# Annual Report and Financial Statements

For the year ended 31 March 2017

**Affinity Water Limited**
(Registered Number 02546950)

# Contents


2 **Affinity Water at a glance**
2 Where we operate
3 Facts and figures

4 **Highlights**
4 Operational highlights 2016/17
5 Financial highlights 2016/17

6 **Chairman's statement**

8 **Strategic report**
8 Chief Executive Officer's introduction
10 Summary of our strategic report
12 Our business model
13 Our vision
17 Our imperatives
21 Our key resources
25 Our long-term planning
27 Customer outcomes
28 Our operating model
32 Our performance
43 Principal risks and uncertainties

*16, 24, 31, 42, 52 Our Customer Charter in action*

53 **Governance**
53 Letter from the Chairman
54 Board leadership, transparency and governance
69 Ownership and financing
73 Audit Committee report
78 Remuneration report
88 Directors' report

94 **Statutory financial statements**

144 **Regulatory annual performance report**


**Page 12**
Information about what our business model looks like for us and for our customers and communities.

**Page 32**
A summary of our operational and financial performance for 2016/17, including our highlights as a responsible business.

**Page 54**
Details about our Board members, their responsibilities and experience.

COVER: Our Lower Standen Pumping Station contributes to the supply of wholesome water in our Dour community.

## 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 be 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' or 'Affinity Water' means Affinity Water Limited; the 'regulated business' or 'regulated activities' means the licensed water activities undertaken by Affinity Water Limited in the South East of England.

See further information online:

**stakeholder.affinitywater.co.uk**

# Affinity Water at a glance

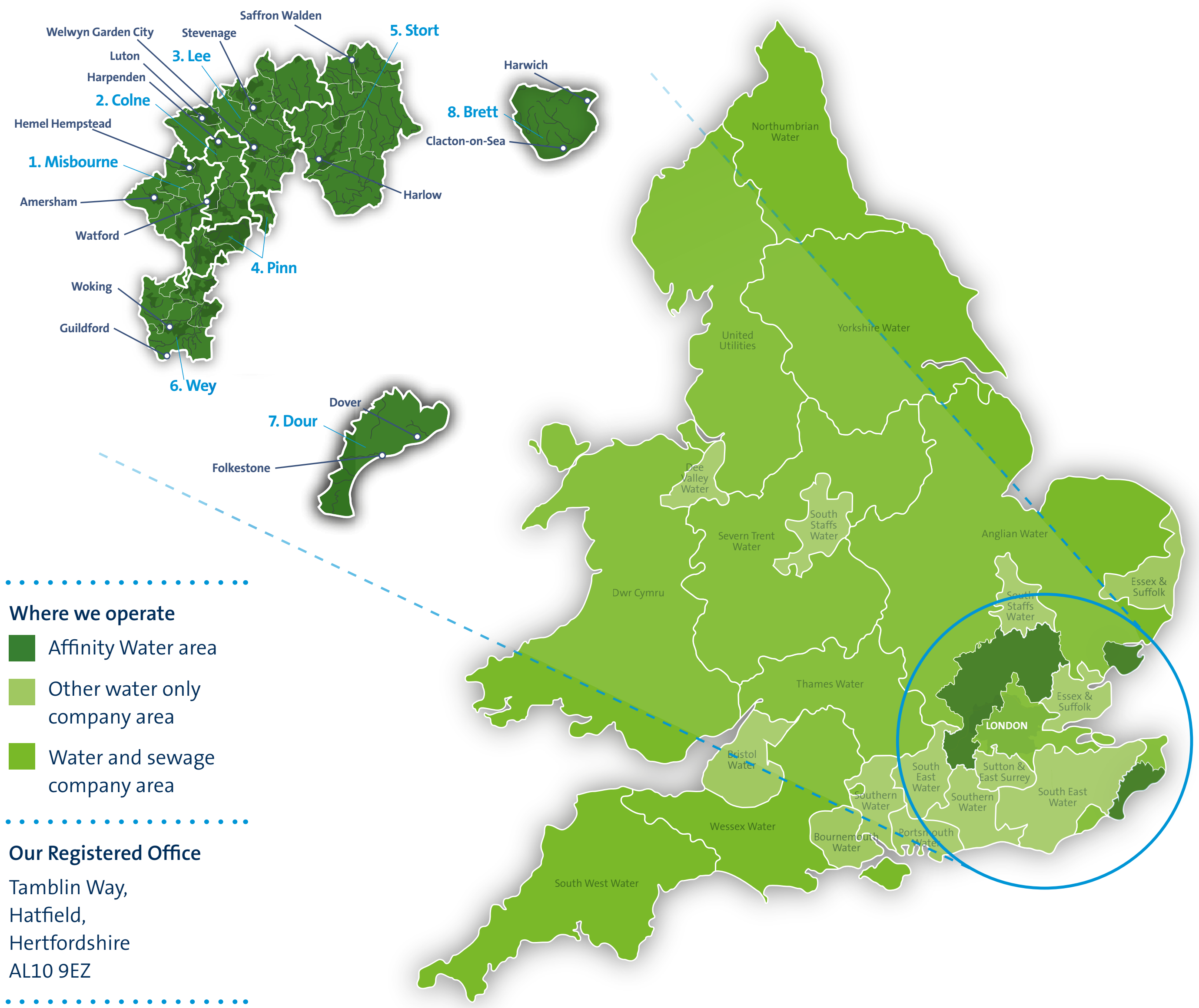
## Where we operate

Affinity Water is the largest water only supply company in the United Kingdom ('UK').

Affinity Water Limited owns and manages the water assets and network in an area of approximately 4,515km² split over three supply regions, comprising eight separate water resource zones, in the South East of England.

Our vision, to be the UK's leading community focused water company, reflects the importance we place on our people working within and for the communities of customers we serve.
By understanding and responding to the needs of different community groups, we are accountable to them at a local level for how well we provide our services. Our economic regulator, Ofwat, acknowledged through awarding us 'enhanced status' for our Price Review 2014 ('PR14') Business Plan (our 'Business Plan') for the 2015-2020 price control period (Asset Management Plan 6, 'AMP6'), that our community approach is something that sets us apart.

We divide our supply area into eight different communities, based on our existing water resource zones and each named after a local river, allowing us to tailor a high quality service to customers at a local level.



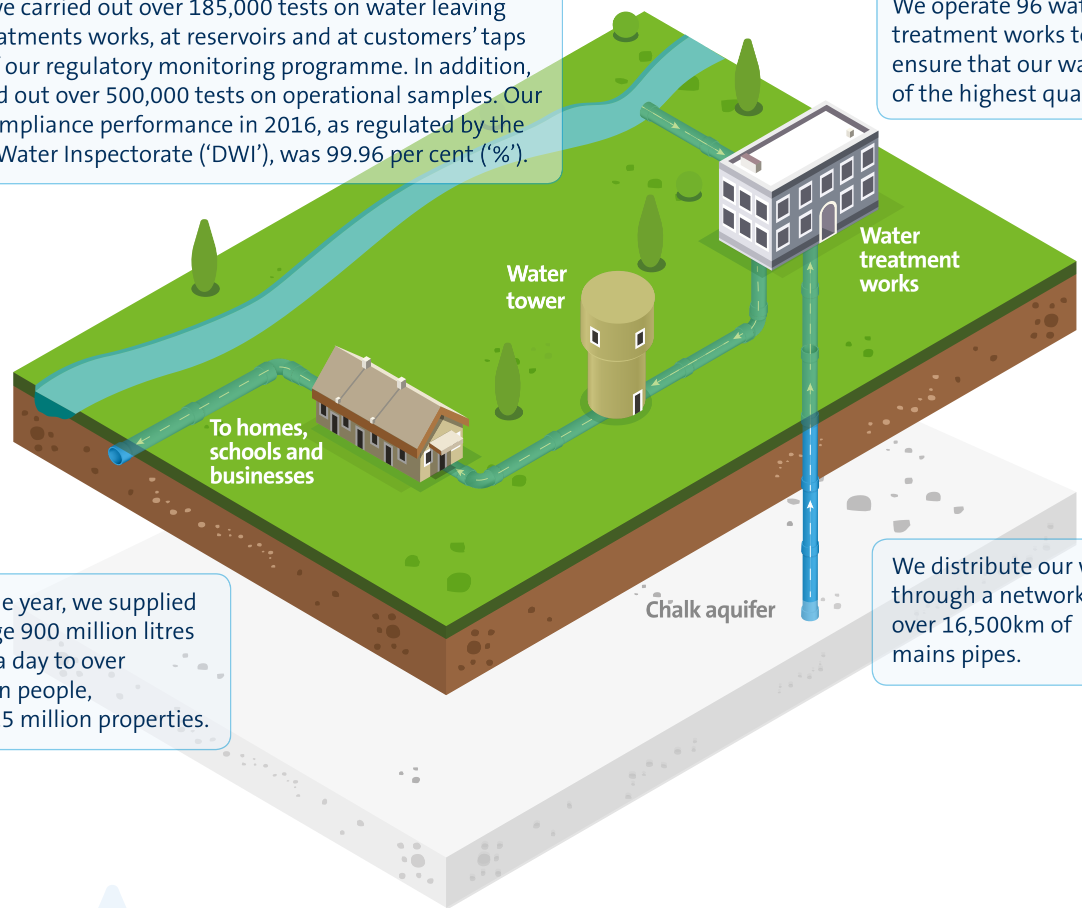

**Where we operate**
- Affinity Water area
- Other water only company area
- Water and sewage company area

**Our Registered Office**
Tamblin Way,
Hatfield,
Hertfordshire
AL10 9EZ

## Facts and figures

In 2016 we carried out over 185,000 tests on water leaving water treatments works, at reservoirs and at customers' taps as part of our regulatory monitoring programme. In addition, we carried out over 500,000 tests on operational samples. Our overall compliance performance in 2016, as regulated by the Drinking Water Inspectorate ('DWI'), was 99.96 per cent ('%').

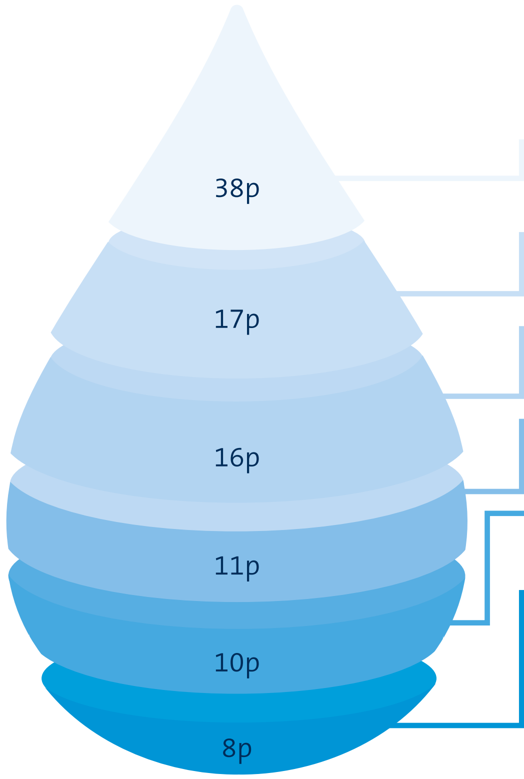
We operate 96 water treatment works to ensure that our water is of the highest quality.




During the year, we supplied on average 900 million litres of water a day to over 3.6 million people, serving 1.5 million properties.

We distribute our water through a network of over 16,500km of mains pipes.

### Where each pound of our customers' bills is spent:




**Our assets: 38p (PY: 30p)**
Investment in our assets

**Our people: 17p (PY: 17p)**
Wages, salaries and pensions

**Our suppliers for operating services: 16p (PY: 26p)**
Operational cost of suppliers' services

**Our bondholders: 11p (PY: 10p)**
Interest paid on debt financing

**Our shareholders: 10p (PY: 7p)**
Dividends

**Local and central government: 8p (PY: 10p)**
Corporation tax, business rates, abstraction charges, employer's national insurance, Climate Change Levy and streetworks permits

Figures are based on our statutory financial statements for the year ended 31 March 2017 on **pages 94 to 143** and have been rounded.

# Highlights

## Operational highlights 2016/17

## Progress made in delivering on our commitments for AMP6

### Protecting our people

We revised our strategy and improvement plan to focus on a number of safety and health initiatives, recording

**0.28** lost time injuries per **100,000** hours worked

compared to a target of 0.3 and actual performance of 0.27 in 2015/16.

### Managing our water resources

We achieved our stretching regulatory leakage target, reducing leakage by **7.9 Megalitres per day** to 173.0 Megalitres per day compared to our 2015/16 performance of 180.9 Megalitres per day.

### Supplying high quality water

We continued to provide high quality water in terms of our mean zonal compliance[1] of **99.96%** for the 2016 calendar year, compared to a target of 99.95% and actual performance in 2015 of 99.99%.

### Minimising disruption

Work is being undertaken to produce 'calmer' networks. This year we experienced **3,077 bursts** compared to our target of 3,100.

### Value for money customer service

Our value for money index is based on in depth telephone surveys with customers who know the value of their bill. This year we achieved a score of **69.6 out of 100** which is similar to our restated[2] 2015/16 performance, when we scored 69.5 out of 100.

**For further information on our operational performance, see pages 32 to 35, and for our highlights as a responsible business, see pages 36 to 37.**

[1] See footnote on **page 33** for details on mean zonal compliance.

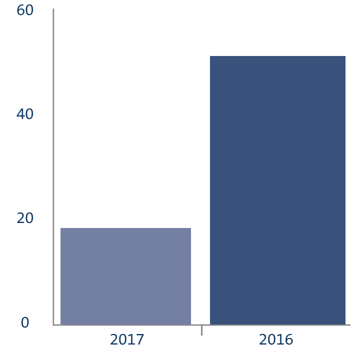
[2] We have restated our 2015/16 performance to better reflect customers' perceptions on value for money. We conduct surveys with nearly 2,000 customers, but only report on customers that know the value of their bill as this measure has been assessed to be the more robust indicator of Value for Money perceptions. This has decreased the sample size to approximately 1,000 and reduced the score by 2.1 points.

## Financial highlights 2016/17

### Net cash inflow before tax and financing[1]

**£18.3m**

Target: £17.6m
2016: £51m



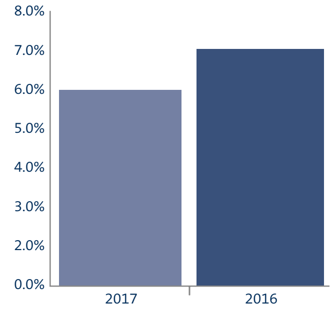

We met our internal target for the year, whilst delivering higher than budgeted asset-related expenditure as required to compensate for delays in the prior year. Net cash inflow before tax and financing compared to the prior year fell significantly as a result.

### Post tax return on regulatory capital value ('RCV')

Our post tax return on capital assumed in price controls for 2016/17 remained consistent with last year.

**5.7%**

Target: 5.9%
2016: 6.9%




### Credit ratings

**A-/A3**

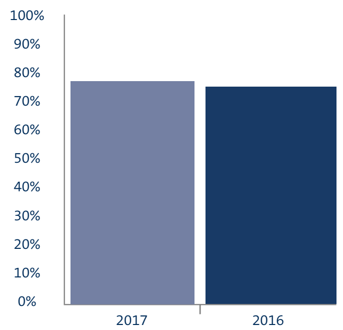
**Target: A-/A3 2016: A-/A3**

We have continued to maintain stable investment grade credit ratings in line with those of our peers in the water sector.

### Gearing

**77%**

**Target: 80%**
**2016: 75%**




Gearing remained below the Board-approved gearing level of 80% at 31 March 2017 and during the financial year. This allows sufficient headroom within our financial covenants, the first trigger of which is a dividend restriction at a gearing level of more than 85%.

For further information on our financial performance, see **pages 38 to 41**.

[1] This "non-GAAP" measure is used internally to evaluate our financial performance.

# Chairman's statement

Dr Philip Nolan, Chairman

## I am delighted to present Affinity Water's annual report and financial statements for the year ended 31 March 2017.

At Affinity Water we understand that we provide an essential service to our customers across the communities we serve, and it is this that drives our vision to be the UK's leading community focused water company. I am pleased that, in the second year of AMP6, we are making good progress on that ambition.

For us, community focused means playing an active role in the communities we serve, keeping our customers informed about our activities and giving them a real opportunity to give us their thoughts on how we are performing.

**Our vision captures our response to three overriding imperatives.**

Firstly, as a private provider of a public utility, we recognise how important it is that our customers trust the service we provide. That is why we will continue to invest in building relationships with our customers and other key stakeholders.

Secondly, our customers and stakeholders must have confidence that we are operating in a responsible and accountable way. To achieve this we publish our performance on our website so our customers can see exactly how we are performing against the commitments we have made for AMP6.

Thirdly, it is vital to us that we create value. We create value by performing efficiently and by maintaining our local environment, sustaining our local communities and supporting our local economies. By doing this, we will achieve value for our investors while delivering the standards of service our customers expect along with the performance commitments we included in our Business Plan. For more information refer to our business model on **page 12**.

We also understand that water is a scarce natural resource and it is important to us that our customers have a say in how we manage it. That is why our community engagement activity and customer feedback is so important to us.

We are currently working with our customers and other key stakeholders to obtain their insight on how we are performing and what more they would like us to do. We will continue to utilise real-time communication solutions such as the Rant and Rave customer engagement platform to gain instantaneous customer feedback on our performance. We have events planned in each of our eight communities across our supply region and we will be asking our customers to help us shape our plans for the future.

Our next Business Plan will be submitted to Ofwat in 2018 and we want it to represent the priorities of our customers in each of our communities. In the coming months we will be informing our customers about how we are performing, explaining the challenges we face and asking for their thoughts on what they think our priorities should be.

Our Customer Challenge Group ('CCG'), which consists of representatives with experience of representing household customers and special interest groups, holds us to account on how we are performing against our AMP6 commitments. As we work towards building a Business Plan that will deliver for our customers in the 2020-2025 price control period (Asset Management Plan 7, 'AMP7'), our CCG is there to challenge us on how we engage and research our plans.

Ofwat has set greater expectations of CCGs for the next Price Review ('PR19'), including provision of independent assurance on the quality of a company's customer engagement and the extent to which this is reflected in its business plan. We continue to meet with our CCG on a regular basis as we strive to deliver our current Business Plan commitments and in our preparations for the next. We welcome feedback from the CCG to ensure that we continue to put our customers at the heart of everything we do.

**Our customers are always at the forefront of our mind as we develop our plans for the future.**

We are committed to our role as stewards of the natural environment. We are proud of the relationships we have developed with organisations in our communities, including local river protection groups and farmers. We recognise that there is still much more to do so that we can protect our environment for future generations.

We are faced with a growing population and an increased number of households across our supply area, so we need to explore the choices that will ensure we have enough water to serve our customers, while leaving more in the environment and ensuring we have a network that is resilient to both droughts and floods.

We have set ourselves ambitious performance commitments for AMP6. Our teams are passionate about delivering against these to ensure a sustainable supply for future generations along with meeting the standards of service our customers expect. Our partnership with our customers and stakeholders in our communities will help us realise that vision.

On 19 May the sale of Affinity Water Limited by Infracapital and Morgan Stanley Infrastructure (MSI) to a consortium comprising Allianz Capital Partners on behalf of the Allianz Group, HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited) and DIF, an independent and specialist fund management company, was concluded.

Infracapital and MSI signed an agreement to sell their 100% interest in Affinity Water Acquisitions (Investments) Limited, which indirectly owns 90% of Affinity Water. As part of the transaction, the buyers acquired Veolia Water UK Limited's 10% stake in Affinity Water.

Following the sale we continue to operate as normal, focused on achieving our strategic objective to become the leading community focused water company in the UK, by continuing to deliver our enhanced business plan for our customers.

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

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

# Strategic report

## Chief Executive Officer's introduction

**It has been a year of continued progress at Affinity Water and I'm pleased to report that we have made significant headway towards our aim of delivering a sustainable business for the customers we serve, the environment and our investors.**

Our vision is to become the UK's leading community focused water company and last year we launched The Affinity Way. This is our internal company narrative that sums up who we are, the responsibilities we have for the services we provide and the behaviours we are looking for from everyone who works in and for the business.

This year we have built on this by launching our Customer Charter which links back to The Affinity Way and outlines the five commitments that flow through everything we do. Refer to **page 13** for further information.

When I look back at our performance in 2016/17, the second year of our five year Business Plan, I am keen to recognise the huge effort from different teams across the business that have delivered improved levels of performance to help us meet the commitments we have made to our customers.

We have been working to improve customers' experience of our website and digital services by providing improved self-service functionality. A good example is our web chat service, which has received great feedback. The way we interact with our customers and communities is key to providing a service that represents value for money, so we want to explore what else customers want from us as if we were their supplier of choice.

These are successes we should be proud of, however we are still facing some challenges we had last year; a growing population, an increasing number of households to serve and a need to protect the environment from which we take our water.

Our Water Saving Programme for AMP6 has installed 85,000 water meters as at the end of March 2017. This metering programme is helping our customers to save water, save energy and save money, by giving them control over their water usage. We are now over a quarter of the way through our programme for AMP6 and our promise to install 280,000 meters in our supply area by 2020.

I am also incredibly proud of the work we are doing to protect our local environment. As part of our National Environment Programme, we are carrying out river restoration work and habitat improvements across our catchment areas where we are also reducing water abstraction. Working with the Environment Agency ('EA'), local landowners and catchment partners we are helping to make improvements to our rivers which improve habitats for wildlife and improve water flow. We understand these successes only have resonance if we are delivering the kind of service our customers expect of us.

Our customers continued to benefit from high quality drinking water during the year. Our Mean Zonal Compliance ('MZC') was 99.96%, exceeding our regulatory target however we do recognise we had a small number of water quality incidents in the year and are committed to improving.

We also achieved our target of fewer than 3,100 mains bursts in the year, although we did experience a higher number of bursts than the previous year. At a time when we are asking our customers to save water, I recognise that it is important we are able to demonstrate that we are playing our part by managing our assets well and providing clean, safe drinking water for our customers.

We know there is more work we can do to ensure that bursts on our network do not result in prolonged interruptions to supply for our customers. On this measure we have fallen short of the target we set ourselves and have incurred a penalty that will be realised as part of PR19.

Over the last year we have invested a great deal in our customer services team by upskilling our colleagues, improving the resilience of the business in dealing with setbacks and bringing in experience from other sectors. An improvement has been seen in our customer service metrics, including a quarter on quarter improvement in our company service incentive mechanism ('SIM') survey results, a 23% reduction in complaints and an overall improvement in customer satisfaction levels from 4.31 out of 5 in 2015/16 to 4.60 in 2016/17.

**The reason why we are continuing to improve is simple: we are continually listening to our customers and responding accordingly.**

Being community focused is at the heart of what we do. That is why we have held events throughout the regions we serve over the last year, received feedback through our Rant and Rave process and spoken to nearly 2,000 customers as part of our Value for Money survey.

In April 2017 the competitive market for non-household customers opened. This has been a significant change for the industry and it is unlikely to be the last. Ofwat has been considering customer views on competition in the household market. Irrespective of the regulatory regime, our commitment to providing high quality water, the empathy we show our customers and the pride we take in our work will always be absolute.

In September 2016, Debbie Ryan joined as our People Director, bringing over 20 years' experience in HR. She is passionate about building a great place to work where people are able to succeed, learn and grow. She has a track record of growing talent within, and enhancing performance of, individuals and teams.

**When I look back over the year I am satisfied with our performance but I am eager to continue improving.**

We are still working hard to achieve the stretching targets we set ourselves for AMP6. We are committed to improving how we work, delivering a great service for our customers and protecting our environment.

These commitments are reflected in our financial performance. Employment costs have risen as we strengthen our teams and depreciation charges have increased as we have invested in our assets for the benefit of our customers and communities. We have also incurred more costs preparing for non-household retail market opening and on financing activities designed to increase our financial resilience.

We acknowledge that we can do more to improve our leakage work. During the year we installed 20,000 acoustic data loggers to help detect leaks on our network, which will be key in delivering the 14% leakage reduction we have committed to in our current Business Plan. Our abstraction reduction work which aims to reduce the amount of water we take from our river catchments, will continue throughout next year and we will continue to pursue our community vision as we seek to achieve our goals.

I am sure that we have the right team in place to deliver for our customers, other key stakeholders and the environment. On behalf of the senior management team and the Board, I would like to thank all our people for their hard work, commitment and their achievements.

# Strategic report continued

## Summary of our strategic report - providing a clear line of sight

### OUR VISION

**Our vision is to be the UK's leading community focused water company. This vision captures our response to three overriding imperatives:**

as a private provider of a public utility service, to retain trust and legitimacy

to operate in a responsible and accountable way by complying with all applicable laws and regulations; and

to create value by performing efficiently and securing investor value, and by maintaining our local environment, sustaining our local communities and supporting our local economies.

### OUR BUSINESS MODEL

**Our business model recognises the need to satisfy these three overriding imperatives while providing all processes and capabilities needed to achieve:**

Find out more on page 12

our customers' expectations by:
- 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;
- providing a value for money service;

assurance to stakeholders of our compliance with all applicable laws and regulations; and

value creation for investors while achieving value for money for customers.

### 2016/17 PERFORMANCE

**Our operational and customer service performance measures and targets are aligned to key commitments for AMP6 made in our regulatory Business Plan.**

Find out more on page 32

Leakage: 170.3 Ml/d. Sustainable abstraction reductions: 12.5 Ml/d

Mean zonal compliance: 99.96%

Mains bursts: 3,077 bursts. Unplanned interruptions to supply over 12 hours: 1,840 properties

SIM: 13th position out of 18

Accident frequency rate: 0.28 lost time accidents per 100,000 hours worked

Net cash inflow before tax and financing: £18.3m

### PRINCIPAL RISKS AND UNCERTAINTIES

**We have in place an established framework in order to identify, evaluate and manage the key risks we face. Our principal risks and uncertainties are:**

Find out more on page 43

- injuries and accidents to our people and the public;
- failure to supply wholesome water;
- unavailability of resources (people and materials);
- information security or privacy failure;

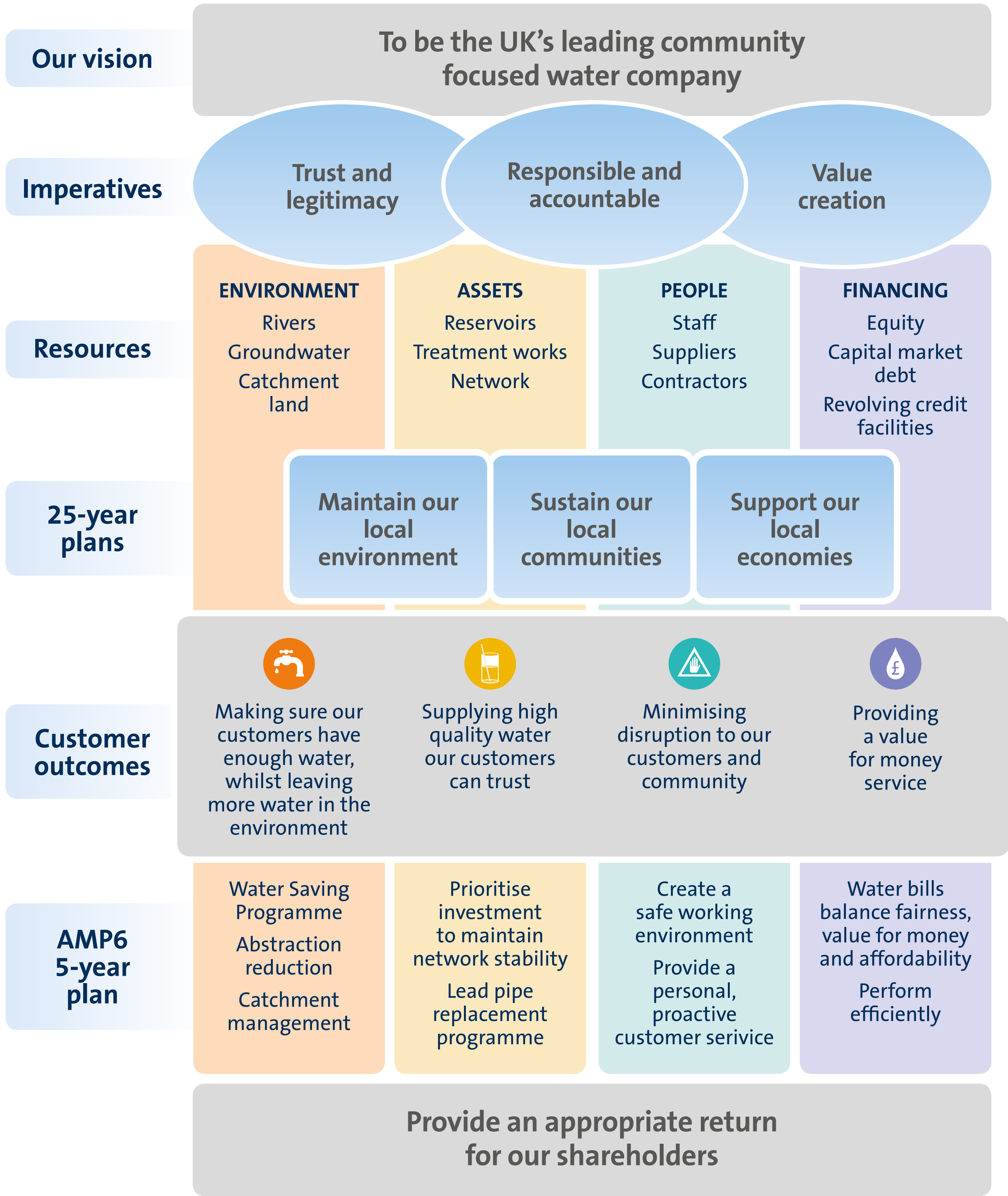
- adverse changes to the regulatory framework;
- adverse change in the social and/or political climate;
- failure to be compliant with laws, our Instrument of Appointment and other recognised standards;
- failure to deliver our Business Plan obligations;
- being required to undertake unremunerated activity;
- failure to operate effectively as a wholesaler in the non-household retail market;

- liquidity risk;
- macro economic risk (interest rate, inflation and tax risks);
- breach of and changes to our borrowing covenants; and
- revenue and debtor risk.

# Strategic report continued



## Our business model



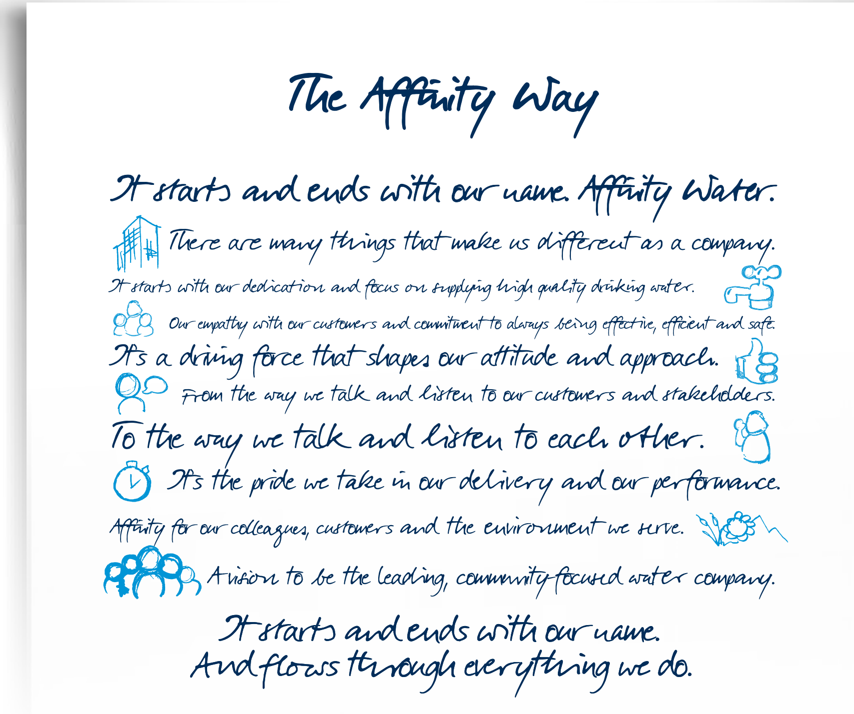

## Our vision

Our vision reflects the importance we place on our people working within and for the communities of customers we serve. By understanding and responding to the needs of different community groups, we are accountable to them at a local level for how well we provide our services.

### THE AFFINITY WAY

Underpinning our vision to be the UK's leading community focused water company is the responsible approach we take to doing business.

We believe that "The Affinity Way", our internal company narrative, sets us apart from other companies operating in our industry. It clearly sums up who we are, the responsibilities we have for the services we provide and the behaviours we expect from our people and the business partners that support us.





### OUR CUSTOMER CHARTER

Our company exists to serve our customers. During the year we developed and launched our Customer Charter, our external company narrative, which incorporates five lines from The Affinity Way and highlights key words that specifically relate to our customers.

Our Customer Charter is designed to clarify the way that we interact with our customers and articulate our commitments to them. We must be able to measure and report our performance to ensure there is a clear line of sight between the activities we undertake and the social, economic and environmental impacts we have on our communities.

Examples of our Customer Charter in action can be found throughout our Strategic Report. Please refer to our case studies on **pages 16, 24, 31, 42 and 52**.

# Strategic report continued

## Our vision (continued)

### A RESPONSIBLE BUSINESS

The Affinity Way and our Customer Charter provide context for our activity as a responsible business. Our 2016/17 highlights as a responsible business are set out on **pages 36 to 37**.

As an entity of significant public interest, we know we need to perform across a wide spectrum of sustainability and business ethics matters. Our approach is reflected through the industry-leading commitments we have made for AMP6, which we set out on **page 27**. We have been recognised for our leading approach to customer consultation and innovation in water efficiency, and are addressing affordability issues through social tariff, value for money and living wage commitments.

As a community-focused, responsible business, we are working with our communities to build a sustainable future for all. It grows from three core branches:

**Investing in science, technology, engineering and mathematics ('STEM') education and future skills**

We are making significant investment in the communities we serve, trialling innovative equipment, contributing to community based organisations and creating employment. Particularly important to us is our school engagement programme, staff volunteering and working with our supply chain.

During the year we created opportunities for young people to engage with our business through our STEM education, apprenticeships and graduate schemes. We improved support for our people by establishing policies for reimbursement of professional fees and community contribution. We have a long-term commitment to recruit, train and retain the best people, ensuring they have the right skills, knowledge and experience to do their job to the best of their ability.

Focusing on the needs of our communities is central to our vision. We take pride in our delivery and performance and recognise that our people, customers and stakeholders within our communities have varying and unique needs. We are committed to creating strong alliances in our supply chain by establishing frameworks and ways of working which encourage and reward responsible business practice.

**Developing community partnerships**

Our communities are at the heart of who we are and we believe the way we talk and listen to our customers and stakeholders makes us different. We have actively engaged through consultations and local events within each of our eight communities and have created and published our first community level performance report. This process has enabled us to understand and respond to the different needs of our communities and recognise the importance of partnerships to deliver a sustainable future.

This year we strengthened our relationship with Wildlife Trusts across our supply area, bringing a strong focus to protecting the local environment and habitats in the communities we serve. We also maintained public access and recreational facilities, providing unique opportunities for local organisations.

We reach out to our customers who are financially vulnerable, offering support through the different payment arrangements and tariffs we have, and working with Citizens Advice Bureau to promote the services we offer. We have worked with Mind and Age UK to understand how to better support the most vulnerable in our communities.

We are keen to develop long-term partnerships with local experts in our communities who reflect our values and share common objectives and report on the issues our communities really care about, such as providing a reliable service, tackling leakage and making local investments.

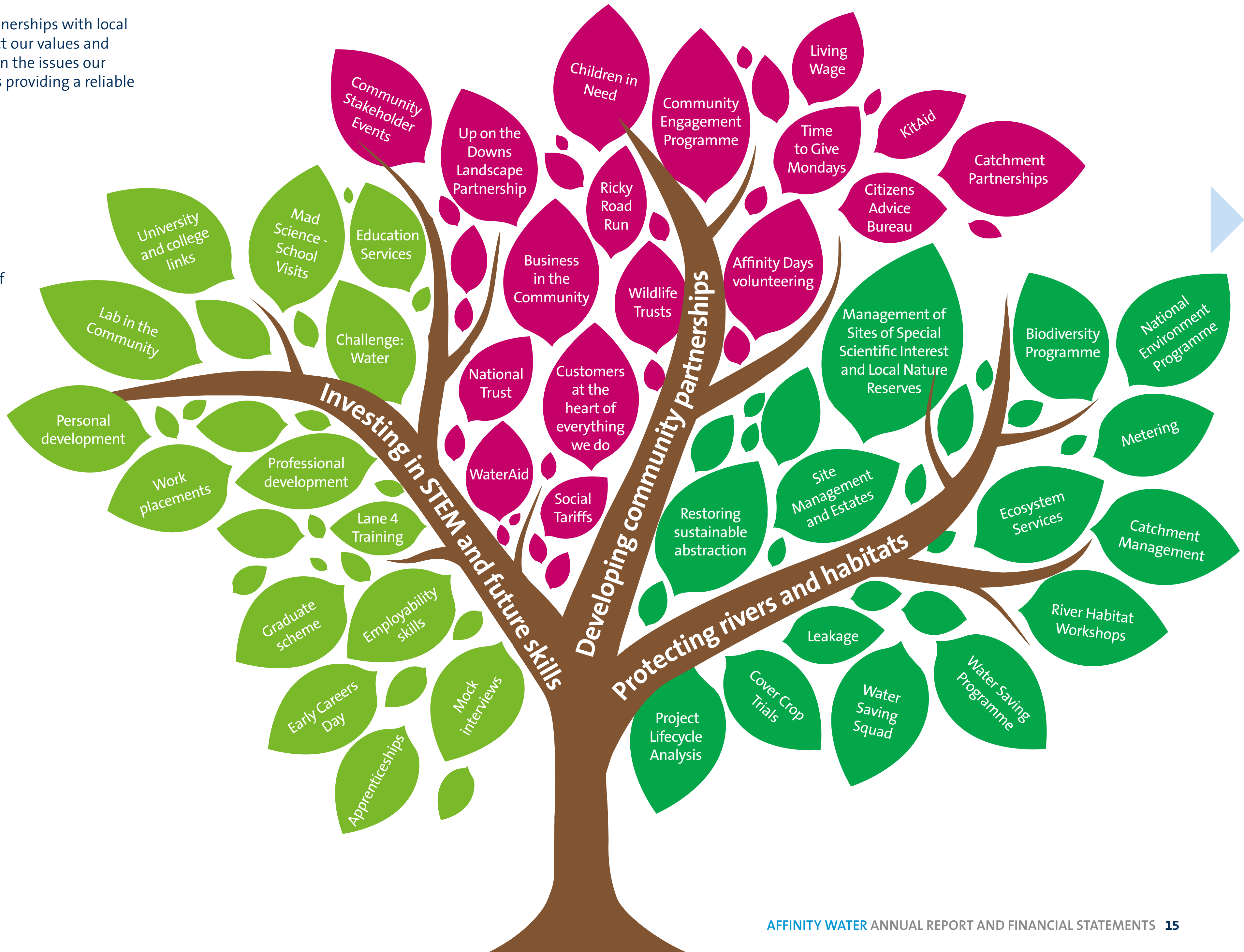
**Protecting local rivers and habitats**

The environment and natural water resources are fundamental to everything we do. We understand the significant impacts of taking water from the environment and take responsibility for ensuring the needs of our growing population are balanced against protecting and maintaining our environment. In AMP6 to date we have reduced abstraction by 12.5 Megalitres per day ('Ml/d'), putting us on track to meet our long-term target of 42.1 Ml/d reduction by 2020.

We respect the right of future generations to have access to and benefit from well stewarded natural resources and have made industry leading commitments that reflect our belief and approach. During the year, we undertook river restoration with local experts to improve our knowledge. On the River Mimram, heavy tree cover was thinned to improve the growth of marginal and in-channel vegetation. This will stabilise the banks and narrow the river's cross-section, speeding up the flow of water and scouring away silt. Furthermore, fish-spawning will be enhanced by the increased exposure of gravel on the riverbed.

We invested in pilot studies with over 30 farmers and other stakeholders to raise awareness and reduce diffuse pollution from agriculture and industry. For more information refer to our case study on **page 16**.

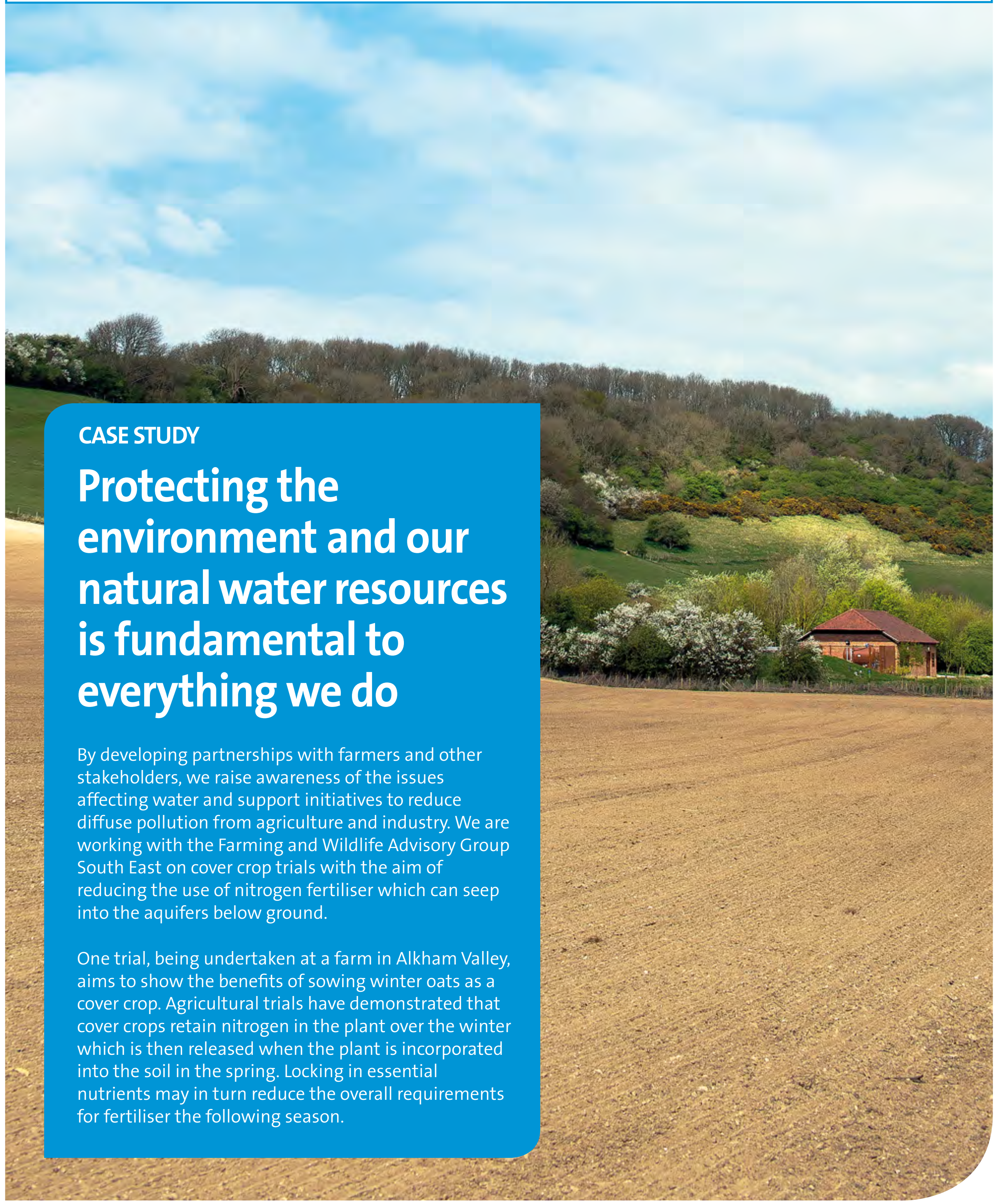
Our long-term aim is to build a resilient future through our Water Saving Programme. Between 2015 and 2020 we will be helping our customers by providing advice and water saving devices to reduce their water use. We have also committed to an investment of £500 million to reduce leakage by 27 Ml/d - the most stretching leakage reduction targets of any water company.



# Strategic report continued

## Our Customer Charter in action

*It starts with our dedication and focus on supplying high quality drinking water*



CASE STUDY

### Protecting the environment and our natural water resources is fundamental to everything we do

By developing partnerships with farmers and other stakeholders, we raise awareness of the issues affecting water and support initiatives to reduce diffuse pollution from agriculture and industry. We are working with the Farming and Wildlife Advisory Group South East on cover crop trials with the aim of reducing the use of nitrogen fertiliser which can seep into the aquifers below ground.

One trial, being undertaken at a farm in Alkham Valley, aims to show the benefits of sowing winter oats as a cover crop. Agricultural trials have demonstrated that cover crops retain nitrogen in the plant over the winter which is then released when the plant is incorporated into the soil in the spring. Locking in essential nutrients may in turn reduce the overall requirements for fertiliser the following season.

## Our imperatives

### As a private provider of an essential public service we have three overriding imperatives:

- retaining trust and legitimacy;
- responsible and accountable operational performance that complies with all applicable laws and regulations; and
- value creation by performing efficiently and securing investor value, and by maintaining our local environment, sustaining our local communities and supporting our local economies.

**Our vision has to balance potentially competing imperatives and ensure alignment between our customers, investors and stakeholders.**

### TRUST AND LEGITIMACY

We are privileged to serve our communities. Being the supplier and the steward of a precious resource for future generations, we are acutely aware that we must continually invest in building trust and legitimacy with our customers in their communities. This is central to achieving our vision.

**Expectations of service and customer experience**

Customers rightly expect that we place their interests at the centre of our operations and that their needs shape the way we deliver our services. We are working hard to ensure customers can find answers to their questions quickly and easily. We continue to respond and adapt to meet our 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.

We continue to use advances in technology to minimise disruption in our communities when we carry out essential maintenance work.

**Affordability and value for money**

Affordability of our water bills is a particularly acute issue in some of the communities we serve. This results in an emphasis across the entire customer population on value for money. Any increase in sewerage charges, which are billed to the majority of our household customers and which we collect on behalf of other companies, can exacerbate underlying affordability concerns.

# Strategic report continued

## Our imperatives (continued)

### RESPONSIBLE AND ACCOUNTABLE

**Being held to account by our customers**

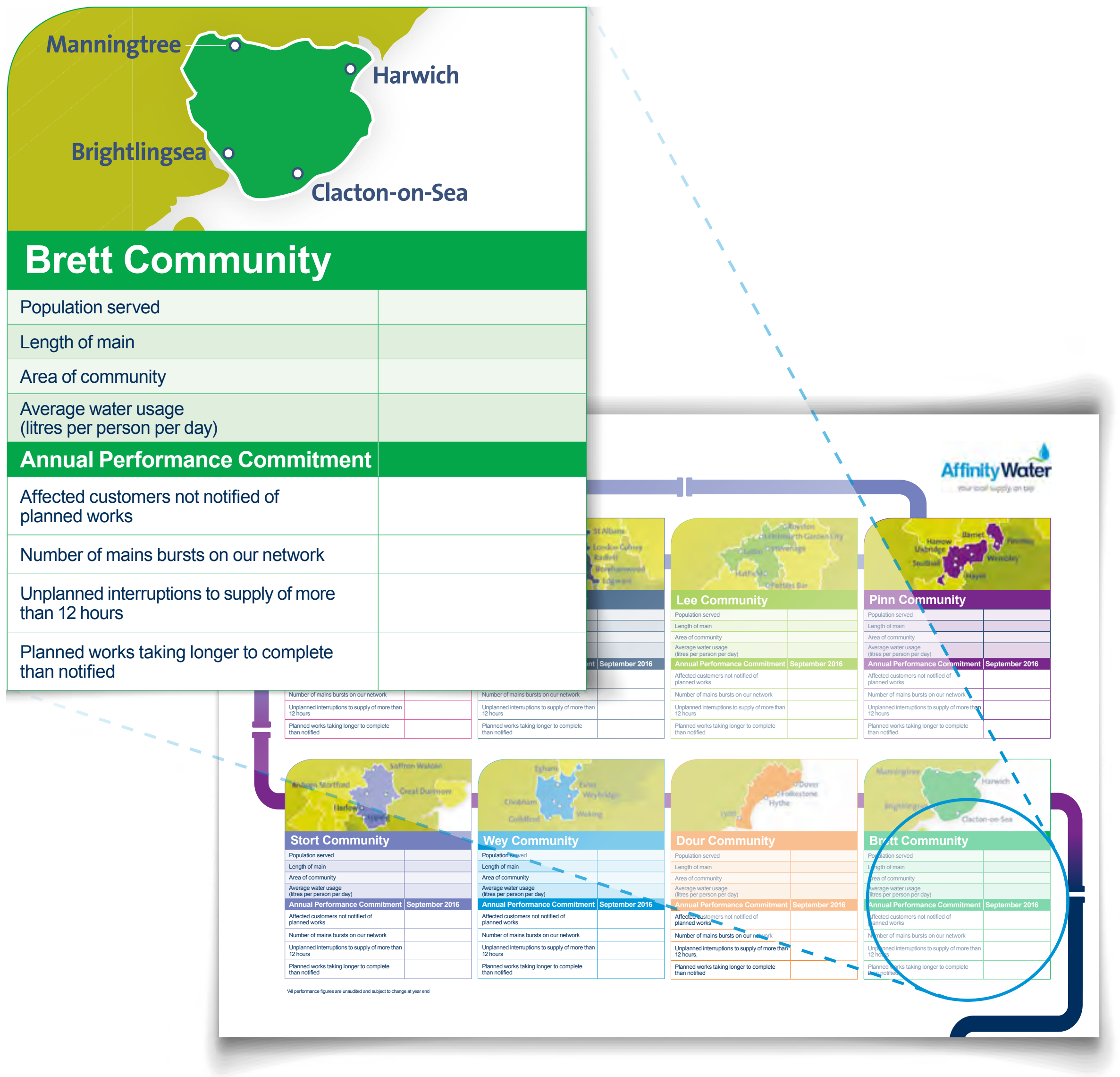
We want our customers and stakeholders to be able to measure our success and hold us to account. We are required to report our performance against targets set by Ofwat, the Drinking Water Inspectorate ('DWI') and the Department for the Environment, Food and Rural Affairs ('Defra'). These targets are for the whole company on an annual basis. Such targets include the performance commitments in our Business Plan.

During the year we held stakeholder meetings across each of our eight communities. These forums enable us to understand the priorities of stakeholders in each area and allow stakeholders to voice local concerns. To meet our commitment of being open and transparent about our performance with customers, we have been reporting our performance at a community level using online dashboards (refer to the template below). We also produce an annual "performance update" which reports our performance for the year to customers and stakeholders, both at a company level and broken down by community, against our regulated targets.

We value the input of a number of customer representative groups. The most significant of these is The Consumer Council for Water which is an independent national statutory customer representative body. In addition, our CCG meets with senior managers quarterly to discuss issues of relevance to customers. We also consult regularly with other groups which are representative of customer interests such as the Citizens Advice Bureau, local charities and politicians with constituencies in our supply areas.

For more information please refer to the Our Performance page of our stakeholder website:

**stakeholder.affinitywater.co.uk**




**Political and regulatory environment**

The industry in which we operate is subject to extensive legal and regulatory requirements with which we must comply. We need to comply with the laws, regulations and standards, and the policies published by Ofwat, the EA, Defra, the DWI, Natural England and other regulators.

The water industry is undertaking progressive reform to facilitate greater competition. On 1 April 2017, the retail market for all non-household water and sewerage customers in England opened to competition.

From 1 October 2016, we engaged in 'shadow operations' which were designed to replicate market conditions post-opening. As part of this, we established a 'wholesale operations service desk', a single point of contact for non-household retailers through which they can interact with our wholesale business.

Our retail non-household operating unit was rebranded as Affinity for Business during the year and became a separate legal entity on 1 April 2017. For more information refer to our operating model on **page 28**. All retailers must be treated by our wholesale business in the same way, and it is particularly important that no preference, either deliberate or inadvertent, is shown to Affinity for Business. Preferential treatment may lead to failure to operate effectively in the new market, which has been identified as a new principal risk for the company in the year. For more information refer to risk number 10 in our principal risks and uncertainties section on **pages 43 to 49**. In order to mitigate this risk, we have undertaken an extensive training programme in order to make our employees aware of what behaviours are and are not acceptable in the new environment.

The opening of the non-household retail market went to plan. From the company's perspective the new market is operating smoothly, with only the minor issues that can be expected with new systems arising.

In November 2015, the government announced that Ofwat would consider the case for the extension of retail competition into the household market. Ofwat published its findings in September 2016. It did not express a view in favour or against the extension of competition to households, but merely set out the costs and benefits, as it perceived them. The balance of this analysis was in favour of the benefits, but there was no clear recommendation to the government. The government has not publicly commented on Ofwat's report.

The Water Act 2014 paved the way for further reform of upstream activities in the water sector. Ofwat published its proposed outline of PR19 in May 2016. This document clarified that prices in the industry will in future be indexed to the Consumer Price Index ('CPI') instead of the Retail Price Index ('RPI'). In order to help the transition from RPI to CPI, a portion of water companies' RCV will still be indexed to RPI beyond 2020. For more information refer to risk number 5 in our principal risks and uncertainties section on **pages 43 to 49**. Ofwat is expected to publish its draft price setting methodology in July 2017.

Ofwat has also consulted on outcomes and customer measures for AMP7. Ofwat and the industry are also conducting projects to 'standardise' the measurement of certain metrics in the industry, in particular, leakage and supply interruptions. This will enable Ofwat to use comparative information in setting and agreeing target benchmarks.

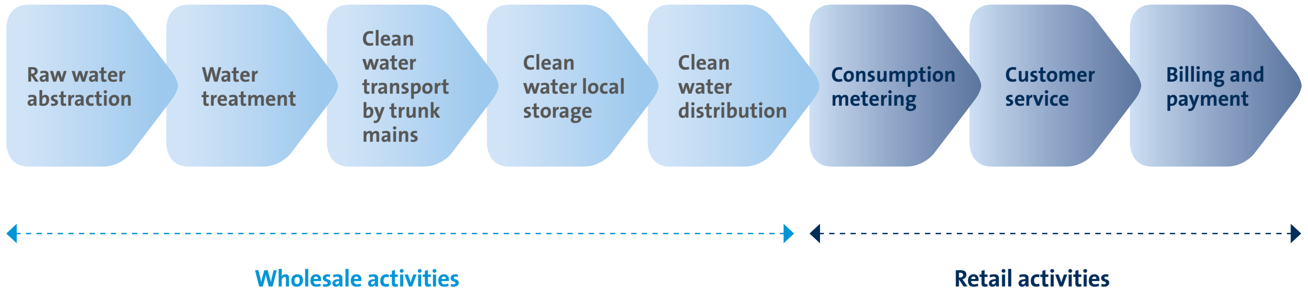
# Strategic report continued

## Our imperatives (continued)

### VALUE CREATION

Our challenge is to achieve value creation for investors by performing efficiently while also achieving value for money for customers by maintaining our local environment, sustaining our local communities and supporting our local economies. Investor value can be created by outperforming in selected areas, thereby receiving rewards for doing so (refer to the information box below), and through effective risk management to reduce cash flow volatility (i.e. offering more predictable cash returns) at the same time as delivering our commitments. Value for money for customers is achieved by delivering the standards of service our customers expect along with the performance commitments we included in our Business Plan at a reasonable price (refer to the table on **page 27**).

### Our value chain




**Economic regulation**

Our business is a regional monopoly and is subject to incentive-based economic regulation by Ofwat. For AMP6 we are subject to a strict revenue control regime, designed to drive efficient investment decisions and facilitate the introduction of retail competition for our non-household customers from April 2017. Ofwat has set three separate controls in order to separate wholesale activity, related to production and distribution, from customer-facing retail activity, divided between household and non-household customers.

The wholesale revenue control is based on incentives related to total expenditure. Household retail controls are based on an industry-wide 'average cost to serve' principle in order to drive efficiency across the sector. Non-household controls serve as protection for customers as competition develops in the retail market and have been set for the period prior to market opening and are under review by Ofwat for the period between 1 April 2017 and 31 March 2020.

For AMP6, Ofwat is assessing companies' operational performance against agreed performance commitments. Each performance commitment contains an Outcome Delivery Incentive ('ODI'), which can carry a financial reward or penalty or both that will be realised as part of the next price review process. There are also reputational consequences for failing to meet these performance commitments.

## Our key resources

**Our business model, presented on page 12, recognises the need to satisfy our three overriding imperatives mentioned previously, while providing all processes and capabilities needed to deliver value for all of our stakeholders.**

### ENVIRONMENT

Maintaining the high quality of the water we supply to customers is vital in the face of pressures and obligations. Increased use of pesticides and an enhancement to the lead compliance standard means that it is important that we promote effective catchment management, implement improvements to our water treatment processes and remove lead pipes using a risk based approach.

Our Business Plan sets out how we ensure that our customers continue to receive the high quality of water that they expect in AMP6 and beyond by investing in our treatment works, targeting lead pipe replacement and enhancing our current programme of catchment management. We continue to work in partnership with the EA and environmental groups.

### ASSETS

Assets allow our people to make use of the water resources provided by the environment to supply our customers. We distinguish between two main classes of assets in the way that we manage our business. Our above ground assets collect water from groundwater or river sources and deliver it to treatment works where we convert raw water into high quality wholesome drinking water. Our below ground network of assets take water from treatment works and deliver it to homes and commercial premises through more than 16,500km of mains (a greater distance than the diameter of the earth). Particularly strict standards of hygiene need to be applied to these assets.

The majority of our assets do not have moving mechanical parts and therefore have long operational lives (pumps being a major exception). As a result, we have a large collection of assets of various vintages, designs, and materials that have accumulated since the mid-nineteenth century. Stewardship of these long-lived assets is therefore a key capability for our people. Our business needs to operate 24 hours a day, 365 days a year, so our assets need to have high levels of reliability. Emergency responses to failure are an important aspect of our business, as are maintenance planning and failure prevention.

Asset-related expenditure to maintain, enhance and create assets is a major cost of our business. Our asset-related expenditure programme is designed to meet our four key customer expectations (refer to **page 27**). During the current regulatory period we are particularly focused on enhancing our environment by reducing the abstraction of water from environmentally sensitive sites and further increasing the resilience of our network.

# Strategic report continued

## Our key resources (continued)



### PEOPLE

Our people play a critical role in creating long-term value. They are our ambassadors, living and working in the communities we serve. They have the local knowledge and understanding to make sure we deliver 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 attractive place to work. We have created a strong culture of learning and development, investing in training, and we are building a culture of coaching and mentoring to release the potential of our people.

During the year, we partnered with a leading consultancy firm to help us develop our senior managers to lead The Affinity Way. The six month programme has enabled us to improve our leadership capability to lead change and transformation within the company and the water industry.

We continue to offer and intend to expand our employment schemes for graduates and apprentices. The Apprenticeship Levy is providing an opportunity for us to review our programmes and ensure they meet industry leading standards. We have invested in new roles, such as Head of Talent Acquisition to ensure we enhance our reputation as a great place to start a career. We are also developing a Professional Network to ensure our people can continue to develop in an environment which supports their professional status.

Our suppliers and contractors provide us with essential services which we rely on to deliver our five year and longer term plans. It is vital that we work closely with them, for example on large capital projects where delivery on time, to budget and with minimal customer impact has economic, societal and environmental benefits. Close collaboration is important to help support the delivery of these benefits and we have framework agreements with our key suppliers to encourage and reward responsible business practice.

The safety, health and wellbeing of our people and suppliers is something we take very seriously. Our vision and the customer expectations that we will continue to meet are all set in the context of our commitment to operating our business without harm. For further information on our safety and health performance in 2016/17, refer to **page 35**.

During the year we launched our Code of Conduct. This sets out the principles by which we work every day, take actions and decisions, and interact with each other and our wider communities. It explains what we stand for and shows others they can rely on us. It is available on the Corporate Responsibility page of our website:

**stakeholder.affinitywater.co.uk/corporate-responsibility.aspx**

**Diversity and gender policy**

We are committed to promoting equality of opportunity in all areas of employment including recruitment, promotion, opportunities for training and pay and benefits.

The following table provides a breakdown of the gender of directors and employees at 31 March 2017:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | Men | Women | Men | Women |
| Company directors[1] | 9 | 1 | 9 | 1 |
| Other senior managers[2] | 5 | 2 | 4 | 2 |
| All other employees | 833 | 449 | 716 | 422 |

**Our position on human rights**

The Companies Act 2006 requires us, to the extent necessary for an understanding of the development, performance or position of the company's business, to include information about human rights issues. Given our operations are limited to the South East of England and that we are highly regulated by numerous regulators, we do not believe this information is necessary for such an understanding and have therefore not included it. However, we do have a Board approved Modern Slavery and Human Trafficking Policy and our statement on Modern Slavery and Human Trafficking is available on the Corporate Responsibility page of our website:

**stakeholder.affinitywater.co.uk/corporate-responsibility.aspx**

### FINANCING

We are a business with a long-term outlook and expenditure commitments, which need to be matched with long-term sources of debt finance. We consider the most cost effective way to raise long-term debt is through the debt capital markets. In February 2013 we raised £575m in these markets to refinance the bank debt used to fund the acquisition of the company from Veolia Environnement S.A. We took the decision to set up a bond programme in the process, which enables us to issue further bonds without the need for significant additional documentation. Since then we have issued further bonds, both new and tap issues, to raise a further £119.2m. See **pages 71 to 72** for further details of our current financing arrangements.

[1] Company directors consist of our Board members, as detailed on **pages 54 to 56**.

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

# Strategic report continued



## Our Customer Charter in action

*Our empathy with our customers and commitment to always being effective, efficient and safe*


CASE STUDY

### Our mains cleaning programme became one of the biggest of its kind ever to be undertaken within the UK

Having committed to the DWI to clean 958km of potable water mains in our Stort, Pinn and Dour communities by 31 March 2017, our mains cleaning programme became one of the biggest of its kind ever to be undertaken within the UK.

We used an innovative solution known as ice pigging, a highly effective way of removing manganese and iron deposits residing within our strategic trunk main system. The method works by using the available mains network pressure to drive a thick slurry of ice through the pipe. As the ice journeys through it collects sediment on the way and holds it within the ice matrix. The ice is removed from a suitable exit point where it is safely collected for disposal in an environmentally responsible way.

The programme, which started in October 2015, was designed to ensure our high standards in drinking water quality and network resilience are maintained long into the future. During 2016/17, 770km of our mains pipes were successfully cleaned safely and efficiently, completing the programme ahead of schedule.

For the remainder of AMP6 we will be focusing on flushing works within our Pinn community to ensure we continue to maintain the highest standards in water quality for our customers.

## Our long-term planning

**We know that the future will provide new challenges in our area – a rising population and increased demand for water, as well as a reduction in the availability of water in the years ahead. This means we may need to do things differently if we are to maintain the levels of service we currently provide. Our Water Resource Management Plan ('WRMP'), published in June 2014, sets out our 25-year plan to meet these resource challenges. We are now working on the next version of this plan, due for publication in the summer of 2019.**

Our customers tell us they expect us to work hard to safeguard the environment. We need to ensure that we undertake our work to meet our customers' expectations in a sustainable and environmentally sound way. Our latest Strategic Direction Statement (published in spring 2013) provides our strategy for meeting the expectations of our customers today and over the next 25 years in a sustainable manner.

### MAINTAINING OUR LOCAL ENVIRONMENT

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, which account for around 64% of the water we supply, and 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 South East 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 WRMP, and as a key performance commitment for AMP6, we agreed with the EA to reduce the amount of water we take from the environment by 42 Ml/d by 2020. This is around 5% of our resource base. A primary challenge for our business 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.

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



## Our long-term planning (continued)

### SUSTAINING OUR LOCAL COMMUNITIES

The population in our supply area is forecast to increase by 0.7% 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 and our customers' demand for water could exceed the supplies we have available.

Our five year and longer term plans include a number of planned 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 lower abstraction by reducing leakage and encouraging our customers to use water more efficiently.

### SUPPORTING OUR LOCAL ECONOMIES

We serve one of the most economically active regions in the UK. Our ambition to be the UK's leading community focused water company extends to ensuring that we play an active role in supporting the growth and development of our local economies.

Our people are essential to improving the service our customers receive. We have been awarded Continuous Professional Development Approved Employer status and have been recognised as an Employer Champion by the Science Council. These accolades recognise our commitment to professional standards.

We also continue to invest in our infrastructure and assets to ensure they are resilient and can support economic growth. We invested over £147m (2015/16: £103m) enhancing and maintaining our infrastructure and assets in 2016/17. This has gone into extensive projects such as our mains cleaning and trunk mains replacement programmes (refer to our case studies on **pages 24 and 42** respectively).

## Customer outcomes

**To shape our Business Plan for this regulatory period, we undertook extensive research with input from more than 12,500 customers. The table below summarises our customers' four expectations and the performance commitments we made for AMP6.**

| Customers' expectations | Our commitments |
|---|---|
| Making sure our customers have enough water, whilst leaving more water in the environment | We will reduce the amount of water we take from the environment by 42 million litres per day.<br>We will encourage our customers to use less water through our Water Saving Programme.<br>We will invest £500 million in our network to reduce leakage by 14 per cent – the equivalent of 27 million litres per day. |
| Supplying high quality water you can trust | We will maintain high quality drinking water.<br>We will implement a targeted programme of lead pipe replacement to meet more stringent legal standards. |
| Minimising disruption to you and your community | We will invest in increased flexibility in our network so we can transfer water more effectively around our communities. |
| Providing a value for money service | Bills will reduce by 1 per cent per year before inflation until 2020.<br>We will promote our LIFT social tariff to support those least able to pay their bill.<br>We will make £106 million of efficiency savings in our running costs to keep bills as low as possible over the next five years.<br>We will make ourselves accountable to our communities for our performance. |

# Strategic report continued

## Our operating model

### During 2016/17 our business consisted of three distinct operating units as shown below.

**Wholesale**
Responsible for water abstraction, treatment and distribution

**Retail household**
Provides customer-facing activities for household customers

**Retail non-household**
Responsible for retail service delivery to non-household customers

**Support services**
Responsible for corporate services

Our retail non-household operating unit was rebranded as Affinity for Business during the year and became a separate legal entity on 1 April 2017. All interactions between this company and Affinity Water Limited are conducted on an 'arms length' basis, compliant with Ofwat's Regulatory Accounting Guideline 5 ('RAG5') and the Competition Act 1998. For more information, refer to our political and regulatory environment update on **page 19**.

### WHOLESALE

We remain fully committed to achieving our vision of zero harm and have launched a new programme aimed at making safety personal. Our safety performance showed signs of improvement during 2016/17 with service strikes to other utilities' underground pipes or cables being the biggest issue faced by our own staff and our contractor partners. For more information on our safety performance refer to our operational key performance indicators ('KPIs') on **pages 32 to 35**.

Our clean water SIM score has improved throughout the year but we intend to do more to ensure we deliver an excellent customer service across our eight communities each and every day. For more information on our overall SIM performance refer to our operational KPIs on **pages 32 to 35**. We formally launched our new Customer Charter in March 2017 with the benefit of insight from our supply chain partners as well as employees and CCG members. For more information refer to our vision on **page 13**.

Sustained progress throughout the year ensured that our business plan aspirations for AMP6 remain on track. We made a commitment to the DWI that we would clean 958 km of mains by 31 March 2017. This was the biggest programme of its kind ever undertaken in the UK and was completed ahead of schedule. For more information refer to our case study on **page 24**.

As part of our Water Saving Programme, the number of meter installations and free home water efficiency checks increased significantly during 2016/17. We also replaced a greater number of lead pipes during the year than we have done previously and commenced the lead replacement programme in schools. We will continue this into 2017/18, bringing forward this investment from future years.

In our Wey community, the Ottershaw to St Anthony's trunk mains replacement scheme was accelerated this year to ensure minimal disruption to our customers and other stakeholders. Our relationship with Surrey County Council and the local community was excellent and we are keen to use this experience when working with our other highway authorities. For more information refer to our case study on **page 42**.

Across our production estate we encountered an unusually high number of reservoir failures during the year. These reservoirs were only out for a short period of time, but as a result we had to import more water from Grafham, a reservoir outside our supply area, to make up for the outages. Investment in production maintenance and pumps continues in line with expectations, however our plans for a new metaldehyde treatment facility at North Mimms have been delayed while we analyse the results from a trial that we conducted at our Iver water treatment works.

We constantly rely on the professionalism and dedication of our people and our contractor partners. We recognise that we have an ageing workforce and are taking the necessary actions in equipping our business for the future. We are launching our Affinity Academy and are investing in training and the up-skilling of our people.

Innovation is key to our success and we are constantly exploring new ideas and techniques across our network and production estate. We have trialled satellite technologies to help us find leaks and have purchased over 20,000 acoustic data loggers making us industry leading in this field as we strive to further reduce leakage from our network. We have also successfully trialled techniques such as ice pigging (refer to our case study on **page 24**), line stopping, hydrant and pipe feeling, with the aim to improve our maintenance and repair processes. We are aiming to launch a new innovation and future thinking framework in 2017/18.

### RETAIL HOUSEHOLD

During 2016/17 we established a new senior leadership team in Customer Relations, focusing on continuing to deliver our customer promises and driving forwards our customer service transformation vision.

A key foundation of this has been getting even closer to our customers, ensuring that their views continue to guide our initiatives, through better utilisation of data and improvements to our customer feedback programme. We now gather customer satisfaction data immediately rather than 24 hours later and have seen response rates increase significantly. We also held an inaugural Customer Excellence Day in October 2016. For more information refer to our case study on **page 31**.

By continually increasing our focus on customers we have been able to deliver improvements in the following areas:

- we have increased our proactive focus with outbound SMS texts to keep customers informed of activity and works underway;
- we have recently introduced a new Quality Team to identify opportunities for continuous improvement within our service delivery;
- the self-service section on our website is now optimised for mobile devices and tablets;
- social media activity continues to grow, with a positive trend seen in sentiment measures. We will continue to grow our non-telephony channels through 2017/18; and
- complaints have decreased by 23% compared to 2015/16.

While we acknowledge there is still more to do, we have seen a consistent improvement in our internal customer satisfaction measure, as well as our SIM score for billing throughout 2016/17. For more information on our overall SIM performance refer to our operational KPIs on **pages 32 to 35**.

Our achievements were recognised externally this year, with the company shortlisted for numerous industry awards. For more information refer to our highlights as a responsible business on **pages 36 to 37**. We have also joined the Institute for Customer Service.

In addition to these customer service improvements we have focused on forming new partnerships with the Citizens Advice Bureau, Step Change and the Money Advice Service. These will enable us to offer more inclusive services to some of our more vulnerable customers. In addition, we have formed a working group with UK Power Networks to create a new Priority Services Register, aligned across the wider energy sector.

Looking forward, as well as continuing to build on the success of this year, we plan to continue delivering our customer service transformation. The key focus for 2017/18 will be delivery of a multi-channel customer service capability, enabling us to evolve through improved digital service. This supports our vision of ensuring we remained fully focused on delivering excellent service to meet and exceed customer needs.

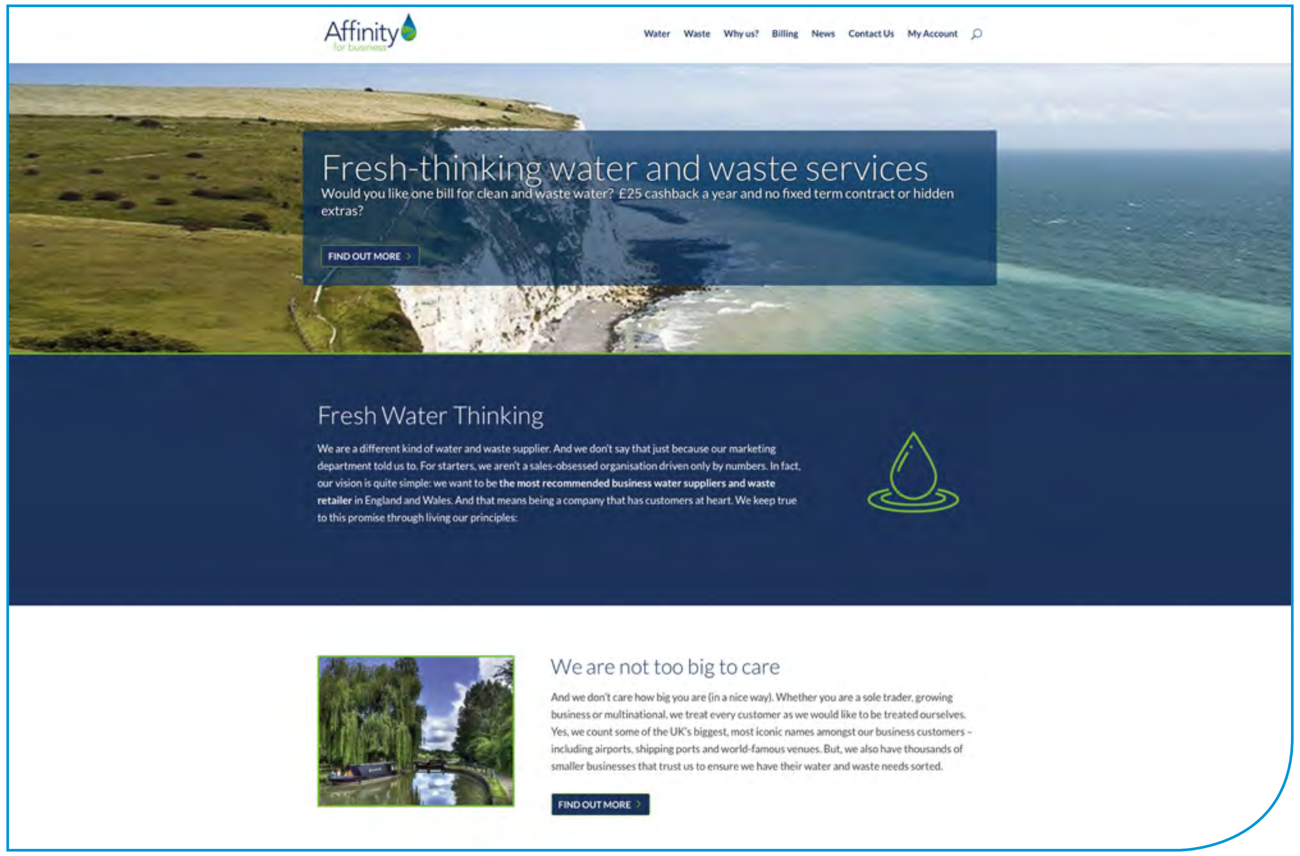
# Strategic report continued

## Our operating model (continued)

### RETAIL NON-HOUSEHOLD

During the year we focused on preparing our business for the competitive non-household retail market which opened on 1 April 2017. We entered into a Shadow Market on 1 October 2016, which gave us the opportunity to test our processes and systems for six months. We also implemented a wholesale operations service desk and developed a company wide training programme to demonstrate that we were market ready and fully compliant.

We rebranded our non-household customer retail services as Affinity for Business and launched a bespoke new website. A separate legal entity, Affinity for Business (Retail) Limited, was established and granted a licence to provide water supply and wastewater services throughout England. We engaged with our non-household retail customers throughout the preparation process and used the Exit Regulations laid out by Defra to transfer the existing customer base from Affinity Water Limited to the new organisation on 1 April 2017.




## Our Customer Charter in action

*The way we talk and listen to our customers and stakeholders*

### CASE STUDY

## On 25 October 2016 we held our inaugural Customer Excellence Day

We invited individuals from across the business to join the Customer Relations team to share experiences and ensure we deliver our best possible service to our customers and put them at the heart of everything we do.

Simon Cocks, our Chief Executive Officer, opened the day with some powerful stories from a selection of our customers who had received a poor service. These personal experiences have encouraged us to ensure we avoid repeats of these situations in future.

The event also included some exceptional speakers from customer service specialists Rant and Rave, Ember and the Institute of Customer Service, who all shared their expertise and experience with the team. It was made clear that all our people have a role to play on our journey to customer excellence.

After the great success of this initial event, we will be holding these days twice a year in future.

# Strategic report continued

## Our performance



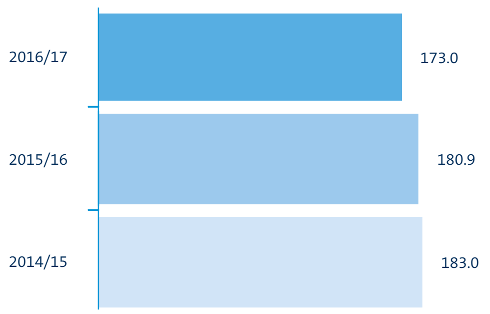
### Our vision, our business model and our customer outcomes are linked through a series of indicators against which we measure our performance.

We have aligned our operational KPIs and targets to key performance commitments made in our Business Plan ('AMP6 PC') in response to customer expectations. Our performance in relation to these targets for 2016/17 is analysed in the table below. For more information on our performance for 2016/17 in relation to all performance commitments we made in our Business Plan refer to **pages 180 to 183** of our regulatory Annual Performance Report, together with our 2016/17 Annual Performance Report publication available on the Reports and Publications page of our website:

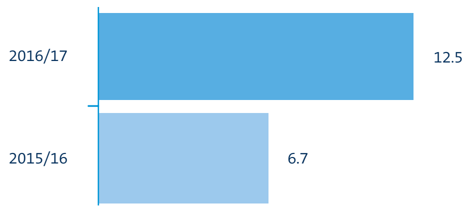
**stakeholder.affinitywater.co.uk/reports-publications.aspx**

**OPERATIONAL KPIS:**

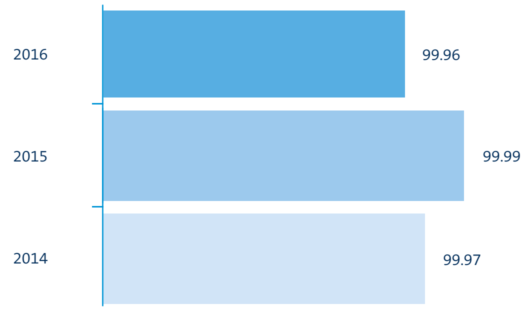
| KPI | Link to strategy | 2016/17 target | Performance | | 2017/18 target |
|---|---|---|---|---|---|
| **Leakage:** average annual water leakage from our network (Ml/d) | Trust and legitimacy imperative<br>Customer outcome<br>AMP6 PC | **178.5** | **173.0** | We attach a high priority to meeting leakage targets, as we want to demonstrate that we are playing our part when we are asking customers to save water, and also to overcome the loss of resources to improve conditions on local catchments. In 2016/17, we achieved one of our best performances and reduced leakage by 5% since 2015; however we have a very ambitious target of reducing leakage by 14% by 2020. | 173.1 |



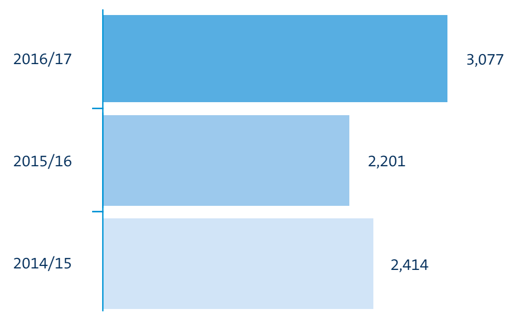

| KPI | Link to strategy | 2016/17 target | Performance | | 2017/18 target |
|---|---|---|---|---|---|
| **Sustainable abstraction reductions:** average annual reduction in water abstracted from our river catchments (Ml/d) | Trust and legitimacy imperative<br>Customer outcome<br>AMP6 PC | **12.5** | **12.5** | We continue to deliver reductions in abstraction in line with our Business Plan and have met our target of 12.5 Ml/d cumulative average annual reduction in water abstracted from our river catchments up to year end 2016/17.<br><br>Work is ongoing to make changes in our infrastructure necessary to maintain the levels of service promised to our customers whilst also leaving more water in the environment for the protection of river flows and local ecology. | 14.1 |




| KPI | Link to strategy | 2016/17 target | Performance | | 2017/18 target |
|---|---|---|---|---|---|
| **Water quality:** MZC[1] (%) | Trust and legitimacy imperative<br>Customer outcome<br>AMP6 PC | **99.95** | **99.96** | In the calendar year 2016 there were 55 exceedances of standards from our sites and consumer properties (2015: 32 exceedances). Of these, 22 exceedances (2015: 11 exceedances) contributed to the MZC calculation.<br><br>Another measure of our performance is the number of serious and significant incidents. During 2016 five events notified to the DWI were classified as serious or significant (2015: nine events). This included the supply of water with a chemical odour in the Staines area in September 2016, which was classified as a serious event.<br><br>Following each event, we have made improvements to reduce the number of failures and events. These improvements were delivered through improvements to our asset resilience, coaching and developing our people, adherence to processes and procedures and through further auditing and control/completion of planned programmes such as lead replacement and mains cleaning. | 99.95 |




| KPI | Link to strategy | 2016/17 target | Performance | | 2017/18 target |
|---|---|---|---|---|---|
| **Mains bursts** (number) | Trust and legitimacy imperative<br>Customer outcome<br>AMP6 PC | **3,100** | **3,077** | Although there has been an increase in the number of mains bursts within the year, the final figures remain within the 3,100 target set for 2016/17.<br><br>To reduce the number of mains bursts, and their consequent affect on service to customers, work is being undertaken to produce 'calmer networks', reduce night pressures and introduce 'intelligent' control to existing pressure control valves. | 3,100 |




[1] 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. It is measured over a calendar year. 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)

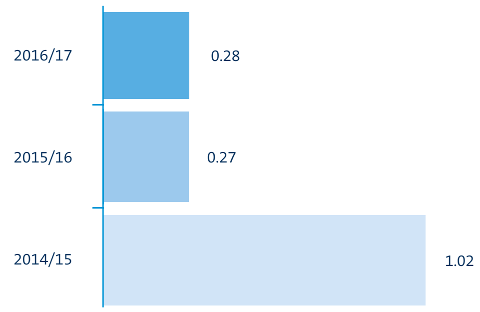


### OPERATIONAL KPIS (CONTINUED):

| KPI | Link to strategy | 2016/17 target | Performance | | 2017/18 target |
|---|---|---|---|---|---|
| **Unplanned interruptions to supply over 12 hours** (number of properties) | Trust and legitimacy imperative<br>Customer outcome<br>AMP6 PC | **320** | **1,840** | Disappointingly in 2016/17, we exceeded our performance commitment for unplanned interruptions to supply over 12 hours.<br><br>As a result, we incurred a penalty through the ODI regime. This is the second year in this AMP period that we have not achieved the target.<br><br>In order to reduce unplanned interruptions, we are focusing on how prevention and restoring supplies can be improved. A new 'network restoration team' will shortly be established. This team will manage interruptions from start to finish and ensure that incidents are dealt with as effectively and efficiently as possible, ensuring continuous supplies are the priority, whether this is through alternative water supplies or rezoning networks. | 320 |
| **SIM[1]** (relative position) | Trust and legitimacy imperative<br>Customer outcome<br>AMP6 PC | **Top 9** | **13th position out of 18 companies[2]** | We continued to improve our customer service during 2016/17, reflected through positive improvements to our SIM survey score. 800 customers were surveyed through the year and we improved from an average of 4.17 out of 5 in 2015/16 to 4.25 this year, being the 5th most improved water company by score. However, our position relative to other companies within the industry remained 13th out of 18.<br><br>We also delivered further improvements as part of our customer experience improvement programme through the year, for example increasing proactive contact to keep customers informed, providing training to resolve customers' queries the first time they call, and through greater analysis of customer satisfaction feedback. We received over 95,000 customer feedback items through the year, which allowed us to continually improve customer service. This was also positively reflected in our complaints volumes which reduced by 23% compared to 2015/16. | Top 9 |



| KPI | Link to strategy | 2016/17 target | Performance | | 2017/18 target |
|---|---|---|---|---|---|
| **Accident frequency rate:** number of lost time injuries per 100,000 hours worked | Responsible and accountable imperative | **<0.30** | **0.28** | During 2016/17 we recorded seven work related lost time injuries, an increase of one on the previous year (2015/16: six injuries). Due to an overall increase in employees this only marginally increased our accident frequency rate and we met our target for the year.<br><br>We delivered this outcome using a revised strategy and improvement plan focused on:<br>• improving safety leadership by implementing a safety leadership framework and self-assessment process;<br>• changing individual beliefs and behaviours through safety culture interventions;<br>• continuing to understand and improve safety and health competencies; and<br>• improving our incident reporting systems and working to increase accessibility for all.<br><br>To continue to improve the safety and health performance there are a number of areas that have been highlighted to prevent injuries and illness occurring as a result of our work activities. These areas are included in our 2017/18 safety and health strategy with particular focus on safety leadership, occupational health and training and competence. | <0.25 |




[1] SIM is a customer experience performance measure with a qualitative element, produced by independent market research surveys of customer satisfaction, and a quantitative element based on the number of 'unwanted' phone calls received, combined with the number of complaints received and the company's effectiveness at resolving those complaints. Unwanted calls are those where customers express any dissatisfaction with the service, including customers who hang up while in call queues, plus any calls that could have been avoided if service had fully met customer expectations.

[2] This is our position relative to the industry in the final qualitative SIM survey of 2016/17. The overall SIM league table will be published once all companies have submitted their regulatory annual performance reports for the year ended 31 March 2017 to Ofwat.

# Strategic report continued

## Our performance (continued)

### 2016/17 highlights as a responsible business

BUSINESS IN THE COMMUNITY

Shortlisted in the Business in the Community's Responsible Business Awards 2016 for the Environmental Leadership Award

*Finalist: Best Customer Service Team of the Year*

Finalists in the European Contact Centre & Customer Service Awards 2016 for Best Customer Service Team of the Year

*Finalist: Customer Centric Culture*

Finalists in the UK Customer Experience Awards 2016 for our Customer Centric Culture being delivered through our Customer Experience Improvement Programme

*Finalist: Best Customer Experience Award*

Finalists in the Institute of Customer Service UK Customer Satisfaction Awards 2017 for the Best Customer Experience Award

**Maintaining our local environment**

SUPPORTING RENEWABLE ENERGY THROUGH NATIONAL GRID'S POWER RESPONSIVE PROGRAMME

ENERGY CHAMPIONS INITIATIVE LAUNCHED, EMPOWERING LOCAL TEAMS TO REDUCE ENERGY

55,000 METERS INSTALLED UNDER OUR WATER SAVING PROGRAMME DURING THE YEAR

ECOLOGICAL SURVEYS UNDERTAKEN AT 60 SITES

WATER QUALITY SAMPLING OF 70 RIVERS, STREAMS AND BROOKS IN OUR CATCHMENTS

OVER 53,000 WATER SAVING DEVICES PROVIDED TO CUSTOMERS THROUGH OUR WATER SAVING PROGRAMME

COVER CROP TRIALS IN 5 CATCHMENTS

TREE CONDITION SURVEYS UNDERTAKEN ON EACH OF OUR 260 SITES WITH TREES PRESENT

168km² OF CATCHMENT AREA INVOLVED IN AGRICULTURAL PESTICIDE SCHEMES TO IMPROVE WATER QUALITY

CONSERVED 1,400 HECTARES OF DESIGNATED LAND, INCLUDING SITES OF SPECIAL SCIENTIFIC INTEREST AND LOCAL NATURE RESERVES

214 DIFFERENT SPECIES RECORDED ON OUR LANDHOLDINGS INCLUDING 32 PROTECTED SPECIES

5 RIVER RESTORATION WORKSHOPS DELIVERED WITH OUR PARTNERS TO HELP MONITOR THE HEALTH OF LOCAL CHALK STREAMS

**Supporting our local economies**

DELIVERED WORK PLACEMENTS THROUGH THE BUSINESS IN THE COMMUNITY BUSINESS CLASS PROGRAMME

ALL OF OUR DIRECT EMPLOYEES EARN THE LIVING WAGE OR ABOVE

APPRENTICE AND GRADUATE SCHEMES OPERATING ACROSS CORE BUSINESS FUNCTIONS: PRODUCTION AND TREATMENT, NETWORK MANAGEMENT AND CUSTOMER SERVICES

CURRICULUM LINKED SITE VISITS AND MOCK INTERVIEWS FOR STUDENTS, BUILDING WORKPLACE UNDERSTANDING AND EMPLOYABILITY SKILLS

WE HAVE CONTINED TO DELIVER OUR IN-HOUSE SAFETY TRAINING PACKAGES AND 78% OF OUR TEAM LEADERS HAVE NOW BEEN TRAINED

**Sustaining our local communities**

OVER 16,000 CHILDREN AND ADULTS ENGAGED THROUGH OUR EDUCATION SERVICES

OVER £17,000 RAISED BY OUR PEOPLE AND MATCHED BY THE COMPANY IN SUPPORT OF 12 LOCAL CHARITIES THROUGH A MONTHLY INITIATIVE CALLED 'TIME TO GIVE'

60 WATER SAVING SQUAD EVENTS TO DISTRIBUTE WATER SAVING DEVICES AND PROMOTE WATER EFFICIENCY

OVER £46,000 DONATED TO 25 LOCAL COMMUNITY GROUPS AND CHARITABLE CAUSES UNDER OUR COMMUNITY ENGAGEMENT PROGRAMME

OVER 44,000 CUSTOMERS ON LOW INCOMES BENEFITING FROM OUR 'LIFT' SOCIAL TARIFF

SUPPORT FOR NEARLY 4,000 CUSTOMERS WITH SPECIAL NEEDS THROUGH OUR WATERSURE SCHEME

BUILDING CONNECTIONS WITH 2 LOCAL UNIVERSITIES AND HELPING PEOPLE INTO FUTURE EMPLOYMENT

200+ AFFINITY DAYS COMMITTED TO VOLUNTEERING TO HELP LOCAL COMMUNITY PARTNERS AND CHARITIES

95,000 CUSTOMERS HAVE GIVEN US FEEDBACK HELPING US TO IMPROVE OUR SERVICE

# Strategic report continued

## Our performance (continued)



### FINANCIAL PERFORMANCE

**Financial results**

Our financial results are prepared in accordance with Financial Reporting Standard 101: 'Reduced disclosure framework' ('FRS 101). For more information refer to the basis of preparation of our statutory financial statements on **page 108**. Our financial results are summarised in the table below:

| | 2017 £m | 2016 £m |
|---|---|---|
| **Revenue** | **308.7** | 302.6 |
| Operating costs | **(248.0)** | (237.5) |
| Other income | **17.1** | 17.2 |
| **Operating profit** | **77.8** | 82.3 |
| Net finance costs | **(51.0)** | (36.7) |
| **Profit before tax** | **26.8** | 45.6 |
| Tax credit/(expense) | **4.1** | 14.1 |
| **Profit for the period** | **30.9** | 59.7 |
| Dividends | **(50.5)** | (40.0) |
| **Transfer to reserves** | **(19.6)** | 19.7 |

Revenue for 2016/17 was £308.7m, being a £6.1m (2.0%) increase on last year (2016: £302.6m). This increase is primarily due to inflationary price adjustments allowed by Ofwat in our last regulatory determination.

Operating costs for the year increased by £10.5m (4.4%) to £248.0m (2016: £237.5m). The variance is explained in the table below:

| Increases in operating costs | £m |
|---|---|
| Inflation | 5.3 |
| Higher employment costs | 6.3 |
| One-off costs of senior management changes in the prior year | (0.7) |
| Market opening preparation costs | 2.0 |
| Higher depreciation due to newly commissioned assets | 5.2 |
| Lower infrastructure renewals activity | (1.6) |
| Lower materials and equipment costs | (1.3) |
| Higher costs associated with new customer connections | 0.8 |
| Costs associated with increased leakage detection and prevention activity | 2.1 |
| Lower production and supply costs | (0.9) |
| Infrastructure and service delivery projects in prior year | (2.4) |
| Lower IT subcontracting costs | (1.5) |
| Lower household retail costs | (0.9) |
| Other decreases | (1.9) |
| **Net increase in operating costs** | **10.5** |

Other income of £17.1 consisted of sundry income, rental income and non-appointed income and was broadly in line with the prior year (2016: £17.2m).

The net finance expense of £51.0m was £14.3m higher than last year, primarily as a result of £9.4m of transaction costs expensed during the year due to the partial extinguishment of the 2022 bond, as well as the impact of higher RPI inflation on the company's index-linked debt. For more information refer to **note 4** of the statutory financial statements.

Profit before tax reduced by £18.8m (41.2%) to £26.8m (2016: £45.6m), primarily due to depreciation and finance costs as outlined above.

**Taxation**

The total tax credit of £4.1m (2016: a tax credit of £14.1m) comprised a current tax expense of £7.2m (2016: £1.6m) and a deferred tax credit of £11.3m (2016: a deferred tax expense of £15.7m).

The current tax expense on profit before tax of £26.8m (2016: £45.6m) was £7.2m (2016: £1.6m). The effective current tax rate (26.7%; 2016: 3.5%) was higher (2016: lower) than the UK corporation tax rate of 20% (2016: 20%).

In the current year we had a large deferred tax credit due to the impact on our deferred tax liability of reductions in the UK corporation tax rate enacted in September 2016.

Total tax paid or collected in the year to 31 March 2017, other than corporation tax, amounted to £29.4m (2016: £28.0m) consisting of employer's national insurance, business rates, environmental taxes and streetworks permits.

Details of our tax strategy can be found on **page 193** of our regulatory Annual Performance Report.

# Strategic report continued

## Our performance (continued)



### FINANCIAL PERFORMANCE (CONTINUED)

**Capital expenditure**

Capital expenditure in the year was £131.7m (2016: £83.7m), and was incurred principally in our mains renewal, trunk mains and lead pipe replacement AMP6 programmes. This excluded £17.9m (2016: £19.5m) of infrastructure renewals expenditure, which is treated as an operating cost under FRS 101.

In aggregate, asset-related expenditure for the year was higher than the amount for 2016/17 budgeted in our Business Plan, due to a rapid acceleration in our mains renewals programme in the final quarter of the year. Looking ahead, expenditure is expected to remain ahead of budget as a number of first year AMP6 projects were pushed back to later years within the AMP.

**Net assets**

Net assets decreased by £22.8m (9.5%) to £216.7m (2016: £239.5m). The decrease is primarily due to higher liabilities resulting from the £19.2m bond issuance and £12.2m bond premium received as well as indexation on the RPI linked bonds.

Trade payables increased by £21.1m (9.6%) to £240.2m (2016: £219.1m) partially offset by a £9.8m (12.3%) increase in trade receivables to £89.7m (2016: £79.9m).

There was a £69.3m (5.3%) combined increase in property, plant and equipment and intangible assets to £1,372.5m (2016: £1,303.2m) as a result of the ongoing investment in the enhancement of our assets, although this has been offset by a £48.3m reduction in cash.

**Cash flow**

Net cash inflow before tax and financing[1] for the year was £18.3m being a 64% decrease on last year (2016: £50.8m). The decrease is due to £44.3m higher fixed asset net expenditure[2] (2017: £122.7m; 2016: £78.4m) offset by £10.9m higher cash generated from operations (2017: £140.1m; 2016: £129.2m).

Equity dividends of £50.5m were paid during the year (2016: £40.0m) continuing to reflect the significant improvements we made to our business during the 2010-2015 price control period (Asset Management Plan 5, 'AMP5'), which contributed towards us achieving enhanced status for our Business Plan. These resulted in favourable adjustments to our RCV at the start of AMP6, some of the benefit of which has been distributed to our shareholders through the payment of dividends. Our customers benefitted during AMP5 from the improvements made, which drove up service levels whilst realising £26.0m in operating cost net efficiencies, through lower bills and better service.

The increase in dividends year on year can be attributed to a £2.0m premium earned on the bond exchange in August, and £8.5m directly from proceeds from the disposal of the company's non-household retail business to Affinity for Business (Retail) Limited. Under the transfer scheme and wholesale contract entered into with Affinity for Business (Retail) Limited, the company was contractually entitled to receipts from Affinity for Business (Retail) Limited broadly equivalent to the amount of the dividend paid.

**Our dividend policy**

The Board approves the company's dividend policy. The amount of the dividend is dependent on the success of the company in generating cash flows and achieving its regulatory outputs in the reported period. Under the policy the company distributes earnings equal to the amount required to maintain net debt to RCV at the targeted gearing ratio of 80%. 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.

**Liquidity and access to markets**

Our objective is to ensure we have banking arrangements and adequate, though not excessive, cash resources, borrowing arrangements and standby facilities to enable us at all times to have the level of funds available which are necessary for the achievement of our business and service objectives. At 31 March 2017, we had cash balances of £45.1m (2016: £93.4m). The decrease in cash held compared to the prior year primarily reflects our continued investment in our assets and increased dividend payments.

The maturity profile of the bonds issued by our subsidiaries is set out on **page 72**. The maturity profile of all our borrowings is set out in **note A4** of our statutory financial statements.

To the extent that additional funding is required, we have access to £100.0m of facilities (2016: £100.0m), which were undrawn at 31 March 2017 (2016: undrawn), to finance capital expenditure and working capital requirements. In addition, we have access to a further £58.0m of liquidity facilities (2016: £58.0m), consisting of a 364 day revolving £38.0m facility to fund any debt service payments in the event of a liquidity shortfall that would otherwise prevent such payments being made and a 364 day revolving facility of £20.0m to fund operating and capital maintenance expenditure in the event of a liquidity shortfall.

At 31 March 2017, net debt, as defined in the financial covenants in the company's securitisation documentation ('compliance net debt'), was £885.2m (at 31 March 2016: £809.3m; refer to **note 1E** of our regulatory Annual Performance Report). Gearing of compliance net debt to RCV at 31 March 2017 of 76.6% (31 March 2016: 74.9%; refer to **note 1E** of our regulatory Annual Performance Report) remains within the Board-approved gearing level of 80.0%. This allows sufficient headroom within financial covenants, which are only triggered at a level of more than 90.0%.

**Interest rates**

Interest rate exposure is primarily managed by using a mixture of fixed rate, floating rate and RPI-linked borrowings (refer to **note A4** of our statutory financial statements). At the year-end, 65.4% of our borrowings were at fixed rates (2016: 64.7%), 34.6% (2016: 35.3%) at rates indexed to RPI and none (2016: none) were at floating rates.

**Pension funding**

The retirement benefit surplus under International Accounting Standard ('IAS') 19: 'Employee benefits' at 31 March 2017 stood at £73.0m compared to a surplus of £72.6m at 31 March 2016. For more information on the movement in the year, refer to **note 9** of our statutory financial statements.

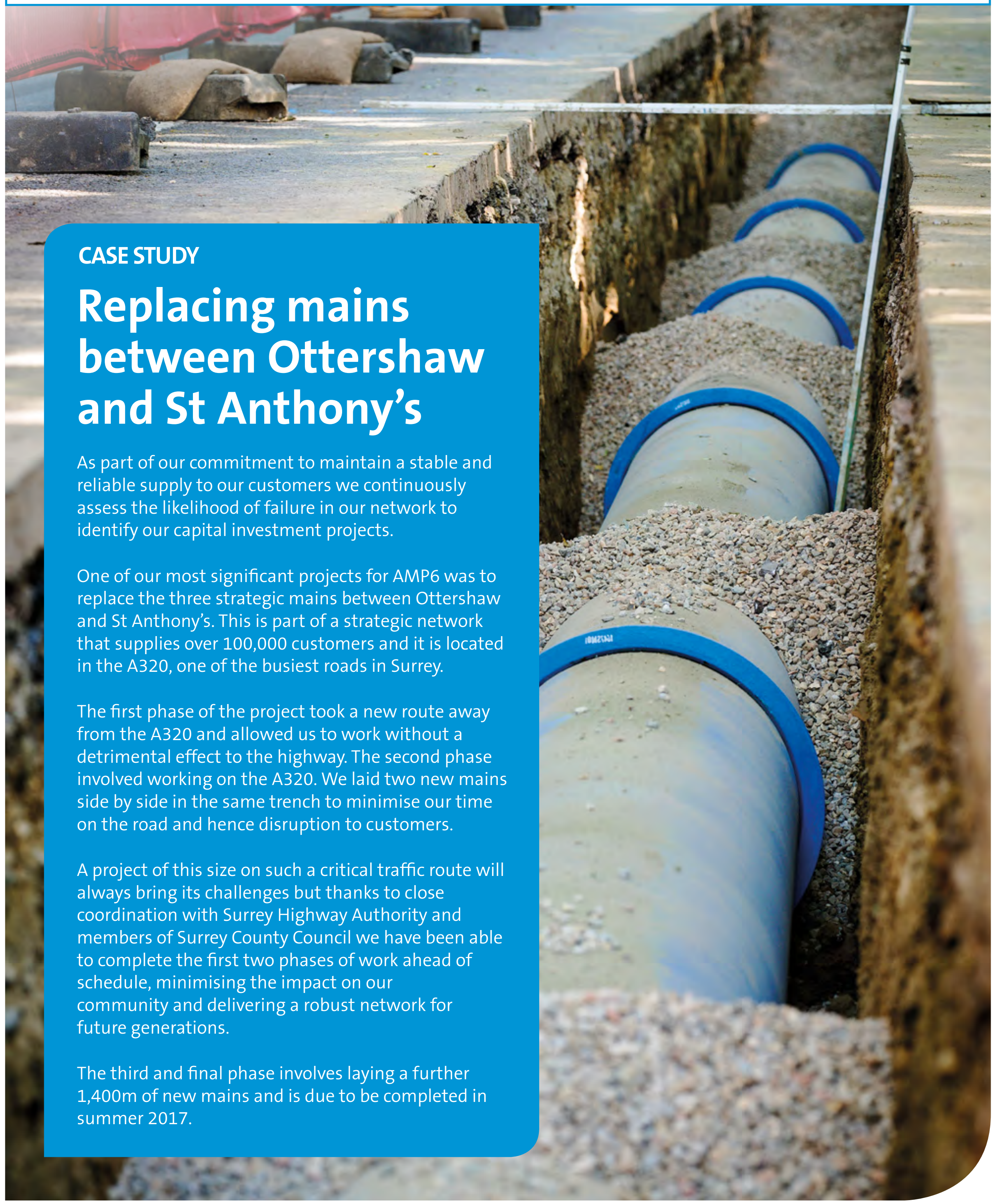
[1] This "non-GAAP" measure is used internally to evaluate our financial performance..

[2] Calculated as the total of the following line items per the statement of cash flows (refer to **page 107**): purchases of property, plant and equipment; capital contributions; proceeds on disposal of property, plant and equipment; and purchase of intangible assets.

# Strategic report continued

## Our Customer Charter in action

*The pride we take in our delivery and performance*



CASE STUDY

### Replacing mains between Ottershaw and St Anthony's

As part of our commitment to maintain a stable and reliable supply to our customers we continuously assess the likelihood of failure in our network to identify our capital investment projects.

One of our most significant projects for AMP6 was to replace the three strategic mains between Ottershaw and St Anthony's. This is part of a strategic network that supplies over 100,000 customers and it is located in the A320, one of the busiest roads in Surrey.

The first phase of the project took a new route away from the A320 and allowed us to work without a detrimental effect to the highway. The second phase involved working on the A320. We laid two new mains side by side in the same trench to minimise our time on the road and hence disruption to customers.

A project of this size on such a critical traffic route will always bring its challenges but thanks to close coordination with Surrey Highway Authority and members of Surrey County Council we have been able to complete the first two phases of work ahead of schedule, minimising the impact on our community and delivering a robust network for future generations.

The third and final phase involves laying a further 1,400m of new mains and is due to be completed in summer 2017.

## Principal risks and uncertainties

We have an established framework for identifying, evaluating and managing the key risks we face. A key aim is to foster a culture in which teams throughout the business manage risks as part of their management of day-to-day operations. Operational risks are recorded and assessed, including existing management and control processes, and action plans are prepared, if necessary, for further mitigation. Activities against these plans are monitored on an on-going basis. Operational risks are also ranked by our teams during the year. Based on these rankings the most significant risks are discussed by our senior management and included in the strategic risk register, which is reviewed by the Board and the Audit Committee. The latter reviews senior management's work on risk management and reports to the Board on the effectiveness of risk management processes. For more information on the responsibilities of the Board and the Audit Committee in relation to risk management and internal control refer to **pages 62 to 63**.

The following have been identified from our risk management process as potentially having a material adverse effect on our business, financial condition, results of operations and reputation. They are managed as described but are not always wholly within our control and may still result in a material adverse impact. Factors other than those listed could also have a material adverse effect on our business activities.

We had previously identified a risk of failing to adequately prepare for the opening of the non-household retail market. The market opened as planned on 1 April 2017, therefore we have updated the details to reflect the risk of failing to operate effectively in that market (refer to risk number 10).

**Key:**

◆ Risk unchanged during the year ▲ Risk increased during the year ▼ Risk decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 50 to 51**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 50 to 51**)

| Status | Risk | Mitigation |
|---|---|---|
| **Operational risks** | | |
| #1 ◆ | **Injuries and accidents to our people and the public**[a]<br>Failing to manage this risk may result in disruption to operations, reputational damage, criminal fines, civil damages and regulatory penalties. | We seek to operate our business to the OHSAS18001 safety standard and help our employees to take personal responsibility for their own safety and the safety of others.<br><br>Our safety and health strategy focuses on compliance and leadership. We have introduced a safety leadership model for our employees and have established a safety improvement plan with measureable objectives specific to each business area. For more information on our safety and health performance refer to **page 35**. |

# Strategic report continued

## Principal risks and uncertainties (continued)

Key:
Risk unchanged during the year | Risk increased during the year | Risk decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 50 to 51**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 50 to 51**)

| Status | Risk | Mitigation |
|---|---|---|
| **Operational risks (continued)** | | |
| #2 Risk unchanged | **Failure to supply wholesome water[b]**<br>We are required to maintain a continuous supply of high quality water for our customers.<br><br>Interruptions to supply (or supply restrictions) caused by drought, water resource restrictions, the contamination of water supplies, pollution and flooding events could impact on the health, safety and security of our people or communities, or on our financial position and our reputation.<br><br>The risk with respect to availability of water remains relatively high for us, as we operate in an area of serious water stress. The construction of the High Speed Two ('HS2') railway, together with plans for a third runway at Heathrow Airport and the Western Rail Link to Heathrow may further increase this risk in the future. | We manage this risk through:<br>• our WRMP which identifies, over a 25 year period, how we will balance available supplies and required demand with sufficient headroom for unplanned outage;<br>• our Water Saving Programme, including new customer meters, water efficiency and leakage reduction, which allows us to maintain headroom as demand grows through new building developments and our supply base is eroded by committed sustainable abstraction reductions;<br>• our drinking water safety plans which provide a comprehensive risk assessment and risk management approach to our water supply chain, supported by our distribution and operations management strategy. We use these plans to inform our investment and maintenance programmes. To provide assurance of the quality of water we supply, we carry out over 185,000 tests per annum on water leaving water treatment works, at reservoirs and at customers' taps. In addition, we carry out over 500,000 tests per annum on operational samples;<br>• investment in our trunk main assets to keep their condition stable through targeted renewal. We are also implementing trunk main burst mitigation schemes to reduce the number of customers potentially affected by any one incident;<br>• our implementation of improvements to increase resilience through measures such as moving and protecting pipework, protecting electrical and control infrastructure, and increasing connectivity to provide greater flexibility of operation;<br>• our Drought Management Plan which is approved by the Secretary of State; and<br>• our emergency and business continuity plans. Should water supplies be compromised, we have plans in place to ensure the provision of essential water supplies at all times. Our contingency plans are audited annually by an independent certifier whose reports are shared with the Secretary of State. |

Key:
Risk unchanged during the year | Risk increased during the year | Risk decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 50 to 51**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 50 to 51**)

| Status | Risk | Mitigation |
|---|---|---|
| **Operational risks (continued)** | | |
| #3 Risk unchanged | **Unavailability of resources (people and materials)[a]**<br>We rely on the availability of skilled employees and contractor resources to maintain service levels and implement our investment plans. In the event of these resources being unavailable, we may experience significant disruption to our service, damage to our reputation and consequent regulatory action.<br><br>The risk has remained medium during the year with ongoing significant construction activity around London, including construction of the Thames Tideway Tunnel, currently underway, reducing contractor availability. | We seek to ensure that our relationship with critical suppliers is secured under long-term agreements, where appropriate. For key activities, we may retain more than one supplier to mitigate the risk of supplier failure. We also undertake significant due diligence in the selection and on-going management of suppliers through audit, inspection and verification of performance.<br><br>We also seek to mitigate this risk by maintaining a constructive relationship with employees regarding their remuneration through our Joint Negotiating and Consultative Committee, succession planning and investing in our employees through training, graduate and apprenticeship schemes.<br><br>During the year our senior leadership team participated in an extensive "Leading the Affinity Way" leadership programme. We expect this to have short and long-term benefits in creating and sustaining a high performing leadership environment. |
| #4 Risk increased | **Information security or privacy failure[a]**<br>Customer information and our data are at risk from unauthorised disclosure and improper use.<br><br>Failure to protect such information may lead to increased costs of operation, reputational damage, criminal fines and civil damages.<br><br>As the use of online communications, cloud-based technology and the sophistication of hackers continue to increase, so too does the risk of cyber attack. | During the year we continued to strengthen our capabilities to ensure that our technical and organisational controls against the unauthorised disclosure, loss or improper use of data are kept under review and improved where appropriate.<br><br>We have made significant progress in implementing a robust information security management system with a view to protecting ourselves against current and future threats. Our progress has been subject to expert third party review.<br><br>We are also progressing with our preparations for the General Data Protection Regulation which will come into force in 2018. |

# Strategic report continued

## Principal risks and uncertainties (continued)

Key:
Risk unchanged during the year | Risk increased during the year | Risk decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 50 to 51**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 50 to 51**)

| Status | Risk | Mitigation |
|---|---|---|
| **Regulatory risks** | | |
| #5 Risk unchanged | **Adverse changes to the regulatory framework**[a] Changes to the regulatory framework by Ofwat or the government may have an adverse effect on our operational or financial performance. Ofwat launched "Towards Water 2020" in July 2015 and a consultation in December 2015 on its preferred approach to the design of the future regulatory framework for the water industry for PR19. Ofwat published further thinking in May 2016 confirming its preferred approach following the December 2015 consultation and setting out specific areas for further consultation. The new framework aims to make greater use of markets in relation to the areas of sludge and water resources with separate binding price controls for both. For PR19 Ofwat has also confirmed its intention to use CPI, rather than RPI, for indexing revenues (and therefore prices) and RCV to be indexed using a combination of CPI and RPI. | We continue to contribute fully to consultations with our regulators and seek to ensure our voice is heard on emerging changes through strong relationships with all our stakeholders. |
| #6 Risk unchanged | **Adverse change in the social and/or political climate**[a] We are exposed to risks arising from the general social and political climate, for example, political pressure to restrict price increases and other issues, such as some objections to compulsory water metering. These pressures may lead to a reduction in revenue or have a reputational impact. | We continue to engage with our customers and their representatives to understand and respond to their issues and concerns. |
| #7 Risk unchanged | **Failure to comply with laws, our instrument of appointment and other recognised standards**[a] We need to ensure that our activities and outputs comply with licence conditions or statutory requirements arising from our appointment, and applicable laws and standards. Failure to do so may result in an enforcement order, a fine up to 10% of appointed turnover or termination of our appointment and special administration. | We continue to operate our abstraction, treatment and supply activities to environmental standard ISO14001 and have adopted the principles of other relevant management systems and standards. Our compliance programme is designed to ensure that: • all employees are adequately educated on the legislation and regulations particularly relevant to their specific job roles; and • appropriate assurance activities are in operation to provide positive evidence of compliance. |

Key:
Risk unchanged during the year | Risk increased during the year | Risk decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 50 to 51**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 50 to 51**)

| Status | Risk | Mitigation |
|---|---|---|
| **Regulatory risks (continued)** | | |
| #8 Risk unchanged | **Failure to deliver our business plan obligations**[a] We have made a number of performance commitments in our Business Plan which, if not met, may result in us incurring financial penalties and suffering reputational damage in the eyes of our regulators and other stakeholders. We must implement the investment programme set out in our Business Plan. Failure to do so may lead to the imposition of sanctions, including financial penalties or other enforcement action. | We have an established programme management function with responsibility for delivering the investment programme. The Board and senior management team monitor performance and ensure that corrective action is taken when required. Our 2016/17 investment programmes all made significant progress during the year and our run rates at the end of the year suggest that we are in a good position to deliver against 2017/18 targets. We continue to actively manage engagement with all our regulators and other stakeholders. In particular, we work very closely with our Customer Challenge Group, an independent body with an independent chair, which advises, challenges and supports us in the development of our plans, to ensure that they reflect customers' priorities. |
| #9 Risk unchanged | **Being required to undertake unremunerated activity**[a] We may experience unforeseen financial, regulatory or legal obligations or costs which were not taken into account by Ofwat in setting our price controls. For example, we incurred greater costs on delivery of the programme for opening the non-household retail market to competition than allowed for in the AMP6 price controls. | Our instrument of appointment provides some protection against unforeseen financial risks materialising during a price control period. We can 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% cost threshold has been met. There is no assurance that Ofwat will make an interim determination or that any determination made would provide adequate revenue compensation. Refer to risk number 11 for details of our mitigation in relation to liquidity risks. |
| #10 Risk increased | **Failure to operate effectively as a wholesaler in the non-household retail market**[a] During the year, we successfully completed preparations for the opening of the non-household market, which took place as planned on 1 April 2017. We are required to comply with our instrument of appointment, level playing field principles and competition law in respect of the market. | We exited the non-household retail market on 1 April 2017 by transferring this business to Affinity for Business (Retail) Limited, which operates as an independent business. Trading relationships are on arm's length terms. During the year, we provided training to all of our employees on the compliance requirements for the non-household retail market and we have updated our Condition R compliance code. We have established a level playing field committee to review and monitor our level playing field risks and the effectiveness of the controls in place to mitigate them. |

# Strategic report continued

## Principal risks and uncertainties (continued)

Key:
Risk unchanged during the year — Risk increased during the year — Risk decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 50 to 51**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 50 to 51**)

| Status | Risk | Mitigation |
|---|---|---|
| **Financial risks** | | |
| #11 Risk unchanged | **Liquidity risk[a]**<br>Our business has an on-going liquidity requirement, driven by the operational cash flows of the business and our substantial capital investment programme.<br><br>This results in liquidity risk in the event that we are unable to meet our cash flow requirements as and when they fall due. | We have revolving loan facilities, cash balances and standby loan facilities to meet our forecast cash flow needs. Our Treasury Policy requires us to maintain a minimum level of liquidity capable of covering at least twelve months' forecast cash flow requirements.<br><br>Longer term financing needs are sourced from the private and public bond markets. Our policy is to maintain a diverse portfolio of counterparties through which we can access liquidity at all times. This ensures we are not reliant on any single treasury counterparty. |
| #12 Risk unchanged | **Macro economic risk (interest rate, inflation and tax risks)[a]**<br>Movements in interest rates can result in an increase in the cost of our debt.<br><br>We have a financial covenant within our WBS documentation stipulating that at least 85% of our outstanding debt is hedged against movements in interest rates.<br><br>Our wholesale revenues in a given financial year are explicitly linked to the RPI published the previous November. An inability to control our cost inflation on the same basis would lead to a reduction in the company's profitability.<br><br>Our RCV is also linked to RPI and nominal returns are therefore likely to be further reduced in a low inflation environment.<br><br>We operate a pension plan providing defined benefits based on final pensionable salary. The assets and liabilities within the plan depend on a number of external factors outside our control, including performance of equity markets, interest rates and future inflation, which may increase the cost of our cash contributions.<br><br>During the year the government introduced proposals to take effect from 1 April 2017 that will limit the amount of interest that may be deductible for corporation tax purposes for the largest UK businesses. Draft legislation was dropped from the Finance Bill 2017 prior to the general election but it is anticipated that this will be brought forward by the new government. | Interest rate risk is primarily managed by using a mixture of fixed rate and inflation-linked borrowings, and approved hedging instruments.<br><br>Further disclosure on the management of interest rate and liquidity risks is included in **note A4** to the financial statements.<br><br>Each year we undertake a robust and challenging budgeting process to ensure costs are clearly understood and then subsequently controlled during the financial year.<br><br>We also use inflation-linked debt to ensure a proportion of our interest costs are linked to RPI and therefore offsets an element of the reduction in revenue and RCV that results from lower inflation.<br><br>The defined benefits pension plan has been closed to new members since September 2004 and the assets of the plan are held separately from those of the company.<br><br>We contribute fully to consultations with HMRC and HM Treasury through Water UK to avoid any unintended tax burden on the water industry.<br><br>With regards to the risk in respect of interest deductible for corporation tax, Water UK, on behalf of the industry as a whole, continues to respond to ongoing consultations. |

Key:
Risk unchanged during the year — Risk increased during the year — Risk decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 50 to 51**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 50 to 51**)

| Status | Risk | Mitigation |
|---|---|---|
| **Financial risks (continued)** | | |
| #13 Risk unchanged | **Breach of and changes to our financial covenants**<br>We are subject to a number of covenants in relation to our borrowings. If a covenant is breached, this could lead to an event of default with any outstanding borrowings becoming immediately repayable. | We have a regular monitoring and certification process of the covenants within our Whole Business Securitisation ('WBS') documentation. This covers information, financial and general covenants.<br><br>Our Treasury Policy requires that financial covenants, which include gearing and interest cover ratios, are monitored and reported on a regular basis to the Board. |
| #14 Risk unchanged | **Revenue and debtor risk[a]**<br>Customer debt and affordability remain key areas of focus for our business.<br><br>We are not permitted to disconnect water supplies to household and certain other types of premises in the event of non-payment, resulting in loss of revenue and increased cost of collection. | We have processes and teams dedicated to the efficient collection of customer debt.<br><br>For those customers who want to pay their bill but struggle to do so, we have payment arrangements that are as flexible as possible and we encourage customers who find themselves in difficulty to contact us as early as possible. We also have a social tariff 'LIFT' to help support customers who are least able to pay their bills. |

**Vote to leave the European Union**

The Board anticipates that whilst the company's activities may be impacted by the UK's decision to leave the European Union over the long-term, the impact is unlikely to be significant in the near term. The company's exposure to inflation rates is broadly hedged with revenue and some significant costs are already secured to the end of AMP6. The company has also secured financing for AMP6 and for the next price control period, AMP7. The company is exposed to foreign exchange rate movements, as some foreign purchase contracts are unhedged; however this exposure is minimal. Finally, although the company's pension plan is currently in an accounting surplus, large market movements may reduce or eliminate this surplus.

# Strategic report continued

## Principal risks and uncertainties (continued)

### VIABILITY STATEMENT

The directors have assessed the company's financial viability over the five-year period to 31 March 2022 (the 'lookout period'). This is based on the period for which the company provides forecasts to its shareholders. The forecasts project beyond the current price control period in view of our WRMP, which identifies over a 25 year period how we will balance available supplies and required demand with sufficient headroom for unplanned outage. For more information refer to our long-term planning on **page 25**.

The directors reviewed the principal risks and uncertainties facing the company set out in the previous section, and assessed which of these risks might threaten the company's financial viability during the lookout period given the likely effectiveness of current and available mitigating actions.

They determined that it was reasonable to expect that none of the individual principal risks identified in the principal risk table on **pages 43 to 49** with the icon (a) would in isolation compromise the company's financial viability during the lookout period. Instead these risks could be considered in a number of different severe but plausible combinations through stress-testing forecasts using sensitivities set at a level reflecting a realistic assessment of how actual cash flows could vary during the lookout period.

Stress-testing was performed on a Board approved base case cash flow forecast (the 'base case cash flow forecast') reflecting the company's actual debt structure, projected revenues for the period to 31 March 2020 as allowed by Ofwat's final determination of price controls and anticipated expenditure for AMP6, together with a projection for the years ending 31 March 2021 and 31 March 2022 (the first two years of the next price control period, AMP7). The projections assume that regulatory price setting mechanisms remain unchanged from PR14 with an updated weighted average cost of debt calculation for return on RCV to reflect the company's forecast debt structure.

The expectation that revenue will be indexed in relation to CPI and RCV a combination of CPI and RPI (refer to risk number 5) with effect from 1 April 2020 is reflected in the projections.

The following sensitivities were used in stress-testing the base case cash flow forecast:

- 10% increase in total expenditure;
- 5% increase in unpaid water customer bills
- 1% decrease in RPI;
- 1% decrease in the November RPI forecast impacting revenue only;
- replacing the base RPI forecast with a negative 1% forecast, while maintaining a 1% increase in expenditure; and
- 1% decrease in the November RPI forecast impacting revenue only, 5% increase in total expenditure and 5% increase in unpaid water customer bills.

The sensitivities applied in relation to total expenditure, revenue and unpaid water customer bills are in line with those used in testing performed during the PR14 determination to assess the robustness and financeability of our Business Plan. The RPI sensitivities reflect severe but plausible scenarios in the context of the company's inflation-linked debt and inflation-linked costs (for example staff costs), which act as natural hedges to any revenue decreases as a result of RPI reduction.

For the principal risk identified in the principal risk table on **pages 43 to 49** with the icon (b), the directors considered that this risk might in isolation threaten financial viability in the event of a major asset failure, potentially leading to significant unforeseen additional cash requirements during the lookout period. Stress-testing was performed on the base case cash flow forecast to specifically model the effects on cash flow of a reasonably plausible but severe major asset failure.

Together with the results of this stress-testing, the directors have also considered the following:

- the company's robust capital solvency position with a debt to RCV ratio of no more than 80%;
- the interest rates and maturity dates of the company's existing long-term bonds, which are matched to its long-term outlook and expenditure commitments, that fall outside of the lookout period;
- the company's ability to renew its short-term borrowing facilities under most market conditions;
- the ability to restrict dividend payments as a key mitigating action; and
- the protections which exist under the regulatory model that a primary legal duty of Ofwat is to ensure that water companies can finance their function.

To conclude, the directors confirm that they have a reasonable expectation that the company will continue to operate and meet its liabilities, as they fall due, for the lookout period.

## Approval of the strategic report

**By order of the Board**

**Dr Philip Nolan**

Chairman
27 June 2017

# Strategic report continued

## Our Customer Charter in action

*An Affinity for our colleagues, customers and the environment we serve*

CASE STUDY

### Building strong partnerships with local experts

By building strong partnerships with local experts who reflect our values and objectives we believe we can achieve more for the communities we serve.

The Wildlife Trust shares our strong focus on protecting the local environment and habitat. Having been members of the Essex Wildlife Trust for over 25 years, this year we have committed our support to Wildlife Trusts across our supply area including Herts and Middlesex, Surrey, Kent and Essex. These partnerships have brought valuable insight to the long-term sustainable management of our natural assets, which include key local nature reserves such as Stockers Lake Complex.

Our partnership has brought expertise from the Trusts into the development of our long-term plans, securing investment from our asset management and estates teams. The mutual support provided by the partnership has also transformed everyday management and stakeholder engagement. By establishing a dedicated People and Wildlife Officer there is real focus on public engagement and the management plans for the site.

Our teams have built great working relationships based on trust and the desire to link our communities with the environment.



# Governance

## Letter from the Chairman

**DR PHILIP NOLAN**
**Chairman**

### UK CORPORATE GOVERNANCE CODE COMPLIANCE

During the year, our business was owned by a combination of private equity and private investors and the principles of the UK Corporate Governance Code were applied in this context.

The Code is founded on the principle of "comply or explain" which recognises that departure from specific provisions may be justified provided reasons for the departure are clearly explained.

The Board considers that the company complies with the principles of the UK Corporate Governance Code (2014) ("the Code"), except in terms of:

- Board composition
- Membership of the Remuneration and Nomination Committees
- Appointment of a senior independent director
- Re-election of directors
- Externally facilitated board evaluation

The reason for each departure is explained within the relevant section of this corporate governance report.

Our governance also has regard to the *Guidelines for Disclosure and Transparency in Private Equity (the Walker Guidelines)* and the work of the Private Equity Reporting Group established to monitor conformity with the Guidelines.

### OUR DIRECTORS

Our directors and their biographies are shown on **pages 54 to 56**. Where a director holds other directorships within the Affinity Water group of companies, the numbers listed alongside his or her name are cross referenced to the relevant company shown on the structure chart on **page 70**.

Membership of our Audit Committee: (A), Remuneration Committee: (R) and Nomination Committee: (N) is also listed alongside the relevant director's name.

I am pleased to present our Corporate Governance Report for 2016/17 on behalf of the Board. My role, together with the Board, is to ensure that we operate to the highest standards of governance.

We support the principles of good corporate governance set out in the 2014 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 Governance Code sets out for our customers, investors, regulators and other stakeholders how we govern and operate our business to high standards of good governance: accountability, transparency, probity and focus on the sustainable success of our business. It is founded on the obligations in our licence conditions with respect to the governance and ring-fencing of our regulated business, and the principles set out in Ofwat's 2014 paper: *Board leadership, transparency and governance – principles*.

Our shareholders have an important role to play and a direct interest in the strong and effective governance and stewardship of our business. We explain how we engage with our shareholders and involve them in decision making in our publication: Engaging with our shareholders. We also publish information about how our UK holding company applies Ofwat's 2014 paper: *Board leadership, transparency and governance – holding company principles*. These publications are available on our website.

During the year we established a functionally separate non-household retail business and put in place the necessary governance to operate this business on a stand-alone basis. On 1 April 2017, we transferred this business to Affinity for Business (Retail) Limited, an associate company licensed to retail non-household water supply and sewerage services. By exiting the non-household retail market and the consequent legal separation of the two businesses, we are confident that we have put in place appropriate arrangements to provide confidence to stakeholders that the company, as a wholesaler, will treat all retailers in the non-household retail market on a level playing field basis.

We continue to meet Ofwat's expectations for independent non-executive directors to form the largest single group on the Board, compared to investor-appointed non-executive directors and executive directors. We have adopted a policy on diversity, including gender and ethnicity, and will keep under review progress made against the policy.

# Governance continued

## Board leadership, transparency and governance

### BOARD OF DIRECTORS

**Chairman**

***Dr Philip Nolan*** R N 12[1]

Dr Philip Nolan was appointed to the Board as Chairman in April 2013 and reappointed for a further three year term from 1 April 2016. Philip is also Chairman of John Laing Group plc, a specialist investor and manager of infrastructure assets, Ulster Bank Limited and ABP 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.

**Executive directors**

***Simon Cocks – Chief Executive Officer (CEO)*** 2 3 4 15

Simon Cocks was appointed to the Board in June 2015. Simon is an electrical engineer with extensive experience of the water and energy industries. He was previously Severn Trent's Managing Director of Wholesale Operations and has extensive cross sector experience in leadership roles in the utility sector. Prior to joining Severn Trent in 2009, Simon was a senior executive at National Grid and started his career at London Electricity.

***Duncan Bates – Chief Financial Officer (CFO)*** 2 3 4 12 13 14

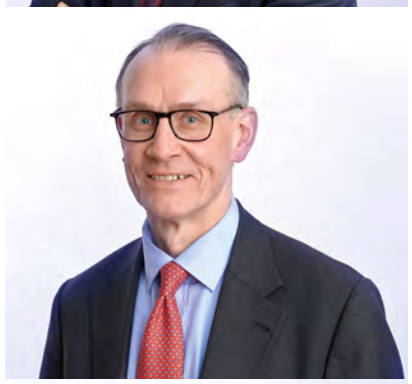
Duncan Bates is Chief Financial Officer of Affinity Water Limited, having joined the company in March 2012 and been appointed to the Board in September of that year. He joined Veolia in 1992 and held a number of financial posts until his appointment as Veolia Environnement UK's Group Financial Controller 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. Duncan will retire from the business during July 2017.

[1] The Board considers that Dr Philip Nolan's chairmanship of Affinity Water Acquisitions (Investments) Limited, the company's UK holding company during the report year, benefited the company, by providing insight into the views of the company's shareholders, and did not compromise his ability to act independently of management and shareholders.

**Independent non-executive directors**

***Chris Bolt*** A R

Chris Bolt joined the Board in February 2015. He has worked in the field of economic regulation for more than twenty years, holding senior roles in both the public and private sectors. His regulation experience has included Ofwat (from 1989 to 1994), the Office of the Rail Regulator (from 1994 to 1999) and Transco plc (from 1999 to 2002). More recently, he was the statutory Arbiter for the London Underground Public-Private Partnership Agreements (from 2002 to 2011), and the first Chairman of the Office of Rail Regulation (from 2004 to 2009). Chris now provides independent regulatory advice to the government, companies and regulators.



***Patrick O'D Bourke*** A N

Patrick O'D Bourke was appointed to the Board in July 2013. Patrick is a Chartered Accountant and is Group Finance Director of John Laing Group 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. Our Board is satisfied that the cross directorship with Dr Philip Nolan does not compromise his ability to act independently[1].

***Trevor Didcock*** A

Trevor Didcock was appointed to the Board in November 2015. Trevor was Chief Information Officer at EasyJet plc from 2010 to 2015, HomeServe plc from 2008 to 2010, the Automobile Association ('AA') Limited from 2003 to 2007 and Group IT Director at RAC Motoring Services Limited from 1999 to 2003. Trevor now provides advisory services to organisations in IT and transformational change and is a non-executive director at Futurice Oy and a non-executive member of the Transformation Programme Board at the Civil Aviation Authority.

***Susan Hooper*** R

Susan Hooper joined the Board in November 2015. She is a non-executive director at Rank Group plc, Wizz Air Holdings plc and the Department for Exiting the EU. She is a Professor of Practice at the LUISS Business School in Rome with a special focus on Customer Centricity and works with private equity companies developing opportunities in the travel industry. Susan was previously Managing Director of British Gas Services Limited and Chief Executive of the Acromas Group's travel division from 2009 to 2013, where she was responsible for Saga Holidays, Hotels, Cruises, the AA Travel division and Titan Travel.

[1] On appointment, our Board recognised the existence of a cross directorship relationship with Dr Philip Nolan. Taking into account Patrick O'D Bourke's considerable experience of senior roles within the regulated utility sector and his personal qualities and character, our Board is satisfied that the cross directorship does not compromise his 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.

# Governance continued

## Board leadership, transparency and governance (continued)

### Non-executive directors

***Gareth Craig*** 2 3 4 5 6 7 8 9 10 18

Gareth Craig was co-founder and former Head of Infrastructure at HSBC Specialist Investments. He was responsible for establishing HICL Infrastructure Company Limited by way of an initial public offering in 2006 and has more than 20 years' experience of the financing and management of major infrastructure projects. Following retirement from Infrared Capital Partners (the investment adviser to HICL) in 2015, Gareth now acts as consultant and non-executive director for infrastructure and asset intensive businesses. He is Chairman of Green Frog Power, a specialist in providing peaking power to the electricity capacity market.

***Jaroslava Korpancova*** 2 3 4 5 6 7 8 9 10 16

Jaroslava Korpancova is Managing Director at Allianz Capital Partners. Since joining Allianz in 2008, she has led the investments made in a number of infrastructure assets, including the Thames Tideway Tunnel, Porterbrook (the train rolling stock leasing business) and the gas distribution business of National Grid. Before joining Allianz Capital Partners in 2008, Jaroslava worked at AIG Financial Products on a number of debt and equity investments, including the acquisition and management of London City Airport. She is a member of the New York bar and a solicitor of the Supreme Court of England and Wales.

***Angela Roshier*** 2 3 4 5 6 7 8 9 10 17

Angela Roshier is DIF's Partner and and Head of Asset Management. She joined in 2010 and oversees the asset management of DIF's PPP and renewable energy Investments. Prior to DIF, Angela was a member of 3i Plc and Actis's Infrastructure teams. Over the past 19 years she has contributed to the origination and asset management of a wide variety of infrastructure assets in the PPP, water, oil tanking and railway sectors, both in Europe and emerging markets. She holds a MBA from London Business School and a MA from the University of Cambridge.

**Former Directors**

***Stephen Nelson***
Non-executive director
31 March 2015 to 19 May 2017

***Nigel Paterson***
Non-executive director
25 July 2014 to 19 May 2017

***Jim Wilmott***
Non-executive director
25 July 2012 to 19 May 2017

### GOVERNANCE INFORMATION

**Schedule of Matters Reserved for the Board**

The Board reserves to itself approval of certain key matters such as:

- Strategy and management
- Changes to structure and Capital
- Annual capital and operating budgets
- Financial statements
- Interim dividends
- Key regulatory reports and submissions
- Delegations of authority
- Corporate governance matters
- Key corporate policies

The full schedule of matters reserved to the Board is published on the company's website.

**Board Committee Terms of Reference**

The terms of reference for the Audit Committee, Remuneration Committee and Nomination Committee are reviewed periodically and published on the company's website at:

**stakeholder.affinitywater.co.uk/our-governance.aspx**

**Roles of the Chairman and Chief Executive Officer**

The roles of the Chairman and Chief Executive Officer are separate. The division of their responsibilities is clearly set out in writing, agreed by the Board and published on the company's website.

**Conflicts of Interest**

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.

### 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 Chairman, Dr Philip Nolan, leads our Board and is responsible for ensuring its effectiveness in 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. Dr Philip Nolan is also Chairman of Affinity Water Acquisitions (Investments) Limited[1].

The Chairman regularly meets our independent non-executive directors without executives present. He also meets with our shareholders 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 that the appointment of a senior independent non-executive director is required. This is a departure from the relevant provision of the Code.

The Board's role is to lead the company and set its strategy to ensure the long-term success of the business. It 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 working effectively. The Board also has responsibility for reviewing performance, resources and standards of conduct.

[1] The Board considers that Dr Philip Nolan's chairmanship of Affinity Water Acquisitions (Investments) Limited, the company's UK holding company during the report year, benefited the company, by providing insight into the views of the company's shareholders, and did not compromise his ability to act independently of management and shareholders.

# Governance continued

## Board leadership, transparency and governance (continued)

### BOARD COMPOSITION AND BALANCE

The composition of the Board during the year is illustrated in the diagram below.

Key
- Chairman
- Executive Director
- Independent Non-Executive Director
- Non-Executive Director

During the year we met Ofwat's expectation that independent non-executive directors should comprise the largest single group on the Board. The Board considers this composition appropriate for a company owned by private investors, while noting it is a departure from the Code provision for at least half of the Board, excluding the Chairman, to comprise non-executive directors determined by the Board to be independent. The board balance in place throughout the year has been maintained following the company's change of ownership on 19 May 2017.

We consider that the composition of our Board is appropriate for balancing the needs of customers, the environment and our shareholders, as the composition of our Board is such that no single director or group of directors can dominate the Board's decision making.

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. They are of sufficient calibre and have sufficient experience for their views to carry significant weight in Board decisions. The terms of appointment of our independent non-executive directors are available on the governance pages of our website:

**stakeholder.affinitywater.co.uk/our-governance.aspx**

### RE-APPOINTMENT OF DIRECTORS

The company's articles of association provide that at each Annual General Meeting ("AGM") any director appointed since the previous AGM, or any director who held office at the previous two AGMs without retiring and being re-elected, must retire and seek re-election. While these arrangements depart from the Code provision 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. In accordance with these provisions, Patrick O'D Bourke, Gareth Craig, Jaroslava Korpancova and Angela Roshier are required to retire from office and seek re-election at this year's AGM.

### DIVERSITY

The Board, led by the Chairman, is responsible for ensuring that the company's directors have a diverse range of backgrounds and skills, The Board values the contribution that all our non-executive directors bring to the governance of the company, and believes that their balance of skills, experience, independence and knowledge of the company ensures strong leadership and governance.

The Board is committed to diversity and equality of opportunity amongst employees and directors, including both executive and non-executive roles.

The Board values diversity in all forms, including gender, ethnicity and characteristics such as intellect, education, critical assessment and judgement, courage, openness, honesty and tact; and the ability to listen, forge relationships and develop trust.

The search for board candidates and senior executives will be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity.

To this end, when engaging the services of executive search firms to identify candidates for Board and senior executive positions, only those search firms who have signed up to the Voluntary Code of Conduct for Executive Search Firms will be engaged.

A breakdown is provided on **page 23** of the number of persons of each gender who at 31 March 2017 were directors, senior managers and employees of the company.

### COMPANY SECRETARY

The Company Secretary works with the Chairman and respective committee Chairs to develop and agree a forward agenda for the Board and Committee meetings for the year ahead. The Company Secretary is responsible for advising the Board through the Chairman on all governance matters, and ensuring that the Board and its Committees receive regular written reports from management that are accurate, timely and contain clear information to enable them to discharge their duties.

The Company Secretary facilitates good information flows within the Board and its committees and between senior management and non-executive directors. All directors have access to the advice and services of the Company Secretary and where a director requires access to independent professional advice; the Company Secretary is responsible for making appropriate arrangements at the expense of the company.

The appointment and removal of the Company Secretary is a matter for the Board as a whole.

# Governance continued

## Board leadership, transparency and governance (continued)

### THE BOARD

The Board is the principal decision making body and provides entrepreneurial leadership within a framework of prudent and effective controls. It sets the company's strategic aims, ensures that the necessary financial and human resources are in place to meet objectives and review management performance. The Board sets the company's values and standards and ensures that its obligations to its shareholders and others are understood and met.

Executive responsibility for delivery of the objectives set by the Board is delegated to the Chief Executive Officer. The Board delegates certain roles and responsibilities to its principal board committees. The committees report to the Board on matters discussed, decisions and actions taken. They make any necessary recommendations to the Board in accordance with their Terms of Reference and minutes of their meetings are made available to the Board.

The Board has established three standing committees: the Audit Committee, Remuneration Committee and Nomination Committee.

Each committee operates in accordance with Terms of Reference approved by the Board. These are published on the governance pages of our website:

**stakeholder.affinitywater.co.uk/our-governance.aspx**

#### Audit Committee

The Audit Committee assists the Board in discharging its responsibilities for the integrity of the company's financial statements, the assessment of the effectiveness of the systems on internal controls, risk management and the internal and external auditors. Refer to **page 64** for more information.

#### Remuneration Committee

The Remuneration Committee determines the company's policy on the remuneration of the Chairman, directors, and other senior executives. Refer to **page 65** for more information.

#### Nomination Committee

The Nomination Committee assists the Board by keeping the structure, size, composition and succession needs of the Board under review. It reviews the skills and experience of members which are best able to balance the needs of our business. Refer to **page 66** for more information.

### BOARD ACTIVITY 2016/17

The table below outlines some of the matters considered by the Board during the year.

| Aspect | Activity |
|---|---|
| People | • reviewed and discussed the health and safety of employees<br>• considered the results of the annual employee engagement survey and the actions being taken by management<br>• approved a revised Code of Conduct for employees |
| Non-household retail market | • discussed and assessed the future direction of the non-household retail business and approved retail exit to an associated legal entity<br>• kept under review preparations for non-household retail market opening, including the readiness of the company's systems, people and processes to operate effectively in the new market and approved the interim assurance and final assurance letters to Ofwat<br>• reviewed Ofwat's proposals to modify water companies' licence conditions to facilitate the non-household retail market opening<br>• approved a policy for operating in the non-household retail market on a level playing field basis and supporting governance arrangements |
| Operating Performance | • kept under review performance against AMP6 performance commitments and associated outcome delivery incentives<br>• kept under review general operating performance, including water quality, leakage, supply interruptions, developer services, customer satisfaction, financial and IT systems. |
| AMP6 Capital Programme | • kept under review the delivery of the AMP6 capital programme |
| Risk Management | • reviewed the principal risks of the company<br>• reviewed the effectiveness of the company's internal control systems and risk management processes, including those relating to cyber security and information strategies<br>• reviewed the company's preparations for managing and mitigating risk arising from the HS2 programme of works |
| Regulatory Matters | • reviewed the work undertaken to prepare wholesale and retail tariffs for 2017/18 and approved 2017/18 tariffs and charges schemes<br>• reviewed the work undertaken by management to prepare (and assurance providers to assure) the Annual Regulatory Performance Report and Customer Performance Report for 2015/16<br>• met the Chair of the Customer Challenge Group to discuss the group's annual report on its work<br>• reviewed Ofwat's proposals to modify water companies' licence conditions to facilitate the non-household retail market opening and revised forms of price control at PR19<br>• considered Ofwat's consultation on its final 2010-2015 reconciliation proposals for PR19 |
| Finance | • reviewed and approved the interim and full-year financial statements and the Annual Regulatory Performance Report, including the long term viability statement and regulatory certificates<br>• kept treasury matters under review and considered and approved a project to extend the tenor of £65.8m of Class A debt from 2022 to 2042<br>• agreed the revised schedule of contributions put in place with the Affinity Water Pension Plan Trustee in respect of the defined benefit scheme<br>• reviewed and approved interim dividend proposals |
| Governance | • approved the re-appointment of Dr Philip Nolan as Chairman for a further three year term<br>• reviewed the company's governance arrangements against the requirements of the UK Corporate Governance Code and Ofwat's governance principles<br>• considered the arrangements established by Ofwat for pre-appointment meetings with prospective non-executive director appointments<br>• approved revised Terms of Reference for the Audit Committee, reflecting changes to the UK Corporate Governance Code for future reporting periods<br>• approved the company's Human Trafficking and Modern Slavery Statement |

# Governance continued

## Board leadership, transparency and 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 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 are fair, balanced and understandable and provide the information necessary for shareholders to assess the company's position and performance, business model and strategy.

The Board believes that the disclosures set out on **pages 8 to 51** 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 monitoring 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 the 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 function, the head of which (the Head of Audit, Risk and Compliance) reports to the Audit Committee, together with other internal control and assurance resources which monitor compliance with laws, regulations, policies and procedures;
- the setting and monitoring of annual budgets at a detailed level supported by a five-year forecast;
- 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 appropriate external assurance review, both fiscal and operational.

The Board approves the company's annual budget and regularly reviews actual performance. All major transactions are reviewed and approved by the Board.

The main features of the company's internal control and risk management systems in relation to the financial reporting process include:

- a structured review process for year-end financial reporting, including review by the Audit Committee early in the drafting process;
- recruitment, training and development of appropriately qualified and experienced financial reporting personnel;
- formalised monthly close control procedures, including journal approval and validation, balance sheet reconciliations and ledger checks; and
- preparation of monthly management accounts on the same basis of accounting as year-end financial reporting.

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 employees 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 principal risks the company faces, including those that would threaten its business model, future performance, solvency or liquidity. This framework has been in place for the year under review and up to the date of approval of this annual report and financial statements. Refer to **page 43** of the strategic report for further information.

The Board confirms that it:

- is satisfied that it has carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity; and
- has reviewed the effectiveness of the risk management and internal control systems including all material financial, operational and compliance controls (including those relating to the financial reporting process) and no significant failings or weaknesses were identified.

In reviewing the effectiveness of risk management and internal control systems, the Board took into account:

- its bi-annual review of the strategic risk register;
- the oversight of treasury matters; and
- reports from the Executive Management Team, the Audit Committee, external Auditor and other assurance providers, and the Internal Audit function in relation to internal control and risk management systems.

# Governance continued

## Board leadership, transparency and governance (continued)

### BOARD COMMITTEES

**Audit Committee**

During the year, membership of the Audit Committee was as follows:

- Patrick O'D Bourke
- Chris Bolt
- Trevor Didcock
- Stephen Nelson[1]
- Jim Wilmott[1]

The Committee is chaired by Patrick O'D Bourke, an independent non-executive director who has relevant and up to date financial experience, and as a whole, members have competency relevant to regulated utilities and infrastructure businesses. The Chief Financial Officer, Head of Audit, Risk and Compliance, external Auditor and other parties are invited to attend meetings as appropriate.

The Committee considers matters identified by the external Auditor in its report to the Committee and, where significant, reports these to the Board. It reviews the provision of non-audit services by the external Auditor to ensure they do not impinge on the external Auditor's independence in undertaking the statutory audit and has primary responsibility for making a recommendation on the appointment, re-appointment and removal of the external Auditor. Information received from the Internal Audit team and the external Auditor is reported at each Committee meeting (a fundamental part of our risk management process).

The Committee reviews policies and the overall process for identifying and assessing business risks, liaising closely with the external Auditor. It receives regular assurance reports from Internal Audit, management and others on the operational effectiveness of matters related to risk and control, and monitors the timeliness and effectiveness of corrective action taken by management. It also monitors and reviews the effectiveness of internal audit activities.

The Committee carries out a robust assessment of the company's principal risks and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy, and considers the clarity of reporting to ensure that shareholder interests are properly protected in relation to financial reporting and internal controls.

An evaluation of the Committee was undertaken in November 2016 by assessing its performance against a range of criteria aligned to the Committee's terms of reference. The assessment confirmed year on year improvement across the range of assessment criteria, particularly the progress made in respect of the Committee's understanding of the company's risk management and internal control framework. It was agreed that work in this area should remain an area of focus, alongside facilitating the development of skills and knowledge.

Further information on the work of the Audit Committee is contained in the Audit Committee report on **pages 73 to 77**.

[1] Stephen Nelson and Jim Wilmott resigned from the Audit Committee on 19 May 2017.

**Remuneration Committee**

During the year, membership of the Remuneration Committee was as follows:

- Susan Hooper
- Chris Bolt
- Dr Philip Nolan
- Stephen Nelson[1]
- Jim Wilmott[1]

The Committee is chaired by Susan Hooper and meets Ofwat's expectations for there to be a majority of independent members. While the Code provision for remuneration committees to comprise at least three independent non-executive directors is not fully met, the Board considers that having a majority of independent members (including the Chairman) is appropriate for a privately owned company.

The Committee 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. In particular, the Committee seeks to ensure that executive directors' remuneration is designed to promote the long term success of the company and performance related elements are transparent, stretching and rigorously applied. Refer to **pages 78 to 87** for the Remuneration Report.

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 during the year is contained in the remuneration report on **pages 78 to 87**.

[1] Stephen Nelson and Jim Wilmott resigned from the Remuneration Committee on 19 May 2017.

# Governance continued

## Board leadership, transparency and governance (continued)

### BOARD COMMITTEES (CONTINUED)

**Nomination Committee**

During the year, membership of the Nomination Committee was as follows:

- Dr Philip Nolan
- Patrick O'D Bourke
- Stephen Nelson[1]
- Jim Wilmott[1]

The Committee is chaired by Dr Philip Nolan. While the Code provision for nomination committees to comprise a majority of independent non-executive directors is not met, the Board notes that the composition achieves a balance between the two shareholder members and two independent members. This provides assurance that the Committee is not dominated by any particular group of its members.

The Committee is required to lead the process for board appointments and to evaluate the balance of skills, experience, independence and knowledge on the Board to ensure the needs of the business, customers, shareholders, the environment and other stakeholders are identified and met, and to achieve the representation and diversity required. In particular, the Committee is responsible for:

- considering succession planning for directors and other senior executives;
- keeping under review the leadership needs of the company to ensure the continued ability of the company to compete effectively in the market in which it operates; and
- identifying and nominating for board approval, candidates to fill board vacancies.

The Nomination Committee did not meet formally during the year. However, members of the Committee met informally at the request of the Board to initiate and support the process to find a successor to Duncan Bates as Chief Financial Officer.

An executive search firm, Russell Reynolds Associates, which is unconnected to the company, was used to identify candidates. Russell Reynolds Associates is a member of the Voluntary Code of Conduct for Executive Search Firms to address gender diversity on corporate boards and best practice for the related search processes.

On 23 June 2017 the company announced the appointment of Stuart Ledger as the Chief Financial Officer of Affinity Water Limited. He will also be appointed a director of the company. He is expected to take up his role by the end of December 2017.

[1] Stephen Nelson and Jim Wilmott resigned from the Nomination Committee on 19 May 2017.

### BOARD AND COMMITTEE ATTENDANCE, EFFECTIVENESS AND EVALUATION

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.

On appointment to the Board, directors are provided with a comprehensive induction which includes information on our business model, key operations and processes, strategic plans, financial reports, business plans, our governance framework and information regarding directors' roles and responsibilities, legal and regulatory duties.

The following table sets out attendance at meetings for the year ended 31 March 2017.

| | Board | Audit Committee | Remuneration Committee | Nomination Committee |
|---|---|---|---|---|
| **Number of meetings in year** | **8** | **4** | **4** | **0** |
| **Chairman** | | | | |
| Dr Philip Nolan | 8/8 | - | 4/4 | 0/0 |
| **Independent non-executive directors** | | | | |
| Chris Bolt | 8/8 | 4/4 | 4/4 | - |
| Patrick O'D Bourke | 8/8 | 4/4 | - | 0/0 |
| Trevor Didcock | 7/8 | 4/4 | - | - |
| Susan Hooper | 7/8 | - | 4/4 | - |
| **Executive directors** | | | | |
| Simon Cocks | 8/8 | - | - | - |
| Duncan Bates | 8/8 | - | - | - |
| **Former directors** | | | | |
| Stephen Nelson | 7/8 | 3/4 | 4/4 | 0/0 |
| Nigel Paterson | 7/8 | - | - | - |
| Jim Wilmott | 8/8 | 4/4 | 4/4 | 0/0 |

- denotes non-membership of that Committee

The Board evaluated its performance during 2016/17 by means of a questionnaire completed by the directors covering the range of their responsibilities and procedures. This process, while considered appropriate for a company owned by private investors, did not meet the provision of the Code for Board evaluation to be externally facilitated at least every three years. The Board considers that an externally-facilitated evaluation would be beneficial and plans for this to take place during 2018/19 to allow time for the newly-constituted board to work together, following the recent acquisition of the company.

The evaluation undertaken by the Board for 2016/17 confirmed that the Board was working effectively and identified opportunities to improve in the following areas: succession planning for key Board members and senior managers; induction on appointment and on-going training to meet development needs of Board members; and undertaking an externally-facilitated evaluation of Board performance at least every third year.

Details of the Audit Committee's performance evaluation are provided in the Audit Committee's report. The performance of the Remuneration Committee and Nomination Committee was evaluated informally. Evaluation of the performance of individual directors will be undertaken ahead of the AGM. Dr Philip Nolan will lead the evaluation, while another independent non-executive director will lead the evaluation of Dr Philip Nolan and Patrick O'D Bourke, in view of their cross directorship.

# Governance continued

## Board leadership, transparency and governance (continued)

### RELATIONSHIP WITH OUR SHAREHOLDERS

The presence on our Board of directors appointed by our shareholders facilitates effective face-to-face dialogue with our shareholders, and allows all the members of the Board, in particular the independent non-executive directors, to develop an understanding of our shareholders' views. Good governance practices provide our shareholders with the opportunity for open and transparent dialogue with the non-executive directors and assurance on the Board's stewardship of their investment.

There are a limited number of matters requiring shareholder approval, reflecting the matters on which a company with listed equity shares would typically involve shareholders in decision-making. It is the Board's responsibility to ensure that a satisfactory dialogue with shareholders takes place that is based on a mutual understanding of the company's objectives. Our shareholders have an important role to play in the strong, effective governance and stewardship of our business, and we maintain an open and transparent relationship with our shareholders to facilitate this.

Our shareholders discharge their responsibilities as shareholders through their representation on our Board and through their participation in, and approval of, decisions relating to matters reserved for shareholder approval, and these can be found in our publication: *Engaging with our shareholders*, available on the governance pages of our website:

**stakeholder.affinitywater.co.uk/our-governance.aspx**

Further information about our shareholders and their ownership is provided on **page 69**.

### 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. Our Governance Code is therefore published on the governance pages of our website:

**stakeholder.affinitywater.co.uk/our-governance.aspx**

**By order of the Board**

**Tim Monod**
Company Secretary
27 June 2017

## Ownership and financing

### OWNERSHIP

Throughout 2016/17, the effective equity interests in the company were:

| | |
|---|---|
| North Haven Infrastructure Partners LP | 40% |
| Infracapital Partners II (comprising Infracapital Partners II LP and Infracapital Partners (NT) II LP | 35% |
| Partners Group Global Infrastructure 2012 INC and Partners Group Direct Infrastructure 2011 LP (together managed by Infracapital Partners II) | 5% |
| Beryl Datura Investment Limited | 10% |
| Veolia Water UK Limited | 10% |

Our UK holding company was Affinity Water Acquisitions (Investments) Limited. We considered Infracapital Partners II and North Haven Infrastructure Partners LP to be our ultimate controllers, as they were in a position to exercise material influence over our policy and affairs. Further information about these entities is provided in our 2015/16 annual report and financial statements

On 19 May 2017, Affinity Water Acquisitions (Investments) Limited was acquired by a consortium comprising DIF, HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited) and Allianz Capital Partners on behalf of the Allianz Group. As part of the transaction, the consortium also acquired Veolia Water UK Limited's 10% equity interest stake in the company.

The consortium made its investment through Daiwater Investment Limited which is now our UK holding company. We consider the following entities to be our ultimate controllers, as they are in a position to exercise material influence over our policy and affairs:

- Allianz Infrastructure Luxembourg I Sarl
- DIF Management Holding BV
- DIF Management UK Limited
- HICL Infrastructure Company Limited
- InfraRed Capital Partners (Management) LLP

These entities, together with Daiwater Investment Limited, 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 our Instrument of Appointment; and
- use their best endeavours to ensure that our Board maintains 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.

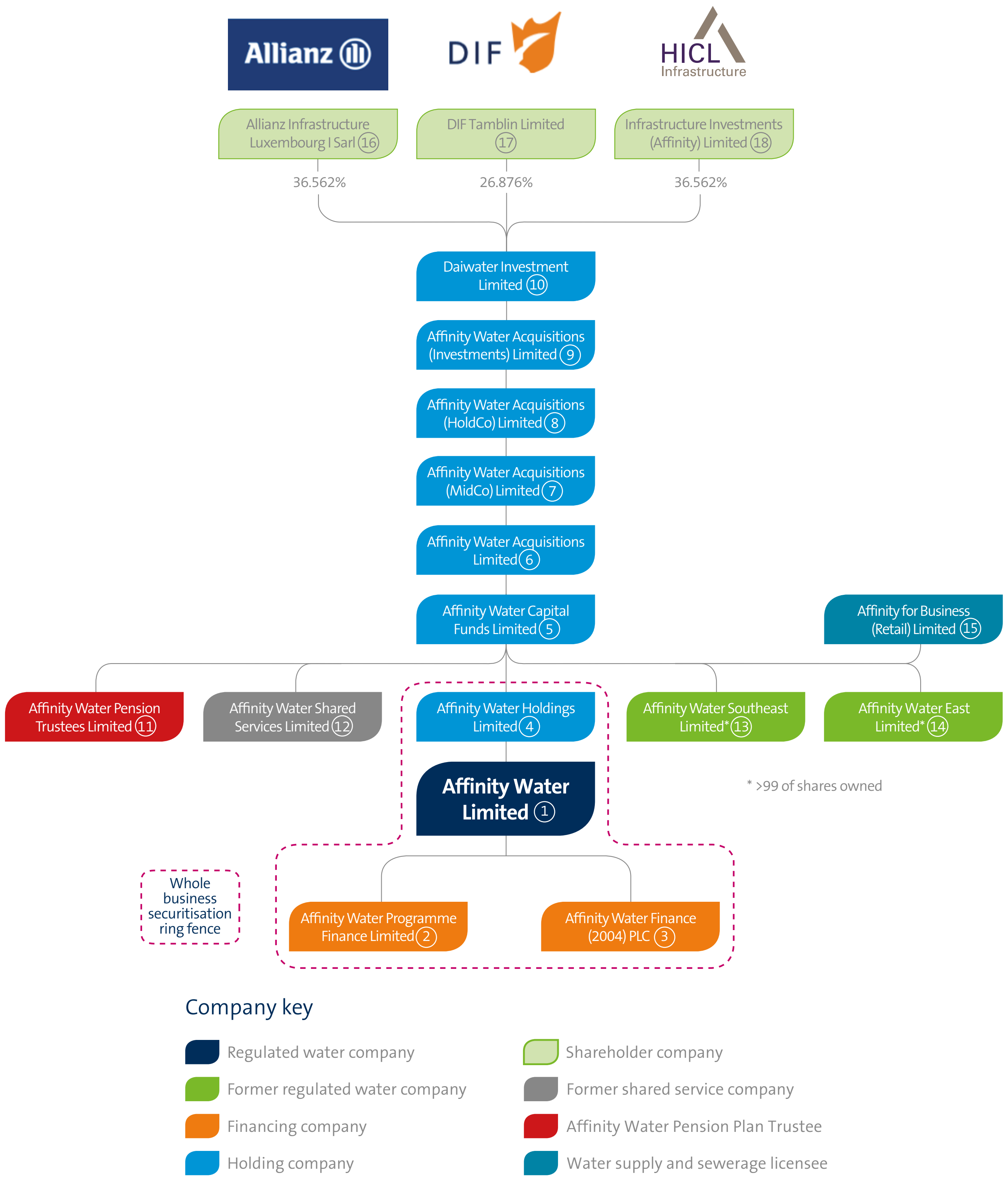
We are satisfied that these undertakings are being properly discharged and that we are able to fully meet our regulatory obligation to operate our appointed business as if it were substantially our sole business and the company were a separate listed company.

# Governance continued

## Ownership and financing (continued)

### OWNERSHIP (CONTINUED)

The chart below shows the effective equity interests held by each owner at the date of acquisition of the company and the group structure, excluding dormant subsidiaries. Unless otherwise indicated, all companies are wholly owned by the parent company shown. The numbers listed alongside the companies within the group structure may be cross referenced to the other group directorships of the company's directors, indicated within their biographies on **pages 54 to 56**.




### OUR FINANCING

Affinity Water Limited is financially and operationally 'ring-fenced' from the rest of the Affinity Water group by way of a whole business securitisation. The securitisation further enhances the ring-fencing provisions already in our licence. 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) PLC has issued an external bond of £250.0m; and
- Affinity Water Programme Finance Limited has issued external bonds totalling £644.2m.

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) PLC 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 when the company was acquired in 2012. 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 at 31 March 2017 can be summarised as follows:

| Debt | Bond (£m) | Coupon | Maturity Date |
|---|---|---|---|
| Class A fixed rate bond 2026* | 250.0 | 5.875% | July 2026 |
| Class A fixed rate bond 2036* | 250.0 | 4.500% | March 2036 |
| Class A RPI linked bond 2045* | 190.0 | 1.548% (real) | June 2045 |
| Class A fixed rate bond 2042* | 85.0 | 3.278% | August 2042 |
| Class A fixed rate bond 2022* | 14.2 | 3.625% | September 2022 |
| **Total Class A** | **789.2** | | |
| Class B RPI linked bond 2033 | 95.0 | 3.249% (real) | June 2033 |
| Class B RPI linked bond 2033 | 10.0 | 1.024% (real) | June 2033 |
| **Total Class B** | **105.0** | | |
| **Total** | **894.2** | | |

* Listed on the London Stock Exchange

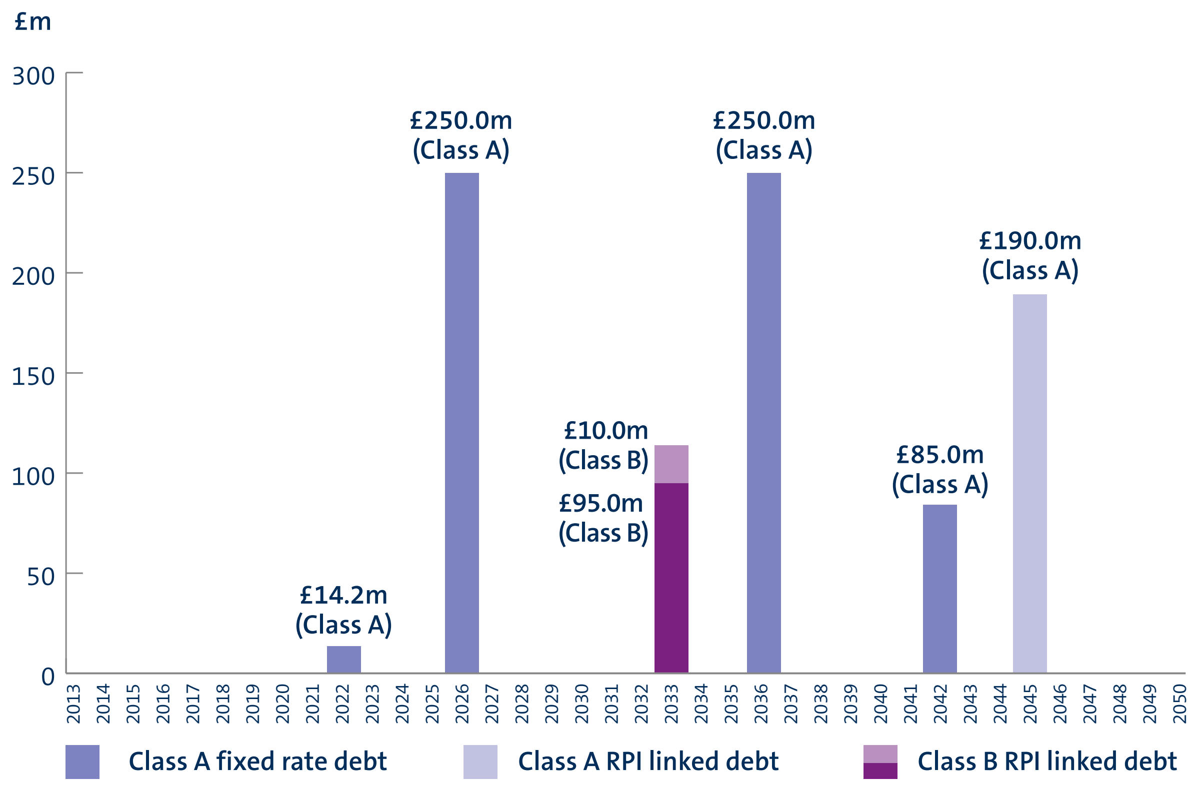
Governance

# Governance continued

## Ownership and financing (continued)

### OUR FINANCING (CONTINUED)

The following chart shows the maturity profile of the bonds at 31 March 2017:




The credit ratings for our subsidiaries' bonds assigned by the rating agencies, Moody's and Standard & Poors, at 31 March 2017 were as follows:

| Bonds | Moody's | Standard & Poors |
|---|---|---|
| Class A | A3 | A - |
| Class B | Baa3 | BBB |
| Corporate family rating | Baa1 | Not applicable |

## Audit Committee report

**PATRICK O'D BOURKE**

**Audit Committee members**

- Patrick O'D Bourke (Chair)
- Chris Bolt
- Trevor Didcock
- Stephen Nelson*
- Jim Wilmott*

For more information on the responsibilities of the Audit Committee and the qualifications of the Chairman, refer to **page 64**. The biographies of the remaining current Committee members are presented on **pages 54 to 56**.

In accordance with the Audit Committee Terms of Reference, key areas of focus are:

- Monitor and review the financial statements, accounting policies and any other formal announcements relating to the company's financial performance;
- Risk management and internal controls;
- Oversight of internal and external audit;
- Review of the adequacy of the company's procedures for whistleblowing, anti bribery and reporting fraud; and
- Regulatory reporting obligations.

### DEAR SHAREHOLDER,

I am pleased to present the report of the Audit Committee which details the role of the Committee and the work it has undertaken during the year. The Audit Committee understands and acknowledges its key role of protecting the interests of shareholders as regards the integrity of published financial information by the company. Part of the Committee's responsibilities are targeted at the regulated information in the annual report published by the company for the benefit of customers.

The Audit Committee is responsible for assisting the Board in discharging its oversight responsibilities for the integrity of the company's financial statements, and the assessment of the effectiveness of the system of internal control and risk management. The Committee also has responsibility for overseeing the relationship with our external Auditor (PricewaterhouseCoopers LLP, 'PwC') including assessment of their ongoing objectivity, and overseeing the assurance of regulatory returns to Ofwat. In performing its duties, the Committee has access to the services of the Head of Audit, Risk and Compliance, the Company Secretary and, if required, external professional advisers.

Our work cannot provide absolute assurance that the company's risk management and internal control systems are operating effectively, nevertheless in summary we are satisfied that the control and compliance culture of the company is strong and the risk base is diversified which helps to provide reasonable assurance that the financial statements are free from material error and / or misstatement.

The Committee is further satisfied that the 2016/17 annual report and financial statements, taken as a whole, provide:

i. a fair, balanced and understandable assessment of the company's position; and

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

To make this assessment, members of the Committee received drafts of the annual report to review early in the process to ensure that key messages set out in the annual report were aligned with the company's position, performance and strategy, and that the narrative sections were consistent with the financial statements.

The significant issues considered by the Committee in relation to the 2016/17 financial statements were consistent with those identified by the external Auditor in its report on **pages 96 to 102**.

* Stephen Nelson and Jim Wilmott resigned from the Audit Committee on 19 May 2017, following completion of the sale of Affinity Water Acquisitions (Investments) Limited.

# Governance continued

## Audit Committee report (continued)

### OVERVIEW OF THE ACTIONS TAKEN BY THE AUDIT COMMITTEE TO DISCHARGE ITS DUTIES

The Committee has an extensive agenda of business which it deals with in conjunction with senior management, the external Auditor and the Internal Audit function. During the year, the Committee met four times. The Chief Financial Officer and other senior managers normally attend meetings, together with the Head of Audit, Risk and Compliance and the external Auditor. In addition, the Committee met privately with both internal and external auditors during the year without management present.

Since the beginning of 2016/17, the items of business considered included:

| | |
|---|---|
| External Auditor | We recommended to the Board the re-appointment of PwC as external Auditor.<br>We reviewed and agreed the scope of the audit work to be undertaken by PwC.<br>We agreed the fees to be paid to PwC for its review of the September 2016 half-yearly report and its audit of the March 2017 financial statements, and fees for non-audit services above pre-approved limits.<br>We conducted an assessment of the qualification, expertise, resources and independence of PwC and the effectiveness of the external audit process. This included consideration of a report on PwC's quality control procedures and its annual independence letter. |
| Internal Audit | We agreed a programme of work for the Internal Audit function.<br>We received reports from the Head of Audit, Risk and Compliance on the work undertaken by Internal Audit, as well as management responses to proposals made in audits issued by the function during the year.<br>We monitored and reviewed the effectiveness of the Internal Audit function. |
| Financial and Other Reporting | We reviewed the September 2016 half-yearly financial results and the March 2017 annual report and financial statements, including the significant financial reporting judgements contained in them. As part of this, we received a report from PwC on its review of the half-yearly financial results and audit of the annual report and financial statements.<br>We reviewed the March 2017 regulatory annual performance report to ensure that the information meets Ofwat's reporting requirements.<br>We advised the Board on whether the annual report and financial statements, taken as a whole, are fair, balanced and understandable, and provide the information necessary for shareholders to assess the company's position and performance, business model and strategy. |
| General | We reviewed and provided advice to the Board on, the effectiveness of the company's risk management and internal control systems and associated disclosures made in the annual report and financial statements.<br>We reviewed compliance certificates and investor reports required under the company's debt facilities.<br>We received presentations on:<br>• tax matters,<br>• the company's insurance programme,<br>• 2017/18 tariffs and charging scheme,<br>• non-financial regulatory reporting management plan and requirements for 2016/17,<br>• Ofwat's company monitoring framework,<br>• a proposal for a company Level Playing Field Committee,<br>• 2015/16 Regulatory Annual Performance Report feedback and new requirements for 2016/17 financial controls,<br>• contractual changes associated with a supplier framework, whistleblowing and the Bribery Act,<br>• directors' and officers' liability insurance,<br>• risk management and risk assurance processes,<br>• viability statement,<br>• information security and<br>• amended Committee Terms of Reference in line with the April 2016 UK Corporate Governance Code changes.<br>We received training presentations from management on the regulatory model.<br>We evaluated our effectiveness as a Committee by means of a questionnaire covering the range of our responsibilities and procedures.<br>We reported to the Board on how we have discharged our responsibilities in accordance with our terms of reference. |

### SIGNIFICANT ISSUES CONSIDERED BY THE AUDIT COMMITTEE IN RELATION TO THE 2016/17 FINANCIAL STATEMENTS

We considered the appropriateness of the company's accounting policies and any requirement to adopt new financial reporting standards applicable in the 2016/17 accounting period. We 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 and the following principal areas of judgement:

- The estimation methodology for the recognition of revenue (specifically the measured income accrual) 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 in line with the company's policy and applicable accounting standards.
- 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 assumptions underpinning the directors' decision to continue to adopt the going concern basis in the financial statements, including the expectation that loan covenants will continue to be met for a period of not less than twelve months from the date of signing the financial statements, were reviewed.
- The process undertaken by management to support and allow the directors to make the company's viability statement: the Audit Committee considered and provided input into the determination of which of the company's principal risks and combinations thereof might have an impact on the company's financial viability, and reviewed the results of management's stress testing of the company's base cash flow forecasts.

The company's viability statement, including information on the company's approach to producing it, can be found on **pages 50 to 51**.

# Governance continued

## Audit Committee report (continued)

### EXTERNAL AUDIT

PwC was appointed as external Auditor in 2013/14 following a competitive tendering exercise. The company intends to put the external audit contract out to tender at least once every ten years, as stipulated in the Audit Committee's terms of reference, to enable the Committee to compare the quality and effectiveness of the services provided by the incumbent external Auditor with those of other audit firms.

In December 2016, the engagement partner, Charles Joseland, retired from PwC and a new partner, Owen Mackney, was appointed with effect from 1 January 2017.

To fulfil our responsibility regarding the independence and objectivity of PwC, we considered:

- PwC's plan for the current year, noting the role of the senior statutory audit partner who signs the audit report, 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; and
- PwC's annual independence letter.

A key factor that may impair PwC's independence is the volume of non-audit services. The company has a policy for the provision of non-audit services, under which all proposals for such work are subject to pre-approved limits. Any non-audit service that exceeds these thresholds requires approval from the Audit Committee.

During the year, PwC provided non-audit services, other than audit related services, in the following areas:

- tax consultancy services with respect to the bond issuance by Affinity Water Programme Finance Limited during the year;
- delivery of a technical accounting session for the company's finance team; and
- assisting with management's valuation of the company's non-household retail business operations.

PwC further provided agreed upon procedures in relation to the accuracy of the company's forecast water charges. PwC was engaged to provide these services as it is recognised as having expertise in these areas.

Auditor objectivity and independence were safeguarded in these instances through the work being performed on a review and recommend basis with the final decision being taken by management, and through ensuring advice was only provided by partners and staff who have no involvement in the statutory audit of the financial statements where the information is used for the purposes of the company's statutory financial statements.

PwC was engaged to provide agreed upon procedures as part of the company's regulatory compliance and annual reporting to Thames Water and Anglian Water. PwC was further engaged to provide letters of comfort in respect of the bond exchange and new debt issuance by Affinity Water Programme Finance Limited in the year. None of the procedures performed were advisory in nature.

No services were provided pursuant to contingent fee arrangements.

On the recommendation of the Audit Committee, the external Auditor's role is considered annually by the Board for reappointment.

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

- its fulfilment of the agreed audit plan and any variations from the plan;
- the robustness and perceptiveness of its handling of key accounting and audit judgements; and
- the content of its reporting on internal control.

Based on the above review, we are recommending to the Board that PwC be re-appointed for the year ending 31 March 2018.

**Note 2** 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

The Head of Audit, Risk and Compliance has direct access to the company Chairman and the Audit Committee Chairman.

To fulfil our responsibilities relating to monitoring and reviewing the effectiveness of the Internal Audit function, we reviewed:

- Internal Audit's charter, 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;
- the level and nature of non-audit activity performed by Internal Audit; and
- the company's whistleblowing policy which contains arrangements for the Head of Audit, Risk and Compliance to receive in confidence concerns about malpractice or misconduct, including 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 concluded that we acted in accordance with our terms of reference and 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
27 June 2017

# Governance continued

## Remuneration report

**SUSAN HOOPER**

**Remuneration Committee members**

- Susan Hooper (Chair)
- Chris Bolt
- Dr Philip Nolan
- Stephen Nelson*
- Jim Wilmott*

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 senior management is linked to standards of performance experienced by customers.

During 2017/18 we will continue to keep the reward packages for our executive directors and other senior managers under review to ensure they remain market competitive, incentivise company and individual performance, and focus on the achievement of short-term targets that will enable the company to fulfil its long-term vision.

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 2017, and changes to the remuneration policy, as presented in last year's report, for 2016/17.

We continue 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 for the year, including health and safety, water quality compliance and other customer experience and operational measures. The achievement of performance against these targets provided the basis for determining the value of annual bonus awards.

We continue to link the remuneration of executive directors to the standards of performance experienced by customers by aligning the leakage and unplanned interruptions annual bonus plan targets for 2016/17 to the commitments for AMP6 in our Business Plan. These are ambitious commitments made to both Ofwat and our customers, and they reflect our desire to continue to improve on what we do.

We also have a long-term incentive plan ('LTIP') to incentivise executive directors and senior management to meet targets for cash available for distribution over a three year period and customer service in the final year of the period.

During the year we appointed Deloitte LLP and Willis Towers Watson PLC, both unconnected to the company, to provide advice on the future design of the annual bonus plan and the LTIP for our executive directors and other senior managers. The Remuneration Committee is considering their findings for implementation in future periods.

### 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.

In relation to shareholder voting at our 2016 AGM, the single available vote was cast in favour of the resolutions to approve the remuneration policy report, which is subject to a binding vote at least every three years, and the remuneration implementation report, which is subject to an annual advisory vote, presented in the annual report and financial statements for the year ended 31 March 2016.

The Act requires the external 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 of the Act. We have asked PwC to report on this basis notwithstanding the regulations do not apply to our business. The auditable part of the directors' remuneration report has been identified as 'audited'. Other information given is not required to be audited.

### REMUNERATION POLICY REPORT

**Remuneration Committee**

The Remuneration Committee is responsible for determining the remuneration policy and terms and conditions of employment of the directors and senior management. The Committee met on four occasions during the year, and was chaired by Susan Hooper.

The other members of the Committee during the year were Jim Wilmott, Stephen Nelson and Chris Bolt. Simon Cocks, the Chief Executive Officer, Duncan Bates, the Chief Financial Officer and Debbie Ryan, the People Director attended 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.

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. Its 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 senior managers and selected managers, and company-wide bonus schemes.



* Stephen Nelson and Jim Wilmott resigned from the Remuneration Committee on 19 May 2017, following completion of the sale of Affinity Water Acquisitions (Investments) Limited.

# Governance continued

## Remuneration report (continued)

### REMUNERATION POLICY REPORT (CONTINUED)

**Remuneration policy for non-executive directors**

Dr Philip Nolan was appointed Chairman of the company in April 2013 for a term of three years, and reappointed for a further three year term on 1 April 2016. He receives a fixed annual fee for his services which is reflective of the time commitment and responsibilities of the role. He served as executive Chairman from 1 January 2015 until 31 May 2015 and thereafter his role reverted to non-executive.

He also benefits from a remuneration arrangement, which aligns his interests with the longer term interests of shareholders. It is common practice for the chairs of listed companies to hold shares. As a privately owned company, this is not practicable to implement, so the arrangement has been aligned as closely as possible to the key features of a shareholding in a listed company. Particulars of the arrangement were communicated at the 2016 AGM.

We have departed from the Accounting Regulations of the Act in not providing full disclosure of the terms of the arrangements to protect commercial confidentiality but have disclosed the award made in respect of 2016/17 in the remuneration implementation report.

The other non-executive directors in office at 31 March 2017 fell into two groups.

| Group A | Group B |
|---|---|
| Patrick O'D Bourke | Stephen Nelson |
| Chris Bolt | Nigel Paterson |
| Trevor Didcock | Jim Wilmott |
| Susan Hooper | |

Our Board considers the directors in Group A to be independent. Each has a written agreement relating to his or her services. They receive a fee for their services which is not related to company performance. They are not in receipt of share options or LTIP's. 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 three months' written notice.

The fee policy for the Group A directors in 2016/17 remained unchanged from that reported in the 2015/16 remuneration policy report and will apply during 2017/18, unless the Committee agrees changes during the year.

The directors in Group B were appointed by our shareholders. They do not receive any fees or other forms of remuneration from the company in respect of their services and were not entitled to receive any payment on termination of their appointment on 19 May 2017.

**Remuneration policy for executive directors**

The remuneration policy is designed to attract, retain and motivate executive directors of the calibre required 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 standards of performance we provide to customers as well as the value created for shareholders.

The remuneration packages for all new executive directors are set in line with the company's approved policy. The Committee takes into account, in arriving at a total package, the skills and experience of the candidate, the market rate for a candidate of that level of experience, as well as the importance of securing the best candidate.

Annual bonuses and long-term incentives are awarded in line with the maximum limits outlined in the prior year remuneration policy report and on the **next page**. Participation in the plans is normally pro-rated for the year of joining.

The Committee may make additional cash awards if deferred pay is forfeited by an executive director on leaving a previous employer. Such awards would take into account the nature of awards forfeited (i.e. cash or shares), time horizons, attributed expected value and performance conditions.

Other payments may be made in relation to relocation expenses and other incidental expenses as appropriate.

Shareholder views on executive directors' remuneration for 2016/17 were considered through the presence of two 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 key elements of the remuneration package for Duncan Bates and Simon Cocks presented in the 2015/16 remuneration policy report remained unchanged during 2016/17.

No changes have been made to the internal performance measures for the 2017/18 annual bonus scheme and at the date of approval of this annual report and financial statements, they continued to be aligned to our performance commitments for AMP6.

No LTIP awards or final operational and financial bonus allocations relating to the 2017/18 period have been finalised given the change in ownership of the business on 19 May 2017.

# Governance continued

## Remuneration report (continued)

### REMUNERATION POLICY REPORT (CONTINUED)

**Remuneration policy for executive directors (continued)**

During the year the arrangements for the 2016/17 base awards under the LTIP for executive directors and senior management were finalised, as presented in the following table.

| Purpose and link to strategy | Policy and approach | Maximum potential value (as percentage of base pay) | Performance metrics | Changes for 2017/18 |
|---|---|---|---|---|
| To incentivise executives to achieve long-term shareholder value whilst achieving high levels of customer experience performance, although both award and payment are discretionary. | Base awards are granted as a percentage of salary and are paid out in cash at the end of a three year performance period, subject to the achievement of performance conditions.<br><br>Base awards include clawback and malus provisions, as detailed below. | Up to 100% of base salary (although outperformance of the financial performance target could cause this to be higher). | The award is determined on the performance of the company over the three years in terms of cash available for distribution to shareholders and the third year's SIM performance relative to the industry. | No LTIP awards relating to the 2017/18 period have been finalised given the change in ownership of the business on 19 May 2017. |

**Executive directors' service contracts**

The executive directors who served during the year each had service contracts, neither of which are fixed term, with notice periods as follows:

| Chief Executive Officer – Simon Cocks | Chief Financial Officer – Duncan Bates |
|---|---|
| From the executive to the company – 12 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.

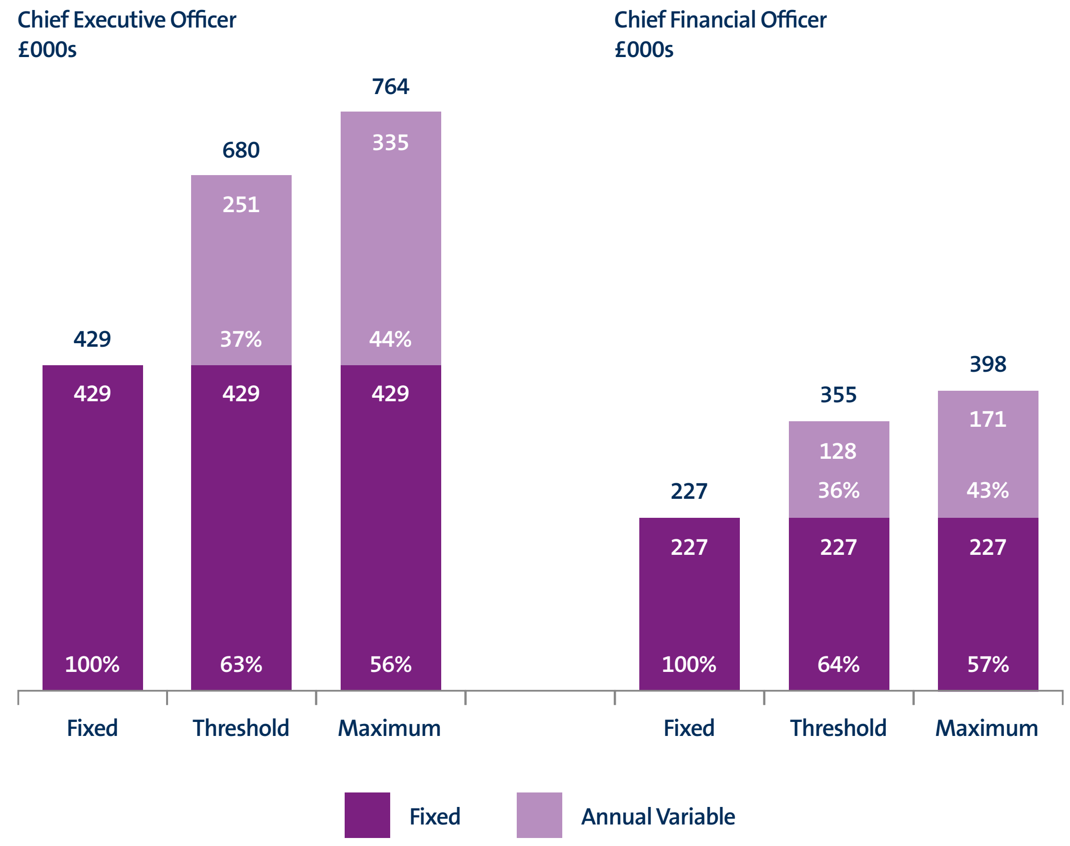
Arrangements for the 2014/15 awards under the LTIP and the annual bonus plan do not include provisions that would enable the company to recover sums paid or withhold the payment of any sum under specific circumstances in which it would be appropriate to do so, and therefore do not comply with the Code in this respect.

2015/16 and 2016/17 base awards under the LTIP include provisions that would enable the company to recover sums paid or withhold the payment of any sum in a circumstance or circumstances of malus before the vesting of the award or within a clawback period of three years commencing on the payment date of the award. Circumstances of malus include wilful or gross misconduct, acts of personal dishonesty or fraud, conviction of certain criminal offences, conduct which resulted in significant losses to the company, material failure of related management or business units, material misstatement in the audited financial statements, and reputational damage.

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 potential remuneration in respect of 2017/18 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, taxable benefits and allowances in lieu of being a member of the company's retirement benefit schemes |
| Threshold[1] | Based on what a director would receive if the threshold level of performance were achieved: annual variable pay out at 75% of maximum (assuming the financial and operational targets are met) |
| Maximum[1] | Based on what a director would receive if the highest level of performance were achieved: annual variable pay out at 100% of maximum (assuming the financial and operational targets are met) |

[1] Given the change in ownership on 19 May 2017 (which resulted in accelerated vesting and payment of all extant LTIP schemes at that date) it is not anticipated that any LTIP payments will be made in 2017/18 in the normal course of events.

# Governance continued

## Remuneration report (continued)

### REMUNERATION POLICY REPORT (CONTINUED)

**Management**

We operate a discretionary performance bonus scheme for other senior managers and selected managers who meet the criteria for inclusion in the scheme. At the date of approval of this annual report and financial statements, such managers continued to be entitled to participate in a performance-related discretionary bonus scheme of up to 40% 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% of the total bonus is dependent on the achievement of financial performance targets, which are identical to the executive directors' annual bonus scheme.
- 25% of the total bonus is dependent on the achievement of operational and customer performance targets, which are identical to the executive directors' annual bonus scheme.
- 25% 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 both 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 operational and customer performance measures and an annual financial performance measure.

At the date of approval of this annual report and financial statements, the bonus targets for operational, customer and financial performance continued to be identical for the executive director, 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.

**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 | 2016/17* | 2015/16* |
|---|---|---|---|
| Our people | Wages, salaries and pensions | **17p** | 17p |
| Our assets | Investment in our assets | **38p** | 30p |
| Our shareholders | Dividends | **10p** | 7p |

*Figures are based on our financial statements for 2016/17 and 2015/16 and have been rounded.

Further details of where each pound of our customers' bills is spent are presented in the Affinity Water at a glance section of the annual report on **page 3**.

### REMUNERATION IMPLEMENTATION REPORT

**Directors' remuneration 2016/17 (audited)**

The following table shows the remuneration paid by the company to directors in respect of 2016/17.

| | Base salary/ fees £000 | | Taxable benefits[1] £000 | | Pension related benefits[2] £000 | | Annual bonus £000 | | LTIP[3] £000 | | Other[4] £000 | | Total remuneration £000 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 |
| **Non-executive** | | | | | | | | | | | | | | |
| **Current** | | | | | | | | | | | | | | |
| Patrick O'D Bourke | 47 | 47 | - | - | - | - | - | - | - | - | - | - | 47 | 47 |
| Chris Bolt | 42 | 41 | - | - | - | - | - | - | - | - | - | - | 42 | 41 |
| Trevor Didcock | 42 | 14 | - | - | - | - | - | - | - | - | - | - | 42 | 14 |
| Susan Hooper | 45 | 15 | - | - | - | - | - | - | - | - | - | - | 45 | 15 |
| **Former** | | | | | | | | | | | | | | |
| Baroness Peta Buscombe | - | 22 | - | - | - | - | - | - | - | - | - | - | - | 22 |
| Jeffrey Herbert | - | 22 | - | - | - | - | - | - | - | - | - | - | - | 22 |
| **Chairman** | | | | | | | | | | | | | | |
| Dr Philip Nolan | 220 | 200 | - | - | - | - | - | - | - | - | 178 | 210 | 398 | 410 |
| **Executive** | | | | | | | | | | | | | | |
| **Current** | | | | | | | | | | | | | | |
| Simon Cocks[5] | 335 | 279 | 14 | 10 | 80 | 67 | 300 | 242 | - | - | 388 | 207 | 1,117 | 805 |
| Duncan Bates | 171 | 170 | 12 | 13 | 44 | 35 | 115 | 111 | 276 | - | - | - | 618 | 329 |
| | 902 | 810 | 26 | 23 | 124 | 102 | 415 | 353 | 276 | - | 566 | 417 | 2,309 | 1,705 |

Neither the company nor its immediate parent entities have any listed shares and so the directors have not been offered any share incentives. The former directors appointed by Infracapital Partners II, North Haven Infrastructure Partners LP and Veolia Water UK Limited did not receive any emoluments from the company.

**Annual bonuses for executive directors (unaudited)**

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 table on the **next page** shows the percentage of maximum annual bonus potential awarded in relation to the 2016/17 year for Duncan Bates and Simon Cocks. No amounts in relation to these bonuses have been deferred.

[1] Taxable benefits comprise company car allowance, living accommodation benefit and healthcare insurance.

[2] With effect from 1 April 2017, Duncan Bates came out of both the money purchase pension scheme and the defined benefit pension scheme. Therefore no contributions for Duncan Bates were paid to the money purchase pension scheme during the year (2016: £5,000). No amounts were accruing to Duncan Bates in relation to the company's defined benefit pension scheme (2016: £30,000). Pension related benefits for Duncan Bates include an allowance of £44,000 in lieu of being a member of the company's retirement benefit schemes (2016: £nil). Pension related benefits for Simon Cocks further include an allowance of £80,000 in lieu of being a member of the company's retirement benefit schemes (2016: £67,000).

[3] 2016/17 remuneration presented in the above table under LTIP relates to amounts paid to Duncan Bates in 2016/17 for the 2013/14 vested LTIP. The amount was excluded from the 2015/16 remuneration implementation report, as the award was determined by the Remuneration Committee after the approval of the prior year annual report and financial statements for the year ended 31 March 2016. No amounts relating to the 2014/15, 2015/16 or 2016/17 LTIP are disclosed in the table above. Details of any awards determined by the Remuneration Committee for LTIP arising on change of ownership of the business in May 2017 will be included in the 2017/18 remuneration implementation report.

[4] Other remuneration for Dr Philip Nolan consists of remuneration received in relation to the arrangement described on **page 80** of the remuneration policy report. Other remuneration for Simon Cocks in both 2016/17 and 2015/16 relates to discretionary payments made in connection with commencement of qualifying services during the year, representing compensation for the forfeit of a variable remuneration arrangement with his previous employer.

[5] 2015/16 remuneration presented above for Simon Cocks is for the period from appointment in June 2015 to March 2016.

# Governance continued

## Remuneration report (continued)

### REMUNERATION IMPLEMENTATION REPORT (CONTINUED)

**Annual bonuses for executive directors (unaudited) (continued)**

| Performance measure | | Link to strategy (refer to page 12) | 2016/17 target | Weighting for 2016/17 (as a % of base salary) | | 2016/17 achievement (as a % of base salary) | |
|---|---|---|---|---|---|---|---|
| | | | | Simon Cocks | Duncan Bates | Simon Cocks | Duncan Bates |
| Financial measure | Cash generated by operations (annual target): net cash outflow before taxation and financing[1] | Value creation imperative | £17.6m | 50.00% | 37.50% | 50.00% | 37.50% |
| Operational measures | Leakage (annual target): volume of water lost through leaks on the network (Ml/d)[2] | Customer outcome | 178.5 | 3.57% | 2.68% | 2.37% | 1.78% |
| | Water availability (annual target): volume of water lost from distribution due to unplanned outages at production sites (Ml/d) | Customer outcome | 38 | 3.57% | 2.68% | 3.57% | 2.68% |
| | Water quality (quarterly targets): number of water quality compliance failures | Customer outcome | Q1: 8<br>Q2: 10<br>Q3: 7<br>Q4: 7 | 3.57% | 2.68% | 0.89% | 0.67% |
| | Unplanned interruptions (quarterly targets): number of properties without water for over 12 hours due to an unplanned interruption to supply | Customer outcome | Less than 80 | 3.57% | 2.68% | 0% | 0% |
| | Water Saving Programme (quarterly targets): number of meters installed | Customer outcome | Q1: 13,750<br>Q2: 13,750<br>Q3: 13,750<br>Q4: 13,750 | 3.57% | 2.68% | 1.79% | 1.34% |
| Customer and community measures | SIM[2, 3] (annual target): our lowest score in the qualitative element of SIM | Customer outcome | 4.4 | 3.57% | 2.68% | 2.37% | 1.78% |
| | Cash collections (annual target): the amount of cash collected through billing in respect of water revenue | Customer outcome | £295.3m | 3.57% | 2.68% | 3.57% | 2.68% |
| Personal performance[4] | | | | 25.00% | 18.75% | 25.00% | 18.75% |
| **Total % of base salary** | | | | **100.00%** | **75.00%** | **89.56%** | **67.18%** |
| **Base salary** | | | | | | **£335,000** | **£171,000** |
| **Bonus paid** | | | | | | **£300,000** | **£115,000** |

[1] This "non-GAAP" measure is used internally to evaluate our performance.

[2] The Remuneration Committee made partial awards for SIM and Leakage as SIM came in at 4.36 against a target of 4.4 and leakage performance was better than the ODI target. The principal of the partial awards for SIM and Leakage was applied to all employee bonus arrangements.

[3] SIM is the industry's measure of customer experience. One element is quantitative (the volume of unwanted contact and complaints we receive) and the other is qualitative (the quality of the experience derived from an independent quarterly survey).

[4] 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.

**2014/15 LTIP**

The 2014/15 LTIP scheme was designed to incentivise executives to achieve long-term shareholder value whilst achieving high levels of customer experience, although award and payment are discretionary. Arrangements for the scheme, as set out in the 2015/16 remuneration policy report, were finalised during the year ended 31 March 2016.

Duncan Bates and Simon Cocks received base awards under the 2014/15 LTIP scheme, which related to the three year performance period ended 31 March 2017. The Committee will determine and communicate to shareholders any awards under the 2014/15 LTIP before the AGM. Details of any awards determined by the Committee will be included in the 2017/18 remuneration implementation report.

**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 27 June 2017 and signed on its behalf by:

**Susan Hooper**
Chair 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 2017.

The company is a limited liability company registered in England and Wales and its immediate parent undertaking is Affinity Water Holdings Limited, a company also registered in England and Wales. The directors consider that Affinity Water Acquisitions (Investments) Limited was the ultimate holding and controlling company in the United Kingdom at 31 March 2017. Details of the ownership of the company and the group structure are set out on **pages 69 to 70** of the governance section and **note 23** of the financial statements. The address of the principal place of business is Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

The strategic report on **pages 10 to 51** 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 2017. Details of the risks and principal uncertainties facing the company are set out on **pages 43 to 49**.

### DIRECTORS

The directors of the company, together with their periods of office and their biographical details, are shown on **pages 54 to 56**.

### 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 4 to 9**.

### RESULTS AND FINANCIAL PERFORMANCE

Profit for the year was £30.9m (2016: £59.7m).

The statement of financial position detailed on **page 105** shows total equity amounting to £216.7m (2016: £239.5m).

Further analysis of our financial performance can be found on **pages 38 to 41** of the strategic report.

### INFORMATION REQUIRED UNDER THE LISTING RULES

During the year no interest was capitalised by the company (2016: £nil).

For disclosures in relation to relevant requirements of the Listing Rules refer to the remuneration report on **pages 78 to 87**.

### GREENHOUSE GAS ('GHG') EMISSIONS STATEMENT[1]

| GHG emission source | 2016/17 Gross[2] ($tCO_2e$) | 2016/17 Intensity[3] ($kgCO_2e/Ml$) | 2015/16 Gross ($tCO_2e$) | 2015/16 Intensity ($kgCO_2e/Ml$) |
|---|---|---|---|---|
| **Scope 1** | **6,141** | **18.8** | **5,888** | **18.1** |
| Fuel combustion | 1,722 | 5.3 | 1,320 | 4.0 |
| Process and fugitive emissions | 2,322 | 7.1 | 2,558 | 7.9 |
| Vehicle fleet | 2,097 | 6.4 | 2,010 | 6.2 |
| **Scope 2** | **89,927** | **275.2** | **101,770** | **313.2** |
| Purchased electricity | 89,927 | 275.2 | 101,770 | 313.2 |
| **Statutory total (scope 1 & 2)[4]** | **96,068** | **294.0** | **107,658** | **331.3** |
| **Scope 3** | **8,538** | **26.1** | **8,834** | **27.2** |
| Business travel in other vehicles | 40 | 0.1 | 33 | 0.1 |
| Outsourced IT activities | 364 | 1.1 | 397 | 1.2 |
| Electricity- transmission and distribution | 8,134 | 24.9 | 8,404 | 25.9 |
| **Total gross emissions** | **104,606** | **320.1** | **116,492** | **358.5** |

Our total gross GHG emissions decreased by over 10% this year. Similar to businesses across the UK, emissions associated with our purchased electricity (accounting for 94% of our total) benefited from more renewable generation. We support the deployment of renewable energy by flexing our electrical demand at times of supply stress. In 2013 we participated in UK Power Network's "Low Carbon London" trial, reducing our electrical demand to manage their local network. Prior to and since then, we also participate in the National Grid's Power Responsive Programme, supporting the deployment of renewable generation.

Our electricity usage (kWh) and intensity (kWh/Ml) both reduced, in spite of increasing volumes of water supply and the water levels lowering in our underground aquifers.

We are continuing the migration of our outsourced IT services to the cloud resulting in a reduction of our emissions for three years in a row.

[1] We report our GHG emissions following the 2015 UK Government Environmental Reporting Guidance and using the 2015 UK Government Conversion Factors for Company Reporting. 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.

[2] We measure our gross GHG emissions in tonnes of carbon dioxide equivalent ('$tCO_2e$').

[3] 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.

[4] Statutory carbon reporting disclosures required by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

# Governance continued

## Directors' report (continued)

### DIVIDENDS

The directors declared and paid the following ordinary dividends during the year ended 31 March 2017:

| | £m |
|---|---|
| Paid: First interim of 11.32p per share in July 2016 | 30.0 |
| Paid: Second interim of 2.26p per share in September 2016 | 6.0 |
| Paid: Third interim of 5.47p per share in March 2017 | 14.5 |
| | 50.5 |

This compares to interim dividends of £40.0m declared and paid in the year ended 31 March 2016.

No final dividend is proposed (2016: £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 its research programme. The UKWIR research programme relating to Affinity Water is currently divided into the following topics: drinking water quality and health; toxicology; water resources; climate change; water mains and services; leakage and metering and regulatory issues. In addition, the company carried out more specific research in the fields of large meters, metaldehyde removal, water quality monitoring and pipeline materials during the year.

### POLITICAL CONTRIBUTIONS

No political contributions were made during the year (2016: £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, email and the intranet. We constantly discuss ways to enhance and improve our communications and consultation channels directly with employees as well as with the Trade Unions to which a number of employees belong. Several initiatives have been introduced with the aim of improving the health and well-being of the company's employees, for example we provide annual health screening to employees based in Field Operations.

Employees are kept informed of changes in the business and general, 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 supported to find appropriate employment within the business.

### FINANCIAL INSTRUMENTS DISCLOSURES

Details are included within risk number 12 on **page 48** of the strategic report and in **note A4** of the financial statements.

### 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 strategic report on **page 19**.

### CORPORATE GOVERNANCE

The company's statement on corporate governance, including information required by the Disclosure and Transparency Rules, can be found in the board leadership, transparency and governance section on **pages 54 to 68** of this annual report and financial statements. This section forms part of this directors' report and is incorporated into it by cross-reference. We have voluntarily reported compliance against the principles of the Code within this report.

### EVENTS AFTER THE REPORTING PERIOD

Affinity Water Limited used the Exit Regulations laid out by Defra to transfer its existing non-household retail base to fellow group member Affinity for Business (Retail) Limited on 1 April 2017.

On 19 May 2017, Infracapital Partners II and North Haven Infrastructure Partners LP sold 100% of their shareholdings in Affinity Water Acquisitions (Investments) Limited, the ultimate holding and controlling company of Affinity Water Limited to a consortium comprising Allianz Capital Partners on behalf of the Allianz Group, HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited) and DIF. As part of the transaction, the buyers also acquired Veolia Water UK Limited's 10% stake in Affinity Water. Affinity Water Limited continues to operate in the ordinary course of business and there is no expectation that the sale will result in any changes at an operational level.

### DIRECTORS' QUALIFYING THIRD PARTY INDEMNITY PROVISIONS

The company has not granted any indemnity to 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.

# Governance continued

## Directors' report (continued)

### 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 applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice, 'UK GAAP'), including FRS 101.

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 United Kingdom Accounting Standards, including FRS 101, have been followed, subject to any material departures disclosed and explained in the financial statements;
- 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.

The directors consider that the annual report and accounts, 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.

Each of the directors, whose names and functions are listed on **pages 54 to 56** confirms that, to the best of his/her knowledge:

- the financial statements, which have been prepared in accordance with UK GAAP, including FRS 101, give a true and fair view of the assets, liabilities, financial position and profit of the company; and
- the strategic report contained in the annual report includes a fair review of the development and performance of the business and the position of the company, together with a description of the principal risks and uncertainties that it faces.

### DISCLOSURE OF INFORMATION TO AUDITORS

In accordance with Section 418 of the Companies Act 2006:

a. so far as each 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 or she 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.

### INDEPENDENT AUDITOR

In accordance with Section 485 of the Companies Act 2006, a resolution to re-appoint PricewaterhouseCoopers LLP will be proposed at the forthcoming AGM.

**By order of the Board**

**Tim Monod**
Company Secretary
27 June 2017

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

# Statutory financial statements

For the year ended 31 March 2017

## Contents

| | |
|---|---|
| Independent auditor's report | 96 |
| Income statement | 103 |
| Statement of comprehensive income | 104 |
| Statement of financial position | 105 |
| Statement of changes in equity | 106 |
| Statement of cash flows | 107 |
| Accounting policies | 108 |
| Notes to the financial statements | 111 |

**Affinity Water Limited**
(Registered Number 02546950)

PHOTO: Inside our Clay Lane Water Treatment Works, one of 96 that we operate across our areas of supply.

# Statutory financial statements continued

## Independent auditor's report to the member of Affinity Water Limited

### Report on the financial statements

#### *Our opinion*

In our opinion, Affinity Water Limited's financial statements (the "financial statements"):

- give a true and fair view of the state of the company's affairs as at 31 March 2017 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.

#### *What we have audited*

The financial statements, included within the Annual Report and Financial Statements (the "Annual Report"), comprise:

- the statement of financial position as at 31 March 2017;
- the income statement and statement of comprehensive income for the year then ended;
- the statement of cash flows for the year then ended;
- the statement of changes in equity for the year then ended;
- the accounting policies; and
- the notes to the financial statements, which include other explanatory information.

Certain required disclosures have been presented elsewhere in the Annual Report, rather than in the notes to the financial statements. These are cross-referenced from the financial statements and are identified as audited.

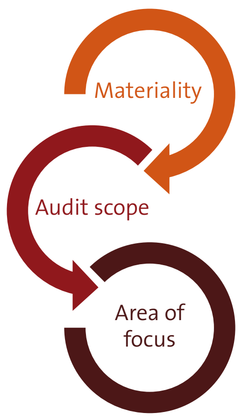
The financial reporting framework that has been applied in the preparation of the financial statements is United Kingdom Accounting Standards, comprising FRS 101 "Reduced Disclosure Framework", and applicable law (United Kingdom Generally Accepted Accounting Practice).

#### *Our audit approach*

***Context***

There was no substantial change in the operation of the business during the year that would cause us to revisit the scope of the audit and therefore the scope of the audit remained consistent with the prior year with the exception of the work we performed in the prior year on the company's adoption of FRS 101 'Reduced disclosure framework - Disclosure exemptions from EU-adopted IFRS for qualifying entities'.

***Overview***




- Overall materiality: £3.3 million which represents 2.5% of earnings before interest, tax, depreciation and amortisation ('EBITDA').
- The company has one finance function and operates a single ledger system. The audit was carried out by one team at the UK headquarters in Hatfield, Hertfordshire.
- Measured income accrual.
- Bad debt provision.
- Cost capitalisation.
- Pension assumptions.

### Report on the financial statements (continued)

#### *Our audit approach (continued)*

***The scope of our audit and our areas of focus***

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)").

We designed our audit by determining materiality and assessing the risks of material misstatement in the financial statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits we also addressed the risk of management override of internal controls, including evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as "areas of focus" in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

| *Area of focus* | *How our audit addressed the area of focus* |
|---|---|
| ***Measured income accrual***<br>Refer to **page 73** (Audit Committee Report), **page 108** (accounting policies) and **page 119** (**note 11**).<br><br>The directors have recorded a measured income accrual of £40.4 million (2016: £41.5 million) relating to revenue from the provision of water services to customers on water meters that had not been read at the year-end date.<br><br>Revenue recognition in respect of the measured income accrual is particularly judgemental, and clearly impacts directly on reported turnover and profit. The measured income accrual accounts for the timing difference between the last meter reading and the consumption of water from this point to the year end. It is calculated based on the average consumption over the past two years by small geographical groupings of customers.<br><br>Given the range of factors underlying the estimate, there is a risk that the measured income accrual and revenue could be misstated. | We have confirmed the mathematical accuracy of the calculations supporting the measured income accrual and agreed a sample of the latest meter readings to the internal billing system from which they were extracted.<br><br>We have reviewed management's analysis of the movements in the measured revenue compared to prior year and agreed these movements to supporting information including property statistic reports detailing additional households in the company's geographical catchment area and RPI inflation representing the standard tariff increase.<br><br>We evaluated the historical accuracy of the estimation process by reviewing bills raised in the current year for all amounts accrued at the prior year end. We note that the prior year accrual differs by <1% to the actual readings taken post year end.<br><br>We have reviewed the customer amounts accrued at 31 March 2017 which have subsequently been billed and noted immaterial differences. At the time of our testing, the total amounts billed represent 14% of the year-end accrual. We have extrapolated the differences across the total accrual and noted no material differences. |

# Statutory financial statements continued

## Independent auditor's report to the member of Affinity Water Limited (continued)

| *Area of focus* | *How our audit addressed the area of focus* |
|---|---|
| ***Provision for impairment of trade debt receivables*** Refer to **page 73** (Audit Committee Report) and **page 108** (accounting policies). <br><br> The Company estimates the recoverable value of its trade receivables and records a provision for impairment based on experience. <br><br> The provision is calculated by applying a percentage based on historical cash collection rates to individual aged debt categories. <br><br> Some customers continue to struggle to pay their bills or in certain instances, choose not to pay them. As there are limited steps that a water company can take to recover debt from domestic customers, there is an ongoing risk of aged debt not being collected. <br><br> The provision needs to reflect all these factors and accordingly could be materially misstated. Our audit focused on the risk that the provision for impairment of trade debt receivable could be understated. | We have reviewed the methodology for calculating the bad debt provision and confirmed that it is reasonable and consistent year on year. We confirmed the mathematical accuracy of the calculations supporting the provision and the underlying data including the type of customer (household v non-household), measurement basis (measured v unmeasured) and ageing of debt. <br><br> To ensure the appropriate classification of customers into ageing categories we selected a sample of debt and ensured this had been correctly treated based on ageing, customer type and measurement basis. <br><br> In addition, we have compared the actual provision rates used in the provision to prior year provision rates and reviewed the level of bad debt write offs which occurred in the year to 31 March 2017 to ensure the accuracy of management's previous estimates. We did not identify any material levels of bad debt which were not previously provided. The level of bad debt write offs are consistent year on year. <br><br> We consider the level of provisioning to be acceptable, based on historical cash collection rates and current ageing of the debt. |
| ***Cost capitalisation*** Refer to **page 73** (Audit Committee Report), **page 108** (accounting policies) and **page 116** (**note 6**). <br><br> The Company capitalises expenditure with respect to its infrastructure assets where such expenditure enhances or increases the capacity of the network, or relates to material replacements of network components. <br><br> The allocation of costs between capital and non-capital spend can be judgemental and has a direct impact on profit in any one year. The key judgement is management's assessment of what constitutes enhancement compared to maintenance expenditure. <br><br> Given the magnitude of capital spend at £129.0m there is a risk that incorrect classification could give rise to material misstatements. | We have reviewed the process for allocating costs to capital projects and are satisfied that this allocation has been made on a consistent basis and is in line with the Company's capitalisation policy. We have selected a sample of items capitalised in the year and ensured these are consistent with the Company's accounting policy and have been appropriately capitalised in line with IAS 16. <br><br> We have examined the process of capitalising staff time through the inspection of time sheet data and tested a sample of staff costs capitalised. We have not noted any exceptions from our testing and conclude that the time capitalised relates to that spent on valid capital projects. <br><br> In addition, we evaluated the nature of overheads capitalised and found these to relate directly to the asset construction operations of the business and therefore are appropriately capitalised. |

| *Area of focus* | *How our audit addressed the area of focus* |
|---|---|
| ***Assumptions relating to retirement benefit surplus*** Refer to **page 73** (Audit Committee Report), **page 108** (accounting policies), **page 118** (**note 9**) and **pages 138 to 141** (**note A5**). <br><br> The company has a defined benefit pension plan and has recognised a net retirement benefit surplus of £73.0m (2016: £72.6m). The plan liabilities increased from £349.9m to £434.0m mainly as a result of a decrease in discount rates. In addition, the plan assets increased from £422.5m to £507.0m. <br><br> The valuation of the net retirement benefit surplus requires significant levels of judgement and technical expertise including the use of actuarial experts to support the Directors in selecting appropriate assumptions. Changes in a number of key financial and demographic assumptions (including salaries increase, inflation, discount rates, and mortality rates) can have a material impact on the calculation of the net asset. | We assessed the competence and independence of the actuary by confirming that the company is a member of the Institute and Faculty of Actuaries and confirming it is appropriately independent of the company. <br><br> We agreed the discount and inflation rates, together with the expected rates of return on plan assets used in the valuation by the external actuary to our internally developed benchmarks. We confirmed that these were within our expected ranges and were consistently positioned within the range year on year. <br><br> The mortality rates and the allowance for future improvements in longevity were agreed to be consistent with our internally developed benchmarks and based on national and industry averages. <br><br> We agreed the salaries increase to be within our expected range based on the Consumer Price Index ('CPI') and Retail Price Index ('RPI'). |

### ***How we tailored the audit scope***

We tailored the scope of our audit to ensure that we performed enough work to be able to give an opinion on the financial statements as a whole, taking into account the geographic structure of the company, the accounting processes and controls, and the industry in which the company operates.

The company operates as a single entity and has a central finance function, with a single general ledger system, and all 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.

### ***Materiality***

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating 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 as follows:

| | |
|---|---|
| ***Overall materiality*** | £3.3 million (2016: £3.3 million). |
| ***How we determined it*** | 2.5% of earnings before interest, tax, depreciation and amortisation ('EBITDA'). |
| ***Rationale for benchmark applied*** | Consistent with last year, we used EBITDA as this is the measure that management focus on internally in their reporting, due to the capital-intensive nature of the business. EBITDA also provides us with a consistent year-on-year basis for our audit. |

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.2 million (2016: £0.2 million) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

# Statutory financial statements continued

## Independent auditor's report to the member of Affinity Water Limited (continued)

***Going concern***

The directors have chosen to voluntarily report how they have applied the UK Corporate Governance Code (the "Code") as if the company were a premium listed company. Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to the directors' statement about whether they considered it appropriate to adopt the going concern basis in preparing the financial statements. We have nothing material to add or to draw attention to.

As noted in the directors' statement, the directors have concluded that it is appropriate to adopt the going concern basis in preparing the financial statements. The going concern basis presumes that the company has adequate resources to remain in operation, and that the directors intend it to do so, for at least one year from the date the financial statements were signed. As part of our audit we have concluded that the directors' use of the going concern basis is appropriate. However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the company's ability to continue as a going concern.

### Other required reporting

### *Consistency of other information*

***Companies Act 2006 opinion***

In our opinion, based on the work undertaken in the course of the audit,

- 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;
- the Strategic Report and the Directors' Report have been prepared in accordance with applicable legal requirements.

In addition, in light of the knowledge and understanding of the company and its environment obtained over the course of the audit, we are required to report if we have identified any material misstatements in the Strategic Report and the Directors' Report. We have nothing to report in this respect.

***ISAs (UK & Ireland) reporting***

As a result of the directors' voluntary reporting on how they have applied the Code, under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

| | |
|---|---|
| • information in the Annual Report is:<br>– materially inconsistent with the information in the audited financial statements; or<br>– apparently materially incorrect based on, or materially inconsistent with, our knowledge of the company acquired in the course of performing our audit; or<br>– otherwise misleading. | We have no exceptions to report. |
| • the statement given by the directors on **page 62**, in accordance with provision C.1.1 of the Code, 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 position and performance, business model and strategy is materially inconsistent with our knowledge of the company acquired in the course of performing our audit. | We have no exceptions to report. |
| • the section of the Annual Report on **page 73**, as required by provision C.3.8 of the Code, 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. |

### *The directors' assessment of the prospects of the company and of the principal risks that would threaten the solvency or liquidity of the company*

As a result of the directors' voluntary reporting on how they have applied the Code, under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to:

| | |
|---|---|
| • the directors' confirmation on **page 62** of the Annual Report, in accordance with provision C.2.1 of the Code, that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. | We have nothing material to add or to draw attention to. |
| • the disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated. | We have nothing material to add or to draw attention to. |
| • the directors' explanation on **pages 50 to 51** of the Annual Report, in accordance with provision C.2.2 of the Code, as to how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate, and their statement as to whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, including any related disclosures drawing attention to any necessary qualifications or assumptions. | We have nothing material to add or to draw attention to. |

### *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.

# Statutory financial statements continued

## Independent auditor's report to the member of Affinity Water Limited (continued)

### 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 92**, 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.

#### *What an audit of financial statements involves*

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.

We primarily focus 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.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in 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. With respect to the Strategic Report and Directors' Report, we consider whether those reports include the disclosures required by applicable legal requirements.

***Owen Mackney (Senior Statutory Auditor)***

for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors

Uxbridge

27 June 2017

## Income statement for the year ended 31 March 2017 (Registered Number 02546950)

| | Note | 2017 £000 | 2016 £000 |
|---|---|---|---|
| **Revenue** | 1 | **308,662** | 302,622 |
| Cost of sales | | **(193,638)** | (184,521) |
| **Gross profit** | | **115,024** | 118,101 |
| Administrative expenses | | **(54,368)** | (52,962) |
| Other income | | **17,133** | 17,195 |
| **Operating profit** | 2 | **77,789** | 82,334 |
| Finance income | 4 | **3,050** | 1,978 |
| Finance costs | 4 | **(54,073)** | (38,681) |
| **Finance costs – net** | | **(51,023)** | (36,703) |
| **Profit before tax** | | **26,766** | 45,631 |
| Tax credit | 5 | **4,135** | 14,101 |
| **Profit for the year** | | **30,901** | 59,732 |

All profits of the company in the current period and prior period are from continuing operations.
The notes on **pages 108 to 143** are an integral part of these financial statements.

Statutory Financial Statements

# Statutory financial statements continued

## Statement of comprehensive income for the year ended 31 March 2017 (Registered Number 02546950)

| | Note | 2017 £000 | 2016 £000 |
|---|---|---|---|
| Profit for the year | | **30,901** | 59,732 |
| Other comprehensive (expense)/income for the year which will not be reclassified to profit or loss: | | | |
| Remeasurements of post-employment benefit assets | 9 | **(3,780)** | 20,667 |
| Deferred tax on items that will not be reclassified | 5 | **643** | (3,720) |
| **Other comprehensive (expense)/income for the year, net of tax** | | **(3,137)** | 16,947 |
| **Total comprehensive income for the year** | | **27,764** | 76,679 |

The notes on **pages 108 to 143** are an integral part of these financial statements.

## Statement of financial position as at 31 March 2017 (Registered Number 02546950)

| | Note | 2017 £000 | 2016 £000 |
|---|---|---|---|
| **Assets** | | | |
| **Non-current assets** | | | |
| Property, plant and equipment | 6 | **1,320,792** | 1,259,527 |
| Intangible assets | 7 | **51,689** | 43,634 |
| Investments | 8 | **60** | 60 |
| Retirement benefit surplus | 9 | **72,997** | 72,588 |
| | | **1,445,538** | 1,375,809 |
| **Current assets** | | | |
| Inventories | 10 | **1,430** | 1,222 |
| Trade and other receivables | 11 | **89,682** | 79,901 |
| Cash and cash equivalents | 12 | **45,129** | 93,444 |
| | | **136,241** | 174,567 |
| **Total assets** | | **1,581,779** | 1,550,376 |
| **Equity and liabilities** | | | |
| **Equity** | | | |
| Ordinary shares | 13 | **26,506** | 26,506 |
| Share premium | 13 | **1,400** | 1,400 |
| Capital contribution reserve | 13 | **30,150** | 30,150 |
| Retained earnings | | **158,661** | 181,397 |
| **Total equity** | | **216,717** | 239,453 |
| **Liabilities** | | | |
| **Non-current liabilities** | | | |
| Trade and other payables | 14 | **94,190** | 87,977 |
| Borrowings | 15 | **941,428** | 902,243 |
| Deferred tax liabilities | 16 | **172,736** | 184,652 |
| Provisions for other liabilities and charges | 17 | **2,462** | 2,885 |
| | | **1,210,816** | 1,177,757 |
| **Current liabilities** | | | |
| Trade and other payables | 14 | **146,010** | 131,153 |
| Current tax liabilities | | **8,236** | 2,013 |
| | | **154,246** | 133,166 |
| **Total liabilities** | | **1,365,062** | 1,310,923 |
| **Total equity and liabilities** | | **1,581,779** | 1,550,376 |

The notes on **pages 108 to 143** are an integral part of these financial statements. The statutory financial statements on **pages 103 to 143** were approved by the Board of Directors and were signed and authorised for issue on 27 June 2017 on its behalf by:

**Simon Cocks** **Duncan Bates**

Statutory Financial Statements

# Statutory financial statements continued

## Statement of changes in equity for the year ended 31 March 2017 (Registered Number 02546950)

| | Note | Share capital £000 | Share premium £000 | Capital contribution reserve £000 | Retained earnings £000 | Total £000 |
|---|---|---|---|---|---|---|
| **Balance as at 1 April 2015** | | 26,506 | 1,400 | 30,150 | 144,718 | **202,774** |
| Profit for the year | | - | - | - | 59,732 | 59,732 |
| Other comprehensive income | | - | - | - | 16,947 | 16,947 |
| **Total comprehensive income** | | **-** | **-** | **-** | **76,679** | **76,679** |
| Dividends | **18** | - | - | - | (40,000) | (40,000) |
| **Total transactions with owners recognised directly in equity** | | - | - | **-** | **(40,000)** | **(40,000)** |
| **Balance as at 31 March 2016** | | 26,506 | 1,400 | 30,150 | 181,397 | **239,453** |
| **Balance as at 1 April 2016** | | 26,506 | 1,400 | 30,150 | 181,397 | **239,453** |
| Profit for the year | | - | - | - | 30,901 | 30,901 |
| Other comprehensive expense | | - | - | - | (3,137) | (3,137) |
| **Total comprehensive income** | | **-** | **-** | **-** | **27,764** | **27,764** |
| Dividends | **18** | - | - | - | (50,500) | (50,500) |
| **Total transactions with owners recognised directly in equity** | | **-** | **-** | **-** | **(50,500)** | **(50,500)** |
| **Balance as at 31 March 2017** | | 26,506 | 1,400 | 30,150 | 158,661 | **216,717** |

The notes on **pages 108 to 143** are an integral part of these financial statements.

## Statement of cash flows for the year ended 31 March 2017 (Registered Number 02546950)

| | Note | 2017 £000 | 2016 £000 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Cash generated from operations | **19** | **140,076** | 129,210 |
| Interest paid | | **(45,484)** | (36,107) |
| Tax paid | | **(915)** | (3,384) |
| Group relief paid | | **-** | (1,809) |
| **Net cash generated from operating activities** | | **93,677** | 87,910 |
| **Cash flows from investing activities** | | | |
| Purchases of property, plant and equipment | | **(118,000)** | (70,924) |
| Capital contributions | | **8,918** | 4,959 |
| Proceeds from sale of property, plant and equipment | | **65** | 91 |
| Purchases of intangible assets | | **(13,700)** | (12,545) |
| Interest received | | **309** | 390 |
| **Net cash used in investing activities** | | **(122,408)** | (78,029) |
| **Cash flows from financing activities** | | | |
| Proceeds from loan from subsidiary undertaking | | **30,916** | 64,635 |
| Equity dividends | **18** | **(50,500)** | (40,000) |
| **Net cash (used in)/generated from financing activities** | | **(19,584)** | 24,635 |
| **Net (decrease)/increase in cash and cash equivalents** | | **(48,315)** | 34,516 |
| Cash and cash equivalents at beginning of year | | **93,444** | 58,928 |
| **Cash and cash equivalents at end of year** | **12** | **45,129** | 93,444 |

The notes on **pages 108 to 143** are an integral part of these financial statements.

# Statutory financial statements continued

## Accounting policies

### BASIS OF PREPARATION

These financial statements have been prepared under the historical cost convention and in accordance with the Companies Act 2006 and Financial Reporting Standard 101: 'Reduced disclosure framework' ('FRS 101') as issued by the Financial Reporting Council. Under FRS 101, the company applies the recognition and measurement requirements of EU-adopted International Financial Reporting Standards ('IFRS'), but makes amendments where necessary in order to comply with the Companies Act 2006 and The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).

### GOING CONCERN

Having assessed the principal risks of the company and the other matters discussed in connection with the viability statement on **pages 50 to 51**, the directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements.

### PRINCIPAL ACCOUNTING POLICIES

The principal accounting policies applied in the preparation of these financial statements are set out in **note A3**. These policies have been consistently applied to all the periods presented, unless otherwise stated.

### ADOPTION OF NEW AND REVISED STANDARDS

No new accounting standards, or amendments to accounting standards that are effective for the year ended 31 March 2017, have had a material impact on the company.

### NEW STANDARDS, AMENDMENTS AND INTERPRETATIONS NOT YET ADOPTED

Standards and interpretations which are not yet effective and have not been early adopted by the company are listed below.

- IFRS 15, 'Revenue from contracts with customers' deals with revenue recognition and establishes principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contracts with customers. Revenue is recognised when a customer obtains control of a good or service and thus has the ability to direct the use and obtain the benefits from the good or service. The standard replaces IAS 18 'Revenue' and IAS 11 'Construction contracts' and related interpretations. The standard is effective for the annual period beginning on 1 April 2018. The full impact of IFRS 15 is currently being assessed by management and the rest of the water industry.

- IFRS 16, 'Leases' addresses the definition of a lease, recognition and measurement of leases and establishes principles for reporting useful information to users of financial statements about the leasing activities of both lessees and lessors. A key change arising from IFRS 16 is that most operating leases will be accounted for on balance sheet for lessees. The standard replaces IAS 17 'Leases', and related interpretations. The standard is effective for the annual period beginning on 1 April 2019. The full impact of IFRS 16 is currently being reviewed by management.

- IFRS 9, 'Financial instruments', addresses the classification, measurement and recognition of financial assets and financial liabilities. It replaces the guidance in IAS 39, 'Financial Instruments', that relates to the classification and measurement of financial instruments. The standard is effective for the annual period beginning on 1 April 2018. Management are considering the impacts of the standard although it is not likely to be material given the nature of the company's financing arrangements.

### DISCLOSURE EXEMPTIONS

As permitted by FRS 101, the company has taken advantage of the following disclosure exemptions available under that standard in the preparation of these financial statements:

- Paragraph 38 of IAS 1: 'Presentation of financial statements' comparative information requirements in respect of:
  - paragraph 79(a)(iv) of IAS 1: 'Presentation of financial statements';
  - paragraph 73(e) of IAS 16: 'Property, plant and equipment'; and
  - paragraph 118(e) of IAS 38: 'Intangible assets' (reconciliations between the carrying amount at the beginning and end of the period)
- The following paragraphs of IAS 1: 'Presentation of financial statements':
  - 10(f) (a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements);
  - 16 (statement of compliance with all IFRS);
  - 38B-D (additional comparative information); and
- Paragraph 30 and 31 of IAS 8: 'Accounting policies, changes in accounting estimates and errors' (requirement for the disclosure of information when an entity has not applied a new IFRS that has been issued but is not yet effective)
- Paragraph 17 of IAS 24: 'Related party disclosures' (key management compensation)
- The requirements in IAS 24: 'Related party disclosures' to disclose related party transactions entered into between two or more members of a group.

### CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS

**Estimates**

The preparation of financial statements in conformity with FRS 101 requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the company's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial information are disclosed below.

Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. The company makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below.

***Measured income accrual***

The company records an accrual for measured consumption of water that has not yet been billed (refer to **note 11**). The accrual is estimated using a defined methodology based upon weighted average water consumption by tariff, which is calculated based upon historical information.

***Provision for impairment of trade receivables***

The company makes an estimate of the recoverable value of trade receivables and records a provision for impairment based on experience (refer to **note 11**). This provision is based on, amongst other things, a consideration of actual collection history. The actual level of receivables collected may differ from the estimated levels of recovery, which could impact operating results positively or negatively.

***Defined benefit pension plan***

The company has an obligation to pay pension benefits to certain employees. The cost of these benefits and the present value of the obligation depend on a number of factors, including: life expectancy, salary increases, asset valuations and the discount rate on corporate bonds. Management estimates these factors in determining the net pension obligation in the statement of financial position. The assumptions (refer to **note A5**) reflect historical experience and current trends, and may differ from actual results due to changing market and economic conditions and longer or shorter lives of participants. There are no restrictions to the realisability of the surplus relating to the defined benefit section of the pension plan.

***Useful economic lives of property, plant and equipment***

The annual depreciation charge for property, plant and equipment is sensitive to changes in the estimated useful economic lives and residual values of the assets. The useful economic lives and residual values are re-assessed annually. They are amended when necessary to reflect current estimates, based on management's judgement and experience, which include the knowledge and research of the company's dedicated asset management teams. Refer to **note 6** for the carrying amount of property, plant and equipment and **note A3** for the useful economic lives for each class of assets.

# Statutory financial statements continued

## Accounting policies (continued)

### CRITICAL JUDGMENTS IN APPLYING THE ENTITY'S ACCOUNTING POLICIES

**Cost capitalisation**

The company capitalises expenditure on its infrastructure assets to property, plant and equipment where such expenditure enhances or increases the capacity of the network, or relates to material replacements of network components. Any expenditure classed as maintenance is expensed in the period it is incurred. Distinguishing between enhancement and maintenance expenditure is a subjective area, particularly when projects have both elements within them. Refer to **note 6** for the carrying amount of property, plant and equipment.

**Discontinued operations and assets held for sale**

From 1 April 2017 all business customers, charities and public sector organisations (non-household customers) have been able to choose their retailers for water and wastewater services (refer to **page 30** of the strategic report for further information). A separate company of the Affinity Water group, Affinity for Business (Retail) Limited, has been established and during the year was granted a licence to provide water supply and wastewater services throughout England.

Affinity Water Limited used the Exit Regulations laid out by Defra to transfer its existing non-household retail customer base to the new organisation when the market opened on 1 April 2017. The operations that were transferred to Affinity for Business (Retail) Limited at 1 April 2017 have not been presented as discontinued operations in this annual report and financial statements, as the operations were not considered to represent a material and separate major line of the company's business. In reaching this conclusion, the directors of the company considered the revenue, operating profit and net book value of fixed assets related to the non-household retail business for the year ended 31 March 2017, as disclosed in section 2 of the regulatory annual performance report on **pages 173 to 179**, in comparison to the equivalent values for the company as a whole. No assets have been presented as held for sale as there were no non-current assets or liabilities transferred to Affinity for Business (Retail) Limited with the non-household customer base.

## Notes to the financial statements

### 1. REVENUE

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Unmeasured supplies | **128,810** | 130,448 |
| Measured supplies | **171,627** | 165,825 |
| Connection charges | **7,542** | 5,564 |
| Chargeable services | **683** | 785 |
| | **308,662** | 302,622 |

All revenue is derived in the United Kingdom.

### 2. OPERATING PROFIT

**2.1 Operating costs**

The following items have been charged/(credited) to either cost of sales or administrative expenses in the income statement:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Staff costs (**note 3.1**) | **60,191** | 51,865 |
| Gain on disposal of property, plant and equipment | **(65)** | (91) |
| Loss on disposal of infrastructure assets | **3,073** | 1,577 |
| Purchase of bulk water and water supplied under statutory entitlement | **6,727** | 6,466 |
| Water abstraction charges | **4,157** | 3,817 |
| Business rates | **16,576** | 16,342 |
| Chargeable services direct expenditure | **222** | 668 |
| Depreciation of infrastructure assets (**note 6**) | **10,972** | 10,906 |
| Depreciation of other property, plant and equipment (**note 6**) | **39,751** | 35,533 |
| Amortisation of intangible assets (**note 7**) | **5,971** | 5,019 |
| Amortisation of deferred grants and contributions | **(1,480)** | (1,447) |
| Impairment of trade receivables | **9,547** | 9,286 |
| Research and development | **177** | 287 |
| Operating lease rentals – land and buildings | **1,547** | 1,547 |
| Operating lease rentals – other | **2,155** | 1,908 |
| Auditor's remuneration (**note 2.3**) | **315** | 541 |
| Cost of inventories used | **1,226** | 1,264 |

**2.2 Other income**

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Commission and rentals | **17,133** | 17,195 |

The majority of other income relates to commission earned by the company from billing and collecting charges in respect of sewerage and infrastructure within its area on behalf of Thames Water Utilities Limited and Anglian Water Services Limited (refer to **note 21**).

Statutory Financial Statements

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 2. OPERATING PROFIT (CONTINUED)

**2.3 Auditor's remuneration**

During the year the company obtained the following services from its auditor and its associates:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Fees payable to the company's auditor and its associates for the audit of the financial statements | **133** | 130 |
| Fees payable to the company's auditor and its associates for other services: | | |
| Audit of the company's associates | **70** | 69 |
| Audit-related assurance services: | | |
| – regulatory reporting | **49** | 57 |
| – Thames Water and Anglian Water annual returns | **8** | 8 |
| – audit related assurance service - other | **22** | 22 |
| Tax advisory services | **8** | - |
| Other assurance services including services related to bond issue | **15** | 137 |
| All other non-audit services | **10** | 118 |
| **Total auditor's remuneration** | **315** | 541 |

### 3. EMPLOYEES

**3.1 Employee benefit expense (including executive directors)**

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Wages and salaries | **57,336** | 47,409 |
| Social security costs | **5,213** | 4,337 |
| Defined benefit pension costs (**note 9**) | **3,853** | 4,543 |
| Defined contribution pension costs (**note A5**) | **1,712** | 1,355 |
| Other pension administration costs | **1,281** | 1,275 |
| **Staff costs** | **69,395** | 58,919 |
| Staff costs capitalised | **(9,204)** | (7,054) |
| **Staff costs recognised in the income statement** | **60,191** | 51,865 |

**3.2 Average number of people employed**

The average monthly number of persons (including executive directors) employed by the company during the year was:

| By activity | 2017 Number | 2016 Number |
|---|---|---|
| Operations | **707** | 645 |
| Customer service | **310** | 349 |
| Administration | **225** | 200 |
| | **1,242** | 1,194 |

**3.3 Directors' remuneration**

The directors' emoluments were as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Aggregate emoluments | **2,309** | 1,670 |

At 31 March 2017, post-employment benefits were not accruing in respect of any director under a defined benefit plan (31 March 2016: one).

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

The directors who were appointed by Infracapital Partners II, North Haven Infrastructure Partners LP and Veolia Water UK Limited did not receive any emoluments from the company, or any company within the Affinity Water group.

**Highest paid director**

The highest paid director's emoluments were as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Aggregate emoluments | **1,117** | 805 |

Aggregate emoluments in 2016 include £207,000 of discretionary payments in connection with commencement of qualifying services during the prior year, representing compensation for the forfeit of variable remuneration arrangements with the relevant director's previous employer.

The highest paid director did not have any amounts accruing under the defined benefit pension plan at 31 March 2017 or 31 March 2016 and the company did not make any contributions to a pension plan in respect of the highest paid director's qualifying services during the year. The highest paid director did not hold any share options during the year.

Further information regarding directors' remuneration during the year can be found within the remuneration report on **pages 78 to 87**.

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 4. FINANCE INCOME AND COSTS

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Interest payable on borrowings held at amortised cost with parent company | **(160)** | (160) |
| Interest payable on borrowings held at amortised cost with subsidiary undertakings | **(35,899)** | (34,754) |
| Accretion payable in respect of borrowings held at amortised cost with subsidiary undertaking | **(8,029)** | (3,189) |
| **Interest payable on borrowings held at amortised cost** | **(44,088)** | (38,103) |
| Other interest expense | **(534)** | (578) |
| Transaction costs expensed on extinguishment of bond | **(9,451)** | - |
| **Finance costs** | **(54, 073)** | (38,681) |
| Net income from post-employment benefits | **2,757** | 1,588 |
| Bank interest income | **293** | 390 |
| **Finance income** | **3,050** | 1,978 |
| **Net finance cost** | **(51,023)** | (36,703) |

### 5. TAX CREDIT

**5.1 Tax credit included in the income statement**

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **Current tax:** | | |
| – UK Corporation tax on profits for the year | **5,222** | 2,340 |
| – Adjustment in respect of prior years | **1,916** | (756) |
| **Total current tax** | **7,138** | 1,584 |
| **Deferred tax:** | | |
| – Origination and reversal of temporary differences | **411** | 7,129 |
| – Impact of change in tax rate | **(10,199)** | (19,949) |
| – Adjustment in respect of prior years | **(1,485)** | (2,865) |
| **Total deferred tax** | **(11,273)** | (15,685) |
| **Tax credit** | **(4,135)** | (14,101) |

Tax expense assessed for the period is lower (2016: lower) than the standard rate of corporation tax in the UK for the year ended 31 March 2017 of 20% (2016: 20%). The differences are explained below

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Profit before tax | **26,766** | 45,631 |
| Tax calculated at the standard rate of tax in the UK of 20% (2016: 20%) | **5,353** | 9,126 |
| Tax effects of: | | |
| – Adjustments in respect of prior years | **431** | (3,621) |
| – Expenses not deductible for tax purposes | **280** | 343 |
| – Impact of change in tax rate on deferred tax | **(10,199)** | (19,949) |
| **Tax credit** | **(4,135)** | (14,101) |

**5.2 Tax (credit)/expense included in the statement of comprehensive income**

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **Deferred tax:** | | |
| – Origination and reversal of temporary differences on retirement benefit surplus | **(643)** | 3,720 |

**5.3 Factors that may affect future tax charges**

In October 2015 and September 2016, changes were enacted to the main rate of corporation tax in the UK to reduce it from 20% to 19% effective from 1 April 2017 and from 19% to 17% effective from 1 April 2020.

A deferred tax credit of £10,199,000 arose during the year due to the impact on the company's deferred tax liability as a result of reductions in the UK corporation tax rate.

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 6. PROPERTY, PLANT AND EQUIPMENT

| | Land, buildings and operational structures £000 | Potable water distribution mains £000 | Raw water pipes £000 | Fixed plant £000 | Vehicles and mobile plant £000 | Assets in course of construction £000 | Total £000 |
|---|---|---|---|---|---|---|---|
| Cost or deemed cost | | | | | | | |
| At 1 April 2016 | 282,695 | 720,152 | 18,847 | 630,407 | 26,479 | 118,715 | **1,797,295** |
| Additions | - | - | - | - | - | 115,061 | **115,061** |
| Transfers | 3,391 | 7,856 | - | 35,416 | 9,375 | (56,038) | **-** |
| Disposals | - | (2,883) | (313) | - | (454) | - | **(3,650)** |
| **At 31 March 2017** | 286,086 | 725,125 | 18,534 | 665,823 | 35,400 | 177,738 | **1,908,706** |
| Accumulated depreciation | | | | | | | |
| At 1 April 2016 | (78,416) | (21,592) | (443) | (417,834) | (19,483) | - | **(537,768)** |
| Charge for the year | (4,889) | (10,665) | (306) | (32,295) | (2,568) | - | **(50,723)** |
| Disposals | - | 115 | 10 | - | 452 | - | **577** |
| **At 31 March 2017** | (83,305) | (32,142) | (739) | (450,129) | (21,599) | - | **(587,914)** |
| Net book amount | | | | | | | |
| At 1 April 2016 | 204,279 | 698,560 | 18,404 | 212,573 | 6,996 | 118,715 | **1,259,527** |
| Movement in year | (1,498) | (5,577) | (609) | 3,121 | 6,805 | 59,023 | **61,265** |
| **At 31 March 2017** | 202,781 | 692,983 | 17,795 | 215,694 | 13,801 | 177,738 | **1,320,792** |

All land and buildings are held as freehold.

### 7. INTANGIBLE ASSETS

| | Goodwill £000 | Computer software development costs £000 | Total £000 |
|---|---|---|---|
| Cost | | | |
| At 1 April 2016 | 14,961 | 46,829 | **61,790** |
| Additions | - | 14,026 | **14,026** |
| **At 31 March 2017** | 14,961 | 60,855 | **75,816** |
| **Accumulated amortisation** | | | |
| At 1 April 2016 | - | (18,156) | **(18,156)** |
| Charge for the year | - | (5,971) | **(5,971)** |
| **At 31 March 2017** | - | (24,127) | **(24,127)** |
| **Net book amount** | | | |
| At 1 April 2016 | 14,961 | 28,673 | **43,634** |
| Movement in year | - | 8,055 | **8,055** |
| **At 31 March 2017** | 14,961 | 36,728 | **51,689** |

Goodwill includes £8,283,000 relating to the unification of the Affinity Water group's regulated businesses on 27 July 2012. The remaining balance of £6,678,000 relates to goodwill arising from the acquisition of the trade and assets of North Surrey Water Limited on 1 October 2000.

Affinity Water Limited is the only cash generating unit ('CGU') due to the fact it constitutes the smallest identifiable group of assets that generate cash flows for the entity, by means of supplying drinking water to customers. The recoverable amount has been determined using the regulatory capital value of Affinity Water Limited at 31 March 2017. Per management's assessment it has been determined that the headroom is such that no reasonable change in any key assumptions is expected to result in impairment of the goodwill recognised.

Computer software development costs include £2,639,000 (2016: £5,535,000) of expenditure in relation to a new work management information system.

### 8. INVESTMENTS

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Investments in subsidiaries (refer to **note A6**) | **60** | 60 |

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

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 9. RETIREMENT BENEFIT SURPLUS

**Defined benefit section**

The net pension expense before taxation recognised in the income statement in respect of the defined benefit plan is:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **Current service cost** | **(3,853)** | (4,543) |
| Pension expense charged to operating profit | **(3,853)** | (4,543) |
| Net pension interest income credited to finance income (**note 4**) | **2,757** | 1,588 |
| **Net pension expense charged before taxation** | **(1,096)** | (2,955) |

The opening and closing retirement benefit surpluses included in the statement of financial position are summarised as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **At 1 April** | **72,588** | 45,098 |
| Employer contributions | **5,285** | 9,778 |
| Current service cost | **(3,853)** | (4,543) |
| Net interest income | **2,757** | 1,588 |
| Net re-measurement (loss)/gain | **(3,780)** | 20,667 |
| **At 31 March** | **72,997** | 72,588 |

Re-measurement gains and losses are recognised directly in the statement of comprehensive income and are summarised as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Re-measurement gains/(losses) on plan assets | **80,190** | (5,311) |
| Re-measurement (losses)/gains on plan liabilities | **(83,970)** | 25,978 |
| | **(3,780)** | 20,667 |

Further analysis and underlying assumptions of the defined benefit plan are provided in **note A5**.

### 10. INVENTORIES

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Raw materials and consumables | **1,430** | 1,222 |

Inventories are stated after provisions for impairment of £511,000 (2016: £603,000).

### 11. TRADE AND OTHER RECEIVABLES

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Trade receivables | **60,135** | 54,883 |
| Less: provision for impairment of trade receivables | **(27,879)** | (26,313) |
| **Trade receivables - net** | **32,256** | 28,570 |
| Amounts owed by group undertakings | **5,284** | - |
| Amounts owed by related parties | **195** | 583 |
| Other receivables | **5,242** | 3,478 |
| Unbilled accrual for metered customers | **40,413** | 41,455 |
| Prepayments and accrued income | **6,292** | 5,815 |
| | **89,682** | 79,901 |

The carrying amounts of trade and other receivables approximate to their fair value.

#### 11.1 Provision for impairment of trade receivables

Trade receivables do not carry interest and are stated net of a provision for impairment, as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **At 1 April** | **26,313** | 24,645 |
| Provision for receivables impairment charged to income statement | **9,547** | 9,286 |
| Receivables written off during the year as uncollectable | **(7,981)** | (7,618) |
| **At 31 March** | **27,879** | 26,313 |

#### 11.2 Ageing analysis of trade receivables

The aged analysis of receivables at the reporting date is as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Aged less than one year | **20,921** | 16,996 |
| Aged between one year and two years | **10,590** | 10,687 |
| Aged greater than two years | **745** | 887 |
| | **32,256** | 28,570 |

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 12. CASH AND CASH EQUIVALENTS

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Cash at bank and in hand | **15,102** | 23,275 |
| Term deposits | **30,027** | 70,169 |
| | **45,129** | 93,444 |

The carrying amounts of cash and cash equivalents approximate to their fair value.

### 13. SHARE CAPITAL, SHARE PREMIUM AND CAPITAL CONTRIBUTION RESERVE

| Alloted and fully paid up | Number of shares (thousands) | Ordinary shares of £0.10 each (£000) | Share premium (£000) | Capital contribution reserve (£000) | Total (£000) |
|---|---|---|---|---|---|
| At 31 March 2016 and 31 March 2017 | 265,058 | 26,506 | 1,400 | 30,150 | **58,056** |

All shares rank pari passu in all respects.

### 14. TRADE AND OTHER PAYABLES

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Non-current | | |
| *Amounts falling due after more than one year:* | | |
| Deferred grants and contributions | **6,183** | 5,807 |
| *Amounts falling due after more than five years:* | | |
| Deferred grants and contributions | **88,007** | 82,170 |
| | **94,190** | 87,977 |
| Current | | |
| *Amounts falling due within one year:* | | |
| Trade payables | **18,620** | 8,120 |
| Amounts due to group undertakings | **176** | 308 |
| Amounts due to related parties | **35** | 206 |
| Interest payable to subsidiary companies | **12,987** | 12,642 |
| Interest payable to external parties | **62** | 63 |
| Social security and other taxes | **1,491** | 1,237 |
| Other payables | **8,286** | 8,111 |
| Capital accruals | **14,406** | 17,022 |
| Deferred grants and contributions | **1,251** | 1,187 |
| Payments received in advance | **48,400** | 47,522 |
| Other accruals and deferred income | **40,296** | 34,735 |
| | **146,010** | 131,153 |
| | **240,200** | 219,130 |

The carrying amounts of trade and other payables approximate to their fair value.

### 15. BORROWINGS

| | 2017 £000 | 2016 £000 |
|---|---|---|
| *Borrowings measured at amortised cost:* | | |
| Loan from Affinity Water Finance (2004) PLC financed by bond issue | **254,747** | 255,045 |
| Loan from Affinity Water Programme Finance Limited financed by bond issue | **683,097** | 643,614 |
| Loan from intermediate parent company | **3,550** | 3,550 |
| 3.5% irredeemable consolidated debenture stock | **-** | - |
| 4% irredeemable consolidated debenture stock | **8** | 8 |
| 4% irredeemable debenture stock | **1** | 1 |
| 4.25% irredeemable debenture stock | **-** | - |
| 5% irredeemable debenture stock | **24** | 24 |
| 5.25% irredeemable debenture stock | **1** | 1 |
| | **941,428** | 902,243 |

On 13 July 2004, the company's subsidiary Affinity Water Finance (2004) PLC issued a £200,000,000 bond at an interest rate of 5.875% and repayable in July 2026. On 16 July 2014 Affinity Water Finance (2004) PLC completed a tap issue of £50,000,000 on the same terms as the existing £200,000,000 bond. The net proceeds of the bond and tap issue were lent to the company on the same terms.

On 4 February 2013, the company's subsidiary Affinity Water Programme Finance Limited issued £80,000,000 Class A Guaranteed Notes maturing in September 2022 with a coupon of 3.625%, £250,000,000 Class A Guaranteed Notes maturing in March 2036 with a coupon of 4.500%, £150,000,000 Class A Guaranteed RPI linked Notes maturing in June 2045 with a coupon of 1.548% and £95,000,000 Class B Guaranteed RPI linked Notes maturing in June 2033 with a coupon of 3.249%. On 29 October 2015, Affinity Water Programme Finance Limited completed a tap issue of its 1.548% RPI linked Notes maturing in June 2045 of £40,000,000 on the same terms as the existing 2045 Notes. On 19 February 2016, Affinity Water Programme Finance Limited issued £10,000,000 Class B guaranteed RPI linked Notes maturing in June 2033 with a coupon rate of 1.024%. On 22 August 2016, Affinity Water Programme Finance Limited exchanged £65,800,000 of its 3.625% guaranteed bonds due 2022 for a new issue of 3.278% guaranteed bonds due 2042. An additional £19,200,000 of 3.278% guaranteed bonds due 2042 were issued at the same time. The net proceeds of the bond issues and the tap issue were lent to the company on the same terms. Due to the partial extinguishment of the bond, this resulted in £9,451,000 of transaction costs expensed during the year.

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 4.500%.

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) PLC and Affinity Water Programme Finance Limited in respect of the bonds issued by these companies. 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. The bonds issued are also guaranteed by Affinity Water Holdings Limited, the immediate parent undertaking of Affinity Water Limited.

The fair value of the bonds on-lent from the two financing subsidiaries at 31 March 2017 is £1,188,729,000 (2016: £1,056,079,000), which has been derived from 'level 1' fair value measurements: quoted prices (unadjusted) in active markets for identical liabilities.

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 regulatory capital value. At the year end the company was not in breach of any financial covenants.

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 16. DEFERRED TAX LIABILITIES

#### 16.1 Analysis of deferred tax assets and deferred tax liabilities

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **Deferred tax assets:** | | |
| Deferred tax asset to be recovered after more than 12 months | **(982)** | (881) |
| | **(982)** | (881) |
| **Deferred tax liabilities:** | | |
| Deferred tax liability to be recovered after more than 12 months | **173,718** | 185,533 |
| | **173,718** | 185,533 |
| **Deferred tax liabilities - net** | **172,736** | 184,652 |

The gross movement on the deferred tax account is as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **At 1 April** | **184,652** | 196,617 |
| Credited to the income statement | **(11,273)** | (15,685) |
| (Credited)/charged to other comprehensive income | **(643)** | 3,720 |
| **At 31 March** | **172,736** | 184,652 |

The movement in deferred tax assets and liabilities during the year is as follows:

#### 16.2 Deferred tax liabilities

| | Accelerated capital allowances £000 | Retirement benefit obligations £000 | Total £000 |
|---|---|---|---|
| **At 1 April 2015** | 194,743 | 9,020 | **203,763** |
| (Credited)/charged to the income statement | (22,276) | 326 | **(21,950)** |
| Charged to other comprehensive income | - | 3,720 | **3,720** |
| **At 31 March 2016** | 172,467 | 13,066 | **185,533** |
| Credited to the income statement | (11,158) | (14) | **(11,172)** |
| Credited to other comprehensive income | - | (643) | **(643)** |
| **At 31 March 2017** | 161,309 | 12,409 | **173,718** |

#### 16.3 Deferred tax assets

| | Provisions £000 | Other £000 | Total £000 |
|---|---|---|---|
| **At 1 April 2015** | (1,473) | (5,673) | **(7,146)** |
| Charged to the income statement | 592 | 5,673 | **6,265** |
| **At 31 March 2016** | (881) | - | **(881)** |
| Credited to the income statement | (101) | - | **(101)** |
| **At 31 March 2017** | (982) | - | **(982)** |

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 17. PROVISIONS FOR OTHER LIABILITIES AND CHARGES

| | Insurance £000 | Other £000 | Total £000 |
|---|---|---|---|
| **At 1 April 2015** | 1,624 | 1,124 | **2,748** |
| Charged to the income statement | 126 | 251 | **377** |
| Utilised in the year | (240) | - | **(240)** |
| **At 31 March 2016** | 1,510 | 1,375 | **2,885** |
| Charged/(credited) to the income statement | 346 | (510) | **(164)** |
| Utilised in the year | (64) | (195) | **(259)** |
| **At 31 March 2017** | 1,792 | 670 | **2,462** |

**Insurance**

Insurance represents the amount of the company's liability in respect of individual claims. This is based upon data provided by loss adjusters to insurers and is calculated on settlement experience.

**Other provisions**

Other provisions include £670,000 (2016: £670,000) in relation to unfunded pension liabilities for a former non-executive director, which will be utilised over the 20 years from January 2019.

### 18. DIVIDENDS

| | 2017 £000 | 2016 £000 |
|---|---|---|
| First interim paid of 11.32p per share (2016: 3.40p) | **30,000** | 9,000 |
| Second interim paid of 2.26p per share (2016: 2.08p) | **6,000** | 5,500 |
| Third interim paid of 5.47p per share (2016: 5.09p) | **14,500** | 13,500 |
| Fourth interim paid of Nil (2016: 3.02p) | **-** | 8,000 |
| Fifth interim paid of Nil (2016: 1.51p) | **-** | 4,000 |
| | **50,500** | 40,000 |

### 19. CASH GENERATED FROM OPERATIONS

| | | 2017 £000 | 2016 £000 |
|---|---|---|---|
| Profit before tax | | **26,766** | 45,631 |
| *Adjustments for:* | | | |
| Depreciation of property, plant and equipment (**note 6**) | | **50,723** | 46,439 |
| Amortisation of grants and contributions | | **(1,480)** | (1,447) |
| Amortisation of intangible fixed assets (**note 7**) | | **5,971** | 5,019 |
| Profit on disposal of property, plant and equipment | | **(65)** | (91) |
| Loss on disposal of infrastructure assets | | **3,073** | 1,577 |
| Post-employment benefits | | **(1,432)** | (5,235) |
| Finance costs – net (**note 4**) | | **51,023** | 36,703 |
| Changes in working capital: | | | |
| – Inventories | | **(208)** | 40 |
| – Trade and other receivables | | **(9,781)** | (672) |
| – Trade and other payables: | - provision element | **(423)** | 137 |
| | - other | **15,909** | 1,109 |
| **Cash generated from operations** | | **140,076** | 129,210 |

### 20. COMMITMENTS

**20.1 Capital commitments**

Capital expenditure contracted for at the end of the reporting period but not yet incurred is as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Property, plant and equipment | **29,651** | 22,333 |
| Intangible assets | **2,691** | 900 |
| | **32,342** | 23,233 |

**20.2 Commitments under operating leases**

The future aggregate minimum lease payments under non-cancellable operating leases are as follows:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | Land and buildings £000 | Other £000 | Land and buildings £000 | Other £000 |
| No later than one year | **1,547** | **1,858** | 1,547 | 1,751 |
| Later than one year and no later than five years | **6,187** | **2,892** | 6,187 | 2,721 |
| Later than five years | **5,285** | **1** | 6,832 | 2 |
| | **13,019** | **4,751** | 14,566 | 4,474 |

# Statutory financial statements continued

## Notes to the financial statements (continued)

### 21. 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 these financial statements in respect of uncollected sewerage and sewerage infrastructure charges at 31 March 2017 (2016: £nil).

### 22. EVENTS AFTER THE REPORTING PERIOD

Affinity Water Limited used the Exit Regulations laid out by Defra to transfer its existing non-household retail base to fellow group member Affinity for Business (Retail) Limited on 1 April 2017.

On 19 May 2017, Infracapital Partners II and North Haven Infrastructure Partners LP sold 100% of their shareholdings in Affinity Water Acquisitions (Investments) Limited, the ultimate holding and controlling company of Affinity Water Limited to a consortium comprising Allianz Capital Partners on behalf of the Allianz Group, HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited) and DIF. As part of the transaction, the buyers also acquired Veolia Water UK Limited's 10% stake in Affinity Water. Affinity Water Limited continues to operate in the ordinary course of business and there is no expectation that the sale will result in any changes at an operational level.

### 23. 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 for the year ended 31 March 2017.

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

Copies of the group financial statements of Affinity Water Acquisitions (Investments) Limited for the year ended 31 March 2017 may be obtained from the Company Secretary, Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

Affinity Water Acquisitions (Investments) Limited was owned by a consortium of investors led by Infracapital Partners II (consisting of Infracapital Partners II LP and Infracapital Partners (NT) II LP) and North Haven Infrastructure Partners LP until 19 May 2017.
Veolia Environnement S.A. held a 10% shareholding in Affinity Water Acquisitions (Holdco) Limited, the direct subsidiary of Affinity Water Acquisitions (Investments) Limited, through its subsidiary Veolia Water UK Limited until the same date. The directors considered Infracapital Partners II and North Haven Infrastructure Partners LP to be the company's ultimate controllers prior to the sale, as they were in a position to exercise material influence over the company's policy and affairs.

Following completion of the sale of Affinity Water Acquisitions (Investments) Limited on 19 May 2017 to Daiwater Investment Limited, the directors consider Allianz Capital Partners on behalf of the Allianz Group, HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited) and DIF to be the company's ultimate controllers.

Allianz Capital Partners is the Allianz Group's in-house investment manager for alternative equity investments. The investment focus is on infrastructure and renewables as well as private equity funds. Allianz Capital Partners' investment strategy is targeted to generate attractive, long-term and stable returns while diversifying the overall investment portfolio for the Allianz Group insurance companies.

HICL Infrastructure Company Limited is a long-term investor in infrastructure assets which are predominantly operational and yielding steady returns. HICL has a portfolio of infrastructure investments, which are positioned at the lower end of the risk spectrum, in three target market segments: public-private partnerships, regulated assets and demand-based assets. The Investment Adviser to HICL is InfraRed Capital Partners Limited, a leading international investment manager focused on infrastructure and real estate.

DIF is an independent and specialist fund management company, which invests in infrastructure assets that generate long-term stable cash flows, including public-private partnerships, regulated infrastructure assets and renewable energy projects in Europe, North America and Australia.

# Statutory financial statements continued

## Notes to the financial statements – appendices

### A1. GENERAL INFORMATION

The company owns and manages the water assets and network in an area of approximately 4,515km$^2$ split over three supply regions, comprising eight separate water resource zones, in the southeast of England. The company is the sole supplier of drinking water in these areas.

The company is a private company and is incorporated and domiciled in the United Kingdom. The address of its registered office is Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

Refer to **note 23** for details of the company's parent company and ultimate parent company.

### A2. SEGMENTAL REPORTING

In the same way that financial information was reported on a monthly basis to the Board, the company's chief operating decision maker, during the current and previous financial year on a combined basis, the company presents its results under a single segment for financial reporting purposes.

### A3. ACCOUNTING POLICIES

**Consolidation**

The company is a majority owned subsidiary of Affinity Water Acquisitions (Investments) Limited, which is the parent undertaking of the smallest and largest group to consolidate the statutory financial statements. It is included in the consolidated financial statements of Affinity Water Acquisitions (Investments) Limited which are publicly available. Therefore the company is exempt by virtue of section 400 of the Companies Act 2006 from the requirement to prepare consolidated financial statements.

**Property, plant and equipment**

Property, plant and equipment are held at historical cost less accumulated depreciation and impairment charges.

Infrastructure assets comprise a network of mains and associated underground pipe-work. Infrastructure assets are held at deemed cost established through an event-driven valuation on transition to FRS 101 in the prior year and subsequent additions are recorded at historical cost less accumulated depreciation and impairment charges.

For accounting purposes the network is segmented into components based on the material used to construct the pipe concerned. The estimated useful economic lives of infrastructure pipes are based on management's judgement and experience, which includes the knowledge and research of the company's dedicated asset management teams. Where management identifies that the actual useful economic life of an asset significantly differs from the estimate used to calculate its depreciation, the depreciation charge is adjusted prospectively.

Expenditure on infrastructure assets relating to increases in capacity, enhancements or material replacements of network components is capitalised where it can be reliably measured and it is probable that incremental future economic benefits will flow to the company. The carrying amount of the replaced part is derecognised. Costs of day-to-day servicing of network components are recognised in the income statement as they arise.

Cost of other property, plant and equipment includes own work capitalised comprising the direct costs of materials, labour and applicable overheads.

Property, plant and equipment are depreciated to their estimated residual values over their estimated useful lives using the straight-line method, with the exception of freehold land which is not depreciated. Assets in the course of construction are not depreciated until commissioned.

The estimated useful lives are:

| | | |
|---|---|---|
| **Infrastructure assets** | | |
| Potable water distribution mains | | 50-150 years |
| Raw water pipes | | 50-150 years |
| **Other property, plant and equipment** | | |
| Buildings | | 40-60 years |
| Operational structures | | 5-85 years |
| Fixed plant: | – short life | 3-10 years |
| | – other | 10-30 years |
| Vehicles and mobile plant | | 3-10 years |

The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognised in operating profit.

The company is required to evaluate the carrying value of its property, plant and equipment for impairment whenever circumstances indicate, in management's judgement, that the carrying value of such assets may not be recoverable. An impairment review in such circumstances requires management to make subjective judgements concerning the future cash flows, growth rates and discount rates of the asset under review.

**Intangible assets**

***Goodwill***

Goodwill represents the excess of the fair value of purchase consideration over the fair value of the net assets acquired. Fair value adjustments based on provisional estimates are amended within one year of the acquisition, if required, with a corresponding adjustment to goodwill.

Goodwill is not amortised but is reviewed for impairment at least annually. Impairment reviews are also carried out if there is an indication that impairment may have occurred, or, where otherwise required, to ensure that intangible assets are not carried above their estimated recoverable amounts. Goodwill is allocated to the CGU that derives benefit from the goodwill for impairment testing purposes. Impairments are recognised immediately in the income statement.

# Statutory financial statements continued

## Notes to the financial statements – appendices (continued)

### A3. ACCOUNTING POLICIES (CONTINUED)

**Intangible assets (continued)**

***Computer software development costs***

Costs associated with maintaining computer software programmes are recognised as an expense as incurred. Development costs that are directly attributable to the design and testing of identifiable and unique software products controlled by the company are recognised as intangible assets only if they meet the criteria of IAS 38: 'Intangible Assets'.

Other development expenditures that do not meet these criteria are recognised as an expense as incurred.

Computer software development costs recognised as assets are amortised on a straight-line basis over their estimated useful lives, which does not exceed five years. Amortisation charged on assets with finite lives is recognised in the income statement in operating costs.

Intangible assets are reviewed for impairment where indicators of impairment exist. Impairments are recognised immediately in the income statement.

**Grants and contributions**

Grants and contributions received in respect of property, plant and equipment are treated as deferred income and released to cost of sales over the useful economic life of the property, plant and equipment to which they relate. Grants and contributions which are given in compensation for expenses incurred with no future related costs, including connection charges billed to developers are recognised in revenue in the income statement in the period that they become receivable.

These grants and contributions are not government grants within the scope of IAS 20: 'Accounting for government grants and disclosure of government assistance'.

**Investment in subsidiaries**

Investments in subsidiaries are held at cost less accumulated impairment losses.

**Trade receivables**

Trade receivables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method, less provision for impairment.

The provision for impairment is based on experience and calculated by applying a range of different percentages to trade receivables of different ages. These percentages also vary between categories of trade receivables. Higher percentages are applied to those categories of trade receivables which are considered to be of greater risk and also to trade receivables of greater age.

**Inventories**

Inventories 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.

**Cash and cash equivalents**

Cash and cash equivalents include cash at bank and in hand, deposits held at call with banks and other short-term highly liquid investments with original maturities of three months or less. Term deposits with original maturities longer than three months that can be redeemed, subject to the interest income being forfeited, are classed as cash and cash equivalents if the deposit is held to meet short term cash needs and there is no risk of a significant change in value as the result of an early withdrawal.

**Current and deferred tax**

The tax expense for the year comprises current and deferred tax. Tax is recognised in the income statement, except to the extent that it relates to items recognised in other comprehensive income or directly in shareholder's funds. In this case, the tax is also recognised in other comprehensive income or directly in shareholder's funds, respectively.

The current tax charge is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the date of the statement of financial position.

Deferred taxation is provided in full, using the liability method, on taxable temporary differences between the tax bases of assets and liabilities and their carrying amounts in the financial statements. A deferred tax asset is only recognised to the extent that it is probable that sufficient taxable profits will be available in the future to utilise it. Deferred taxation is measured on a non-discounted basis using the tax rates and laws that have been enacted or substantively enacted by the date of the statement of financial position and are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when they relate to taxes levied by the same taxation authority and the company intends to settle its current tax assets and liabilities on a net basis.

**Payables**

Payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest method.

**Borrowings**

All loans 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 income statement is allocated to accounting periods over the term of the debt using the effective interest method.

An exchange of debt with substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. At the point of refinancing, all costs relating to the previous debt have been written off to the income statement in full.

# Statutory financial statements continued

## Notes to the financial statements – appendices (continued)

### A3. ACCOUNTING POLICIES (CONTINUED)

**Provisions**

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

**Revenue recognition**

Revenue represents the fair value of the income receivable in the ordinary course of business for goods and services provided. The company recognises revenue when the amount of revenue can be reliably measured, when it is probable that future economic benefit will flow to the entity and when specific criteria have been met.

Charges billed to customers for water provided are recognised in the year in which they are earned. An accrual is estimated for unmeasured consumption relating to metered customers 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. The company does not recognise revenue where historical evidence indicates that the company will probably never be able to collect the revenue billed.

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

The recognition of connection charges billed to developers is detailed in the grants and contributions accounting policy.

**Other income**

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

**Interest income**

Interest income is recognised using the effective interest method. When a loan receivable is impaired, the company reduces the carrying amount to its recoverable amount, being the estimated future cash flow discounted at the original effective interest rate of the instrument, and continues unwinding the discount as interest income.

**Leases**

Leases in which substantially all the risks and rewards of ownership are retained by the lessor are classified as operating leases. Operating lease rentals are charged to the income statement on a straight-line basis over the period of the lease.

The company does not hold any finance leases.

**Grafham reservoir**

Under the Great Ouse Water Act of 1961, the company has an entitlement to water from the Grafham reservoir owned and operated by Anglian Water Services Limited ('Anglian Water'). The company pays Anglian Water a charge for the supply of water, which covers its share of the overall costs of running Grafham reservoir. These costs are recognised as an expense in the income statement as incurred.

**Retirement benefits**

The company operates a pension plan, the Affinity Water Pension Plan ('AWPP'), providing defined benefits based on final pensionable salary. 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 immediately in the income statement. When a settlement or a curtailment occurs, the changes 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 income statement. 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 retirement benefit surplus or deficit in the statement of financial position comprises the present value of the defined benefit obligation (using a discount rate based on high quality corporate bonds), 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.

Re-measurement gains and losses arising from changes in actuarial assumptions are charged or credited to shareholder's funds in other comprehensive income in the period in which they arise.

The amount charged or credited to finance costs is a net interest amount calculated by applying the liability discount rate to the net defined benefit asset or liability.

Contributions to the defined contribution section of the plan are recognised in the income statement in the period in which they become payable.

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

**Dividend distributions**

Dividend distributions to the company's shareholder are recognised as a liability in the company's financial statements in the period in which the dividends are approved by the company's shareholder.

# Statutory financial statements continued

## Notes to the financial statements – appendices (continued)

### A4. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

**Risk management**

The company's financial instruments comprise borrowings, debentures, cash and liquid resources, and various items, such as trade receivables and trade payables that arise directly from operations. The main purpose of these financial instruments is to provide finance for the company's operations. The company finances its operations through a mixture of retained profits, borrowings from its subsidiary companies, borrowings from Affinity Water Capital Funds Limited, its intermediate parent, and debentures.

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 liquidity risk, credit risk, and interest rate and inflation risk. Treasury policies in relation to these risks are agreed in conjunction with the wider Affinity Water group.

The Board reviews and agrees policies for managing each of these risks (refer to **page 43** of the strategic report for further information on management of these risks). These policies have remained unchanged during the year.

Day-to-day responsibility for operational compliance with the treasury policies rests with the group treasurer. A treasury report is provided monthly to the Board, which summarises treasury activities and includes details on the company's position in regards to debt and cash at the end of the month.

The company's treasury function does not act as a profit centre and does not undertake speculative transactions.

**Liquidity risk**

The objective of the company's liquidity risk management policy is to ensure that the company has banking arrangements and adequate, though not excessive, cash balances, revolving credit facilities and standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business and service objectives.

Liquidity risk is primarily managed by maintaining a level of liquidity such that there are sufficient cash balances and committed loan facilities capable of immediate draw down to cover as a minimum the next twelve months' forecast cash requirement ensuring that over-reliance is not placed on any one counterparty, whether through cash holdings or available facilities.

Liquidity is actively monitored by the company's treasury function and reported to the Board on a monthly basis through the treasury report.

At 31 March 2017, the company had £203,129,000 (2016: £251,444,000) of available liquidity, which comprised £45,129,000 (2016: £93,444,000) of cash and term deposits and £158,000,000 (2016: £158,000,000) of undrawn committed borrowing facilities.

Undrawn borrowing facilities:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **Floating rate:** | | |
| Expiring within one year | **58,000** | 58,000 |
| Expiring in more than one year | **100,000** | 100,000 |
| | **158,000** | 158,000 |

The facilities expiring in more than one year comprise two revolving credit facilities, £60,000,000 provided by Barclays Bank PLC and £40,000,000 provided by Lloyds Bank PLC. The facilities are intended for the purpose of financing capital expenditure and working capital requirements to the extent that additional funding is required.

The facilities expiring within one year comprise two standby facilities with different counterparties in the event of a liquidity shortfall: a 364 day revolving Debt Service Reserve Facility of £38,000,000, which is intended for the purpose of funding any debt service payments, and a 364 day revolving Operations and Maintenance Reserve Facility of £20,000,000, which is intended for the purpose of funding operating and capital maintenance expenditure.

***Maturity analysis***

Additional risk may arise if large cash flows are concentrated within particular time periods. The maturity profile in the following table represents the forecast future contractual principal and interest cash flows in relation to the company's financial liabilities with agreed repayment periods on an undiscounted basis.

| At 31 March 2017 | Total £000 | 1 year or less £000 | 1-2 years £000 | 2-3 years £000 | 3-4 years £000 | 4-5 years £000 | More than 5 years £000 |
|---|---|---|---|---|---|---|---|
| Loans from subsidiaries | **1,567,518** | **35,968** | **36,170** | **36,377** | **36,591** | **36,812** | **1,385,600** |
| Loan from intermediate parent | **6,585** | **160** | **160** | **160** | **160** | **160** | **5,785** |
| **Borrowings** | **1,574,103** | **36,128** | **36,330** | **36,537** | **36,751** | **36,972** | **1,391,385** |
| **At 31 March 2016** | **Total £000** | **1 year or less £000** | **1-2 years £000** | **2-3 years £000** | **3-4 years £000** | **4-5 years £000** | **More than 5 years £000** |
| Loans from subsidiaries | 1,509,856 | 35,361 | 35,533 | 35,717 | 35,907 | 36,101 | 1,331,237 |
| Loan from intermediate parent | 6,745 | 160 | 160 | 160 | 160 | 160 | 5,945 |
| **Borrowings** | 1,516,601 | 35,521 | 35,693 | 35,877 | 36,067 | 36,261 | 1,337,182 |

# Statutory financial statements continued

## Notes to the financial statements – appendices (continued)

### A4. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTINUED)

**Credit risk**

Credit risk arises principally from trading (the supply of services to customers) and treasury activities (the depositing of cash). The company does not believe it is exposed to any material concentrations of credit risk.

The company manages its risk from trading through effective management of customer relationships. Concentrations of credit risk with respect to trade receivables are limited due to the company's customer base consisting of a large number of unrelated households and businesses. The Water Industry Act 1991 (as amended by the Water Industry Act 1999) prohibits the disconnection of a water supply and the limiting of supply with the intention of enforcing payment for certain premises, including domestic dwellings. However allowance is made by Ofwat in revenue limits at each price review for a proportion of receivables deemed to be irrecoverable. Therefore the directors of the company do not believe there is any further credit risk provision required in excess of the provision for impairment of trade receivables (see **note 11**).

The company manages its risk from treasury activities by ensuring counterparties meet the minimum credit requirements approved by the Board, which include a maximum peak exposure limit and minimum credit rating. Credit exposure is monitored regularly by the company's treasury function and is reported monthly to the Board through the treasury report.

At 31 March 2017 and 31 March 2016, the maximum exposure to credit risk was represented by the carrying amount of each financial asset in the statement of financial position:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| Cash and term deposits (**note 12**) | **45,129** | 93,444 |
| Trade and other receivables (excluding prepayments) | **85,068** | 75,591 |
| | **130,197** | 169,035 |

**Interest rate and inflation risk**

The company seeks to manage its interest rate risk by maintaining its exposure within a board approved range, primarily through using a mixture of fixed, inflation linked and floating rate borrowings.

The company earns an economic return on its RCV, comprising a real return through revenues and an inflation return as an uplift to its RCV. To the extent that nominal debt liabilities finance a proportion of the RCV, there is an asset liability mismatch which potentially exposes the company to the risk of economic loss where actual inflation is lower than that implicitly locked in through nominal debt. The company's index-linked borrowings, which are linked to RPI inflation, form a partial economic hedge of the company's regulatory assets, which are also linked to RPI inflation.

Interest rate and inflation risks are reported monthly to the Board through the treasury report.

The interest rate profile of the company's debt is as follows:

| As at | Fixed rate debt £000 | RPI-linked debt £000 | Total £000 |
|---|---|---|---|
| **31 March 2017** | **615,254** | **326,174** | **941,428** |
| 31 March 2016 | 583,888 | 318,355 | 902,243 |

***Sensitivity analysis***

Sensitivity analysis has not been performed on movements in interest rates as the company's fixed rate debts had no exposure to interest rates as at 31 March 2017.

The following table details the sensitivity of profit before taxation to changes in RPI on the company's index-linked borrowings. The analysis relates to the position at the reporting date and is not indicative of the years then ended, as these factors would have varied throughout the year.

| | 2017 £000 | 2016 £000 |
|---|---|---|
| 1 per cent increase in RPI | **(3,236)** | (3,156) |
| 1 per cent decrease in RPI | **3,236** | 3,154 |

The analysis assumes a one per cent change in RPI having a corresponding one per cent impact on this position over the next 12-month period.

**Currency risk**

The company has no material net exposure to movements in currency rates.

**Capital risk management**

The gearing policy approved by the Board is a target measured as net debt (as defined in the company's WBS documentation, refer to **note 1E** of the company's regulatory annual performance report) to RCV, of 80%. This allows sufficient headroom within the company's financial covenants, which are triggered at a level of more than 90%. The company's gearing on this basis was 77% at 31 March 2017 (75% at 31 March 2016).

Assuming no significant changes to existing credit rating agencies' methodologies or sector risk assessments, the company aims to maintain its existing credit ratings of A3 with Moody's and A- with Standard & Poor's for the Class A bonds issued by its financing subsidiaries. These ratings are used by the industry's economic regulator, Ofwat, to assess the company's ability to comply with its licence requirement to maintain an investment grade credit rating.

The company looks to manage its risk by monitoring and maintaining the relevant key financial ratios used by the credit rating agencies to determine the credit ratings given. Further detail on the precise measures and methodologies used to assess water companies' credit ratings can be found in the methodology papers published by the rating agencies. Gearing and credit ratings are reported monthly to the Board through the treasury report.

# Statutory financial statements continued

## Notes to the financial statements – appendices (continued)

### A5. RETIREMENT BENEFITS

**Defined benefit section**

The company's pension plan providing benefits based on final pensionable salary is closed to new members (the two precursor plans closing in April 1996 and September 2004). The assets of the AWPP are held separately from those of the company. The plan's corporate trustee (the 'Trustee') is a subsidiary of Affinity Water Capital Funds Limited, an intermediate parent of the company.

The risks of the plan are as follows:

***Asset volatility***

The plan liabilities are calculated using a discount rate set with reference to high quality corporate bond yields. If plan assets underperform this yield, this will create a deficit.

The assets of the plan include a significant proportion of equities, which are expected to outperform corporate bonds in the long-term while providing volatility and risk in the short-term. As the plan further matures, the Trustee intends to reduce the level of investment risk by investing more in assets that better match the liabilities of the plan and expected cash outflows based on the plan's maturity profile.

The company believes that due to the strength of its business and the long-term nature of the plan liabilities, a level of continuing equity investment is an appropriate element of the Trustee's long-term strategy to manage the plan efficiently.

***Changes in bond yield***

A decrease in corporate bond yields will increase plan liabilities, although this will be partially offset by an increase in the value of the plan's bond holdings.

***Life expectancy***

The majority of the plan's obligations are to provide benefits for the life of its members, so increases in life expectancy will result in an increase in the plan's liabilities.

***Inflation risk***

The pension obligations are linked to inflation, and higher inflation will lead to higher liabilities (although, in most cases, caps on the level of inflationary increases are in place to protect the plan against extreme inflation). In addition, the Trustee has increased the level of interest rate and inflation hedging provided by the plan's assets.

The latest formal valuation of the AWPP, determined by an independent qualified actuary, was at 31 December 2015. This actuarial valuation was made on the "attained age" funding method, based on the following assumptions:

| | |
|---|---|
| **RPI inflation:** | measured by reference to the Bank of England gilt inflation curve less an allowance for an inflation risk premium of 0.1% per annum; |
| **CPI inflation:** | measured by reference to the RPI inflation curve described above less 1.0% per annum; |
| **Pre-retirement discount rate:** | measured by reference to the Bank of England gilt yield curves plus 2.5% per annum; |
| **Post retirement discount rate:** | measured by reference to the Bank of England gilt yield curves plus 0.5% per annum; |
| **Salary increases:** | measured by reference to the RPI inflation curve described above plus 1% per annum; |
| **Deferred pension increases:** | measured by reference to the CPI or RPI inflation curves described above with an appropriate adjustment for any caps and collars; and |
| **Pension increases:** | measured by reference to the CPI or RPI inflation curves described above with an appropriate adjustment for any caps and collars. |

Comparative figures for 2016 are based on the previous actuarial valuation at 31 March 2013.

**Defined benefit section – employer contributions**

Based on the latest actuarial valuation at 31 December 2015, the contributions expected to be paid in the year ending 31 March 2018 are £6,400,000 (£9,656,000 in the year ended 31 March 2017 based on the actuarial valuation at 31 March 2013).

The weighted average duration of the defined benefit obligation is 18.0 years (2016: 17.1 years).

**Defined benefit section - financial and demographic assumptions**

Adjustments to the aforementioned actuarial valuations at 31 December 2015 and 31 March 2013 for 2017 and 2016 respectively have been made based on the following assumptions:

| | 2017 | 2016 |
|---|---|---|
| Discount rate | **2.55% pa** | 3.55% pa |
| Salary growth | **3.10% pa** | 2.85% pa |
| RPI | **3.10% pa** | 2.85% pa |
| CPI | **2.10% pa** | 1.85% pa |
| Life expectancy for a male pensioner from age 65 (years) | **22** | 22 |
| Life expectancy for a female pensioner from age 65 (years) | **25** | 24 |
| Life expectancy from age 65 (years) for a male participant currently aged 45 (years) | **24** | 24 |
| Life expectancy from age 65 (years) for a female participant currently aged 45 (years) | **26** | 26 |

Deferred pensions are revalued to retirement age in line with the CPI assumption of 2.10% per annum (2016: 1.85% per annum) unless otherwise prescribed by statutory requirements or the plan rules.

# Statutory financial statements continued

## Notes to the financial statements – appendices (continued)

### A5. RETIREMENT BENEFITS (CONTINUED)

**Defined benefit section - sensitivity analysis**

| | Change in assumption | Impact on defined benefit obligation | Change in assumption | Impact on defined benefit obligation |
|---|---|---|---|---|
| **2017** | | | | |
| **Discount rate** | **0.5% decrease** | **9.4% increase** | **0.5% increase** | **9.4% decrease** |
| **Salary growth** | **0.5% increase** | **1.2% increase** | **0.5% decrease** | **1.2% decrease** |
| **Pension growth rate** | **0.5% increase** | **8.0% increase** | **0.5% decrease** | **8.0% decrease** |
| **Life expectancy** | **1 year increase** | **3.0% increase** | **1 year decrease** | **3.0% decrease** |
| 2016 | | | | |
| Discount rate | 0.5% decrease | 8.1% increase | 0.5% increase | 8.1% decrease |
| Salary growth | 0.5% increase | 0.9% increase | 0.5% decrease | 0.9% decrease |
| Pension growth rate | 0.5% increase | 6.7% increase | 0.5% decrease | 6.7% decrease |
| Life expectancy | 1 year increase | 3.0% increase | 1 year decrease | 3.0% decrease |

The above sensitivity analyses are based on a change in an assumption while holding all other assumptions constant. In practice this is unlikely to occur, and changes in some of the assumptions may be correlated. When calculating the sensitivity of the defined benefit asset to significant actuarial assumptions, the same method (present value of the defined benefit asset calculated using the projected unit credit method at the end of the reporting period) has been applied as when calculating the pension asset recognised within the statement of financial position.

**Defined benefit section - net retirement benefit surplus**

At 31 March, the fair values of the plan's assets recognised in the statement of financial position were as follows:

| | Plan assets % | 2017 £000 | Plan assets % | 2016 £000 |
|---|---|---|---|---|
| Equity securities | **14%** | **70,510** | 15% | 64,980 |
| Debt securities | **20%** | **103,460** | 27% | 113,920 |
| Diversified growth funds | **23%** | **113,450** | 24% | 99,000 |
| Property | **1%** | **4,920** | 1% | 4,370 |
| Infrastructure | **2%** | **11,230** | 2% | 10,240 |
| Liability driven investments | **40%** | **202,060** | 31% | 129,110 |
| Cash and cash equivalents | **0%** | **1,370** | 0% | 880 |
| **Total fair value of the plan's assets** | **100%** | **507,000** | 100% | 422,500 |
| **Present value of defined benefit obligations** | | **(434,003)** | | (349,912) |
| **Net retirement benefit surplus** | | **72,997** | | 72,588 |

**Defined benefit section - fair value of plan assets**

Movements in the fair value of the plan's assets were as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **At 1 April** | **422,500** | 419,222 |
| Benefits paid | **(16,615)** | (15,167) |
| Employer contributions | **5,285** | 9,778 |
| Contributions by plan participants | **738** | 844 |
| Interest income | **14,902** | 13,134 |
| Re-measurement gains/(losses) | **80,190** | (5,311) |
| **At 31 March** | **507,000** | 422,500 |

**Defined benefit section - present value of plan liabilities**

Movements in the present value of the defined benefit liabilities are as follows:

| | 2017 £000 | 2016 £000 |
|---|---|---|
| **At 1 April** | **(349,912)** | (374,124) |
| Benefits paid | **16,615** | 15,167 |
| Contributions by plan participants | **(738)** | (844) |
| Current service cost | **(3,853)** | (4,543) |
| Interest expense | **(12,145)** | (11,546) |
| Re-measurement (losses)/gains | **(83,970)** | 25,978 |
| **At 31 March** | **(434,003)** | (349,912) |

**Defined contribution section**

At the same time that the defined benefit section became closed to new entrants, the company established a defined contribution section to provide pension benefits to qualifying employees.

The total pension charge for the defined contribution section of the AWPP for the year ended 31 March 2017 was £1,712,000 (2016: £1,355,000). There are no amounts prepaid or outstanding in respect of the defined contribution section at 31 March 2017 (2016: nil).

# Statutory financial statements continued

## Notes to the financial statements – appendices (continued)

### A6. SUBSIDIARIES

| Name of company | Country of registration/ incorporation | Registered address | Nature of business | Type of holding | Proportion of voting rights and shares held |
|---|---|---|---|---|---|
| Affinity Water Finance (2004) PLC | United Kingdom | Tamblin Way, Hatfield, Hertfordshire AL10 9EZ | Financing company | Ordinary shares | 100% |
| Affinity Water Programme Finance Limited | Cayman Islands | PO Box 309, Ugland House, Grand Cayman, KY1-1104 | Financing company | Ordinary shares | 100% |
| Three Valleys Water Limited | United Kingdom | Tamblin Way, Hatfield, Hertfordshire AL10 9EZ | Dormant company | Ordinary shares | 100% |
| Tendring Hundred Water Services Limited | United Kingdom | Tamblin Way, Hatfield, Hertfordshire AL10 9EZ | Dormant company | Ordinary shares | 100% |
| Folkestone and Dover Water Services Limited | United Kingdom | Tamblin Way, Hatfield, Hertfordshire AL10 9EZ | Dormant company | Ordinary shares | 100% |
| White Cliffs Water Limited | United Kingdom | Tamblin Way, Hatfield, Hertfordshire AL10 9EZ | Dormant company | Ordinary shares | 100% |

The company has an investment of £50,000 in 100% of the £1 ordinary shares of a subsidiary company, Affinity Water Finance (2004) PLC. The principal activity of Affinity Water Finance (2004) PLC, incorporated in the United Kingdom, is to raise finance for the company. It made a profit of £1,000 for the year ended 31 March 2017 (2016: £1,000).

On 11 January 2013, Affinity Water Limited incorporated Affinity Water Programme Finance Limited as a special purpose vehicle, registered in the Cayman Islands (resident for the purposes of tax in the United Kingdom). The company invested £10,000 in 100% 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 £5,000 in the year ended 31 March 2017 (2016: £3,000).

The dormant subsidiaries listed above file accounts at Companies House.

### A7. RELATED PARTY TRANSACTIONS

**a) Purchases of goods and services**

| | | | 2017 | | 2016 | |
|---|---|---|---|---|---|---|
| Related party | Nature of Relationship | In respect of | Value £000 | Balance £000 | Value £000 | Balance £000 |
| Veolia Water UK Limited | Shareholder | Management and technical support | **50** | **15** | 256 | 206 |
| Veolia Environmental Services (UK) Limited | Partial common ownership | Waste water disposal | **304** | **20** | 350 | - |
| VWS (UK) Limited | Partial common ownership | Transport and other services | **47** | **-** | 715 | - |

**b) Sales of goods and services**

| | | | 2017 | | 2016 | |
|---|---|---|---|---|---|---|
| Related party | Nature of Relationship | In respect of | Value £000 | Balance £000 | Value £000 | Balance £000 |
| Veolia Water UK Limited | Shareholder | Transitional services, capability sharing agreement and other support | **216** | **138** | 302 | 334 |
| Veolia Environmental Services (UK) Limited | Partial common ownership | Waste water disposal | **20** | **3** | 22 | 2 |
| Other Veolia entities | Partial common ownership | Transitional services, capability sharing agreement and laboratory services | **108** | **54** | 84 | 247 |

**c) Term deposit**

| | | | 2017 | | 2016 | |
|---|---|---|---|---|---|---|
| Related party | Nature of Relationship | In respect of | Value £000 | Balance £000 | Value £000 | Balance £000 |
| Morgan Stanley Liquidity Funds | Common ownership | Term deposit and interest thereon | **36** | **10,000** | 9 | 10,000 |

See **note 3** for disclosure of the directors' remuneration.

# Regulatory annual performance report

for the year ended 31 March 2017

## Contents


| | |
|---|---|
| Certificates of compliance | 146 |
| Statement of risk and compliance | 149 |
| Independent auditor's report | 151 |
| Section 1 - Regulatory financial reporting | |
| Income statement | 158 |
| Statement of comprehensive income | 159 |
| Statement of financial position | 160 |
| Statement of cash flows | 162 |
| Net debt analysis | 163 |
| Statement of accounting policies | 164 |
| Statement of directors' remuneration and standards of performance | 168 |
| Section 2 - Price review and other segmental reporting | 173 |
| Section 3 - Performance summary | 180 |
| Section 4 - Non-audited additional regulatory information | 184 |
| Tax strategy related to the appointed business | 193 |
| Data assurance summary | 194 |


The following regulatory annual performance report is prepared to enable the Water Services Regulation Authority (Ofwat) to monitor the financial performance of the regulated water business. This regulatory annual performance report should be read in conjunction with the annual report and financial statements as a whole.

**Affinity Water Limited**
(Registered Number 02546950)

PHOTO: Our Education Centre in our Colne community engaged over 16.000 children and adults during the year.

# Regulatory annual performance report 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 27 June 2017 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
27 June 2017

### 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 2017 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.

# Regulatory annual performance report continued

## Certificates of compliance (continued)

### STATEMENT OF DIRECTORS' RESPONSIBILITIES

In addition to their responsibilities to prepare financial statements in accordance with the 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 the Regulatory Accounting Guidelines ('RAGs') 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 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 is 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 its report. This confirmation is given and should be interpreted in accordance with the provisions of section 418 of the Companies Act 2006.

## Statement of risk and compliance

### PURPOSE OF THIS STATEMENT

The purpose of this statement is:

- to confirm that the company has complied with all its relevant statutory, licence and regulatory obligations;
- to confirm that the company is taking appropriate steps to manage or mitigate the risks it faces; and
- to explain any significant matters relevant to the company's performance in 2016/17, as presented in section 3 of this regulatory annual performance report on **pages 180 to 183**.

The statement explains the company's approach to regulatory compliance and assurance and sets out its statement of compliance. It should be read alongside the company's annual report and financial statements for the year ended 31 March 2017, which include a summary of the company's operational and financial performance for 2016/17 on **pages 32 to 41** and set out how the company manages risk and uncertainty on **page 43**.

### REGULATORY COMPLIANCE AND ASSURANCE

The company's approach to achieving and assuring compliance with its licence and regulatory obligations is based on a sound system of internal controls and governance. The company's Board and Audit Committee members carry out a range of activities to inform themselves about the company's compliance.
The company's Director of Regulation is responsible for monitoring regulatory compliance and is supported in discharging this responsibility by employees in the Regulation, Legal and Internal Audit teams.

The company continues to employ an external reporter (the 'Reporter') to scrutinise, challenge and give independent advice on the procedures the company uses to collect and report the information underpinning this compliance statement. As a result of the Reporter's and the Internal Audit team's scrutiny, the company has identified the following areas for improvement. Neither of these are material risks to regulatory compliance or reporting of performance this year but are areas the company wishes to address to mitigate compliance and performance risks in the longer term:

- Leakage (W-A1) and Average Water Use (W-A2): Improve clarity around the assumptions relating to non-household night use and improve the verification process for monitoring and checking bulk meters used in the distribution input calculation.
- Mains bursts (W-A3): Improve the reliability of reporting to remove the current tendency to over-report the number of mains bursts.

### REGULATORY OUTPUTS

The Board has reviewed the performance of the company against its regulatory outputs set at the Final Determination for PR14. This regulatory annual performance report identifies differences between the outputs that the company has delivered in the year and those that are assumed in its Final Determination for PR14.

# Regulatory annual performance report continued

## Statement of risk and compliance (continued)

### COMPLIANCE STATEMENT

As a Board, we confirm that:

- we have a full understanding of, and are meeting, our statutory and regulatory obligations;
- we have taken steps to understand and meet our customers' expectations;
- we are satisfied that we have sufficient processes and internal systems of control to meet our obligations; and
- we have appropriate systems and processes in place to allow us to identify, manage and review our risks.

On behalf of the Board:

**Simon Cocks**
Chief Executive Officer

**Patrick O'D Bourke**
Independent non-executive director

## Independent auditor's report to the Water Services Regulation Authority (the 'WSRA') and the directors of Affinity Water Limited

### Opinion on Annual Performance Report

In our opinion, Affinity Water Limited's Regulatory Accounting Statements within the Annual Performance Report:

- have been properly prepared in accordance with Condition F, the Regulatory Accounting Guidelines issued by the WSRA (RAG1.07, RAG2.06, RAG3.09, RAG4.06 and RAG5.06) and the accounting policies (including the Company's published accounting methodology statement(s), as defined in RAG 3.09, appendix 3) set out on **pages 164 to 167**.

### Emphasis of matter – basis of preparation

Without modifying our opinion on the Regulatory Accounting Statements within the Annual Performance Report, we draw attention to the fact that the Annual Performance Report has been prepared in accordance with Condition F, the Regulatory Accounting Guidelines, the accounting policies (including the company's published accounting methodology statement, as defined in RAG 3.09, appendix 3) set out in the statement of accounting policies and under the historical cost convention. The nature, form and content of the Regulatory Accounting Statements 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 WSRA's purpose. Accordingly we make no such assessment.

The Annual Performance Report is separate from the statutory financial statements of the Company and has 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.

The Regulatory Accounting Statements on **pages 144 to 192** have been drawn up in accordance with Regulatory Accounting Guidelines with a number of departures from UK GAAP. A summary of the effect of these departures from Generally Accepted Accounting Practice in the Company's statutory financial statements is included in the tables within **section 1**.

### What we have audited

The tables within Affinity Water Limited's Annual Performance Report that we have audited ("the Regulatory Accounting Statements") comprise:

- the regulatory financial reporting tables comprising the income statement (**table 1A**), the statement of comprehensive income (**table 1B**), the statement of financial position (**table 1C**), the statement of cash flows (**table 1D**) and the net debt analysis (**table 1E**) and the related notes; and
- the regulatory price review and other segmental reporting tables comprising the segmental income statement (**table 2A**), the totex analysis for wholesale water and wastewater (**table 2B**), the operating cost analysis for retail (**table 2C**), the historical cost analysis of fixed assets for wholesale and retail (**table 2D**), the analysis of capital contributions and land sales for wholesale (**table 2E**), the household water revenues by customer type (**table 2F**), the non-household water revenues by customer type (**table 2G**) and the revenue analysis by customer type (**table 2I**) and the related notes.

The financial reporting framework that has been applied in their preparation comprises Condition F, the Regulatory Accounting Guidelines issued by the WSRA and the accounting policies (including the company's published accounting methodology statement, as defined in RAG 3.09, appendix 3) set out in notes to the Annual Performance Report.

In applying the financial reporting framework, the directors have made a number of subjective judgements, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

We have not audited the Outcome performance tables (**tables 3A to 3D**) and the additional regulatory information in **tables 4A to 4H**.

# Regulatory annual performance report continued

## Independent auditor's report to the Water Services Regulation Authority (the 'WSRA') and the directors of Affinity Water Limited (continued)

### What we have audited (continued)

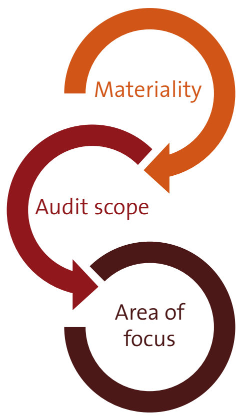
This report is made, on terms that have been agreed, solely to the Company and the WSRA in order to meet the requirements of Condition F of the Instrument of Appointment granted by the Secretary of State for the Environment to the Company as a water undertaker under the Water Industry Act 1991 ("Condition 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.

### Our audit approach

***Context***

There has been no significant change in the business during the year that affected our risk assessment and audit planning, so our approach was consistent with last year.

***Overview***




- Overall materiality: £3.3 million (2016: £3.3 million) which represents 2.5% of earnings before interest, tax, depreciation and amortisation ('EBITDA').
- The company requires an audit 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").
- Measured income accrual.
- Bad debt provision.
- Cost capitalisation.
- Pension assumptions.
- Compliance with Regulatory Accounting Guidelines.

***The scope of our audit and our areas of focus***

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)").

We designed our audit by determining materiality and assessing the risks of material misstatement in the Regulatory Accounting Statements. In particular, we looked at where the directors made subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. As in all of our audits we also addressed the risk of management override of internal controls, including evaluating whether there was evidence of bias by the directors that represented a risk of material misstatement due to fraud.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as "areas of focus" in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

### Our audit approach (continued)

***The scope of our audit and our areas of focus (continued)***

| ***Area of focus*** | ***How our audit addressed the area of focus*** |
|---|---|
| ***Measured income accrual***<br>Refer to **page 73** (Audit Committee Report), **page 108** (accounting policies) and **page 119** (**note 11**).<br><br>The directors have recorded a measured income accrual of £40.4 million (2016: £41.5 million) relating to revenue from the provision of water services to customers on water meters that had not been read at the year-end date.<br><br>Revenue recognition in respect of the measured income accrual is particularly judgemental, and clearly impacts directly on reported turnover and profit. The measured income accrual accounts for the timing difference between the last meter reading and the consumption of water from this point to the year end. It is calculated based on the average consumption over the past two years by small geographical groupings of customers.<br><br>Given the range of factors underlying the estimate, there is a risk that the measured income accrual and revenue could be misstated. | We have confirmed the mathematical accuracy of the calculations supporting the measured income accrual and agreed a sample of the latest meter readings to the internal billing system from which they were extracted.<br><br>We have reviewed management's analysis of the movements in the measured revenue compared to prior year and agreed these movements to supporting information including property statistic reports detailing additional households in the Company's geographical catchment area and RPI inflation representing the standard tariff increase.<br><br>We evaluated the historical accuracy of the estimation process by reviewing bills raised in the current year for all amounts accrued at the prior year end. We note that the prior year accrual differs by <1% to the actual readings taken post year end.<br><br>We have reviewed the customer amounts accrued at 31 March 2017 which have subsequently been billed and noted immaterial differences. At the time of our testing, the total amounts billed represent 14% of the year-end accrual. We have extrapolated the differences across the total accrual and noted no material differences. |
| ***Provision for impairment of trade debt receivables***<br>Refer to **page 73** (Audit Committee Report) and **page 108** (accounting policies).<br><br>The Company estimates the recoverable value of its trade receivables and records a provision for impairment based on experience.<br><br>The provision is calculated by applying a percentage based on historical cash collection rates to individual aged debt categories.<br><br>Some customers continue to struggle to pay their bills or in certain instances, choose not to pay them. As there are limited steps that a water company can take to recover debt from domestic customers, there is an ongoing risk of aged debt not being collected.<br><br>The provision needs to reflect all these factors and accordingly could be materially misstated. Our audit focused on the risk that the provision for impairment of trade debt receivable could be understated. | We have reviewed the methodology for calculating the bad debt provision and confirmed that it is reasonable and consistent year on year. We confirmed the mathematical accuracy of the calculations supporting the provision and the underlying data including the type of customer (household v non-household), measurement basis (measured v unmeasured) and ageing of debt.<br><br>To ensure the appropriate classification of customers into ageing categories we selected a sample of debt and ensured this had been correctly treated based on ageing, customer type and measurement basis.<br><br>In addition, we have compared the actual provision rates used in the provision to prior year provision rates and reviewed the level of bad debt write offs which occurred in the year to 31 March 2017 to ensure the accuracy of management's previous estimates. We did not identify any material levels of bad debt which were not previously provided. The level of bad debt write offs are consistent year on year.<br><br>We consider the level of provisioning to be acceptable, based on historical cash collection rates and current ageing of the debt. |

# Regulatory annual performance report continued

## Independent auditor's report to the Water Services Regulation Authority (the 'WSRA') and the directors of Affinity Water Limited (continued)

### Our audit approach (continued)

***The scope of our audit and our areas of focus (continued)***

| *Area of focus* | *How our audit addressed the area of focus* |
|---|---|
| ***Cost capitalisation***<br>Refer to **page 73** (Audit Committee Report), **page 108** (accounting policies) and **page 116** (**note 6**).<br><br>The Company capitalises expenditure with respect to its infrastructure assets where such expenditure enhances or increases the capacity of the network, or relates to material replacements of network components.<br><br>The allocation of costs between capital and non-capital spend can be judgemental and has a direct impact on profit in any one year. The key judgement is management's assessment of what constitutes enhancement compared to maintenance expenditure.<br><br>Given the magnitude of capital spend at £129.0m there is a risk that incorrect classification could give rise to material misstatements. | We have reviewed the process for allocating costs to capital projects and are satisfied that this allocation has been made on a consistent basis and is in line with the Company's capitalisation policy. We have selected a sample of items capitalised in the year and ensured these are consistent with the Company's accounting policy and have been appropriately capitalised in line with IAS 16.<br><br>We have examined the process of capitalising staff time through the inspection of time sheet data and tested a sample of staff costs capitalised. We have not noted any exceptions from our testing and conclude that the time capitalised relates to that spent on valid capital projects.<br><br>In addition, we evaluated the nature of overheads capitalised and found these to relate directly to the asset construction operations of the business and therefore are appropriately capitalised. |
| ***Assumptions relating to retirement benefit surplus***<br>Refer to **page 73** (Audit Committee Report), **page 108** (accounting policies), **page 118** (**note 9**) and **pages 138 to 141** (**note A5**).<br><br>The company has a defined benefit pension plan and has recognised a net retirement benefit surplus of £73.0m (2016: £72.6m). The plan liabilities increased from £349.9m to £434.0m mainly as a result of a decrease in discount rates. In addition, the plan assets increased from £422.5m to £507.0m.<br><br>The valuation of the net retirement benefit surplus requires significant levels of judgement and technical expertise including the use of actuarial experts to support the Directors in selecting appropriate assumptions. Changes in a number of key financial and demographic assumptions (including salaries increase, inflation, discount rates, and mortality rates) can have a material impact on the calculation of the net asset. | We assessed the competence and independence of the actuary by confirming that the Company is a member of the Institute and Faculty of Actuaries and confirming it is appropriately independent of the Company.<br><br>We agreed the discount and inflation rates, together with the expected rates of return on plan assets used in the valuation by the external actuary to our internally developed benchmarks. We confirmed that these were within our expected ranges and were consistently positioned within the range year on year.<br><br>The mortality rates and the allowance for future improvements in longevity were agreed to be consistent with our internally developed benchmarks and based on national and industry averages.<br><br>We agreed the salaries increase to be within our expected range based on the Consumer Price Index ('CPI') and Retail Price Index ('RPI'). |

### Our audit approach (continued)

***The scope of our audit and our areas of focus (continued)***

| *Area of focus* | *How our audit addressed the area of focus* |
|---|---|
| ***Compliance with Regulatory Accounting Guidelines***<br>The Regulatory Accounting Statements need to be prepared in accordance with Condition F, the Regulatory Accounting Guidelines issued by the WSRA (RAG1.07, RAG2.06, RAG3.09, RAG4.06 and RAG5.06) and the accounting policies (including the Company's published accounting methodology statement). Given the level of complexity within the Regulatory Accounting Guidelines there is a risk that incorrect classification or allocation of costs could give rise to a significant misstatement. | We have performed substantive testing ensuring that the Regulatory Accounting Statements have been prepared on a basis that is consistent with both the Regulatory Accounting Guidelines issued by the WSRA (RAG1.07, RAG2.06, RAG3.09, RAG4.06 and RAG5.06) and the accounting policies (including the Company's published accounting methodology statement). No material inconsistencies were identified.<br><br>We have evaluated the adjustments shown as "Differences between statutory and RAG definitions" in tables 1A-1E to ensure that these are appropriately reflected.<br><br>For tables 2A to 2I, we have checked the consistency of the Accounting Separation Model to the audited trial balance and verified the mathematical accuracy of the model with no inconsistencies or exceptions noted. Allocation of costs between Wholesale (Water Resources and Water Network+) and Retail (Household and Non-Household) have been audited to appropriate supporting documentation with no material inconsistencies identified. |

***How we tailored the audit scope***

The Company comprises Affinity Water Limited operating as the regulated water business, which was subject to a regulatory audit by the Company audit engagement 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.

***Materiality***

The scope of our audit was influenced by our application of materiality. We set certain quantitative thresholds for materiality. These, together with qualitative considerations, helped us to determine the scope of our audit and the nature, timing and extent of our audit procedures on the individual financial statement line items and disclosures and in evaluating 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 as follows:

| | |
|---|---|
| ***Overall materiality*** | £3.3 million (2016: £3.3 million). |
| ***How we determined it*** | 2.5% of earnings before interest, tax, depreciation and amortisation ('EBITDA'). |
| ***Rationale for benchmark applied*** | Consistent with last year, we used EBITDA as this is the measure that management focus on internally in their reporting, due to the capital-intensive nature of the business. EBITDA also provides us with a consistent year-on-year basis for our audit. |

We agreed with the Audit Committee that we would report to them misstatements identified during our audit above £0.2 million (2016: £0.2 million) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

# Regulatory annual performance report continued

## Independent auditor's report to the Water Services Regulation Authority (the 'WSRA') and the directors of Affinity Water Limited (continued)

### Respective responsibilities of the WSRA, the Directors and Auditors

As explained more fully in the Statement of Directors' Responsibilities set out on **page 148**, the directors are responsible for the preparation of the Annual Performance Report in accordance with Condition F, the Regulatory Accounting Guidelines issued by the WSRA and the Company's accounting policies (including the Company's published accounting methodology statement, as defined in RAG 3.09, appendix 3).

Our responsibility is to audit and express an opinion on the Regulatory Accounting Statements within the Annual Performance Report in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)"), except as stated in the section on 'What an audit of the Annual Performance Report involves' below, and having regard to the guidance contained in *ICAEW Technical Release Tech 02/16 AAF 'Reporting to Regulators on Regulatory Accounts'* issued by the Institute of Chartered Accountants in England & Wales. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### What an audit of the Annual Performance Report involves

An audit involves obtaining evidence about the amounts and disclosures in the Regulatory Accounting Statements sufficient to give reasonable assurance that the Regulatory Accounting Statements within the Annual Performance Report 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; and the reasonableness of significant accounting estimates made by the directors. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited tables within the Annual Performance Report 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 Annual Performance Report are consistent with those used in the preparation of the statutory financial statements of the company. Furthermore, as the nature, form and content of Annual Performance Report is 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).

The Company has presented the allocation of operating costs and assets in accordance with the accounting separation policy set out in section 2 and its Accounting Methodology Statement published on the Company's website in June 2017. We are not required to assess whether the methods of cost allocation set out in the Methodology Statement are appropriate to the circumstances of the Company or whether they meet the requirements of the WSRA, 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 Accounting Statements are in agreement with the accounting records and returns retained for the purpose of preparing the Annual Performance Report.

### Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where under International Standards on Auditing (UK and 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 Regulatory Accounting 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
- otherwise misleading.

In particular, we are required to consider whether we have identified any inconsistencies between our knowledge acquired during the audit and the directors' statement that they consider the Annual Report is fair, balanced and understandable and whether the Annual Performance Report appropriately discloses those matters that we communicated to the Audit Committee which we consider should be disclosed.

### Other matters

Our opinion on the Regulatory Accounting Statements within the Annual Performance Report is separate from our opinion on the statutory financial statements of the Company for the year ended 31 March 2017 on which we reported on 27 June 2017, 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 members, as a body, 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 members those matters we are required to state to them 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

Uxbridge

27 June 2017

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting

### 1A - INCOME STATEMENT FOR THE 12 MONTHS ENDED 31 MARCH 2017

| | | Adjustments | | | |
|---|---|---|---|---|---|
| | Statutory £000 | Differences between statutory and RAG definitions £000 | Less: non-appointed £000 | Total adjustments £000 | Total appointed activities £000 |
| **Revenue** | **308,662** | **(5,747)** | **-** | **(5,747)** | **302,915** |
| Operating costs | (248,006) | (245) | (2,324) | 2,079 | (245,927) |
| Other operating income | 17,133 | (6,238) | 11,726 | (17,964) | (831) |
| **Operating profit** | **77,789** | **(12,230)** | **9,402** | **(21,632)** | **56,157** |
| Other income | - | 12,230 | - | 12,230 | 12,230 |
| Interest income | 293 | - | - | - | 293 |
| Interest expense | (54,073) | - | - | - | (54,073) |
| Other interest expense | 2,757 | - | - | - | 2,757 |
| **Profit before tax and fair value movements** | **26,766** | **-** | **9,402** | **(9,402)** | **17,364** |
| Fair value gains/(losses) on financial instruments | - | - | - | - | - |
| **Profit before tax** | **26,766** | **-** | **9,402** | **(9,402)** | **17,364** |
| UK Corporation tax | (7,138) | - | (1,880) | 1,880 | (5,258) |
| Deferred tax | 11,273 | - | - | | 11,273 |
| **Profit for the year** | **30,901** | **-** | **7,522** | **(7,522)** | **23,379** |
| **Dividends** | **(50,500)** | **-** | **-** | **-** | **(50,500)** |

£2,353,000 of the difference between statutory and RAG defined revenue relates to the disapplication in the Regulatory Accounts of the provision of IAS 18: 'Revenue' ('IAS 18'), which states that revenue should only be recognised when it is probable that the economic benefits associated with the transaction will flow to the entity (refer to the revenue recognition accounting policy note on **page 164**). This difference is offset by the reclassification of £7,541,000 of connection charges income and £559,000 of income from providing developer information and the administration of new connections, which are presented within other income in the Regulatory Accounts.

The difference between statutory and RAG defined operating costs consists of the revenue recognition adjustment described in the previous paragraph of £2,353,000 and the reclassification of £1,480,000 of amortisation associated with deferred grants and contributions, which is presented within other income in the Regulatory Accounts, offset by the reclassification of a £3,130,000 net loss on disposal of fixed assets which are presented within other operating income in the Regulatory Accounts. In addition, £458,000 of meter read commission included within other operating income was offset against operating costs in the Regulatory Accounts.

The difference between statutory and RAG defined other operating income consists of the reclassification of the net loss on disposal of fixed assets from operating costs described in the previous paragraph of £3,130,000 and the reclassification of £2,650,000 of rental and sundry income, which is presented within other income in the Regulatory Accounts. £458,000 of meter read costs included within other operating income in the statutory accounts were offset against operating costs in the Regulatory Accounts.

The difference between statutory and RAG defined other income consists of the reclassification of £7,541,000 of connection charges income and £559,000 of income from providing developer information and the administration of new connections, £1,480,000 of amortisation associated with deferred grants and contributions and £2,650,000 of rental and sundry income described in the previous paragraphs.

### 1B - STATEMENT OF COMPREHENSIVE INCOME FOR THE 12 MONTHS ENDED 31 MARCH 2017

| | | Adjustments | | | |
|---|---|---|---|---|---|
| | Statutory £000 | Differences between statutory and RAG definitions £000 | Less: non-appointed £000 | Total adjustments £000 | Total appointed activities £000 |
| **Profit for the year** | **30,901** | **-** | **7,522** | **(7,522)** | **23,379** |
| Actuarial gains/(losses) on post employment plans | (3,780) | - | - | - | (3,780) |
| Other comprehensive income | 643 | - | - | - | 643 |
| **Total comprehensive income for the year** | **27,764** | **-** | **7,522** | **(7,522)** | **20,242** |

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting (continued)

### 1C - STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2017

| | | Adjustments | | | |
|---|---|---|---|---|---|
| | Statutory £000 | Differences between statutory and RAG definitions £000 | Less: non-appointed £000 | Total adjustments £000 | Total appointed activities £000 |
| **Non-current assets** | | | | | |
| Fixed assets | 1,320,792 | - | - | - | 1,320,792 |
| Intangible assets | 51,689 | - | - | - | 51,689 |
| Investments – loans to group companies | - | - | - | - | - |
| Investments – other | 60 | - | - | - | 60 |
| Financial instruments | - | - | - | - | - |
| Retirement benefit assets | 72,997 | - | - | - | 72,997 |
| **Total** | **1,445,538** | **-** | **-** | **-** | **1,445,538** |
| **Current assets** | | | | | |
| Inventories | 1,430 | - | - | - | 1,430 |
| Trade and other receivables | 89,682 | - | 349 | (349) | 89,333 |
| Financial instruments | - | - | - | - | - |
| Cash and cash equivalents | 45,129 | - | 5,096 | (5,096) | 40,033 |
| **Total** | **136,241** | **-** | **5,445** | **(5,445)** | **130,796** |
| **Current liabilities** | | | | | |
| Trade and other payables | (130,353) | 1,618 | (3,073) | 4,691 | (125,662) |
| Capex creditor | (14,405) | - | - | - | (14,405) |
| Borrowings | - | - | - | - | - |
| Financial instruments | - | - | - | - | - |
| Current tax liabilities | (8,236) | - | (2,372) | 2,372 | (5,864) |
| Provisions | (1,252) | 1,252 | - | 1,252 | - |
| **Total** | **(154,246)** | **2,870** | **(5,445)** | **8,315** | **(145,931)** |
| **Net current assets/(liabilities)** | **(18,005)** | **2,870** | **-** | **2,870** | **(15,135)** |
| **Non-current liabilities** | | | | | |
| Trade and other payables | - | - | - | - | - |
| Borrowings | (941,428) | - | - | - | (941,428) |
| Financial instruments | - | - | - | - | - |
| Retirement benefit obligations | - | - | - | - | - |
| Provisions | (2,462) | - | - | - | (2,462) |
| Deferred income – grants and contributions ('G&C's') | (94,190) | (2,870) | - | (2,870) | (97,060) |
| Preference share capital | - | - | - | - | - |
| Deferred tax | (172,736) | - | - | - | (172,736) |
| **Total** | **(1,210,816)** | **(2,870)** | **-** | **(2,870)** | **(1,213,686)** |
| **Net assets** | **216,717** | **-** | **-** | **-** | **216,717** |

| | | Adjustments | | | |
|---|---|---|---|---|---|
| | Statutory £000 | Differences between statutory and RAG definitions £000 | Less: non-appointed £000 | Total adjustments £000 | Total appointed activities £000 |
| **Equity** | | | | | |
| Called up share capital | 26,506 | - | - | - | 26,506 |
| Retained earnings and other reserves | 190,211 | - | - | - | 190,211 |
| **Total equity** | **216,717** | **-** | **-** | **-** | **216,717** |

The £1,618,000 difference between statutory and RAG defined trade and other payables consists of the reclassification of payments received for costs incurred in relation to the HS2 rail programme, which will cross the Affinity Water supply area. In line with our accounting policy for grants and contributions received in respect of property, plant and equipment, which include contributions received for diversions, in the company's statutory financial statements income received will be treated as deferred income and released to cost of sales over the useful economic life of the property, plant and equipment to which it relates once these assets have been commissioned (as at 31 March 2017, no assets had been commissioned and the payments received have been included within payments in advance in trade and other payables).
Given assets constructed by the company under the HS2 programme may not be commissioned for several years, adopting this accounting policy in the Regulatory Accounts will lead to a mismatch of costs incurred and payments received in relation to these costs in the total expenditure ('totex') tables in **sections 2** and **4** of these Regulatory Accounts (**tables 2B, 4B and 4D**). Therefore the payments received in relation to HS2 have been reclassified to deferred income – G&C's in the Regulatory Accounts and included in the totex tables to offset the expenditure incurred. The amount has also been included in the diversions line within the analysis of capital contributions and land sales table (**table 2E**).

The £1,252,000 difference between statutory and RAG defined provisions within current liabilities relates to the reclassification of current deferred G&C's to deferred income – G&C's.

The £2,870,000 difference between statutory and RAG defined deferred income – G&C's related to the reclassifications detailed in the above two paragraphs.

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting (continued)

### 1D - STATEMENT OF CASH FLOWS FOR THE 12 MONTHS ENDED 31 MARCH 2017

| | | Adjustments | | | |
|---|---|---|---|---|---|
| | Statutory £000 | Differences between statutory and RAG definitions £000 | Less: non-appointed £000 | Total adjustments £000 | Total appointed activities £000 |
| **Operating profit** | **77,789** | **(12,230)** | **9,402** | **(21,632)** | **56,157** |
| Other income | - | 12,230 | - | 12,230 | 12,230 |
| Depreciation | 56,694 | - | - | - | 56,694 |
| Amortisation – G&C's | (1,480) | - | - | - | (1,480) |
| Changes in working capital | 5,920 | - | (263) | 263 | 6,183 |
| Pension contributions | (6,717) | - | - | - | (6,717) |
| Movement in provisions | 4,862 | - | - | - | 4,862 |
| Profit on sale of fixed assets | 3,008 | - | - | - | 3,008 |
| **Cash generated from operations** | **140,076** | **-** | **9,139** | **(9,139)** | **130,937** |
| Net interest paid | (45,484) | - | - | | (45,484) |
| Tax paid | (915) | - | (1,945) | 1,945 | 1,030 |
| **Net cash generated from operating activities** | **93,677** | **-** | **7,194** | **(7,194)** | **86,483** |
| **Investing activities** | | | | | |
| Capital expenditure | (131,700) | - | - | - | (131,700) |
| Grants and contributions | 8,918 | - | - | - | 8,918 |
| Disposal of fixed assets | 65 | - | - | - | 65 |
| Other | 309 | - | - | - | 309 |
| **Net cash used in investing activities** | **(122,408)** | **-** | **-** | **-** | **(122,408)** |
| **Net cash generated before financing activities** | **(28,731)** | **-** | **7,194** | **(7,194)** | **(35,925)** |
| **Cashflows from financing activities** | | | | | |
| Equity dividends paid | (50,500) | - | (7,522) | 7,522 | (42,978) |
| Net loans received | 30,916 | - | - | - | 30,916 |
| Cash inflow from equity financing | - | - | - | - | - |
| **Net cash generated from financing activities** | **(19,584)** | **-** | **(7,522)** | **7,522** | **(12,062)** |
| **Increase/(decrease) in net cash** | **(48,315)** | **-** | **(328)** | **328** | **(47,987)** |

The difference between statutory and RAG defined operating profit consists of the reclassification of £7,541,000 of connection charges income and £559,000 of income from providing developer information and the administration of new connections, £1,480,000 of amortisation associated with deferred grants and contributions and £2,650,000 of rental and sundry income all of which are shown in other income.

### 1E - NET DEBT ANALYSIS AT 31 MARCH 2017

| | Fixed rate £000 | Floating rate £000 | Index linked £000 | Total £000 |
|---|---|---|---|---|
| Borrowings (excluding preference shares) | 615,254 | - | 326,174 | **941,428** |
| Preference share capital | | | | **-** |
| **Total borrowings** | | | | **941,428** |
| Cash | | | | **(40,033)** |
| Short term deposits | | | | **-** |
| **Net debt** | | | | **901,395** |
| Gearing | | | | 77.96% |
| Adjusted gearing | | | | 76.57% |
| Full year equivalent nominal interest cost | 29,398 | - | 16,814 | **46,212** |
| Full year equivalent cash interest payment | 29,398 | - | 6,617 | **36,015** |
| **Indicative interest rates:** | | | | |
| Indicative weighted average nominal interest rate (%) | 4.88 | - | 5.29 | **5.02** |
| Indicative weighted average cash interest rate (%) | 4.88 | - | 2.08 | **3.91** |
| **Weighted average years to maturity** | 15.37 | - | 23.74 | **18.26** |

There are no differences between total borrowings presented in the above table and total borrowings presented in **note 15** to the statutory financial statements.

Adjusted gearing is calculated using the definition of net debt set out in the company's WBS documentation, as presented in the following table.

| | Fixed rate £000 | Floating rate £000 | Index linked £000 | Total £000 |
|---|---|---|---|---|
| Borrowings (excluding preference shares) | 615,254 | - | 326,174 | **941,428** |
| Preference share capital | | | | **-** |
| Less: capitalised bond issue costs | | | | **(20,509)** |
| Less: loan from intermediate parent company | | | | **(3,550)** |
| | | | | **917,369** |
| Add: accrued interest on borrowings | | | | **12,987** |
| **Total borrowings** | | | | **930,356** |
| Cash | | | | **(45,129)** |
| Short term deposits (including non-appointed cash) | | | | **-** |
| **Net debt** | | | | **885,227** |

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting (continued)

### STATEMENT OF ACCOUNTING POLICIES

**Basis of preparation**

These accounts have been prepared in accordance with the relevant RAGs.

Accounting policies used are the same as those adopted in the statutory accounts, except as set out below.

Regulatory accounts are prepared to enable Ofwat to monitor the financial performance of the regulated water business. Note tables 2H and 4E have not been presented as they are not applicable for water supply only companies.

**Revenue recognition**

Revenue 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 relating to metered customers that has not yet been billed (refer to the measured income accrual section below).

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

Charges on income arising from court, solicitor and debt recovery agency fees are recognised in revenue.

***Measured income accrual***

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 revenue.

Revenue for the year ended 31 March 2016 included a measured income accrual of £41,455,000. The value of billing recognised in the year ended 31 March 2017 for consumption in the prior year was £41,087,000. This resulted in a decrease of £368,000 in the current year's revenue due to the over-estimation of the prior year's revenue. This represented 0.12% of 2016/17 revenue and is within acceptable tolerance for accounting estimates.

***Adjustments from statutory to regulatory accounts***

The Regulatory Accounts disapply the provision of IAS 18: 'Revenue' ('IAS 18') which states that revenue should only be recognised when it is probable that the economic benefits associated with the transaction will flow to the entity. For regulatory reporting purposes, companies are required to assume that where an amount is billed it is probable that cash will be collected, thereby deviating from the IAS 18 requirement in that there is no judgement applied to the probability of collection. Therefore in the Regulatory Accounts the company does not derecognise revenue where historical evidence indicates that the company will probably never be able to collect the revenue billed.

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 at which it is recorded that water is being used or required. Exceptions to this, where the company waives water charges at its 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 to recognise 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 it 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 customers with meters.

In each of the above cases, if a bill is sent, the company would recognise it within revenue 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 revenue. 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.

**Capitalisation policy**

Expenditure on infrastructure assets relating to increases in capacity, enhancements or material replacements of network components is capitalised where it can be reliably measured and it is probable that incremental future economic benefits will flow to the company. Expenditure generally will only meet the criteria for capitalisation when it relates to specific planned works. Where this work does not involve a mains pipe exceeding a diameter of 300mm (considered qualitatively material due to its strategic importance in the generation of future economic benefits), replacement is considered quantitatively material when the pipe involved is at least 2km long and uses a new material for that location, which enhances the section of network being re-laid.

Costs of day-to-day servicing of network components are recognised in the income statement as they arise.

The company does not capitalise any borrowing costs in its statutory accounts, as the costs do not meet the criteria for capitalisation set out in IAS 23: 'Borrowing costs'.

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting (continued)

### STATEMENT OF ACCOUNTING POLICIES (CONTINUED)

**Bad debt**

At each reporting date, the company evaluates the collectability of trade receivables and records a provision for impairment based on experience. The provision for impairment is charged to operating costs to reflect the company's assessment of the risk of non-recovery of trade receivables. The provision for impairment is calculated by applying a range of different percentages to trade receivables of different ages. These percentages also vary between categories of receivable. Higher percentages are applied to those categories of receivable which are considered to be of greater risk and also to trade receivables of greater age. The value of the provision for impairment 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 trade receivables 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 policy for provision for impairment has remained unchanged and has been consistently applied in the current and prior years. There has not been a significant increase in the provision from £26,313,000 at 31 March 2016 to £27,879,000 at 31 March 2017.

The company's 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 receivable amounts 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 there is a forwarding address for the customer.
- Closed accounts under £100 are written off following all internal recovery activity where there is no forwarding address for the customer.

Amounts are also written off on accounts where the company is 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 write-off policy has remained unchanged and has been consistently applied in the current year compared with the previous year. The amount of debt written off has increased from £7,618,000 in 2015/16 to £7,981,000 in 2016/17 primarily due to inflationary increases.

There has been an increase in trade receivables from £28,570,000 at 31 March 2016 to £32,256,000 at 31 March 2017 as a result of timing differences in billing as customers switch from unmeasured to measured billing following the company's Water Saving Programme.

### GRANTS AND CONTRIBUTIONS

Grants and contributions received in respect of property, plant and equipment are treated as deferred income and released to cost of sales over the useful economic life of the property, plant and equipment to which they relate. Grants and contributions which are given in compensation for expenses incurred with no future related costs are recognised in revenue in the income statement in the period that they become receivable.

Grants and contributions received by the company are not government grants within the scope of IAS 20: 'Accounting for government grants and disclosure of government assistance'.

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting (continued)

### STATEMENT OF DIRECTORS' REMUNERATION AND STANDARDS OF PERFORMANCE

Executive directors' remuneration comprises a package of base salary together with an annual performance-related bonus and a long-term incentive plan. Executive directors' bonuses paid by the company are linked to the standards of performance of the company and are therefore in accordance with RAG 3.09. The elements of the 2016/17 remuneration arrangements for executive directors were established by the company's Remuneration Committee in meetings in 2014/15, 2015/16 and 2016/17.

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 2017/18 |
|---|---|---|---|---|
| **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.<br>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 changes were made to the policy for 2017/18 up to the date of approval of this annual report and financial statements. |
| **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 changes were made to the policy for 2017/18 up to the date of approval of this annual report and financial statements. |
| **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.<br>The bonus is based on internal performance indicators, which have been aligned to the company's commitments for AMP6, plus individual targets. | Up to 75% of base salary for Duncan Bates and up to 100% of base salary for Simon Cocks. | 50% of the total bonus is determined on the achievement of the financial performance target, which is based on net cash outflow before taxation and financing.<br>25% of the total bonus is determined on the achievement of operational and customer and community performance targets.<br>25% of the total bonus is determined on the achievement of personal objectives. | No changes have been made to the internal performance measures for the 2017/18 annual bonus scheme and at the date of approval of this annual report and financial statements, they continued to be aligned to our performance commitments for AMP6.<br>Final % allocations relating to the 2017/18 period have yet to be finalised given the change in ownership of the business on 19 May 2017. |
| **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.<br>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% of salary and the company contributes at 20%.<br>Duncan Bates was a member of the company's defined benefit scheme and defined contribution "top up" scheme until 31 March 2016. From 1 April 2016, Duncan Bates ceased to be a member of either pension scheme and receives a taxable allowance equivalent to the benefit he previously received. | In lieu of being a member of the company's retirement benefit schemes, Duncan Bates receives a taxable allowance of approximately 26% of base pay.<br>In lieu of being a member of the company's retirement benefit schemes, Simon Cocks receives a taxable allowance of approximately 24% of base pay. | N/A | No changes were made to the policy for 2017/18 up to the date of approval of this annual report and financial statements. |
| **LTIP** | | | | |
| To incentivise executives to achieve long-term shareholder value whilst achieving high levels of customer experience performance, although award and payment are discretionary. | Base awards are granted as a percentage of salary and are paid out in cash at the end of a three year performance period, subject to the achievement of performance conditions.<br>Base awards include clawback and malus provisions. | Up to 100% of base salary (although outperformance of the financial performance target may cause this to be higher). | The award will be determined on the performance of the company over the three years in terms of cash available for distribution to shareholders and the third year's SIM performance relative to the industry. | No LTIP awards relating to the 2017/18 period have been finalised given the change in ownership of the business on 19 May 2017. |

Regulatory Annual Performance Report

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting (continued)

### STATEMENT OF DIRECTORS' REMUNERATION AND STANDARDS OF PERFORMANCE (CONTINUED)

Dr Philip Nolan was appointed Chairman in April 2013 for a term of three years, and re-appointed for a further three year term on 1 April 2016. He receives a fixed annual fee for his services which is reflective of the time commitment and responsibilities of the role. He served as executive Chairman from 1 January 2015 until 31 May 2015 and thereafter his role reverted to non-executive.

He also benefits from a remuneration arrangement, which aligns his interests with the longer term interests of shareholders. To this end, it is common practice for the chairs of listed companies to hold shares. As a privately owned company, this is not practicable to implement, so the arrangement has been aligned as closely as possible to the key features of a shareholding in a listed company. Particulars of the arrangement were communicated at the 2016 AGM.

We have departed from the Accounting Regulations of the Act in not providing full disclosure of the terms of the arrangements to protect commercial confidentiality but have disclosed the award made in respect of 2016/17 in the table below.

The following table shows the remuneration paid to directors by the company in respect of 2016/17.

| | Base salary/fees £000 | | Taxable benefits[1] £000 | | Pension related benefits[2] £000 | | Annual bonus £000 | | LTIP[3] £000 | | Other[4] £000 | | Total remuneration £000 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 | 16/17 | 15/16 |
| **Non-executive** | | | | | | | | | | | | | | |
| **Current** | | | | | | | | | | | | | | |
| Patrick O'D Bourke | **47** | 47 | **-** | - | **-** | - | **-** | - | **-** | - | **-** | - | **47** | 47 |
| Chris Bolt | **42** | 41 | **-** | - | **-** | - | **-** | - | **-** | - | **-** | - | **42** | 41 |
| Trevor Didcock | **42** | 14 | **-** | - | **-** | - | **-** | - | **-** | - | **-** | - | **42** | 14 |
| Susan Hooper | **45** | 15 | **-** | - | **-** | - | **-** | - | **-** | - | **-** | - | **45** | 15 |
| **Former** | | | | | | | | | | | | | | |
| Baroness Peta Buscombe | **-** | 22 | **-** | - | **-** | - | **-** | - | **-** | - | **-** | - | **-** | 22 |
| Jeffrey Herbert | **-** | 22 | **-** | - | **-** | - | **-** | - | **-** | - | **-** | - | **-** | 22 |
| **Chairman** | | | | | | | | | | | | | | |
| Dr Philip Nolan | **220** | 200 | **-** | - | **-** | - | **-** | - | **-** | - | **178** | 210 | **398** | 410 |
| **Executive** | | | | | | | | | | | | | | |
| **Current** | | | | | | | | | | | | | | |
| Simon Cocks[5] | **335** | 279 | **14** | 10 | **80** | 67 | **300** | 242 | **-** | - | **388** | 207 | **1,117** | 805 |
| Duncan Bates | **171** | 170 | **12** | 13 | **44** | 35 | **115** | 111 | **276** | - | **-** | - | **618** | 329 |
| | **902** | 810 | **26** | 23 | **124** | 102 | **415** | 353 | **276** | - | **566** | 417 | **2,309** | 1,705 |

[1] Taxable benefits comprise company car allowance, living accommodation benefit and healthcare insurance.

[2] With effect from 1 April 2017, Duncan Bates came out of both the money purchase pension scheme and the defined benefit pension scheme. Therefore no contributions for Duncan Bates were paid to the money purchase pension scheme during the year (2016: £5,000). No amounts were accruing to Duncan Bates in relation to the company's defined benefit pension scheme (2016: £30,000). Pension related benefits for Duncan Bates include an allowance of £44,000 in lieu of being a member of the company's retirement benefit schemes (2016: £nil). Pension related benefits for Simon Cocks further include an allowance of £80,000 in lieu of being a member of the company's retirement benefit schemes (2016: £67,000).

[3] 2016/17 remuneration presented in the above table under LTIP relates to amounts paid to Duncan Bates in 2016/17 for the 2013/14 vested LTIP. The amount was excluded from the 2015/16 remuneration implementation report, as the award was determined by the Remuneration Committee after the approval of the prior year annual report and financial statements for the year ended 31 March 2016. No amounts relating to the 2014/15, 2015/16 or 2016/17 LTIP are disclosed in the table above. Details of any awards determined by the Remuneration Committee for LTIP arising on change of ownership of the business in May 2017 will be included in the 2017/18 remuneration implementation report.

[4] Other remuneration for Dr Philip Nolan consists of remuneration received in relation to the arrangement described on **page 80** of the remuneration policy report. Other remuneration for Simon Cocks in both 2016/17 and 2015/16 relates to discretionary payments made in connection with commencement of qualifying services during the year, representing compensation for the forfeit of a variable remuneration arrangement with his previous employer.

[5] 2015/16 remuneration presented above for Simon Cocks is for the period from appointment in June 2015 to March 2016.



### Achievement against performance related measures (annual bonus)

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 awarded in relation to the 2016/17 year for Simon Cocks and Duncan Bates. No amounts in relation to these bonuses have been deferred.

| Performance measure | | Link to strategy (refer to page 12) | 2016/17 target | Weighting for 2016/17 (as a % of base salary) Simon Cocks | Weighting for 2016/17 (as a % of base salary) Duncan Bates | 2016/17 achievement (as a % of base salary) Simon Cocks | 2016/17 achievement (as a % of base salary) Duncan Bates |
|---|---|---|---|---|---|---|---|
| Financial measure | Cash generated by operations (annual target): net cash outflow before taxation and financing[1] | Value creation imperative | £17.6m | 50.00% | 37.50% | 50.00% | 37.50% |
| Operational measures | Leakage (annual target): volume of water lost through leaks on the network (Ml/d)[2] | Customer outcome | 178.5 | 3.57% | 2.68% | 2.37% | 1.78% |
| | Water availability (annual target): volume of water lost from distribution due to unplanned outages at production sites (Ml/d) | Customer outcome | 38 | 3.57% | 2.68% | 3.57% | 2.68% |
| | Water quality (quarterly targets): number of water quality compliance failures | Customer outcome | Q1: 8<br>Q2: 10<br>Q3: 7<br>Q4: 7 | 3.57% | 2.68% | 0.89% | 0.67% |
| | Unplanned interruptions (quarterly targets): number of properties without water for over 12 hours due to an unplanned interruption to supply | Customer outcome | Less than 80 | 3.57% | 2.68% | 0% | 0% |
| | Water saving programme (quarterly targets): number of meters installed | Customer outcome | Q1: 13,750<br>Q2: 13,750<br>Q3: 13,750<br>Q4: 13,750 | 3.57% | 2.68% | 1.79% | 1.34% |
| Customer and community measures | SIM[2,3] (annual target): our lowest score in the qualitative element of SIM | Customer outcome | 4.4 | 3.57% | 2.68% | 2.37% | 1.78% |
| | Cash collections (annual target): the amount of cash collected through billing in respect of water revenue | Customer outcome | £295.3m | 3.57% | 2.68% | 3.57% | 2.68% |
| Personal performance[4] | | | | 25.00% | 18.75% | 25.00% | 18.75% |
| **Total % base salary** | | | | **100.00%** | **75.00%** | **89.56%** | **67.18%** |
| **Base salary** | | | | | | **£335,000** | **£171,000** |
| **Bonus paid** | | | | | | **£300,000** | **£115,000** |

[1] This "non-GAAP" measure is used internally to evaluate our performance.

[2] The Remuneration Committee made partial awards for SIM and Leakage as SIM came in at 4.36 against a target of 4.4 and leakage performance was better than the ODI target. The principal of the partial awards for SIM and Leakage was applied to all employee bonus arrangements.

[3] SIM is the industry's measure of customer experience. One element is quantitative (the volume of unwanted contact and complaints we receive) and the other is qualitative (the quality of the experience derived from an independent quarterly survey).

[4] 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.

# Regulatory annual performance report continued

## Section 1 – Regulatory financial reporting (continued)

### STATEMENT OF DIRECTORS' REMUNERATION AND STANDARDS OF PERFORMANCE (CONTINUED)

**Achievement against performance related measures (2014/15 LTIP)**

The 2014/15 LTIP scheme was designed to incentivise executives to achieve long-term shareholder value whilst achieving high levels of customer experience, although award and payment are discretionary. Arrangements for the scheme, as set out in the 2015/16 remuneration policy report, were finalised during the year ended 31 March 2016.

Duncan Bates and Simon Cocks received base awards under the 2014/15 LTIP scheme, which related to the three year performance period ended 31 March 2017. The Remuneration Committee will determine and communicate to shareholders any awards under the 2014/15 LTIP before the AGM. Details of any awards determined by the Remuneration Committee will be included in the 2017/18 remuneration implementation report.

Further information regarding directors' remuneration during the year and future policy can be found within the remuneration report on **pages 78 to 87**.

## Section 2 – Price review and other segmental reporting

### ACCOUNTING POLICY FOR PRICE CONTROL SEGMENTS

The tables in this section have been prepared in accordance with RAG 2.06, as detailed in the company's Accounting Separation Methodology Statement, which can be found on the company's 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 and assets have been allocated to business units based on an assessment of the principal user, as described in the methodology.

### 2A - SEGMENTAL INCOME STATEMENT FOR THE 12 MONTHS ENDED 31 MARCH 2017

| | Retail | | Wholesale | | | |
|---|---|---|---|---|---|---|
| | Household £000 | Non-household £000 | Water resources £000 | Water network+ £000 | Water Total £000 | Total £000 |
| Revenue – price control | 27,885 | 4,997 | - | 267,293 | 267,293 | 300,175 |
| Revenue – non price control | - | - | - | 2,740 | 2,740 | 2,740 |
| Operating expenditure | (29,597) | (4,557) | (16,418) | (138,661) | (155,079) | (189,233) |
| Depreciation – tangible fixed assets | (52) | - | (756) | (49,915) | (50,671) | (50,723) |
| Amortisation – intangible fixed assets | (1,725) | - | - | (4,246) | (4,246) | (5,971) |
| Other operating income | 1,557 | 93 | (200) | (2,281) | (2,481) | (831) |
| **Operating profit before recharges** | **(1,932)** | **533** | **(17,374)** | **74,930** | **57,556** | **56,157** |
| Recharges from other segments | (1,414) | (386) | (245) | - | (245) | (2,045) |
| Recharges to other segments | 386 | - | - | 1,659 | 1,659 | 2,045 |
| **Operating profit** | **(2,960)** | **147** | **(17,619)** | **76,589** | **58,970** | **56,157** |

Regulatory Annual Performance Report

# Regulatory annual performance report continued

## Section 2 – Price review and other segmental reporting (continued)

### 2B - TOTEX ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2017 – WHOLESALE WATER

| | Water resources £000 | Water network+ £000 | Total £000 |
|---|---|---|---|
| **Operating expenditure** | | | |
| Power | 4,170 | 17,790 | 21,960 |
| Income treated as negative expenditure | (34) | (146) | (180) |
| Service charges | 4,121 | - | 4,121 |
| Bulk supply | 1,182 | 5,506 | 6,688 |
| Other operating expenditure | 4,933 | 99,140 | 104,073 |
| Local authority and Cumulo rates | 2,046 | 13,979 | 16,025 |
| **Total operating expenditure excluding third party services** | **16,418** | **136,269** | **152,687** |
| **Third party services** | **-** | **2,392** | **2,392** |
| **Total operating expenditure** | **16,418** | **138,661** | **155,079** |
| **Capital expenditure** | | | |
| Maintaining the long term capability of the assets - infra | - | 38,521 | 38,521 |
| Maintaining the long term capability of the assets – non-infra | 577 | 36,249 | 36,826 |
| Other capital expenditure – infra | - | 5,496 | 5,496 |
| Other capital expenditure – non-infra | 2,898 | 43,625 | 46,523 |
| **Total gross capital expenditure (excluding third party)** | **3,475** | **123,891** | **127,366** |
| **Third party services** | **-** | **170** | **170** |
| **Total gross capital expenditure** | **3,475** | **124,061** | **127,536** |
| **Grants and contributions** | | | |
| Less: Grants and contributions[1] | - | 16,031 | 16,031 |
| **Totex** | **19,893** | **246,691** | **266,584** |
| **Cash expenditure** | | | |
| Pension deficit recovery payments | 198 | 1,946 | 2,144 |
| Other cash items | - | - | - |
| **Totex including cash items** | **20,091** | **248,637** | **268,728** |

### 2C - OPERATING COST ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2017 – RETAIL

| | Household £000 | Non-household £000 | Total £000 |
|---|---|---|---|
| **Operating expenditure** | | | |
| Customer services | 8,170 | 363 | 8,533 |
| Debt management | 1,320 | 429 | 1,749 |
| Doubtful debts | 8,736 | 964 | 9,700 |
| Meter reading | 2,880 | 68 | 2,948 |
| Services to developers | - | 231 | 231 |
| Other operating expenditure | 8,491 | 2,502 | 10,993 |
| **Total operating expenditure excluding third party services** | **29,597** | **4,557** | **34,154** |
| Third party services operating expenditure | - | - | - |
| **Total operating expenditure** | **29,597** | **4,557** | **34,154** |
| Depreciation – tangible fixed assets | 52 | - | 52 |
| Amortisation – intangible fixed assets | 1,725 | - | 1,725 |
| **Total operating costs** | **31,374** | **4,557** | **35,931** |
| **Debt written off** | **7,429** | **552** | **7,981** |

Household operating costs and other operating income (refer to **table 2A**) are £1,760,000 greater than revenue allowed in the PR14 price determination. This variance is due in part to a change in allocation methodologies between household and non-household activities for meter reading costs and the cost of handling non-network customer enquiries and complaints. The primary driver, however, was that cost efficiencies assumed in the price determination were not fully achieved.

Non-household operating costs and other operating income (refer to **table 2A**) are £650,000 less than revenue allowed in the PR14 price determination. This is due to the allocation changes discussed above together with a reduction in bad debt charge commensurate with improved cash collection.

[1] Grants and contributions exclude £885,000 of connection charges, recognised in the income statement during the year, received by Affinity Water East Limited and Affinity Water Southeast Limited prior to acquisition of the assets and liabilities of these entities by the company on 27 July 2012. Refer to the footnote under **table 2I** for further details.

# Regulatory annual performance report continued

## Section 2 – Price review and other segmental reporting (continued)

### 2D - HISTORIC COST ANALYSIS OF TANGIBLE FIXED ASSETS - WHOLESALE AND RETAIL

| | Wholesale | | Retail | | |
|---|---|---|---|---|---|
| | Water resources £000 | Water network+ £000 | Household £000 | Non-household £000 | Total £000 |
| **Cost** | | | | | |
| At 1 April 2016 | 19,736 | 1,773,392 | 4,167 | - | 1,797,295 |
| Disposals | - | (3,650) | - | - | (3,650) |
| Additions | 3,477 | 111,584 | - | - | 115,061 |
| Assets adopted at nil cost | - | - | - | - | - |
| **At 31 March 2017** | **23,213** | **1,881,326** | **4,167** | **-** | **1,908,706** |
| **Depreciation** | | | | | |
| At 1 April 2016 | (10,087) | (526,750) | (931) | - | (537,768) |
| Disposals | - | 577 | - | - | 577 |
| Charge for the year | (756) | (49,915) | (52) | - | (50,723) |
| **At 31 March 2017** | **(10,843)** | **(576,088)** | **(983)** | **-** | **(587,914)** |
| **Net book amount at 31 March 2017** | **12,370** | **1,305,238** | **3,184** | **-** | **1,320,792** |
| Net book amount at 1 April 2016 | 9,649 | 1,246,642 | 3,236 | - | 1,259,527 |
| **Depreciation charge for year** | | | | | |
| Principal services | (756) | (49,336) | (52) | - | (50,144) |
| Third party services | - | (579) | - | - | (579) |
| **Total** | (756) | (49,915) | (52) | - | (50,723) |

The net book value includes £177,738,000 in respect of assets in the course of construction.

### 2E - ANALYSIS OF CAPITAL CONTRIBUTIONS AND LAND SALES FOR THE 12 MONTHS ENDED 31 MARCH 2017 – WHOLESALE

| | Fully recognised in income statement £000 | Capitalised and amortised (in income statement) £000 | Fully netted off capex £000 | Total £000 |
|---|---|---|---|---|
| **Grants and contributions - water** | | | | |
| Connection charges (s45)[1] | 6,656 | - | - | **6,656** |
| Infrastructure charge receipts (s146) | - | 4,997 | - | **4,997** |
| Requisitioned mains (s43, s55 and s56) | - | - | - | **-** |
| Diversions (s185) | - | 2,846 | - | **2,846** |
| Other contributions | - | 1,532 | - | **1,532** |
| **Total** | 6,656 | 9,375 | - | **16,031** |
| **Value of adopted assets** | - | - | - | **-** |

| **Movements in capitalised grants and contributions** | |
|---|---|
| Brought forward | **89,164** |
| Capitalised in year | **9,375** |
| Amortisation (in income statement) | **(1,480)** |
| **Carried forward** | **97,059** |

| **Land sales** | |
|---|---|
| Proceeds from disposals of protected land | **-** |

[1] Connection charges exclude £885,000 of connection charges, recognised in the income statement during the year, received by Affinity Water East Limited and Affinity Water Southeast Limited prior to acquisition of the assets and liabilities of these entities by the company on 27 July 2012. Refer to the footnote under **table 2I** for further details.

Regulatory Annual Performance Report

# Regulatory annual performance report continued

## Section 2 – Price review and other segmental reporting (continued)

### 2F - HOUSEHOLD – REVENUES BY CUSTOMER TYPE

| | Wholesale charges revenue £000 | Retail revenue £000 | Total revenue £000 | Number of customers | Average household retail revenue per customer £ |
|---|---|---|---|---|---|
| Unmeasured water only customer | 115,302 | 12,084 | 127,386 | 659,818 | 18.31 |
| Measured water only customer | 97,842 | 15,801 | 113,643 | 698,276 | 22.63 |
| **Total** | **213,144** | **27,885** | **241,029** | **1,358,094** | **20.53** |

### 2G - NON-HOUSEHOLD – REVENUES BY TARIFF TYPE

| | Wholesale charges revenue £000 | Retail revenue £000 | Total revenue £000 | Number of connections | Average non-household retail revenue per connection £ |
|---|---|---|---|---|---|
| **Default tariffs** | | | | | |
| Measured half yearly | 29,097 | 3,197 | 32,294 | 54,167 | 59.02 |
| Measured monthly | 21,998 | 1,454 | 23,452 | 2,262 | 642.79 |
| Unmeasured | 1,990 | 268 | 2,258 | 6,709 | 39.95 |
| Assessed | 174 | 37 | 211 | 1,922 | 19.25 |
| Special agreements | 890 | 41 | 931 | 7 | 5,857.14 |
| **Total default tariffs** | **54,149** | **4,997** | **59,146** | **65,067** | **76.80** |
| **Non default tariffs** | | | | | |
| Total non-default tariffs | - | - | - | - | - |
| **Total** | **54,149** | **4,997** | **59,146** | **65,067** | **76.80** |

| | Number of customers | Average non-household retail revenue per customer £ |
|---|---|---|
| **Revenue per customer** | | |
| **Total** | **65,060** | **76.81** |

### 2I - REVENUE ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2017

| | Household £000 | Non-household £000 | Total £000 |
|---|---|---|---|
| **Wholesale charge – water** | | | |
| Unmeasured | 115,302 | 2,175 | 117,477 |
| Measured | 97,842 | 51,974 | 149,816 |
| Third party revenue | - | - | - |
| **Wholesale total** | **213,144** | **54,149** | **267,293** |
| **Retail revenue** | | | |
| Unmeasured | 12,084 | 305 | 12,389 |
| Measured | 15,801 | 4,692 | 20,493 |
| Other third party revenue | - | - | - |
| **Retail total** | **27,885** | **4,997** | **32,882** |
| **Third party revenue – non-price control** | | | |
| Bulk supplies | | | 2,602 |
| Other third party revenue | | | 138 |
| **Principal services – non-price control** | | | |
| Other appointed revenue | | | - |
| **Total appointed revenue** | | | **302,915** |

| | Total £000 |
|---|---|
| Wholesale revenue governed by price control | 267,293 |
| Grants & contributions[1] | 11,653 |
| **Total revenue governed by wholesale price control** | **278,946** |
| Amount assumed in wholesale determination | 277,233 |
| Adjustment for in-period ODI revenue | - |
| Adjustment for WRFIM | - |
| **Total assumed revenue** | **277,233** |
| **Difference** | **1,713** |

The adverse variance difference between allowed and actual revenue under the wholesale control was as a result of increased grants and contributions received following increased developer services work during the year, offset by certain properties remaining empty for longer during the year than anticipated in the company's Business Plan.

[1] Relevant capital contributions as defined in the company's final determination for PR14. These exclude £885,000 of connection charges, recognised in the income statement during the year, received by Affinity Water East Limited and Affinity Water Southeast Limited prior to acquisition of the assets and liabilities of these entities by the company on 27 July 2012. These amounts have been excluded, as they relate to the previous price control period during which they would have been treated as a negative capital cost and not considered as part of a revenue adjustment mechanism.

# Regulatory annual performance report continued

## Section 3 - Performance summary

### 3A - OUTCOME PERFORMANCE TABLE

| Unique ID | Performance commitment | Unit | Decimal places | 2016-17 performance level - actual | Commited Performance Level met? | Reward or penalty - in-period ODIs | Reward or penalty - in-period ODIs £000 | Reward or penalty - ODIs payable at end of AMP6 | Reward or penalty - ODIs payable at end of AMP6 £000 | 31 March 2020 forecast - total AMP6 reward or penalty | 31 March 2020 forecast - total AMP6 reward or penalty £000 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PR14AF WWSW _W-A1 | Leakage | Ml/d | 2 | 172.99 | Yes | N/A | N/A | Reward deadband | £nil | None | £nil |
| PR14AF WWSW _W-A2 | Average water use | l/person/d | 1 | 159.7 | No | N/A | N/A | None | £nil | None | £nil |
| PR14AF WWSW _W-A3 | Water available for use | Ml/d | 2 | 1,153.02 | Yes | N/A | N/A | None | £nil | None | £nil |
| PR14AF WWSW _W-A4 | Sustainable abstraction reduction | Ml/d | 1 | -12.5 | Yes | N/A | N/A | None | £nil | None | £nil |
| PR14AF WWSW _W-A5 | Abstraction incentive mechanism | N/A | N/A | -2.55 | - | N/A[1] | N/A | N/A | N/A | N/A | N/A |
| PR14AF WWSW _W-B1 | Compliance with water quality standards | % | 2 | 99.96 | Yes | N/A | N/A | None | N/A | None | N/A |
| PR14AF WWSW _W-B2 | Customer contacts for discolouration | Number per 1,000 people | 2 | 0.28 | Yes | N/A | N/A | None | N/A | None | N/A |
| PR14AF WWSW _W-C1 | Unplanned interruptions to supply over 12 hours | Number of properties | 0 | 1,840 | No | N/A | N/A | Penalty | (1,637.550) | Penalty | (3,275.100) |
| PR14AF WWSW _W-C2 | Mains bursts | Number of bursts | 0 | 3,077 | Yes | N/A | N/A | None | N/A | None | N/A |
| PR14AF WWSW _W-C3 | Customers not being notified of planned interruptions | Number of properties | 0 | 111 | No | N/A[1] | N/A | N/A | N/A | N/A | N/A |
| PR14AF WWSW _W-C4 | Planned works taking longer than notified | Number of events | 0 | 436 | Yes | N/A[1] | N/A | N/A | N/A | N/A | N/A |
| PR14AF WHHR _R-A1 | Service Incentive Mechanism ('SIM') | Score out of 100 | 1 | 78.51 | - | N/A | N/A | None | £nil | None | £nil |
| PR14AF WHHR _R-A2 | Value for money survey | Score out of 100 | 1 | 69.6 | - | N/A[1] | N/A | N/A | N/A | N/A | N/A |

[1] These are reputational incentives and therefore do not have any associated financial rewards or penalties.

The company set very challenging performance targets at PR14. The ambition of these targets contributed towards Ofwat awarding the company 'enhanced status' for its Business Plan. In most cases in 2016/17 the company met or exceeded these targets. There were three exceptions:

**Unplanned interruptions to supply over 12 hours**

A disappointing performance in 2016/17, we exceeded the performance commitment for unplanned interruptions to supply over 12 hours. As a result of our failure to meet this performance commitment, we incurred a penalty through the ODI regime. This is the second year in this AMP that we have not achieved the target. In order to reduce unplanned interruptions we are focussing on how prevention and restoring supplies can be improved. A new 'network restoration team' will shortly be introduced. This team will manage interruptions from start to finish ensuring that incidents are dealt with as effectively and efficiently as possible. The team will ensure continuous supplies are the priority, whether this is through alternative water supplies or re-zoning networks.

**Customers not being notified of planned interruptions**

This typically occurs from an unintended or unforeseen consequence of a planned action. We only narrowly exceeded what is a very challenging target and significantly improved our performance in this area over 2015/16.

**Average water use per head of population**

We have exceeded the performance commitment for average water use in 2016/17. This was primarily driven by higher than expected unmeasured per capita consumption in our Central and East regions. In order to reduce the company's average water use and meet our performance commitment, we will implement an action plan over the next year to improve the accuracy of our water balance, as well as promote our water efficiency campaign to support and help our customers reduce their water use. We also expect to see a reduction in demand as more customers become metered and move onto measured tariffs under our Water Saving Programme.

### 3B – SUB-MEASURE PERFORMANCE TABLE

This table has not been presented, as the company does not have any sub-measures to report.

# Regulatory annual performance report continued

## Section 3 - Performance summary (continued)

### 3C - ABSTRACTION INCENTIVE MECHANISM ('AIM')

| Abstraction site | Decimal places | 2016-17 AIM performance | 2016-17 normalised AIM performance | Cumulative AIM performance 2016-17 | Cumulative normalised AIM performance | Contextual information relating to performance on the AIM |
|---|---|---|---|---|---|---|
| Bricketwood | 0 | 233 | 0 | 233 | 0 | AIM calculated for both Bricketwood and Netherwild |
| Netherwild | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Bricketwood and Netherwild |
| Well Head | 0 | 0 | 0 | 0 | 0 | |
| Oughton Head | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Oughton Head and Offley Bottom |
| Offley Bottom | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Oughton Head and Offley Bottom |
| Digswell | 0 | 0 | 0 | 0 | 0 | |
| Fulling Mill | 0 | 0 | 0 | 0 | 0 | |
| Bow Bridge | 0 | 0 | 0 | 0 | 0 | |
| Holywell | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Holywell and Mud Lane |
| Mud Lane | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Holywell and Mud Lane |
| Marlowes | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Marlowes and Piccotts End |
| Piccotts End | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Marlowes and Piccotts End |
| Amersham | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Amersham and Chalfont St Giles |
| Chalfont St Giles | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Amersham and Chalfont St Giles |
| Whitehall | 0 | -15 | 0 | -15 | 0 | |
| Chesham | 0 | 0 | 0 | 0 | 0 | |
| Hughenden | 0 | -181 | -1 | -181 | -1 | |
| Periwinkle Lane | 0 | -1,623 | -1 | -1,623 | -1 | AIM calculated for both Periwinkle Lane and Runleywood Chalk |
| Runleywood Chalk | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Periwinkle Lane and Runleywood Chalk |
| Slip End | 0 | -3 | -1 | -3 | -1 | |
| Primrose | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Primrose and Buckland Mill |
| Buckland Mill | 0 | 0 | 0 | 0 | 0 | AIM calculated for both Primrose and Buckland Mill |
| Denge Gravels | 0 | -33 | 0 | -33 | 0 | |
| **Total** | **0** | **-1,622** | **-3** | **-1,622** | **-3** | |

### 3D – SIM SCORE TABLE

| Row | Line description | Units | Decimal places | Score |
|---|---|---|---|---|
| 1 | 1st survey score | score | 2 | 4.11 |
| 2 | 2nd survey score | score | 2 | 4.23 |
| 3 | 3rd survey score | score | 2 | 4.31 |
| 4 | 4th survey score | score | 2 | 4.36 |
| 5 | Qualitative SIM score (out of 75) | calc | 2 | 60.98 |
| 6 | Quantitative composite score | score | 2 | 148.53 |
| 7 | Quantitative SIM score (out of 25) | calc | 2 | 17.57 |
| 8 | Total annual SIM score (out of 100) | calc | 0 | 79 |

# Regulatory annual performance report continued

## Section 4 – Non-audited additional regulatory information

### ACCOUNTING SEPARATION POLICY

**Tables 4B, 4C, 4D, 4F and 4G** within this section have been prepared in accordance with the company's Accounting Separation Methodology Statement, which can be found on the company's 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 and assets have been allocated to business units based on an assessment of the principal user, as described in the methodology.

### 4A - NON-FINANCIAL INFORMATION FOR THE 12 MONTHS ENDED 31 MARCH 2017

| | Unmeasured | Measured |
|---|---|---|
| **Retail - household** | | |
| Number of void households | 24,064 | 24,092 |
| Per capita consumption (excluding supply pipe leakage) l/h/d | 167.74 | 138.87 |
| | | **Water** |
| **Wholesale** | | |
| **Volume (Ml/d)** | | |
| Bulk supply export | | 21.956 |
| Bulk supply import | | 31.027 |
| Distribution input | | 901.939 |

### 4B - WHOLESALE TOTEX ANALYSIS

| | 2017 £000 | Cumulative £000 |
|---|---|---|
| **Actual totex** | **268,728** | **498,088** |
| **Less: Items excluded from the menu** | | |
| Third party costs | **2,562** | 7,184 |
| Pension deficit recovery payments | **2,144** | 5,904 |
| Other 'Rule book' adjustments | **73** | 73 |
| **Total costs excluded from the menu** | **4,779** | 13,161 |
| **Add: Transition expenditure** | | |
| Transition expenditure | **-** | - |
| **Adjusted actual totex** | **263,949** | 484,927 |
| **Adjusted actual totex – base year prices** | **239,814** | 456,125 |
| **Allowed totex based on final menu choice – base year prices** | **244,300** | 486,100 |

The difference between actual and allowed cumulative totex is primarily due to a slower than anticipated start to the company's metering programme, lead pipe replacement programme and delays in technology selection for water quality projects. Programmes of work accelerated significantly in 2016/17, in particular for meter installations and mains renewals. The work planned for the remainder of the AMP has been re-profiled to ensure our totex obligations are still achieved.

### 4C - IMPACT OF AMP PERFORMANCE TO DATE ON RCV

| | 2017 £000 |
|---|---|
| RCV determined at final determination at 31 March | **1,156,160** |
| RCV element of cumulative totex over/underspend so far in the price control period | **(10,415)** |
| Adjustment for ODI rewards or penalties | **(3,605)** |
| **Projected 'shadow' RCV** | **1,142,140** |

# Regulatory annual performance report continued

## Section 4 – Non-audited additional regulatory information (continued)

### 4D - TOTEX ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2017 – WHOLESALE WATER

| | Water resources | | Network+ | | | | |
|---|---|---|---|---|---|---|---|
| | Abstraction licences £000 | Raw water abstraction £000 | Raw water transport £000 | Raw water storage £000 | Water treatment £000 | Treated water distribution £000 | Total £000 |
| **Operating expenditure** | | | | | | | |
| Power | - | 4,170 | 3,123 | - | 1,537 | 13,130 | 21,960 |
| Income treated as negative expenditure | - | (34) | (25) | - | (13) | (108) | (180) |
| Abstraction charges | 4,121 | - | - | - | - | - | 4,121 |
| Bulk supply | 861 | 321 | - | - | 5,506 | - | 6,688 |
| Other operating expenditure | 686 | 4,247 | 4,162 | 871 | 17,128 | 76,979 | 104,073 |
| Local authority and Cumulo rates | - | 2,046 | 350 | - | 2,992 | 10,637 | 16,025 |
| **Total operating expenditure excluding third party services** | **5,668** | **10,750** | **7,610** | **871** | **27,150** | **100,638** | **152,687** |
| Third party services | - | - | - | - | - | 2,392 | 2,392 |
| **Total operating expenditure** | **5,668** | **10,750** | **7,610** | **871** | **27,150** | **103,030** | **155,079** |
| **Capital expenditure** | | | | | | | |
| Maintaining the long term capability of the assets – infra | - | - | 1,798 | - | - | 36,723 | 38,521 |
| Maintaining the long term capability of the assets – non-infra | - | 577 | 209 | - | 9,182 | 26,858 | 36,826 |
| Other capital expenditure – infra | - | - | - | - | - | 5,496 | 5,496 |
| Other capital expenditure – non-infra | - | 2,898 | 3,218 | - | 9,792 | 30,615 | 46,523 |
| **Total gross capital expenditure (excluding third party)** | **-** | **3,475** | **5,225** | **-** | **18,974** | **99,692** | **127,366** |
| Third party services | - | - | - | - | 142 | 28 | 170 |
| **Total gross capital expenditure** | **-** | **3,475** | **5,225** | **-** | **19,116** | **99,720** | **127,536** |
| Grants and contributions[1] | - | - | - | - | - | 16,031 | 16,031 |
| **Totex** | **5,668** | **14,225** | **12,835** | **871** | **46,266** | **186,719** | **266,584** |
| **Cash expenditure** | | | | | | | |
| Pension deficit recovery payments | 13 | 185 | 81 | 9 | 515 | 1,341 | 2,144 |
| Other cash items | - | - | - | - | - | - | - |
| **Totex (including cash items)** | **5,681** | **14,410** | **12,916** | **880** | **46,781** | **188,060** | **268,728** |

[1] Grants and contributions exclude £885,000 of connection charges, recognised in the income statement during the year, received by Affinity Water East Limited and Affinity Water Southeast Limited prior to acquisition of the assets and liabilities of these entities by the company on 27 July 2012. Refer to the footnote under **table 2I** for further details.

### Unit cost information (operating expenditure)

| | Water resources | | Network+ | | | |
|---|---|---|---|---|---|---|
| | Abstraction licences £000 | Raw water abstraction £000 | Raw water transport £000 | Raw water storage £000 | Water treatment £000 | Treated water distribution £000 |
| | Licensed volume available | Volume abstracted | Volume transported | Average volume stored | Distribution input volume | Distribution input volume |
| Volume (Ml) | 434,147 | 341,355 | 60,795 | - | 329,261 | 329,261 |
| Unit cost (£/Ml) | 13.06 | 31.49 | 125.16 | - | 82.16 | 312.91 |
| Population | 3,614,984 | 3,614,984 | 3,614,984 | 3,614,984 | 3,614,984 | 3,614,984 |
| Unit cost (£/pop) | 1.57 | 2.97 | 2.11 | 0.24 | 7.51 | 28.50 |

### 4F - OPERATING COST ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2017 – HOUSEHOLD RETAIL

| | Unmeasured £000 | Measured £000 | Total £000 |
|---|---|---|---|
| **Operating expenditure** | | | |
| Customer services | 3,476 | 4,694 | 8,170 |
| Debt management | 622 | 698 | 1,320 |
| Doubtful debts | 5,011 | 3,725 | 8,736 |
| Meter reading | - | 2,880 | 2,880 |
| Other operating expenditure | 4,136 | 4,355 | 8,491 |
| **Total operating expenditure excluding third party services** | **13,245** | **16,352** | **29,597** |
| Third party services operating expenditure | - | - | - |
| **Total operating expenditure** | **13,245** | **16,352** | **29,597** |
| Depreciation – tangible fixed assets | 25 | 27 | 52 |
| Amortisation – intangible fixed assets | 824 | 901 | 1,725 |
| **Total operating costs** | **14,094** | **17,280** | **31,374** |

Other operating expenditure includes the net retail expenditure for the following retail activities, which are part funded by wholesale activities:

| | £000 |
|---|---|
| **Household** | |
| Demand-side water efficiency – gross expenditure | 2,145 |
| Demand-side water efficiency – expenditure funded by wholesale | (1,735) |
| **Demand-side water efficiency – net retail expenditure** | **410** |
| Customer-side leak repairs – gross expenditure | 864 |
| Customer-side leak repairs – expenditure funded by wholesale | - |
| **Customer-side leak repairs – net retail expenditure** | **864** |

# Regulatory annual performance report continued

## Section 4 – Non-audited additional regulatory information (continued)

### 4G - WHOLESALE CURRENT COST FINANCIAL PERFORMANCE FOR THE 12 MONTHS ENDED 31 MARCH 2017

| Income Statement | Total £000 |
|---|---|
| **Revenue** | **270,033** |
| Operating expenditure | (155,079) |
| Capital maintenance charges | (75,754) |
| Other operating income | (2,481) |
| **Current cost operating profit** | **36,719** |
| Other income | 12,230 |
| Interest income | 293 |
| Interest expense | (54,073) |
| Other interest expense | 2,757 |
| **Current cost profit before tax and fair value movements** | **(2,074)** |
| Fair value gains/(losses) on financial instruments | - |
| **Current cost profit before tax** | **(2,074)** |

### 4H - FINANCIAL METRICS FOR THE 12 MONTHS ENDED 31 MARCH 2017

| **Financial indicators** | |
|---|---|
| Net debt | £901.395m |
| Regulated equity | £254.765m |
| Regulated gearing | 77.96% |
| Post tax return on regulated equity | 4.75% |
| RORE (return on regulated equity) | 4.72% |
| Dividend yield | 16.87% |
| Retail profit margin – Household | (1.45)% |
| Retail profit margin – Non household | 0.75% |
| Credit rating | Baa1 |
| Return on RCV | 5.65% |
| Dividend cover | 0.54 |
| Funds from operations (FFO) | £80.299m |
| Interest cover (cash) | 2.77 |
| Adjusted interest cover (cash) | 1.74 |
| FFO/Debt | 0.09 |
| Effective tax rate | 19.23% |
| Free cash flow (RCF) | £37.320m |
| RCF/capex | 0.28 |
| **Revenue and earnings** | |
| Revenue (actual) | £300.175m |
| EBITDA (actual) | £110.942m |
| **Borrowings** | |
| Proportion of borrowings which are fixed rate | 65.35% |
| Proportion of borrowings which are floating rate | - |
| Proportion of borrowings which are index linked | 34.65% |
| Proportion of borrowings due within 1 year or less | - |
| Proportion of borrowings due in more than 1 year but no more than 2 years | - |
| Proportion of borrowings due in more than 2 years but no more than 5 years | - |
| Proportion of borrowings due in more than 5 years but no more than 20 years | 66.57% |
| Proportion of borrowings due in more than 20 years | 33.43% |

The key components driving the reduction in base RORE set at the last price review, from 5.6% to 4.7%, are higher retail service costs of £9.9m and the impact of a failed ODI in each year of the AMP with a resultant cumulative penalty of £2.6m, being partly offset by £5.6m lower real cost of debt across the two years. An adjustment has been made for the timing of £30m of total expenditure which is expected to now occur in future years of the AMP.

### 4I - FINANCIAL DERIVATIVES FOR THE 12 MONTHS ENDED 31 MARCH 2017

This table has not been presented, as the company did not hold any financial derivatives during the year ended 31 March 2017.

# Regulatory annual performance report continued

## Section 4 – Non-audited additional regulatory information (continued)

### TRANSACTIONS WITH ASSOCIATED COMPANIES

| Company | Service | Turnover of associate* £000 | Terms of supply | Value £000 |
|---|---|---|---|---|
| **Expenditure** | | | | |
| Veolia Environmental Services (UK) Limited | Waste water disposal | 832,617 | Market tested | 304 |
| Affinity Water Capital Funds Limited** | Interest paid on loan | - | No market | 163 |
| Affinity Water Holdings Limited** | Dividends paid | - | No market | 50,500 |
| Affinity Water Finance (2004) PLC** | Interest paid on loan | - | No market | 14,300 |
| Affinity Water Programme Finance Limited** | Interest paid on loan | - | No market | 29,630 |
| **Income** | | | | |
| Veolia Water UK Limited | Transitional services, capability sharing agreement and other support | 155 | Market tested | 216 |
| Other Veolia entities | Transitional services, capability sharing agreement and laboratory services | - | Market tested | 108 |

* 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 with individual related parties.

In 2004, Affinity Water Limited borrowed £200,000,000 from its wholly owned subsidiary, Affinity Water Finance (2004) PLC, 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% and lent on the same terms. On 16 July 2014 Affinity Water Finance (2004) PLC completed a tap issue of £50,000,000 on the same terms as the existing £200,000,000 bond. The net proceeds of both the bond and the tap issue have been lent to the company on the same terms. The amount outstanding at year end, net of amortised debt issuance costs, was £254,747,000 (2016: £255,045,000).

As part of the WBS in February 2013, all existing loans and revolving credit 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%, £250,000,000 Class A Guaranteed Notes maturing in March 2036 with a coupon of 4.500%, £150,000,000 Class A Guaranteed RPI linked Notes maturing in June 2045 with a coupon of 1.548% and £95,000,000 Class B Guaranteed RPI linked Notes maturing in June 2033 with a coupon of 3.249%.

On 29 October 2015 Affinity Water Programme Finance Limited completed a tap issue of £40,000,000 on the same terms as its existing £150,000,000 Class A Guaranteed RPI linked Notes. On 19 February 2016 Affinity Water Programme Finance Limited issued £10,000,000 Class B guaranteed RPI linked Notes maturing in June 2033 with a coupon rate of 1.024%. On 22 August 2016, Affinity Water Programme Finance Limited exchanged £65,800,000 of its 3.625% guaranteed bonds due 2022 for a new issue of 3.278% guaranteed bonds due 2042. An additional £19,200,000 of 3.278% guaranteed bonds due 2042 were issued at the same time. The net proceeds of the bond issues and the tap issue have been lent to the company on the same terms. The amount outstanding at year end, net of amortised debt issuance costs, was £683,097,000 (2016: £643,614,000).

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 4.500%.

There are no loans to group companies.

At 31 March 2017, the company had £10,000,000 in a term deposit with Morgan Stanley Liquidity Funds, a fund under common ownership at that time.

### DIVIDEND POLICY

The company's dividend policy is primarily based on maintaining a target level of gearing (net debt to RCV) of 80%. 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 declared and paid ordinary dividends of £50,500,000 during the year ended 31 March 2017. This compares to £40,000,000 declared and paid in the year ended 31 March 2016.

The increase in dividends year on year can be attributed to a £2,000,000 premium earned on the bond exchange in August, and £8,500,000 directly from proceeds from the disposal of the company's non-household retail business to Affinity for Business (Retail) Limited. Under the transfer scheme and wholesale contract entered into with Affinity for Business (Retail) Limited, the company was contractually entitled to receipts from Affinity for Business (Retail) Limited broadly equivalent to the amount of the dividend paid.

No final dividend is proposed (2016: £nil).

### VIABILITY STATEMENT

The company's viability statement, including information on the company's approach to producing this statement, can be found within the strategic report on **pages 50 to 51**. The approach taken considers sensitivities for stress-testing included in Ofwat's July 2015 consultation on a new financial monitoring framework.

# Regulatory annual performance report continued

## Section 4 – Non-audited additional regulatory information (continued)

### CURRENT TAX RECONCILIATIONS

The appointed current tax charge assessed for the period is higher than the standard rate of corporation tax in the UK for the year ended 31 March 2017 of 20%. The differences are explained below:

| | £000 |
|---|---|
| **Profit on appointed activities before tax** | **17,364** |
| Tax calculated at the standard rate of tax in the UK of 20% | 3,473 |
| Tax effects of: | |
| - Adjustments in respect of prior years | 1,916 |
| - Expenses not deductible for tax purposes | 77 |
| - Accelerated capital allowances | 263 |
| - Other timing differences - pension | (838) |
| - Other timing differences - provisions | 367 |
| **Appointed current tax charge** | **5,258** |

Significant variations between the appointed current tax charge and the total current tax charge for the year ended 31 March 2017 allowed in the company's price limits are explained below:

| | £000 |
|---|---|
| **Appointed current tax charge** | **5,258** |
| Variance in profit before tax | (1,002) |
| Adjustments in respect of prior years | (1,916) |
| Variance in assumptions - capital allowances | (417) |
| Other timing differences - pensions | 373 |
| Other timing differences - provisions | (259) |
| Other | (637) |
| **Total current tax charge allowed in price limits** | **1,400** |

### FACTORS AFFECTING FUTURE TAX CHARGES

In October 2015 and September 2016, changes were enacted to the main rate of corporation tax in the UK to reduce it from 20% to 19% effective from 1 April 2017 and from 19% to 17% effective from 1 April 2020.

## Tax strategy related to the appointed business

### Our approach to tax is based on the values incorporated in the Affinity Water Code of Conduct:

We always act honestly, openly and responsibly, so that we are trusted. We uphold the Affinity Way together by complying with the law and regulatory requirements, making decisions with integrity, and speaking up when we believe that conduct falls short of our principles.

We are transparent in our dealings with government and regulators, fulfilling our obligations honestly and promptly. We don't hide information that should be in the public domain and we don't disclose information that we shouldn't. We are clear and honest about our services, processes, policies, achievements and prospects. We encourage people to speak up whenever they see conduct that falls short of our principles and we take their concerns seriously.

Our tax strategy includes the following:

1. Approach to Risk Management and Governance
2. Attitude to Tax Planning
3. Level of Acceptable Risk in relation to UK Tax
4. Approach to dealing with HM Revenue and Customs ("HMRC")

### APPROACH TO RISK MANAGEMENT AND GOVERNANCE

The Group CFO is ultimately responsible for our tax strategy. Responsibility for day to day tax matters, and for reporting to the Audit Committee and the Board on significant tax risks and developments, is delegated to the Group Tax Manager. Tax strategy is part of our overall risk management and governance framework, which is overseen by the Audit Committee and the Board.

We consider our main tax risk to be the introduction of new legislation or changes in tax practice, which could result in increased tax payments that have not been included in the current regulatory settlement.

### ATTITUDE TO TAX PLANNING

We do not use artificial tax avoidance schemes or tax havens to reduce our tax liabilities, and we always comply with what we understand to be both the letter and the spirit of the law. We operate solely in the UK and all of our customers are based here. All of our profits are taxed in the UK.

One of our two financing subsidiaries is incorporated in the Cayman Islands but resident in the UK for tax purposes. By being resident in the UK for tax purposes we are clear that this arrangement does not avoid UK tax and brings no tax benefit. No funds are held off-shore, and all finance is raised and held within the UK.

Whilst we do not interpret tax legislation aggressively, we try to minimise our tax liability so that our customers are not funding excessive and unnecessary charges through increased bills.

We seek external advice when necessary, in order to ensure that our interpretation of current tax law and practice is correct.

### LEVEL OF ACCEPTABLE RISK IN RELATION TO UK TAX

Our approach to tax risk is part of our wider risk management framework, in the context of our regulatory settlement.

### DEALING WITH HMRC

We have an open relationship with HMRC, and we advise them of any complex issues so that we can work with them to determine the correct amount of tax due. We actively engage with HMRC and other relevant authorities on proposed changes to tax legislation, either directly or as part of our industry group.

# Regulatory annual performance report continued

## Data assurance summary

The data presented in this regulatory annual performance report has been subject to the company's governance, risk management and internal control framework as set out in the governance section of the annual report and financial statements on **pages 62 to 63**.

For further information on our assurance procedures and results, please refer to our Data Assurance Report, which is published on our website:

**stakeholder.affinitywater.co.uk**


# Areas of supply

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