbers). Notably, Experian's own property forecast assumed a lower rate of new development than the forecast based on local authority plans, which shows that the experts who helped estimate our forecast new properties did not foresee the significant increase in new development that we have experienced.

We reviewed Experian's results to determine which of the three sets of forecasts should be used for our WRMP14. Our review comprised a comparison of the forecasts with projections undertaken for the previous WRMP (2009) and with actual numbers of new properties connected for water supply over the previous six years. We also adjusted the household property figures to align with our actual household number for our three operating areas from billing records for 2012 to adjust for unoccupied and multi-occupancy properties as well as special supplies such as animal troughs and garages.

We reviewed the three forecasts and concluded that local authority plan-based housing projections were the most appropriate and were fully compliant with the Environment Agency guideline. This approach reconciled with our actual (AMP5) numbers of new housing connections. We also carried out a sensitivity check on the potential effect of using the trend-based figures as part of supply demand modelling. Our WRMP14 forecast (supported by the Experian projections) is 288,000 new properties over the entire WRMP14 period (a rise of 22% on average)[8] , and 41,563 new connections in 2015-20. The basis for this forecast is explained further in section 4.8.6.

We reviewed independent evidence from around the time we were preparing our PR14 plans (i.e. 2013 and the first half of 2014) to test whether the housebuilding market recovery seen during AMP6 had been foreseen by others. PwC's Economic Outlook generally includes a section on the housing market. We looked at the economic outlook publications from around the time of the WRMP14 forecasting to compare the assessments of the housebuilding markets. The July 2013 full PwC economic outlook report[9] states that:

"The supply of housing has been quite subdued since 2007... Over the last couple of years, while the number of dwellings completed has increased very gradually, dwellings started have still witnessed a downward trend"… "PwC experts on housebuilding think that confidence levels amongst builders are still relatively low as regards prospects for a strong recovery in the market. Another reason why supply is subdued is because of planning permission delays. Furthermore, after the housing market crash, not much cash was reinvested to get land ready to be built upon since the house builders were more concerned about bringing their debts down. For all these reasons, it is likely to take many years for the UK housing stock to rise to meet any increase in demand."

The PwC Economic Outlook published in 2014[10], stated that there had been a recovery, but remained cautious about the prospects for the longer term, stating that:

"Private housing construction has been a source of strength. New private housing output was 13% higher in August than it was a year earlier. However, over the month it fell by 5.5% suggesting that new private house building might be starting to slow."

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[8] Source: Affinity Water "Final Water Resources Management Plan for 2015-40." p109
[9] PwC, July 2013. "UK Economic Outlook, July 2013." Feature article: Is the UK housing market on the road to recovery? pp20-21
[10] PwC, November 2014. "UK Economic Outlook, November 2014." p14. This falls slightly later than the planning timeframe.

4.8.6 How we assessed our forecasts at PR14

As set out above, we used an expert consultant (Experian) to generate a number of new property scenarios. We assessed these scenarios as set out below and chose the one we assessed to be both credible and compliant with the WRMP Guideline.

Experian took account of Local Authority plans in its forecasts. The local plans will have assumed a property mix (e.g. of dwelling type and greenfield/ brownfield mix) that was incorporated into the forecast. Experian also sought to calibrate the forecasts using site level planning application and contract progress data sourced from Emap Glenigan. This will also have revealed the planned mix of properties and types of site served in the developer pipeline for our operating area[11.]

We included an appendix to WRMP14 which assessed the property and population forecasts[12]. This included analysis comparing our historic (PR09) forecasts with actual new development, distinguishing with 'on site' (larger scale) new development and ad hoc development. The analysis showed an upsurge in the number of flats versus houses in the run up to the financial crash. The number of flats completed in our area declined after the crash, whereas the number of houses increased.

None of the alternative projections predicted that the number of new connections would be more than double our favoured approach. Recovery in the new homes market has elevated the number of new connections and this is not within our management control.

As stated above, the prevailing view at the time was that the housing market was not likely to recover quickly. Hence, at the time, we assessed that the flatter trend of the Experian forecast was more realistic than the profile for PR09 (which had over-estimated new connections in the early years of AMP5).

The PR14 demand forecasts (including forecast new connections) were audited by our technical assurers, Atkins. They did not raise any issues with the Experian forecasts, nor with our use of those forecasts.

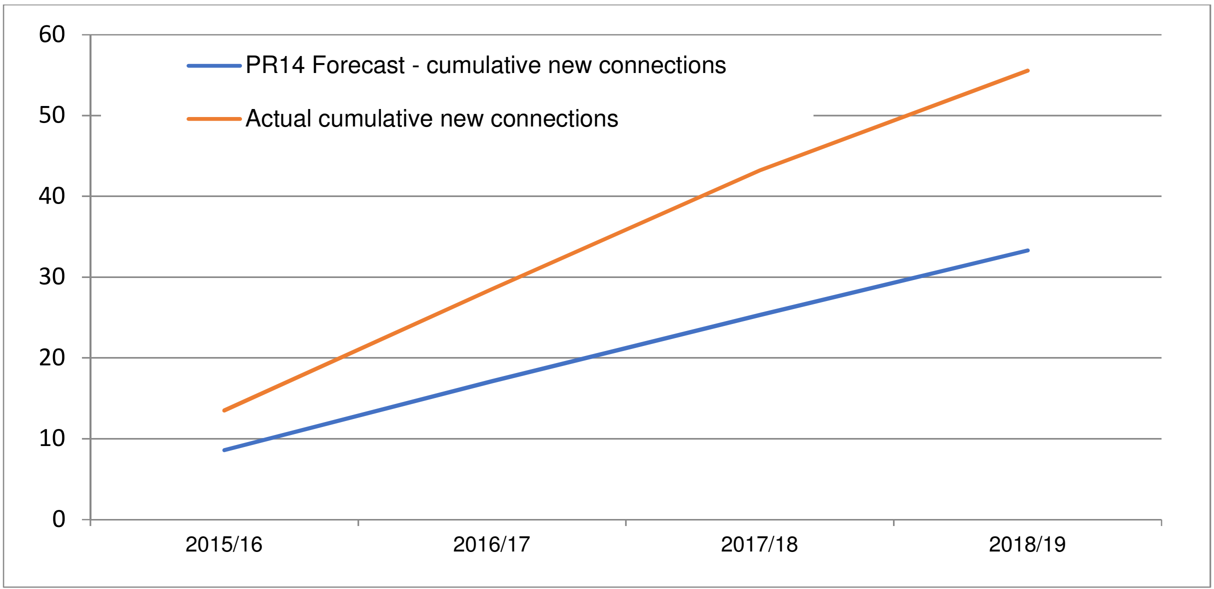
In its representation on our PR14 draft plan, the Environment Agency stated that "The company has followed appropriate methods to derive and estimate key components of the plan, including supply, estimating population and properties, headroom and the impact of climate change.[13]"

4.8.7 Reasons for variance between PR14 forecast and actual grants and contributions

Given that our forecasts were based on local plans, the rate of new development was also significantly higher than predicted by local authorities at the time. The difference between our PR14 forecast and actual was due entirely to an upturn in the housebuilding market that was not predicted by sector experts at the time we wrote our 2014 WRMP. The difference is shown in Figure 4.

[11] Source: Experian, June 2013. "Population, Household and Dwelling Forecasts for WRMP14: Phase 2 Draft Final Report. Affinity Water"
[12] Affinity Water, September 2013. "Water Resources Management Plan Technical Report 2.2. Updates to the domestic housing and population forecast."
[13] Environment Agency, July 2013. "Representation on Affinity Water's draft water resources management plan" p3

Figure 4: Cumulative forecast verses actual new connections 2015-19 (property numbers in thousands)



Source: Affinity Water analysis.

The upturn in the housing market has partly been driven by stimulus to promote the supply of housing. A number of factors have stimulated the market that we could not have foreseen when we forecast at PR14. The main stimuli that we believe to have impacted our AMP6 outturn new connections are:

- The Mayor of London's Housing Zones
- Help to Buy Equity Loan Scheme
- Stimulus for affordable housing in London

4.8.8 Initiatives affecting North London

The Mayor of London has designated 30 'housing zones' across London, including seven zones in the London Boroughs that Affinity Water serves. These are expected to generate 25,164 properties in the Boroughs we serve over 2015-25[14]. Given that this initiative runs until 2025, we expect that new property numbers in our North London area will continue to be supported above the natural rate of new development until the end of AMP7.

The stimulus available for affordable homes is also greater for London. Over the period 2015-19, housing association developments in the London Boroughs we served were 25.3% of the total (versus 18.3% across all the Local Authorities falling within our operating area)[15]. The affordable homes programme for 2016-21 is an example of a City Hall initiative that has bolstered new development rates for housing association and local authority housing in greater London.

Further stimulus for affordable housing has been announced more recently. For example, City Hall cites that £4.8bn has been secured from the Government to help start building at least 116,000 affordable homes by March 2022, in a prospectus published in 2018. Around £235m of this is allocated to the

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[14] Source: City Hall Website, sum of total properties expected from two housing zones in Brent, one in Ealing, two in Enfield, one in Harrow and one in Hillingdon.
[15] Source: Affinity Water analysis of MHCLG live table 253

London Boroughs falling within our operating area[16]. We assume that this initiative would have an impact on our future new connections.

4.8.9 The Help to Buy Equity Loan Scheme

The Help to Buy Equity loan scheme had started around the time we were making our PR14 forecasts (it was launched in April 2013). However, the likelihood of the scheme providing effective stimulus for new build properties was initially downplayed when the scheme launched in 2013[17]. This coincided with the period when we were preparing our forecasts, and initial uptake was relatively lower than it is now (see Figure 5). Hence, it was not clear when we were preparing our PR14 plans that Help to Buy would have a significant impact.

More recent assessments of the Help to Buy scheme acknowledge the impact on housebuilding. For example, the NAO progress review of Help to Buy[18] states that “Our literature review also identified suggestions that Help to Buy has supported and increased new build house prices through increased demand”.

The chart below shows the uptake of the Help to Buy Equity Loan Scheme in the Local Authority areas that we serve (in full or in part) as a percentage of total new properties. The Help to Buy Equity Loan scheme is only available to purchasers of new build properties. Properties provided for the Help to Buy scheme are a significant and growing proportion of our new connections. Based on the analysis of MHCLG data for 2018/19, Help to Buy completions made up around 45% of total new properties in our East area, around 30% in our South East area and around 25% in our Central area. All areas show a rising trend in Help to Buy as a proportion of total new builds. The underlying data show an increase in absolute terms from around 1,750 properties across the Local Authority areas in 2013/14 to around 5,330 properties in 2018/19.

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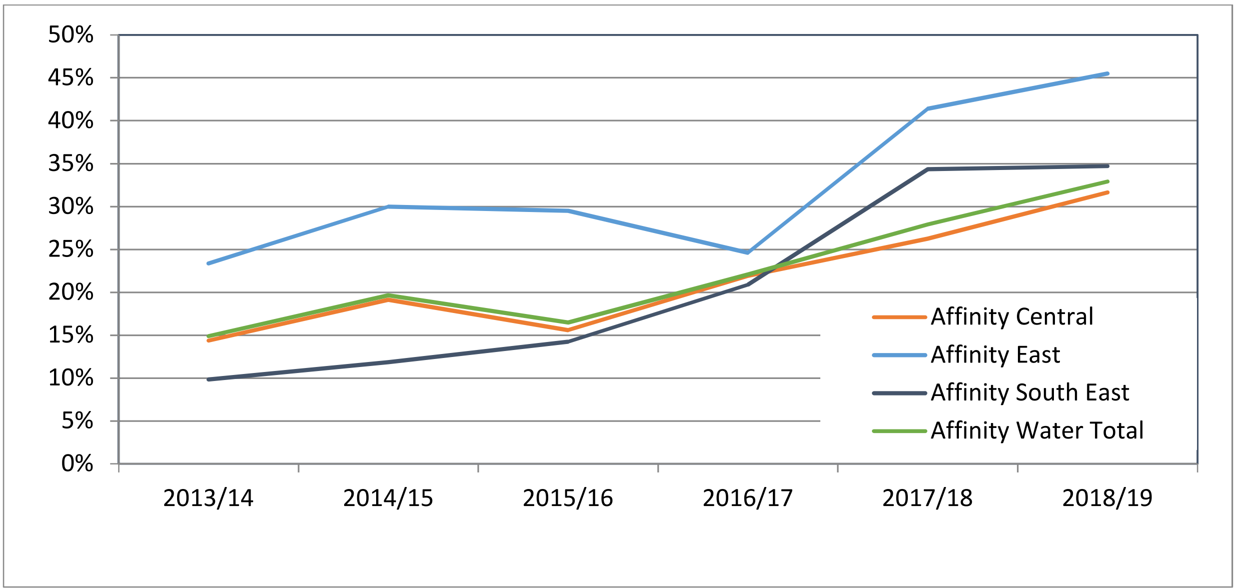
[16] Source: City Hall website

[17] *The Guardian (Josephine Moulds and Jennifer Rankin, 26 March 2013). "Help to Buy scheme could drive up house prices, says OBR". The report cites OBR evidence to* the Treasury Select Committee: *“The OBR said … that the scheme would do little to boost the construction industry but was likely to inflate property prices.”*

[18] NAO June 2019. “Help to Buy: Equity Loan scheme – progress review”

Figure 5: Help to Buy Equity Loan properties in Local Authority areas served by Affinity Water (annual completions) as a percentage of total new property completions



Sources: Affinity analysis of Ministry of Housing, Communities and Local Government (MHCLG) help to buy equity loan statistics (quarterly data by Local Authority), and DCLG LiveTable 253 (new property completions by Local Authority)

The value available for Help to Buy loans has been increased for London since February 2016 at 40% of the market value of the property (increased from 20%)[19]. The rate of uptake in the London Boroughs we serve has risen significantly since the loan percentages changed, to around 35% in 2018/19 (see Table 13).

Table 13: Help to Buy Equity Loan properties in London Boroughs served by Affinity Water (annual completions) as a percentage of total new property completions

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Help to Buy as a % of total new properties in London Boroughs served by us (%)	9.2%	9.8%	9.9%	17.4%	21.6%	35.4%
Total Help to Buy properties in London Boroughs served by us (nr)	309	251	483	739	1,135	1,559

Sources: Affinity analysis of Ministry of Housing, Communities and Local Government (MHCLG) help to buy equity loan statistics (quarterly data by Local Authority), and DCLG LiveTable 253 (new property completions by Local Authority)

While we appreciate that we cannot say definitively that these properties would not have been developed absent the scheme being in place, the evidence suggests strongly that developers have responded.

We anticipate that the number of new connections made to serve purchasers using the Help to Buy Equity Loan scheme will increase in 2019/20, given that there has been an increase every year that the scheme has been running so far. The NAO report on Help to Buy supports this conclusion[20].

[19] NAO June 2019. "Help to Buy: Equity Loan scheme – progress review"
[20] NAO June 2019. "Help to Buy: Equity Loan scheme – progress review". The chart on p23 of the report includes an actual and forecast for 2018/19 of 57,100. For 2019/20, NAO forecasts 62,100 Help to buy properties and 64,300 for 2020/21.

The Help to Buy Equity Loan scheme closes in 2021. However, we understand that there are plans to extend stimulus to 2023. Hence, we expect this to contribute to similar rates of new connections in the early years of AMP7 to those we have seen in AMP6. The NAO report states that:

> *"A new scheme, to follow on immediately from the current scheme for two years to March 2023, will be restricted to first-time buyers and will introduce lower regional caps on the maximum property value, while remaining at £600,000 in London."*

4.8.10 Overall impact of stimulus on housebuilding in our operating area

Our total cumulative variance in new properties between actual and PR14 forecast over 2015-19 is 22,250. Of these:

- Around 15,000 Help to Buy properties have been developed in our area during the same period;
- At a constant annual rate of development, the London Housing Zones initiative adds a maximum of around 10,000[21] new properties in the London Boroughs we serve. Correcting for overlap with Help to Buy[22], the number is around 8,000 new properties; and
- Applying the difference in percentage housing association properties in London Boroughs served by us versus our area more widely gives an estimate of the stimulus for social housing in London. This adds around 330 properties.

4.8.11 Response to Ofwat intervention on infrastructure charges

Ofwat made the following challenge to our WRFIM claim in its response to action AFW.PD.A5:

"We are rejecting the proportion of the claim that relates to infrastructure charges for 2018-20, as, under the new 'Charges scheme rules issued by the Water Services Regulation Authority under sections 143(6A) and 143B of the Water Industry Act 1991', the company has the ability to smooth infrastructure charges over a five year period to recover its costs."

We believe that our current approach to setting infrastructure charges is cost reflective (as evidenced in Section 4.8.12) and will result in charges that are smoothed over a five-year period. Ofwat has not objected to our proposed infrastructure charges. We set out in APR19 that our infrastructure charges receipts broadly balance with the costs (reproduced in Table 15).

That said, we are prepared to vary our claim in the interests of closing the gap between our position and Ofwat's position. We are presenting our alternative view of the proportion of the variance for 2018-20 that relates to infrastructure charges. In our view, the Ofwat intervention appears to be out of proportion given that the variance is only a proportion of the total contributions received. Our analysis is set out in the table below.

[21] I.e. 40% of the 25,164 properties identified for the London Boroughs we serve
[22] 20.9% of our new properties in London Boroughs were Help to Buy over 2015-19.

Table 14: Adjustment for our claim for infrastructure charges component of WRFIM claim relating to 2018-20

	2018-20
A. Total Ofwat adjustment to our claim (£m, this comprises £24m - £15.5m)	(8.500)
B. Total actual and forecast infrastructure charges for 2018/19 and 2019/20 (£m)	11.406
C. Variance in contributions as a percentage of total contributions over 2018-20 (%)	41.0%
D. Adjustment to our claim (B x C)	(4.639)

Sources: Ofwat Draft Determination, Affinity Water analysis.

4.8.12 The link with costs

The charges to developers discussed in this representation comprise mains requisitions, connection charges and infrastructure charges. There is also a link with household and non-household customer bills because all charges within the single till[23] contribute to recovering our allowed revenue.

With respect to our charges for new connections, we recover the costs partly from developers and partly from revenues generated from the new customers. Water companies do not generally recover the full cost of laying the main as it is assumed that the addition of a new bill paying customer offsets some of the value. The difference is therefore recovered through customer bills.

Our infrastructure charges are set to balance our network reinforcement costs over a five-year period as required under Ofwat's charging rules. The table below sets out our analysis of the variance between charges and costs in the first year following introduction of the new charging rules.

Table 15: Comparison of costs and revenues from infrastructure charges

£m	2018/19
Gross infrastructure charges	5.584
Network reinforcement costs	(5.660)
Variance	(0.076)

Source: AFW APR 2018/19 Table 2J

In 2015-18 we were not able to change infrastructure charges other than by inflation. Since 2018/19 we are enabled (through the introduction of new charging rules) to exercise management control to keep infrastructure charges and expenditure in balance. We only have one year's data relating to cost reflectivity, which shows a very small variance (of £76k) indicating that the charges are in balance. This is the best evidence we have currently that our charges will balance over five years – we will achieve this balance through reviewing our charges year on year and keeping the cumulative variance as low as possible.

Although it might be possible to reduce the revenue variance through changing the level of our infrastructure charges, this would not necessarily be cost reflective either over one year or over five years. This method could possibly be used for short term fluctuations in the housebuilding market, if we can predict that the variance is a one-off. The trend in housebuilding over 2015-19 has been a gradual recovery rather than a spike.

[23] By single till, we mean a regulatory approach where two sorts of revenue are accounted for under a single price control. In this instance Ofwat considers revenue from household and non-household customers with revenue from developers (grants and contributions)

We also have a time lag. We set charges prior to the charging year based on information about the previous 1-2 years' revenue recovery, which means corrections for revenue variances for WRFIM are necessarily offset in time.

The overall impact is that we have needed to reduce bills to households and non-households to correct for the revenue variance. The changes to bills we have needed to make as a result of the single till have had knock on effects on our ability to remunerate our other ongoing operating costs[24]. It has meant household and non-household customer bill reductions (as opposed to infrastructure charges as presented above) during AMP6, which will have benefited our customers in the short term. In the longer term, the single till may create less benign bill instability due to fluctuations in the housebuilding market and our future investment needs to build a resilient business.

4.8.13 Management control

We have mitigated for the increase in new properties through reducing bills to our existing household customers below what was assumed at PR14. However, the rate of growth in new connections has been significant and was not foreseen by market experts at the time we made our forecasts. Our ability to correct for it has lagged because we have been adjusting household tariffs to correct for performance in prior years.

We did not adjust infrastructure charges in the early years of the AMP because we could not do so prior to 2018/19. In 2018/19 we gained the ability to flex rates through revised Ofwat charging rules. As set out in Section 4.8.12, our view is that changing our infrastructure charges to manage revenue variances would not be cost reflective and would therefore not be compliant with the charging rules.

The following excerpt from our Charges Scheme Charges 2019/20 Assurance Statements (Appendix B) dated 1st February 2019 sets out our approach:

"It was our practice for a number of years up to and including 2017/18 when calculating contributions payable by developers under Section 42 of the Water Industry Act 1991 to net off anticipated infrastructure charges from the development against network reinforcement costs otherwise recoverable under Section 42. Contributions to Network Reinforcement costs were therefore only made by developers where the anticipated infrastructure charges did not exceed the costs of Network Reinforcement. We therefore consider it appropriate to continue to set infrastructure charges at the level that would have applied had Licence Condition C not been disapplied from 1 April 2018. The number of new connections each year can vary considerably but our forecasts indicate it is not unreasonable to expect that maintaining the infrastructure charge at £375 for 2019/20 will facilitate the recovery of the costs of Network Reinforcement for the five-year period ending 31 March 2024. We will keep our forecasts of the number of new connections and the amount of the water infrastructure charge under review to ensure the water infrastructure charge remains consistent with this principle."

During the Draft Determination query process, Ofwat asked us several questions about our approach to self-lay as a potential mitigate. We believe this was driven by South Staffordshire and Cambridge Water's case for a WRFIM adjustment, where the company set out that a lower than forecast proportion of self-lay connections was one of the factors that had led to increased revenue. We have seen an increase in self-lay during AMP6 rather than a decrease against our forecast. However, our assessment of the causes of the revenue variance shows that self-lay had a neutral impact on our revenue variance during AMP6, we recognise and support this growing market. Currently we are actively working with 15 self-lay providers

[24] A higher number of new connections means higher costs for the infrastructure to service those connections. However, we need to limit our recovered revenue to our FD14 allowed revenue. This means that the FD14 revenue allowance needs to cover the costs we were allowed to run our operations at FD14 plus an increment on the FD14 allowed costs for growth and new connections.

(SLPs) serving our supply area. Connection activity performed by SLPs has increased from nil in AMP5, to 7% in 2015/16 and to 16% in 2018/19.

The work we have been doing with SLPs in our area has stimulated the self-lay market to the extent that we were able to control this.

4.8.14 Conclusion

We maintain a claim for WRFIM, which we have adjusted for the following items:

- An adjustment to our 2019/20 forecast contributions to reflect new data on actual performance.
- An adjustment to the infrastructure charges component of the claim in response to Ofwat's challenge.
- We have also made some very minor changes to the WRFIM Feeder Model we submitted on 15 July 2019 and table WS13 for our Representation, assuming that additional revenue has been allowed to compensate for the loss of price-controlled tariff revenue caused by excess growth in connections revenue.

We summarise the evolution of our claim in the table below.

Table 16: Summary of WRFIM claim

£m	2018/19
A. Revised Plan grants and contributions variance	21.870
B. 15 July submission grants and contributions variance	22.698
C. Minor amendment to 15 July submission (starting point for represented plan WRFIM claim)	22.657
D. Change to reflect revised 2019/20 forecasts	(1.460)
E. Change to reflect infrastructure charges component in 2018-20	(4.639)
F. Represented plan claim (C + D + E)	**16.558**

Source: Affinity Water analysis.

We have made changes to the WRFIM Feeder Model we submitted on 15 July 2019 and table WS1 for our Representation to reflect our revised claim, assuming that additional revenue has been allowed to compensate for the loss of price-controlled tariff revenue caused by excess growth in connections revenue. We have not resubmitted App28 because the data will be included in the developer services data request submission.

4.8.15 Supporting documentation

Table 17: Evidence to support our response on WRFIM

Reference	Document name
AFW-FR-Appendix C	Population, Household and Dwelling Forecasts for WRMP14: Phase 2 Draft final report, June 2013, Experian

Source: Affinity Water analysis.

5 Representation: Sector back in balance

5.1 Purpose of this section

The purpose of this section is to provide an update on the progress the company has made in this area and to address the related interventions in the DD.

5.2 Main conclusions

Affinity Water reaffirms its commitment to meeting the expectations set out in Ofwat's 'Putting the sector in balance: position statement' putting the sector in balance, this is demonstrated through the changes it has made to its dividend and executive pay policies, adopting the full default sharing mechanism and the reduction in gearing being delivered through real equity and the intent to reduce its gearing.

5.3 Table of relevant actions and interventions

The table below sets out those actions and interventions addressed in this representation.

Table 18: Ofwat actions and interventions for Sector back in balance

Section	Action reference	Intervention area
Financeability	AFW.LR.A5	Please explain: • How the company will achieve the planned reduction of gearing to 70% referred to in the plan; • How the company will maintain Baa1/BBB+ credit ratings if its planned gearing reduction does not proceed as planned; and The company's assessment of the impact of the gearing outperformance mechanism for PR19 on its financial metrics in case the planned gearing reduction is not achieved.
Sector back in balance	AFW.CA.A3	There remain some details to be finalised, for example details of the weightings of the underlying metrics in the annual and long-term bonus schemes. Once finalised, we expect Affinity Water to provide an update in its response to the draft determination to demonstrate that it is committed to meet the expectations we have set out in 'Putting the sector in balance' position statement. We expect the company and its remuneration committee to ensure its performance related executive pay policy demonstrates a substantial link to performance delivery for customers through 2020-25 and is underpinned by targets that are stretching. Trust and confidence can best be maintained where stretching performance is set by reference to the final determination and taking account of stretching regulatory benchmarks (for example delivery of upper quartile performance) and should include a commitment that it will continually assess performance targets to ensure targets will continue to be stretching throughout 2020-25.
Sector back in balance	AFW.CA.A2	We expect Affinity Water to demonstrate that its dividend policy for 2020-25 takes account of obligations and commitments to customers and other stakeholders, including performance in delivery against the final determination.

Source: Ofwat Draft Determination

5.4 Structure of this section

This section sets out:

- Section 5.5 our planned reduction to our gearing and our intent to reduce gearing further;
- Section 5.6 provides details of the updates to our dividend policy;
- Section 5.7 further updates to our executive pay policy; and
- Sections 5.8, 5.9, and 5.10 provides updates on the simplification of our corporate structure the fair tax mark and the removal of our Cayman company.

5.5 Gearing

5.5.1 Reduction of gearing

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.

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, we 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.

We have now agreed with the Company's shareholders to reduce the gearing of the Company over AMP7. This will be achieved by investing all the 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.

Our Represented business plan will result in the gearing level reducing to 76.8% by the end of AMP7. We, and the Company's shareholders, share the intention to reducing the 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.

Overall, this approach will mean:

- no dividend would be paid 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.

Our shareholders have also engaged Evercore to continue to develop the capital restructuring plans of the Daiwater Investments limited Group as a means to further reduce the gearing level in Affinity Water Limited. These plans involve additional debt at holding company level resulting in further equity being made available to the appointed business. Evercore have 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.

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.

Our Represented Business 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 declining gearing to 76.8% and reflected in the data table Wn3 line 10. Our previous PR19 Business Plan submission also included this mechanism in full.

5.5.2 Maintaining Baa1/BBB+ credit rating if the planned gearing reduction does not proceed.

The planned reduction in gearing does not materially affect the ratios that the credit ratings agencies currently use in their current methodology to the determine our credit rating. If the planned reduction did not happen we believe that this would not adversely affect our credit rating and therefore credit rating would be expected to be maintained.

5.5.3 The impact of the sharing mechanism on the financial metrics should the de-gearing plan not be achieved

The de-gearing will happen over the AMP period which means the reduction in the value of the sharing declines. If the de-gearing plan were not to happen, gearing would be maintained at around 80%. This would result in a difference of £0.95m over the AMP, increasing the total benefit sharing to £10.51m. We would expect to fully apply this difference. This level of revenue reduction is within the stress tests we have applied and therefore it is not expected to affect the financeability of the company.

5.6 Dividend policy

5.6.1 Amendments to the Policy

We have a provided a copy of our dividend policy in full which we submit alongside this document in AFW-FR-Appendix B, and restate the key areas below relating to the action in the Draft Determination.

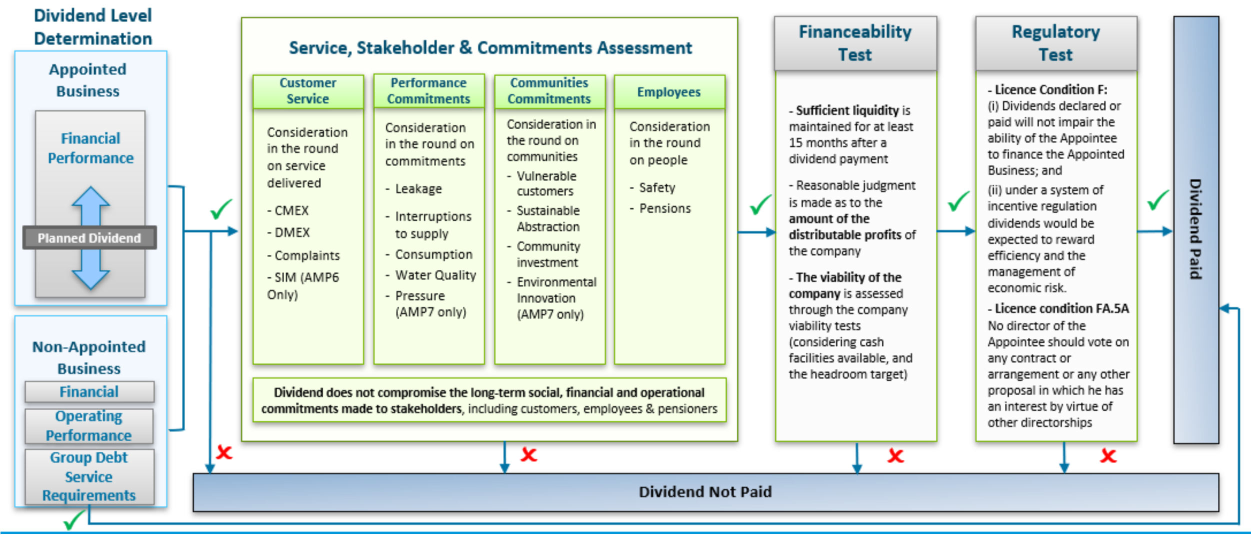
The dividend policy of Affinity Water Limited is to pay a dividend commensurate with the long-term returns and performance of the business and allowing shareholders to earn an appropriate return from an investment in the company, whilst not impairing the company’s longer term financeability and taking into account commitments to its stakeholders and customers.

An assessment will be completed by the Board to determine if the payment or part payment of the dividend reflects and/or would compromise the long-term social, financial and operational commitments made to stakeholders, which includes the following areas: customer service; operational commitments; community commitment; and employees and the health of the pension schemes. This assessment will also demonstrate that the dividend policy for 2020-25 will take account of obligations and commitments to customers and other stakeholders, including performance of delivery against the final determination for AMP7. This will include in particular assessment of performance commitments with associated ODI’s as set in the Final Determination and any ODI penalties or rewards earned. It will also require an assessment of the long-term financial resilience of the company as per section 5 of this policy.

We have updated our dividend policy as reported in section 4.3 above to allow dividends from the non-appointed business to be paid to service debt requirements in the Daiwater Investments Group.

Our policy includes the infographic below to visually explain how the policy functions.

Figure 6: Affinity Water dividend policy



Source: Affinity Water, Appendix A

5.7 Executive pay

5.7.1 Amendments to the Policy

We have a provided a copy of our executive pay remuneration policy in full which we submit alongside this document in AFW-FR-Appendix B, and restate the key areas relating to your query below.

The executive remuneration policy of Affinity Water Limited aims to continue to align executive pay to the company's performance and strategy of delivering value through high quality customer and operational performance whilst ensuring the cost of water remains affordable for customers by incentivising financial efficiencies as well as the value created for shareholders.

This approved policy replaces the previous policy that became effective from 1 September 2018. The key changes made relate to the inclusion of considerations of performance delivery against the Final Determination for the 2020-25 price control period.

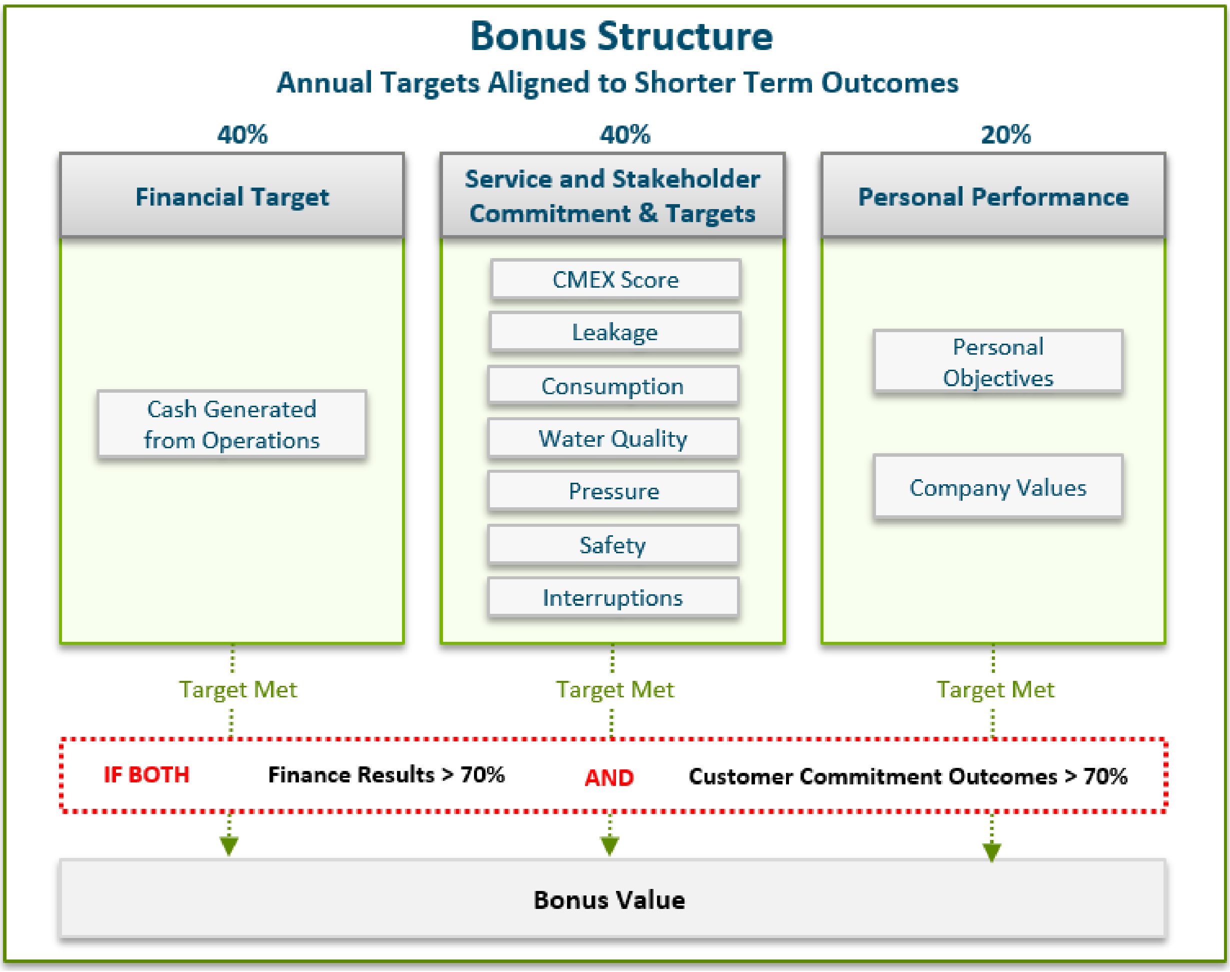
The company reports remuneration in the Annual Report and Financial Statements (including the Annual Performance Report) in accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (the 'Regulations'), which are applicable to companies whose equity shares are listed. The Regulations are not applicable to the company. The remuneration report also meets the relevant requirements of the Listing Rules of the Financial Conduct Authority and describes how the company has applied the principles relating to directors' remuneration in the UK Corporate Governance Code (the 'Code').

Annual bonuses and Long Term Incentive Plan ('LTIP') awards are to be made in line with the maximum limits outlined in the prior year remuneration policy report. The Annual Performance Report will also provide further updates to the development of this policy that will apply in 2020-25.

The Committee will ensure that the performance related element of our executive director remuneration policy demonstrates a substantial link to performance delivery for customers through 2020-25, underpinned by stretching targets to be set by reference to the final determination for AMP7. The Committee will continually assess performance targets to ensure they continue to be stretching throughout AMP7.

It is expected that weightings applied against each of the individual components of the scheme as listed in Appendix A will be proportional to financial exposure reflecting relative ODI rates.

Figure 7: Affinity Water executive pay policy



Source: Affinity Water, Appendix B

5.8 Trust Fund

Our plan continues to include the introduction of a trust fund from 2020-21 with £0.1m made available per year to support customers who are in severe financial hardship.

5.9 Company Structure

In our Business Plan submission in September 2018 we committed to simplify our corporate structure. We confirm that we have stated the process and plan to complete the majority of this activity during 2019/20.

5.10 Cayman Registered Company and Fair Tax

In January 2019 we completed the substitution of our Cayman Islands financing entity with a UK entity. Although we have always been clear that having a Cayman Islands entity within our group structure did not avoid UK tax or bring any tax benefit, we recognised that having such a structure can complicate perception and have substituted it in order to be regarded as being fully transparent.

In March 2019, we were awarded the Fair Tax Mark, becoming only the 50th company to receive this certification, which recognises that we pay the right amount of corporation tax, at the right time and in the right place, and have reached the highest standard of transparency. We expect to maintain the mark due to our practices in the area and our transparent reporting.

Appendix A Dividend policy

This appendix is provided separately.

Appendix B Executive pay policy

This appendix is provided separately.

Appendix C Bill profile customer research

This appendix is provided separately.

Appendix D Experian Report: P14 population property forecast

This appendix is provided separately.

Appendix E Third party assurance

This appendix is confidential and provided separately.

Appendix F PAYG and RCV run-off rates

This appendix is provided separately.