Investor Report

Six Month Period ended
30 September 2017

Affinity Water Limited ("Affinity Water")

Published on
22 December 2017

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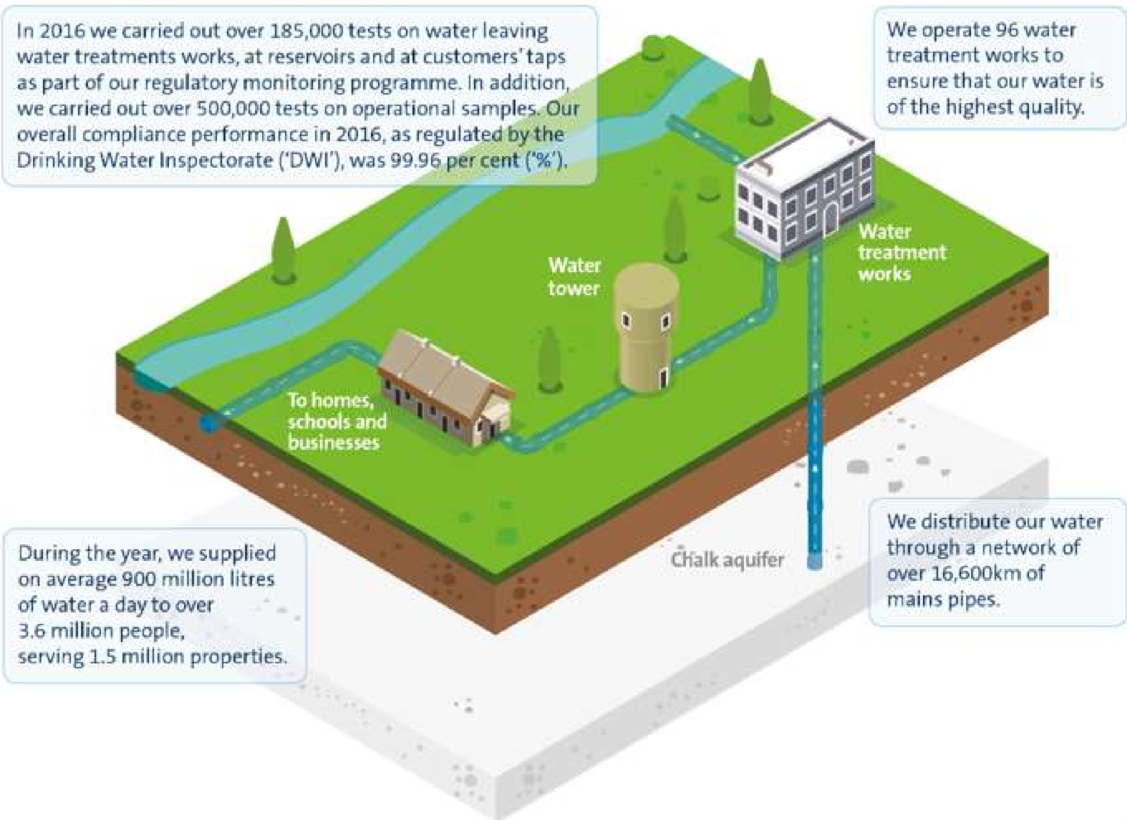
[1] Common Terms Agreement

Affinity Water

Affinity Water at a glance

Affinity Water is the UK's largest water only supply company. We own and manage the water assets and network in an area of approximately 4,515km^2 split over three regions in the Southeast of England. We divide our supply area into eight different communities, based on our existing water resource zones and have named each of them after a local river, allowing us to tailor a high quality service to customers at a local level. We are the sole supplier of drinking water in these areas.

Our vision is to be the UK's leading community focused water company.



Our commitments

As part of the price review process for AMP6[2] ('PR14'), we agreed a number of performance commitments with Ofwat, which were shaped by the expectations of our customers. These stretching targets are to respond to the significant social and environmental challenges we face – a rising population and increased demand for water, as well as a reduction in the availability of water in years ahead.

We want our customers and stakeholders to be able to measure our success and hold us to account. The table below summarises our customers' four expectations and the performance commitments we have 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. We will encourage our customers to use less water through our Water Saving Programme. 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. 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. We will promote our LIFT social tariff to support those least able to pay their bill. We will make £106 million of efficiency savings in our running costs to keep bills as low as possible over the next five years. We will make ourselves accountable to our communities for our performance.

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. Our supply area is broken down into 8 water resource zones, which we call communities and we are now publishing performance at the community level as well. More information can be found at:

https://stakeholder.affinitywater.co.uk/company-performance.aspx

[2] Asset Management Plan 6

Change in ownership

On 19 May 2017, Affinity Water Acquisitions (Investments) Limited was acquired by 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. As part of the transaction, the consortium also acquired Veolia Water UK Limited's 10% equity interest stake in the company.

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.

Operational performance

For the 2015 – 2020 price control period (AMP6), Ofwat is assessing companies' operational performance against agreed performance commitments as set out in our Business Plan for this period. 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.

Investor value can be created by exceeding our performance targets 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 at a reasonable price.

We continue to align our operational key performance indicators and targets to key performance commitments made in our Business Plan in response to our customer outcomes. These are necessarily stretching targets to respond to the significant social and environmental challenges we face – a rising population and increased demand for water, as well as a reduction in the availability of water in the years ahead. We operate in geographical areas that the Secretary of State for the Environment, Food and Rural Affairs has designated as being under serious water stress.

We want to be the leading community focused water company to help customers understand the value of water, in turn reducing consumption, and helping to protect the environment. At the end of the second year of AMP6, we recognised that there was more to do to deliver on all of our commitments, reflecting the genuinely challenging targets we have set ourselves. In the first six months of the current financial year, we have made good progress in delivering on a number of our key programmes to ensure we continue to meet our customer outcomes.

Environment

As a community focused organisation we remain committed to those issues which our customers and stakeholders feel strongly about. Protecting the rare and sensitive chalk streams within our operating area is a priority. Through our industry leading initiative of leakage and abstraction reductions within one of the fastest growing regions of the UK, we are addressing the environmental challenges of protecting our precious local rivers and habitats while encouraging behavioural change.

We have committed to reducing the amount of water we take from the environment by 42 Megalitres per day (ML/d) by the end of AMP6. Despite the rainfall over the summer, our ground water levels remain below average. We are continuing to monitor the situation closely with clear plans in place to make sure we are fully prepared should we experience another dry winter in 2017/18. We are also investing £500m over AMP6 to improve our infrastructure to ensure we meet our commitment to make sure our customers have enough water, whilst leaving more water in the environment, which includes a commitment to reduce leakage on our network by 14%.

We estimate that around a third of total network leakage occurs from customers' supply pipes. The installation of meters has been proven to reduce usage by our customers and also offers critical data in our understanding of usage and finding leaks. We believe that the meters installed to date will have highlighted 16ML/d of customer side leakage by the end of AMP6. Our aim is to install over 280,000 meters by 2020. In July 2017 we installed our 100,000th meter as part of our Water Saving Programme ('WSP').

As outlined in our Business Plan, all customers receiving a water meter as part of our WSP can opt to switch to a measured tariff immediately or remain on their unmeasured tariff for a period of two years. September 2017 marked two years since the first meters were installed, and as such, we have started switching customers onto measured tariffs. We anticipate around two thirds of our customers will be financially better off with a meter. We will continue to support the remaining customers to reduce their consumption and value of their bill, through initiatives such as our "Keep Track of the Tap" campaign.

Our partnership with the Herts and Middlesex Wildlife Trust has continued to evolve during the period. We share common objectives with the Trust to maintain resilient water ecosystems in our supply area and conserve and enhance biodiversity in our Pinn, Misbourne, Colne and Lee Communities. We were proud to host the Herts and Middlesex Wildlife Trust 2017 Annual Review at our Hatfield office, and fund the recruitment of a full time Project Officer to manage three of our local nature reserves; Stockers Lake, Springwell Reedbed and Hilfield Park Reservoir, helping to improve important habitat for wildlife and increase community engagement.

Assets

Our assets allow our people to make use of the water resources provided by the environment to supply our customers. 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 takes water from treatment works and deliver it to homes and commercial premises through more than 16,600km of mains. Asset-related expenditure to maintain, enhance and create assets is a major part of our business.

We aim to survey and complete 4,160 lead pipe replacements this year as part of our £25m AMP6 lead pipe replacement programme. Where possible, we are combining our lead replacement programme with our WSP and mains renewals programme in order to work more efficiently.

In August 2017 we experienced a major burst near our Weston Hills Reservoir which left 3,300 properties in Baldock without water. This incident, along with others, will result in an ODI penalty for 2017/18 relating to unplanned interruptions to supply over 12 hours. We are planning on achieving our target of mains renewals of 81.5km for the year and continuously invest in our network, also setting ourselves a target to replace 4.9km of trunk mains this year.

As part of our AMP6 capital programme, two major projects were completed during the period in our Stort community. Uttlesford Bridge water treatment works was upgraded to provide a more reliable and resilient supply to our customers. Existing booster pumps were replaced with new high pressure borehole pumps and new water treatment technology and a standby power generator was installed. The project won the 2017 British Construction Industry Award for the Application of Technology.

The construction of our new Sibley reservoir will support the 13ML/d of water treated at Uttlesford Bridge by providing an additional storage capacity of 9ML. It will work in parallel with our existing 18ML storage facility to meet the peak average demand for projected housing growth in the area to 2040. The new reservoir was commissioned and put into service in July 2017 on budget and ahead of schedule. The project was completed with no interruption to supply in and out of the existing reservoir, and minimal impact on the neighbouring businesses with no road closures or earthworks material needing to be imported or exported from the site.

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 makes a difference.

The safety, health and wellbeing of our people and suppliers are matters we take very seriously. Our vision and the customer outcomes that we will continue to meet are all set in the context of our commitment to operating our business without harm. During the period, we recorded two work related lost time injuries and our accident frequency rate fell to 0.24 lost time injuries per 100,000 hours worked, from 0.28 for the year ended 31 March 2017.

In May 2017, 120 people from across the business took part in our second Customer Excellence Day. This was followed by our Customer Relations Leaders Day in August 2017. These events included keynote speakers and interactive sessions to ensure we deliver our best possible service to our customers. Our Customer Engagement Improvement Programme continues to improve the customer journey by understanding the areas that require focus and taking remedial action. We are focusing our efforts on the things that can make a real difference to our customers: response times, quicker resolution and keeping our customers informed.

Customer satisfaction is of utmost importance to us. We know that customer priorities are changing and their expectations are growing. We have seen a reduction in the number of complaints and unwanted contact compared to the same period last year, and we won two silver awards at the UK Customer Experience Awards for 'Best Customer Insight and Feedback' and 'Customers at the Heart of Everything' in September 2017. In Quarter 2 Ofwat Service Incentive Mechanism ('SIM') survey, the results of which were released at the end of September 2017, we achieved our highest ever score in clean water and one of our highest ever scores in billing, to place us in 8th position in the industry overall. The next survey results are due to be released at the end of December 2017.

Our Education Team has worked with over 10,000 students in 2017, either welcoming them to our Education Centre in Bushey or through our outreach programme, visiting pupils in schools to deliver curriculum activities. Our production and community team in Dour recently hosted students from two local colleges at our Drellingore pumping station, where they gained an insight into some of our operational procedures and received an explanation of the water treatment processes. We support our local economies through our role as a local employer offering apprenticeships and graduate schemes. In September 2017, we welcomed 15 new graduates to the company who will develop broad business knowledge and experience through their programme over the next 24 months.

Financial performance

Financial results for the period ended 30 September 2017

Our financial results are prepared in accordance with the recognition and measurement requirements of EU-adopted International Financial Reporting Standards ('IFRS'). Our unaudited financial results for the six months to 30 September 2017 are summarised as follows:

	2017 £m	2016 £m
Revenue	**154.6**	155.9
Operating costs	**(122.1)**	(122.2)
Other income	**8.8**	8.4
Operating profit	**41.3**	42.1
Profit on disposal of non-household business	**11.0**	-
Net finance costs	**(25.9)**	(32.1)
Profit before tax	**26.4**	10.0
Tax (expense)/credit	**(4.2)**	8.3
Profit for the period	**22.2**	18.3
Dividends	**(28.5)**	(36.0)
Transfer to reserves	**(6.3)**	(17.7)

Revenue for the first six months of the year was £154.6m, being a 1% decrease on the same period last year (2016: £155.9m). The decrease is primarily due to the disposal of the non-household retail business and lower new connections activity, partially offset by inflationary price increases.

Operating expenditure

Total operating costs of £122.1m for the first half of the year were £0.1m lower than in the same period last year (2016: £122.2m). The variance is explained in the table below:

Increases/(decreases) in operating costs	**£m**
Inflation	3.1
Lower infrastructure renewals activity	(2.1)
Market opening preparation costs in the prior period	(1.3)
Costs relating to the non-household business in the prior period	(0.6)
Higher employment costs	1.1
Higher network costs due to increased job volumes	1.0
Higher leakage detection and repair costs	0.5
Lower production and supply costs	(1.1)
Other decreases	(0.7)
Net decrease in operating costs	(0.1)

Other income of £8.8m consisted of sundry income, rental income and non-appointed income and was £0.4m higher than the prior year (2016: £8.4m).

Profit on disposal of the non-household business to Affinity for Business (Retail) Limited on 1 April 2017 was £11.0m

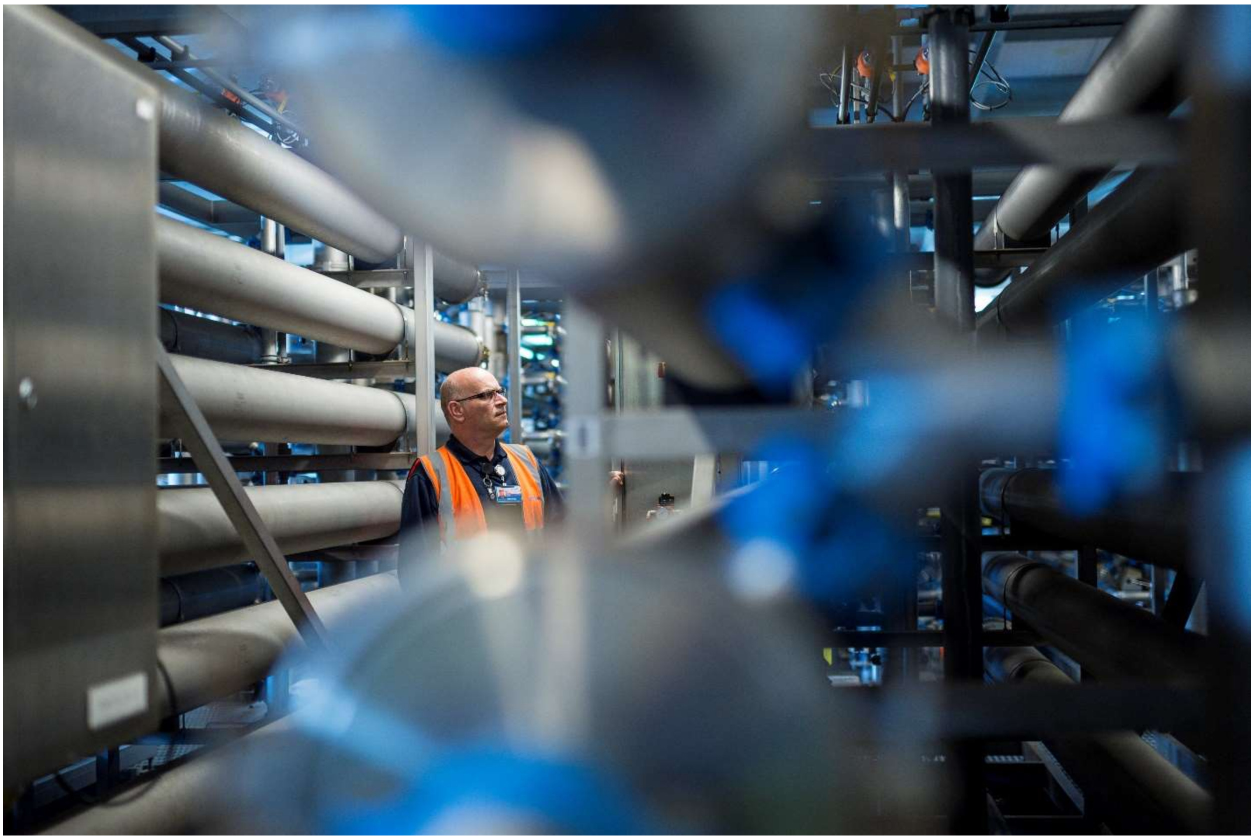
Finance costs

The net finance expense of £25.9m was £6.2m lower than the first half of last year primarily due to £9.5m transaction costs written off in the prior year, partially offset by an increase in indexation on the RPI-linked notes.

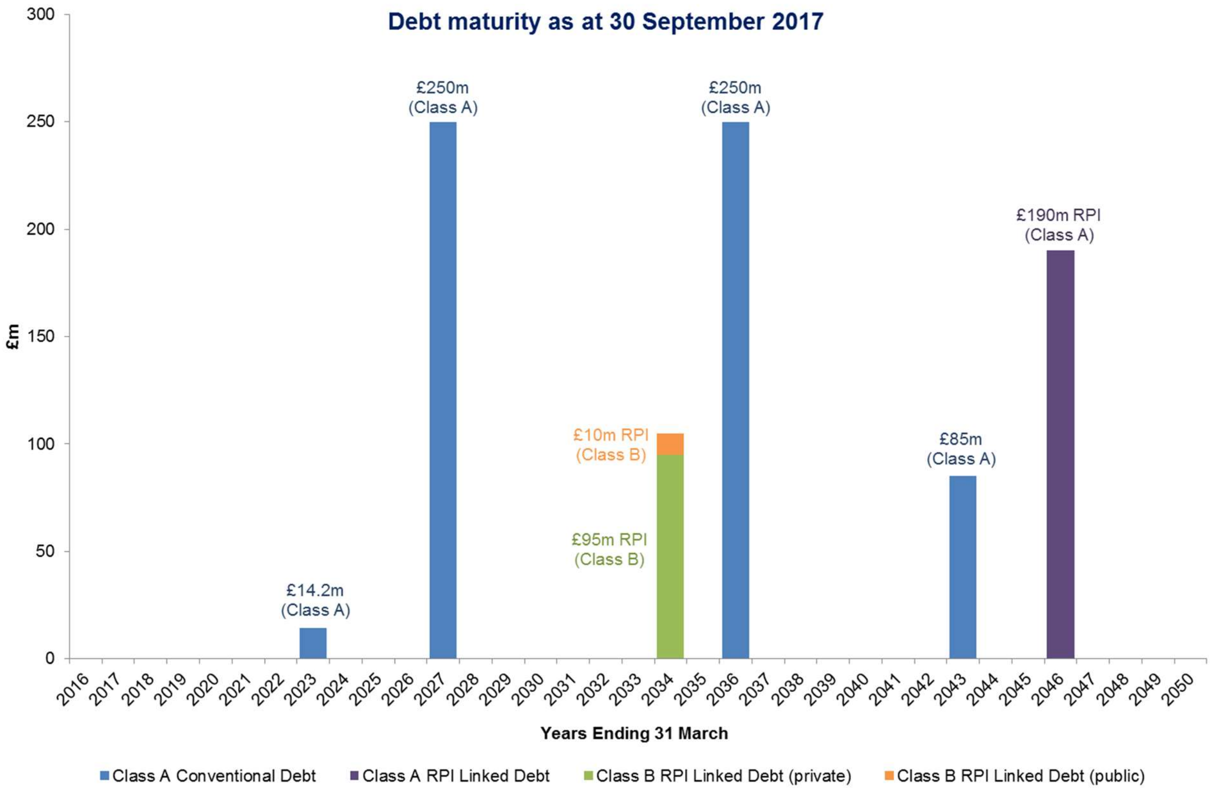
Capital expenditure

Capital expenditure in the period was £66.5m (2016: £54.3m), and was incurred principally in our mains renewals, trunk main replacement, sustainability reduction, water saving and lead pipe replacement AMP6 programmes. This excludes £6.7m (2016: £8.7m) of infrastructure renewals expenditure, which is treated as an operating cost under the recognition and measurement requirements of IFRS.

The higher capital expenditure in the first half of this year compared to the same period last year reflects the acceleration in the pace of investment in our mains renewals, trunk mains, lead pipe replacement and meter installation programmes.



Financing update



The above maturity profile will be updated in the March 2018 Investor Report with the bond issuances in November 2017.

Regulatory update

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 Environment Agency, the Department for the Environment, Food and Rural Affairs, the Drinking Water Inspectorate, 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. Our retail non-household operating unit was rebranded as Affinity for Business. It became a separate legal entity, Affinity for Business (Retail) Limited, on 1 April 2017 outside the Affinity Water Limited group, to which the retail non-household business was sold.

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 by the company to Affinity for Business (Retail) Limited. Preferential treatment could lead to failure to operate effectively in the new market, a principal risk for the company. 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 Water Act 2014 paved the way for further reform of upstream activities in the water sector. Ofwat published its draft price setting methodology in July 2017. This document clarified that prices in the industry will, in future, be indexed to the Consumer Price Index ('CPI') instead of theRPI. In order to help the transition from RPI to CPI, a portion of water companies' Regulatory Capital Value ('RCV') will still be indexed to RPI beyond 2020.

Ofwat has also recently consulted on outcomes and customer measures for the 2020 – 2025 price control period ('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.

Governance update

Board changes

Stuart Ledger joined Affinity Water as Chief Financial Officer from 9 October 2017, replacing Duncan Bates who will continue his involvement with the wider Affinity Water Group, working on a part time basis as Group Financial Officer until March 2018, supporting Stuart and on projects outside the regulated business.

Stuart is an accountant with significant experience in utilities. He started his career at EDF Energy and went on to hold a number of senior finance roles. He was the Financial Controller at Wolseley before joining Thames Water in 2008 as Group Financial Controller and then Chief Financial Officer for Retail in 2013.

At the end of August 2017, Affinity Water Chief Executive Officer, Simon Cocks and Affinity Water Chairman, Dr Philip Nolan have decided to step down from their roles. Dr. Philip Nolan will stay as chairman until a successor has been found while Simon Cocks plans to leave by the end of 2018.

Common Terms Agreement compliance

Calculation of financial ratios

Test Period		Year 1 1 April 2017 to 31 March 2018 Forecast	Year 2 1 April 2018 to 31 March 2019 Forecast	Year 3 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow divided by	£m	155.1	136.2	138.4
Class A Debt Interest	£m	33.7	34.3	34.8
Class A ICR[3]	**Ratio**	**4.6**	**4.0**	**4.0**
Net Cash Flow less	£m	155.1	136.2	138.4
CCD and IRC	£m	0	0	0
Adjusted Net Cash Flow divided by	£m	155.1	136.2	138.4
Class A Debt Interest	£m	33.7	34.3	34.8
Class A Adjusted ICR	**Ratio**	**4.6**	**4.0**	**4.0**
Net Cash Flow less	£m	155.1	136.2	138.4
CCD and IRC	£m	0	0	0
Adjusted Net Cash Flow divided by	£m	155.1	136.2	138.4
Senior Debt Interest	£m	37.2	37.9	38.6
Senior Adjusted ICR	**Ratio**	**4.2**	**3.6**	**3.6**

[3] Interest Cover Ratio

Calculation of financial ratios (continued)

Test Period		Year 1 1 April 2017 to 31 March 2018 Forecast	Year 2 1 April 2018 to 31 March 2019 Forecast	Year 3 1 April 2019 to 31 March 2020 Forecast
Year 1	Ratio	4.6	4.6	4.6
Year 2	Ratio	4.0	4.0	4.0
Year 3	Ratio	4.0	4.0	4.0
Class A Average Adjusted ICR	**Average**	**4.2**	**4.2**	**4.2**
Year 1	Ratio	4.2	4.2	4.2
Year 2	Ratio	3.6	3.6	3.6
Year 3	Ratio	3.6	3.6	3.6
Senior Average Adjusted ICR	**Average**	**3.8**	**3.8**	**3.8**
Net Cash Flow less	£m	155.1	136.2	138.4
RCV Depreciation and Capitalised IRE[4]	£m	63.7	65.6	70.9
Conformed Adjusted Net Cash Flow divided by	£m	91.4	70.6	67.5
Class A Debt Interest	£m	33.7	34.3	34.8
Conformed Class A Adjusted ICR	**Ratio**	**2.7**	**2.1**	**1.9**

[4] Infrastructure Renewals Expenditure

Calculation of financial ratios (continued)

Test Period		Year 1 1 April 2017 to 31 March 2018 Forecast	Year 2 1 April 2018 to 31 March 2019 Forecast	Year 3 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow less	£m	155.1	136.2	138.4
RCV Depreciation & Capitalised IRE	£m	63.7	65.6	70.9
Conformed Adjusted Net Cash Flow divided by	£m	91.4	70.6	67.5
Senior Debt Interest	£m	37.2	37.9	38.6
Conformed Senior Adjusted ICR	**Ratio**	**2.5**	**1.9**	**1.8**
Year 1	Ratio	2.7	2.7	2.7
Year 2	Ratio	2.1	2.1	2.1
Year 3	Ratio	1.9	1.9	1.9
Conformed Class A Average Adjusted ICR	**Average**	**2.2**	**2.2**	**2.2**
Year 1	Ratio	2.5	2.5	2.5
Year 2	Ratio	1.9	1.9	1.9
Year 3	Ratio	1.8	1.8	1.8
Conformed Senior Average Adjusted ICR	**Average**	**2.0**	**2.0**	**2.0**

Calculation of financial ratios (continued)

Date		30 September 2017 Actual	31 March 2018 Forecast	31 March 2019 Forecast	31 March 2020 Forecast
Class A Net Indebtedness divided by	£m	799.3	818.4	849.3	870.9
RCV	£m	1,187.1	1,206.7	1,234.6	1,245.7
Class A RAR[5]	**Ratio**	**0.67**	**0.68**	**0.69**	**0.70**
Senior Net Indebtedness divided by	£m	916.5	936.2	971.0	996.5
RCV	£m	1,187.1	1,206.7	1,234.6	1,245.7
Senior RAR	**Ratio**	**0.77**	**0.78**	**0.79**	**0.80**

The following table reconciles the Class A Net Indebtedness and Senior Net Indebtedness to the amounts reported in the financial statements.

Date	30 September 2017 £m
Borrowings	949.9
Exclude Permitted Legacy Loan	(3.6)
Add Back Unamortised Debt Issue Costs and Bond Premium	(20.1)
Add Revolving Credit Facility Drawdown	20.0
Add Accrued Interest	5.7
Less Cash and cash equivalents	(35.5)
Senior Net Indebtedness	**916.5**
Remove Class B Debt Amounts	(117.2)
Class A Net Indebtedness	**799.3**

[5] Regulatory Asset Ratio

Further certifications

Surplus

Affinity Water Limited's dividend policy is to pay dividends that target a Senior RAR of 80% at each of the compliance test dates as well as remaining consistent with the requirements of Condition F of the licence. Condition F states that any dividends declared or 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.

For the 6 month period to 30 September 2017, Affinity Water Limited paid dividends totalling £28.5 million (6 months to 30 September 2016: £36.0 million).

Debt Service Reserve Account

There is no balance in the Debt Service Reserve Account as at 30 September 2017. The required debt service reserve is provided by a liquidity facility from HSBC Bank PLC totalling £38.0 million.

Authorised Investments

Counterparty	Bank Deposits (£m)	Liquidity Funds (£m)	Total (£m)
HSBC Sterling Liquidity Fund	-	-	-
Lloyds Bank plc	-	-	-
Santander UK plc	4.0	-	4.0
Morgan Stanley Sterling Liquidity Fund	-	-	-
BNP Paribas Insticash Sterling Liquidity Fund	-	-	-
LGIM Sterling Liquidity Fund	-	-	-
Amundi GBP Short Term Money Market Fund	-	3.0	3.0
Total	4.0	3.0	7.0

Permitted Subsidiaries Acquired

There were no Permitted Subsidiaries acquired pursuant to a Permitted Acquisition in the period to 30 September 2017.

Annual Finance Charge

Up to September 2017, Affinity Water Limited calculated the Annual Finance Charge as £36.5m with a Monthly Payment Amount of £3.042m.

Post the bond issuances in November 2017, the Annual Finance Charge will increase to £37.2m and the Monthly Payment Amount will be £3.098m. Calculation of the Annual Finance Charge is set out in the table to the right.

	1 April 2017 to 31 March 2018 (£m)
Forecast interest paid on bonds	36.7
Forecast interest paid on loans	0.0
Other recurring finance fees paid	0.5
Total	**37.2**

Additional Confirmations

Affinity Water Limited also confirms that:

(a) no Default or Potential Trigger Event is outstanding; and

(b) that Affinity Water Limited's insurances are being maintained in accordance with the Common Terms Agreement.

Further Periodic Information

Additional periodic reports and publications can can be found on our stakeholder website:

https://stakeholder.affinitywater.co.uk/reports-publications.aspx

Yours faithfully,

Stuart Ledger

Chief Financial Officer

For and on behalf of

Affinity Water Limited

(in its capacity as Transaction Agent)