Affinity Water

Your local supply, on tap

Annual Report and Financial Statements

for the year ended 31 March 2014

Affinity Water Limited

Registered Number 2546950


ESSEX AND SUFFOLK WATER
CAMBRIDGE WATER
ANGLIAN WATER
Saffron Walden
Stevenage
Luton
ANGLIAN WATER
Harwich
Clacton-on-Sea
Harlow
Watford
ESSEX AND SUFFOLK WATER
AFFINITY WATER
THAMES WATER
SOUTHERN WATER
LONDON
Woking
Guildford
SUTTON & EAST SURREYWATER
SOUTH EAST WATER
SOUTH EAST WATER
Dover
Folkestone
SOUTH EAST WATER
PORTSMOUTH WATER

Who are we?

Affinity Water Limited owns and manages the water assets and network in an area of approximately 4,515km^2 split over three regions in the southeast of England: southeast (413km^2) (the Southeast or 'SE' region), central (3,720km^2) (the Central region) and east (382km^2) (the East region). Affinity Water Limited is the sole supplier of drinking water in these three areas.

As financial information is reported to the Board on a combined basis, the company presents its results under a single segment for financial reporting purposes.

We understand the trust and confidence our customers place in us to supply high quality drinking water every day. Our business has been fulfilling this vital role in the communities we serve for over 100 years.

"Our business has been fulfilling this vital role in the communities we serve for over 100 years."

What service do we provide?

We supply high quality drinking water to communities within the southeast of England:

- We supply 904 million litres of water a day to around 3.6 million people, serving 1.5 million households and non-households;
- We operate 98 water treatment works to ensure that our water is of the highest quality;
- We distribute our water through a network of 16,500km of mains;
- We bill, on behalf of sewerage companies, our customers for sewerage services (except in our Southeast region);
- We provide a wide variety of ways for customers to contact us about their water service, including over the phone, online and using social media; and
- We charge on average £173 a year for our water service compared to an industry average of £186.

Contents

Contents continued

See further information online:
stakeholder.affinitywater.co.uk

Important information

Cautionary statement: The annual report and financial statements contain certain statements that are forward-looking. Although the company believes that the expectations reflected in these forward-looking statements are reasonable, it can give no assurance that these expectations will prove to have been correct. Because these statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by these forward-looking statements. The company undertakes no obligation to update any forward-looking statements whether as a result of new information, future events or otherwise.

Terms used in this report: The 'company', 'Affinity Water' or 'AWL' means Affinity Water Limited; the 'regulated business' or 'regulated activities' means the licensed water activities undertaken by Affinity Water Limited in the southeast of England.

Highlights

- Ensuring the safety, health and wellbeing of our employees has been one of our top priorities. This was given greater recognition in January 2014, as the Board formally adopted a commitment to zero harm as one of our six strategic priorities.

  For further information on our safety, health and wellbeing initiatives, see page 28.

- We submitted our Price Review 2014 ('PR14') Business Plan in December 2013 which sets out our proposed prices, performance commitments and levels of investment for the five years from April 2015 to March 2020 (Asset Management Plan 6, 'AMP6'). To ensure we understood and reflected the views of our customers, we undertook extensive research receiving input from more than 12,500 customers.

  For further information on our engagement with our customers and communities, see page 25.

- As part of our Water Resources Management Plan, we have agreed with the Environment Agency ('EA') to reduce our abstractions by nearly 5 per cent in AMP6. To maintain our balance of supply and demand for water, we are committed to reduce leakage by 27 million litres per day (14 per cent) and to encourage our customers to use less water by promoting water efficiency, metering and providing advice and water saving devices.

  For further information on the supply and demand drivers on our business, see pages 15 and 16.

- In March 2014 Ofwat pre-qualified for enhanced status our PR14 Business Plan for the next AMP6 regulatory period based on its high quality link through to customer research evidence, and its community-focus vision. In April 2014 Ofwat confirmed our enhanced status.

  For further information on the commitments made in our Business Plan for AMP6, see page 30.

- We published our governance code in March 2014 to ensure customers and stakeholders can be confident of the strong governance of our business.

  For further information on our Board leadership, transparency and governance, see page 37.

- We continue to make improvements in our operational performance. Our water quality performance was very high with 99.99 per cent mean zonal compliance (2012: 99.95 per cent) and the number of customers experiencing unplanned interruptions reduced to 163 (2012/13: 218).

  For further information on our operational performance in 2013/14, see page 18.

Highlights continued

- As a result of unusually high rainfall, for ten days in February 2014 we operated part of our business under an Emergency Incident, reporting daily to the various local and Government emergency resilience organisations. The floods, in some cases, have had a significant effect on our customers' lives. We maintained a safe supply of drinking water to our customers throughout, and provided visible support and advice at flood assistance centres.
- We ended the year in a strong financial position with earnings before interest, corporation tax, depreciation and amortisation up 8 per cent. We have continued to make operating efficiencies reducing our cost of operations by £7 million.

For further information, see page 22.

Chairman's statement continued

Dr Philip Nolan

CHAIRMAN

I am delighted to present Affinity Water's annual report and financial statements for the year ended 31 March 2014. This is the first full year of operating as a single water company following the unification of our three formerly separately managed and regulated water companies on 27 July 2012 and the adoption of the Affinity Water brand on 1 October 2012.

In this fourth year of our current 2010-2015 price control period, I am pleased to report further progress in our operational and customer service performance. Our customers continue to benefit from high quality drinking water with 99.99 per cent mean zonal compliance as well as below average bills for water in England and Wales. The number of customers experiencing unplanned interruptions of more than 12 hours fell by 25 per cent over the last year.

2013/14 was a significant year from a customer support perspective. The unification programme was completed, consolidating teams, processes, websites and billing systems from the three previously separate businesses. This led to some resources being deflected from customer facing activities, which meant we did not achieve the Service Incentive Mechanism ('SIM') score improvements witnessed during the previous two years. However we expect SIM performance to return to an improving trend for 2014/15 when enhancements we have made to our customer-focused IT infrastructure take effect.

We have continued to make operating efficiencies reducing our cost of operations by £7 million. Our customers will benefit from these cost savings from 2015.

Chairman's statement continued

In order to continue to improve our service to customers, we have invested £18 million more than we were funded during the first four years of the current price control period. Furthermore, customers are already benefiting from the operational efficiencies we have achieved to date through the decrease, in real terms, of average bills.

We are delighted that Ofwat confirmed in April 2014 that our PR14 Business Plan, which sets out our proposed prices, performance commitments and levels of investment for the next price control period, 2015 to 2020, has achieved 'enhanced' status. Ofwat's decision will fast track our determination and thus will allow us to concentrate on running our business, preparing our delivery plans and focusing on our customers.

We consider that our PR14 Business Plan will deliver real benefits for our customers and the environment, and build on the significant improvements in our operational performance. It is based on a demand management strategy, which has the support of our customers, to respond effectively and responsibly to our longer-term supply/demand challenge and leave more water in the environment.

Our governance arrangements continue to strengthen, as we recognise the importance of demonstrating to customers, regulators and other stakeholders that we operate to the highest standards of governance and transparency. To this end, we published our Governance Code in March 2014.

Ensuring the safety, health and wellbeing of our employees and the public has long been our highest priority. This was reinforced and re-emphasised in January 2014 when the Board formally adopted a commitment to zero harm. Whilst our safety performance indicators showed a marked improvement in the second half of the financial year compared to the first half, our safety performance needs to continue to improve.

The improvement of our business in terms of customer, operational and financial performance, and our PR14 Business Plan being awarded enhanced status is due to the hard work of our loyal and committed people. On behalf of the Board, I would like to thank all of them for their hard work and achievements.

Dr Philip Nolan
Chairman

STRATEGIC REPORT

Chief Executive Officer's Introduction

Richard Bienfait
CHIEF EXECUTIVE OFFICER

I am delighted to present Affinity Water's strategic report for the year ended 31 March 2014.

Our vision is to be the leading community-focused water company. For the past four years we have focused on gaining a better understanding of the needs of our customers and making improvements to our business to improve our service.

I am pleased to report that throughout 2013/14 we have made significant progress towards achieving that vision. On 4 April, we were one of only two water companies in England and Wales to be awarded 'enhanced' status by Ofwat for our PR14 Business Plan.

I believe this decision reflects two things. First, the progress we have made in improving our business performance to achieve the targets set in the challenging PR09 regulatory determination. We have realised £25 million in operating cost net efficiencies since 2010 and we will continue to deliver our planned savings in the forthcoming period.

Second, we have put communities we serve at the heart of our business, improving the way we communicate and engage with them. This approach is driving real change and innovation, and it is shaping our business in a positive way.

As an example, our 'Service Delivery Map' represents an innovative approach to delivering predictable customer service levels based on improved asset management. It enables us to identify the specific strengths and vulnerabilities of our assets at a community level.

Our community focus is important because we supply water to 3.6 million people in some of the most water stressed areas in the UK. We divide our supply area into eight communities, some of which have the highest demand for water in the country. The population in our supply area is forecast to increase by 0.7 per cent per year over the next 25 years. Our customers expect us to maintain the current high quality of our water whilst meeting this increased demand.

We know that we can only do this working in partnership with our customers and communities.

Understanding our customers

Our business is stronger because we have developed a good understanding of our customers' needs and we are shaping our investment plans to meet those needs. Each year over 50,000 customers provide us with valuable feedback.

During 2013/14 we refined our approach to customer engagement as part of our consultation on the draft PR14 Business Plan. We benefited from having an independent customer challenge group review both our engagement and our interpretation of customer feedback. That assurance helped us develop a plan which was robust and worthy of 'enhanced status'.

In preparing our Business Plan we actively engaged in dialogue with our customers, running campaigns with a reach over 1.5 million and a social media reach of 300,000. As a result of these campaigns, over 12,500 people responded to us, helping to shape the service we will provide to them.

Over the coming twelve months we plan to embed this engagement approach in our every day business operations. We know that as a supplier of an essential public resource, we must focus on our customers' needs and ensure we are accountable for our performance.

Supporting our communities

Our vision to be community-focused reflects the fact that we understand that the communities we serve are different and that they have very different needs. For example, customers in our Brett community (east Essex) use 122 litres per person per day, compared with customers in our Misbourne community (Buckinghamshire/West Hertfordshire), where demand is at 174 litres per person per day.

Our vision also reflects the fact that we have a responsibility to minimise our impact on the local environment. Most of the world's chalk streams are in southeast England with many flowing through our supply area. We have a responsibility to protect these chalk streams and their biodiversity by leaving more water in the environment. We have a key role to play in developing strategic partnerships with non-governmental organisations and local river and community groups to promote biodiversity and wildlife habitats.

STRATEGIC REPORT continued

Openness and transparency with our communities are important parts of our approach. In 2013/14 we worked closely with local authorities in our supply area and we communicated with all the Members of Parliament who represent the communities we serve. Building on our progress this year, we have given a very clear commitment to develop structured stakeholder engagement plans for each of our communities and we will assess perception of the service we provide through online Community Feedback Panels ('CFPs'). We are committed to being open and transparent about our performance and we will do so in each of our eight communities, not just on a company-wide basis.

Our people

Our people are fundamental to our success. We have built high levels of employee engagement, with over 80 per cent saying that they would recommend Affinity Water as an employer. Feedback from our people has been at the centre of the improvements to our processes and our performance. Our teams have a clear community-focused purpose: they feel involved and supported and are energised by our approach.

Delivering our Business Plan and preparing for the future

The challenges we face as a business are clear. To address these challenges, we have developed an ambitious Business Plan which has been shaped by our customers and which, with a highly engaged team, we are confident we can deliver.

Over the next regulatory period we aim to deliver a 14 per cent reduction in leakage. That represents the highest percentage reduction committed by any company. We also plan to reduce the amount of water we take from the environment by 42 million litres per day in AMP6. We will be very focused on demand reduction in our supply areas, achieving this through our water saving programme of targeted support and universal metering to encourage our customers to use water wisely.

Our Business Plan delivers real benefits for customers and the environment and we will achieve this whilst keeping bills down for our customers. Our average bill is already one of the lowest for any water company and our Business Plan commits us to keeping price rises below the rate of inflation during AMP6.

In addition to delivering an ambitious plan, we are preparing for market reform in 2017. The retail market for non-household customers will open up to competition, with further reform in other water markets expected to follow. New companies will be able to enter the water market, giving business customers the opportunity to select their retail water service provider. We are actively preparing for this reform and engaging with regulatory partners and the Open Water Programme. We will continue to operate our business efficiently to deliver the best service to our customers for the best possible price, to ensure that we are their supplier of choice.

We have performed well against very challenging targets in this regulatory period and we have delivered year-on-year improvements in asset management and cost efficiency. We have demonstrated to our regulator, Ofwat, that we can deliver strong performance and that we are working in a way which delivers real benefits to our customers. Over the past year we have strengthened the foundations for our customer and stakeholder engagement strategy and this will enable us to maintain the momentum we have achieved as we move forward into the next price control period.

Our future plans

You can read more about how we are planning for the future by visiting our website:

stakeholder.affinitywater.co.uk/our-future-plans

STRATEGIC REPORT continued

Our vision and business model

Since most of our customers are not able to choose their water supplier, we recognise it is essential we understand the needs of our customers and the communities we serve. For this reason we have a vision to be the UK's leading community-focused water company. It is critical for our success that we maintain the legitimacy with our customers to be their sole supplier of drinking water. Being community-focused allows our people to respond to the differing needs of our customers across our areas of supply. Being community-focused enables us to encourage our customers to value water and be efficient in their water use. This vision and approach is something that we believe sets us apart from other water companies.

Our business model

At a strategic level

As a business, we have three overriding imperatives: first, to comply with all applicable laws and regulations; second, as a provider of an essential public service, to retain public trust and legitimacy; and third, to perform efficiently and secure shareholder value.

At a strategic level, our business model seeks to resolve the tensions between those imperatives, and balance the sometimes conflicting needs of our stakeholders. We aim for operational excellence, understanding and meeting the needs of our shareholders and ensuring we can implement our regulatory Business Plan.

Our strategic priorities direct how we deliver our aims and our vision. They emphasise areas to ensure that we are a well-run company providing exemplary compliance, the best possible service to our customers and attractive returns to investors.

Our six strategic priorities are to:

1. create a working environment to achieve zero harm and improved well-being;
2. practise great asset management;
3. provide great and visible customer experience;
4. create an engaged, team-based organisation that delivers pioneering performance;
5. drive effectiveness, efficiency and innovation through technology and easy processes; and
6. secure favourable regulatory and policy outcomes from our regulators and stakeholders.

At an operational level

There are eight Water Resource Zones ('WRZ') making up our area of supply. We view each WRZ as a community and we have named each after a local river to underline the link between the service we provide and the local environment from which we source water. We know that our customers' preferences and operating conditions may be unique to individual communities therefore we will tailor our operations and report our operating performance at a community level.

STRATEGIC REPORT continued

We want our customers to be able to measure our success and hold us to account. We are currently required each year to report our performance against targets set by Ofwat and the Drinking Water Inspectorate ('DWI'). In future, from April 2015, we will report our operational performance against commitments we have tested with our customers and stakeholders, and proposed to Ofwat in our PR14 Business Plan.

On a day-to-day basis, we have eight key internal performance measures and targets that link our vision, our strategic priorities and our customer expectations. These eight performance measures are shared monthly with all our people. Our targets are more stringent than the performance targets agreed with Ofwat. See page 17 for further details of these performance indicators, and our performance for 2013/14 against both internal targets and those set by our regulators.

Customer engagement and our commitments for 2015-2020

Over the last two years we have undertaken extensive customer and stakeholder research to establish our key outcomes: the expectations our stakeholders have of our business, as well as to help shape the detailed priorities and aspects of our Business Plan. Our research involved a variety of means, including face-to-face workshops, online panels and web-based and paper surveys. Our Let's Talk Water campaign reached an estimated 1.5 million customers. Our independent Customer Challenge Group ('CCG') advised and challenged us during each stage of the creation of our Business Plan.

Our consultation and engagement told us that our customers and stakeholders have four key expectations:

- **making sure our customers have enough water, whilst leaving more water in the environment;**
- **supplying high-quality water our customers can trust;**
- **minimising disruption to our customers and community; and**
- **providing a value for money service.**

These expectations formed the basis of our Business Plan.

We are keen to maintain accountability to customers and going forward we have given a commitment to be clear and transparent about our performance against our Business Plan at a community and company level:

STRATEGIC REPORT continued

Drivers and opportunities

At a strategic level

Regulatory compliance

As the industry in which we operate is subject to extensive legal and regulatory controls with which we must comply, at a strategic level our business is primarily driven by the need to comply with the laws, regulations and standards, and the policies published by Ofwat, the EA, the Department for the Environment, Food and Rural Affairs ('Defra'), the DWI, Natural England and other regulators.

Regulatory compliance includes compliance with Ofwat guidelines for the price review for the next regulatory period (PR14), and eventually the PR14 determination. We welcomed Ofwat's policy statement[1] promoting the more formal engagement of customers in price setting for PR14, as our vision places our customers at the heart of our business.

See pages 31 to 32 for details of the legal and regulatory risks to which we are exposed.

Market reform and increased competition

Changes to our regulatory environment present us with opportunities as well as challenges. The water industry is experiencing regulatory pressure towards a progressive reform of its market to facilitate greater competition. This will facilitate new entrants to the water market and allow customers to exercise more choice, in order to drive efficiencies for the ultimate benefit of customers. We operate on the principle that for all our customers we should work hard to be their supplier of choice.

In April 2017, a competitive market for all non-domestic water and sewerage customers in England will take effect. Non-domestic customers will be able to choose their retailer for water and sewerage services, with the ability to select individual retailers for each of the service types provided to their premises. In order to facilitate these changes the Open Water Programme has been established, working with market participants, Ofwat and Defra. The programme will deliver the market architecture, codes, central systems and contracts required to implement the new arrangements. We are taking an active role in the programme.

Further advances towards water market reform: upstream reform will continue after 2020.

Economic regulation

Our business is a regional monopoly and is subject to incentive-based economic regulation by Ofwat. The tariffs we charge our customers are subject to price controls set by Ofwat on a five year cycle. Price determinations can have a significant impact on profits and cash flows.

For AMP6 we will be subject to a new price control regime, created to drive efficient investment decisions and facilitate the forecast introduction of retail competition for our non-domestic customers from 2017 onwards. Ofwat will set three separate price controls in order to separate wholesale activity, related to production and distribution, from customer-facing retail activity, which will itself be divided between domestic and non-domestic customers.

The future wholesale price control shares some characteristics and principles with the current price control regime but is based on incentives related to total expenditure, rather than distinguishing between capital expenditure and operating costs. Domestic retail price controls are to be based on an industry-wide 'average cost to serve' principle, in order to drive efficiency across the sector. Non-domestic controls will serve as protection for customers as competition develops in the retail market.

1. 'Involving customers in price setting', Ofwat Customer Engagement Policy Statement dated August 2011.

STRATEGIC REPORT continued

Shareholder and investor expectations

At a strategic level our business is also driven by the expectations of our shareholders and investors, such as achieving the cash returns envisaged in our Business Plan for the next regulatory period. The commitments laid out in our Business Plan already imply a significant stretch over our current capabilities. Our challenge is to explore all practical means to create or safeguard shareholder value while maintaining service at the levels committed in our Business Plan. Shareholder value, can be created through outperforming in selected areas, thereby receiving rewards for doing so, and through effective risk management to reduce cash flow volatility (i.e. offering more predictable cash returns).

Financeability of future plans

We are a business with a long-term outlook and expenditure commitments, which need to be matched with long-term sources of debt finance. Since the 2008 financial crisis long-term bank debt is less available, therefore the most cost-effective way to raise long-term debt is through the debt capital markets. We refinanced in February 2013 £552m of debt used to fund the acquisition of the company from Veolia Environnement S.A., taking the strategic decision to set up a bond programme in the process, which enables us to issue further bonds without the need for significant additional documentation. See pages 50 to 51 for further details of our current financing arrangements.

At an operational level

Acute pressure to increase the sustainability and resilience of supply

The Secretary of State for the Environment, Food and Rural Affairs has designated all three of our supply regions as areas of 'serious water stress[1]'. Government and regulators have emphasised the importance of resilience and long-term planning in adapting to increased water stress.

We have a high dependency on groundwater sources, around 60 per cent of our water, which need to be replenished each year by winter rainfall. Other than natural aquifers, we do not have significant storage for untreated water. This means we are particularly susceptible to drought and pollution events as well as being vulnerable to the effects of planned sustainability abstraction reductions.

Most of the world's chalk streams are in the southeast of England with many flowing through our supply area. They are particularly at risk of drying up if water tables in the chalk bedrock are lowered by too much abstraction. We have a responsibility to protect the chalk stream ecosystems and their biodiversity by leaving more water in the environment.

As part of our Water Resources Management Plan 2014, we have agreed with the EA to make sustainability abstraction reductions of 42 million litres per day by 2020, nearly 5 per cent of our resource base. A primary challenge for our business at an operational level is adapting to the reduction in abstraction from a number of our groundwater sources in order to improve flows and habitats in local chalk streams. For information on how we are currently managing the impact of our abstractions on our local environment, see page 27.

We also have to contend with a less predictable and more variable climate, further increasing the pressure to improve the resilience and sustainability of our operations.

1 Areas where the current household demand for water is a high proportion of the current effective rainfall which is available to meet that demand; and/or the future household demand for water is likely to be a high proportion of the effective rainfall available to meet that demand.

STRATEGIC REPORT continued

Drivers and opportunities continued

At an operational level continued

Increasing water demand as a result of population growth

The population in our areas of supply is forecast to increase by 0.7 per cent per year over the next 25 years. This means that if consumption per head remains constant, total domestic water demand in our licence area will increase commensurately and our customers' demand for water could exceed the supplies we have available.

We therefore need to implement measures to ensure our customers have enough water whilst ensuring we comply with our obligation to leave more water in the environment. This means we have to compensate for the lost water resources by reducing leakage and encouraging our customers to use water more efficiently. For information on how we are currently encouraging our customers to use water more efficiently, see page 26.

More stringent water quality standards

Drinking water quality standards are becoming more stringent over time and we must do more to maintain compliance with them. For example some pipes in our network are made of lead, which can potentially be harmful and we will need to do more replacement work.

Changes in manufacturing and agricultural practices can introduce chemicals into the natural environment, which can affect the quality of untreated water. We need to ensure that our treatment processes are able to effectively deal with emerging pollutants, as well as known current pollutants. We also need to take action where deposits of minerals build up in our pipes over time, which can cause the water we supply to become discoloured.

Our customers

Increased expectations of service and interaction

Customers rightly expect that we place their interests at the centre of our operations and their needs shape the way we deliver our services. With easy access to information everyone expects to be able to find answers at their fingertips.

We have to respond and adapt to meet customers' expectations, whether this is in the way we provide and share information, provide services, enable our customers to manage their bills or provide explanations when we do not meet the standards they expect.

Affordability and value for money

The economy of southeast England is showing broad recovery after the recent recession. Nevertheless, there is an uneven distribution of the benefits of recovery over our areas of supply. This results in an emphasis across the entire customer population on value for money, but also means that the affordability of water bills is a particularly acute issue in some of the communities we serve. The expected increase in Thames Water sewerage bills, as a result of the Thames Tideway Tunnel scheme, which is charged to the majority of our customers and for which we collect, will add to this. On the other hand, social, political and regulatory pressures to maintain current water bill levels and to reduce them for certain classes of vulnerable customers will continue. For further information on how we are currently responding to this challenge, see page 25.

STRATEGIC REPORT continued

Our performance

Our vision, our strategic priorities and our customer expectations are linked through a series of indicators against which we measure our performance.

We measure and publish our performance for Ofwat, the DWI and for internal purposes. As in previous years of AMP5, we have identified eight internal performance measures and targets which we routinely measure and publish throughout the business, on a weekly, monthly, quarterly and annual basis. Our targets were originally set based on our best ever historical performance and are calibrated on a quarterly basis, reflecting the seasonality of our business, and reflecting the continuous improvements in our performance that we expect and plan to make. The internal performance targets for water quality, unplanned interruptions and leakage are more stringent than the targets set by Ofwat.

Our performance against our eight internal targets and associated targets set by our regulators for 2013/14 is analysed in the sections below.

Ofwat requires companies to use a 'traffic light system' when reporting their current performance, as per the table below:

Green – the company's performance is in line with or better than expected.

Amber – the company's performance is not in line with expectations but performance has slipped only slightly.

Red – the company's performance is significantly below target or expectation.

Our performance continued

Operational performance indicators

Where relevant in this section, we have grouped together operational performance indicators and targets that help us to evaluate our performance against each of our four customer expectations (as outlined on page 13).

Health and safety

Creating a working environment to achieve zero harm and improved well-being is one of our six strategic priorities that direct how we will deliver our vision (as outlined on page 12).

Performance indicator	2013/14 target[1]	Our performance		Our 2013/14 performance in context	2014/15 target
		2013/14	2012/13		
Internal indicator 1: number of accidents resulting in more than three days' lost time and RIDDOR[2] reportable incidents[3]	**Internal:** zero	**14**	9	Although the total number of incidents impacting on this measure increased from 9 to 14 there were five months during the year when the zero target was achieved. Our safety performance showed a marked improvement in the second half of the year compared to the first half, as the impact of safety-related initiatives introduced since unification of the regulated businesses began to take place. For further information on these initiatives, see page 28.	Zero

1 Quarterly internal targets have been converted into annual targets through totalling quarterly targets or calculating the mean average.
2 Reporting of Injuries, Diseases and Dangerous Occurrences Regulations 2013 ('RIDDOR').
3 Affinity Water employees only, does not include road traffic accidents or our contractors' accidents.

Making sure our customers have enough water, whilst leaving more water in the environment

Leakage

Our customers expect us to make sure they have enough water, whilst leaving more water in the environment. To do this we need to balance the demand for water against the supplies available. Controlling leakage from our pressurised network and from customers' pipework is one of the ways we ensure we have enough water to satisfy demand.

Performance indicator	2013/14 target	Our performance		Our 2013/14 performance in context	2014/15 target
Internal indicator 2: leakage in terms of millions of litres per day (Ml/d)	**Internal:** 5 per cent (%) below the Ofwat annual target	**2013/14** **9% below**	2012/13 4% below	We attach a high priority to meeting leakage targets. For 2013/14, we have continued to reduce the amount of water that leaks from our network and achieved our internal target, set at 5 per cent below (2012/13: 5 per cent below) the Ofwat target. Our customers have asked us to reduce leakage further and as part of our PR14 Business Plan and Water Resource Management Plan we have committed to reducing leakage by a further 14 per cent over the next 5 years. This further reduction will help to ensure that we secure supplies to our customers and protect the environment.	**Internal:** less than 175Ml/d
	Regulatory: annual target, as set out in the 2009 price review final determination: less than 197.7 Ml/d	**2013/14** **180.74**	2012/13 189.49		

STRATEGIC REPORT continued

Supplying high quality water our customers can trust

Water quality

Performance indicator	2013/14 target	Our performance		Our 2013/14 performance in context	2014/15 target
Internal indicator 3: number of water-quality compliance failures	**Internal:** less than 28 water-quality compliance failures	**2013/14** **43**	2012/13 101	A reduction in failures of the pesticide standard due to lower use of pesticides by farmers in our water supply catchments in 2013/14 compared to 2012/13, contributed to fewer compliance failures, together with investment at our Iver and Egham water treatment works and in catchment management. There has been a decrease in the detection of coliforms resulting from improvements to the method used to disinfect sample taps. Consequently, our MZC performance in 2013 returned to being above the industry average. We investigate cases when water quality samples do not meet the standards set. None of these were likely to have been harmful to human health.	**Internal:** less than 28 water-quality compliance failures
Mean Zonal Compliance ('MZC') (%)[1]	**Regulatory:** Not applicable – the DWI does not set a target	**2013** **99.99%**	2012 99.95%		

1 Water-quality indicators are based on data for the calendar year. MZC is the average of the 'mean zonal compliance' performance of 39 water-quality parameters and is an important measure of the quality of the water supplied to our customers. The individual results for each parameter are taken from the company's compliance sampling programme and are reported to the DWI.

STRATEGIC REPORT continued

Our performance continued

Operational performance indicators continued

Minimising disruption to our customers and community

Our customers expect us to minimise disruption to them and their community. We measure whether we are succeeding by analysing the trends in customer service and infrastructure serviceability indicators that include measures of asset performance. If these differ dramatically from the levels achieved in the past, it can indicate that we need to act. The performance of our assets tells us that we are maintaining and renewing them appropriately.

Interruptions to our customers

Performance indicator	2013/14 target	Our performance		Our 2013/14 performance in context	2014/15 target
Internal indicator 4: number of properties experiencing an interruption for more than 12 hours	**Internal:** not more than 300 properties experiencing an interruption for more than 12 hours[1]	**2013/14** **163**	2012/13 218	36 per cent (2012/13: 38 per cent) of properties where supply was interrupted for more than 3 hours were planned interruptions to carry out essential maintenance work and customers received at least 48 hours prior notice in these cases. The number of properties experiencing an unplanned interruption to supply greater than 3 hours was 47,709; this is 3 per cent of all customers. Only 163 customers suffered an unplanned interruption longer than 12 hours, compared to 218 in 2012/13. To reduce risks further, we are specifically investing at 'hotspots' in the mains network where we know that if the water main were to burst, disruptions affecting large numbers of customers are likely to last for a long time.	**Internal:** not more than 300 properties experiencing an interruption for more than 12 hours[1]
Number of hours lost due to water supply interruptions for 3 hours or longer per property served	**Regulatory:** to deliver a reliable water supply to customers	**2013/14** **0.38**	2012/13 0.32		

1 This level of target has been set as 75 per quarter which sums to just below Ofwat's reference level.

Infrastructure serviceability

Performance indicator	2013/14 target	Our performance		Our 2013/14 performance in context
Serviceability water non-infrastructure	**Regulatory:** **Green:** Improving or stable **Amber:** Marginal **Red:** Deteriorating	**2013/14** **Stable**	2012/13 Stable	Serviceability is an assessment of the capability of assets to provide the required level of service to customers and to safeguard the environment now and into the future. This measure is important as, under our operating licence, we are required to maintain our assets, such that services to customers can be sustained over the long-term. Ofwat seeks to set its price limits, so as to allow for sufficient maintenance of these assets. Mains bursts in 2013/14 continue to be within the reference level target. Our serviceability is maintained as 'stable' for both infrastructure and non-infrastructure serviceability and we are committed to maintaining this performance into the future.
Serviceability water infrastructure	**Regulatory:** **Green:** Improving or Stable **Amber:** Marginal **Red:** Deteriorating	**2013/14** **Stable**	2012/13 Stable	

STRATEGIC REPORT continued

Our performance continued

Providing a value-for-money service

We aim to stop the need for customers to have to call or write to us. In addition, we seek to provide them with web based easy to use self serving solutions that are available 24/7. The measures below relate to our strategic priority of providing a great and visible customer experience.

Performance indicator	2013/14 target	Our performance		Our 2013/14 performance in context	2014/15 target
Internal indicator 5: number of written complaints	**Internal:** less than 1,725 written complaints	2013/14 **2,544**	2012/13 2,176	2013/14 was a significant year from a customer support perspective. The unification programme was completed, consolidating teams, processes, websites and billing systems from the three previously separate businesses. This led to some resources being deflected from customer facing activities, which meant we did not achieve the Service Incentive Mechanism ('SIM') score improvements witnessed during the previous two years. Although the 2013/14 SIM score decreased slightly from 80 to 79, compared to 2012/13, the overall AMP5 SIM performance to 2013/14 will demonstrate a second quartile industry mid-table position. The enhanced IT infrastructure supporting customers and customer service teams created in 2013/14 includes: • a new debt management system; • fully automated web based customer self serve solutions for processes such as moving home and direct debit set up; and • a streamlined single billing engine. Our intention is that this strengthened IT platform, combined with our highly engaged customer service teams in Hatfield, Folkestone and in the communities we serve, will help us return the SIM performance to an improving trend for 2014/15.	**Internal:** less than 2,150 written complaints
Internal indicator 6: unwanted contact: number of unwanted contacts	**Internal:** less than 124,004 unwanted contacts	2013/14 **146,646**	2012/13 137,544		**Internal:** less than 129,000
Internal indicator 7: customer experience measured by Net Promoter Score[2]	**Internal:** achieve a NPS of at least 46	2013/14 **49**	2012/13 43		**Internal:** achieve a NPS of at least 51
Service Incentive Mechanism ('SIM')[3] score (score out of 100)	**Regulatory:** **Green:** ≥ 50 **Amber:** 40-50 **Red:** <40	2013/14 **78.7**	2012/13 80.3		

1 The 2014/15 target is set at a level which is a 15 per cent improvement on our 2013/14 actual performance. If we achieved this target, we would exceed our best-ever performance.

2 Net Promoter Score ('NPS') is a customer loyalty metric based on a direct question: "How likely are you to recommend our company/service/product to your friends and colleagues?". The scoring for this answer is based on a 0 to 10 scale. The NPS score is calculated by subtracting the proportion of customers answering 0 to 6 out of 10 (known as detractors) from those answering 9 to 10 (known as promoters).

3 Each water company in England and Wales is required by Ofwat to measure its customer experience performance through a comparative measure called the' Service Incentive Mechanism' ('SIM'). SIM has two elements. The first qualitative element is produced by independent market research surveys of customer satisfaction from a sample of customers who have contacted us. The second is a score based on the number of 'unwanted' phone calls we receive, combined with the number of complaints we receive and our effectiveness at resolving those complaints. Unwanted calls are those where customers express any dissatisfaction with the service, including customers who hang up while waiting in call queues, plus any calls that could have been avoided if our service had fully met customer expectations.

STRATEGIC REPORT continued

Our performance continued

Financial performance indicators

Our financial performance indicators and targets set out in the following table are used to evaluate how we are performing in terms of creating or safeguarding shareholder value, while meeting commitments made in our Business Plan for the regulatory period.

Performance indicator	2013/14 target	Our performance		Our 2013/14 performance in context	2014/15 target
		2013/14	2012/13		
Internal indicator (financial indicator) 8: earnings before interest, corporation tax, depreciation and amortisation ('EBITDA')	**Internal:** £164.0 million[1]	**£164.7 million**	£152.9 million	Turnover for the year was £291.4m, being a 4 per cent increase on last year (2012/13: £279.5m). The increase is due to the full inclusion of the three unified regulated water companies, the prior period's turnover representing only eight months of unified business as the unification took place on 27 July 2012. Total operating costs of £216.8m were £5.6m higher than last year (2012/13: £211.2m). An increase in operating costs in the year as a result of the full inclusion of the three unified businesses was partially offset by efficiencies generated through the unification, together with higher non-recurring costs incurred in the previous year related to various restructuring activities arising from a wider Affinity Water group reorganisation following its change in ownership in June 2012. These efficiency savings enabled us to achieve our annual EBITDA target.	**Internal:** £164.3 million

1 Our 2013/14 and 2014/15 internal targets, and the actual performance presented for 2013/14 include current service costs in relation to the Shared Service division of the Affinity Water Pension Plan. These costs are excluded from the EBITDA of the company for statutory reporting purposes, as the employees in the Shared Service division have not yet been transferred over to the company from another group undertaking.

STRATEGIC REPORT continued

Financial performance indicators – continued

Performance indicator	2013/14 target	Our performance		Our 2013/14 performance in context	2014/15 target
Post tax return on capital[1]	**Regulatory:** post-tax return on capital as assumed in price limits for the reporting year	**2013/14** **5.84%**	2012/13 5.54%	A reconciliation of our opening to closing RCV for the year is included in the non-audited supplementary regulatory information on page 141 of our regulatory financial statements.	
Credit rating[2]	**Regulatory:** maintain investment grade credit rating **Financial covenant:** maintain at least BBB+/Baa1	**2013/14** **A-/A3**	2012/13 A-/A3	We continue to maintain Class A bond credit ratings at existing levels. These ratings are investment grade and are in line with those of our peers in the water sector.	**Financial covenant:** Maintain at least BBB+/ Baa1 **Internal:** Maintain existing covenant levels of A-/A3
Gearing[3]	**Regulatory:** not applicable – no target has been set **Financial covenant trigger event:** less than 85 per cent (%)	**2013/14** **79%**	2012/13 77%	The policy approved by the Board is a target gearing level of 80 per cent. This allows sufficient headroom within our financial covenants which are triggered at 85 per cent.	**Financial covenant trigger event:** less than 85 per cent.
Interest cover[4] (times)	**Regulatory:** not applicable – no target has been set **Financial covenant trigger event:** greater than 1.1 times	**2013/14** **1.4 times**	2012/13 2.4 times	Following the refinancing of our debt in the bond markets in February 2013, there has been a significant increase in the cash interest costs of the business for 2013/14 versus 2012/13 which has significantly lowered our interest cover ratios. This is in line with the Business Plan and we expect to stay at or above this level going forward. Our interest cover remains comfortably above our financial covenant minimum requirements.	**Financial covenant trigger event:** greater than 1.1 times

1 Current cost operating profit less tax as a return on regulatory capital value ('RCV'; Ofwat's published RCV in outturn prices adjusted for actual capital expenditure to date).

2 The credit ratings given to the long-term Class A bonds issued by the company's subsidiaries by rating agencies, which are used to assess the company's ability to comply with its licence requirement to maintain an investment grade credit rating. For a summary of the bonds issued by the company's subsidiaries, see pages 50 to 51.

3 Gearing performance indicator is on the basis of our Senior Regulated Asset Ratio, as defined in our financial covenants. This is our net debt divided by our RCV. An analysis of net debt and gearing is included in note 9 of the regulatory financial statements on page 136.

4 Interest cover performance indicator is on the basis of our Senior Adjusted Interest Cover Ratio, as defined in our financial covenants. This is our operating cash flow less tax paid less current cost depreciation and infrastructure renewals charge divided by interest paid.

Corporate responsibility

We continue to adapt our way of working to meet the needs of our customers and stakeholders. We are committed to being the leading community-focused water company, listening and responding to our customers and the communities we serve while balancing the sometimes conflicting requirements of our various stakeholders.

We have a diverse range of stakeholders with whom we are in regular contact, responding to their feedback and providing them with opportunities to influence the investment decisions we make. Our key stakeholder groups include:

- Customers
- Special interest groups
- Media
- Other financial investors
- Our people
- Elected representatives
- Regulators
- Shareholders
- Suppliers

Our engagement programme has been developed and implemented with independent expert specialists, and is managed and co-ordinated by our own team including a dedicated Stakeholder Engagement Manager.

We set out in the following sections our performance in relation to issues that we perceive matter most to our stakeholders and those which have the most profound effect on our business. It is our objective to develop a formalised materiality matrix, informed by stakeholder consultation, to guide our corporate responsibility reporting in the future.

This report does not contain information in relation to human rights, as we have judged that a breach of human rights is not a material risk for the business, due to existing legal and regulatory requirements in the UK.

STRATEGIC REPORT continued

Our customers and communities

Delivering for our customers

Most of our customers are not able to choose their water supplier. We believe passionately that, in order to maintain their trust, we should actively listen to our customers and be responsive to their needs. Each month we receive feedback from over 4,000 customers through our Voice of the Customer programme. This feedback is used to improve our processes and make sure we are meeting their expectations of us.

Some significant examples of customer-focused innovation:

- Our 'Service Delivery Map' is a state-of-the-art approach to delivering predictable customer service levels based on improved asset management and reduced asset failure. It is supported by a deep understanding of our asset base and how to operate it optimally, recognising its specific strengths, vulnerabilities, risks and costs at the community level.
- In 2010, we reorganised our network operational activities to improve the service we provide to our communities. We created a new team called Community Operations allowing us to manage network operations, such as leakage and mains burst repairs, with a strong emphasis on using our local knowledge in the community to substantially improve levels of service to our customers.
- We have invested and will continue to invest in managing and analysing data more efficiently and in our capability to derive more value from it. This is a driver for understanding and predicting asset performance, for efficient network control, for insightful risk management and for helping our customers use water more efficiently.

We continue to minimise disruption to our customers and communities by managing the condition and performance of our assets to ensure that our water supply system is stable over time. We achieve this by carefully operating our water supply system and by investing sufficient money in replacing and renewing the infrastructure. In 2013/14 we renewed 140.3 km of water mains. For information on our infrastructure serviceability performance for 2013/14, see page 20.

When disruptions do occur, such as when a water main bursts, our community-based teams respond rapidly to minimise the consequences. During such times it is important that we keep customers informed. Customers can access information on our website, using our mobile phone application or by telephoning us. For information on our customer service performance for 2013/14, see page 21.

We understand that the challenging economic climate has made it harder for some of our customers to meet costs of living and pressures on household budgets. Our water bills remain some of the lowest in the country. Over the past four years the average household bills have gone up by less than the rate of inflation, whilst we invested £18 million more than we were funded during the first four years of the current price control period.

In March 2014 we implemented Pingit: a new, smart and easy way for our customers to pay their bills. Pingit is a Barclays Bank Smartphone application that enables our customers to pay their bills wherever they are, whenever they want.

Supporting vulnerable customers

In April 2014 we launched a new social tariff which is designed to support customers who are struggling to pay their bills. The new tariff: **'LI£T'**, is designed to complement the existing measures we have, such as the industry WaterSure tariff and flexible payment plans. Households who are in receipt of means-tested benefits or who earn less than £15,800 can apply for the **LI£T** tariff which could result in around 40 per cent reduction on an average water bill for such households. We are aiming to support approximately 30,000 customers by 2020.

We will be working in partnership with local authorities and trusted third parties, such as Charis Grants, to promote the scheme so that we raise awareness and are able to provide support to those customers who are most in need of assistance.

STRATEGIC REPORT continued

Corporate responsibility
continued

Supporting our local communities

We are passionate about making a positive contribution to the communities we serve. We have an active programme of engagement in each of our eight communities and each year we support local community initiatives through financial contributions and fundraising. We also actively support the volunteering activities of our people who live and work in the communities we serve.

We work in partnership with our communities to help them understand the value of water and how to use it in a sustainable way. This means that together we can take care of our local rivers and streams and leave more water in the environment for future generations. Our track record in our Southeast region shows that by working in partnership with local authorities, customers and local environmental groups, we can encourage our customers to value water and use it more efficiently.

Our specialist Education Team supports local schools, providing a hands-on learning experience delivered by qualified teachers. During 2012/13 our Education Centre located in Bushey, South Watford, welcomed over 6,400 visitors from 158 schools and we supported a further 25 schools with our education outreach programme. These educational activities help to raise awareness of the environment and the need to save water with these children.

Other highlights in 2013/14 - we:

- established a new Community Engagement Fund and contributed around £44,000 to support local community organisations;
- matched funding raised by our employees through a monthly initiative called 'Time to Give': in 2013/14 charities benefited from direct financial assistance of over £11,880;
- offered our UK based call centre to support Children in Need: we were one of only 47 call centres to support the initiative, collecting nearly £71,000; and
- we raised over £41,000 for WaterAid, the water industry's flagship charity, KitAid and local charity, Watford New Hope Trust, through our long-running community event, the Ricky Road Run.

Reducing demand for water in our Southeast region

Customers in our Southeast region have significantly reduced their water use as a result of our seven year water efficiency programme.

In the last four years, we have installed 11,747 water meters and provided our customers with advice and help on how to reduce the amount of water they use. Over 93 per cent of our customers in the area now use meters and consume an average 126 litres per day compared to the national average of 150 litres per day per person.

Making a difference on the Folkestone Downs

A group of our employees from Folkestone spent a day volunteering with the White Cliffs Countryside Partnership to help remove potentially poisonous weeds in grassland at Castle Hill. The weed can take over grassland and can be ingested by cattle and horses.

The project is part of a regular 'Make a Difference day' initiative by White Cliffs Countryside Partnership, a not for profit organisation we have sponsored for the past seven years.

As well as providing support to the local community, the volunteering days give colleagues the opportunity to work directly with members of the community and our customers.

Ian McArthy from Dour Community taking part in a 'Make a Difference' day with the White Cliffs Countryside Partnership.

STRATEGIC REPORT continued

Our environment

We are committed to managing our impact on the environment. Almost 95 per cent of our greenhouse gas emissions are from electricity which is used in our operational activities. We have delivered over 60 large energy efficiency schemes, enabling us to also achieve operational cost reduction targets through reducing energy consumption and costs at our pumping systems, and utilising lower cost energy sources. 86 per cent of our electricity taken from the grid is supplied from renewable sources certified by our energy supplier. For further information on our 2013/14 greenhouse gas emissions, see page 66.

We have also encouraged our employees to embed environmentally-conscious working practices into their day-to-day activities by:

- providing a financial incentive for employees participating in our low carbon car scheme;
- subsidising bus travel in the local area to encourage green travel to and from the workplace;
- operating a car sharing scheme; and
- encouraging recycling and re-use within our offices, and engaging in national campaigns.

Protecting our local environment

The area we serve contains a significant number of the world's chalk streams. We have an important role to play to protect biodiversity by leaving more water in the environment. We have a dedicated Catchment Management Team, which works hard to reduce the impact of pollution on our abstractions and the local environment.

We introduced a new catchment management scheme in October 2010. An important part of this scheme involves working in close partnership with Defra on specific projects, which we support through direct funding, resource and technical expertise. These projects include some specific projects to protect precious chalk streams in our area.

Many of the chalk streams within our supply area are failing to meet Good Ecological Status under the Water Framework Directive ('WFD'). As part of the National Environment Programme, we have been working closely with the EA to understand the effects of our abstractions on stream flows. We have also introduced measures under the WFD to control abstraction pressures and promote efficient and sustainable water use.

We own approximately 1,400 hectares of land, including statutory designated sites, for example Dungeness Sites of Special Scientific Interest ('SSSI'), Wraysbury Lakes SSSI and Ramsar site, and sites of local conservation importance, for example Stockers Lake, which require management to ensure biodiversity is maintained and enhanced. These are managed successfully in conjunction with local and national stakeholders, for example wildlife trusts, the Royal Society for the Protection of Birds and the EA.

We also want our local communities to benefit from access to these wildlife havens, and support local angling societies and other charities in providing access to such sites.

Biodiversity project

We are working with the Herts and Middlesex Wildlife Trust to restore the reed beds at Springwell Lake in Rickmansworth.

The project aims to enhance the existing habitat, providing a sanctuary for breeding birds and wildlife in the area.

Reed beds are among the most important habitats for breeding birds in the UK and support a number of species, including the nationally rare bittern. There is only a small amount of reed bed coverage left in the UK; therefore it is vital that what remains is conserved and protected.

Springwell Lake is one of the largest reed beds in the area, but over time it has degraded due to the drying effect of plant litter build-up and the encroachment of shrub and woodland.

Springwell Reedbed, post restoration

STRATEGIC REPORT continued

Corporate responsibility

continued

Our people

Our people are our ambassadors. They live and work in our communities. They have the local knowledge and understanding to make sure we are delivering what our communities expect of us and ensure our contribution to those communities really makes a difference.

Attracting and retaining highly motivated people who are proud to work for us is central to our ability to deliver an outstanding service for our customers, and we strive to make Affinity Water an inspiring place to work where people at all levels of our organisation feel free to speak their minds and contribute.

We strongly believe that we can create a zero harm environment for our people. We prioritise health and safety training and encourage all our people to put their health and safety, and that of their colleagues, above all else. For information on our health and safety performance for 2013/14, see page 18.

We have created a strong culture of learning and development, investing in training, and building a culture of coaching and mentoring to release the potential of our people. For this reason we have highly engaged teams. In our last employee survey over 80 per cent of our people said they would recommend us as an employer.

During 2013/14 we invested £276,000 in training and development. Our priority is technical and operational training, particularly with regard to health and safety. We have also continued to invest in our graduate and apprentice programmes.

This year we have undertaken capability profiling to further understand core technical and business capabilities, and training requirements. We have also rolled out a Team Leader Coaching programme to develop the leadership, coaching and facilitation skills of our team leaders. By updating our programmes, we aim to encourage progression opportunities that are open to all, irrespective of gender or ethnicity.

Zero harm environment

We are committed to creating a working environment to achieve zero harm and improved well-being for all our people. This commitment was formally adopted as one of our six strategic business priorities in January 2014.

We recognise the need for strong and active leadership and our directors and senior managers undertake frequent safety tours. We have established director-led safety leadership teams that bring together employees and managers to respond to safety concerns, share best practice and promote improvement initiatives.

We value the contribution that all our people can make to creating a working environment to achieve zero harm. We have developed specific safety training packages for our team leaders to ensure they know how to keep themselves and their colleagues safe.

We continue to forge a strong working relationship with our recognised trade unions and in December 2013 put in place a formal agreement that sets out the arrangements for representation, consultation and involvement for the unions on health and safety matters.

We also recognise the importance of engaging our suppliers and contractors in improving safety performance and during January 2014 we held a safety, health and well-being week, culminating in a first Affinity Water hosted safety conference.

For details of our health and safety performance for 2013/14, go to page 18.

STRATEGIC REPORT continued

The table below provides a breakdown of the gender of directors and employees at 31 March 2014.

	Men	Women
Company directors[1]	10	1
Other senior managers[2]	6	-
All other employees	587	333

1 Company directors consist of our Board members, as detailed on pages 37 to 39.

2 Other senior managers' is as defined in the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, and includes persons responsible for planning, directing or controlling the activities of the company.

For the fifth year in succession all employees received an annual bonus aligned to the company's performance. We strongly support a company-wide flexible working policy to promote an atmosphere where all our people can reach their potential.

Our suppliers

We spend around £160 million annually with a supply chain of around 900 suppliers. We operate a procurement policy based on transparency and fairness during the tendering process, supported through the use of tailored suites of pre-qualification, tender and framework documents.

A constructive and effective trading relationship with suppliers and contractors is maintained. Corporate responsibility is an important part of the assessment of potential suppliers where selection criteria, including quality, environmental, health and safety and ethics, are assessed at the appointment stage and throughout the life of our key supply chain relationships.

We encourage and promote sustainability initiatives within our supply chain. Our principal contractors continue to use recycled aggregate material, which leads to a significant reduction in the amount of waste taken to landfill and the volume of material imported for reinstatement works. This is a significant waste stream due to the nature of our activities.

Following a selection process, whereby fuel economy and carbon dioxide emission levels were assessed as key criteria, we have awarded a new contract for the supply of cars and commercial vehicles. In doing so, we have reduced the environmental impact of our fleet operations.

We spend £18 million per annum on electricity. As discussed previously, the majority of our purchased power originates from renewable sources and is Climate Change Levy exempt therefore having a lower impact on the environment.

STRATEGIC REPORT continued

Our future plans

The expectations of our customers have shaped our Business Plan for AMP6, the next regulatory period. For example, our customers told us that they prefer demand management options over supply-side options in tackling the challenges we face in relation to a supply/demand deficit. As a result we are proposing to reduce demand through metering and a water efficiency programme, and to use water more efficiently through reducing leakage by 14 per cent by 2020. The diagram below summarises the four key expectations (customer 'outcomes') and the commitments that we have made in our Business Plan in relation to these. Our challenge is to meet our customers' expectations by delivering a water service that achieves these performance commitments, whilst safeguarding and creating shareholder value.

Outcome/commitments

Making sure our customers have enough water, whilst leaving more water in the environment	**Reduce leakage by 14% – 27 Ml/d** A stretching target for reducing leakage from the network to reflect the importance our customers place on it.
	Reduce average water use by 7% Supporting our customers to reduce their consumption by offering water-efficiency advice and introducing universal metering for 280,000 households in the most water-stressed communities.
	Improve the water available for use by 4% Increasing flexibility in our network, so we can transfer water more effectively around our communities.
	Abstraction Incentive Mechanism Ofwat will review our sustainability performance and compare this with other water companies.
	Sustainable abstraction reductions of 42 million litres a day by 2020 Improving our efficiency in supply and reducing the demand for water will enable us to leave more water in the environment.
Supplying high quality water you can trust	**Compliance with water-quality standards** Maintaining the high quality of water by investing at our treatment works, sampling across our network and preserving the quality of our water sources.
	Customer contacts for discolouration Understanding and responding to local concerns about water aesthetics.
Minimising disruption to you and your community	**Unplanned interruptions to supply over 12 hours** Targeted investment in strategic mains to limit prolonged disruption to supply.
	Number of burst mains Investing in our network to maintain service levels.
	Affected customers not notified of planned maintenance Keeping our customers updated when we have to carry out planned maintenance.
	Planned works taking longer to complete than notified Effectively planning and carrying out necessary maintenance to our assets to minimise disruption.
Providing a value-for-money service	**Service Incentive Mechanism** Delivering a service which meets our customers' expectations.
	Value-for-money survey Ensuring that we are providing the service that our customers and communities value, and that we help those who may struggle to pay.

At the heart of our community-focused ambition is a desire to be transparent and accountable for our performance and the way we do business. In our Business Plan we have committed to be accountable at a local level, not just a national level, by committing to publish details of our performance for each of our eight communities (our eight WRZs), and we will hold an annual forum for customers and stakeholders in each community so that we can continue to understand their needs and drive better performance.

We are in the process of linking our Business Plan to our long-term vision and strategic priorities in order to develop strategic objectives that are aligned to the delivery of our price review commitments, both for AMP5 and AMP6, and to address the drivers and opportunities for our business that stretch beyond our regulatory business plans. For example in light of changing patterns of demand and customer expectations, we need to ensure that adequate supplies of high-quality water are reliably available to meet future demand. This requires long-term planning, investment and management of source, treatment and our distribution assets.

STRATEGIC REPORT continued

Principal risks and uncertainties

We have an established framework for identifying, evaluating and managing the key risks we face, which we have been refreshing during the year. Strategic and operational risks are reviewed and discussed by senior management. A key aim is to foster a culture in which staff throughout the business manage all risks as part of their management of day to day operations. The Audit Committee reviews senior management's work on risk management and reports to the Board on significant risks. During 2014/15 we are developing our risk management processes and further integrating them into the operation and governance of our business. For 2013/14, we report on our risks under the key themes of:

- Economic, regulatory and political risks
- Competition and market reform risks
- Operational risks
- Financial risks
- People risks

Economic, regulatory and political risks

Risks relating to our Instrument of Appointment

In certain circumstances, the conditions of our appointment as a water undertaker may be modified by Ofwat or the Secretary of State. If we do not consent to a proposed modification, Ofwat may ask the Competition and Markets Authority to determine whether there are effects adverse to the public interest which can be remedied or prevented by modifications. The Water Act 2014 provides Ofwat and the Secretary of State a time-limited power to modify licence conditions without consent where it is necessary or expedient to implement the provisions of that Act. Any modification of our conditions of appointment could have an adverse impact on the financial or operational performance of the company.

If we fail to comply with the conditions of our Instrument of Appointment or certain statutory duties, this may lead to the making of an enforcement order or the imposition of financial penalties of up to 10 per cent of our appointed turnover. Failure to comply with an enforcement order (as well as certain other defaults) may lead to the Secretary of State making a special administration order, which would have a substantial adverse impact on the business.

The Secretary of State or Ofwat may in certain circumstances by order replace the company as the regulated water undertaker for all or part of our currently appointed area. In these circumstances, the Secretary of State or Ofwat (as the case may be) would have a duty to ensure (so far as consistent with their other duties under the Water Industry Act 1991) that the interests of creditors were not unfairly prejudiced by the terms on which the new appointee(s) could accept transfers of our property, rights and liabilities.

Price control risks

The turnover, profitability and cash flow of our appointed business are substantially influenced by the periodic reviews undertaken by Ofwat. For AMP6, Ofwat will determine wholesale and retail price controls, performance commitments and associated outcome delivery incentives which will influence our turnover, profitability and cash flow during the period. Price controls create risks relating to the allowed cost of capital, allowed revenue and regulatory assumptions concerning operating expenses and required capital expenditure proving not to be sufficiently accurate. We may also experience unforeseen financial, regulatory or legal obligations or costs after a periodic review which were not taken into account by Ofwat in setting our price controls.

Revenue and our RCV are linked to the Retail Prices Index ('RPI') and are therefore subject to fluctuation. Changes in the rate of inflation may impact our operating and capital costs and the ability of our customers to pay their water bills. Non-recovery of customer debt may adversely affect cash flow and profitability. We are prohibited from disconnecting household and certain other premises for non-payment. An allowance for bad debt is made in the price controls at each periodic review. We take a robust approach to the collection of outstanding charges and have implemented a new debt collection IT system to improve our effectiveness in collecting debt.

Principal risks and uncertainties continued

Price control risks (continued)

Our Instrument of Appointment provides some protection against unforeseen financial risks materialising during a price control period. We may ask Ofwat to undertake an interim determination of price limits in certain circumstances. Ofwat will make an interim determination only where it is satisfied that a 10 per cent cost threshold has been met, so we must always bear any additional cost which does not exceed this threshold. Where the cost threshold is met, there is no assurance that Ofwat will make an interim determination or that any determination made would provide adequate revenue compensation.

We are required under our price controls to achieve certain regulatory outputs and implement the investment programme for which allowance is made. Ofwat may seek at a future periodic review to recover amounts equivalent to the "allowed costs" of any parts of our investment programme that are not delivered. Failure to achieve regulatory outputs may lead to the imposition of other sanctions, including financial penalties or other enforcement action. To mitigate these risks, we have established a programme management function responsible for delivery of our investment programme and the Board and our senior executive team monitor performance and ensure that appropriate corrective action is taken where necessary.

Political risk

As a regulated business holding a near monopoly on the provision of water supplies within our supply area, we are exposed to risk arising from the general political climate from time to time. During the year, we observed the political pressure applied to energy companies to restrain consumer price increases and were asked by the Secretary of State and Ofwat to consider not implementing price increases allowed within our current price control. In response to these requests, we decided not to implement the full inflationary allowance within our price controls in our tariffs for household customers for 2014/15.

Risks from competition and market reform

Currently, certain non-household customers may choose to be supplied by a water supply licensee. The Water Act 2014 makes provision for all non-household customers to have the option to switch their supplier. It is planned that that this will be introduced from 1 April 2017. Where we make a wholesale supply available to a licensee or provide the licensee access to our network we will make a charge for access to these facilities, thereby mitigating the loss of revenue from our former customer. As preparations for the opening of this market develop under the Open Water programme, we expect more non-household customers may wish to switch their supplier. To support market opening, we are reviewing how our wholesale and retail functions operate and developing our retail offering for non-household customers so we can compete effectively in the market.

An inset appointment allows one water undertaker to replace another as the water supplier in a specified geographical area within another regulated company's appointed territory. Inset appointments within our water supply area would lead to a reduction in revenue from customers within the inset area that we would otherwise have supplied. In recent years, we have seen an increase in enquiries from potential inset appointees asking us to provide a bulk supply of water to service potential inset areas.

Operational risks

Water quality

We are required to maintain for our customers a continuous supply of high quality water. In doing so, we recognise the significant contribution we make to public health and the substantial adverse consequences for our customers and our business should we fail in this duty. Should we fail, we may face regulatory sanctions and in certain cases, criminal prosecution.

To ensure that the water we supply is safe for human consumption and meets relevant health-based standards and other regulatory requirements, we have developed water safety plans which provide a comprehensive risk assessment and risk management approach to all the steps in the water supply chain. Our water

STRATEGIC REPORT continued

safety plans are designed to minimise contamination of source waters, reduce or remove contamination through appropriate treatment processes and prevent contamination in our distribution network and the domestic distribution system. We utilise these plans to inform our investment and maintenance programmes. To provide assurance of the quality of water we supply, we test and analyse almost 100,000 samples each year, reporting results to the Drinking Water Inspectorate. Our laboratory and sampling activities are accredited to ISO17025.

Water availability

Our three water supply areas are designated by the Secretary of State as being subject to serious water stress. A projected significant growth in population, climate change and pressure to reduce abstractions which adversely affected the flow of chalk stream rivers would place significant pressures on the supply and demand balance. We manage this risk through our statutory Water Resources Management Plan which identifies, over a 25 year planning period, how we will ensure that available supplies and required demand are kept in balance. Measures include the development of new supplies, importing water from neighbouring companies, reducing leakage and reducing customer demand through metering and promoting water efficiency.

We may experience temporary shortages of water. In the event of drought, we manage this risk through our statutory Drought Management Plan which is approved by the Secretary of State. In the event of drought, we may need to place restrictions on supply through a temporary use ban or drought orders, or seek drought permits to abstract from rivers or other sources. Interruptions to supply through drought in certain circumstance can lead to significant compensation becoming payable to customers.

We consider that risks from climate change are most likely to affect our business in the context of the availability of water resources and drought. We have reported to the Secretary of State on our plans for adaptation in response to a direction to report under the Climate Change Act 2008.

The environment

The operations of our business are subject to significant environmental controls. In particular, our abstraction of water from the environment, discharges to watercourses at our water treatment works and trade effluent discharges into the sewerage system are all subject to strict environmental controls. To mitigate the risk from non-compliance of fines or other regulatory sanctions or intervention, we operate our abstraction, treatment and supply activities to environmental standard ISO14001.

Information and data security

Customers rightly expect that we protect their information from unauthorised disclosure and improper use. As the use of on-line communications and cloud-based technology continues to increase, so does the risk of cyber crime. We have therefore strengthened our capabilities to ensure that our technical and organisational controls against the unauthorised disclosure, loss or use of data are kept under review and improved where appropriate.

Business continuity

Failure of, or disruption at, a key site or installation could cause a significant interruption to the supply of services. Catastrophic events such as fire, earthquake, flood, drought or terrorism or cyber attack could compromise our ability to operate our business and assets. Should water supplies be compromised, we have plans in place to ensure the provision of essential water supplies at all times. In the event of interruption to the piped water supply, we plan to provide domestic customers a minimum alternative potable supply of 10 litres per head a day. Our contingency plans are audited annually by an independent certifier and their reports are shared with the Secretary of State. Our business continuity plans also include contingencies in the event of the loss of key personnel through pandemic or other disease.

Financial risks

We finance our operations from a mixture of retained profits, borrowings from our financing subsidiaries, borrowings from our parent company and debentures. Our ability to improve operating performance and our financial results depends upon economic, financial, regulatory and other factors, including fluctuations in interest rates and general economic conditions in the United Kingdom.

STRATEGIC REPORT continued

Principal risks and uncertainties continued

Financial instruments

The company's financial instruments comprise borrowings, debentures, cash and liquid resources, and various items, such as trade debtors and trade creditors that arise directly from operations. The main purpose of these financial instruments is to raise finance for our operations. It is our policy, and has been throughout the report year, not to undertake any speculative trading in financial instruments.

The main risks arising from our financial instruments are interest rate risk and liquidity risk. Our Board has approved a treasury policy which manages these and other risks and regularly reviews performance against the policy. Our policies have remained unchanged during the reporting period.

For further details of our financial instruments refer to note 26 of the financial statements.

Financial liquidity risk

Our substantial capital investment generates an on-going need for financing. We are subject to variability of cash flow due to the billing cycle and the uncertainty of timing of customer payments. We therefore ensure that we have banking arrangements and adequate, though not excessive, cash resources, borrowing arrangements, overdraft or standby facilities which are necessary for the achievement of our strategic objectives.

We ensure a minimum level of liquidity such that there is sufficient cash and committed loan facilities capable of immediate drawdown to cover as a minimum the next twelve months' forecast cash requirement.

Our liquidity is supported through access to a further borrowing facility of £100 million with a tenor of 5 years from 28 June 2012. This facility consists of a £70 million capital expenditure facility and a £30 million working capital facility.

Disclosure on the management of liquidity risk is included in note 26 of the financial statements.

Interest rate and inflation risk

We are required to manage exposure to interest rates (and may manage inflation exposure). Interest rate and inflation risk is primarily managed by using a mixture of fixed, inflation linked and floating rate borrowings, and approved hedging instruments. Our policy is that at least 85 per cent of outstanding debt is not exposed to interest rate movements.

Foreign exchange risk

We are required to manage our foreign currency risk. Our policy requires us to hedge any exposure to foreign currency movements when in aggregate they exceed the greater of 0.1 per cent of RCV or £1 million.

High leverage

Indebtedness is substantial in relation to the company's RCV. Under the whole business securitisation, we may increase leverage to 90 per cent. However, a percentage exceeding 85 per cent will result in a restriction on certain payments, such as dividends.

We are subject to a number of covenants in relation to our borrowings which, if breached, would result in our loans becoming immediately repayable. These covenants include observing certain limits in terms of key ratios such as net cash flow to debt interest and net debt to RCV. At the year end the financing group was not in breach of any financial covenants.

STRATEGIC REPORT continued

Financial credit risk

Our main credit risk relates to trade debtors. We are not permitted to disconnect water supplies to household and certain other types of premises in the event of non-payment. The risk from non-payment is spread over a large number of low value customer accounts. We ensure that sufficient resources are allocated to debt recovery to reduce the impact of this risk.

People risks

Health and safety

We are committed to creating a working environment to achieve zero harm and improved well-being for our employees. To manage the risk of harm and to improve well-being we have adopted this commitment as a strategic priority and are implementing a series of programmes to improve our capabilities and performance. We seek to operate our business to the OHSAS 18001 safety standard and employ a dedicated health and safety team to support the business in meeting this priority.

Unavailability of skilled resource

We rely on the availability of skilled employees and contractor resources to maintain service and implement our investment plans. In the event of these resources being unavailable, whether due to industrial action, skill shortages or pandemic disease we may experience significant disruption to our service, damage to our reputation and consequent regulatory enforcement action. We seek to mitigate this risk by maintaining a constructive relationship with employees through the Joint Negotiating and Consultative Committee, succession planning and investing in our employees through training and apprenticeship schemes.

Approval of the strategic report

By order of the Board

Richard Bienfait
Chief Executive Officer
20 June 2014

GOVERNANCE

Letter from the Chairman

We are committed to the highest standards of governance and support the principles of good corporate governance set out in the UK Corporate Governance Code ('the Code') and the UK Stewardship Code, which have been developed to promote good governance for companies whose equity shares are listed. Our business is owned by private investors and we therefore apply the principles of the Code in this context.

We are mindful that best practice in corporate governance continues to evolve, with greater emphasis in recent years being placed on shareholders holding the Board to account for the fulfilment of its governance responsibilities - alongside monitoring and engaging with Boards on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration. We have explained how we engage our shareholders and involve them in decision making in our publication: *Engaging with our shareholders*.

Our governance arrangements continue to evolve, as we recognise the importance of demonstrating to customers, regulators and other stakeholders that we operate to the highest standards of governance and transparency. To this end, we published our *Governance Code* in March 2014. We welcome Ofwat's publication: *Board leadership, transparency and governance – principles*, and our Governance Code explains how we are meeting these principles.

We consider that the company complies with all the principles of the Code, except in terms of board composition, membership of committees and re-election of directors, which we explain further in this section of the annual report.

Dr Philip Nolan
CHAIRMAN

Board composition

In my role as Chairman of the Board, I am responsible for ensuring that our directors have a diverse range of backgrounds and skills and that they all contribute to our decision-making. As a Board, we value the contribution that all our non-executive directors bring to the governance of the company, and believe that their balance of skills, experience, independence and knowledge of the company ensures strong leadership and governance.

Board changes

After serving for almost eight years as an independent non-executive director, Fiona Woolf CBE resigned on 31 December 2013. We wish Fiona well during the year as she fulfils the role of Lord Mayor of London, and are currently searching for a replacement. In July 2013, Patrick O'D Bourke was appointed as an independent non-executive director and as Chairman of the Audit Committee. Andrew Dench (replaced by Olivier Bret), Alberto Donzelli, Mathieu Lief and Bernd Schumacher also stepped down during the reporting year and I would like to thank them for their contributions.

Dr Philip Nolan
Chairman

Dividend policy

The amount of the dividend is dependent on the level of success of the company in generating cash flows and achieving its regulatory outputs in the reported period. The policy distributes earnings equal to the amount required to maintain net debt to RCV at the targeted gearing ratio of 80 per cent. This is consistent with the requirements of Condition F of our Licence that dividends paid will not impair our ability to finance our appointed business, and under a system of incentive regulation, dividends would be expected to reward efficiency and the management of economic risk.

GOVERNANCE continued

Board leadership, transparency and governance

Board of directors

Biographies for the members of our Board are shown below. Where a director holds other directorships within the Affinity Water Group of companies, the numbers listed alongside their name may be cross referenced to the relevant company shown on the structure chart on page 49.

Chairman

Dr Philip Nolan

Dr Philip Nolan was appointed to the Board as Chairman in April 2013 and his role became non-executive on 1 April 2014. Philip is also Chairman of John Laing plc., a specialist investor and manager of infrastructure assets and Ulster Bank Limited. He is also a non-executive director at Providence Resources plc. and EnQuest plc. He was previously Chief Executive of Eircom, Ireland's national telecommunications supplier from 2002 to 2006. Prior to that, he served as an executive director of BG Group and Chief Executive of Transco from 1998 and in 2000, led the demerger of Transco as Chief Executive of the Lattice Group.

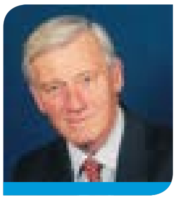
Independent non-executive directors

Patrick O'D Bourke

Patrick O'D Bourke was appointed to the Board in July 2013. He is a Chartered Accountant and is currently Group Finance Director of John Laing plc. He was previously Chief Executive of Viridian Group, having first undertaken the role of Group Finance Director, and formerly was Group Treasurer of Powergen plc. He chairs our Audit Committee and has a wide range of experience in regulated businesses operating within the private and quoted sectors.

Baroness Peta Buscombe

Baroness Peta Buscombe was appointed to the Board in 2006. She is a barrister, an active member of the House of Lords and has held a number of shadow ministerial positions including responsibility for industry and enterprise, regulatory reform, the media and education. Formerly Chairman of the Press Complaints Commission, she is a non-executive Director of Local World Limited, a member of the Human Rights Joint Committee, served on the Inquiries Act 2005 Committee and is Chairman of the Advisory Board for the Samaritans.



Dr Jeffrey Herbert

Dr Jeffrey Herbert was appointed to the Board in July 2012. He was previously Chairman of Veolia Water East Limited. He is an industrialist who has held Chief Executive Officer and Chairman roles for a number of large, international businesses in the automotive, mineral extraction and mechanical engineering sectors. His non-executive roles have included Chairman/Deputy Chairman in the retail, aerospace, investment and water sectors. He is a Fellow of the Royal Academy of Engineering.

GOVERNANCE continued

Board leadership, transparency and governance continued

Executive directors

Richard Bienfait – Chief Executive Officer 1 2 3 4 5 6 7 8

Richard Bienfait is Chief Executive Officer and was appointed Managing Director of the company in March 2010. He joined Veolia Water in 1997 as Group Financial Controller and joined the Board of Veolia Water UK and became Chief Financial Officer in 2004. He is a member of the Institute of Chartered Accountants and an associate member of the Association of Corporate Treasurers.

Duncan Bates – Chief Financial Officcer 1 2 3 4 5 7

Duncan Bates is Chief Financial Officer of Affinity Water Limited, having joined the company in March 2012 and appointed to the Board in September of that year. He began his career in Veolia in 1992 and held a number of financial posts until his appointment as Veolia Environnement UK's Group Financial Controller in 1999. In 2007, he became Finance Director of Veolia Water's non-regulated business, a post he held until joining Affinity Water. He is a Fellow of the Chartered Institute of Management Accountants.

Non-executive directors

Antonio Botija 1 2 3 8 9 10 11 12 15 16

Antonio Botija was appointed a director in 2012. He joined Infracapital in 2009 as an Associate Director and is responsible for investment origination and execution. Prior to joining Infracapital, Antonio worked as Associate Director at the Infrastructure and Transport Group of UBS Investment Bank in London, where he was a financial advisor on infrastructure projects and transactions across many sectors including roads, railroads, airports, ports and airlines.

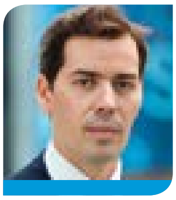
Kenton Bradbury 1 2 3 7 8 9 10 11 12

Kenton Bradbury was appointed a director in 2012 and is a member of the Audit Committee (chairing it until July 2013), Remuneration Committee and Nomination Committee. He is a Director of Infracapital and a number of companies in which Infracapital has invested including companies within the Zephyr Investments, Calvin Capital, Infracapital Solar and Falbygdens Energi groups of companies. Prior to joining Infracapital, he was Senior Vice President of Infrastructure and Regulation for E.ON based in Germany.

Olivier Bret 1 2 3 8 9 10 11 13

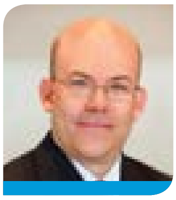
Olivier Bret was appointed a director on 31 December 2013. He is Chief Executive Officer of Veolia Water UK Ireland and Northern Europe having joined the business in June 2008. He holds a number of directorships of companies within the Veolia Water group. Previously he was a director at executive consulting services firm DYDESYS and worked for four years at management consultants AT Kearney.

GOVERNANCE continued



Yacine Saidji 1 2 3 8 9 10 11 12

Yacine Saidji was appointed a director in 2012. He is Executive Director at Morgan Stanley Infrastructure, focusing on European investing and holds directorships in the Madrileña Red de Gas group of companies. Prior to joining Morgan Stanley in 2006, he spent three years at McKinsey & Company advising clients in the energy sector.



James Wilmott 8 9 10 11 12

James Wilmott was appointed a director in 2012 and is a member of the Remuneration Committee and Nomination Committee. He is a Managing Director and Head of Europe of Morgan Stanley Infrastructure and is a director of European Rail Finance (GB) Limited, the Eversholt Rail Group and a number of companies affiliated with Morgan Stanley.

Former directors

Fiona Woolf CBE

Fiona Woolf served as an independent non-executive director between 20 February 2006 and 31 December 2013.

Andrew Dench

Andrew Dench served as a non-executive director of the company between 25 July 2012 and 31 December 2013.

Alberto Donzelli

Alberto Donzelli served as a non-executive director between 25 July 2012 and 27 June 2013.

Mathieu Lief

Mathieu Lief served as a non-executive director of the company between 25 July 2012 and 22 April 2013.

Bernd Schumacher

Bernd Schumacher served as a non-executive director between 25 July 2012 and 27 June 2013.

GOVERNANCE continued

Board leadership, transparency and governance continued

Board leadership

Our Board is collectively responsible for the long-term success of the company. It sets our strategic aims, ensures that the necessary financial and human resources are in place to meet our objectives and reviews management performance. It sets our values and standards and ensures that our obligations to shareholders and others are understood and met.

Our Board is led by our Chairman, Dr Philip Nolan. He is responsible for leading the Board and ensuring its effectiveness on all aspects of its role. This includes regulatory interactions concerning governance matters that would, for a listed company, be discharged by a senior independent non-executive director. To support the Chief Executive Officer during the preparation of our Business Plan, Dr Philip Nolan agreed to serve as executive Chairman during 2013/14. As envisaged at the time of his appointment, the Board determined that the role of Chairman should be non-executive from 1 April 2014. Dr Philip Nolan is also non-executive Chairman of our ultimate UK holding company, Affinity Water Acquisitions (Investments) Limited.

The roles of Chairman and Chief Executive Officer are separated, set out in writing and agreed by the Board. The Chairman meets our independent non-executive directors without executives present. He also meets regularly with our shareholder investors to listen to their views and any concerns they may have about governance or other matters. In view of the representation of our major investors on our Board we do not consider the appointment of a senior independent non-executive director is required.

Richard Bienfait, as Chief Executive Officer, is responsible to the Board for managing the business from day to day in an efficient, economical and effective manner. He is responsible for implementing Board decisions and for those matters delegated to him by the Board.

The Board's role is to lead and control the company and to set corporate strategy, objectives and major plans bearing on the success of the business. The Board is responsible for ensuring that the company has competent, prudent and effective executive management and that all necessary management systems and processes are in place and are working effectively. It also brings judgement to bear on issues of performance, resources and standards of conduct.

The Board reserves to itself the approval of certain key matters such as strategy and management, changes to the company's structure and capital, annual capital and operating budgets, financial statements, declaration of interim dividends and key regulatory submissions, reports and plans. It also approves key policies relating to safety, health and the environment, corporate responsibility and ethical conduct, risk management and business continuity planning. These matters, together with the terms of reference for the Board Committees discussed below, were reviewed, updated and published in November 2013.

GOVERNANCE continued

Board composition and balance

During 2013/14 the composition of our Board did not comply with the requirements of the Code for at least half of the Board, excluding the Chairman, to comprise non-executive directors determined by the Board to be independent. However during the year we increased the number of independent non-executive directors on the Board to four, thereby strengthening the independent voice in decision making.

The composition of our Board at the date of approval of this annual report and financial statements is shown as follows and biographies of our directors are shown on pages 37 to 39.

Non-executive Chairman
Dr Philip Nolan

- **Independent Non-executive Directors**
  - Dr Jeffrey Herbert
  - Patrick O'D Bourke
  - Baroness Buscombe
  - Vacancy
- **Executive Directors**
  - Richard Bienfait, **Chief Executive Officer**
  - Duncan Bates, **Chief Financial Officer**
- **Non-executive Directors**
  - Antonio Botija
  - Oliver Bret
  - Kenton Bradbury
  - Yacine Saidji
  - James Wilmott

We consider that our Board and its Committees have the appropriate balance of skills, experience, independence and knowledge to enable them to discharge their respective duties and responsibilities effectively. Our non-executive directors constructively challenge and help develop the strategy of our business. Our Board considers that Patrick O'D Bourke, Baroness Peta Buscombe and Dr Jeffrey Herbert are independent. They are of sufficient calibre and have sufficient experience for their views to carry significant weight in Board decisions.

Baroness Peta Buscombe has served for more than six years on our Board and Dr Jeffrey Herbert, who has served on our Board for two years, previously served as Chairman of Veolia Water East Limited. Our Board values the continuity and experience brought by Baroness Peta Buscombe and Dr Jeffrey Herbert, and considers this particularly important following our change of ownership and unification of our three former businesses in 2012.

Patrick O'D Bourke has since 2011 been Group Finance Director of John Laing plc., which is chaired by Dr Philip Nolan. Prior to this, Patrick O'D Bourke held senior executive roles at Viridian Group (between 2000 and 2011) and Powergen plc. (between 1995 and 2000). On appointment, our Board recognised the existence of the cross directorship with Dr Philip Nolan. Taking into account Patrick O'D Bourke's considerable experience of senior roles within the regulated utility sector, the comparatively short period during which he has served on the Board of John Laing plc. with Dr Philip Nolan and his personal qualities and character, our Board is satisfied that the cross directorship does not compromise Patrick O'D Bourke's ability to act independently. Arrangements have been established to ensure that Dr Philip Nolan and Patrick O'D Bourke are not involved in the evaluation of each other's performance.

Collectively, the Board is satisfied that our independent non-executive directors have connections with, and knowledge of, the areas within which the company provides water services and an understanding of the interests of customers and how these can be respected and protected. Our Nomination Committee is actively seeking to identify and recommend a potential candidate to fill the vacant independent non-executive role left after Fiona Woolf CBE stepped down as director in December 2013.

GOVERNANCE continued

Board leadership, transparency and governance continued

Board composition and balance continued

Certain Board members are also directors of other group companies. These directorships are shown on pages 38 to 39. All directors declare their position when as individuals they have a possible conflict of interest and do not vote on any contract, arrangement or proposal in which they have an interest by virtue of other directorships. Directors have access to the advice and services of the Company Secretary and are able to obtain access to independent professional advice where they think it necessary.

The composition of our Board is such that our directors, in accordance with their duties, act independently of our shareholders. We intend to maintain a minimum of four independent non-executive directors on our Board who, collectively, have knowledge of customer issues and the areas our business supplies, together with an independent non-executive Chairman.

We value the contribution that all our non-executive directors bring to the governance of the company, and believe that the balance of skills, experience, independence and knowledge they bring ensures strong leadership and governance. We are committed to maintaining significant independent representation on our Board and its Committees.

We consider that the composition of our Board is appropriate for balancing the needs of customers, the environment and our shareholders, having taken into account the Code, Ofwat's principles and the privately-owned nature of our business. The composition of our Board is such that no single director or group of directors can dominate the Board's decision making because:

- no individual investor has a majority of voting rights and none of the directors appointed by investors is individually able to veto Board decisions; and
- there is no arrangement between investors as to how to vote on particular matters; directors appointed by an investor act independently of those appointed by the other investors.

Where potential conflict exists between the interests of the company as a water undertaker and those of other companies in the group, each director has regard exclusively to the interests of the company as a water undertaker. These arrangements are reflected in the company's Articles of Association, which also require that at each annual general meeting ('AGM'), any director who:

- has been appointed by the Board since the last AGM;
- held office at the time of the two preceding AGMs and who did not retire at either of them; or
- has held office with the company, other than employment or executive office, for a continuous period of nine years or more at the date of the meeting,

must retire from office and may seek re-appointment by the company's shareholder. At this year's AGM, Patrick O'D Bourke, Olivier Bret, Baroness Peta Buscombe and Jeffrey Herbert will be required to retire from office and may seek re-election. While this does not comply with the requirements of the Code with respect to annual re-election of all directors, the Board considers these arrangements for re-election are appropriate for a company owned by private investors.

We publish the terms and conditions of the appointment of our independent non-executive directors on our website.

GOVERNANCE continued

Board accountability

Financial and business reporting

Our Board is responsible for presenting a fair, balanced and understandable assessment of the company's position and prospects in the company's financial statements. The strategic report sets out the basis on which the company generates or preserves value over the longer term and the strategy for meeting the company's objectives.

Having taken into account all matters considered by the Board and brought to its attention during the year, the Board is satisfied that the annual report and financial statements taken as a whole, is fair, balanced and understandable.

The Board believes that the disclosures set out on pages 10 to 35 of the annual report provide the information necessary for shareholders to assess the company's performance, business model and strategy.

Risk management and internal control

Our Board has overall responsibility for the company's systems of internal control and for reviewing the effectiveness of these systems, including financial, operational and compliance controls and risk management, and is advised by its Audit Committee on these matters. The systems are designed to manage the risk of failure to achieve business objectives (though such risk cannot be completely eliminated), and provide reasonable, and not absolute, assurance against material misstatement or loss. Particular features of the systems of risk management, planning and internal controls include:

- a comprehensive suite of internal control procedures across both operational and financial matters, supported by segregation of duty matrices and detailed delegated levels of authority;
- an Internal Audit Team, the Head of which reports to the Audit Committee together with other internal control and assurance resources which monitor compliance with policies and procedures;
- the setting and monitoring of annual budgets at a detailed level supported by a long term plan;
- specialist planning teams retained within the organisation to work on major projects, such as business-planning activities, supported by external specialists where appropriate; and
- the use of considerable external assurance review, both fiscal and operational.

The Board approves the company's annual budget and annual capital expenditure budget and regularly reviews actual performance. There is a defined organisational structure with appropriate delegation of authorities to line management and segregation of duties. All major transactions are reviewed and approved by the Board. Through the year, the Board has assessed the effectiveness of internal control systems through reports from the Audit Committee, external auditors and other assurance providers. The Board has not identified, nor been advised of, any failings or weaknesses which it has determined to be significant. Therefore a confirmation in respect of necessary actions has not been considered appropriate.

A whistleblowing procedure is in place that supports the open culture that the company promotes in its dealings with members of staff and all people with whom it engages in its business activities. The procedure encourages members of staff to communicate their concerns about malpractice or misconduct in an open and honest manner without fear of any form of detriment to their employment or career prospects.

We have an established framework for identifying, evaluating and managing the significant risks we face, which has been in place for the year under review and up to the date of approval of this annual report and financial statements. The Chief Executive Officer and his executive management team keep under review the management of risks already identified and emerging and expected risks, in order to integrate fully the consideration of risk into the overall management of the business. The Chief Executive Officer appraises the Board of any significant emerging risks. A review of the process for identifying, evaluating and managing the significant risks faced by the company is being undertaken to ensure it is aligned to and integrated within the company's new governance arrangements.

GOVERNANCE continued

Board leadership, transparency and governance continued

Board Committees

Our Board has established an Audit Committee, Renumeration Committee and Nomination Committee to assist it in discharging its responsibilities. Each Committee operates in accordance with terms of reference approved by our Board and which are published on our website.

During 2013/14 the composition of our Committees did not comply with the requirements of the Code with respect to the representation of independent non-executive directors. However during the year we have appointed independent non-executive directors to all our Committees, thereby strengthening the independent perspective in their work.

Membership of each Committee at the date of approval of this annual report and financial statements is as follows:

Audit Committee	Renumeration Committee	Nomination Committee
Patrick O'D Bourke (Chairman)*	Dr Philip Nolan (Chairman)	Dr Philip Nolan (Chairman)
Jeffrey Herbert*	Baroness Buscombe*	Patrick O'D Bourke*
Kenton Bradbury	Jeffrey Herbert*	Baroness Buscombe*
Yacine Saidji	Kenton Bradbury	Kenton Bradbury
Vacancy	James Wilmott	James Wilmott

* denotes Committee members that the Board considers to be independent.

While membership of these Committees does not fully meet the relevant Code provisions, our independent non-executive directors are strongly represented on each Committee and this ensures an independent voice and perspective are brought to bear on their work and decision-making.

The Regulation Committee, established in 2012 to support the Board in discharging its responsibilities with respect to the oversight, scrutiny and challenge of key regulatory submissions to regulators and the monitoring of regulatory performance against regulatory, financial and operating targets, no longer meets. Its work was taken on by the Board in May 2013.

Further information about the Audit Committee, Remuneration Committee and Nomination Committee is provided in the following sections.

Audit Committee

The Audit Committee comprises three independent non-executive directors (currently one vacancy) and two non-executive directors not considered to be independent. It meets at least four times a year. It is chaired by Patrick O'D Bourke, an independent non-executive director who has relevant and up to-date financial experience. The Chief Financial Officer, Head of Internal Audit, external auditor and other parties are invited to attend meetings as appropriate. The Board recognises that the Committee would benefit from the appointment of a further independent non-executive director with recent and relevant financial experience and has asked the Nomination Committee to consider this requirement.

The Committee reviews the company's statutory annual financial statements and regulatory financial statements before submission to the Board to ensure that the report and financial statements meet the obligations of the directors and give a true and fair representation of the company's financial position. The key areas of audit focus agreed with the auditor for the year ended 31 March 2014 related to revenue recognition, bad debt provisioning, cost capitalisation, contractual and legal claims, pension assumptions and taxation. The Committee considers the matters identified by the external auditor in its report to the Committee and, where significant, reports these to the Board. The Committee further provides advice to the Board on whether the annual report and financial statements, taken as a whole, is fair, balanced and

GOVERNANCE continued

understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

The Committee meets with the external auditor and reviews the information to be provided in the annual performance report to Ofwat before submission to the Board to ensure that the information meets Ofwat's reporting requirements.

Discussions are held with the external auditor before audits begin, in the course of their work and when the work is completed, to establish the nature and scope of the audit work, assess its cost effectiveness, and the auditor's independence and objectivity and review the results of audit work.

The Committee keeps under review the level of audit fees, the appointment of the external auditor, and the nature and extent of non-audit services provided by them, seeking to balance the maintenance of objectivity with value for money. During the year the Committee considered tenders for the provision of audit services and recommendations were made to the Board. The Committee also approves in advance the internal audit plan and keeps under review the effectiveness of the internal audit function.

The Committee is responsible for drawing the attention of the Board to, and advising on, any matters which should appropriately be decided by the Board as a whole. It also considers and advises the Board on the policies and procedures for controlling and managing risks throughout the company and supervises actions to define, assess, control and limit risk.

The Committee each year evaluates its performance by means of a questionnaire covering the range of its responsibilities and procedures.

Further information on the work of the Audit Committee is contained in the Audit Committee report on pages 52 to 54.

Remuneration Committee

Our Remuneration Committee operates under terms of reference established by the Board and is responsible for determining and agreeing with the Board the broad policy for the remuneration of the Chairman, independent non-executive directors, executive directors and other members of the executive management team. The Committee is chaired by Dr Philip Nolan, and includes two directors who the Board considers independent.

The Board values the experience and knowledge Dr Philip Nolan brings to this role from his chairmanship of other remuneration committees.

The Committee is responsible, in consultation with the Chief Executive Officer, for determining the total individual remuneration package including bonuses and incentive payments of the executive directors and other members of the executive management team. No director or manager is involved in any decisions as to his or her own remuneration. Further information on the work of the Remuneration Committee is contained in the remuneration report on pages 55 to 63.

Nomination Committee

Our Nomination Committee keeps under review the skills and balance of our Board to ensure the right skills and experience which are best able to balance the needs of our business, customers, shareholders, the environment and other stakeholders. In undertaking its work, our Nomination Committee has regard to the Financial Reporting Council's guidance on board effectiveness. It operates under terms of reference approved by the Board which provide a formal, rigorous and transparent procedure for the appointment of all new directors to the Board.

During the year, Dr Philip Nolan, Baroness Peta Buscombe and Patrick O'D Bourke were appointed to the Committee. The Committee is chaired by Dr Philip Nolan and includes two directors who the Board considers independent. During the year, the Committee oversaw the process to select and recommend to the Board the appointment of Patrick O'D Bourke and is currently working to identify a replacement for Fiona Woolf CBE. In the case of the former, the Committee did not use an external search consultancy nor open advertising as Patrick O'D Bourke was already known to the Chairman and having interviewed him as a candidate, the Committee was satisfied as to his experience and suitability for the role of chairing the Audit Committee.

In the forthcoming year, the Committee plans to support the Board in developing a policy on diversity, including gender, and measurable objectives for implementing this policy. During 2013/14, the Board did not adopt a diversity policy.

GOVERNANCE continued

Board leadership, transparency and governance continued

Board and Committee attendance, effectiveness and evaluation

The Board ordinarily meets monthly but during 2013/14 further meetings were required, primarily to oversee the development of and provide assurance on the PR14 Business Plan in December 2013 and our subsequent Risk and Reward submission. The Audit Committee and Remuneration Committee ordinarily meet four times a year and the Nomination Committee meets as required.

Directors are expected to allocate sufficient time to the company to discharge their responsibilities effectively. In addition to formal Board and Committee meetings, directors are encouraged to participate in informal briefings from management. The expected time commitment of our Chairman and independent non-executive directors is recorded in their respective letters of appointment.

The following table sets out attendance at meetings for the year ended 31 March 2014.

	Board	Audit Committee	Board	Nomination Committee
Number of meetings in period	**20**	**6**	**4**	**1**
Chairman				
Dr Philip Nolan	19/20	-	4/4	0/1
Independent non-executive directors				
Patrick O'D Bourke	12/15*	3/3*	-	0/0*
Baroness Peta Buscombe	18/20	-	0/0*	0/0*
Jeffrey Herbert	18/20	6/6	0/0*	-
Executive directors				
Richard Bienfait	18/20	-	-	-
Duncan Bates	20/20	-	-	-
Non-executive directors				
Antonio Botija	6/20	-	-	-
Kenton Bradbury	17/20	6/6	4/4	1/1
Olivier Bret	9/9*	-	-	-
Yacine Saidji	18/20	3/3*	-	-
James Wilmott	17/20	-	3/4	1/1
Former directors				
Andrew Dench	10/11*	-	-	-
Alberto Donzelli	3/3*	3/3*	-	-
Mathieu Lief	0/1*	-	-	-
Bernd Schumacher	0/3*	-	-	-
Fiona Woolf CBE	11/11*	-	-	-

- denotes non-membership of that Committee
* denotes not a member of the Board or Committee for the whole 12 months

GOVERNANCE continued

The Company Secretary is responsible for ensuring that the Board and its Committees receive regular written reports from management of sufficient quality to enable them to discharge their duties. The Company Secretary also advises the Board on governance matters and facilitates information flows between management and the directors. Where a director requires access to independent professional advice the Company Secretary is responsible for making appropriate arrangements. The appointment and removal of the Company Secretary is a matter for the Board as a whole.

The Board recognises that improvement is needed in the arrangements for the induction of directors following appointment and for the provision of a tailored training programme for each director. Appropriate arrangements for induction and on-going training will be developed by the Chairman and Company Secretary.

The performance of the Board and its Committees is evaluated both informally and, from time to time, formally by the Board. Evaluations of performance of the Committees and individual directors for the year ended 31 March 2014 are planned in advance of the AGM.

Relationship with our shareholders

During 2013/14, our Board approved a limited number of matters requiring shareholder approval, reflecting the matters that a company with listed equity shares would typically involve shareholders in decision-making. These matters are explained in our publication: *Engaging with our shareholders*.

The presence on our Board of directors appointed by our shareholders facilitates effective dialogue with our shareholders and allows all the members of the Board, in particular the independent non-executive directors, to develop an understanding of their views.

Further information about our shareholders and ownership is provided on pages 48 to 49.

Transparency

We are committed to being accountable to our customers and our communities. We aim to maintain legitimacy with them by being open and transparent about our governance. We have therefore published a Governance Code which sets out for our customers, investors, regulators and other stakeholders how we will govern and operate our business to high standards of governance and transparency. Alongside our Governance Code, we have published *Engaging with our shareholders*, in which we explain the matters our Board has reserved for shareholder approval and the terms of reference for the Board and its Committees.

By order of the Board,

Tim Monod
Company Secretary
20 June 2014

GOVERNANCE continued

Ownership and financing

Ownership

Introduction

We are committed to transparency in order to maintain trust and legitimacy with our customers, regulators and other stakeholders. This section sets out our ownership and corporate structure.
The effective equity interest in Affinity Water Limited is as follows:

Infracapital Partners II	Morgan Stanley Infrastructure Partners	Veolia Water UK Limited	Beryl Datura Investment Limited
40%	40%	10%	10%

Infracapital Partners II

Infracapital Partners II is one of a number of European infrastructure funds managed by M&G Investment Management Limited, a subsidiary of Prudential plc. It was established in 2010 to make investments in income-generative infrastructure assets and businesses, including electricity and gas networks, water companies, transport infrastructure and renewable energy. It holds its investment in the company through Infracapital F2 Rift S.à.r.l., which is a wholly owned subsidiary of Infracapital F2 Rift Holdings S.à.r.l.. Both Infracapital F2 Rift S.à.r.l. and Infracapital F2 Rift Holdings S.à.r.l. are incorporated in Luxembourg.

Morgan Stanley Infrastructure Partners

Morgan Stanley Infrastructure Partners (MSIP) is a global infrastructure investment fund managed by Morgan Stanley Infrastructure Inc., part of the investment management division of Morgan Stanley. It was established in 2007 to make investments in core infrastructure assets that provide essential public goods and services to societies across the globe and seeks to improve asset performance using active management. It holds its investment in the company indirectly through MSIP Dalis B.V., which is incorporated in the Netherlands.

Beryl Datura Investment Limited

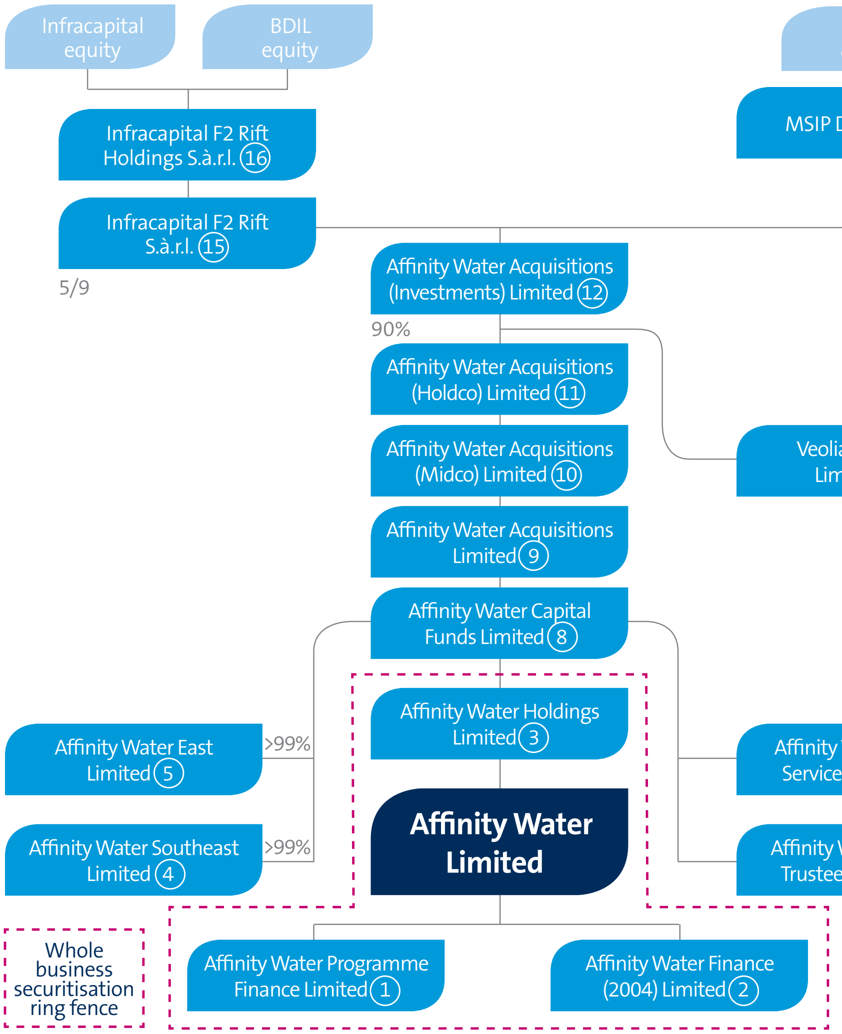
Beryl Datura Investment Limited (BDIL) is a company established by the State Administration of Foreign Exchange of the People's Republic of China. It is managed by Gingko Tree Investments Limited, which focuses on investments in real assets such as infrastructure and real estate and is attracted to relatively stable, predictable, long-term investments. It holds its investment in the company through Infracapital F2 Rift Holdings S.à.r.l..

Veolia Water UK Limited

Veolia Water UK Limited is incorporated in England and Wales and is a subsidiary of Veolia Environnement S.A. which is listed on the Paris and New York Stock Exchanges. It holds its investment in the company through its shareholding in Affinity Water Acquisitions (Holdco) Limited and has established with the company a capability sharing arrangement. This arrangement gives it access to the company's knowhow, experience and expertise while the company has access to Veolia Water's advice on global water technologies and developments.

GOVERNANCE continued

The following chart shows the ownership of the company and the group structure, excluding dormant subsidiaries. Unless otherwise indicated, all companies are wholly owned by the parent company shown.



Our UK holding company is Affinity Water Acquisitions (Investments) Limited and we consider Infracapital Partners II and Morgan Stanley Infrastructure Partners to be our ultimate controllers, as they are in a position to exercise material influence over our policy and affairs. These entities have provided us with legally enforceable undertakings that they will:

- give us such information as may be necessary to enable us to comply with our obligations under the Water Industry Act 1991 and Instrument of Appointment;
- refrain from any action which would cause us to breach any of our obligations under the Water Industry Act 1991 or the conditions of the Appointment; and
- use their best endeavours to ensure that our Board maintains not less than three independent non-executive directors, who shall be persons of standing with relevant experience and who shall collectively have connections with and knowledge of the areas for which we are a water undertaker and an understanding of the interests of our customers and how these can be respected and protected.

We are satisfied that these undertakings are being properly discharged and that we are able fully to meet our regulatory obligation to operate our appointed business as if it were substantially our sole business and the company were a separate listed company.

GOVERNANCE continued

Ownership and financing

continued

Our financing

In February 2013 Affinity Water Limited was financially and operationally 'ring-fenced' from the rest of the Affinity Water group as part of the whole business securitisation established at that time. This has further enhanced the ring-fencing provisions already in our licence granted by Ofwat. The sole business of our immediate holding company, Affinity Water Holdings Limited, is holding the shares of Affinity Water Limited.

We have two financing subsidiaries which have issued bonds which are listed by the UK Listing Authority ('UKLA') and the proceeds of which have been lent on to and are guaranteed by the company:

- Affinity Water Finance (2004) Limited
- Affinity Water Programme Finance Limited

Affinity Water Programme Finance Limited issued external bonds totalling £575m on 4 February 2013. At the same time, the £200m bonds issued by Affinity Water Finance (2004) Limited in 2004 were brought within the securitisation. We believe that the ring-fencing structure provides significant corporate benefits, providing better access to long-term debt markets and an opportunity to reduce the cost of capital employed in the regulated business for the benefit of customers.

Bonds issued by both Affinity Water Programme Finance Limited and Affinity Water Finance (2004) Limited are subject to the Listing Rules and Disclosure and Transparency Rules, being listed by the UKLA.

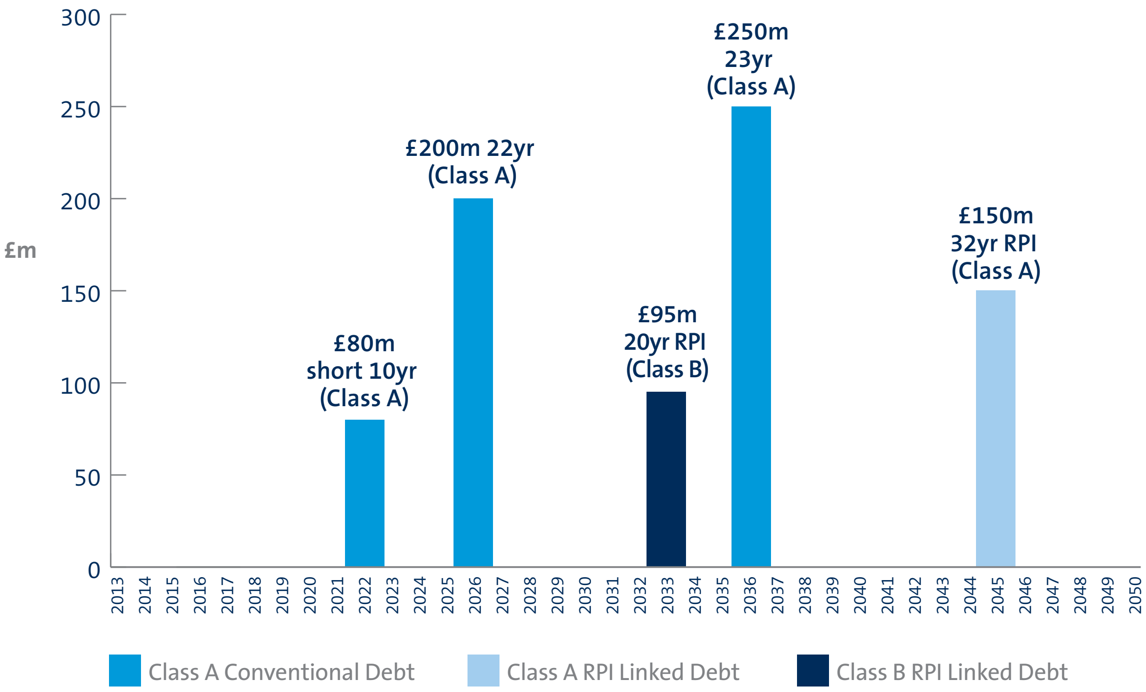
Affinity Water Programme Finance Limited is incorporated in the Cayman Islands but resident in the United Kingdom for tax purposes, as the bonds were, in part, used to discharge financing put in place by our investors in 2012 to finance their acquisition. It was not possible for us to establish a UK company to act as issuer. By being resident in the United Kingdom for tax purposes we are clear that this arrangement does not avoid UK tax and brings no tax benefit. Further, there are no funds which are held off-shore with all finance being raised and held within the United Kingdom.

The bonds issued by the company's subsidiaries can be summarised as follows:

Debt	Bond £m	Cost	Maturity Date
Class A fixed rate 2004 bond	200.0	5.88%	July 2026
Class A index linked (IL) refinancing bond	150.0	1.548% (real)	June 2045
Class A fixed rate refinancing bond (1)	250.0	4.501%	March 2036
Class A fixed rate refinancing bond (2)	80.0	3.685%	September 2022
Total Class A	**680.0**		
Class B			
Class B IL refinancing bond	95.0	3.249% (real)	June 2033
Total Class B	**95.0**		
Total	**775.0**		

GOVERNANCE continued

The following chart shows the maturity profile of the bonds:



The credit ratings for our bonds assigned by the rating agencies, Moody's and Standard & Poors are:

Bonds	Moody's	Standard & Poors
Class A	A3	A -
Class B	Baa3	BBB
Corporate Family Rating for Affinity Water Limited	Baa1	Not applicable

GOVERNANCE continued

Audit Committee Report

Patrick O'D Bourke
CHAIRMAN OF THE AUDIT COMMITTEE

Dear shareholder,

As part of our work over the last year, we concluded that appropriate risk management and internal control systems have been in place throughout the year ended 31 March 2014. From the information and assurance provided by the day-to-day work of the Internal Audit function and the external review/audit conducted by the auditor PricewaterhouseCoopers LLP ('PwC') at the half-year and full year; our understanding of the business; and information provided by the executive management team, the Committee was satisfied that the annual report and financial statements, taken as a whole, provides a fair, balanced and understandable assessment of the company's position at 31 March 2014 and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

CURRENT COMMITTEE MEMBERS

Patrick O'D Bourke (Chairman)
Kenton Bradbury
Dr Jeffrey Herbert
Yacine Saidji

For further information on the responsibilities of the Audit Committee and the qualifications of the Chairman, refer to pages 41 and 44.

Overview of the actions taken by the Audit Committee to discharge its duties

Since the beginning of 2013/14, we have:

- recommended to the Board the appointment of PwC as auditor;
- reviewed the September 2013 half-yearly financial report and the March 2014 annual report and financial statements. As part of this, we received a report from PwC on their review of the half-yearly financial report and audit of the annual report and financial statements;
- reviewed the March 2014 regulatory accounts taking into account any feedback on the March 2013 regulatory accounts;
- considered the processes in place to generate forecasts of cash flow and accounting valuation information, including the choice and consistent use of key assumptions;
- considered the company's processes used to identify, evaluate and mitigate risks;
- reviewed the effectiveness of the company's internal controls and associated disclosures made in the annual report and financial statements;
- reviewed and agreed the scope of the audit work to be undertaken by PwC;
- agreed the fees to be paid to PwC for their review of the September half-yearly report and their audit of the March 2014 financial statements;
- agreed a programme of work for the Internal Audit function;
- received reports from the Head of Internal Audit on the work undertaken by Internal Audit, as well as management responses to proposals made in audit reports issued by the function during the year;
- undertaken an assessment of the qualification, expertise, resources and independence of PwC and the effectiveness of the audit process. This included consideration of a report on PwC's quality control procedures and their annual transparency report;
- assessed the risks associated with the possible withdrawal of PwC from the market;
- reviewed compliance certificates required under the company's debt facilities;
- received presentations on the credit ratings attaching to the company's debt facilities, its treasury policy and its International Financial Reporting Standards ('IFRS') implementation plan; and

GOVERNANCE continued

- as requested by the Board, provided advice on whether the annual report and financial statements, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

We plan to review our own effectiveness in advance of the AGM.

Significant issues considered by the Audit Committee in relation to the 2013/14 financial statements

We have considered the on-going appropriateness of the company's accounting policies and any requirement to adopt new financial reporting standards applicable in the current accounting period. We have also discussed the critical accounting judgements and key sources of estimation uncertainty, and concluded that the estimates, judgements and assumptions used were reasonable based on the information available and that these had been used appropriately in applying the company's accounting policies.

In relation to the company's existing accounting policies, we discussed the following principal areas of judgement:

- The estimation methodology for the recognition of revenue during the year was reviewed and it was concluded that the approach taken was appropriate.
- The policy for providing against doubtful debts was reviewed and it was concluded that the approach taken was appropriate.
- The processes and policies in place to distinguish between maintenance and enhancement costs were discussed and it was concluded that these would result in cost capitalisation that was in line with the company's policy and applicable accounting standards.
- Any on-going contractual and legal claims against the company were discussed and it was concluded that the related accounting treatment was appropriate.
- The company's assumptions used in calculating the defined benefit pension asset were reviewed and the reasons for the improvement in the net position discussed.
- The tax treatment of the company's assets was reviewed and it was concluded that the tax position of the company was appropriately reflected in the financial statements.
- The assumptions underpinning the directors' assessment that the company has adequate resources to meet its current operational and financial obligations, and their reasonable expectation that this will continue for the foreseeable future; and therefore the directors' decision to continue to adopt the going concern basis in the financial statements.

External auditor

Early in 2013/14, following a competitive tendering exercise, the Committee recommended the appointment of PwC as auditor to replace Ernst & Young LLP.

To fulfil our responsibility regarding the independence of PwC, we reviewed:

- PwC's plan for the current year, noting the role of the senior statutory audit partner who signs the audit report and who, in accordance with professional rules, has not held office for more than five years, and any changes in key audit staff;
- the arrangements for day-to-day management of the audit relationship;
- a report from PwC describing their arrangements to identify, report and manage any conflicts of interest; and
- the overall extent of non-audit services provided by PwC, in addition to case-by-case approval of the provision of non-audit services by PwC.

During the year PwC provided non-audit services, other than audit related services, in the form of consultancy services in relation to the company's pension arrangements with the executive directors and certain members of the senior management team. PwC was engaged to provide these services since they are widely recognised as a market leader in these areas and have a reputation for quality. Auditor objectivity and independence was safeguarded in these instances through the advice being provided by partners and staff who have no involvement in the audit of the financial statements.

Audit Committee Report

continued

PwC was engaged to provide agreed upon procedures as part of the company's regulatory compliance, submission of its PR14 Business Plan, and annual reporting to Thames Water and Anglian Water. None of the procedures performed were advisory in nature.

No services were provided pursuant to contingent fee arrangements.

We considered the likelihood of a withdrawal by PwC from the audit market and noted that there are no contractual obligations to restrict the choice of external auditor.

The auditor's role is considered annually by the Board for reappointment on the recommendation of the Audit Committee.

To assess the effectiveness of PwC, the Audit Committee reviewed:

- the arrangements for ensuring PwC's independence and objectivity;
- their fulfilment of the agreed audit plan and any variations from the plan;
- the robustness and perceptiveness of PwC in their handling of key accounting and audit judgements; and
- the content of their reporting on internal control.

Based on the above review, we are recommending to the Board that PwC be re-appointed.

Note 4 to the financial statements includes disclosure of the auditor's remuneration for the year, including an analysis of audit services, audit related services and other non-audit services under those headings prescribed by law.

Internal Audit function

To fulfil our responsibilities relating to the adequacy of the resourcing and plans of the Internal Audit function, we reviewed:

- Internal Audit's terms of reference, reporting lines and access to the Audit Committee and all members of the Board;
- Internal Audit's plans and its achievement thereof;
- the results of key audits and other significant findings, including the adequacy of management's response and the timeliness of resolution;
- the function's resources, team members' qualifications and experience, and timeliness of reporting; and
- the level and nature of non-audit activity performed by Internal Audit.

The company's Whistleblowing Policy contains arrangements for the Head of Internal Audit to receive, in confidence, complaints on accounting, risk issues, internal controls, auditing issues and related matters for reporting to the Audit Committee as appropriate.

Overview

As a result of the Committee's work during the year, we have concluded that we have acted in accordance with our terms of reference and have ensured the independence and objectivity of PwC.

I will be available at the AGM to answer any questions about the activities of the Committee.

Approval

On behalf of the Audit Committee

Patrick O'D Bourke
Chairman of the Audit Committee
20 June 2014

GOVERNANCE continued

Remuneration report

I am pleased to present the report on directors' remuneration, which sets out the remuneration paid to the directors of the company in the financial year ended 31 March 2014, and the policy for the 2014/15 year.

During 2013 the UK Government's Department for Business, Innovation and Skills announced changes to the way in which directors' remuneration is to be reported. We welcome this move towards greater transparency of the linkage between performance and pay.

In this report we have adopted the new regulations, which include the requirement to split our report into a distinct remuneration policy report followed by further details about how our policies have been implemented.

We aim to align executive pay to the company's performance and strategy of delivering shareholder value through high quality customer and operational performance whilst ensuring the cost of water remains affordable for our customers by incentivising financial efficiencies. We therefore link directors' remuneration to the standards of performance we provide to customers as well as the value created for shareholders.

The remuneration of executive directors reflects the performance of the business through the annual bonus plan. The Remuneration Committee established measures of financial and non-financial performance, including health and safety, water quality compliance and other customer experience and operational measures, for the year. The achievement of performance against these targets provides the basis for determining the value of annual bonus awards.

There is an intention to implement a long term incentive plan, covering a three year period to incentivise the executive directors to meet targets for cash available for distribution over the three year period and SIM in the final year of the period.

Dr Philip Nolan
CHAIRMAN

CURRENT COMMITTEE MEMBERS

- Dr Philip Nolan (Chairman)
- Kenton Bradbury
- Baroness Peta Buscombe
- Dr Jeffrey Herbert
- James Wilmott

Remuneration in 2014/15

We believe that the remuneration policy is working well to support the company's strategy. Customers, regulators and stakeholders rightly expect that the remuneration of executive directors and other senior executives is linked to standards of performance experienced by customers.

We consider the design of both the annual bonus plan targets and the proposed long term incentive plan targets provide assurance to customers and stakeholders that management is appropriately incentivised to focus on providing high standards of service to customers.

During 2014/15 we will continue to ensure that the reward packages for our directors remain market competitive, incentivise company and individual performance, and ensure focus on the achievement of short-term targets that will enable the company to fulfil its long-term strategic objectives.

Dr Philip Nolan
Chairman

GOVERNANCE continued

Remuneration report continued

Introduction

We have prepared this report in accordance with regulations made under Schedule 8 to the Accounting Regulations of the Companies Act 2006 (the 'Act'), which are applicable to companies whose equity shares are listed. The report also meets the relevant requirements of the Listing Rules of the Financial Conduct Authority and describes how we have applied the principles relating to directors' remuneration in the Code. A resolution to approve the report will be proposed at the AGM of the company.

The Act requires the auditor to report to the company's members on certain parts of the directors' remuneration report and to state whether in their opinion those parts of the report have been properly prepared in accordance with the Accounting Regulations. We have asked our auditor to report on this basis notwithstanding the regulations do not apply to our business.

Remuneration policy report

Remuneration Committee

Our Remuneration Committee is responsible for determining the remuneration policy and terms and conditions of employment of the executive directors and senior executives. It operates in accordance with terms of reference approved by our Board. The Committee met on four occasions during the year, and was chaired by Dr Philip Nolan.

The other members of the Committee were Kenton Bradbury and James Wilmott. Baroness Peta Buscombe and Dr Jeffrey Herbert joined the committee in December 2013, subsequent to the final meeting of 2013/14. Richard Bienfait, the CEO, and Richard Brimble, the Director of Organisation Development, attend the meetings when requested by the Committee. Tim Monod is the secretary to the Committee. Members of the Committee and attendees are excluded from discussions regarding their own remuneration and conditions of employment.

During the year Baker McKenzie LLP, who are unconnected to the company, were appointed by the Committee to provide advice on the design and implementation of a long term incentive plan.

The Committee meets to review the performance of the business as well as the performance of executive directors and senior executives against planned targets. The Committee also meets to consider and apply an appropriate remuneration framework to retain high calibre management. Their focus is on ensuring that the company can attract, motivate and reward executives who can lead the business to achieve short and long-term targets and on ensuring those targets are closely linked to standards of performance which are of benefit to customers.

The remuneration framework is structured and appropriately balanced between fixed elements and incentive pay, to ensure that executives deliver a high standard of performance, whilst minimising risk. A high priority is placed on achieving high standards of safety. The Committee ensures that the performance measures are objective, easy to understand and motivational to the participants. The Committee also reviews and approves the company-wide bonus scheme for all employees with reference to eight performance measures.

GOVERNANCE continued

Remuneration policy for non-executive directors

Dr Philip Nolan was appointed Chairman on 1 April 2013 for a term of three years. He receives a fixed annual fee for his services which is set at a market competitive level. During 2013/14 he served as executive Chairman. On appointment, it was agreed to put in place a long term incentive plan based on the performance of the company during the three year term of his appointment. The Chairman will not participate in the Remuneration Committee's consideration of the terms of his remuneration. From 1 April 2014, his role became non-executive.

The other non-executive directors in office at 31 March 2014 fall into two groups.

Group A	Group B
Patrick O'D Bourke	Kenton Bradbury
Baroness Peta Buscombe	Antonio Botija
Dr Jeffrey Herbert	Olivier Bret
	Yacine Saidji
	James Wilmott

Our Board considers the directors in Group A to be independent. Each has a written agreement relating to their services. They receive a fee for their services which is not related to company performance. They are not in receipt of share options or long-term incentive plans. The fees for these directors are set taking into account the market rate for non-executive directors, with particular reference to the water industry in the United Kingdom. There are no specific termination payments applicable to these appointments. The directors are appointed until the conclusion of the next AGM, unless terminated earlier by either the director or the company giving to the other party three months' written notice.

In November 2013, the director fees for the Group A directors were reviewed and increased to £40,000 per annum together with a fee of £2,000 per annum for serving on (or £5,000 per annum for chairing) each Board Committee. This increase was effective from 1 December 2013 and will apply during 2014/15, unless the Committee agrees further changes during the year.

The directors in Group B are appointed by our shareholders. They do not receive from the company any fees or other forms of remuneration in respect of their services and are not entitled to receive any payment on termination of their appointment.

Remuneration policy for executive directors

The remuneration policy is designed to attract, retain and motivate executive directors of the calibre to deliver the business strategy. Individual remuneration packages are structured to align rewards with the performance of the company and the interests of shareholders. The remuneration arrangements incorporate performance measures which link to the company's vision, customer expectations and strategic priorities (as described in the strategic report on pages 17 to 23).

An approach to recruitment remuneration has not yet been developed by the Committee, as no executive directors have been appointed during the year. The Committee will determine the principles to apply when agreeing the various components of the remuneration package for the appointment of directors.

Shareholder views on executive directors' remuneration are considered through the presence of Kenton Bradbury and James Wilmott, directors appointed by our shareholders, on the Committee.

The Committee did not consult with employees when drawing up the directors' remuneration policy but considered the average base salary increase of employees, which is subject to inflationary increases, in setting base salaries for the executive directors. The Committee further used the findings from a benchmarking remuneration study by PwC of the executive director roles to consider the level of fixed and variable remuneration in the future. PwC were appointed to provide remuneration advice to the Committee before their appointment as the company's external auditor.

GOVERNANCE continued

Remuneration report continued

Remuneration policy report continued

Remuneration policy for executive directors continued

The following table provides a summary of the key elements of the remuneration package for Richard Bienfait and Duncan Bates.

Purpose and link to strategy	Policy and approach	Maximum potential value (as percentage of base pay)	Performance metrics	Changes for 2014/15
Base salary				
To provide competitive fixed remuneration that will attract and retain key employees and reflect their experience and position in the company.	Reviewed annually. Aims to position salaries for executive directors at slightly below mid-market levels, preferring to compensate total reward with variable remuneration.	N/A	N/A	No change to the policy.
Other taxable benefits				
To provide market competitive benefits.	Private health care insurance cover, life assurance and income protection are provided, together with a fully expensed company car (or car allowance).	N/A	N/A	No change to the policy.
Annual bonus plan				
The annual bonus plan is designed to provide a direct link between executive and company performance and the level of bonus awarded, although award and payment remain discretionary.	Maximum bonus potential is set at a market competitive level. Bonus is based on the company's key performance indicators plus individual targets.	Up to 75 per cent of base salary.	50 per cent of the total bonus is determined on the achievement of the financial performance target, which is based on EBITDA. 25 per cent of the total bonus is determined on the achievement of the additional seven operational and customer performance targets, which are set out on pages 17 to 23 of the strategic report. 25 per cent of the total bonus is determined on the achievement of personal objectives.	No change to the policy.

GOVERNANCE continued

Purpose and link to strategy	Policy and approach	Maximum potential value (as percentage of base pay)	Performance metrics	Changes for 2014/15
Pension related benefits				
To provide competitive post-retirement benefits.	Executives joining the company after 2004 are invited to participate in the company's defined contribution pension scheme. Executives who joined the company prior to this date may be members of the company's defined benefit scheme. The defined benefit scheme provides retirement benefits up to a scheme cap. Where an executive's base salary is greater than the defined benefit scheme cap, the company invites the executive to join the company's defined contribution scheme to contribute a "top up" for the portion of base salary which exceeds the defined benefit cap. Under the defined contribution scheme, the executive contributes at a rate of 7 per cent of salary and the company contributes at 20 per cent. Duncan Bates is a member of the company's defined benefit scheme and defined contribution "top up" scheme. Richard Bienfait was a member of the company's defined benefit scheme and defined contribution "top up" scheme up until 28 February 2014, From 1 March 2014, Richard Bienfait ceased to be a member of either pension scheme.	Under the company's defined benefit scheme, Duncan Bates is accruing service at 1/60th of pensionable salary for each year of pensionable service. Richard Bienfait was accruing service at 1/45th of pensionable salary for each year of pensionable service under the company's defined benefit scheme. From 1 March 2014, in lieu of being a member of the company's retirement benefit schemes, Richard Bienfait receives a taxable allowance of 35 per cent of base salary.	N/A	No change to the policy.

GOVERNANCE continued

Remuneration report continued

Remuneration policy report continued

Remuneration policy for executive directors continued

The Remuneration Committee put in place an adhoc bonus arrangement related to PR14. This arrangement aimed to incentivise the executive directors to develop a high quality Business Plan assessed by Ofwat as "enhanced" or "standard". The scheme assumed a maximum award of 44 per cent of base salary if Ofwat awarded the business "enhanced" status and 25 per cent award of base salary if Ofwat awarded the business "standard" status.

Executive directors' service contracts

Notice periods are as follows:

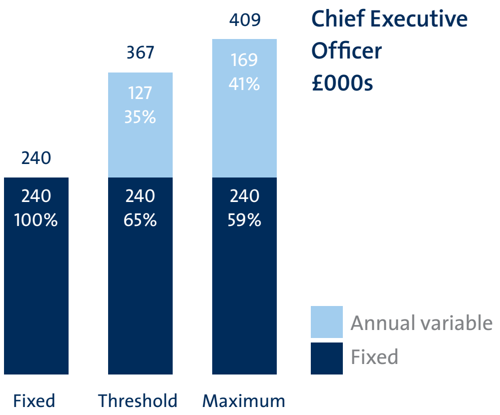
Chief Executive Officer – Richard Bienfait	Chief Financial Officer – Duncan Bates
From the executive to the company – 6 months	From the executive to the company – 6 months
From the company to the executive – 12 months	From the company to the executive – 6 months

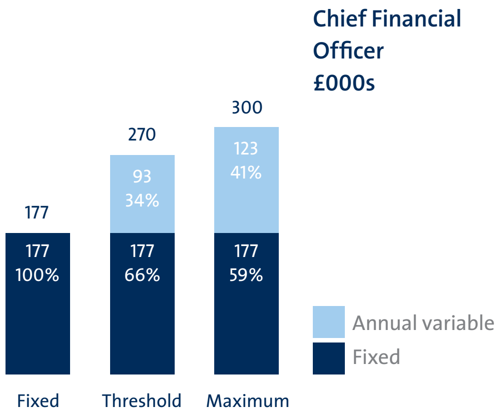
In the event of loss of office, the executive directors are subject to the terms and conditions as set out in their respective service contracts and employment letters with the company. These service contracts do not set out details of how the circumstances of the director's departure and performance during a period of office might be taken into account when exercising discretion in relation to loss of office payments. They also do not contain provisions implying an obligation on the company in the event of loss of office.

There are no arrangements in place for the remuneration of executive directors by any holding company or other company in the group.

Payouts under different scenarios

The following charts show the payout under the proposed arrangements for the Chief Executive Officer and Chief Financial Officer under different scenarios.





In developing the scenarios the following assumptions have been made:

Fixed	Consists of base salary, benefits and employer contributions into the company's defined contribution pension scheme
Threshold	Based on what a director would receive if the threshold level of performance were achieved: annual variable element pays out at 75 per cent of maximum
Maximum	Based on what a director would receive if the highest level of performance were achieved: annual variable element pays out at 100 per cent of maximum

GOVERNANCE continued

Chief Executive Officer remuneration

We have not reported the percentage year on year change in remuneration of the director undertaking the role of Chief Executive compared to the percentage change in average employee remuneration, as 2013/14 was the first full year of a director undertaking this role since the ownership of the company changed on 28 June 2012.

Management

We operate a discretionary performance bonus scheme for other senior managers and selected managers who meet the criteria for inclusion in the scheme. They are entitled to participate in a performance-related discretionary bonus scheme of up to 20 per cent of their salary. This is paid after the end of the financial year. Bonus awards are dependent on the success of the company and are determined by reference to three components:

- 50 per cent of the total bonus is dependent on the achievement of the financial performance target, which is based on EBITDA (earnings before interest, corporation tax, depreciation and amortisation).
- 25 per cent of the total bonus is dependent on the achievement of operational and customer performance targets, which are set out on pages 18 to 21 of the strategic report.
- 25 per cent of the total bonus is dependent on the achievement of personal objectives.

The scheme is designed to provide a direct link between senior management and company performance and bonus award and payment remain discretionary.

Company-wide bonus scheme

The Committee reviews and approves a discretionary company-wide performance bonus scheme for all employees, who are not otherwise entitled to the discretionary senior manager or selected manager performance bonus scheme. The discretionary company-wide bonus scheme targets seven operational and customer performance measures assessed quarterly and an annual financial performance measure, as set out on pages 18 to 23 of the strategic report.

The bonus targets for operational, customer and financial performance are identical for the senior manager, selected manager and company-wide schemes. This ensures there is a common focus across the business, particularly with respect to service to customers.

For the year ended 31 March 2014, 12 of the 28 quarterly operational and customer performance targets set were achieved. These targets are designed to be stretching, to support high standards of services to customers and to incentivise year on year improvements in performance. The financial performance target set was also achieved.

There are no provisions for the recovery of sums paid and no payment has been withheld.

Relative importance of spend on pay

Out of each pound of our customers' bills, we spend the following on our people and our suppliers for assets:

Stakeholder	Description	2013/14*	2012/13*
Our people	Wages, salaries and pensions	**13p**	14p
Our suppliers for assets	Investment in our assets	**34p**	34p

*Breakdown figures are based on our financial statements for 2013/14 and 2012/13. Figures have been rounded.

GOVERNANCE continued

Remuneration report continued

Remuneration implementation report

Directors' remuneration 2013/14 (audited)

The following table shows the remuneration paid by the company in respect of 2013/14.

	Base salary/fees £000	Taxable benefits[1] £000	Pension related benefits[2] £000	Annual bonus £000	Adhoc bonus £000	Total remuneration[3] £000	
	2013/14	2013/14	2013/14	2013/14	2013/14	2013/14	2012/13
Non-executive							
Current							
Patrick O'D Bourke	28	-	-	-	-	28	-
Baroness Peta Buscombe	38	-	-	-	-	38	31
Jeffrey Herbert	38	-	-	-	-	38	23
Fiona Woolf CBE	26	-	-	-	-	26	31
Olivier Bret	-	-	-	-	-	-	12
Former							
Olivier Grunberg	-	-	-	-	-	-	7
Philippe Guitard	-	-	-	-	-	-	7
Neil Summerton	-	-	-	-	-	-	38
Executive							
Duncan Bates	161	13	48	106	73	401	406
Richard Bienfait	219	16	69	145	99	548	409
Dr Philip Nolan[4]	200	-	-	-	-	200	-
	710	29	117	251	172	1,279	964

1 Taxable benefits comprise company car allowance and healthcare insurance. Taxable benefits for Richard Bienfait further include an allowance that commenced on 1 March 2014 of £7,000 in lieu of being a member of the company's retirement benefit schemes.

2 Included in pension related benefits is £15,000 (2013: £7,000) relating to contributions paid to money purchase pension schemes (£3,000 related to Duncan Bates and £12,000 related to Richard Bienfait); there were no amounts outstanding at the year end. These amounts also include £45,000 accruing to Duncan Bates and £57,000 accruing to Richard Bienfait in relation to the company's defined benefit pension scheme. Amounts have been calculated based on their accrued benefits in the defined benefit pension scheme multiplied by 20 less contributions made by the directors in the financial year. The normal retirement date for Duncan Bates is 65 years and 60 years for Richard Bienfait. The accrued benefit at the start and end of the year for Duncan Bates was £36,000 and £39,000 respectively (change during the year: £3,000). The accrued benefit at the start and end of the year for Richard Bienfait was £51,000 and £54,000 respectively (change during the year: £3,000).

3 Total emoluments and remuneration for 2012/13 have been restated to reflect bonuses paid to Duncan Bates (£112,000) and Richard Bienfait (£164,000) in 2013/14, which relate to the company's performance in 2012/13 and to the successful completion of refinancing and bond issuance. These discretionary bonuses were approved by the Remuneration Committee after the approval of the annual report and financial statements for the year ended 31 March 2013. Total remuneration for 2012/13 has also been restated to include £217,000 accruing to Duncan Bates and £78,000 accruing to Richard Bienfait in relation to the company's defined benefit pension scheme.

4 From 1 April 2014, the Chairman's role on the Board became a non-executive position.

The following table shows further detail of the remuneration paid by the company in respect of 2012/13 performance.

	Base salary/fees £000	Taxable benefits £000	Pension related benefits £000	Annual bonus £000	Adhoc bonuses £000	Total remuneration £000
Duncan Bates	71	6	217	62	50	406
Richard Bienfait	152	8	85	114	50	409

The remuneration paid by the company to directors in 2012/13 not presented in the above table related to director fees and a £27,000 payment to a former independent non-executive director of the company relating to compensation for loss of office.

Neither the company nor its immediate parent entities have any listed shares and so the directors have not been offered any share incentives.

The directors who sit on the Board and appointed by Infracapital Partners II, Morgan Stanley Infrastructure Partners and Veolia Water UK Limited do not receive any emoluments from the company.

GOVERNANCE continued

Annual bonuses for executive directors

The annual bonus scheme is designed to provide a direct link between executive and company performance and the level of bonus awarded, although award and payment remain discretionary. The following table shows the percentage of maximum annual bonus potential paid for each executive director in the 2013/14 year.

Performance measure		Weighting for 2013/14 (per cent of base salary)	2013/14 achievement (as a per cent of base salary)	
			Duncan Bates	Richard Bienfait
Financial measure	Financial: annual EBITDA	37.50%	37.50%	37.50%
Operational and customer measures	Health and safety: number of accidents resulting in more than three days' lost time and RIDDOR reportable incidents	2.68%	0.00%	0.00%
	Water quality: number of water quality compliance failures	2.68%	2.01%[1]	2.01%[1]
	Unplanned interruptions: number of properties experiencing an interruption for more than 12 hours	2.68%	2.68%	2.68%
	Written complaints: number of written complaints	2.68%	0.00%	0.00%
	Leakage: leakage in terms of millions of litres per day	2.68%	0.67%[2]	0.67%[2]
	Unwanted contact: number of unwanted contacts	2.68%	0.00%	0.00%
	Customer experience: measured by NPS	2.68%	2.68%	2.68%
Personal performance		18.75%	18.75%[3]	18.75%[3]
Total per cent base pay		**75.00%**	**64.29%**	**64.29%**
Base salary			**£165,000**	**£225,000**
Bonus paid			**£106,000**	**£145,000**

1 Three out of four quarterly water quality targets for 2013/14 were met.

2 One out of four quarterly leakage targets for 2013/14 was met.

3 The Remuneration Committee exercised discretion in determining the level of bonus awarded in relation to the personal performance element of the executive directors' annual bonus within the pre-agreed base salary percentage cap. The Committee considered achievement of personal objectives set at the start of the year in exercising its discretion together with events occurring during the year.

Additionally, Duncan Bates and Richard Bienfait were paid the maximum award of 44 per cent of base salary (£73,000 and £99,000 respectively) under the adhoc bonus arrangement related to PR14 given the assessment by Ofwat of our PR14 Business Plan as 'enhanced'.

No amounts in relation to these bonuses have been deferred.

Statutory requirements

This remuneration report has been prepared on behalf of the Board by the Remuneration Committee. The report was approved by the Board on 20 June 2014 and signed on its behalf by:

Dr Philip Nolan
Chairman of the Remuneration Committee

GOVERNANCE continued

Directors' report

Introduction

The directors present their annual report and the audited statutory financial statements of Affinity Water Limited ('the company') for the year ended 31 March 2014.

The company is a limited liability company registered in England and Wales and the immediate parent undertaking of the company is Affinity Water Holdings Limited, a company also registered in England and Wales. The directors consider that Affinity Water Acquisitions (Investments) Limited is the ultimate holding and controlling company in the United Kingdom. Details of the ownership of the company and the group structure are set out on pages 48 to 49 of the governance section and note 30 of the financial statements. The address of the principal place of business is Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

The strategic report on pages 11 to 35 provides detailed information relating to the company, its strategy, the operation of its business and its results and financial position for the year ended 31 March 2014. Details of the risks and principal uncertainties facing the company are set out on pages 31 to 35.

Directors

The directors of the company, together with their periods of office and their biographical details, are shown on pages 37 to 39.

Significant events during the year

Details of the significant events that occurred during the year are set out in the highlights, Chairman's statement and Chief Executive Officer's introduction on pages 8 to 11.

On 1 April 2013, the company entered into a Business Transfer Agreement with Affinity Water Shared Services Limited. Fixed assets and stock were purchased from Affinity Water Shared Services Limited for a value of £1,920,000 with the remaining assets transferred at book value during the year.

Results and financial performance

Profit on ordinary activities after tax for the year was £44,412,000 (2013: £43,495,000).

An analysis of turnover compared to our PR09 final determination target is presented in note 4 of the regulatory accounts on page 132.

Details of our financial performance in terms of EBITDA against our internal target and prior year performance are set out on page 22 of the strategic report.

Financing costs of £41,191,000 for the year were 67 per cent higher than last year (£24,647,000) due to the refinancing of the business in February 2013 (see pages 50 to 51 for further details).

Net cash inflow from operations in the year amounted to £156,192,000 (2013: £140,162,000). This cash inflow contributed to the net servicing of finance of £34,225,000 (2013: £20,128,000), taxation of £7,055,000 (2013: £6,940,000) and equity dividends paid of £45,842,000 (2013: £153,455,000).

Investment in tangible fixed assets during the year amounted to £117,101,000 (2013: £103,455,000), for which an amount of £7,969,000 (2013: £11,679,000) was received by way of capital contributions. The 19 per cent increase in net cash investment on last year is partly due to the full inclusion of the three unified regulated water companies. We also continue to invest increasingly more than we were funded for each year of the current price control period.

The balance sheet detailed on page 77 shows shareholder's funds amounting to £352,317,000 (2013: £341,743,000).

GOVERNANCE continued

Dividends

The directors have declared and paid the following ordinary dividends during the year ended 31 March 2014:

	£000
Interim – paid in July 2013 of 12.37p per share	32,792
Interim – paid in December 2013 of 1.75p per share	4,650
Interim – paid in March 2014 of 3.17p per share	8,400
	45,842

This compares to interim dividends of £153,455,000 declared and paid in the year ended 31 March 2013. No final dividend is proposed (2013: £nil).

Research and development activities

The development and application of new techniques and technology is an important part of the company's activities. The company is a member of UK Water Industry Research ('UKWIR') and participates and benefits from their research programme. The UKWIR research programme is currently divided into the following topics: drinking water quality and health; toxicology; water resources; climate change; wastewater treatment and sewerage; sewage sludge; water mains and services; leakage and metering; and regulatory issues.

Political contributions

No political contributions were made during the year (2013: £nil), in accordance with the company's policy of not making political contributions.

Employee matters

We consult and inform our employees on all aspects of business performance through formal and informal consultation bodies, regular team meetings and the intranet. We constantly discuss ways to enhance and improve our communications and consultation channels with the Trade Unions to which employees belong. Several initiatives have also been introduced with the aim of improving the health and well-being of the company's employees.

Employees are kept informed of changes in the business and general and financial and economic factors influencing the company together with performance targets. This is achieved through a systematic approach to employee communication, which includes regular briefings or presentations and electronic mailings. We also produce a regular employee magazine, which is sent to all company sites.

We aim to ensure that each employee or applicant for employment receives the same treatment irrespective of race, gender, disability, sexual orientation, religious belief, creed, marital or parental status. This extends through all company policies including recruitment where the candidate's particular aptitudes and abilities are consistent with the requirements of the job. Opportunities are available to disabled employees for training, career development and promotion. Employees who become disabled whilst employed by the company are actively encouraged to find appropriate employment within the business.

Financial instruments disclosures

Details are included on page 34 of the strategic report and in note 26 of the financial statements.

GOVERNANCE continued

Greenhouse gas emissions statement

Our approach

We report below our greenhouse gas ('GHG') emissions following the 2013 UK Government Environmental Reporting Guidance and using the 2013 UK Government Conversion Factors for Company Reporting[1]. We have included emissions within the direct management responsibility of the company. This is consistent with our financial reporting boundary with the exception of scope 3 emissions, which are off-balance sheet emissions. Significant scope 3 emissions have been quantified for outsourced data support and emissions from the distribution and transmission of grid electricity.

The data has been externally verified as part of our regulatory reporting requirements.

Performance

Our gross GHG emissions totalled 110,823 tonnes of carbon dioxide equivalent ('tCO_2e') in 2013/14 (2012/13: 120,440 tCO_2e), consistent with the projections we made in our PR09 Business Plan for the current regulatory period from 1 April 2010 to 31 March 2015. We also monitor our relative operational GHG emissions from year to year through expressing our emissions by way of an industry standard intensity ratio, kilograms of CO_2e per megalitre ('$kgCO_2e/Ml$') of clean water supplied. Our GHG emissions and intensity measurement have reduced in line with lower carbon intensity for grid electricity and due to increased asset efficiency.

GHG emission source	2013/14	
	(tCO_2e)	($kgCO_2e/Ml$)
Scope 1	**7,011**	**20.7**
Fuel combustion	1,956	5.8
Process and fugitive emissions	2,714	8.0
Vehicle fleet	2,342	6.9
Scope 2	**95,105**	**280.3**
Purchased electricity	95,105	280.3
Statutory total (scope 1 & 2)*	102,116	300.9
Scope 3	**8,707**	**25.7**
Business travel in other vehicles	9	-
Outsourced IT activities	566	1.7
Electricity- transmission and distribution	8,132	24.0
Total gross emissions	**110,823**	**326.7**

* Statutory carbon reporting disclosures required by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013

We recognise that a significant proportion of our GHG emissions (94 per cent), are from the generation and transmission of electricity purchased to abstract, treat and distribute water to customers. Since April 2012, we have purchased Climate Change Levy exempt electricity for our large sites, 86 per cent of our emissions. This energy is produced entirely from renewable sources, certified by our energy supplier.

Further information on how we manage our GHG emissions can be found on page 27.

1 '2013 government GHG conversion factors for company reporting: methodology paper for emission factors', Department for Environment, Food and Rural Affairs dated July 2013.

Future developments

Likely future developments in the business resulting from expected changes in the regulatory and competitive environments that we operate in are discussed in the drivers and opportunities and our future plans sections of our strategic report on pages 14 to 16 and page 30 respectively.

Corporate governance

The company's statement on corporate governance can be found in the board leadership, transparency and governance section on pages 36 to 47 of this annual report and financial statements. This report forms part of this directors' report and is incorporated into it by cross-reference.

GOVERNANCE continued

Post balance sheet events

There were no significant post balance sheet events.

Going concern

The company has adequate resources to meet its current operational and financial obligations, and the directors have a reasonable expectation that this will continue for the foreseeable future. This assessment is based on consideration of the company's budgeted cash flows, long term forecasts and related assumptions, and its available debt facilities. For this reason, the directors continue to adopt the going concern basis in the statutory financial statements.

Directors' qualifying third party indemnity provisions

The company has granted an indemnity to one of its directors against liability in respect of proceedings brought by third parties, subject to the conditions set out in Section 234 of the Companies Act 2006. This qualifying third party indemnity provision was in force during the financial year and remains in force as at the date of approving the directors' report.

Statement of directors' responsibilities

The directors are responsible for preparing the strategic report, directors' report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the company's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Disclosure of information to auditors

In accordance with Section 418 of the Companies Act 2006, directors' reports shall include a statement, in the case of each director in office at the date the directors' report is approved, that:

(a) so far as the director is aware, there is no relevant audit information of which the company's auditor is unaware; and

(b) he or she has taken all the steps that he ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the company's auditor is aware of that information.

Auditor

PricewaterhouseCoopers LLP were appointed as auditor at the AGM on 23 September 2013. In accordance with Section 485 of the Companies Act 2006, a resolution to re-appoint PwC will be proposed at the forthcoming AGM.

By order of the Board

Tim Monod
Company Secretary
20 June 2014

Registered Office:
Affinity Water Limited
Tamblin Way
Hatfield
Hertfordshire
AL10 9EZ

Affinity Water

Your local supply, on tap

Statutory Financial Statements

for the year ended 31 March 2014

STATUTORY FINANCIAL STATEMENTS

INDEX

Independent auditors' report to the member of Affinity Water Limited

Report on the financial statements

Our opinion

In our opinion the financial statements, defined below:

- give a true and fair view of the state of the company's affairs as at 31 March 2014 and of its profit and cash flows for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

This opinion is to be read in the context of what we say in the remainder of this report.

What we have audited

The financial statements, which are prepared by Affinity Water Limited, comprise:

- the balance sheet as at 31 March 2014;
- the profit and loss account, statement of total recognised gains and losses and note of historical cost profits and losses for the year then ended;
- the cash flow statement and the notes to the cash flow statement for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies and other explanatory information.

The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

What an audit of financial statements involves

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ('ISAs (UK & Ireland)'). An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

In addition, we read all the financial and non-financial information in the Annual Report and Financial Statements (the 'Annual Report') to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Overview of our audit approach

Materiality

We set certain thresholds for materiality. These helped us to determine the nature, timing and extent of our audit procedures and to evaluate the effect of misstatements, both individually and on the financial statements as a whole.

Based on our professional judgement, we determined materiality for the financial statements as a whole to be £4.2 million. This represents approximately 2.5% of earnings before interest, tax, depreciation and amortisation. This benchmark was used as earnings before interest, tax , depreciation and amortisation is a good proxy for operating cash flow, which is a key measure in the water industry.

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.2 million as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Overview of the scope of the audit

Following unification on 27 July 2012 of Veolia Water Central Limited, Veolia Water East Limited and Veolia Water Southeast Limited, the operations of the three businesses were transferred to one operating system within a single legal entity, Affinity Water Limited. There are certain financial statement line items where these three divisions (Central, East and Southeast) remain but all the audit work was carried out by one team. In establishing the overall approach to our audit, we assessed the risk of material misstatement, taking into account the nature, likelihood and potential magnitude of any misstatement. Following this assessment, we applied professional judgement to determine the extent of testing required over each balance in the financial statements.

Areas of particular audit focus

In preparing the financial statements, the directors made a number of subjective judgements, for example in respect of significant accounting estimates, that involved making assumptions and considering future events that are inherently uncertain. We primarily focused our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

In our audit, we tested and examined information, using sampling and other auditing techniques, to the extent we considered necessary to provide a reasonable basis for us to draw conclusions. We obtained audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

We considered the following areas to be those that required particular focus in the current year. This is not a complete list of all risks or areas of focus identified by our audit. We discussed these areas of focus with the Audit Committee. Their report on those matters that they considered to be significant issues in relation to the financial statements is set out on page 53.

Area of focus	*How the scope of our audit addressed the area of focus*
Fraud in revenue recognition ISAs (UK & Ireland) require that we consider fraud in revenue recognition. In a water company the measured income accrual, which impacts directly on reported turnover and profit, is the key area of judgement in this respect and is complex due to the range of factors underlying the estimate.	We evaluated the estimation methodology underlying the measured income accrual, taking into account the accuracy of historical estimations. We also tested the controls over revenue recognition and re-performed the accrued income calculation.
Bad debt provision The bad debt provision is based on a detailed calculation that applies a percentage provision to individual aged debt categories. As economic conditions continue to be challenging, there is an ongoing risk of older debt being more difficult to collect. The calculation is inherently judgemental and accordingly could result in estimation errors in the valuation of the provision.	We evaluated and tested the calculation of the bad debt provision, taking into account collections made against old balances and year on year movement of aged debt categories, trends in cash receipts compared to billings, the debt write-off policy and the expected collection period for overdue debts.
Cost capitalisation The allocation of costs between capital and non-capital spend can be subjective. Given the magnitude of capital spend there is a risk that incorrect classification could give rise to errors.	We evaluated the levels of own work capitalised and the controls in place to distinguish between maintenance and enhancement. We tested items being capitalised are in line with both the accounting policy and accounting standards. We also scanned the repairs and maintenance expenditure and tested items to assess appropriate classification as an operating expense.
Risk of management override of internal controls ISAs (UK & Ireland) require that we consider this.	We assessed the overall control environment of the company, including the arrangements for staff to "whistle-blow" inappropriate actions, and interviewed senior management and the company's internal audit function. We examined the significant accounting estimates and judgements relevant to the financial statements for evidence of bias by the directors that may represent a risk of material misstatement due to fraud. We also tested journal entries.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Strategic report and the Directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Other matters on which we are required to report by exception

Adequacy of accounting records and information and explanations received

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- we have not received all the information and explanations we require for our audit; or
- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Corporate governance statement

The directors have chosen to voluntarily comply with the UK Corporate Governance Code ("the Code") as if the company were a premium listed company. On page 43 of the Annual Report, as required by the Code Provision C.1.1, the directors state that they consider the Annual Report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the company's performance, business model and strategy. On page 45, as required by C.3.8 of the Code, the Audit Committee has set out the significant issues that it considered in relation to the financial statements, and how they were addressed. Under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

- the statement given by the directors is materially inconsistent with our knowledge of the company acquired in the course of performing our audit; or
- the section of the Annual Report describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We have no exceptions to report arising from this responsibility.

Other information in the Annual Report

Under ISAs (UK & Ireland) we are required to report to you if, in our opinion, information in the Annual Report is:

- materially inconsistent with the information in the audited financial statements; or
- apparently materially incorrect based on, or materially inconsistent with, our knowledge of the company acquired in the course of performing our audit; or
- is otherwise misleading.

We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of directors' responsibilities set out on page 67, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and ISAs (UK & Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for, and only for, the company's member in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Charles Joseland (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Cambridge
23 June 2014

STATUTORY FINANCIAL STATEMENTS continued

Profit and loss account for the year ended 31 March 2014 (Registered Number 2546950)

	Note	2014 £000	2013 £000
Turnover	2	**291,381**	279,469
Cost of sales		**(177,686)**	(172,431)
Gross profit		**113,695**	107,038
Administrative expenses		**(39,158)**	(38,810)
Other operating income	3	**9,880**	9,020
Operating profit		**84,417**	77,248
Profit on disposal of tangible fixed assets		**1,480**	3,752
Profit on ordinary activities before interest and taxation		**85,897**	81,000
Interest receivable and similar income	6	**345**	12
Interest payable and similar charges	7	**(41,191)**	(24,647)
Other finance income	8	**654**	71
Profit on ordinary activities before taxation		**45,705**	56,436
Tax on profit on ordinary activities	9	**(1,293)**	(12,941)
Profit on ordinary activities after taxation and for the financial year	21	**44,412**	43,495

All profits of the company are from continuing operations. The notes on pages 80 to 111 form part of these financial statements.

STATUTORY FINANCIAL STATEMENTS continued

Statement of total recognised gains and losses for the year ended 31 March 2014 (Registered Number 2546950)

	Note	2014 £000	2013 £000
Profit for the financial year	21	**44,412**	43,495
Actuarial gain/(loss) recognised in the pension scheme	21	**14,785**	(20,015)
Deferred tax movement relating to actuarial gain/(loss)	21	**(2,781)**	4,603
Total recognised gains for the year	22	**56,416**	28,083

The notes on pages 80 to 111 form part of these financial statements.

STATUTORY FINANCIAL STATEMENTS continued

Note of historical cost profits and losses for the year ended 31 March 2014 (Registered Number 2546950)

	Note	2014 £000	2013 £000
Reported profit on ordinary activities before taxation		45,705	56,436
Realisation of property revaluation gains of previous years	21	896	1,775
Historical cost profit on ordinary activities before taxation		46,601	58,211
Historical cost profit for the year retained after taxation		45,308	45,270

The notes on pages 80 to 111 form part of these financial statements.

STATUTORY FINANCIAL STATEMENTS continued

Balance sheet as at 31 March 2014 (Registered Number 2546950)

	Note	2014 £000	2013 £000
Fixed assets			
Intangible assets	12	14,961	15,423
Tangible assets	13	1,211,963	1,187,818
Investment	14	61	61
		1,226,985	1,203,302
Current assets			
Stocks	15	1,412	1,576
Debtors	16	81,204	77,709
Cash at bank and in hand		16,826	35,779
		99,442	115,064
Creditors – amounts falling due within one year	17	(132,585)	(122,413)
Net current liabilities		(33,143)	(7,349)
Total assets less current liabilities		1,193,842	1,195,953
Creditors – amounts falling due after more than one year	18	(795,230)	(786,105)
Provisions for liabilities	19	(48,784)	(55,087)
Net assets excluding pension asset/(liability)		349,828	354,761
Net pension asset/(liability)	25	2,489	(13,018)
Net assets		352,317	341,743
Capital and reserves			
Called up share capital	20	26,506	26,506
Share premium account	21	1,400	1,400
Revaluation reserve	21	207,097	207,993
Capital contribution	21	30,150	30,150
Profit and loss account	21	87,164	75,694
Total shareholder's funds	22	352,317	341,743

The notes on pages 80 to 111 form part of these financial statements. The statutory financial statements on pages 74 to 111 were approved by the Board of directors and were signed and authorised for issue on 20 June 2014 on its behalf by:

Richard Bienfait
Chief Executive Officer

Duncan Bates
Chief Financial Officer

STATUTORY FINANCIAL STATEMENTS continued

Cash flow statement for the year ended 31 March 2014 (Registered Number 2546950)

	Note	2014 £000	2013 £000
Net cash inflow from operating activities	(a)	156,192	140,162
Returns on investments and servicing of finance			
Interest received		345	12
Interest paid		(34,570)	(20,013)
Interest element of finance lease payments		-	(127)
Net cash outflow from returns on investments and servicing of finance		(34,225)	(20,128)
Taxation		(7,055)	(6,940)
Capital expenditure and financial investment			
Purchase of tangible fixed assets		(117,101)	(103,455)
Capital contributions		7,969	11,679
Proceeds on disposal of tangible fixed assets		1,743	6,379
Net cash outflow from capital expenditure and financial investment		(107,389)	(85,397)
Acquisitions			
Purchase of assets and liabilities of East and Southeast*		-	(131,200)
Net debt acquired from East and Southeast		-	(57,351)
Net cash outflow for acquisitions		-	(188,551)
Equity dividends		(45,842)	(153,455)
Net cash outflow before financing		(38,319)	(314,309)
Financing			
Proceeds on issue of share capital		-	1,400
Capital contribution from Affinity Water Capital Funds Limited		-	30,150
Capital element of finance lease payments		-	(1,591)
Loan from subsidiary		-	565,885
Loan from parent company		-	(205,787)
Loan from other group undertaking		-	(43,903)
Loan from intermediate parent company		-	3,550
Financing of assets operated by other parties		2,167	(329)
Drawdown of short-term credit facilities		17,200	-
Repurchase of debentures		(1)	-
Net cash inflow from financing		19,366	349,375
(Decrease)/increase in net cash	(b)/(c)	(18,953)	35,066

STATUTORY FINANCIAL STATEMENTS continued

Notes to the cash flow statement for the year ended 31 March 2014

a) Reconciliation of operating profit to net cash inflow from operating activities

	2014 £000	2013 £000
Operating profit	84,417	77,248
Depreciation of tangible fixed assets	80,874	75,683
Amortisation of goodwill	462	297
Amortisation of deferred credit	(297)	(311)
Decrease/(increase) in stocks	164	(198)
Increase in debtors	(3,495)	(4,078)
(Decrease)/increase in provisions	(392)	704
(Decrease)/increase in creditors	(995)	10,654
Pension contributions in excess of operating charge	(4,546)	(19,837)
Net cash inflow from operating activities	156,192	140,162

b) Reconciliation of net cash flow to movement in net debt

	2014 £000	2013 £000
(Decrease)/increase in cash in the year	(18,953)	35,066
Cash inflow from increase in debt and finance leasing	(19,366)	(317,825)
Non cash inflow from increase in debt and finance leasing	(7,168)	(1,809)
Movement in net debt in the year	(45,487)	(284,568)
Net debt at the beginning of the year	(747,849)	(463,281)
Net debt at the end of the year	(793,336)	(747,849)

c) Analysis of net debt

	At 1 April 2013 £000	Cash flow £000	Non cash flow £000	At 31 March 2014 £000
Net cash				
Bank	35,779	(18,953)	-	16,826
Debt				
Loans from subsidiary financed by bond issue	(762,764)	-	(7,212)	(769,976)
Loan from intermediate parent company	(3,550)	-	-	(3,550)
Debentures	(36)	1	-	(35)
External short-term credit facilities	-	(17,200)	-	(17,200)
Financing of assets used by the company and operated by other parties	(17,278)	(2,167)	44	(19,401)
	(783,628)	(19,366)	(7,168)	(810,162)
Net debt	(747,849)	(38,319)	(7,168)	(793,336)

* Affinity Water East Limited ('East') and Affinity Water Southeast Limited ('Southeast')

The notes on pages 80 to 111 form part of these financial statements.

Notes to the financial statements for the year ended 31 March 2014

1. Statement of accounting policies

Basis of preparation

These financial statements have been prepared on the going concern basis as stated in the directors' report on page 67, under the historical cost convention, as modified by the revaluation of certain tangible fixed assets described below, and in accordance with the Large and Medium-sized Companies and Groups Regulations 2008 (SI 2008/410), which form part of the Companies Act 2006, and applicable UK accounting standards, except for the treatment of certain grants and contributions, described below, and the non-amortisation of the goodwill relating to the acquisition of North Surrey Water Limited.

The financial statements of Affinity Water Limited and its wholly owned subsidiaries, Affinity Water Finance (2004) Limited and Affinity Water Programme Finance Limited, are not presented in consolidated format as Affinity Water Limited is itself a majority owned subsidiary of Affinity Water Acquisitions (Investments) Limited, which is the parent undertaking of the smallest and largest group to prepare consolidated financial statements. The company has not prepared group accounts as allowed under Section 400 of the Companies Act 2006.

The principal accounting policies have been applied consistently throughout the current and prior year.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual outcomes could differ from those estimates.

Revenue recognition

Revenue is recognised in accordance with Financial Reporting Standard 5: 'Reporting the substance of transactions' in the period in which it is earned. The company does not recognise revenue where payment is received in advance. In accordance with Application Note G of Financial Reporting Standard 5, the company does not recognise revenue where historic evidence indicates that the company will probably never be able to collect the revenue billed.

Charges billed to customers for water services are recognised in the period in which they are earned. An accrual is estimated for unmeasured consumption that has not yet been billed. The accrual is estimated using a defined methodology based upon weighted average water consumption by tariff, which is calculated based upon historical information.

Where an invoice has been raised and payment made but the service has not been provided in the year this will be treated as a payment in advance. The value of invoices raised will not be recognised within the current year's turnover but will instead be recognised within creditors as deferred income.

Other operating income

Other operating income includes all income derived from sources associated with the ordinary activities of the business other than turnover, which is derived from the regulatory activities of the business. It is stated net of value added taxes.

Bad debt provisioning

At each reporting date, the company evaluates the collectability of debtors and records provisions for bad and doubtful debts based on experience. The bad debt provision is calculated by applying a range of different percentages to debtors of different ages. These percentages also vary between categories of debt. Higher percentages are applied to those categories of debt which are considered to be of greater risk and also to debtors of greater age. The value of the bad debt provision is sensitive to the specific percentages applied.

Financial instruments

Income and expenditure arising on financial instruments are recognised on an accruals basis and credited or charged to the profit and loss in the financial period in which they arise.

Issue costs on capital instruments are allocated to accounting periods over the term of the instrument as a consistent proportion of the outstanding amount in accordance with the requirements of Financial Reporting Standard 4: 'Capital instruments'.

Research and development

The costs of research and development are written off in the year in which they are incurred.

STATUTORY FINANCIAL STATEMENTS continued

Current taxation

Current taxation is corporation tax in the United Kingdom based on the taxable profit for the period and is provided at amounts expected to be paid or recovered using tax rates and laws that have been enacted or substantively enacted at the balance sheet date.

Taxable profit differs from the net profit as reported in the profit and loss account as it excludes items of income or expenditure that are taxable or deductible in other years as well as items that will never be taxable or deductible.

Deferred taxation

Deferred tax is provided, except as noted below, on timing differences that have arisen but not reversed by the balance sheet date, where the timing differences result in an obligation to pay more tax, or a right to pay less tax, in the future. Timing differences arise because of differences between the treatment of certain items for accounting and taxation purposes. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered.

In accordance with Financial Reporting Standard 19: 'Deferred tax', deferred tax is not provided on timing differences arising from:

(a) revaluation gains on land and buildings, unless there is a binding agreement to sell such assets at the balance sheet date and it is unlikely that any gain will be rolled over;

(b) gains on the sale of non-monetary assets, where on the basis of all available evidence it is more likely than not that the taxable gain will be rolled over into replacement assets; and

(c) fair value adjustment gains to fixed assets and stock when an acquisition is made.

Deferred tax is measured at the tax rates that are expected to apply in the periods when the timing differences are expected to reverse, based on tax rates and legislation enacted or substantively enacted at the balance sheet date.

Where legislation or accounting standards require gains and losses to be recognised in the statement of total recognised gains and losses, the related taxation is also taken directly to the statement of total recognised gains and losses in due course.

The company has adopted a policy of discounting deferred tax assets and liabilities to reflect the time value of money. Deferred tax assets and liabilities are discounted using a discount rate equivalent to the post tax yield that could be obtained at the balance sheet date on government bonds with similar maturity dates and currencies. The increase or decrease in the discount deducted in arriving at the deferred tax balance is included in the deferred tax charge or credit in the profit and loss account.

Pension costs

The company operates a pension plan providing defined benefits based on final pensionable salary. The plan, which has separate Central, East and Southeast divisions, closed to new members in April 1996 and September 2004. The assets of the plan are held separately from those of the company.

The cost of providing benefits under the defined benefit plan is determined using the projected unit method, which attributes entitlement to benefits to the current period (to determine current service cost) and to the current and prior periods (to determine the present value of defined benefit obligations) and is based on actuarial advice. Past service costs are recognised in profit or loss on a straight-line basis over the vesting period or immediately if the benefits have vested. When a settlement or a curtailment occurs, the change in the present value of the plan liabilities and the fair value of the plan assets reflect the gain or loss which is recognised in the profit and loss account. Losses are measured at the date that the employer becomes demonstrably committed to the transaction and gains when all parties whose consent is required are irrevocably committed to the transaction.

The interest element of the defined benefit cost represents the change in present value of plan obligations resulting from the passage of time, and is determined by applying the discount rate to the opening present value of the benefit obligation, taking into account material changes in the obligation during the year. The expected return on plan assets is based on an assessment made at the beginning of the year of long-term market returns on plan assets, adjusted for the effect on the fair value of plan assets of contributions received and benefits paid during the year. The difference

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

1. Statement of accounting policies continued

Pension costs (continued)

between the expected return on plan assets and the interest cost is recognised in the profit and loss account as other finance income or expense. Actuarial gains and losses are recognised in full in the statement of total recognised gains and losses in the period in which they occur.

The defined benefit pension asset or liability in the balance sheet comprises the total for each division of the plan of the present value of the defined benefit obligation (using a discount rate based on high quality corporate bonds that have been rated at AA or equivalent status), less any past service cost not yet recognised and less the fair value of plan assets out of which the obligations are to be settled directly. Fair value is based on market price information and in the case of quoted securities is the published bid price. The value of a net pension benefit asset is limited to the amount that may be recovered either through reduced contributions or agreed refunds from the plan.

Contributions to the defined contribution section of the plan are recognised in the profit and loss account in the period in which they become payable.

The company also has an unfunded obligation to pay pensions to former non-executive directors. A provision in respect of the obligation is included within the net pension liability.

Goodwill and amortisation

Goodwill arising on acquisitions since 1 January 1998 is capitalised, classified as an asset on the balance sheet and amortised on a straight line basis over its useful economic life up to a maximum of 20 years. It is reviewed for impairment at the end of the first full financial year following the acquisition and in other periods if events or changes in circumstances indicate that the carrying value may not be recoverable.

Goodwill relating to the acquisition of the trade and assets of North Surrey Water Limited in the year ended 31 March 2001 amounting to £6,678,000 has been capitalised. The directors consider that this goodwill has an indefinite life and accordingly is not amortised but is subject to annual review for impairment. This is not in accordance with the Large and Medium-sized Companies and Groups Regulations 2008 (SI 2008/410) which form part of the Companies Act 2006, and which require that all goodwill be amortised. The directors consider that this would not give a true and fair view of the profit for the year and that the economic measure of performance in any period is properly made by reference only to any impairment that may have arisen. The effect on the financial statements of this departure amounts to £334,000 per annum over 20 years. Any impairment charge is included within operating profit.

Tangible fixed assets and depreciation

Financial Reporting Standard 15: 'Tangible fixed assets' requires fixed assets which are carried at revalued amounts to be shown at their current value at the balance sheet date. To achieve this, all tangible fixed assets are subject to a full valuation every five years with an interim valuation carried out in the third year of this cycle.

Tangible fixed assets comprise:

- Infrastructure assets – mains and associated underground pipe-work.
- Other assets – land and buildings, operational structures, fixed plant, vehicles and mobile plant.

Infrastructure assets (being mains and associated underground pipe-work) comprise a network of systems. Expenditure on infrastructure assets, including renewals, is treated as an addition and included at cost after deducting grants and contributions.

The depreciation charge for infrastructure assets is the estimated level of annual expenditure required to maintain the operating capability of the network which is based on the company's independently certified asset management plan. The disposal value of infrastructure assets is based on the estimated lives of the assets at the point of replacement.

Depreciation is provided on all other fixed assets except freehold land and is calculated to write off their cost over their estimated useful lives on a straight-line basis. Assets acquired under finance leases are depreciated over the shorter of their useful life or the lease term. The performance of assets is continually monitored and where

STATUTORY FINANCIAL STATEMENTS continued

impairment is identified, fixed assets are written down to their recoverable amount. Tangible fixed assets are reviewed for impairment at the end of each reporting period when the estimated remaining useful economic life of the assets exceeds 50 years.

The estimated useful lives of these assets are:

Buildings		40-60 years
Operational structures		15-100 years
Fixed plant	- Short life	3-10 years
	- Other	10-30 years
Vehicles and mobile plant		3-10 years

Land and assets in the course of construction are not depreciated.

Any revaluation surplus is credited to the revaluation reserve in equity except to the extent that it reverses a decrease in the carrying value of the same asset previously recognised in profit or loss, in which case the increase is recognised in profit or loss. A revaluation deficit is recognised in profit or loss, except to the extent of any existing surplus in respect of that asset in the revaluation reserve.

Capital contributions

Infrastructure charges received in respect of connections to the mains network are allocated to fixed assets, surface and infrastructure, in accordance with the basis on which the charges are calculated.

Grants and contributions receivable relating to infrastructure assets are deducted from the cost of tangible fixed assets. This is not in accordance with the Large and Medium-sized Companies and Groups Regulations 2008 (SI 2008/410) which form part of the Companies Act 2006, and which require tangible fixed assets to be shown at cost, and hence grants and contributions to be accounted for as deferred income. This departure from the requirements of the Companies Act 2006 is, in the opinion of the directors, necessary for the financial statements to show a true and fair view as, while a provision is made for depreciation of infrastructure assets, these assets have indefinite economic lives and therefore no basis exists on which to recognise grants and contributions in the profit and loss account. The effect of this treatment on the book value of tangible fixed assets is disclosed in note 13.

Capital contributions received in respect of tangible fixed assets, other than infrastructure assets, are deferred and credited to the profit and loss account by instalments over the expected useful lives of the related assets.

Leased assets

Assets financed by leases are included in tangible fixed assets and the net obligation to pay future rentals is included within creditors. Instalments are apportioned between the finance element, which is charged to the profit and loss account as interest, and the capital element, which reduces the outstanding obligation for future instalments.

Rentals paid under an operating lease are charged against profits on a straight-line basis over the life of the lease.

Assets held under finance leases, which are leases where substantially all the risks and rewards of ownership of the asset are passed to the company, and hire purchase contracts are capitalised in the balance sheet and are depreciated over the shorter of the lease term and the assets' useful lives. The capital elements of future obligations under leases and hire purchase contracts are included as liabilities in the balance sheet. The interest elements of the rental obligations are charged in the profit and loss account over the periods of the leases and hire purchase contracts and represent a constant proportion of the balance of capital repayments outstanding.

Fixed asset investments

Fixed asset investments are stated at cost less any provisions in respect of permanent diminution in value.

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

1. Statement of accounting policies continued

Grafham reservoir

Under the Great Ouse Water Act of 1961, Affinity Water Limited has an entitlement to water from the Grafham reservoir which is owned and operated by Anglian Water Services Limited ('Anglian Water').

Affinity Water Limited includes within its fixed assets (and RCV) a proportion of the original cost of the reservoir and annual increments related to capital expenditure made by Anglian Water on the reservoir. The other accounting entry is an obligation of around £19,401,000 relating to the original embedded debt of Anglian Water as incremented by subsequent asset additions.

This obligation is treated as a quasi-finance lease within these financial statements under the category of 'financing of assets operated by third parties' (see notes 17, 18 and 24).

The method utilised for allocating the costs between the company and Anglian Water as required by the legislation results in an interest charge and capital repayment on this quasi-finance lease. The maturity period of the quasi-finance lease is currently assessed as being 28 years, assuming no further capital expenditure on the reservoir by Anglian Water. In practice, both the value of the lease obligation and the maturity period have remained broadly constant for a number of years as the capital repayments made have been similar to the company's proportion of the incremental expenditure by Anglian Water on the reservoir.

Ardleigh reservoir

The company and Anglian Water own the Ardleigh reservoir and ancillary works jointly in approximately equal shares, the company's share of the capital expenditure being included in tangible fixed assets (see note 13). The reservoir is operated on behalf of both undertakings through the Ardleigh Reservoir Committee, and the company's share of the expense incurred is included within abstraction licences and bulk purchase within cost of sales in the profit and loss account.

Stocks and work in progress

Stocks are valued at the lower of cost or net realisable value after allowance for obsolete and slow moving items. In accordance with established practice in the water industry, no value has been placed upon the water in reservoirs, mains or in the course of treatment. Work in progress for chargeable services is valued at cost.

Loans

All loans held with the company's subsidiaries are recognised initially at fair value plus directly attributable transaction costs. The carrying amount of the debt is increased by the amortisation of the finance and transaction costs determined using the effective interest rate in respect of the accounting period and reduced by any payments made in the year. The finance cost recognised in the profit and loss account is allocated to accounting periods over the term of the debt using the effective interest method.

Provision for liabilities

A provision is recognised when the company has a legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation.

STATUTORY FINANCIAL STATEMENTS continued

2. Turnover

Turnover represents income from the supply of water and other chargeable services exclusive of VAT arising wholly within the United Kingdom.

Turnover relating to unmeasured supplies comprises amounts due to the company for the accounting year.

	2014 £000	2013 £000
Unmeasured supplies	**130,731**	134,403
Measured supplies	**160,377**	144,561
Chargeable services	**273**	505
	291,381	279,469

3. Other operating income

	2014 £000	2013 £000
Commission and rentals	**9,880**	9,020

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

4. Operating profit

Operating profit is stated after charging/(crediting):	2014 £000	2013 £000
Purchase of bulk water and water supplied under statutory entitlement	1,681	2,079
Water abstraction	6,413	5,675
Business rates	16,497	14,999
Chargeable services direct expenditure	1,111	916
Depreciation of infrastructure assets	47,309	45,809
Depreciation of tangible fixed assets – owned	32,969	29,138
Depreciation of tangible fixed assets – leased	596	736
Research and development	212	222
Restructuring costs arising from the unification of the water licences	-	732
Other costs arising from the unification of the water licences	-	310
Costs relating to rebranding	-	728
Hire of equipment not under operating lease	538	638
Operating lease rentals – land and buildings	1,547	1,547
Operating lease rentals – other	862	783
Amortisation of deferred credit	(297)	(311)
Amortisation of goodwill	462	297
Pension scheme set up costs	170	620
Auditor's remuneration (see below)	436	311
Auditor's remuneration		
Fees payable to the company's auditor and its associates for the audit of the financial statements	125	147
Fees payable to the company's auditor and its associates for other services		
Audit of the company's associates	65	52
Audit-related assurance services		
- regulatory reporting	188	39
- Thames Water and Anglian Water annual returns	8	6
- Audit related assurance service - other	23	-
Corporate finance services	-	61
All other non-audit services	27	6
	436	311

STATUTORY FINANCIAL STATEMENTS continued

The company's auditor in the prior year was Ernst & Young LLP ('EY'). During the current year, PricewaterhouseCoopers LLP ('PwC') was appointed as the company's auditor. Consequently, fees in the current year are fees payable to PwC and fees payable in the prior year are fees payable to EY.

During the year, additional assurance services were commissioned from PwC with respect to the company's PR14 Business Plan submission to Ofwat.

The above items are included within the cost of sales, customer services and administrative expenses in the profit and loss account.

5. Employees and directors

Staff costs (including executive and non-executive directors) consist of:	2014 £000	2013 £000
Wages and salaries	33,592	29,415
Social security costs	2,824	2,656
Defined benefit pension costs (note 25)	4,295	4,047
Defined contribution pension costs	722	443
Other pension administration costs	544	528
Effect of pension asset limit (note 25)	-	(1,491)
	41,977	35,598

The average number of employees (including executive and non-executive directors) during the year were as follows:

	2014	2013
Operations	524	391
Customer service	301	350
Administration	82	87
	907	828

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

5. Employees and directors continued

Directors' emoluments

	Base salary /fees £000	Taxable benefits[1] £000	Bonus £000	Aggregate emoluments[2] £000		Pension related benefits[3] £000	Total remuneration[2] £000	
	2013/14	2013/14	2013/14	2013/14	2012/13	2013/14	2013/14	2012/13
Non-executive								
Current								
Patrick O'D Bourke	28	-	-	28	-	-	28	-
Baroness Peta Buscombe	38	-	-	38	31	-	38	31
Jeffrey Herbert	38	-	-	38	23	-	38	23
Fiona Woolf CBE	26	-	-	26	31	-	26	31
Olivier Bret	-	-	-	-	12	-	-	12
Former								
Olivier Grunberg	-	-	-	-	7	-	-	7
Philippe Guitard	-	-	-	-	7	-	-	7
Neil Summerton	-	-	-	-	38	-	-	38
Executive								
Duncan Bates	161	13	179	353	189	3	356	189
Richard Bienfait	219	16	244	479	324	12	491	331
Dr Philip Nolan[4]	200	-	-	200	-	-	200	-
	710	29	423	1,162	662	15	1,177	669

1 Taxable benefits comprise company car allowance and healthcare insurance. Taxable benefits for Richard Bienfait further include an allowance that commenced on 1 March 2014 of £7,000 in lieu of being a member of the company's retirement benefit schemes.

2 Total emoluments and remuneration for 2012/13 have been restated to reflect bonuses paid to Duncan Bates (£112,000) and Richard Bienfait (£164,000) in 2013/14, which relate to the company's performance in 2012/13 and to the successful completion of refinancing and bond issuance. These discretionary bonuses were approved by the Remuneration Committee after the approval of the annual report and financial statements for the year ended 31 March 2013.

3 Included in pension related benefits is £15,000 (2013: £7,000) relating to contributions paid to money purchase pension schemes (£3,000 related to Duncan Bates and £12,000 related to Richard Bienfait); there were no amounts outstanding at the year end.

4 From 1 April 2014, the Chairman's role on the Board became a non-executive position.

STATUTORY FINANCIAL STATEMENTS continued

Neither the company nor its immediate parent entities have any listed shares and so the directors have not been offered any share incentives.

The directors who sit on the Board and appointed by Infracapital Partners II, Morgan Stanley Infrastructure Partners and Veolia Water UK Limited do not receive any emoluments from the company, or any company within the Affinity Water group.

Highest paid director

Aggregate emoluments for the highest paid director were £479,000 (2013: £324,000). The highest paid director had an amount accrued under the defined benefit pension scheme at 31 March 2014 of £54,000 (2013: £49,600). The highest paid director did not hold any share options during the year and did not have any benefits accruing under any long term incentive schemes.

6. Interest receivable and similar income

	2014 £000	2013 £000
Other interest	**345**	12

7. Interest payable and similar charges

	2014 £000	2013 £000
Interest payable to parent company	**160**	3,711
Interest payable to other group undertaking	**-**	4,176
Financing costs of assets used by the company and operated by other parties	**1,088**	961
Finance lease charges	**-**	97
Debenture interest	**2**	1
Interest payable to subsidiary in respect of bond issue	**38,724**	15,059
Other interest payable	**1,217**	642
	41,191	24,647

8. Other finance income

	2014 £000	2013 £000
Expected return on pension scheme assets	**14,798**	13,894
Interest on pension scheme liabilities	**(14,144)**	(13,823)
	654	71

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

9. Tax on profit on ordinary activities

	2014 £000	2013 £000
Current taxation		
Current tax on profit of the year	6,595	8,807
Adjustment in respect of prior years	(1,080)	(920)
Current taxation	5,515	7,887
Deferred taxation		
Origination and reversal of timing differences – current year	6,357	7,753
Adjustment in respect of prior years	1,190	841
Decrease in discounting	1,309	48
Impact of change in tax rate	(13,078)	(3,588)
Deferred tax (credit)/charge for the year	(4,222)	5,054
Tax on profit on ordinary activities	1,293	12,941

The tax assessed for the year is lower (2013: lower) than the standard rate of corporation tax in the UK (23%). The differences are explained below:

	2014 £000	2013 £000
Current taxation reconciliation		
Profit on ordinary activities before taxation	45,705	56,436
Theoretical tax at UK corporation tax rate of 23% (2013: 24%)	10,512	13,545
Effects of:		
Adjustment to tax in respect of prior years	(1,080)	(920)
Accelerated capital allowances	(3,428)	(3,161)
Developer contributions	1,141	1,024
Other timing differences	(2,182)	(2,813)
Permanent differences	552	212
Actual current taxation charge	5,515	7,887

Tax on recognised gains and losses not included in the profit and loss account (see note 21):

	2014 £000	2013 £000
Other deferred tax (charge)/credit relating to pension scheme	(2,781)	4,603

STATUTORY FINANCIAL STATEMENTS continued

Factors that may affect future tax charges

In 2012 the main rate of corporation tax in the United Kingdom was reduced to 23 per cent effective from 1 April 2013 and applicable to the financial year ended 31 March 2014. Legislation was included in the Finance Act 2013 to reduce the corporation tax rate from 23 per cent to 21 per cent effective from 1 April 2014 and from 21 per cent to 20 per cent effective from 1 April 2015.

10. Dividends on equity shares

	2014 £000	2013 £000
Ordinary:		
First interim paid of 12.37p per share (2013: 6.15p)	32,792	16,291
Second interim paid of 1.75p per share (2013: 51.75p)	4,650	137,164
Third interim paid of 3.17p per share (2013: nil)	8,400	-
	45,842	153,455

11. Business combination

There were no business combinations during the year ended 31 March 2014.

On 27 July 2012 Affinity Water Limited acquired the assets and liabilities of Affinity Water East Limited ('East') and Affinity Water Southeast Limited ('Southeast').

The fair value of the identifiable assets and liabilities at the date of acquisition amounted to:

	East £000	Southeast £000	Total £000
Tangible fixed assets	79,087	107,030	186,117
Investment	1	-	1
Cash at bank and in hand	2	58	60
Stocks and work in progress	236	190	426
Debtors	2,798	6,688	9,486
Net pension (liability)/asset	(237)	2,266	2,029
Provisions for liabilities	(2,385)	(4,012)	(6,397)
Creditors falling due within one year	(13,752)	(36,812)	(50,564)
Creditors falling due after more than one year	(6,500)	(12,500)	(19,000)
	59,250	62,908	122,158
Cash consideration	65,000	66,200	131,200
Goodwill	5,750	3,292	9,042

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

11. Business combination continued

The fair value of the identifiable assets and liabilities as at the date of acquisition was equal to the book values for all line items on the balance sheet apart from tangible fixed assets. Tangible fixed assets were revalued during the year ended 31 March 2013, of which £34,600,000 of the revaluation surplus related to assets transferred in from East and Southeast. The revaluation was subsequently adjusted against the book value of the tangible fixed assets acquired as a result of unification. No further adjustments were made to the fair value of the identifiable assets and liabilities as at the date of acquisition.

The pre-acquisition performance of East and Southeast for the four months from 1 April 2012 to 27 July 2012 is summarised as follows:

	East £000	Southeast £000
Turnover	5,171	5,863
Operating costs	(3,623)	(5,798)
Other income	309	170
Operating profit	1,857	235
(Loss)/profit on disposal of fixed assets	(52)	96
Interest	(211)	(371)
Profit/(loss) before taxation	1,594	(40)
Taxation	(890)	233
Profit after taxation	704	193
Dividend paid	(2,392)	(1,707)

For the year ended 31 March 2012 the profit after tax of East was £2,902,000 and of Southeast was £4,652,000.

In the year ended 31 March 2013 the East and Southeast regions of Affinity Water Limited contributed £9,311,000 to the company’s net operating cash flows, paid £1,015,000 in respect of interest, £238,000 in respect of taxation and utilised £3,341,000 for capital expenditure.

STATUTORY FINANCIAL STATEMENTS continued

12. Intangible fixed assets

	Goodwill £000
Cost at 1 April 2013 and 31 March 2014	**15,720**
Accumulated amortisation at 1 April 2013	297
Charge for the year	462
At 31 March 2014	**759**
Net Book Value at 31 March 2014	**14,961**
Net Book Value at 31 March 2013	15,423

Goodwill includes £8,283,000 relating to the unification of the regulated businesses on 27 July 2012. The directors consider that this goodwill has a life of 20 years and it has been amortised accordingly. In estimating the useful economic life of goodwill, account has been taken of the nature of the unified business and the stability of the industry. The remaining balance relates to the unamortised goodwill arising from the acquisition of the trade and assets of North Surrey Water Limited.

13. Tangible assets

	Land, buildings and operational structures £000	Mains and other infrastructure assets £000	Fixed plant £000	Vehicles and mobile plant £000	Assets in the course of construction £000	Total £000
Cost or valuation						
At 1 April 2013	274,936	1,165,110	549,607	50,409	78,787	2,118,849
Additions at cost	114	46,253	2,850	2,130	62,144	113,491
Transfers to complete	4,754	3,966	19,374	5,786	(33,880)	-
Capital contributions	-	(8,202)	-	-	-	(8,202)
Disposals	(263)	-	-	(292)	-	(555)
At 31 March 2014	**279,541**	**1,207,127**	**571,831**	**58,033**	**107,051**	**2,223,583**
Accumulated depreciation						
At 1 April 2013	66,782	475,628	347,916	40,705	-	931,031
Charge for the year	4,977	47,309	22,697	5,891	-	80,874
Disposals	-	-	-	(285)	-	(285)
At 31 March 2014	**71,759**	**522,937**	**370,613**	**46,311**	**-**	**1,011,620**
Net book value						
At 31 March 2014	**207,782**	**684,190**	**201,218**	**11,722**	**107,051**	**1,211,963**
At 31 March 2013	208,154	689,482	201,691	9,704	78,787	1,187,818

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

13. Tangible fixed assets continued

Assets used by the company and operated by other parties (note 24) are included on the previous page at 31 March 2014 and 31 March 2013 as follows:

	Land, buildings and operational structures £000	Mains and other infrastructure assets £000	Fixed plant £000	Vehicles and mobile plant £000	Assets in the course of construction £000	Total £000
31 March 2014						
Cost	8,419	23,165	63,874	4,834	-	100,292
Accumulated depreciation	(7,908)	(11,068)	(63,667)	(4,834)	-	(87,477)
Net book value	**511**	**12,097**	**207**	**-**	**-**	**12,815**
31 March 2013						
Cost	8,419	23,165	63,874	4,834	-	100,292
Accumulated depreciation	(7,811)	(10,930)	(63,305)	(4,834)	-	(86,880)
Net book value	608	12,235	569	-	-	13,412

The net book value of mains and other infrastructure assets for the company is stated after the deduction of grants and contributions received since April 1990 amounting to £182,172,000 (2013: £173,970,000) in order to give a true and fair view. All land and buildings are held as freehold.

Certain classes of the company's tangible fixed assets were professionally valued at October 2009 and March 2010 by PwC in their capacity as independent qualified valuers. These valuations were performed in accordance with Financial Reporting Standard 15 which requires that assets subject to a policy of revaluation should be carried at their current value. Current value is defined in Financial Reporting Standard 15 as the lower of replacement cost and recoverable amount. The recoverable amount is further defined as the higher of Net Realisable Value ('NRV') and Value in Use ('VIU').

Having considered the above definitions of value, PwC concluded that the most reliable valuation method to determine the current value for the tangible fixed assets of a water company in the United Kingdom was a two step approach:

- **Step 1:** Estimating the business VIU, using a discounted cash flow ('DCF') model to determine the business enterprise value, cross-checked against RCV, followed by
- **Step 2:** Allocating the VIU of the business (less relevant working capital balances, deferred tax liabilities and other adjustments) to individual classes of tangible fixed assets.

Such valuations were incorporated into the financial statements with the resulting revaluation adjustments taken to the revaluation reserve.

PwC carried out an interim valuation using a consistent basis during the year ended 31 March 2013. The revaluation surplus of £84,600,000 at 31 March 2013 was attributed to infrastructure assets and was taken to the revaluation reserve. Deferred tax has not been provided on timing differences arising from the revaluation of fixed assets unless, by the balance sheet date, a binding commitment to sell the asset has been entered into and it is unlikely that any gain will be rolled over.

STATUTORY FINANCIAL STATEMENTS continued

If the revalued assets were stated on a historical cost basis, the historic cost before depreciation would be £1,681,200,000 (2013: £1,576,479,000). If the revalued assets were stated on a historical cost basis, the net book value would be: £669,580,000 (2013: £648,924,000).

Information on the condition of assets is also provided to the Regulator every five years as part of the price review mechanism.

14. Investments

	£000
Investment in subsidiaries	61

The company has an investment of £50,000 in 100 per cent of the £1 ordinary shares of a subsidiary company, Affinity Water Finance (2004) Limited. The principal activity of Affinity Water Finance (2004) Limited is to raise finance for the company. It made neither profit nor loss for the year ended 31 March 2014 (2013: £nil).

On 11 January 2013, Affinity Water Limited incorporated Affinity Water Programme Finance Limited as a special purpose vehicle, registered in the Cayman Islands (tax registered in the United Kingdom), for the purpose of issuing asset backed securities. The company invested £10,000 in 100 per cent of the £1 ordinary shares of Affinity Water Programme Finance Limited. The principal activity of Affinity Water Programme Finance Limited is to raise finance for the company. It made a profit of £3,000 in the year ended 31 March 2014 (2013: £nil).

The directors believe that the carrying value of the investments is supported by their underlying net assets.

15. Stocks

	2014 £000	2013 £000
Raw materials and consumables	1,412	1,576

16. Debtors

	2014 £000	2013 £000
Trade debtors and customers' water charges	30,042	30,689
Accrual for unbilled metered customers	37,790	36,044
Amounts owed by group undertaking	3,943	736
Amounts owed by related parties	402	893
Other debtors	3,508	6,655
Prepayments and accrued income	5,519	2,692
	81,204	77,709

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

17. Creditors – amounts falling due within one year

	2014 £000	2013 £000
Short-term credit facilities	**17,200**	-
Financing of assets used by the company and operated by other parties (note 24)	**1,005**	1,093
Amounts owed to related parties	**1,166**	1,655
Payments received in advance	**32,581**	39,091
Trade creditors	**10,827**	8,238
Interest payable to subsidiary companies	**10,321**	11,417
Interest payable to intermediate parent company	**-**	25
Interest payable to external parties	**146**	-
Corporation tax	**3,414**	4,951
Other taxation and social security	**1,038**	1,343
Other creditors	**10,587**	7,969
Capital accruals	**17,826**	20,181
Other accruals and deferred income	**26,474**	26,450
	132,585	122,413

The short-term credit facilities are subject to the terms of the whole business securitisation and therefore rank at least pari passu with all other present and future unsecured obligations. They are also guaranteed by Affinity Water Holdings Limited, the immediate parent undertaking of Affinity Water Limited.

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

18. Creditors – amounts falling due after more than one year

	2014 £000	2013 £000
Financing of assets used by the company and operated by other parties (note 24)	**18,396**	16,185
Deferred credit – contributions to surface assets	**3,274**	3,570
Loan from Affinity Water Finance (2004) Limited financed by bond issue	**197,036**	196,879
Loan from Affinity Water Programme Finance Limited financed by bond issue	**572,939**	565,885
Loan from parent company	**3,550**	3,550
3.5% irredeemable consolidated debenture stock	**4**	4
4% irredeemable consolidated debenture stock	**8**	9
4% irredeemable debenture stock	**1**	1
4.25% irredeemable debenture stock	**1**	1
5% irredeemable debenture stock	**20**	20
5.25% irredeemable debenture stock	**1**	1
	795,230	786,105

During the year the company repurchased £1,032 nominal irredeemable outstanding debenture stock for cancellation (2013: £nil).

On 13 July 2004 Affinity Water Finance (2004) Limited issued a £200,000,000 bond at an interest rate of 5.875 per cent and repayable in July 2026. The net proceeds of the bond issue were then lent to the company on the same terms.

On 4 February 2013, as a part of the refinancing, Affinity Water Programme Finance Limited issued £80,000,000 Class A Guaranteed Notes maturing in September 2022 with a coupon of 3.625 per cent, £250,000,000 Class A Guaranteed Notes maturing in March 2036 with a coupon of 4.50 per cent, £150,000,000 Class A Guaranteed RPI index-linked Notes maturing in June 2045 with a coupon of 1.548 per cent and £95,000,000 Class B Guaranteed RPI index-linked Notes maturing in June 2033 with a coupon of 3.249 per cent (together 'Bonds'). The net proceeds of the bond issue were then lent to the company on the same terms.

On 4 February 2013, the company borrowed an amount of £3,550,000 from Affinity Water Capital Funds Limited, the company's intermediate parent company. The final repayment date of this loan is 31 March 2036, with interest terms having been set at 4.5 per cent.

Refer to page 50 of the ownership and financing section for a chart showing the maturity profile of the bonds.

The company has unconditionally and irrevocably guaranteed the due and punctual payment of all sums from time to time payable by Affinity Water Finance (2004) Limited and Affinity Water Programme Finance Limited in respect of the issued bonds. This guarantee constitutes direct, general and unconditional obligations of the company which will at all times rank at least pari passu with all other present and future unsecured obligations. These issues are also guaranteed by Affinity Water Holdings Limited, the immediate parent undertaking of Affinity Water Limited.

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

18. Creditors – amounts falling due after more than one year continued

All loans held with the company's subsidiaries are recognised initially at fair value plus directly attributable transaction costs. The carrying amount of the debt is increased by the amortisation of the finance and transaction costs determined using the effective interest rate in respect of the accounting period and reduced by any payments made in the year. The finance cost recognised in the profit and loss account is allocated to accounting periods over the term of the debt using the effective interest method.

The company is subject to a number of covenants in relation to its borrowings, which, if breached, would result in its loans becoming immediately repayable. These covenants specify certain limits in terms of key ratios such as net cash flow to debt interest and net debt to RCV. At the year end the company was not in breach of any financial covenants.

19. Provisions for liabilities

	Deferred tax £000	Insurance £000	Other £000	Total £000
At 1 April 2013	(50,869)	(2,795)	(1,423)	(55,087)
Charged to the profit and loss account	-	-	(1,050)	(1,050)
Utilised in the year	5,911	1,186	256	7,353
At 31 March 2014	**(44,958)**	**(1,609)**	**(2,217)**	**(48,784)**

Deferred tax

	2014 £000	2013 £000
Accelerated capital allowances	**91,158**	99,429
Other timing differences	**(2,031)**	(3,080)
Undiscounted provision for deferred tax	**89,127**	96,349
Discount	**(44,169)**	(45,480)
Discounted provision for deferred tax	**44,958**	50,869
Deferred tax liability/(asset) on pension asset/liability (see note 25)	**622**	(3,889)
Provision at the end of the year including deferred tax on pension asset	**45,580**	46,980

STATUTORY FINANCIAL STATEMENTS continued

Deferred tax (liability)/asset relating to pension asset

	2014 £000	2013 £000
At 1 April	3,889	4,665
Acquisitions*	-	(605)
Deferred tax credit to the profit and loss account	(1,730)	(4,774)
Deferred tax (credit)/charge to the statement of total recognised gains and losses (see note 25):		
– on actuarial gain/loss	(2,457)	4,803
– change in tax rate	(324)	(200)
At 31 March	(622)	3,889

*Transferred from Affinity Water East Limited and Affinity Water Southeast Limited on unification of the water licences (see note 11).

A deferred tax liability of £622,000 (2013: £3,889,000 asset) has been deducted in arriving at the net pension asset on the balance sheet (2013: pension liability).

Factors that may affect future tax charges

Based on current capital investment plans, the group expects to continue to claim capital allowances in excess of depreciation in future years at a similar level to the current year.

Reference should also be made to note 9 regarding future changes to the tax system in the United Kingdom.

Insurance

Insurance represents the amount of the company's liability in respect of excesses on individual claims. This is based upon data provided by loss adjusters to insurers on levels of reserve and is calculated on settlement experience. It is expected that this provision will be utilised within 24 months.

Other provisions

Other provisions include £218,000 (2013: £218,000) covering the risk of remedy due to an encroachment issue anticipated to be utilised within 12 months, and £670,000 in relation to unfunded pension liabilities for former directors, which will be utilised over the 20 years from January 2019. The remaining balance relates to outstanding legal claims at 31 March 2014 anticipated to be utilised within 12 months.

20. Called up share capital

Allotted, called up and fully paid share capital

	2014 £000	2013 £000
Ordinary shares (265,057,824 of £0.10 each)	26,506	26,506

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

21. Reserves

	Share premium account £000	Capital contribution £000	Revaluation reserve £000	Profit and loss account £000	Total £000
At 1 April 2013	1,400	30,150	207,993	75,694	315,237
Actuarial gain recognised in the pension scheme	-	-	-	14,785	14,785
Deferred tax arising thereon	-	-	-	(2,781)	(2,781)
Realisation of property revaluation gains of previous years	-	-	(896)	896	-
Profit for the financial year	-	-	-	44,412	44,412
Dividends paid	-	-	-	(45,842)	(45,842)
At 31 March 2014	**1,400**	**30,150**	**207,097**	**87,164**	**325,811**

Non-returnable capital contributions totalling £30,150,000 were received from Affinity Water Capital Funds Limited in the year ended 31 March 2013.

22. Reconciliation of movements in shareholder's funds

	2014 £000	2013 £000
Profit for the financial year	**44,412**	43,495
Actuarial gain/(loss) recognised in the pension scheme	**14,785**	(20,015)
Deferred tax arising thereon	**(2,781)**	4,603
Total gains recognised for the year	**56,416**	28,083
Dividends paid	**(45,842)**	(153,455)
Capital contribution received	**-**	30,150
Movement in called up and fully paid share capital (including share premium)	**-**	1,400
Revaluation during the year	**-**	84,600
Net addition to/(reduction in) shareholder's funds	**10,574**	(9,222)
Opening shareholder's funds	**341,743**	350,965
Closing shareholder's funds	**352,317**	341,743

STATUTORY FINANCIAL STATEMENTS continued

23. Capital commitments

The directors have authorised a programme of capital expenditure (including infrastructure renewals), of which the contracted element not provided for in the financial statements amounts to £24,081,000 (2013: £20,189,000).

24. Commitments under finance and operating leases

The company has no short term obligations due under finance leases.

Financing of assets operated by third parties:

	2014 £000	**2013 £000**
In one year or less, but on demand	**1,005**	1,093
In more than one year but not more than two years	**1,078**	1,029
In more than two years but not more than five years	**1,509**	2,682
In more than five years	**15,809**	12,474
Net obligations due	**19,401**	17,278

The company had annual commitments under non-cancellable operating leases as follows:

Operating leases which expire:

	2014 Land and buildings £000	**2014 Other £000**	2013 Land and buildings £000	2013 Other £000
Within one year	**-**	**85**	-	123
In two to five years	**-**	**1,415**	-	862
After five years	**1,547**	**-**	1,547	-
	1,547	**1,500**	1,547	985

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

25. Pensions

Composition of the pension plan

The company operates a pension plan providing benefits based on final pensionable salary. The assets of the plan are held separately from those of the company.

A new Affinity Water Pension Plan ('AWPP') was established in February 2013, set up as an identical scheme to the Veolia UK Pension Plan ('VUKPP'), the plan in which the company participated until 28 March 2013. The benefits of employees and former employees of the company were transferred into the AWPP with effect from 28 March 2013.

The VUKPP was a multi-employer sectionalised pension plan with defined benefits and defined contribution sections. The defined benefit section was closed to new entrants in September 2004 since when new members have only been eligible to join the defined contribution section. The sectionalised plan had separate Central, East and Southeast divisions which have been replicated in the AWPP.

Each division of the VUKPP was merged with its corresponding division of the Veolia Water Supply Companies' Pension Plan ('VWSCPP') on 31 May 2011, the latter plan having been closed to new entrants in April 1996.

The latest formal valuation of the VUKPP, determined by an independent qualified actuary, was at 31 December 2010. The actuarial valuation was made on the "attained age" funding method, based on the following assumptions:

Rate of investment return	6.2% (pre-retirement), 5.2% (post-retirement)
Rate of increase in remuneration	4.8%
Rate of pension increase	2.8% (former members of VWSCPP scheme)
Rate of pension increase	3.3% (VUKPP other members)

The valuation as at 31 December 2010 stated the market valuations of the plan's assets to be £219,000,000 with a funding level of 90 per cent for the Central division, £16,600,000 with a funding level of 93 per cent for the East division, and £23,700,000 with a funding level of 119 per cent for the Southeast division.

A formal valuation of the AWPP is currently being carried out as at 31 March 2013, although it is now largely complete and has been agreed in principle, with its expected signing date being after the date of approval of this annual report and financial statements in June 2014.

Contributions to the AWPP over the period ended 31 March 2014 were paid by members in accordance with the rules of the plan and by the company expressed as fixed monetary amounts according to the size of the relevant payroll and any surplus or deficit in the relevant division of the plan.

The contributions expected to be paid in the year from 31 March 2014 are £9,119,000 (2013: £8,787,000).

Principal assumptions

The present values of pension liabilities are estimated by discounting pension commitments, including salary growth, at an AA corporate bond yield.

STATUTORY FINANCIAL STATEMENTS continued

In calculating the liabilities of the plan, the following financial assumptions have been used:

	2014	2013	2012
Discount rate	**4.30% pa**	4.20% pa	4.95% pa
Salary growth	**3.90% pa**	4.20% pa	4.70% pa
RPI	**3.30% pa**	3.20% pa	3.20% pa
CPI	**2.30% pa**	2.50% pa	2.50% pa
Life expectancy for a male pensioner from age 65 (years)	**22**	23	23
Life expectancy for a female pensioner from age 65 (years)	**24**	25	25
Life expectancy from age 65 (years) for a male participant currently aged 45 (years)	**24**	25	23
Life expectancy from age 65 (years) for a female participant currently aged 45 (years)	**27**	27	25

Deferred pensions are revalued to retirement age in line with the CPI assumption of 2.3 per cent per annum unless otherwise prescribed by statutory requirements or the plan rules.

The assets of the plan are held separately to those of the company, being invested by independent fund managers. Contributions to the plan are charged to the profit and loss account so as to spread the cost of pensions over the employees' working lives with the company.

The total pensions charge including the defined contribution section of the AWPP for the year ended 31 March 2014 was £5,017,000 (2013: £4,490,000). There are no amounts prepaid or outstanding in respect of the defined contribution section at 31 March 2014 (2013: £nil). The effect of the asset limit charged to the statement of total recognised gains and losses was £2,933,000 (2013: £1,491,000 credited to the profit and loss account). This has arisen from a change in the maximum allowable surplus relating to the net asset position of the Southeast division, and has been booked to the statement of total recognised gains and losses in the current year as the change relates solely to changes in actuarial assumptions.

The assets of the scheme and the weighted average expected rate of return were:

	At 31 March 2014		At 31 March 2013	
	Value £000	**Long term rate of return expected (% pa)**	Value £000	Long term rate of return expected (% pa)
Equities	**148,724**	**6.54**	143,002	6.24
Bonds	**55,512**	**4.30**	56,276	4.10
Property	**6,353**	**7.00**	10,037	6.75
Cash and cash equivalents	**109,741**	**3.45**	114,539	2.96
Fair value of assets	**320,330**		323,854	

The expected return on scheme assets is determined by considering the expected returns available on the assets underlying the investment policy. Expected yields on fixed interest investments are based on gross redemption yields as at the balance sheet date. Expected returns on equity investments reflect long-term real rates of return experienced in the respective markets.

The actual return on scheme assets in the year was a loss of £1,726,000 (2013: £30,493,000 gain).

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

25. Pensions continued

The amounts for the current period and the previous four periods are as follows:

Year ended – 31 March	2014	2013	2012	2011	2010
Defined benefit obligation (£m)	(313.7)	(340.2)	(256.5)	(246.6)	(262.6)
Plan assets (£m)	320.3	323.9	237.1	217.7	217.1
Effect of asset limit (£m)	(3.5)	(0.6)	-	-	-
Surplus/(deficit) (£m)	3.1	(16.9)	(19.4)	(28.9)	(45.5)
Difference between expected and actual return on plan assets:					
Percentage of plan assets	(5.2%)	4.9%	(4.0%)	1.0%	(18.0%)
Experience gains/(losses) on plan liabilities:					
Percentage of plan liabilities	3.3%	0.0%	1.0%	0.0%	0.0%

	2014 £000	2013 £000
Reconciliation of present value of scheme liabilities:		
At 1 April	340,194	256,513
Current service cost	4,295	4,047
Interest cost	14,144	13,823
Liabilities assumed in a business combination[1]	-	40,048
Liabilities assumed from pension plan transfer	760	(633)
Actuarial (gain)/loss	(33,363)	36,614
Benefits paid	(13,020)	(10,957)
Contributions by scheme participants	709	739
At 31 March	313,719	340,194

1 From Affinity Water East Limited and Affinity Water Southeast Limited on the unification of the water licences.

STATUTORY FINANCIAL STATEMENTS continued

	2014 £000	2013 £000
Reconciliation of fair value of scheme assets:		
At 1 April	**323,854**	237,078
Contributions paid by employer	**9,753**	22,393
Contributions by scheme participants	**709**	739
Expected return on scheme assets	**14,798**	13,894
Assets assumed from pension plan transfer	**760**	(633)
Assets acquired in a business combination[1]	**-**	44,741
Actuarial (loss)/gain	**(16,524)**	16,599
Benefits paid	**(13,020)**	(10,957)
At 31 March	**320,330**	323,854
Surplus/(deficit) of funded plan liabilities	**6,611**	(16,340)
Effect of asset limit	**(3,500)**	(567)
Pension asset/(liability) before deferred tax	**3,111**	(16,907)
Related deferred tax	**(622)**	3,889
Net pension asset/(liability) at 31 March	**2,489**	(13,018)
The amounts recognised in the profit and loss account are as follows:		
Current service cost	**4,295**	4,047
Expected return on scheme assets	**(14,798)**	(13,894)
Interest on pension scheme liabilities	**14,144**	13,823
Effect of asset limit	**-**	(1,491)
Total charge	**3,641**	2,485
Total actuarial gains and losses included in the statement of total recognised gains and losses:		
Actuarial (losses)/gains on scheme assets[2]	**(15,645)**	16,599
Actuarial gains/(losses) on scheme liabilities	**33,363**	(36,614)
Effect of asset limit	**(2,933)**	-
Total credit/(charge)	**14,785**	(20,015)
Deferred tax arising thereon	**(2,781)**	4,603
Credit/(charge) after deferred tax	**12,004**	(15,412)

1 From Affinity Water East Limited and Affinity Water Southeast Limited on the unification of the water licences.

2 Updated to reflect the effect of contributions received by the plan in the year subsequent to payment as a result of the transition period on the set up of the AWPP.

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

26. Financial instruments and risk management

The company's financial instruments comprise borrowings, debentures, cash and liquid resources, and various items, such as trade debtors and trade creditors that arise directly from operations. The main purpose of these financial instruments is to provide finance for the company's operations.

It is the company's policy, and has been throughout the year under review, that no trading in financial instruments shall be undertaken.

The main risks arising from the company's financial instruments are interest rate risk and liquidity risk. The Board reviews and agrees policies for managing each of these risks. These policies have remained unchanged during the period.

The company finances its operations through a mixture of retained profits, borrowings from its subsidiary companies, borrowings from its parent company and debentures. Treasury policies are agreed in conjunction with the wider Affinity Water group (including liquidity and interest rate risks). The company does not undertake speculative transactions. Interest rate exposure is primarily managed by using a mixture of fixed rate, floating rate and RPI-linked borrowings.

Further disclosures are included in notes 17 and 18.

Financial liabilities: excluding non-debt current liabilities

The company has a £3,550,000 loan from its parent company (2013: £3,550,000).

The interest rate profile of the company's financial liabilities excluding non-debt current liabilities and deferred credits at 31 March 2014 was as follows:

	Total £000	Fixed rate financial liabilities £000	Floating rate financial liabilities £000	RPI-linked financial liabilities £000
31 March 2014	**810,162**	**544,791**	**17,200**	**248,171**
31 March 2013	783,628	542,319	-	241,309

Fixed rate liabilities represent loans with Affinity Water Finance (2004) Limited and Affinity Water Programme Finance Limited, irredeemable debenture stock and the financing of assets used by the company and operated by other parties.

Floating rate liabilities represent the working capital and capex loan facilities that were set up at the time of refinancing The RPI-linked liabilities represent loans with Affinity Water Programme Finance Limited.

STATUTORY FINANCIAL STATEMENTS continued

Fixed rate financial liabilities (including RPI linked)

As at	Weighted average interest rate %	Weighted average period for which rate is fixed* Years	Weighted average period until maturity Years
31 March 2014			
- Loan from subsidiaries	**4.1**	**19.5**	**19.5**
- Loan from intermediate parent	**4.5**	**22.0**	**22.0**
- Other	**5.3**	**25.8**	**25.8**
31 March 2013			
- Loan from subsidiary	4.2	20.5	20.5
- Loan from parent	4.5	23.0	23.0
- Other	5.3	28.8	28.8

*This calculation excludes the irredeemable debenture stock where the interest rate is fixed in perpetuity (see note 18).

The maturity profile of the company's financial liabilities at 31 March 2014 was as follows:

	2014 £000	2013 £000
In one year or less or on demand*	**18,205**	1,093
In more than one year but not more than two years	**1,078**	1,029
In more than two years but not more than five years	**1,509**	2,682
In more than five years	**789,370**	778,824
	810,162	783,628

* Short-term credit facilities, inter-company borrowings and obligations under finance leases

All financial liabilities due after one year comprise financing of assets used by the company and operated by other parties, irredeemable debenture stock, amounts due to its subsidiary companies and other group undertakings.

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

26. Financial instruments and risk management continued

The company has various undrawn committed borrowing facilities. The undrawn facilities available at 31 March 2014 in respect of which all conditions precedent had been met were as follows:

	2014 £000	2013 £000
Expiring in one year or less	**55,000**	57,500
Expiring in more than one year but not more than two years	**-**	-
Expiring in more than two years	**82,800**	100,000
	137,800	157,500

The company has access to a borrowing facility of £100,000,000 with a tenor of five years from 28 June 2012. This facility consists of a £70,000,000 capital expenditure facility and a £30,000,000 working capital facility. As at 31 March 2014, £11,200,000 had been drawn down from the capital expenditure facility (leaving £58,800,000 capacity) and £6,000,000 from the working capital facility (leaving £24,000,000 capacity).

The company has available a 364 day revolving Debt Service Reserve Liquidity Facility of £35,000,000. The facility is intended for the purpose of funding any debt service payments in the event of a liquidity shortfall that would otherwise prevent such payments being made.

The company has also available a 364 day revolving Operations and Maintenance Reserve Facility of £20,000,000. The facility is intended for the purpose of funding any general liquidity shortfall.

Fair values of financial liabilities

Set out below is a comparison by category of book value and fair value of the financial liabilities of the company as at 31 March 2014, with the exception of the fixed rate liability in respect of the financing of assets by the company operated by other parties, where the fair value calculated by market interest rates of the financial instrument is not expected to be materially different from book value.

	Book value		**Fair value**	
	2014 £000	2013 £000	**2014 £000**	2013 £000
Primary financial instruments held or issued to finance the company's operations				
Long-term borrowings	**769,975**	762,764	**812,848**	829,895
	769,975	762,764	**812,848**	829,895

The fair value of the Bonds, having a combined book value of £769,975,000, has been determined by reference to published and other information, as well as prices from the active markets on which the instruments involved are traded.

The company has taken advantage of the exemption of Financial Reporting Standard 29: 'Financial Instruments: Disclosures' and has not disclosed information required by that standard, as the consolidated financial statements of Affinity Water Acquisitions (Investments) Limited, in which the company is included, provide equivalent disclosures.

STATUTORY FINANCIAL STATEMENTS continued

27. Billing on behalf of Thames Water and Anglian Water

The company bills and collects charges in respect of sewerage and infrastructure within its area on behalf of Thames Water Utilities Limited and Anglian Water Services Limited. No amounts are included in the financial statements in respect of uncollected sewerage and sewerage infrastructure charges at 31 March 2014 (2013: £nil).

28. Related party transactions

Purchases

	Nature of relationship	In respect of	2014 Value £000	2014 Balance outstanding £000	2013 Value £000	2013 Balance outstanding £000
Affinity Water Acquisitions Limited	Intermediate parent	Interest paid on loan	-	-	2,493	-
Affinity Water Capital Funds Limited	Intermediate parent	Interest paid on various loans	160	-	3,711	25
Affinity Water Capital Funds Limited	Intermediate parent	Loans outstanding	-	3,550	-	3,550
Affinity Water Capital Funds Limited	Intermediate parent	Dividends paid	-	-	153,455	-
Affinity Water Holdings Limited	Immediate parent	Dividends paid	45,842	-	-	-
Affinity Water Shared Services Limited	Group undertaking	Support services (including capital expenditure)	8,240	-	21,630	2,460
Affinity Water Finance (2004) Limited	Subsidiary undertaking	Interest on bonds	11,908	8,402	11,909	8,402
Affinity Water Programme Finance Limited	Subsidiary undertaking	Interest on bonds	26,816	1,919	3,150	3,010
Affinity Water Trust	Trust Fund	Donations	565	-	570	-
Veolia Water UK Limited	Shareholder[1]	Management and technical support	50	1,484	158	1,645
Veolia Environnement S.A.	Shareholder[2]	Interest paid on loan	-	-	1,654	-
Veolia Environmental Services (UK) Limited	Common ownership[3]	Waste water disposal	340	-	-	-
Other Veolia entities	Common ownership[3]	Transport and other services	6	-	304	62

The company has an outstanding loan balance of £197,036,000 (2013: £196,879,000) with Affinity Water Finance (2004) Limited and £572,939,000 (2013: £565,885,000) with Affinity Water Programme Finance Limited.

1 Veolia Water UK Limited holds a 10 per cent shareholding in Affinity Water Acquisitions (Holdco) Limited, an intermediate parent of the company.

2 Veolia Environnement S.A. is the ultimate parent company of Veolia Water UK Limited.

3 The ultimate parent company of these entities is Veolia Environnement S.A., the ultimate parent company of Veolia Water UK Limited which holds a 10 per cent shareholding in an intermediate parent of the company.

STATUTORY FINANCIAL STATEMENTS continued

Notes to the financial statements for the year ended 31 March 2014 continued

28. Related party transactions continued

Sales

	Nature of relationship	In respect of	2014 Value £000	2014 Balance £000	2013 Value £000	2013 Balance £000
Affinity Water Shared Services Limited	Group undertaking	Employee costs	9,064	3,943	2,196	736
Veolia Water UK Limited	Shareholder[1]	Transitional services and capability sharing agreement and other support	235	318	1,224	735
Southern Water Services Limited	Former related party[4]	Meter reading	-	-	238	-
Other Veolia entities	Common ownership[3]	Transitional services, capability sharing agreement and laboratory services	103	84	482	157

There are no other material related party transactions which require disclosure

1 Veolia Water UK Limited holds a 10 per cent shareholding in Affinity Water Acquisitions (Holdco) Limited, an intermediate parent of the company.

2 Veolia Environnement S.A. is the ultimate parent company of Veolia Water UK Limited.

3 The ultimate parent company of these entities is Veolia Environnement S.A., the ultimate parent company of Veolia Water UK Limited which holds a 10 per cent shareholding in an intermediate parent of the company.

4 Southern Water Services Limited held a minority interest in Affinity Water Southeast Limited, a fellow group undertaking of the company. From 28 June 2012, Southern Water Services was not a related party of the company.

29. Post balance sheet events

There were no significant post balance sheet events.

STATUTORY FINANCIAL STATEMENTS continued

30. Ultimate parent company and controlling party

The immediate parent undertaking of the company is Affinity Water Holdings Limited, a company registered in England and Wales.

Affinity Water Holdings Limited is majority owned by Affinity Water Acquisitions (Investments) Limited, a company registered in England and Wales. Affinity Water Acquisitions (Investments) Limited is the parent undertaking of the smallest and largest group to consolidate the statutory financial statements of this company.

The directors consider that Affinity Water Acquisitions (Investments) Limited is the ultimate holding and controlling company in the United Kingdom.

Copies of the group financial statements of Affinity Water Acquisitions (Investments) Limited for the year ended 31 March 2014 may be obtained from the Company Secretary, Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

Affinity Water Acquisitions (Investments) Limited is owned by a consortium of investors led by Infracapital Partners II, the infrastructure investment fund managed by M&G (the European Investment arm of Prudential plc.), and Morgan Stanley Infrastructure Partners. Veolia Environnement S.A. holds a 10 per cent shareholding in Affinity Water Acquisitions (Holdco) Limited, the direct subsidiary of Affinity Water Acquisitions (Investments) Limited, through its subsidiary Veolia Water UK Limited. The directors consider Infracapital Partners II and Morgan Stanley Infrastructure Partners to be the company's ultimate controllers, as they are in a position to exercise material influence over the company's policy and affairs.

Infracapital Partners II is one of a number of European infrastructure funds managed by M&G Investment Management Limited, a subsidiary of Prudential plc. It was established in 2010 to make investments in income-generative infrastructure assets and business, including electricity and gas networks, water companies, transport infrastructure and renewable energy.

Morgan Stanley Infrastructure Partners is a leading global infrastructure investment fund. It is managed by Morgan Stanley Infrastructure Inc., part of the investment management division of Morgan Stanley. Morgan Stanley Infrastructure Partners targets core infrastructure assets that provide essential public goods and services to societies across the globe and seeks to improve asset performance using active management.

Affinity Water

Your local supply, on tap

Regulatory Financial Statements

for the year ended 31 March 2014

Registered Number 2546950

REGULATORY FINANCIAL STATEMENTS

INDEX

The following accounts are prepared to enable the Water Services Regulation Authority (Ofwat) to monitor the financial performance of the regulated water business. At the request of Ofwat, comparative figures have been prepared on the basis that the combination of Affinity Water Limited, Affinity Water East Limited and Affinity Water Southeast Limited was in effect from 1 April 2012 rather than 27 July 2012 as is the case for the statutory financial statements.

These regulatory financial statements should be read in conjunction with the preceding annual report and financial statements.

REGULATORY FINANCIAL STATEMENTS continued

Certificates of compliance

To: Water Services Regulation Authority
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Certificate of compliance with licence condition F6A

This is to certify that on 20 June 2014 the Board of Affinity Water Limited ('the Appointee') resolved that in its opinion:

1) the Appointee will have available to it sufficient financial resources and facilities to enable it to carry out, for at least the next 12 months, the Regulated Activities (including the investment programme necessary to fulfil the Appointee's obligations under the Appointment); and

2) the Appointee will, for at least the next 12 months, have available to it

(a) financial resources and facilities;

(b) management resources; and

(c) systems of planning and internal control

which are sufficient to enable it to carry out those functions; and

3) all contracts entered into with any associated company include all necessary provisions and requirements concerning the standard of service to be supplied to the Appointee, to ensure that it is able to meet all its obligations as a water undertaker.

These statements are based on:

– the net worth of the company as shown in the financial statements, the budget and plan for the forthcoming year, and the financing arrangements available to the company;

– the adequacy of the senior management team and management resources, robust internal control and delegated authority procedures, an internal audit team reporting to the Audit Committee, the availability of specialist planning teams, as well as the information from point 1) above itself; the company is also subject to considerable external assurance review, both fiscal and operational;

– an examination of the contracts with associated companies.

Tim Monod

Company Secretary
20 June 2014

REGULATORY FINANCIAL STATEMENTS continued

Compliance with condition K

Paragraph 3.1 of Condition K of the company's Instrument of Appointment requires the company to ensure at all times, so far as reasonably practicable, that if a special administration order were made, it would have available to it sufficient rights and assets (other than financial reserves) to enable a special administrator to manage the affairs, business and property of the appointed business of the company.

The company hereby certifies that at 31 March 2014 it was in compliance with paragraph 3.1 of Condition K.

Statement of disclosure of transactions with associated companies

With respect to the disclosure of transactions with associated companies, the directors declare that to the best of their knowledge:

- All appropriate transactions with associated companies have been disclosed;
- Transactions with associated companies are at arms length (except where agreed with Ofwat) with no cross-subsidy occurring; and
- No directors have acted as both purchaser and supplier in any transaction with an associate company

Statement of directors' responsibilities

In addition to their responsibilities to prepare financial statements in accordance with Companies Act 2006, the directors are also responsible under Condition F of the Instrument of Appointment granted by the Secretary of State for the Environment to the company as a water undertaker as amended by the Variation and Modifications dated 27 July 2012 under what is now the Water Industry Act 1991 and Regulatory Accounting Guidelines issued by Ofwat for:

(a) ensuring that proper accounting records are maintained by the Appointee to enable compliance with the requirements of Condition F and having regard also to the terms of guidelines notified by Ofwat to the Appointee from time to time;

(b) preparing on a consistent basis for each financial year accounting statements in accordance with Condition F, or as specified under the Variation and Modifications dated 27 July 2012, having regard also to the terms of guidelines notified by Ofwat from time to time, which so far as is reasonably practicable have the same content as the annual financial statements of the Appointee prepared under the Companies Act 2006 and which are prepared in accordance with the formats, accounting policies and principles which apply to these accounts;

(c) preparing accounting statements on a current cost basis in respect of the same accounting period in accordance with guidelines issued by Ofwat from time to time or as specified under the Variation and Modifications dated 27 July 2012;

(d) preparing such other accounting and related information as is required by Condition F having regard also to the terms of guidelines issued by Ofwat from time to time;

(e) preparing accounting separation tables with regards to the guidelines issued by Ofwat from time to time.

In the case of each of the persons who are directors of the company at the date when this report was approved, so far as each of the directors are aware there is no relevant audit information of which the company's auditor is unaware; and each of the directors has taken all the steps that he/she ought to have taken as a director in order to make himself/herself aware of any relevant information and to establish that the company's auditor is aware of that information.

Relevant audit information means information needed by the company's auditor in connection with preparing their report. This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

Independent Auditors' report to the Water Services Regulation Authority (the Authority, referred to as the "WSRA") and the Directors of Affinity Water Limited

Opinion on Regulatory Accounts

In our opinion the Regulatory Accounts, defined below:

- fairly present in accordance with Condition F, the Regulatory Accounting Guidelines issued by the WSRA and the accounting policies set out on page 125 (including the accounting separation methodology), the state of the Company's affairs at 31 March 2014 on an historical cost and current cost basis, and its historical cost and current cost profit and its current cost cash flow for the year then ended; and
- have been properly prepared in accordance with Condition F, the Regulatory Accounting Guidelines and the accounting policies (including the accounting separation methodology).

This opinion is to be read in the context of what we say in the remainder of this report.

What we have audited

We have audited the regulatory accounts of Affinity Water Limited ("the Company") for the year ended 31 March 2014 on pages 118 to 139 (the "Regulatory Accounts") which comprise:

- the regulatory historical cost accounting statements comprising the regulatory historical cost profit and loss account, the regulatory historical cost statement of total recognised gains and losses, the regulatory historical cost balance sheet and the historical cost reconciliation between the statutory accounts and the Regulatory Accounts; and
- the regulatory current cost accounting statements, for the appointed business comprising the current cost profit and loss account, the current cost cash flow statement and the related notes including the Statement of Accounting Policies.

These Regulatory Accounts have been prepared in accordance with the basis of preparation and accounting policies set out in the Statement of Accounting Policies.

Basis of preparation

In forming our opinion on the Regulatory Accounts, which is not modified, we draw attention to the fact that the Regulatory Accounts have been prepared in accordance with Condition F, the Regulatory Accounting Guidelines, the accounting policies set out in the statement of accounting policies and, in the case of the regulatory historical cost accounting statements, under the historical cost convention.

The Regulatory Accounts are separate from the statutory financial statements of the Company and have not been prepared under the basis of United Kingdom Generally Accepted Accounting Practice ("UK GAAP"). Financial information other than that prepared on the basis of UK GAAP does not necessarily represent a true and fair view of the financial performance or financial position of a company as shown in statutory financial statements prepared in accordance with the Companies Act 2006. Furthermore, the regulatory historical cost accounting statements on pages 118 and 121 have been drawn up in accordance with Regulatory Accounting Guideline 3.07 in that infrastructure renewals accounting as applied in previous years should continue to be applied and accordingly, that the relevant sections of Financial Reporting Standards 12 and 15 be disapplied. The effect of this departure from Generally Accepted Accounting Practice and a reconciliation of the balance sheet drawn up on this basis to the balance sheet drawn up under the Companies Act 2006 is given on page 122.

Scope of the audit of the Regulatory Accounts

An audit involves obtaining evidence about the amounts and disclosures in the Regulatory Accounts sufficient to give reasonable assurance that the Regulatory Accounts are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the Regulatory Accounts. In addition, we read all the financial and non-financial information in the Regulatory Financial Statements to identify material inconsistencies with the audited Regulatory Accounts and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

We have not assessed whether the accounting policies are appropriate to the circumstances of the Company where these are laid down by Condition F. Where Condition F does not give specific guidance on the accounting policies to be followed, our audit includes an assessment of whether the accounting policies adopted in respect of the transactions and balances required to be included in the Regulatory Accounts are consistent with those used in the preparation of the statutory financial statements of the Company. Furthermore, as the nature, form and content of Regulatory Accounts are determined by the WSRA, we did not evaluate the overall adequacy of the presentation of the information, which would have been required if we were to express an audit opinion under International Standards on Auditing (UK & Ireland).

Opinion on other matters prescribed by Condition F

Under the terms of our contract we have assumed responsibility to provide those additional opinions required by Condition F in relation to the accounting records. In our opinion:

- proper accounting records have been kept by the appointee as required by paragraph 3 of Condition F; and
- the Regulatory Accounts are in agreement with the accounting records and returns retained for the purpose of preparing the Regulatory Accounts.

Respective responsibilities of the WSRA, the Directors and Auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 115, the directors are responsible for the preparation of the Regulatory Accounts and for their fair presentation in accordance with the basis of preparation and accounting policies. Our responsibility is to audit and express an opinion on the Regulatory Accounts in accordance with International Standards on Auditing (UK and Ireland), except as stated in the 'Scope of the audit of the Regulatory Accounts' below, and having regard to the guidance contained in Audit 05/03 'Reporting to Regulators of Regulated Entities' issued by the Institute of Chartered Accountants in England and Wales. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report is made, on terms that have been agreed, solely to the Company and the WSRA in order to meet the requirements of Condition F of the Instrument of Appointment granted by the Secretary of State for the Environment to the Company as a water and sewage undertaker under the Water Industry Act 1991 ("Condition F"). Our audit work has been undertaken so that we might state to the Company and the WSRA those matters that we have agreed to state to them in our report, in order (a) to assist the Company to meet its obligation under Condition F to procure such a report and (b) to facilitate the carrying out by the WSRA of its regulatory functions, and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the WRSA, for our audit work, for this report or for the opinions we have formed.

Other matters

The nature, form and content of Regulatory Accounts are determined by the WSRA. It is not appropriate for us to assess whether the nature of the information being reported upon is suitable or appropriate for the WRSA's purposes. Accordingly we make no such assessment.

Our opinion on the Regulatory Accounts is separate from our opinion on the statutory financial statements of the Company for the year ended 31 March 2014 on which we reported on 23 June 2014, which are prepared for a different purpose. Our audit report in relation to the statutory financial statements of the Company (our "Statutory audit") was made solely to the Company's member in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our Statutory audit work was undertaken so that we might state to the Company's member those matters we are required to state to it in a statutory audit report and for no other purpose. In these circumstances, to the fullest extent permitted by law, we do not accept or assume responsibility for any other purpose or to any other person to whom our Statutory audit report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Cambridge
23 June 2014

Notes

1. The maintenance and integrity of the company's web site is the responsibility of the directors and the maintenance and integrity of the Regulator's web site is the responsibility of the Regulator; the work carried out by the auditor does not involve consideration of these matters and, accordingly, the auditor accepts no responsibility for any changes that may have occurred to the regulatory accounts since they were initially presented on the web sites.

2. Legislation in the United Kingdom governing the preparation and dissemination of financial statements and regulatory accounts may differ from legislation in other jurisdictions.

REGULATORY FINANCIAL STATEMENTS continued

Historic cost profit and loss account for the 12 months ended 31 March 2014

	2014			2013		
	Appointed £000	Non-appointed £000	Total £000	Appointed £000	Non-appointed £000	Total £000
Turnover	292,978	-	292,978	292,277	-	292,277
Operating costs	(134,990)	(2,424)	(137,414)	(141,123)	(2,443)	(143,566)
Infrastructure renewals charge	(47,310)	-	(47,310)	(47,189)	-	(47,189)
Historical cost depreciation	(33,717)	-	(33,717)	(31,682)	-	(31,682)
Operating income	3,630	-	3,630	5,668	-	5,668
Operating profit/(loss)	80,591	(2,424)	78,167	77,951	(2,443)	75,508
Other income	-	7,730	7,730	-	7,626	7,626
Net interest	(40,187)	(5)	(40,192)	(25,131)	(5)	(25,136)
Profit on ordinary activities before taxation	40,404	5,301	45,705	52,820	5,178	57,998
Taxation						
- current	(4,256)	(1,219)	(5,475)	(7,201)	(1,243)	(8,444)
- deferred	4,182	-	4,182	(5,324)	-	(5,324)
Profit on ordinary activities after taxation	40,330	4,082	44,412	40,295	3,935	44,230
Extraordinary items	-	-	-	-	-	-
Profit for the year	40,330	4,082	44,412	40,295	3,935	44,230
Dividends	(41,760)	(4,082)	(45,842)	(153,619)	(3,935)	(157,554)
Retained loss for the year	(1,430)	-	(1,430)	(113,324)	-	(113,324)

REGULATORY FINANCIAL STATEMENTS continued

Statement of total recognised gains and losses (historical cost accounting) for the 12 months ended 31 March 2014

	2014 £000	2013 £000
Profit for the year	**40,330**	40,295
Actuarial gains/(losses) on post employment plans	**14,785**	(19,932)
Other gains and losses	**(2,781)**	4,584
Total recognised gains and (losses) for the year	**52,334**	24,947

REGULATORY FINANCIAL STATEMENTS continued

Historic cost balance sheet as at 31 March 2014

	2014			2013		
	Appointed £000	**Non-appointed £000**	**Total £000**	Appointed £000	Non-appointed £000	Total £000
Fixed assets						
Tangible assets	1,224,386	-	1,224,386	1,198,774	-	1,198,774
Investments						
- loan to group company	-	-	-	-	-	-
- other	61	-	61	61	-	61
Total fixed assets	1,224,447	-	1,224,447	1,198,835	-	1,198,835
Infrastructure renewals accrual	(12,424)	-	(12,424)	(10,956)	-	(10,956)
Other current assets	89,774	9,668	99,442	109,547	5,516	115,063
Creditors – amounts falling due within one year						
Borrowings	(18,205)	-	(18,205)	(1,093)	-	(1,093)
Other creditors	(104,712)	(9,668)	(114,380)	(115,805)	(5,516)	(121,321)
Total creditors - amounts falling due within one year	(122,917)	(9,668)	(132,585)	(116,898)	(5,516)	(122,414)
Net current liabilities	(45,567)	-	(45,567)	(18,307)	-	(18,307)
Total assets less current liabilities	1,178,880	-	1,178,880	1,180,528	-	1,180,528
Creditors – amounts falling due after more than one year						
Borrowings	(791,957)	-	(791,957)	(782,534)	-	(782,534)
Other creditors	-	-	-	-	-	-
Total creditors - amounts falling due after one year	(791,957)	-	(791,957)	(782,534)	-	(782,534)
Provisions for liabilities and charges	(49,567)	-	(49,567)	(71,675)	-	(71,675)
Preference share capital	-	-	-	-	-	-
Net assets employed	337,356	-	337,356	326,319	-	326,319
Capital and reserves	337,356	-	337,356	326,319	-	326,319

REGULATORY FINANCIAL STATEMENTS continued

Explanatory notes to the historical cost balance sheet

The treatment of infrastructure renewals accruals/prepayments within the regulatory accounts differs from that in the historical cost financial statements. For regulatory accounts, Ofwat requires the infrastructure renewals accrual to be shown separately on the balance sheet. Consequently tangible assets above are reported at £18,101,000 higher (2013: £15,681,000 higher) than in the historical cost financial statements with an addition to debtors of the same amount.

In the statutory financial statements goodwill of £6,678,000 arose on the acquisition of North Surrey Water Limited on 1 October 2000. The directors consider that this goodwill has an indefinite life and accordingly it is not amortised but is subject to annual review for impairment. As at 31 March 2014, this goodwill had not been impaired. Additionally, goodwill of £9,042,000 arose on the unification of the regulated businesses on 27 July 2012. The directors consider that this goodwill has a life of 20 years and it has been amortised accordingly. In estimating the useful economic life of goodwill, account has been taken of the nature of the unified business and the stability of the industry. No goodwill arises in the regulatory accounts, as the acquisitions have been accounted for as mergers.

REGULATORY FINANCIAL STATEMENTS continued

Reconciliation between statutory accounts and regulatory accounts for the year ended 31 March 2014

In the preparation of its annual report and financial statements for the year ended 31 March 2014 ('statutory accounts'), the company has followed common industry practice and adopted the infrastructure renewals accounting basis as set out in Financial Reporting Standard 15: 'Tangible Fixed Assets'. However for the purposes of the regulatory accounts, Ofwat has requested that Financial Reporting Standard 15 is not applied for infrastructure renewals accounting, thereby providing a basis consistent with prior years. In addition, Ofwat has decided to depart from UK GAAP and disapply the provisions of Application Note G of Financial Reporting Standard 5: 'Reporting the substance of transactions', which states that turnover should not include amounts that the company does not expect to collect.

Reconciliation of certain items in the regulatory accounts to the statutory accounts is set out below:

	Statutory UK GAAP £000	Regulatory £000	
Profit and loss account			
Turnover	291,381	292,978	Disapplication of the provisions of Application Note G of Financial Reporting Standard 5 in the regulatory accounts of £1,597,000.
Operating profit	84,417	80,591	Statutory accounts include other operating income of £7,731,000 but exclude profit on disposal of fixed assets which in 2013/14 was £1,480,000. Non appointed cost excluded from operating profit in the regulatory accounts is £2,424,000.
Balance sheet			
Tangible fixed assets (net book value)	1,211,963	1,224,386	In the statutory accounts the tangible fixed assets include the infrastructure renewals accrual. For regulatory accounts, Ofwat requires the infrastructure renewals accrual to be shown separately on the balance sheet. £5,678,000 of capital expenditure in relation to assets used by the company and operated by other parties has also been excluded from the tangible fixed assets net book value for the regulatory accounts, which is consistent with the treatment required by Ofwat in previous years.
Infrastructure renewals accrual	N/A	(18,101)	
Debtors	81,204	80,712	Non appointed debtors excluded from debtors in the regulatory accounts are £492,000.
Deferred income	N/A	3,274	Amount relates to deferred credit for contributions to surface assets of £3,274,000 and has been classified within creditors falling due after more than one year in the statutory accounts.

REGULATORY FINANCIAL STATEMENTS continued

Current cost profit and loss account for the 12 months ended 31 March 2014 (appointed business only)

		Note	2014 £000	2013 £000
Turnover				
Unmeasured	- household		**129,145**	134,536
	- non-household		**2,698**	2,822
Measured	- household		**102,870**	95,515
	- non-household		**55,341**	56,143
Bulk supplies/intercompany payment			**2,040**	2,131
Other third party service (including non-potable water)			**884**	1,130
Other sources			**-**	-
Total turnover			**292,978**	292,277
Current cost operating costs - wholesale			**(197,791)**	(198,090)
Current cost operating costs - retail			**(32,419)**	(37,581)
Other operating (cost)/income			**(1,674)**	2,925
Working capital adjustment			**841**	1,018
Current cost operating profit		5	**61,935**	60,549
Other income			**-**	-
Net interest			**(40,187)**	(25,131)
Financing adjustment			**20,592**	9,200
Current cost profit before taxation			**42,340**	44,618
Net revenue movement out of tariff basket			**10**	214
Back-billing amount identified			**2,703**	4,524

All results for appointed business in the current and prior years are from the provision of water services.

REGULATORY FINANCIAL STATEMENTS continued

Current cost cash flow statement for the 12 months ended 31 March 2014 (appointed business only)

	2014 £000	2013 £000
Current cost operating profit	**61,935**	60,549
Working capital adjustment	**(841)**	(1,018)
Movement in working capital	**(4,430)**	(18,386)
Receipt from other income	**-**	-
Current cost depreciation	**47,909**	47,864
Current cost loss/(profit) on sale of fixed assets	**3,824**	(2,653)
Infrastructure renewals charge	**47,310**	47,189
Movement in provisions	**(392)**	704
Net cash inflow from operating activities	**155,315**	134,249
Returns on investments and servicing of finance	**(34,220)**	(20,735)
Taxation paid	**(5,836)**	(5,976)
Capital expenditure and financial investment		
Gross cost of purchase of fixed assets	**(71,245)**	(69,001)
Receipt of grants and capital contributions	**7,969**	11,347
Infrastructure renewals expenditure	**(45,842)**	(37,309)
Disposal of fixed assets	**1,743**	8,009
Movements on long-term group loans to group companies	**-**	31,550
Payments for investment	**-**	(131,200)
Net cash outflow from investing activities	**(107,375)**	(186,604)
Acquisitions and disposals	**-**	(52,240)
Equity dividends paid	**(41,761)**	(153,619)
Net cash outflow from management of liquid resources	**-**	-
Net cash outflow before financing	**(33,877)**	(284,925)
Net cash inflow from financing	**19,366**	319,634
(Decrease)/increase in cash	**(14,511)**	34,709

REGULATORY FINANCIAL STATEMENTS continued

Notes to the current cost financial information

1. Statement of accounting policies

Basis of current cost accounting

These accounts have been prepared in accordance with relevant Regulatory Accounting Guidelines ('RAGs').

The accounting policies used are the same as those adopted in the statutory accounts, except as set out below.

The following accounts are prepared to enable Ofwat to monitor the financial performance of the regulated water business.

At the request of the Ofwat, comparative figures have been prepared on the basis that the combination of Affinity Water Limited, Affinity Water East Limited and Affinity Water Southeast Limited was in effect from 1 April 2012 rather than 27 July 2012 as is the case for the statutory financial statements.

Revenue recognition

Turnover represents the income receivable in the ordinary course of business from the regulated activities of the business in the year exclusive of value added tax. Charges billed to customers for water services are recognised in the period in which they are earned. An accrual is estimated for unmeasured consumption that has not yet been billed.

The measured income accrual is an estimation of the amount of mains water unbilled at the year end. The accrual is estimated using a defined methodology based upon weighted average water consumption by tariff, which is calculated based upon historical information. No changes have been made to the methodology in calculating the measured income accrual during the year. The measured income accrual is recognised within turnover.

Where an invoice has been raised and payment made but the service has not been provided in the year this will be treated as a payment in advance. The value of invoices raised will not be recognised within the current year's turnover but will instead be recognised within creditors as deferred income.

Charges on income arising from court, solicitor and debt recovery agency fees are credited to operating costs. They are not recognised in turnover.

Differences between statutory and regulatory accounts

The regulatory accounts disapply the provisions of Application Note G of Financial Reporting Standard 5: 'Reporting the substance of transactions', which states that turnover should not include amounts that the company does not expect to collect.

No further differences exist between the revenue recognition policies in the statutory accounts and in the regulatory accounts.

Charging policy

Water charges are payable in full from the date of connection or change of customer on all properties which are recorded as where water is being used or required. Exceptions to this, where we waive water charges at our discretion on being informed by customers, include where the customer is in a care home; in long-term hospitalisation; in prison; overseas long term; or in the event of the death of the customer.

Definition and treatment of properties

The company classifies unoccupied bulk owner properties as 'occupied' if they are empty for less than 26 weeks for short-term situations such as refurbishment or change of tenancy. These properties are billed in full and then a percentage is deducted from the amount owed in recognition that some properties will have been empty. Where properties are unoccupied for more than 26 weeks, the agreement with the bulk owner provides that the local authority will notify the company so that the property can be formally recorded as 'empty' on the company's billing system and, therefore, will not be billed.

The company no longer raises bills addressed to 'The Occupier' when there is no consumption detected at the property. The company's assumption is that these properties are not occupied. The company makes further enquiries and when the company receives information that the property has become occupied the status of the account is amended, the customer's name applied to the account and billing commences. Where enquiries give the company reason to believe that the property is inhabited but it has not been possible to obtain the customer's name, a bill is then issued in the name of 'The Occupier'. This only occurs for measured customers.

In each of the above cases, if a bill is sent, the company would recognise it within turnover in the regulatory accounts.

All new properties are metered. Charges accrue from the date at which the meter is installed. The developer is billed between the date of connection and first occupancy and this is recognised as turnover. If the developer is no longer responsible for the property and no new occupier has been identified the property management process referred to above is followed to identify the new occupier. Until the new occupier has been identified the property is treated as unoccupied and is not billed.

REGULATORY FINANCIAL STATEMENTS continued

Notes to the current cost financial information continued

1. Statement of accounting policies continued

Acquisitions

On 1 October 2000 the company acquired the trade, assets and liabilities of North Surrey Water Limited. Details of the acquisition are given in the statutory accounts of the company for the year ended 31 March 2001. The acquisition was funded by the issue of share capital and debt. The additional debt taken on of £20.0m was added to the opening balance of long-term creditors. No goodwill arises in the regulatory accounts, as the acquisition has been accounted for as a merger.

On 27 July 2012 the company acquired the trade, assets and liabilities of Affinity Water East Limited and Affinity Water Southeast Limited on unification of the water licences. The acquisition was funded by debt. No goodwill arises in the regulatory accounts, as the acquisition has been accounted for as a merger. Any difference between the consideration transferred and the net assets acquired is recognised directly in reserves.

Bad debt

At each reporting date, the company evaluates the collectability of debtors and records provisions for bad and doubtful debts based on experience. The bad debt provision is charged to operating costs to reflect the company's assessment of the risk of non-recovery of debtors. The bad debt provision is calculated by applying a range of different percentages to debtors of different ages. These percentages also vary between categories of debt. Higher percentages are applied to those categories of debt which are considered to be of greater risk and also to debtors of greater age. The value of the debt provision is sensitive to the specific percentages applied. The specific percentages applied are updated annually to reflect the latest collection performance data from the company's billing system. All debtors greater than five years old are fully provided for. Actual amounts recovered may differ from the estimated levels of recovery which could impact on operating results.

The company's bad and doubtful debts provision policy has remained unchanged and has been consistently applied in the current and prior years. However there has not been a significant increase in the provision from £23,758,000 at 31 March 2013 to £24,325,000 at 31 March 2014.

Our policy is to write-off closed and live accounts that fall under the following categories: bankruptcy, liquidation, debt relief orders, deceased accounts where there is no estate, failed legal action and debts from customers who have moved out of the property with no forwarding address or are no longer responsible for payment of a water bill.

Accounts are written off following all internal recovery activity and subsequent external debt collection agency activity, except as follows:

- Closed accounts under £15 are written off without any internal recovery activity.
- Closed accounts under the name of 'the occupier' are written off without any internal recovery action.
- Closed accounts under £50 are written off following all internal recovery activity where we have a forwarding address for the customer.
- Closed accounts under £100 are written off following all internal recovery activity where we have no forwarding address for the customer.

Amounts are also written off on accounts where we are still supplying the customer and where all reasonable internal and external debt collection activities have been undertaken. Under these circumstances if the total debt contains amounts over six years old, the amount over six years old, or more, is written off.

The company's bad debt write-off policy has remained unchanged and has been consistently applied in the current year compared with the previous year. There has not been a significant increase in the level of write off from £8,080,000 in 2012/13 to £8,456,000 in 2013/14.

REGULATORY FINANCIAL STATEMENTS continued

Tangible fixed assets

Expenditure on maintaining the operating capability of the network in accordance with defined standards of service is charged as an operating cost. Costs relating to increases in capacity or enhancements to the network are capitalised. No depreciation is charged on the mains network because it is required to be maintained in perpetuity and therefore has no finite economic life.

The treatment in the current cost accounts differs from that in the historical cost accounts in relation to the disapplication of renewals accounting paragraphs of Financial Reporting Standard 15: 'Tangible fixed assets' and Financial Reporting Standard 12: 'Provisions, contingencies and commitments', as required by RAGs. The non-compliance has no effect on the profit and loss account other than to reclassify infrastructure renewals charges as depreciation.

Third party contributions

Infrastructure charges and other third party contributions received since 31 March 1990 are carried forward to the extent that any balance has not been credited to revenue. The balance carried forward is restated for the change in the RPI for the year and treated as deferred income.

Infrastructure charges received in respect of connections to the mains network are allocated to fixed assets, surface and infrastructure, in accordance with the basis on which the charges are calculated. Contributions received relating to infrastructure assets, which are not depreciated, are deducted from the cost of tangible fixed assets in order to show a true and fair view.

Real financial capital maintenance adjustments

The following adjustments are made to historical cost profit in order to arrive at profit after maintenance of financial capital in real terms.

(a) Depreciation adjustment: this is the difference between depreciation based on the current cost value of assets in these accounts and depreciation charged in arriving at historical cost profit.

(b) Working capital adjustment: this is calculated by applying the change in the RPI over the year to the opening total of trade debtors and stock less trade creditors.

(c) Financing adjustment: this is calculated by applying the change in the RPI over the year to the opening balance of net finance, which comprises all monetary assets and liabilities in the balance sheet apart from those included in working capital.

(d) Disposal of fixed asset adjustment – per RAG 1.02: this is calculated by applying the difference between the net book value of the current cost and the net book value of the historical cost of disposed assets, to the profit from disposal of fixed assets as shown in the historical cost accounts.

Accounting separation policy

The tables presenting the analysis of operating costs and fixed assets (activity cost analysis for appointed business 2013/14 on pages 138 and 139 and current cost analysis of tangible fixed assets by type on pages 133 and 134) have been prepared in accordance with the company's accounting separation methodology statement, which can be found on our stakeholder website: stakeholder.affinitywater.co.uk. The methodology statement explains the basis for the allocations of costs and assets and has been updated for changes to the requirements in the year. Changes to the methodology are explained within the company's accounting separation methodology statement on the company's website. Wherever possible, direct costs and assets have been directly attributed to business units. Where this is not possible, appropriate cost allocations have been applied, as described in the methodology.

REGULATORY FINANCIAL STATEMENTS continued

Notes to the current cost financial information continued

2. Directors' remuneration

Executive directors' remuneration comprises a package of base salary together with an annual performance-related bonus. Executive directors' bonuses paid by the company are linked to the standards of performance of the company and, therefore, in accordance with RAG 3.07. The elements of the 2013/14 remuneration arrangements for executive directors were established by the company's Remuneration Committee in Remuneration Committee meetings held on 5 July 2013, 23 September 2013 and 20 November 2013.

The following table provides a summary of the key elements of the remuneration package for executive directors:

Purpose and link to strategy	Policy and approach	Maximum potential value (as percentage of base pay)	Performance metrics	Changes for 2014/15
Base salary				
To provide competitive fixed remuneration that will attract and retain key employees and reflect their experience and position in the company.	Reviewed annually. Aims to position salaries for executive directors at slightly below mid-market levels, preferring to compensate total reward with variable remuneration.	N/A	N/A	No change to the policy.
Other taxable benefits				
To provide market competitive benefits.	Private health care insurance cover, life assurance and income protection are provided, together with a fully expensed company car (or car allowance).	N/A	N/A	No change to the policy.
Annual bonus plan				
The annual bonus plan is designed to provide a direct link between executive and company performance and the level of bonus awarded, although award and payment remain discretionary.	Maximum bonus potential is set at a market competitive level. Bonus is based on the company's key performance indicators plus individual targets.	Up to 75 per cent of base salary.	50 per cent of the total bonus is determined on the achievement of the financial performance target, which is based on EBITDA. 25 per cent of the total bonus is determined on the achievement of the additional seven operational and customer performance targets, which are set out on pages 17 to 23 of the strategic report. 25 per cent of the total bonus is determined on the achievement of personal objectives.	No change to the policy.

REGULATORY FINANCIAL STATEMENTS continued

Purpose and link to strategy	Policy and approach	Maximum potential value (as percentage of base pay)	Performance metrics	Changes for 2014/15
Pension related benefits				
To provide competitive post-retirement benefits	Executives joining the company after 2004 are invited to participate in the company's defined contribution pension scheme. Executives who joined the company prior to this date may be members of the company's defined benefit scheme. The defined benefit scheme provides retirement benefits up to a scheme cap. Where an executive's base salary is greater than the defined benefit scheme cap, the company invites the executive to join the company's defined contribution scheme to contribute a "top up" for the portion of base salary which exceeds the defined benefit cap. Under the defined contribution scheme, the executive contributes at a rate of 7 per cent of salary and the company contributes at 20 per cent. Duncan Bates is a member of the company's defined benefit scheme and defined contribution "top up" scheme. Richard Bienfait was a member of the company's defined benefit scheme and defined contribution "top up" scheme up until 28 February 2014. From 1 March 2014, Richard Bienfait ceased to be a member of either pension scheme.	Under the company's defined benefit scheme, Duncan Bates is accruing service at 1/60th of pensionable salary for each year of pensionable service. Richard Bienfait was accruing service at 1/45th of pensionable salary for each year of pensionable service under the company's defined benefit scheme. From 1 March 2014, in lieu of being a member of the company's retirement benefit schemes, Richard Bienfait receives a taxable allowance of 35 per cent of base salary.	N/A	No change to the policy.

The Remuneration Committee put in place an adhoc bonus arrangement related to PR14. This arrangement aimed to incentivise the executive directors to develop a high quality Business Plan assessed by Ofwat as "enhanced" or "standard". The scheme assumed a maximum award of 44 per cent of base salary if Ofwat awarded the business "enhanced" status and 25 per cent award of base salary if Ofwat awarded the business "standard" status.

Dr Philip Nolan was appointed Chairman on 1 April 2013 for a term of three years. He receives a fixed annual fee for his services which is set at a market competitive level. During the year he served as executive Chairman. On appointment, it was agreed to put in place a long term incentive plan based on the performance of the company during the three year term of his appointment. The Chairman will not participate in the Remuneration Committee's consideration of the terms of his remuneration. From 1 April 2014, his role became non-executive.

REGULATORY FINANCIAL STATEMENTS continued

Notes to the current cost financial information continued

2. Director's remuneration continued

The following table shows the remuneration paid by the company in respect of 2013/14.

	Base salary /fees £000	Taxable benefits[1] £000	Annual bonus £000	Adhoc bonus £000	Aggregate emoluments[2] £000		Pension related benefits[3] £000	Total remuneration[2] £000	
	2013/14	**2013/14**	**2013/14**	**2013/14**	**2013/14**	2012/13	**2013/14**	**2013/14**	2012/13
Non-executive									
Current									
Patrick O'D Bourke	**28**	-	-	-	**28**	-	-	**28**	-
Baroness Peta Buscombe	**38**	-	-	-	**38**	31	-	**38**	31
Jeffrey Herbert	**38**	-	-	-	**38**	23	-	**38**	23
Fiona Woolf CBE	**26**	-	-	-	**26**	31	-	**26**	31
Olivier Bret	-	-	-	-	-	12	-	-	12
Former									
Olivier Grunberg	-	-	-	-	-	7	-	-	7
Philippe Guitard	-	-	-	-	-	7	-	-	7
Neil Summerton	-	-	-	-	-	38	-	-	38
Executive									
Duncan Bates	**161**	**13**	**106**	**73**	**353**	189	**3**	**356**	189
Richard Bienfait	**219**	**16**	**145**	**99**	**479**	324	**12**	**491**	331
Dr Philip Nolan[4]	**200**	-	-	-	**200**	-	-	**200**	-
	710	**29**	**251**	**172**	**1,162**	662	**15**	**1,177**	669

1 Taxable benefits comprise company car allowance and healthcare insurance. Taxable benefits for Richard Bienfait further include an allowance that commenced on 1 March 2014 of £7,000 in lieu of being a member of the company's retirement benefit schemes.

2 Total emoluments and remuneration for 2012/13 have been restated to reflect bonuses paid to Duncan Bates (£112,000) and Richard Bienfait (£164,000) in 2013/14, which relate to the company's performance in 2012/13 and to the successful completion of refinancing and bond issuance. These discretionary bonuses were approved by the Remuneration Committee after the approval of the annual report and financial statements for the year ended 31 March 2013.

3 Included in pension related benefits is £15,000 (2013: £7,000) relating to contributions paid to money purchase pension schemes (£3,000 related to Duncan Bates and £12,000 related to Richard Bienfait); there were no amounts outstanding at the year end.

4 From 1 April 2014, the Chairman's role on the Board became a non-executive position.

The following table shows further detail of the remuneration paid by the company in respect of 2012/13 performance.

	Base salary /fees £000	Taxable benefits £000	Annual bonus £000	Adhoc bonus £000	Total emoluments £000	Pension related benefits £000	Total remuneration £000
Duncan Bates	71	6	62	50	189	-	189
Richard Bienfait	152	8	114	50	324	7	331

The remuneration paid by the company to directors in 2012/13 not presented in the above table related to director fees and a £27,000 payment to a former independent non-executive director of the company relating to compensation for loss of office.

REGULATORY FINANCIAL STATEMENTS continued

Neither the company nor its immediate parent entities have any listed shares and so the directors have not been offered any share incentives.

The directors who sit on the Board and appointed by Infracapital Partners II, Morgan Stanley Infrastructure Partners and Veolia Water UK Limited do not receive any emoluments from the company, or any company within the Affinity Water group.

Annual bonuses for executive directors

The annual bonus scheme is designed to provide a direct link between executive and company performance and the level of bonus awarded, although award and payment remains discretionary. The following table shows the percentage of maximum annual bonus potential paid for each executive director in the 2013/14 year.

Performance measure		Weighting for 2013/14 (per cent of base salary	2013/14 achievement (per cent of base salary)	
			Duncan Bates	Richard Bienfait
Financial measure	Financial: annual EBITDA	37.50%	37.50%	37.50%
Operational and customer measures	Health and safety: number of accidents resulting in more than three days' lost time and RIDDOR reportable incidents	2.68%	0.00%	0.00%
	Water quality: number of water quality compliance failures	2.68%	2.01%[1]	2.01%[1]
	Unplanned interruptions: number of properties experiencing an interruption for more than 12 hours	2.68%	2.68%	2.68%
	Written complaints: number of written complaints	2.68%	0.00%	0.00%
	Leakage: leakage in terms of millions of litres per day	2.68%	0.67%[2]	0.67%[2]
	Unwanted contact: number of unwanted contacts	2.68%	0.00%	0.00%
	Customer experience: measured by NPS	2.68%	2.68%	2.68%
Personal performance		18.75%	18.75%[3]	18.75%[3]
Total per cent base pay		**75.00%**	**64.29%**	**64.29%**
Base salary			**£165,000**	**£225,000**
Bonus paid			**£106,000**	**£145,000**

Additionally, Duncan Bates and Richard Bienfait were paid the maximum award of 44 per cent of base salary (£73,000 and £99,000 respectively) under the adhoc bonus arrangement related to PR14 given the assessment by Ofwat of our PR14 Business Plan as "enhanced".

No amounts in relation to these bonuses have been deferred.

Further information regarding directors' remuneration during the year and future policy can be found within the remuneration report on pages 55 to 63 of the annual report and financial statements.

1 Three out of four quarterly water quality targets for 2013/14 were met.

2 One out of four quarterly leakage targets for 2013/14 was met.

3 The Remuneration Committee exercised discretion in determining the level of bonus awarded in relation to the personal performance element of the executive directors' annual bonus within the pre-agreed base salary percentage cap. The Committee considered achievement of personal objectives set at the start of the year in exercising their discretion together with events occurring during the year.

REGULATORY FINANCIAL STATEMENTS continued

Notes to the current cost financial information continued

3. Measured income accrual and debt disclosures

In accordance with RAG 3.07 we highlight the following comments in respect of turnover for the year.

(i) Turnover for the year ended 31 March 2013 included a measured income accrual of £36,044,000. The value of billing recognised in the year ended 31 March 2014 for consumption in the prior year was £35,189,000. This has resulted in a decrease in the current year's turnover due to the over-estimation of the prior year's turnover of £855,000. This represents 0.29 per cent of current year turnover and is within acceptable tolerance for accounting estimates.

(ii) There has not been a significant decrease in the trade debtor balance from £30,689,000 at 31 March 2013 to £30,042,000 at 31 March 2014 (a 2.1 per cent decrease).

4. Revenue reconciliation of price determination projections to actual reported amount

Turnover for 2013/14 of £292,978,000 is £4,927,000 less than the final determination target of £297,905,000. The reasons for this under-performance against the final determination are set out in the reconciliation below.

	2014 £000	2013 £000
Final determination projection	**277,744**	276,668
Impact of higher inflation	**20,161**	17,929
Final determination adjusted for inflation movement	**297,905**	294,597
Tariff basket revenue	**(555)**	1,791
Large user revenue	**(3,689)**	(3,889)
Rechargeable works and compensation	**(487)**	(229)
Bulk supplies	**(588)**	(415)
Special agreement (including non-potable supply)	**477**	494
Other appointed business revenue (third party)	**(85)**	(71)
Actual reported revenue	**292,978**	292,277

The non-tariff revenue is £4,372,000 lower than the final determination target, which is mainly driven by a reduction of large users due to the economic climate. There is also a decrease in the tariff basket revenue of £555,000 compared to the final determination target driven by lower consumption volumes compared to the final determination target. This is offset by 3,014 additional new properties connected during the year (2013/14: 10,534 new properties compared to the final determination target of 7,520 new properties).

REGULATORY FINANCIAL STATEMENTS continued

5. Reconciliation of historical cost operating profit to current cost operating profit for appointed business

	2014 £000	2013 £000
Total historical cost operating profit	**80,591**	77,951
Current cost depreciation and amortisation of deferred credit	**(47,909)**	(47,360)
Historic cost deferred credit	**(297)**	(605)
Historical cost depreciation	**34,013**	32,288
Current cost adjustment on disposal of fixed assets	**(5,304)**	(2,743)
Working capital adjustment	**841**	1,018
Current cost operating profit	**61,935**	60,549

6. Current cost analysis of tangible fixed assets by type

Wholesale business	Resources £000	Raw water distribution £000	Treatment £000	Treated distribution £000	Total £000
Non infrastructure assets					
Gross replacement cost At 1 April 2013*	1,252,800	44,544	1,844,199	1,355,298	4,496,841
AMP adjustment	-	-	-	-	-
Reclassification adjustment	-	-	-	-	-
RPI adjustment	30,728	1,093	45,234	33,242	110,297
Disposals	(2,766)	-	(2,766)	-	(5,532)
Additions	9,579	1,337	12,369	34,758	58,043
At 31 March 2014	**1,290,341**	**46,974**	**1,899,036**	**1,423,298**	**4,659,649**
Depreciation At 1 April 2013*	244,904	15,519	430,425	365,668	1,056,516
AMP adjustment	-	-	-	-	-
Reclassification adjustment	-	-	-	-	-
RPI adjustment	6,007	381	10,557	8,969	25,914
Disposals	-	-	-	-	-
Charge for the year	16,094	567	17,732	11,404	45,797
At 31 March 2014	**267,005**	**16,467**	**458,714**	**386,041**	**1,128,227**
Net book value at 31 March 2014	**1,023,336**	**30,507**	**1,440,322**	**1,037,257**	**3,531,422**
Net book value at 1 April 2013*	1,007,896	29,025	1,413,774	989,630	3,440,325
Infrastructure assets					
Gross replacement cost At 1 April 2013*	12,017	169,524	-	5,151,987	5,333,528
AMP adjustment	-	-	-	-	-
Reclassification adjustment	-	-	-	-	-
RPI adjustment	295	4,158	-	123,366	130,819
Disposals	-	-	-	-	-
Additions	-	289	-	7,467	7,756
At 31 March 2014	**12,312**	**173,971**	**-**	**5,285,820**	**5,472,102**

* values restated from 2012/13 accounts, details can be found on our stackholder website: stakeholder.affinitywater.co.uk

REGULATORY FINANCIAL STATEMENTS continued

Notes to the current cost financial information continued

6. Current cost analysis of tangible fixed assets by type continued

Retail business	Household £000	Non-household £000	Total £000
Gross replacement cost			
At 1 April 2013*	190,769	11,380	202,149
AMP adjustment	-	-	-
Reclassification adjustment	-	-	-
RPI adjustment	4,679	279	4,958
Disposals	(342)	(19)	(361)
Additions	335	19	354
At 31 March 2014	**195,441**	**11,659**	**207,100**
Depreciation			
At 1 April 2013*	124,553	7,426	131,979
AMP adjustment	-	-	-
Reclassification adjustment	-	-	-
RPI adjustment	3,055	182	3,237
Disposals	(303)	(17)	(320)
Charge for the year	2,478	147	2,625
At 31 March 2014	**129,783**	**7,738**	**137,521**
Net book value at 31 March 2014	**65,658**	**3,921**	**69,579**
At 31 March 2013*	66,216	3,954	70,170

* values restated from 2012/13 accounts, details can be found on our stackholder website: stakeholder.affinitywater.co.uk

REGULATORY FINANCIAL STATEMENTS continued

7. Analysis of capital expenditure, grants and land sales for the 12 months ended 31 March 2014

	2014			2013		
	Gross £000	**Grants and contributions £000**	**Net £000**	Gross £000	Grants and contributions £000	Net £000
Capital expenditure – water						
Base infrastructure renewals expenditure (IRE)	**47,323**	**-**	**47,323**	39,786	-	39,786
Maintenance non-infrastructure (MNI)	**43,582**	**-**	**43,582**	39,969	-	39,969
Enhancements infrastructure	**7,756**	**(8,202)**	**(446)**	7,864	(11,679)	(3,815)
Non-infrastructure enhancements	**14,829**	**-**	**14,829**	17,411	-	17,411
Total capital expenditure – water	**113,490**	**(8,202)**	**105,288**	105,030	(11,679)	93,351
Grants and contributions – water						
Developer contributions (i.e. enhancement requisitions, grants and contributions)	**-**	**(5,101)**	**-**	-	(9,836)	-
Infrastructure charge receipts – new connections	**-**	**(3,101)**	**-**	-	(1,843)	-
Other contributions	**-**	**-**	**-**	-	-	-
Total grants and contributions – water	**-**	**(8,202)**	**-**	-	(11,679)	-
Land sales – proceeds from disposals of protected land	**-**	**-**	**(1,737)**	-	-	(5,692)

REGULATORY FINANCIAL STATEMENTS continued

Notes to the current cost financial information continued

8. Analysis of working capital

		2014 £000	2013 £000
Stocks		1,412	1,576
Trade debtors	- measured household	8,074	7,048
	- unmeasured household	8,276	9,704
	- measured non-household	12,600	10,999
	- unmeasured non-household	203	238
	- other	891	5,079
Measured income accrual		37,790	36,044
Prepayments and other debtors		5,519	2,692
Trade creditors		(10,827)	(8,238)
Deferred income – customer advance receipts		(24,723)	(31,000)
Capital creditors		(17,826)	(20,181)
Accruals and other creditors		(42,658)	(48,236)
Total working capital		(21,269)	(34,275)
Total revenue outstanding	- household	39,269	33,110
	- non-household	13,919	18,192

9. Analysis of net debt, gearing and interest costs

	2014			
	Fixed rate £000	**Floating rate £000**	**Index linked £000**	**Total £000**
Borrowings (excluding preference shares)	544,791	17,200	248,171	810,162
Preference share capital				-
Total borrowings				810,162
Appointed cash				(7,632)
Short term deposits				-
Net debt				802,530
Regulatory capital value				997,462
Gearing				80.46%
Full year equivalent nominal interest cost	25,900	303	11,551	37,754
Full year equivalent cash interest payment*	25,900	303	5,412	31,615
Indicative interest rates				
Indicative weighted average nominal interest rate	4.89%	1.76%	4.71%	4.77%
Indicative weighted average cash interest rate	4.89%	1.76%	2.21%	3.99%
Weighted average years to maturity**	21.3	5.2	31.5	24.1

*excludes the impact of RPI
**definition of 'maturity' is 'number of years to maturity from 31 March 2009', as per RAG4.04.

REGULATORY FINANCIAL STATEMENTS continued

Non-audited supplementary information

The following table presents the same analysis of net debt, gearing and interest costs but borrowings have been adjusted to reflect the definition of net debt per the securitisation financing agreement.

	2014			
	Fixed rate £000	Floating rate £000	Index linked £000	Total £000
Borrowings (excluding preference shares)	544,791	17,200	248,171	810,162
Preference share capital				-
Add: - capitalised bond issue costs				11,875
Less: - financing of assets used by the company and operated by other parties				(19,401)
- loan from intermediate parent company				(3,550)
				799,086
Add: - accrued interest on borrowings				10,256
Total borrowings				809,342
Cash				(16,826)
Short term deposits				-
Net debt				792,516
Regulatory capital value				997,462
Gearing				79.45%
Full year equivalent nominal interest cost	25,900	303	11,551	37,754
Full year equivalent cash interest payment*	25,900	303	5,412	31,615
Indicative interest rates				
Indicative weighted average nominal interest rate	4.89%	1.76%	4.71%	4.77%
Indicative weighted average cash interest rate	4.89%	1.76%	2.21%	3.99%
Weighted average years to maturity**	21.3	5.2	31.5	24.1

*excludes the impact of RPI
**definition of 'maturity' is 'number of years to maturity from 31 March 2009', as per RAG4.04.

LICENCE CONDITION F – PARAGRAPH 7

Operating cost analysis
for the 12 months ended 31 March 2014 (wholesale business only)

	Water resources £000	Raw water distribution £000	Water treatment £000	Treated water distribution £000	Water service total £000
Operating expenditure					
Power	-	3,158	13,029	3,578	19,765
Income treated as negative expenditure	-	-	-	-	-
Service charges	5,997	-	-	-	5,997
Bulk supply imports	-	-	2,872	2	2,874
Other operating expenditure	2,451	2,455	15,861	37,840	58,607
Local authority rates	1,906	322	2,794	9,936	14,958
Exceptional items	-	-	-	-	-
Total operating expenditure excluding third party services	10,354	5,935	34,555	51,356	102,200
Capital maintenance					
Infrastructure renewals charge	-	1,966	-	45,344	47,310
Current cost depreciation	16,094	567	17,655	11,404	45,720
Recharges to other business units	-	-	-	-	-
Recharges from other business units	-	-	-	-	-
Amortisation of deferred credit	(171)	(171)	(171)	-	(513)
Amortisation of intangible assets	-	-	-	-	-
Total capital maintenance excluding third party services	15,923	2,362	17,484	56,748	92,518
Third party services					
Operating expenditure	-	-	-	2,996	2,996
Infrastructure renewals charge	-	-	-	-	-
Current cost depreciation	-	-	77	-	77
Total operating costs	**26,277**	**8,297**	**52,117**	**111,110**	**197,791**

LICENCE CONDITION F – PARAGRAPH 7 continued

Operating cost analysis for the 12 months ended 31 March 2014 (retail business only)

	Household £000	Non-household £000	Retal Services Total £000
Operating expenditure			
Customer services	7,144	908	8,052
Debt management	158	42	200
Doubtful debts	8,061	952	9,013
Meter reading	2,834	338	3,172
Services to developers	-	58	58
Other operating expenditure	7,490	1,316	8,806
Local authority rates	466	27	493
Exceptional items	-	-	-
Total operating expenditure excluding third party services	26,153	3,641	29,794
Third party services operating expenditure	-	-	-
Total operating expenditure	26,153	3,641	29,794
Capital maintenance			
Current cost depreciation	2,478	147	2,625
Recharges to other business units	-	-	-
Recharges from other business units	-	-	-
Amortisation of deferred credits	-	-	-
Amortisation of intangible assets	-	-	-
Total capital maintenance	2,478	147	2,625
Total operating costs	**28,631**	**3,788**	**32,419**
Debt written off	**7,563**	**893**	**8,456**

Based on the company's current systems it is not possible to exclude court and other debt recovery costs from debt written off amounts.

NON-AUDITED SUPPLEMENTARY REGULATORY INFORMATION

Non financial information for the 12 months ended 31 March 2014

	2014 Water	2013 Water
Number of properties		
Households billed	**1,337,776**	1,333,208
Non-households billed	**70,125**	71,643
Households void	**36,849**	31,840
Non household voids	**9,897**	9,393
Properties served by new appointee in supply as at 1 April 2009	**2**	-
Per capita consumption (excluding supply pipe leakage) l/h/d		
Unmeasured household		
- Central region	**170.88**	162.96
- Southeast region	**175.93**	196.50
- East region	**157.78**	145.41
Measured household		
- Central region	**135.40**	133.49
- Southeast region	**121.20**	124.62
- East region	**109.54**	99.05
Volume (Ml/d)		
Bulk supply export	**30.95**	30.58
Bulk supply import	**23.92**	25.97
Distribution input	**904.28**	877.03

NON-AUDITED SUPPLEMENTARY REGULATORY INFORMATION continued

Regulatory capital value

	2014 £000	2013 £000
Opening RCV for the year*	**1,000,522**	980,572
Capital expenditure	**59,080**	59,358
Infrastructure renewals expenditure	**52,577**	49,551
Infrastructure renewals charge	**(50,583)**	(49,165)
Grants and contributions	**(4,281)**	(3,441)
Depreciation	**(50,924)**	(51,590)
Out performance of regulatory assumptions (5 years in arrears)	**(8,929)**	(8,715)
Closing RCV carried forward	**997,462**	976,570
Average regulatory capital value	**986,968**	962,733

* prior year closing balance carried forward is adjusted for current year RPI

The table shows the RCV used in setting the price limits for the period. The differences from the actual capital expenditure, depreciation and other items will not affect price limits in the current period.

Capital efficiencies and the effects of construction price inflation will be taken into account in the calculation for the next periodic review.

NON-AUDITED SUPPLEMENTARY REGULATORY INFORMATION continued

Transactions with associated companies

Company		Turnover of associate* £000	Terms of supply	Value £000
Expenditure				
Affinity Water Capital Funds Limited**	Interest paid on loan	-	No market	160
Affinity Water Holdings Limited**	Dividends paid	-	No market	45,842
Affinity Water Shared Services Limited	Support services (including capital expenditure)	19,406	Market tested	8,240
Veolia Environmental Services (UK) Limited	Waste water disposal	1,290,000	Market tested	340
Affinity Water Finance (2004) Limited	Interest on bonds	-	No market	11,962
Affinity Water Programme Finance Limited	Interest on bonds	-	No market	26,815
Affinity Water Trust	Trust Fund	-	No market	565
Income				
Affinity Water Shared Services Limited	Employee costs	19,406	Market tested	9,064
Veolia Water UK Limited	Transitional services and capability sharing agreement and other services	406,966	Market tested	235

* from latest publicly available financial statements.
** these companies do not have turnover.

The company has applied a materiality threshold of £100,000 for disclosing transactions.

In 2004, Affinity Water Limited borrowed £200,000,000 from its wholly owned subsidiary, Affinity Water Finance (2004) Limited, the loan being the proceeds of the latter's £200,000,000 Class A bonds issued in that year and maturing in July 2026 with an annual coupon of 5.875 per cent and lent on the same terms. The amount outstanding at year end, net of amortised debt issuance costs, is £197,037,000 (2013: £196,879,000).

As part of the refinancing in February 2013, all existing loans and revolving facilities were replaced by the following four new bonds issued on 4 February 2013 by the company's subsidiary, Affinity Water Programme Finance Limited: £80,000,000 Class A Guaranteed Notes maturing in September 2022 with a coupon of 3.625 per cent, £250,000,000 Class A Guaranteed Notes maturing in March 2036 with a coupon of 4.50 per cent, £150,000,000 Class A Guaranteed RPI index-linked Notes maturing in June 2045 with a coupon of 1.548 per cent and £95,000,000 Class B Guaranteed RPI index-linked Notes maturing in June 2033 with a coupon of 3.249 per cent (together 'Bonds'). The amount outstanding at year end, net of amortised debt issuance costs, is £572,939,000 (2013: £565,885,000). The proceeds of the above bond issues were lent to the company on the same terms.

On 4 February 2013, the company borrowed an amount of £3,550,000 from Affinity Water Capital Funds Limited, the company's intermediate parent company. The final repayment date of this loan is 31 March 2036, with interest terms having been set at 4.5 per cent.

There are no loans to group companies.

NON-AUDITED SUPPLEMENTARY REGULATORY INFORMATION continued

Dividend policy

The company's dividend policy is primarily based on maintaining a target level of gearing (net debt to RCV) of 80 per cent. The amount of the dividend is dependent on the company's ability to generate cash flows and to achieve its regulatory outputs in the reported period. The policy distributes earnings equal to the amount necessary to maintain net debt to RCV at the targeted gearing ratio. This is consistent with the requirements of Condition F of the licence that dividends paid will not impair the ability of the appointee to finance the appointed business and under a system of incentive regulation, dividends would be expected to reward efficiency and the management of economic risk.

All profits arising from non-appointed business activities are paid out as dividends.

The directors have declared and paid ordinary dividends of £45,842,000 during the year ended 31 March 2014. This compares to £153,455,000 declared and paid in the year ended 31 March 2013.

No final dividend is proposed (2013: £nil).

Accounting separation trial 2013/14

	Water resources £000	Raw water distribution £000	Water treatment £000	Treated water distribution £000
Operating expenditure	10,354	5,935	34,556	54,352
Infrastructure renewals charge	-	1,966	-	45,344
Current cost depreciation	16,094	567	17,732	11,404
Amortisation of deferred credit	(171)	(171)	(171)	-
Total operating costs	**26,277**	**8,297**	**52,117**	**111,100**

	Water resources		Raw water distribution			Treated water distribution	
	Abstraction licence £000	Raw water abstraction £000	Raw water transport £000	Raw water storage £000	Water treatment £000	Trunk treated water distribution £000	Local treated water distribution £000
Operating expenditure	5,997	4,357	5,899	36	34,556	796	53,556
Infrastructure renewals charge	-	-	1,966	-	-	26,925	18,419
Current cost depreciation	-	16,094	-	567	17,732	6,772	4,632
Amortisation of deferred credit	-	(171)	(171)	-	(171)	-	-
Total operating costs	**5,997**	**20,280**	**7,694**	**603**	**52,117**	**34,493**	**76,607**

The above data is derived from the accounting separation data on page 138 and 139 and the current cost depreciation data on pages 133 and 134.

Details behind the preparation of the accounting separation table above can be found on our stakeholder website: stakeholder.affinitywater.co.uk.

Your local supply, on tap

Affinity Water Limited, Tamblin Way
Hatfield, Hertfordshire AL10 9EZ

Tel: 01707 268111 (main switchboard)
Fax: 01707 277333

www.affinitywater.co.uk