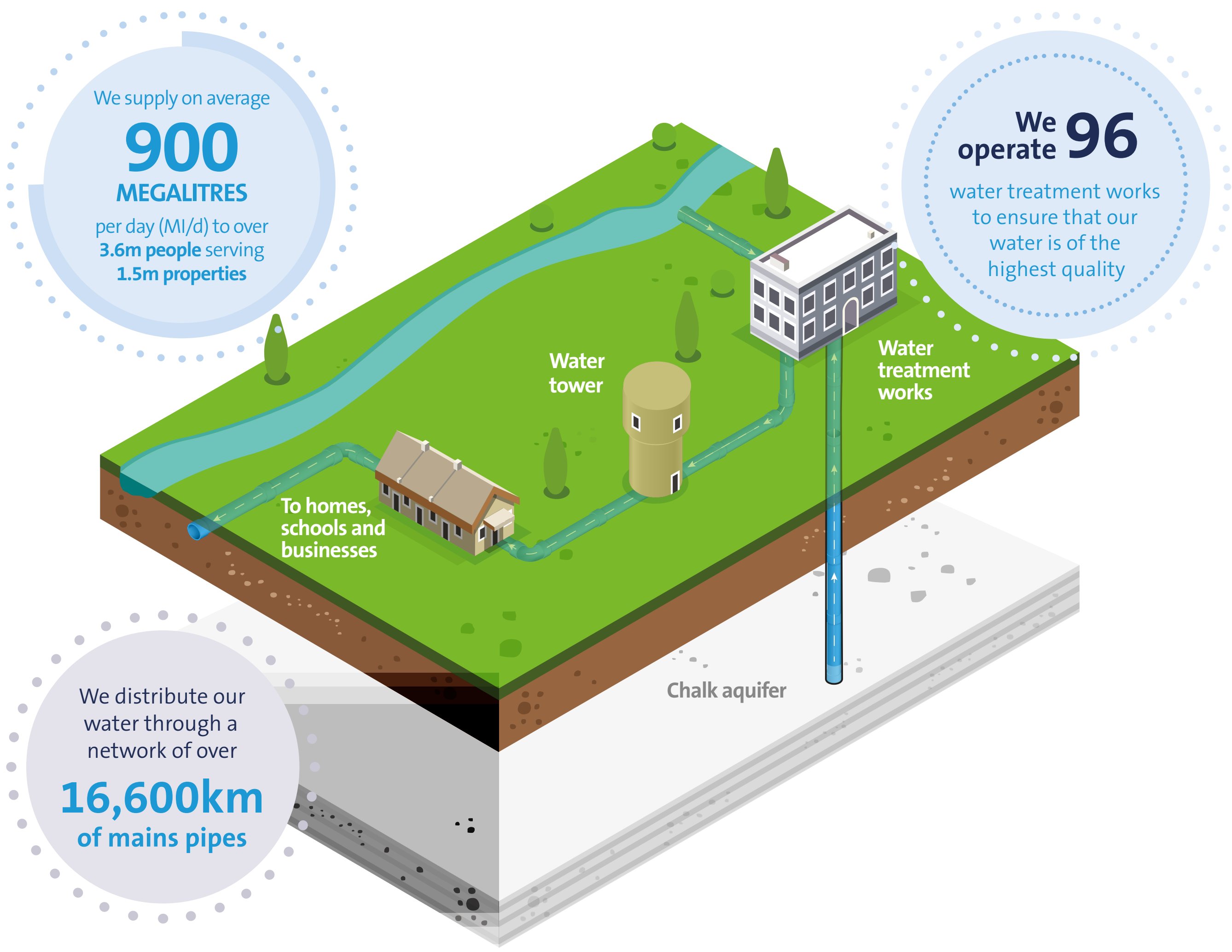
Affinity Water

Annual Report and Financial Statements

For the year ended 31 March 2018

Affinity Water Limited
(Registered Number 02546950)



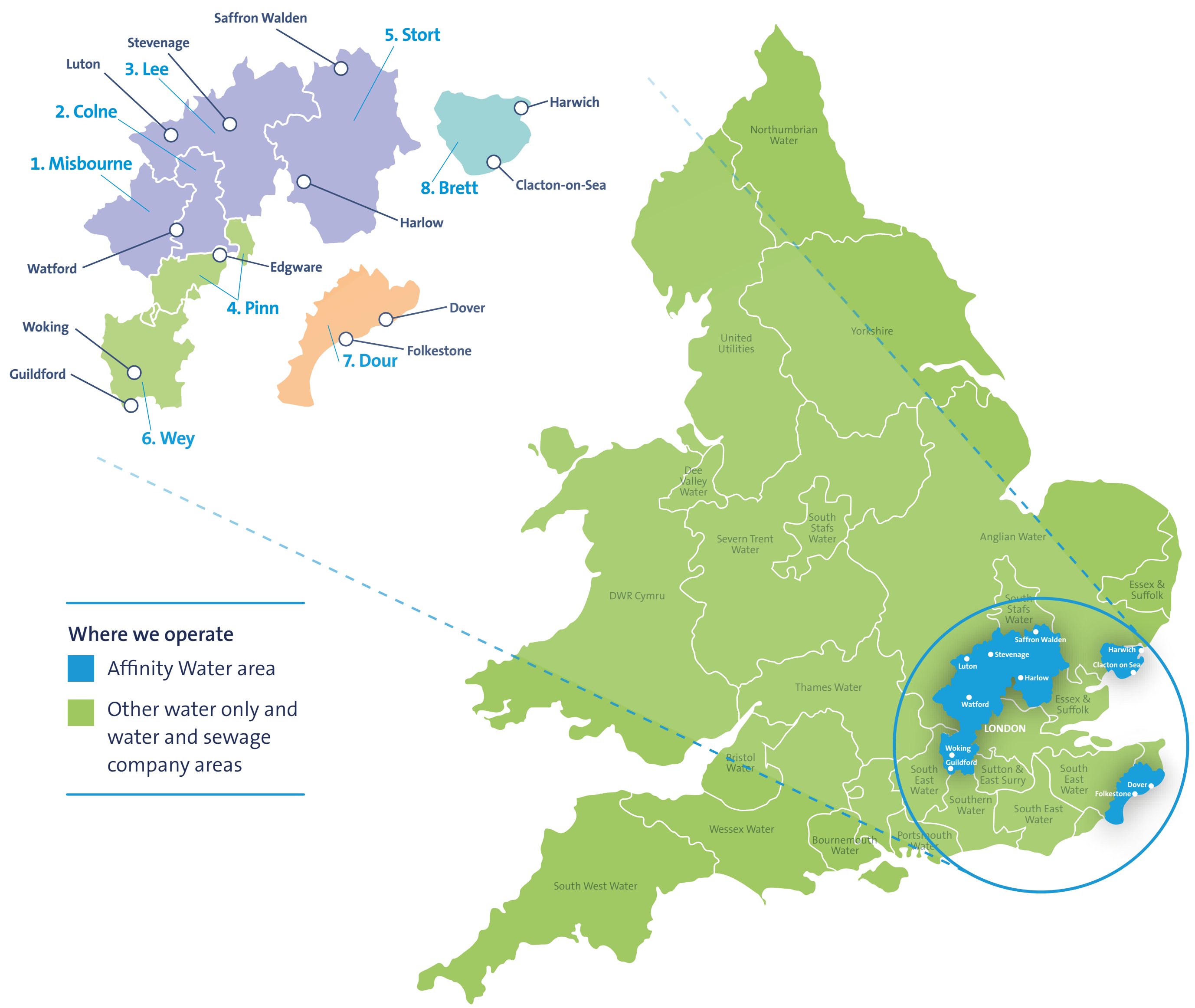
Affinity Water at a glance

Where we operate

Affinity Water Limited is the largest water only supply company in the United Kingdom, owning and managing the water assets and network in an area of approximately 4,515km² split over three supply regions in the South East of England.

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

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.



Important information

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.

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.

Integrated report

We aim to continually develop our reporting in order to improve our communication with customers and stakeholders. This annual report and financial statements has been prepared using the principles of the International Integrated Reporting Framework.

Our Registered Office

Tamblin Way
Hatfield
Hertfordshire
AL10 9EZ

affinitywater.co.uk

Cover
Monitoring operations at a water treatment works

Affinity Water at a glance

Our financial highlights 2017/18

Net cash inflow before tax and financing[1]:

£56.3m

Target: £82.6m; 2016/17: £18.3m

Our net cash inflow was higher than the prior year, primarily due to proceeds from the sale of the non-household retail business and lower fixed asset expenditure

Operating profit:

£72.3m

2016/17: £77.8m

Our operating profit for 2017/18 was lower than the prior year due to lower revenue as a result of the sale of the non-household retail business and increased operating costs

Post tax return on regulated capital value:

6.1%

2016/17: 5.7%

Our post tax return on regulated capital value assumed in price controls for 2017/18 was higher than the prior year due to profit from the sale of the non-household business included within our return

£120.0m

of bonds issued in the year to ensure we have the finances in place to deliver our expected investment programme for the 2020-2025 price control period and to deliver high levels of service

Credit ratings:

Baa1

2016/17: Baa1

During the year, we continued to maintain an investment grade corporate family credit rating in line with our peers in the water sector, being two notches above investment grade

Gearing:

78.6%

2016/17: 76.6%

Gearing remained below the internal threshold of 80.0% at 31 March 2018 and throughout the financial year. This allows sufficient headroom within our financial covenants

[1] This "non-GAAP" measure is calculated for 2017/18 as the total of the following line items per the statement of cash flows (refer to **page 111**): cash generated from operations; purchases of property, plant and equipment; capital contributions; proceeds on disposal of property, plant and equipment; proceeds on disposal of non-household business; and purchase of intangibles. The 2016/17 figure is as reported in the annual report and financial statements for the year ended 31 March 2017.

Our operational highlights 2017/18

We remain on track to meet the industry's most challenging leakage reduction target for 2015-2020, having reduced leakage for the last three years and have reduced our customers' average water use (per person, per day) by

8.0litres

to 151.7 litres, compared to our 2016/17 performance

Mean zonal compliance ('MZC')[1] of

99.96%

for the 2017 calendar year, compared to a target of 99.95% and actual performance in 2016 of 99.96%

Since 2014/15 we have revised our strategy and improvement plan to focus on a number of safety and health initiatives. We recorded

0.29

lost time injuries per

100,000

hours worked,

compared to actual performance of 1.02 in 2014/15

We experienced

7,890

unplanned interruptions

to supply over 12 hours compared to a target of 320 and actual performance of 1,840 in 2016/17. Excluding the impact of a severe weather event, we would have met the target for the second half of the year

We experienced

2,923

bursts

compared to our target of 3,100 and actual performance in 2016/17 of 3,077

Improvements have been seen in our customer service metrics, including a

32% reduction in complaints & **34% reduction** in escalated complaints

[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 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 Drinking Water Inspectorate ('DWI').

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Strategic report

Chairman's welcome

I am delighted to present Affinity Water's annual report and financial statements for the year ended 31 March 2018, having recently been appointed as Chairman of the company.

Firstly, I would like to take this opportunity to thank Dr Philip Nolan on behalf of the Board, for his leadership and service to Affinity Water during his time as Chairman.

During my first few months as Chairman I have been impressed at the commitment of the team at Affinity Water to continue to deliver resilient and affordable water to 3.6 million people across the South East of England, and I am looking forward to working with the Affinity Water Board, its investors and the management team to build on the achievements of the last few years.

I would also like to introduce Pauline Walsh, who joined us as Chief Executive Officer ('CEO') on 1 May 2018, succeeding Simon Cocks in the role. I would like to extend my gratitude to Simon for his leadership over the past three years and I look forward to continuing working alongside him on the Board as he takes up his new position as a non-executive director.

Stuart Ledger was also appointed to the Board during the year having joined the company as Chief Financial Officer ('CFO') in October 2017, replacing Duncan Bates who continues his involvement with the wider Affinity Water group, as a non-executive director of Affinity for Business (Retail) Limited.

SALE OF THE BUSINESS

On 19 May 2017, Affinity Water Limited was sold 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. We would like to formally welcome our new long-term investors to the business.

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

We continue to operate as normal, remaining focused on achieving our strategic objectives.

REGULATION, POLITICAL ENVIRONMENT AND GOVERNANCE

This year the debate over water companies, their regulation and governance, and the long-term requirements has increased substantially.

During the election campaign in the summer of 2017 the Labour opposition proposed the renationalisation of the industry. Also in 2017 Ofwat finalised their methodology for the next price review of the industry ('PR19'). At the beginning of this year, the Secretary of State set out his views on trust and financial resilience in the water sector, and the Chairman of Ofwat has responded. In February 2018, the Department for the Environment, Food and Rural Affairs ('Defra') published its 25 year plan to improve the environment with forewords by the Prime Minister and Secretary of State, and which set a clear commitment to protect and enhance the environment for the next generations, including how we use water. In April 2018, the National Infrastructure Commission published its report on preparing for a drier future, which recommends plans are put in place to deliver additional water supply and demand reduction; and in May 2018, the Environment Agency published its report on the state of water resources, which also concluded that action must continue to reduce demand, increase supply and minimise wasting of water.

As a firm with the vision to be the leading community focused water company, we welcome these challenges. We recognise the importance of ensuring that our customers and communities can trust the service we provide, and we know that we must ensure that they are confident that we are operating in a way which is responsible, accountable, and transparent. We strongly agree that companies in our sector must be financially resilient in the round, given the importance of the industry to customers and communities, and given its capital intensity and long-term nature. As a newcomer to the industry, I have also been struck by the need to focus on the physical resilience of our infrastructure, particularly in the context of population growth, climate change, and weather shocks such as drought and flood, and the long-term improvement of the environment for future generations. My colleagues in the company are very focused on physical resilience, and ensuring that we can continue to deliver clean, safe water reliably and cost-effectively for future generations.

As a Board, we spend a significant amount of time aligning our company plans to the interests of customers, employees and wider stakeholders, discussing at length how we can make our infrastructure and company more resilient in the long term.

In the last few years we have strengthened our Board, carefully selecting individuals with relevant skills and experiences to challenge and support the business, whilst also putting in place the finance required to invest in our infrastructure. Together these will help us to deliver excellent service to customers and ensure we can meet the future water demand in our region.

OUR BUSINESS PLAN

We have just completed the third year of our latest five-year business plan (the 2015-2020 price control period, Asset Management Plan 'AMP6'), in which we had set ourselves a number of stretching objectives. Ofwat acknowledged the level of ambition in that plan, and also highlighted our community approach by awarding us 'enhanced status'. I am pleased to say that we are achieving most of our targets and are taking mitigating action in those few cases where we have fallen behind – please see the review from Simon Cocks and more detail on **pages 33 to 35**. We have also established a Community Committee as a subcommittee of the Board to oversee and continue to enhance our community approach.

Our next Business Plan for the 2020-2025 price control period (Asset Management Plan 7, 'AMP7'), has to be submitted to Ofwat by 3 September 2018. In preparing this Business Plan, we are consulting extensively, and expect to consult with 10,000 customers and stakeholders, to ensure we represent the priorities of customers in each of our communities.

We are also working on the next version of our Water Resource Management Plan ('WRMP'), which sets out our plan to meet our long-term water supply challenges. Our draft WRMP is available in full on our website: **affinitywater.co.uk/water-resources.aspx**.

Our Customer Challenge Group ('CCG'), which consists of individuals 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 more for customers in AMP7, our CCG is there to challenge us on how we engage and research our plans. We welcome feedback from the CCG to ensure that we continue to put customers at the heart of everything we do.

Our enduring vision is to be the UK's leading community focused water company. It reflects the importance of the community focused water company. It reflects the importance of the way we work with and for customers and the communities we serve, understanding and responding to the needs of different community groups and acting as the steward of a precious resource. This vision will be consistent in our next Business Plan.

Tony Cocker

Chairman

Strategic report continued

Chief Executive Officer's review

I have thoroughly enjoyed my tenure as CEO of Affinity Water and am excited to continue my involvement with the company as a non-executive director. I am proud that in 2017/18 we have continued to make progress in meeting the performance commitments that we included within our AMP6 Business Plan.

OUR VISION

At Affinity Water, we understand that we provide an essential service to customers across the communities we serve, and it is this that drives our vision to become the leading community focused water company in the UK.

For us, community focused means playing an active role in the communities we serve, keeping customers informed about our activities and giving them a real opportunity to give us their thoughts on how we are performing. We are helping customers to understand the value of water, in turn reducing consumption and supporting the ongoing protection of the environment.

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

VALUE CREATION

We create value by performing efficiently and by maintaining our local environment, sustaining our local communities and supporting our local economies. We do this by drawing upon the following resources and relationships as inputs to our business:

- Our environment;
- Our assets and sites;
- Our customers and communities;
- Our people; and
- Our finances

The way in which we operate and utilise these inputs is key to creating value. We transform them through our operating activities to deliver the standards of service that customers expect and meet the performance commitments that we promised in our AMP6 Business Plan. For more information on our commitments and how we create value, please refer to **pages 16 to 17**.

OPERATIONAL PERFORMANCE

Customers and our stakeholders must have confidence that we are operating in a responsible and accountable way. To achieve this we publish our performance at a community level so customers can see how we are performing in their area. Please refer to our stakeholder website:
stakeholder.affinitywater.co.uk/company-performance.aspx

During the current regulatory period, we are particularly focused on enhancing our environment by reducing the abstraction of water from environmentally sensitive sites. In order to achieve this we have committed to reducing leakage on our network by 14% over AMP6 and remain on track to achieve this, having reduced leakage for the past three consecutive years. Our average water use per person has also fallen by 8.0ML/d (5.1%) from 159.7ML/d in 2016/17 to 151.7ML/d for 2017/18.

During the year we reduced abstraction in our Beane, Mimram and Hughenden catchments. This programme is currently 12 months ahead of schedule having delivered a cumulative average annual reduction of 32.7 ML/d towards our commitment of 42.1 ML/d during the current AMP.

UK CUSTOMER EXPERIENCE AWARDS

Winner of two silver awards for 'Best Customer Insight and Feedback' and 'Customers at the Heart of Everything'

european contact centre & customer service awards 2017

Winner of the 'Best Customer Transformation' and 'Best Corporate Social Responsibility' awards

rant&rave

Winner of the 'Most Improved Customer Satisfaction' award

Customers continued to benefit from high quality drinking water during the year. Our MZC was 99.96%, outperforming our regulatory target. However we do acknowledge we had a small number of water quality incidents in the year. Whilst there was no risk to customers, we are committed to improving our performance.

We also achieved our target of fewer than 3,100 mains bursts in the year, and experienced fewer bursts than the previous year, despite a spell of severe winter weather from late February to early March 2018 followed by a rapid increase in temperature and resultant thaw causing disruption on our network. At a time when we are asking customers to save water, we 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 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 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.

We are working incredibly hard to reduce unplanned interruptions to supply and have introduced a structured plan aimed at improving our processes to prevent disruption to customers. If it had not been for the severe weather event in early March 2018, the business would have achieved its performance commitments for the whole of the second half of the year. During the period of 2 to 7 March 2018, we repaired 182 burst mains, 230 repair jobs regarding supply pipe leaks were created and 64 waste notices were issued. The increased demand caused by supply side leakage and bursts resulted in distribution input similar to summer peaks. We were fully prepared to respond to these challenges. Our preparations for events of this nature are supported by a number of detailed operational plans which ensure we are ready to respond, with the right resources, in the right place at the right time.

An improvement has been seen in our customer service metrics, including our external service incentive mechanism ('SIM') survey results, which were the fourth most improved in the industry. There has also been a 32% reduction in complaints and 34% reduction in escalated complaints, and an overall improvement in our customer satisfaction levels.

We are using more customer insights, more regularly to drive business decisions. Our digital transformation is now underway, with the launch of a new self-service solution on our website, and webchat and bots now live.

We are currently focusing on our digital technologies and are on a journey to move key applications out of data centres to cloud based systems to support and minimise disruption to our IT systems. We also launched our fieldwork management system in the year, with completion of the roll out in June 2018. This will help to drive future efficiencies and we will now seek to maximise the benefits of these new systems.

The safety and health of our people are of utmost importance. During the year we experienced 0.29 lost time injuries per 100,000 hours worked compared to a target of 0.24 and actual performance of 0.28 in 2016/17.
We reviewed and updated our strategy and improvement plan during the year and aim to reduce lost time injuries further going forwards.

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 customers. For more information on our operational performance, please refer to **page 33**.

Simon Cocks

(CEO until 30 April 2018)

Strategic report continued

Chief Executive Officer's review (continued)

I am delighted to have joined Affinity Water at an exciting time for the water industry. Firstly, on behalf of the senior management team and the Board, we would like to thank all our people for their hard work, dedication and achievements over the past year. I believe that we are well placed to respond to the challenges and opportunities ahead.

OUR FUTURE PLANS

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 have set ourselves ambitious performance commitments for AMP6 and will continue to work hard to achieve these. Our teams are focused on delivering against these to ensure a sustainable supply for future generations along with meeting the standards of service customers expect. Our partnerships with customers and stakeholders in our communities will help us realise that vision.

We are currently working on our AMP7 Business Plan, for which we are engaging with over 10,000 stakeholders. I have enjoyed meeting with customers to understand their priorities, which helps us to tailor our plan to their needs.

For more information on how we are planning for the future, please refer to our stakeholder website: **stakeholder.affinitywater.co.uk**.

VULNERABLE CUSTOMERS

We know within our communities we have vulnerable customers who need extra support to meet their individual circumstances and we have services to help. We are helping more than 49,000 customers through schemes such as our LIFT social tariff and Water Direct Scheme. By using trusted partners, such as the Citizens Advice Bureau, we can reach many more. For more information, please refer to our case study on **page 20**.

We are creating specialist Advance Care Champions who receive additional training to fully understand, identify and support customers' needs. We are committed to becoming a dementia-friendly business as we know that dementia is one of the greatest challenges faced in society today.

INNOVATION

As a business we are constantly innovating. In 2016 we purchased 20,000 acoustic loggers to help us achieve the industry's most challenging leakage reduction target for AMP6. The loggers work by 'listening' for the sound of leaks on our network. We now find leaks 46 days quicker and have reduced leakage by 10.3 ML/d across the AMP.

We are also acutely conscious that our roadworks can cause delays. We have been trialling artificially intelligent traffic lights, which use smart sensors to detect traffic volumes and optimise flow. We are trialling these with two of our Highway Authorities. This should provide a much better experience for road users.

Pauline Walsh

(CEO from 1 May 2018)

Chief Financial Officer's review

I am delighted to have joined Affinity Water and I am thrilled to be part of the leadership team working with the Board and investors to deliver the stretching commitments made to customers and meet future challenges.

This year has been a challenging year operationally with several significant events causing disruption on our network, which have impacted our financial performance. In particular the severe weather event in early March 2018 led to additional expenditure being incurred to ensure interruptions to supply were minimised. We have continued to invest in our assets during the year to improve the resilience of our network.

The physical and financial resilience of the sector has been the subject of much public discussion during the year. Given the capital intensive nature of this industry, coupled with the need for new investment, and its importance for our customers and communities, we strongly agree that companies in our sector should be financially resilient in the round, and able to withstand shocks. During the year we further enhanced our financial resilience through raising the funds required to deliver our expected AMP7 investment programme.

Stuart Ledger

Chief Financial Officer

Strategic report continued

Chief Financial Officer's review (continued)

2017/18 FINANCIAL PERFORMANCE

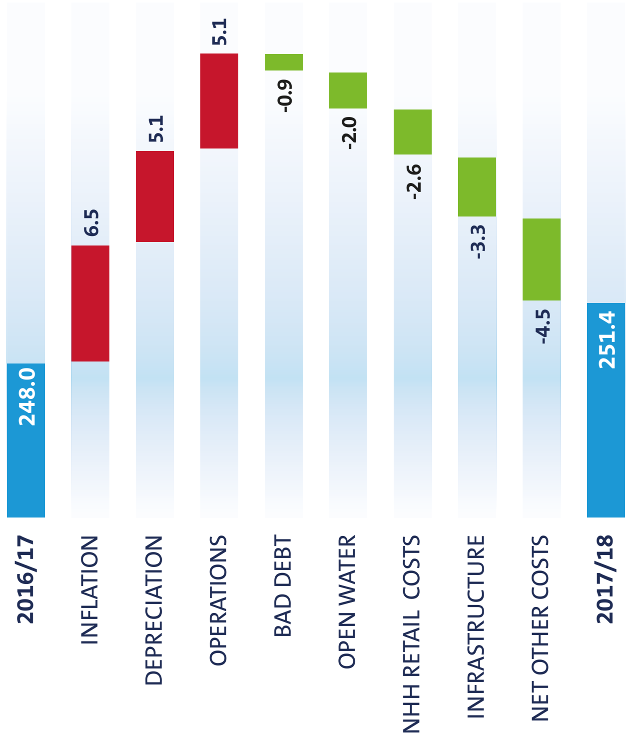
Our financial results are prepared in accordance with Financial Reporting Standard 101: 'Reduced disclosure framework' ('FRS 101') and are summarised in the table below.

For more information refer to the basis of preparation of our statutory financial statements on **page 112**.

	2018 £m	2017 £m
Revenue	**306.3**	308.7
Operating costs	**(251.4)**	(248.0)
Other income	**17.4**	17.1
Operating profit	**72.3**	77.8
Profit on disposal of non-household retail business	**10.9**	–
Net finance costs	**(47.3)**	(51.0)
Profit before tax	**35.9**	26.8
Taxation	**(6.3)**	4.1
Profit for the year	**29.6**	30.9

Revenue for 2017/18 was £306.3m, being a £2.4m (0.8%) decrease on the prior year (2017: £308.7m). This decrease is primarily due to the sale of the non-household (NHH) retail business on 1 April 2017, partially offset by inflationary price adjustments allowed in our last regulatory determination.

Operating costs for the year increased by £3.4m (1.4%) to £251.4m (2017: £248.0m), as explained in the graph below:



The net finance expense of £47.3m was £3.7m lower than last year, primarily as a result of £9.5m of transaction costs expensed during the prior year due to the partial extinguishment of the 2022 bond, offset by the impact of higher inflation on the company's index-linked debt in the current year. For more information refer to note 5 of the statutory financial statements.

There was a £10.9m profit on the sale of the non-household retail business to Affinity for Business (Retail) Limited, which largely explains the increase in profit before tax of £9.1m (34.0%) to £35.9m (2017: £26.8m).

TAXATION

The income tax expense on profit before tax was £6.3m (2017: £4.1m credit). The effective current tax rate (7.5%; 2017: 26.7%) was lower (2017: higher) than the UK corporation tax rate of 19% (2017: 20%). Taxable profits have been reduced this year by a one-off non-taxable profit on sale of the non-household retail business. Further information and a full reconciliation of the current tax charge is in note 6.4 of our statutory financial statements.

Total tax paid in the year to 31 March 2018, other than corporation tax, amounted to £29.1m (2017: £29.4m) consisting of employer's national insurance, business rates, environmental taxes and streetworks permits.

All our profits are taxed in the UK. We do not use artificial tax avoidance schemes or tax havens to reduce our tax liabilities, and we comply with what we understand to be both the letter and the spirit of the tax legislation. Details of our tax strategy can be found on **page 209** in our regulatory Annual Performance Report and on our website at: **stakeholder.affinitywater.co.uk/investor-library.aspx**.

CASH FLOW

Net cash inflow before tax and financing for the year was £56.3m being a 208% increase on last year (2017: £18.3m). The increase is due to £27.0m received from the sale of the non-household retail business, £14.3m lower fixed asset net expenditure (2018: £108.4m; 2017: £122.7m), offset by £2.4m lower cash generated from operations (2018: £137.7m; 2017: £140.1m) and £0.9m net other variances.

CAPITAL EXPENDITURE

Capital expenditure in the year was £123.3m (2017: £131.7m), and was incurred principally in our mains renewal, trunk mains, lead pipe replacement, integrated water savings and leakage AMP6 programmes. This excluded £14.6m (2017: £17.9m) of infrastructure renewals expenditure, which is treated as an operating cost under FRS 101.

We are a business with a long-term outlook and expenditure commitments, which need to be matched with long-term sources of debt finance. Our financing subsidiaries have outstanding external bonds totalling £1,014.2m, raised in the debt capital markets and on-lent to the company on the same terms.

NET DEBT AND GEARING

Our net debt as at 31 March 2018 was £949.0m, an increase of £63.8m since last year (2017: £885.2m) due to the issuance of new bonds in November 2017 offset by higher cash held at the year end.

Our gearing of net debt to regulatory capital value ('RCV') at 31 March 2018 is 78.6% (2017: 76.6%). While we have at first sight higher gearing than some of our peers in the water industry, this measure does not reflect our strong pension position. We have no swaps or derivatives linked to our debt.

Our retirement benefit asset under International Accounting Standard ('IAS') 19: 'Employee benefits' at 31 March 2018 stood at a surplus of £105.6m compared to £73.0m at 31 March 2017. For more information, refer to note 10 of our statutory financial statements.

DIVIDENDS

Equity dividends of £58.5m were paid during the year (2017: £50.5m), of which £50.5m relates to the regulated business (2017: £43.0m). The increase in dividends year on year can be attributed to the increase in RPI on the company's RCV and proceeds from the disposal of the company's non-household retail business to Affinity for Business (Retail) Limited. £43.0m of our equity dividends were paid out of the Affinity Water group to its shareholders (2017: £22.5m equity dividends and £11.7m interest on subordinated debt).

Strategic report continued

Our industry

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 a number of regulators, including:

Water Services Regulation Authority ('Ofwat')

Our economic regulator.
www.ofwat.gov.uk

Environment Agency ('EA')

The EA controls how much water we can abstract from the environment.
www.gov.uk/government/organisations/environment-agency

Drinking Water Inspectorate ('DWI')

The DWI ensures we comply with the drinking water quality regulations.
www.dwi.gov.uk

Department for the Environment, Food and Rural Affairs ('Defra')

Defra is the UK government department responsible for water policy.
www.gov.uk/government/organisations/department-for-environment-food-rural-affairs

Natural England

Responsible for the protection of designated sites for nature conservation.
https://www.gov.uk/government/organisations/natural-england

Consumer Council for Water ('CCW')

The CCW investigates customer complaints relating to service, price and value for money.
https://www.ccwater.org.uk

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. 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.

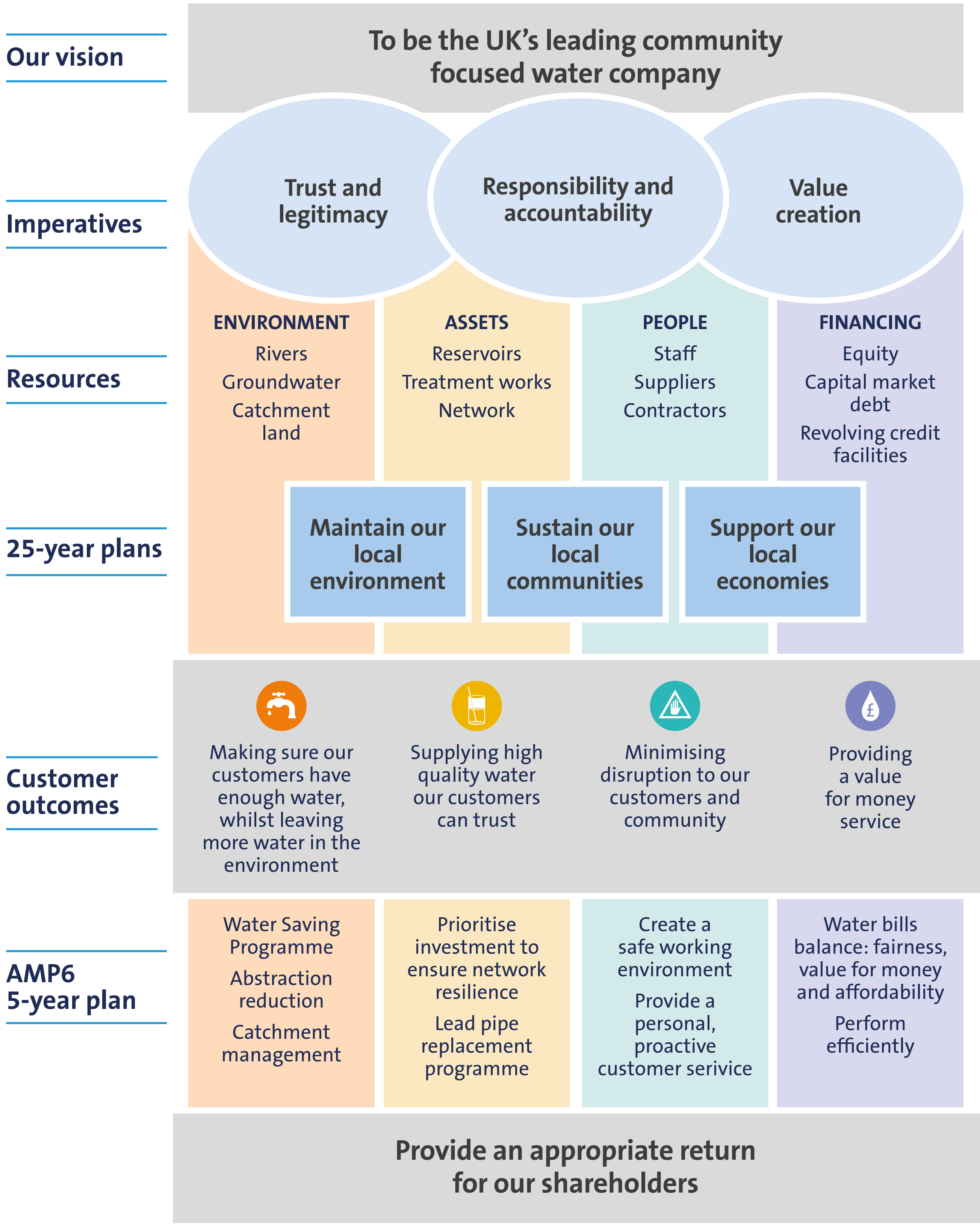
At the start of the financial year we exited the non-household retail market through a sale of that business, and now only operate in the retail household and wholesale price controls, both of which are monopoly activities. The wholesale revenue control is based on incentives related to total expenditure. Household retail controls are based on an industry-wide 'average cost to serve' principle in order to drive efficiency across the sector.

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.

Ofwat published its final methodology for PR19 in December 2017. This document confirmed 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 8 in our principal risks and uncertainties section on **pages 36 to 44**. Ofwat published its draft price setting methodology in July 2017 and will set final price limits in December 2019.

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.

Our business model



Strategic report continued

How we create value

Our inputs

Our customers and communities
Relationship and trust between us and our stakeholders.

Our environment
The natural resources that we rely on.

Our people
Our experience, skills and competences we share.

Our assets and sites
The lifecycle of our assets and investment projects.

Our finances
Finance available to sustain our business.

Our Community Engagement Strategy

Our vision is to be the UK's leading community focused water company, by helping customers to understand the value of water, in turn reducing consumption and supporting the ongoing protection of the environment.

Our Community Engagement Strategy allows us to make contributions to the communities in which we live and work, adding value to our customers in meaningful ways.

The way in which we operate and utilise our resources is key to creating value. We create long-term value for our customers and stakeholders by maintaining our local environment, sustaining our local communities and supporting our local economies.

We draw upon our resources and relationships as inputs to our business and transform them through our operating activities into our customer outcomes, continuously balancing potentially competing imperatives to ensure alignment between the interests of customers, our people, our investors, regulators and stakeholders.

This report shows how we are using our inputs to better understand our business impacts and dependencies, and the total contribution that we are making to society and the economy.

Our AMP6 commitments[1] / Our customer outcomes

Our AMP6 commitments[1]	Our customer outcomes
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% - the equivalent of 27 million litres per day.	Making sure our customers have enough water, whilst leaving more water in the environment
We will maintain high quality drinking water. We will implement a targeted programme of lead pipe replacement to meet more stringent legal standards.	Supplying high quality water you can trust
We will invest in increased flexibility in our network so we can transfer water more effectively around our communities.	Minimising disruption to you and your community
Bills will reduce by 1% 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 five years of AMP6. We will make ourselves accountable to our communities for our performance.	Providing a value for money service

[1] Our operational key performance indicators ('KPIs') are based upon these commitments and our performance is recorded against them. Please refer to page 33 for further details.

Strategic report continued

Our customers and communities

Our vision to be the UK's leading community focused water company reflects the importance we place on the way our people work within the communities we serve. It also reflects the emphasis we place on understanding and responding to the needs of different communities, helping our customers connect with the service they receive to achieve a more water resilient future for our region.

Our 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.

The way we interact with our customers and communities is key to providing a service that represents value for money. Building on the foundations delivered last year, we have continued to use insight gained from surveys to inform customer service decisions and have delivered significant performance improvements. By continually increasing our focus on customers we have been able to deliver improvements in the following areas:

- we have introduced new channels for customers by providing a new self-service My Account solution which is Amazon Alexa enabled and a webchat service in response to customer feedback;
- improvements have been delivered to simplify customer interactions including reporting a leak, reinstatement after works, billing and refunds; and
- we launched a newly designed bill, incorporating customer feedback throughout the design phase, to make things clearer and simpler.

We have received around 130,000 pieces of customer feedback this year via our website and text messages and are now personalising our surveys to ensure we receive even more relevant information. We have also involved customers in focus groups and usability testing to ensure their feedback guides the work we deliver and forms the basis of staff training exercises. We are holding training days for our senior leaders focused on our strategy of keeping customers at the heart of all we do.

CUSTOMER SATISFACTION

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. Our complaints have fallen by 32% and our escalated complaints have fallen by 34%. During the year, we won two silver awards at the UK Customer Experience Awards for 'Best Customer Insight and Feedback' and 'Customers at the Heart of Everything'; two awards at the European Contact Centre and Customer Service Awards for 'Best Customer Transformation' and 'Best Corporate Social Responsibility'; and 'Most Improved Customer Satisfaction' at the Rant & Rave awards.

While we acknowledge there is still more to do, these successes have been reflected in positive movements in our customer satisfaction measure since 2015/16. We scored an average of 4.42 in 2015/16, increasing to 4.46 in 2016/17 and achieving a score of 4.54 in 2017/18. The numbers of customers rating us satisfied or very satisfied grew from 86% in 2015/16 to 89% in 2017/18 reflecting improvements in the service levels customers are receiving. From an external position, we have seen an improvement in our SIM score for billing and clean water, but we intend to do more to ensure we deliver an excellent customer service each and every day. For more information on our overall SIM performance refer to our operational performance on **page 33**.

Looking forward, as well as continuing to build on the success of this year, we plan to continue delivering our customer service transformation by rolling out more digital services. The key focus for 2018/19 will be continuing to deliver new improved customer interactions across all channels and delivering a digital customer service solution that exceeds customer expectations.

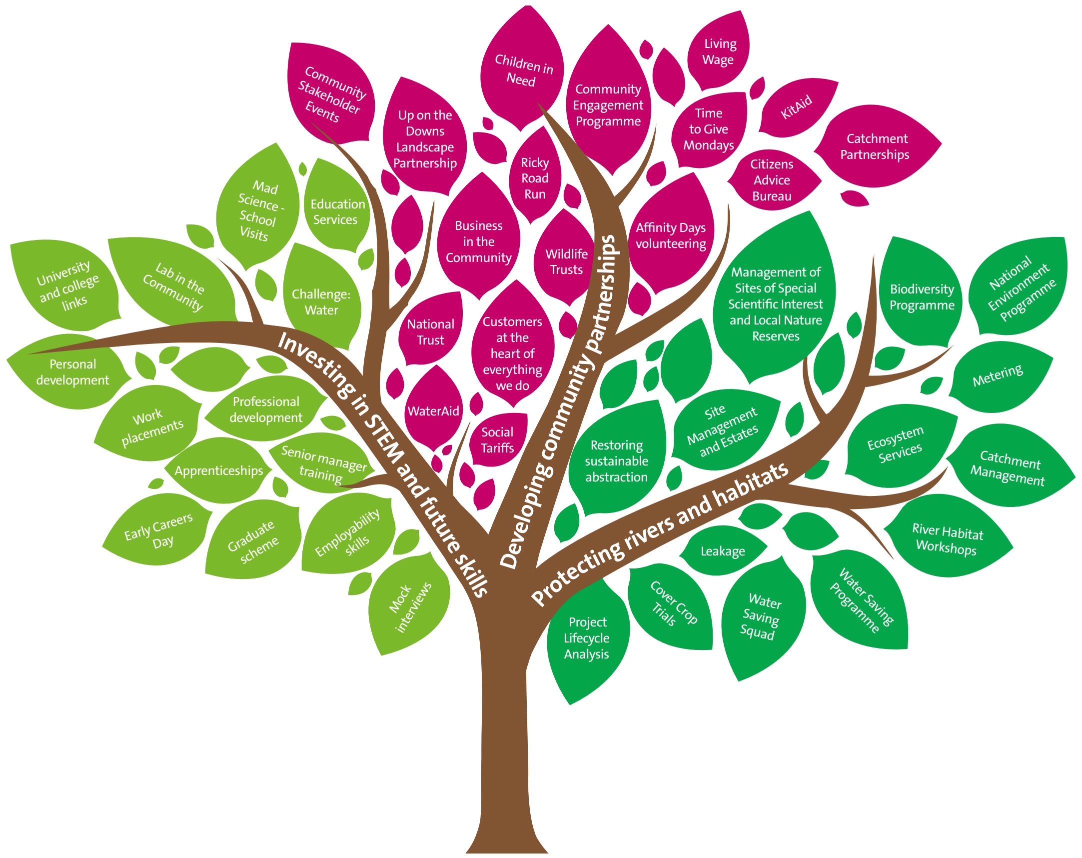
Reached out to
1.1million
people with our Tap Chat campaign talking about water efficiency

120+
Affinity Days committed to volunteering to help local community partners and charities

SERVING OUR COMMUNITIES

We are privileged to serve our communities. Being the monopoly supplier and 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. This is central to achieving our vision of being a community focused, sustainable and responsible business.

Our Community Engagement Strategy, embedded across the organisation, focuses on three core areas, illustrated in the diagram below. An example of our Community Engagement Strategy in action is included on **page 32**.



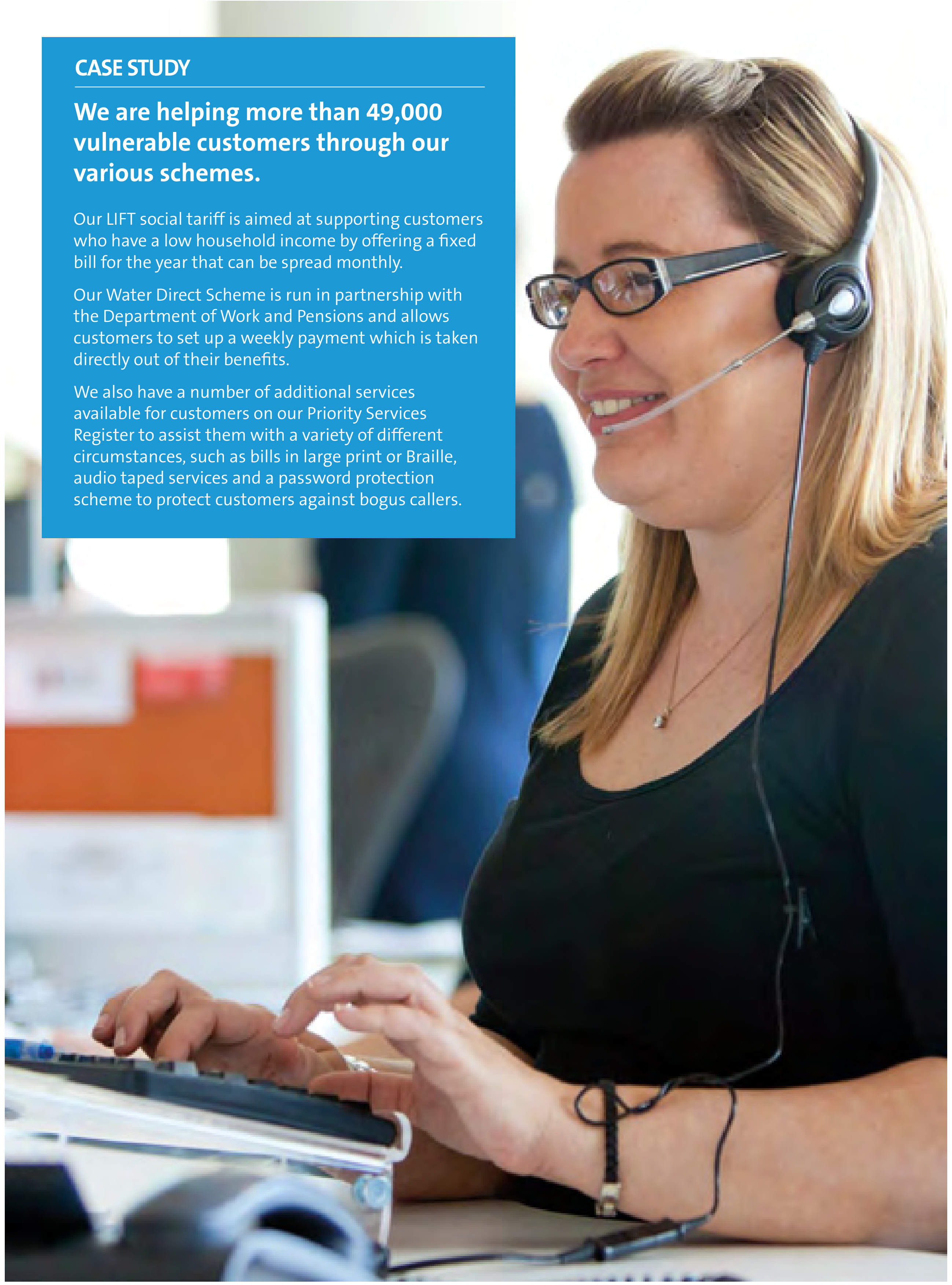
In the last few years, we have built the foundations of our community approach and are now planning a step change in the way we work with our communities. In 2018, we established a Community Committee as a subcommittee of the Board to oversee and continue to enhance our Community Engagement Strategy. We are adopting a partnership approach with our communities, understanding that we are not always best placed to drive change or influence behaviours and should draw on the skills of subject matter experts. We must make use of existing networks and communities, working in collaboration to develop a view of what we want the future to look like and a shared plan on how we will get there together. It will require us to be catalysts, supporting communities to facilitate and advocate change. We will continue to define and test our approach for the remainder of this AMP and this will form a critical foundation for our AMP7 Business Plan.

We value the input of our customer representative groups. One of these is the CCW 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.

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 we provide information in "Our Year in Review", 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. For more information please refer to the Our Performance page of our stakeholder website: **stakeholder.affinitywater.co.uk/company-performance.aspx**.

Strategic report continued

Our customers and communities (continued)



CASE STUDY

We are helping more than 49,000 vulnerable customers through our various schemes.

Our LIFT social tariff is aimed at supporting customers who have a low household income by offering a fixed bill for the year that can be spread monthly.

Our Water Direct Scheme is run in partnership with the Department of Work and Pensions and allows customers to set up a weekly payment which is taken directly out of their benefits.

We also have a number of additional services available for customers on our Priority Services Register to assist them with a variety of different circumstances, such as bills in large print or Braille, audio taped services and a password protection scheme to protect customers against bogus callers.

Our environment

CASE STUDY

Our Education Services Team works with tens of thousands of young people each year in the Affinity Water area, either visiting children in schools to run workshops and activities, or hosting them at our purpose built Education Centre in Hertfordshire.

We recognise the importance of working with our future customers. That is why our team engages and communicates with schools and young people on Affinity Water related issues to inspire future generations to value and protect our water resources.

One of the initiatives that the team has been running with local secondary schools is Challenge: Water - a science, technology, engineering and mathematics ('STEM') based water efficiency initiative, in partnership with WaterAid.

Schools compete to become Challenge: Water champions with teams at each school undertaking research in their community to identify the top water wasting behaviours. They then focus on tackling one of these behaviours by designing a water efficient product and launching their own campaign aimed at changing people's attitudes to water saving.

Strategic report continued

Our environment (continued)

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

We know that the future will provide new challenges across all of our areas. We have estimated that our population is forecast to increase in the order of 8% by 2025, 20% by 2045 and 38% by 2080 (equivalent to approximately 1.4m more people in our supply area). This means that if consumption per head remains constant, total domestic water demand in our licence area will increase and demand for water could exceed the supplies we have available.

Our WRMP, published in June 2014, sets out our plan to meet these resource challenges. We are now working on the next version of this plan, due for publication in 2019, which will consider customer needs from 2020 to 2080. It will explore all the options to find the best solutions for customers and the environment in the event that current water supplies do not meet anticipated future demand. We have consulted with various stakeholders on our draft plan which we believe addresses the challenges we face. Our draft WRMP is available in full on our website: **affinitywater.co.uk/water-resources.aspx**.

We sponsored
3
River Restoration Masterclasses on the Rivers Misbourne and Lee

We are corporate members of
4
Wildlife Trusts covering Herts & Middlesex, Surrey, Essex and Kent

LEAVING MORE WATER IN THE ENVIRONMENT

Customers expect us to work diligently and respectfully to safeguard the environment. 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. Other than natural aquifers, we do not have significant storage for untreated water. This means we are particularly susceptible to periods of prolonged dry weather and pollution events as well as being vulnerable to the effects of planned sustainability abstraction reductions.

Following a relatively dry winter in 2016/17, we have been actively planning for drought since early 2017 in case it occurs. Our drought risk mitigation programme aims to ensure that we have maximised our water resource capabilities and eliminated major risks to supplying water to all customers. We engage proactively with stakeholders including the EA and catchment partnerships to ensure that environmental impacts of drought are anticipated and managed.

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 environmentally sensitive sites by 42.1 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 enhance our environment by improving flows and habitats in local chalk streams. Please refer to **page 33** for more detail on our abstraction reduction performance.

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. 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. We have a responsibility to protect the chalk stream ecosystems and their biodiversity by leaving more water in the environment. This means we must compensate for lower abstraction by reducing leakage and encouraging customers to use water more efficiently.

REDUCING LEAKAGE ON OUR NETWORK

We are investing £500m over AMP6 mainly on infrastructure, improving it to ensure customers have enough water whilst leaving more water in the environment. Meeting this commitment requires us to reduce leakage on our network by 14%. Last year, the business invested in leading technology, through the installation of 20,000 perma-loggers across 22% of our network, improving our monitoring and response times. A clear focus has remained on reducing leakage throughout 2017/18. Our annual leakage reduction target was met taking the total AMP6 reductions to 10.3 ML/d to date. Please refer to **page 33** for more detail on our leakage performance.

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 customers on measured tariffs and also offers critical data in our understanding of usage and finding leaks. As part of our Water Saving Programme ('WSP'), we have achieved our target of metering 55,000 properties in the year and have pinpointed over 2,000 customer side leaks. Our customers will be switched onto measured tariffs after a transition period of two years and we are expecting this to drive down per capita consumption. We remain on track to meter over 280,000 properties by 2020. More information on our WSP is available on our website: **affinitywater.co.uk/water-saving-programme.aspx**.

Implemented pesticide reduction schemes with over
90
farm business, covering
13,000
hectares of arable farmland

53,000
free water saving devices provided to our customers

SUPPLYING HIGH QUALITY WATER

Maintaining the high quality of the water we supply to customers is vital in the face of pressures and obligations. During the year, we carried out 160,000 tests on water leaving water treatment works, at reservoirs and at customers' taps as part of our regulatory monitoring programme. In addition, we carried out over 600,000 tests on operational samples, with all plastic bottles used in the process being sent for recycling. Our overall compliance performance in 2017, as regulated by the DWI was 99.96%. Please refer to **page 34** for more detail on our water quality performance.

Increased use of pesticides and an enhancement to the lead compliance standard means that it is important that we promote effective catchment management and implement improvements to our water treatment processes. We have constructed eight new granular activated carbon filters at Iver, our largest water treatment works and commenced design work at our North Mymms site for the treatment of metaldehyde.

Our catchment management programme has increased significantly in the past year. Our Catchment Team investigate the sources of pollution posing a risk to drinking water and work collaboratively with a range of stakeholders including regulators, land owners, farmers, advisers, environmental groups and businesses to minimise the impact pollution has on the water environment and public water supply. Our team gave talks and presentations at 12 local, regional, national and international events throughout the year to promote key messages on protection of water from pollution.

We have been working in partnership with other water companies in the Thames River Basin to develop our understanding of high risk areas for pesticide pollution. We now operate pesticide reduction schemes in 600km^2 of river catchment upstream of our water treatment works where the risk is greatest. This has led to improvements in water quality in all of these catchments. We also offered a pesticide amnesty to farmers in two of our catchments, offering a free, legal and confidential disposal of unwanted or expired pesticides. The aim of this scheme was to safeguard against any chemicals accidentally finding their way into watercourses or ground water. This amnesty collected over two tonnes of chemicals and was positively received by the agricultural community.

[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 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 to ensure that our contribution to them 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 customers. We surveyed our people twice in the year to 31 March 2018, with over 80% participation, to ask them key questions about working for us. We achieved an increase in participation during the year (2017: 76%), and plan to demonstrate our commitment to make Affinity Water a great place to work by implementing actions to address findings to ensure we achieve an improvement survey on survey.

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.

Our Code of Conduct 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.

We are building connections with
2
local universities and helping people into future employment

Over
£17,000
raised by our people through our 'Time to Give' initiative

TRAINING AND DEVELOPMENT

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. 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 investing in training and the up-skilling of our people to maximise our own internal talent through development and succession planning. We will also continue to use innovation to identify new ways of working and develop our own teams to reach their full potential.

We have taken significant steps during 2017/18 to achieve parity between mental and physical health. We have trained 14 Mental Health First Aiders and have an evolving programme of awareness of mental health across our company. We have also worked with the Samaritans to provide awareness training for our Customer Relations colleagues and will be expanding this further to include visual awareness training and Dementia Friends training.

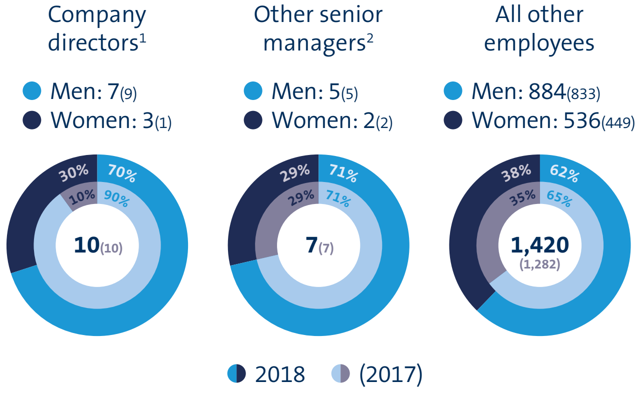
We continue to offer our employment schemes for graduates and apprentices. We have 18 apprentices on two programmes funded by the Apprenticeship Levy, which is providing an opportunity for us to review our programmes of work and ensure they meet industry leading standards. The Production Electrical Upskilling apprenticeship will run for 4 years upskilling our colleagues from an Operative to a Technician level of competency, while the Customer Services Apprenticeship is a 12 month course leading to the qualification of Customer Services Level 2.

Our people are essential to improving the service 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.

DIVERSITY AND EQUALITY

We are committed to promoting equality of opportunity in all areas of employment including recruitment, internal promotions, opportunities for training and pay and benefits. This year we have begun a partnership with the Engineering Development Trust which delivers over 40,000 STEM experiences each year for young people aged nine to 21 across the UK.

Our gender pay report published in April 2018 on our website:
stakeholder.affinitywater.co.uk/corporate-responsibility.aspx showed a mean gender pay gap of 25%. We are working to understand in more detail the reasons behind our gender pay gap to identify the actions we need to take. We have increased the proportion of females on our Board. The following table provides a breakdown of the gender of directors and employees at 31 March 2018:



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 a highly regulated business, we do not believe this information is necessary for such an understanding and have therefore not included it.

The Board has approved a Modern Slavery and Human Trafficking Policy and approves the company's annual statement on Modern Slavery and Human Trafficking, published on our website:
stakeholder.affinitywater.co.uk/corporate-responsibility.aspx.
We undertake training of our employees about modern slavery and human trafficking issues, and ensure robust systems and processes are in place to assess our supply chain.

SAFETY AND HEALTH

The safety, health and wellbeing of our people and suppliers are priorities 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. We remain fully committed to achieving zero harm and have launched a new programme aimed at making safety personal.
For further information refer to our operational performance on **page 33**.

All employees now have a licence to access Rivo, which is our system for recording and managing health and safety incidents, and we have also invested in the mobile application which allows community based colleagues to report incidents in real time. One of the biggest risks faced by our operational teams is the danger posed by other utility services in the ground they are excavating. We have made a number of investments and process changes to improve the overall performance of our people and supply chain partners including:

- investment in latest technology cable detection equipment with data download capacity;
- improved process for obtaining other utility service drawings out of hours;
- investment in flame retardant clothing and double insulated hand tools for our dig teams;
- investment in a new works management system which allows teams to have other utility service drawings electronically on site; and
- Common Safety Standard procedures and guidance improved to give more detail of requirements.

14
of our employees have received training to become mental health first aiders

[1] Company directors consist of our Board members, as detailed on **pages 48 to 53**.

[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 people (continued)

CASE STUDY

In September 2017, we welcomed 14 new graduates to the company. They will develop broad knowledge and experience over the next 24 months, by undertaking a number of placements in different departments across the business, working on some of our key projects.

Alex Sage is one of this year's intake, currently working as a Graduate Scientist in the Hydrology team of the Asset Strategy department, responsible for monitoring and advising on our groundwater sources levels.

She said: "The graduate scheme is a great opportunity for those who want to take a step into the water industry. We get to experience many different aspects that make the company tick.

My role varies between collecting data out in the field, and analysing it back in the office. I then contribute to reports and plans that the department produce.

But it's not just the day job though; the graduates organise multiple charitable events alongside their placements, gaining useful and transferrable skills whilst raising money for some amazing causes."

Our assets and sites

CASE STUDY

In October 2017 our new reservoir near Folkestone was commissioned and put into service. We have invested £2.4m in the construction of this storage facility along with a new pumping station nearby.

The new reservoir provides an additional capacity of 3.2 ML working in parallel with our existing 10 ML storage facility. It will significantly increase security of supply for customers in the rural area of our Dour community.

We ensured that the environmental and visual impacts of the new reservoir were minimised by undertaking extensive ecological surveys to assist with planning and design. The new storage facility is much smaller than the existing one and uses screening and grass banks to blend it into the local landscape.

Strategic report continued

Our assets and sites (continued)

Our assets allow our people to make use of the water resources provided by the environment to supply 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 our 96 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. Particularly strict standards of hygiene are applied to these assets.

We have commenced a programme of work to protect our sites in line with the Security and Emergency Measure Directive obligations. 165 of our 282 sites are now compliant using a range of physical and electronic protective features. Further surveys have been completed to determine our workload for securing sites in 2018/19. We have also produced an enforcement and sanctions policy and set up an Enforcement Decision Panel to manage illegal network connections within a clear framework. This is required to ensure that we have the highest quality of water and there are no risks of contamination.

In January 2018 the laboratory and sampler teams were audited by the United Kingdom Accreditation Service and successfully retained their accreditation with very positive commentary by the assessors. We have also extended our external accreditation to now cover both the production of Legionella risk assessments and Legionella sampling and monitoring activities. We are one of only 12 companies in the UK to gain this accreditation as at March 2018.

We hosted a **Water Pollution Day** to raise awareness and collaborate with stakeholders at Iver water treatment works

PRODUCTION AND SUPPLY

Across our production estate we encountered a number of short duration reservoir failures during the year. As a result we had to import more water from Anglian Water's Grafham Reservoir, to make up for the outages. In order to establish a longer term solution for our supply failures, significant changes have been made to our inspection and maintenance regime following detailed operational condition assessments. We have successfully commissioned two new service reservoirs to bolster storage and facilitate inspections of existing assets.

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

The construction of a new reservoir in the Uttlesford district of Essex will provide 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 put into service in July 2017 on budget and ahead of schedule, with no interruption to supply into or out of the existing facility.

During the year, we failed to meet our performance target for unplanned interruptions to supply over 12 hours, but we have taken steps in improve our performance in this area. If it had not been for the severe weather event in early March 2018, the business would have achieved its performance commitments for the whole of the second half of the year. We have established a new 24 hour Network Control Desk to centrally coordinate our responses to these events and an interruption to supply delivery team to formulate the procedures that will govern how our restoration and repair solutions will be delivered more rapidly and consistently. This includes investment in new equipment, plant and machinery to support our operational teams. Please refer to **page 33** for more details on our operational performance.

MAINTAINING OUR ASSETS

Our Business Plan sets out how we ensure that customers continue to receive the high quality of water that they expect in AMP6 and beyond by investing in our treatment works and targeting lead pipe replacement to further increase the resilience of our network. Our Lead Programme has continued to make progress this year and remains on course to remove all lead service pipes from Finchley and Watford as well as all primary schools in our supply area by the end of the AMP.

Sustained progress throughout the year has continued to be realised across our mains renewals programme with more than 256km of mains replaced in this AMP. We have also replaced 8km of our trunk main network this year, bringing our AMP6 total to 29km. Other supporting projects were also successfully completed including burst mitigations, mains monitoring and condition assessments.

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

Our Asset Performance laboratory aims to improve our understanding of the health of our pipeline assets and inform our rehabilitation strategy. When a pipe bursts or scheduled renewal work takes place, samples are sent to the lab team so that we can understand how the soil environment and internal chemistry affect the lifespan of the pipes. Since its inception in 1992, the lab has processed more than 5,500 pipe samples, capturing the data in our Geographical Information System. The information is used to determine the deterioration rates of the network and the remaining useful life of the pipes, informing future investments.

The lab uses a range of technology to carry out surveys of our water wells and boreholes, and for water quality sampling. A laser scanner is used for detailed analysis and 3D models, improving our understanding of network performance. The team also carries out live inspections of distribution mains. Fiberscope surveys enable the team to look inside our mains without the need for any digging or disturbing the network. These help to identify water quality issues, where services are attached and where the pipe changes from cast iron to plastic. We also deploy fast logging sensors to detect pressure surges that could potentially damage our pipes. During scheduled maintenance and pump failures, the team can send a camera down a borehole to assess what is happening and identify any future works that may be needed in order to meet our supply requirements.

We are constantly innovating and exploring new ideas and techniques across our network and production estate. As the South East of England experienced a second successive dry winter, we successfully increased our surface water output levels, reducing our reliance on groundwater sources. This required a behavioural shift in control operations and we successfully tested business contingency measures and proved key resilience systems against a backdrop of sustainability reductions.

Strategic report continued

Our finances

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 £575.0m 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 £189.2m. We have in place the finance required to deliver our expected AMP7 investment programme. See pages 72 to 73 for further details of our financing arrangements, including the maturity profile of all our bonds, which includes a further £250.0m bond issued in 2004. The maturity profile of all our borrowings is set out in note A4 to our statutory financial statements.

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 2018, we had cash balances of £114.8m (2017: £45.1m). The increase in cash held compared to the prior year is as a result of the proceeds of the bond issuances in November 2017 offset by our continued investment in our assets and increased dividend payments in the year.

Interest rate exposure is primarily managed by using a mixture of fixed rate, floating rate, CPI and RPI-linked borrowings (refer to note A4 to our statutory financial statements). Ofwat's final methodology for PR19 has confirmed that prices in the industry will in future be indexed to CPI instead of RPI. In order to manage this inflation risk, £60.0m of CPI linked debt was raised during the year. At the year-end, 62.8% of our gross borrowings were at fixed rates (2017: 65.4%), 31.6% (2017: 34.6%) at rates indexed to RPI, 5.6% (2017: none) at rates indexed to CPI and none (2017: none) were at floating rates.

To the extent that additional funding is required, we have access to £100.0m of bank facilities (2017: £100.0m), which were undrawn at 31 March 2018 (2017: undrawn), to finance capital expenditure and working capital requirements. In addition, we have access to a further £58.0m of liquidity facilities (2017: £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 2018, net debt, as defined in the financial covenants in the company's securitisation documentation ('compliance net debt'), was £949.0m (at 31 March 2017: £885.2m). Gearing of compliance net debt to RCV at 31 March 2018 of 78.6% (at 31 March 2017: 76.6%) remains below our internal maximum gearing level of 80.0%. This allows sufficient headroom within financial covenants, which are only triggered at a level of more than 90.0%. For more information, refer to table 1E of our regulatory Annual Performance Report.

OUR DIVIDEND POLICY

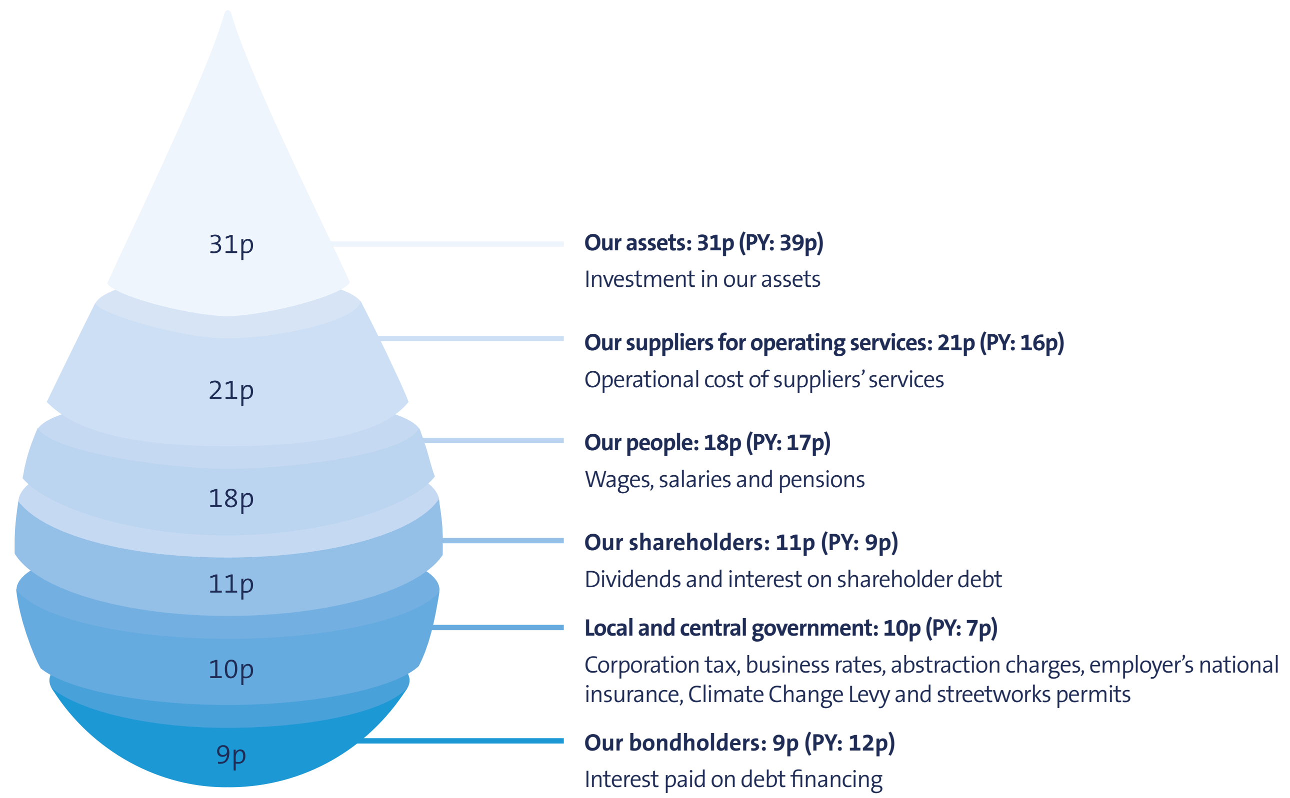
The Board approves the company's dividend policy. The amount of the dividend, which is voted on by the independent non-executive directors only, is dependent on the success of the company in generating cash flows and achieving its regulatory outputs in the reported period. To ensure the business remains financially resilient, the company distributes earnings equal to the amount required to maintain net debt to RCV at the targeted gearing ratio of 80% at test dates of March and September. This is appropriate considering 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. Following our ownership change, we continue to support a dividend policy that explicitly reflects operational and investment performance, and considers customers, communities, pensioners and employees in the long and short-term.

VALUE FOR MONEY BILLS

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 regulatory rewards for doing so and through effective risk management to reduce cash flow volatility. Value for money for customers is achieved by delivering the standards of service customers expect along with the performance commitments we included in our Business Plan at a reasonable price (refer to the table on **page 17**).

We have been addressing affordability issues through social tariff, value for money and living wage commitments. 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.

Each pound of our customers' bills is spent as follows[1]:



[1] Figures are based on our regulatory financial statements for the year ended 31 March 2018 and have been rounded.

Strategic report continued

Our Community Engagement Strategy in action

The River Beane is a chalk stream tributary of the River Lea in Hertfordshire. As part of the EA's National Environment Programme we have been tasked with both reducing abstraction and carrying out river improvement projects to meet the Water Framework Directive targets on the Beane.

KEY STAKEHOLDERS

- The Environment Agency
- The Woodhall Park Estate
- The River Beane Restoration Association
- Affinity Water employees

ACTIONS & OUTPUTS

- We have reduced the amount of water abstracted from our groundwater source to the north of Watton-at-Stone by 16ML/d.
- Volunteers from Affinity Water, the River Beane Restoration Association and estate staff at Woodhall Park worked to rescue native marginal plants from the river channel. These will be replanted once the new bypass channel has been constructed.
- The project will reconnect 3km of river and create 1.4km of new chalk stream.
- The project will remove obstacles such as weirs, or move the river around these obstacles, to create uninterrupted sections of river for fish to navigate.

OUTCOMES

A more natural channel meaning improved fish passage, more natural river processes and habitats both in the river channel and on the banks of watercourses.

More employees involved in hands-on biodiversity restoration works, developing their skills and broadening their knowledge.

Operational performance

We have aligned our operational KPIs to our key performance commitments in response to customer expectations. We want 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 DWI and Defra. These targets include the performance commitments made in our Business Plan. Our performance in relation to these targets for 2017/18 is analysed in the table below.

For more information on our performance for 2017/18 in relation to all performance commitments we made in our Business Plan refer to **pages 189 to 191** in our regulatory Annual Performance Report.

KPI: Leakage
Average annual water leakage from our network (ML/d)

2017/18 actual:
172.7

2017/18 target:
173.1

2018/19 target:
167.7

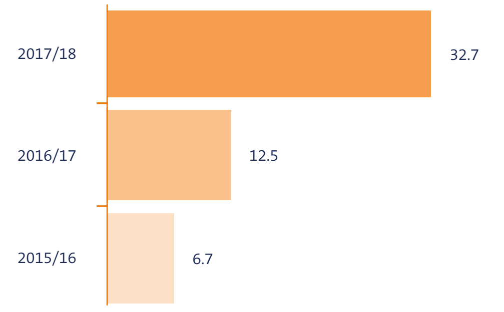
We attach a high priority to meeting leakage reduction targets, as we want to demonstrate that we are playing our part when we are asking customers to save water, and also to overcome the loss of resources to improve conditions on local catchments. In 2017/18, we continued to reduce leakage, and remain on track to achieve our very ambitious target of reducing leakage by 14% (27.1 ML/d) by 2020.

KPI: Sustainable abstraction reductions
Cumulative average annual reduction in water abstracted from our river catchments (ML/d)

2017/18 actual:
32.7

2017/18 target:
14.1

2018/19 target:
42.1



We continue to deliver the reductions in abstraction included in our Business Plan. We implemented reductions in the Beane and Mimram catchments 12 months earlier than originally planned, resulting in a cumulative average annual reduction to date of 32.7 ML/d. We remain on target to deliver a further 9.4 ML/d reduction in 2018/19, completing our programme of reductions (42.1ML/d) for AMP6.

Work is ongoing to make changes in our infrastructure necessary to maintain the levels of service promised to customers whilst also leaving more water in the environment for the protection of river flows and local ecology. We are also continuing our programme of river restoration and habitat enhancement works to help improve a number of chalk streams in our supply area.

Strategic report continued

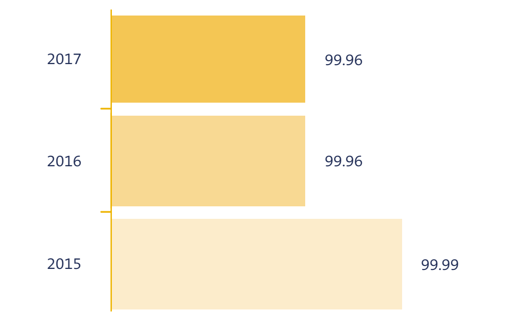
Operational performance (continued)

KPI: Water quality
MZC (%)

2017 actual:
99.96

2017 target:
99.95

2018 target:
99.95



In the calendar year 2017 there were 68 exceedances of standards from 160,000 compliance samples taken from our sites and consumer properties (2016: 55 exceedances from 186,000 compliance samples). Of these, 32 exceedances (2016: 22 exceedances) contributed to the MZC calculation. Another measure of our performance is the number of serious and significant incidents. During 2017 four events notified to the DWI were classified as serious or significant (2016: five events).

We continue to work to reduce the number of exceedances and events, through:

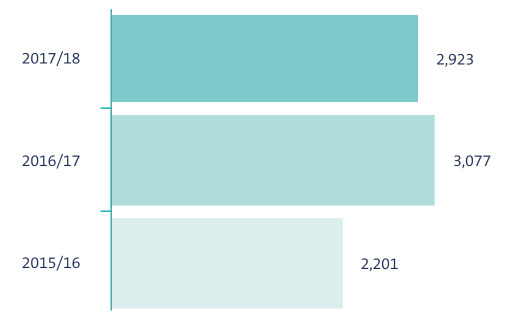
- making improvements to our asset resilience;
- coaching and developing our people;
- adherence to processes and procedures;
- auditing and control/completion of planned programmes such as pesticide removal schemes at our water treatment works; and
- replacement of lead communication pipes.

KPI: Mains bursts
(Number)

2017/18 actual:
2,923

2017/18 target:
3,100

2018/19 target:
3,100



We have seen a slight reduction in our burst numbers compared to last year and remain under the target of 3,100 bursts set for 2017/18.

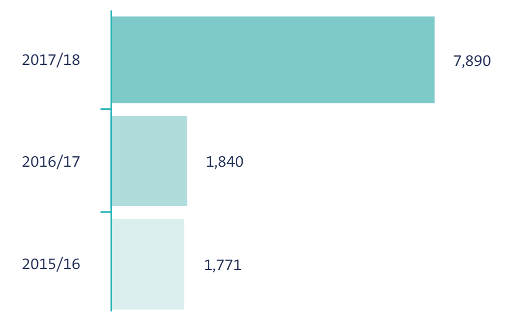
We continue to look at ways to reduce bursts and their effect on service to customers and the network as a whole. Work is on-going to produce 'calmer networks' to reduce night pressures and introduce 'intelligent' control to existing pressure control valves.

KPI: Unplanned interruptions to supply over 12 hours
(Number of properties)

2017/18 actual:
7,890

2017/18 target:
320

2018/19 target:
320



We have not met our performance commitment for unplanned interruptions to supply over 12 hours. As a result we have incurred a penalty through our ODI regime. This is the fourth successive year we have not achieved this KPI.

Performance against this metric is very disappointing and we are aware that we need to make significant improvements. In order to reduce interruptions we are focusing on how prevention and restoring supplies can be improved.

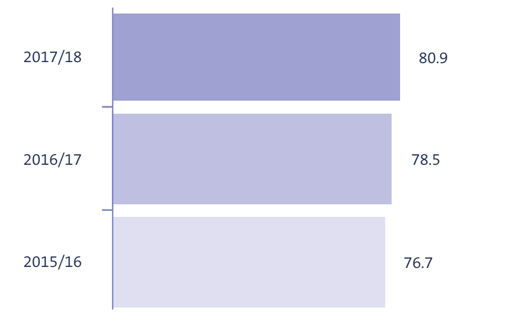
During the year we launched our 24 hour network control desk whose role is to provide a central coordination point for all network activities, including emergencies. If it had not been for the severe weather event in early March 2018, the business would have achieved its performance commitments for the whole of the second half of the year and we are optimistic that we can achieve our targets going forwards.

KPI: SIM
(Score)

2017/18 actual:
80.9

2017/18 target:
80.0

2018/19 target:
81.3



Building on the foundations of 2016/17 we delivered further customer service improvements this year. Within the survey part of SIM, of 800 customers surveyed, 79% were satisfied or very satisfied with our service and only 9% were dissatisfied. Last year our average survey score was 4.25 out of 5, compared to 4.26 this year. Convergence of scores between all water companies continues with 0.36 points between the highest and lowest scoring companies this year. We were the 4th most improved water company however given such small ranges of scores, our final position was 16th of 18 companies.

We made huge improvements within the quantitative SIM measure, reducing unwanted contacts by 24% compared to 2016/17. We also delivered a step change in complaints volumes, reducing by 32% compared to 2016/17.

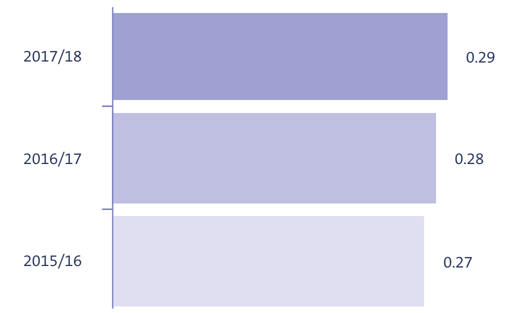
Our customer transformation team has grown and this positive performance reflects the success in this space. We are using more customer insights, more regularly to drive business decisions. Our digital transformation is also now underway, with the launch of a new self-service solution on our website and webchat and bots now live. We have a robust plan into 2018/19 to continue rolling out improvements across customer journeys.

KPI: Accident frequency rate
(Number of lost time injuries per 100,000 hours worked)

2017/18 actual:
0.29

2017/18 target:
0.24

2018/19 target:
0.24



Since 2014/15 we have revised our strategy and improvement plan to focus on a number of safety and health initiatives. During the year, we recorded 0.29 lost time injuries per 100,000 hours worked, compared to 1.02 in 2014/15.

We recorded eight work related lost time injuries during 2017/18, compared to seven in 2016/17. We failed to meet our target of 0.24 accidents per 100,000 hours worked for the year.

During the year we reviewed and updated our strategy and improvement plan so it focused on:

- more specific plans with our Network and Production teams;
- increasing the protection of our dig teams from other utility services through a series of investment improvements;
- enhancing our incident reporting systems by giving all employees direct access, including use of a mobile app; and
- working towards and delivering improved health and wellbeing offerings.

Strategic report continued

Principal risks and uncertainties

RISK MANAGEMENT

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, to implement 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 **page 61**.

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 being required to undertake unremunerated activity in the context of the risk of incurring greater costs than allowed for in AMP6 price controls on delivery of the programme for opening the non-household retail market to competition. As this programme has been completed, it is not expected that this risk will have a material adverse effect impact on our business activities and therefore is no longer considered a principal risk.

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.

OPERATIONAL RISKS

Key:

- Residual/net risk (i.e. after the application of control activities) unchanged during the year
- Residual/net risk (i.e. after the application of control activities) increased during the year
- Residual/net risk (i.e. after the application of control activities) decreased during the year
- # New risk

[a] Risks included in the sensitivity stress testing for the viability statement (refer to **pages 44 to 46**)
[b] Risk included in the scenario stress testing for the viability statement (refer to **pages 44 to 46**)

1. Failure to prevent injuries and accidents to our people and the public[a]

Risk: Failing to manage this risk may result in personal injury or occupational ill-health, disruption to operations, reputational damage, criminal fines, civil damages and regulatory penalties.

Mitigation: We seek to operate our business using our safety and health management system, which is certified to OHSAS 18001, and we provide our employees with appropriate arrangements to enable them to take personal responsibility for their own safety, occupational health and well-being, and that of others.

Our safety and health strategy focuses on active leadership and engagement. We have introduced a safety leadership model for our employees and our improvement plan sets out measurable objectives for individuals and teams across our organisation. For more information on our safety and health performance refer to **page 35**.

2. Failure to meet our water supply obligations[b]

Risk: We are required to maintain a continuous supply of high quality water for customers.

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.

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.

Mitigation: We manage this risk through:

- our WRMP which identifies, over a 60 year period, how we will balance available supplies and required demand with sufficient headroom for unplanned outage;
- 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;
- 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;
- 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;
- 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;
- our Drought Management Plan, reviewed during the year, which is approved by the Secretary of State; and
- 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.

Strategic report continued

Principal risks and uncertainties (continued)

OPERATIONAL RISKS (CONTINUED)

3. Failure to supply high-quality drinking water[b]

Risk: The supply of high-quality water to customers is critical to the overall success of our business and to public health in general.

Failure to achieve this would have potentially catastrophic effects: losing the confidence of customers in their drinking water, and legal and reputational risks for our business.

Mitigation: our drinking water safety plans ('DWSP') provide a comprehensive risk assessment and risk management approach to our supply from source to tap. During the first quarter of 2018/19 a new DWSP database will be delivered to automate and improve this process and make information more widely available. In the proposed 2018 drinking water quality regulations these risk assessments will require formal accreditation, providing independent assurance that the risks are being captured accurately and consistently.

The DWSP risk assessments have been used to identify investment requirements in AMP6 and AMP7 and they inform our maintenance programmes for production, storage and distribution. Our network fittings regulations team inspects premises which pose greatest risk to our network and the public health of their users using the Water Industry Act to enforce remedial works. We also investigate reports of unauthorised access to our distribution network.

Our laboratory and sampling teams are UKAS accredited against ISO 17025 and NQA assess water quality procedures as part of the ISO 9001 annual audit. Internally the water quality team audits production and storage sites against our own procedures and those used by the DWI. We also audit network sites to ensure any interventions are in line with our procedures and do not adversely impact public health or quality standards. There are several sub-groups that review specific areas of risk including treatment chemicals and reservoir and storage facilities. The water quality senior management team review strategic risks on a monthly basis to ensure controls are working effectively and report this to the Executive Management Team each month.

In 2017, we carried out 160,000 tests on our water and our overall compliance performance was 99.97% while our MZC, the measure used by the DWI, was 99.96%.

4. Failure to secure appropriate resources (people and materials)[a]

Risk: 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.

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.

Mitigation: 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.

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.

5. Information security failure[a]

Risk: Customer information and our data are at risk from unauthorised disclosure and improper use.

Failure to protect such information may lead to increased costs of operation, reputational damage, criminal fines and civil damages.

As the use of online communications, cloud-based technology and the sophistication of hackers continue to increase, so too do the risks of cyber attack and other external threats.

Mitigation: We continue to strengthen our capabilities to ensure that technical and organisational controls to prevent the unauthorised disclosure, loss or improper use of data are kept under review and improved where appropriate.

Alignment with ISO 27001, the global information security standard, will demonstrate our commitment to security best practices and ensure that we meet relevant regulatory requirements.

We also continue to monitor and enhance our information security management system, designed to protect us against current and future threats.

6. Failure to adequately protect personal data[a]

Risk: The General Data Protection Regulation ('GDPR') places a legal obligation on organisations to handle personal data securely, in order to avoid that data being put at risk from unauthorised or unlawful processing, accidental loss, destruction or damage.

The GDPR has further strengthened and unified data protection for all individuals within the EU. This has introduced some new and onerous obligations for UK companies, including notification to the Information Commissioner's Office in the event of a breach.

Non-compliance with the new regulation could result in a fine of up to 4% of worldwide turnover compared to a previous maximum £500,000 fine under the Data Protection Act.

Mitigation: We have recently completed a project to ensure we are prepared for the new regulation, taking a risk-based approach to ensure that particularly sensitive data is adequately secured.

Privacy impact assessments are carried out for all projects and initiatives to analyse the potential effects on the privacy of individuals.

Our enterprise-level security controls, aligned with ISO 27001, are designed to secure all our information assets and therefore contribute to the protection of all personal data which we process.

Whilst we have taken sufficient steps to reduce the net likelihood of this risk occurring, the increase in potential financial penalty for non-compliance is such that the severity and, therefore, the overall risk has increased during the year.

Strategic report continued

Principal risks and uncertainties (continued)

OPERATIONAL RISKS (CONTINUED)

7. Failure to provide adequate levels of customer service[a]

Risk: It is crucial that we provide consistently high levels of service to all customers and that they are demonstrably satisfied that we are doing so.

Failure to maintain and continually improve our levels of service in the eyes of our customers will severely impact customer satisfaction levels, volumes of unwanted contact and complaints, and our reputation.

Ofwat uses SIM to measure our customer service performance against that of other water companies. Sub-median performance when compared to our industry peers is likely to attract significant financial penalties.

Mitigation: We adopt a continuous improvement strategy with regards to customer service. Our Customer Experience Improvement Board meets monthly and is attended by our CEO.

We hold Customer excellence days twice-yearly at which we review our performance, celebrate successes, and consider opportunities for further improvement. These events include presentations by external speakers so that we can learn from other companies' experiences with regards to customer service.

We have an ongoing programme of improvements to on-line capabilities for customers and to the customer journey in general.

We actively engage with our customers on a day-to-day basis. As part of our PR19 business planning we are conducting an extensive, multi-phase customer engagement programme in order to fully understand customers' needs and expectations.

We employ a third-party customer feedback partner to measure our customer service performance. In 2017/18, our partner surveyed 118,000 customers with whom we had experienced some interaction. Of those surveyed, 89% expressed themselves as "satisfied" or "very satisfied".

We analyse all complaints and ensure that any required remedial actions are promptly addressed.

REGULATORY RISKS

8. Adverse changes to the regulatory framework[a]

Risk: Changes to the regulatory framework by Ofwat or the government may have an adverse effect on our operational or financial performance.

Ofwat published its final PR19 price setting methodology in December 2017 following a formal consultation earlier in the year. The final methodology sets out Ofwat's approach to the design of the regulatory framework for the water industry for 2020-2025. The final price setting 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 CPIH, rather than RPI, for indexing revenues (and therefore prices) and RCV to be indexed using a combination of CPIH and RPI. The final price setting methodology also continues to use econometric cost assessment to determine efficient levels of cost allowance for separate binding price controls. These models continue to be developed by Ofwat and will not be published before the final business plan submission in September 2018.

Ofwat continues to consult with the industry on its PR19 price setting methodology, including in relation to a new proposal to require companies to share financing outperformance from gearing above a prescribed level.

Mitigation: 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.

9. Adverse change in the social and/or political climate[a]

Risk: We are exposed to risks arising from the general social and political climate, for example, debate around the merits of the current ownership model, political pressure to restrict price increases and other issues, such as the adequacy of our water resource management plans and some objections to compulsory water metering. These pressures may lead to a reduction in revenue or have a reputational impact.

Mitigation: We continue to engage with our stakeholders, customers and their representatives to understand and respond to their issues and concerns.

10. Failure to comply with laws, our Instrument of Appointment and other recognised standards[a]

Risk: 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.

Mitigation: We continue to operate our abstraction, treatment and supply activities to environmental standard ISO 14001 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.

Strategic report continued

Principal risks and uncertainties (continued)

REGULATORY RISKS (CONTINUED)

11. Failure to deliver our Business Plan obligations[a]

Risk: 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.

Mitigation: 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 2017/18 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 2018/19 targets.

We continually monitor our performance on a wide range of business plan metrics and commitments, and take prompt corrective action to address any indicators of under-performance.

We continue to actively manage engagement with all our regulators and other stakeholders. In particular, we work 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.

12. Failure to achieve a favourable PR19 outcome[a]

Risk: We are required to make our final business plan submission to Ofwat by 3 September 2018. Our plan will cover the period 2020–2025, incorporating how much we are going to charge customers and how we are going to use the money raised to ensure that we meet those customers' expectations as well as balance the competing priorities of multiple stakeholders.

Ofwat have stressed four key themes in their methodology:

- Great customer service
- Resilience
- Affordable bills
- Innovation

Ofwat have also stressed that water companies must deliver more of what matters for customers through effective engagement, lower costs and better performance. Our submission must be high quality, ambitious and subject to rigorous challenge and supported by a Board Statement of Assurance.

Mitigation: Our PR19 programme and governance arrangements were established early in 2017 and this has enabled the development of our plan to be monitored by our Board and managed day-to-day by a PR19 Steering Committee. The Steering Committee oversees a number of work streams each with dedicated leads and accountable Executive Management Team sponsors.

We are well-advanced in the various programmes of work to develop our PR19 submission. Many enabling programmes of work have been completed and we are carrying out the second phase (valuing and testing) of our multi-phase customer engagement programme to understand customer priorities.

We have appointed a third party independent assurance partner, who has developed a three-phase programme of work to provide an overall strategic assurance framework, assurance of the programme delivery and governance, and detailed assurance of all financial data tables.

FINANCIAL RISKS

13. Failure to secure appropriate financing for our business activities[a]

Risk: Our business has an on-going liquidity requirement, driven by the operational cash flows of the business and our substantial capital investment programme.

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 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. This could also impact our ability to raise funds on sufficiently favourable terms in the future.

Mitigation: 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 12 months' forecast cash flow requirements.

Longer term financing needs are sourced from the private and public bond markets. During the year we raised the funds required to deliver our expected AMP7 investment programme. 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.

We have a regular monitoring and certification process of the financial covenants within our Whole Business Securitisation ('WBS') documentation. This covers information, financial and general covenants. 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. Macro-economic risk (interest rate and inflation risks)[a]

Risk: Movements in interest rates can result in an increase in the cost of our debt.

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.

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.

Our RCV is also linked to inflation and nominal returns are therefore likely to be further reduced in a low inflation environment.

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.

Mitigation: Interest rate risk is primarily managed by using a mixture of fixed rate and inflation-linked borrowings, and approved hedging instruments. Further disclosure on the management of interest rate and liquidity risks is included in note A4 to the financial statements.

Each year we undertake a robust and challenging budgeting process to ensure costs are clearly understood and then subsequently controlled during the financial year.

We also use inflation-linked debt to ensure a proportion of our interest costs is linked to inflation and therefore offsets an element of the reduction in revenue and RCV that results from lower inflation.

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.

We have invested in our defined benefit pension plan so that it is in a surplus on a technical provisions basis (refer to notes 10 and A5 to the financial statements) and the long term objective is for the plan to be in a position such that it is largely self-sufficient on an on-going basis by 2026. 80% of the interest rate and inflation risk associated with the plan's liabilities are hedged by the plan's assets through Liability Driven Investment.

Strategic report continued

Principal risks and uncertainties (continued)

FINANCIAL RISKS (CONTINUED)

15. Revenue and debtor risk[a]	
Risk: Customer debt and affordability remain key areas of focus for our business. 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.	**Mitigation:** We have processes and teams dedicated to the efficient collection of customer debt. 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.

VIABILITY STATEMENT

The directors have assessed the company's financial viability over the five-year period to 31 March 2023 (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 60 year period how we will balance available supplies and required demand with sufficient headroom for unplanned outage.

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 36 to 44** 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, plausible and reasonable 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 first three years of the next price control period, AMP7, to the year ending 31 March 2023. The projections are consistent with the business plan that is currently being prepared in respect of the price review for 2020-2025.

Tests are applied to the base case cash flow forecast to assess for resilience against financial shocks, compliance with financial covenants and availability of cash reserves. The directors regularly review the base case cash flow forecast and formally review the output of the stress-testing on an annual basis.

The expectation that revenue will be indexed in relation to CPI/CPIH and that RCV will be indexed in relation to a combination of CPI/CPIH and RPI (refer to risk number 8) with effect from 1 April 2020 is reflected in the projections. Where a stress test scenario is inflation based, the movement has been applied to the three relevant metrics (RPI, CPI and CPIH) under the assumption that the metrics all move in line.

The following sensitivities, approved by the Audit Committee, were used in stress-testing the base case cash flow forecast:

- 10% increase in total expenditure;
- 5% increase in unpaid water customer bills represented by a 5% reduction in revenue;
- 1% decrease in the three inflation metrics;
- 1% decrease in the November inflation metric forecast impacting revenue only;
- replacing the base inflation metric forecast with a negative 1% forecast, while maintaining a 1% increase in expenditure; and
- 1% decrease in the November inflation metric 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 directors consider that the sensitivity applied in relation to total expenditure is of a sufficient magnitude to capture the financial impact in severe, plausible and reasonable scenarios of exceptional items, such as regulatory fines and legal costs, and costs not taken into account by Ofwat in setting our price controls.

The sensitivity applied in relation to unpaid water customer bills reflects a severe, plausible and reasonable scenario considering that the risk is spread across our whole customer base. The directors consider that this sensitivity is of a sufficient magnitude to also capture the financial impact in severe, plausible and reasonable scenarios of ODI penalties incurred through worse than planned operational performance.

The inflation sensitivities reflect severe, plausible and reasonable 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 lower revenue increases as a result of a reduction in inflation.

For the principal risks identified in the principal risk table on **pages 36 to 44** with the icon (b), the directors considered that these risks might in isolation threaten financial viability in the event of a major asset failure or severe drought incident within our supply region, 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 and to cover the impact of a severe drought incident within our supply region in line with our Drought Management Plan.

Strategic report continued

Principal risks and uncertainties (continued)

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, except for a £14.2m Class A fixed rate bond repayable in 2022, fall outside of the lookout period;
- the company's ability to renew its existing short-term borrowing facilities under most market conditions;
- the ability to restrict dividend payments as a key mitigating action;
- the company is financially and operationally 'ring-fenced' from the rest of the Affinity Water group by way of a whole business securitisation (refer to **pages 68 to 73** for further details of the group structure and company's financing arrangements); 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.

It is not envisaged that further funding will be required under the scenarios considered.

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

Tony Cocker

Chairman
20 June 2018

Governance

Introduction from the Chairman

I am delighted to present our Corporate Governance Report for 2017/18 on behalf of the Board.

My role is to ensure that we operate to the highest standards of governance. Transparency in the way we manage our standards of governance is key to achieving these standards and we support the principles of good corporate governance set out in 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 and conditions within the company's Instrument of Appointment 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 on our website information about how our UK holding company applies Ofwat's 2014 paper: Board leadership, transparency and governance – holding company principles.

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. I regularly seek views from our independent non-executive directors on governance and any other matters of concern they may have, without the presence of the executives or shareholders.

The Board has adopted a policy on diversity, including gender and ethnicity, and continues to drive this agenda.

During the year the Board has continued to focus on the company's risk management and internal control systems and on **page 36** of our strategic report, further detail of how risk assessment activities were carried out can be found. The Annual Report and Financial Statements remains the principal means of reporting to our shareholders on the Board's governance policies and sets out how our approach to good governance has been applied in practice.

Tony Cocker

Chairman

UK CORPORATE GOVERNANCE CODE COMPLIANCE

Since May 2017, our business has been owned by a consortium of long-term private investors. The principles of the UK Corporate Governance Code 2016 ('the Code') were applied in this context.

CODE PRINCIPLES

- Leadership
- Effectiveness
- Accountability
- Remuneration
- Relations with shareholders

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 complied with the principles of the Code during 2017/18, except in terms of:

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

The reason for each departure is explained within the relevant section of this corporate governance report. The Board considers our governance arrangements appropriate for a company owned by private investors. In April 2018, the Board appointed Susan Hooper a member of the Nomination Committee, thereby making independent members the majority and meeting the Code provision. The Board intends to appoint a SID and undertake an externally facilitated board evaluation during 2018/19.

PRINCIPLES OF CORPORATE GOVERNANCE

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;
- the OECD Principles of Corporate Governance (2004); and
- the principles set out in Ofwat's 2014 paper, Board leadership, transparency and governance – holding company principles.

Governance continued

Board leadership, transparency and governance

BOARD OF DIRECTORS

Our directors and their biographies are shown on the following pages. Where a director holds other directorships within the Affinity Water group, the numbers listed alongside his or her name are cross referenced to the relevant company shown on the structure chart on **page 69**.

Director membership of our Board Committees is also listed by letter, alongside the relevant director's name:

- Audit Committee: A
- Remuneration Committee: R
- Nomination Committee: N
- Community Committee: C

Independent non-executive chairman

Tony Cocker – Chairman R N C

Appointment to the Board: 15 January 2018 (appointed Chairman on 30 January 2018)

Qualifications: Tony has a BA and D.Phil from Oxford University, and a Master of Business Administration ('MBA').

Skills and career experience: Tony has significant experience in the utilities industry, having worked for E.ON SE for 20 years, most recently as CEO and Chairman of E.ON UK plc. Prior to this he was Strategic Planning Manager of Bass plc and Associate Manager at LEK Consulting.

Other current directorships/business interests: Tony is Governor and Deputy Chairman of Warwick Independent Schools Foundation and is non-executive Chairman of Infinis Energy Management Limited. He is also non-executive Chairman of the Energy Innovation Centre and in May 2018 was appointed a non-executive director of SSE plc.

The Board considered Tony Cocker to be independent on his appointment.

Independent non-executive directors

Chris Bolt A R

Appointment to the Board: 26 February 2015

Qualifications: Chris has a BA Economics from Gonville & Caius College Cambridge and a MSc (Econ) from the University of London.

Skills and career experience: Chris has worked in the field of economic regulation for more than 20 years, holding senior roles in both the public and private sectors. 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. His regulation experience has included Transco plc from 1999 to 2002, the Office of the Rail Regulator from 1994 to 1999 and Ofwat from 1989 to 1994.

Other current directorships/business interests: Chris provides independent regulatory advice to the government, companies and regulators.

Patrick O'D Bourke A N

Appointment to the Board: 24 July 2013

Qualifications: Patrick has a MA from the University of Cambridge and is a Chartered Accountant.

Skills and career experience: Patrick was previously Chief Executive of Viridian Group, having first undertaken the role of Group Finance Director and prior to that was Group Treasurer of Powergen plc. As chair of our Audit Committee he can bring a wide range of experience in regulated businesses operating within the private and quoted sectors.

Other current directorships/business interests: Patrick is Group Finance Director of John Laing Group plc.

Governance continued

Board leadership, transparency and governance (continued)

BOARD OF DIRECTORS (CONTINUED)

Independent non-executive directors (continued)

Trevor Didcock A C

Appointment to the Board: 30 November 2015

Qualifications: Trevor has a BSc (Hons) in Mechanical Engineering from the University of Nottingham, and a MBA and Marketing Diploma.

Skills and career experience: Trevor was Chief Information Officer at EasyJet plc from 2010 to 2015, HomeServe plc from 2008 to 2010, the Automobile Association 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.

Other current directorships/business interests: Trevor 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 N C

Appointment to the Board: 30 November 2015

Qualifications: Susan has a MA and a BA from the Johns Hopkins University.

Skills and career experience: Susan 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.

Other current directorships/business interests: Susan is a non-executive director at Rank Group plc, Wizz Air Holdings plc, Uber London Limited, Uber Britannia Limited and the Department for Exiting the EU.

Non-executive directors

Gareth Craig 2 3 4 5 6 7 8 9 10 18 19 A N

Appointment to the Board: 19 May 2017

Qualifications: Gareth has a BSc (Econ) from Cardiff University.

Skills and career experience: Gareth has more than 20 years' experience of the financing and management of major infrastructure projects and 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.

Other current directorships/business interests: Gareth is Chairman of Green Frog Power, a specialist in providing peaking power to the electricity capacity market. 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.

Jaroslava Korpanec 2 3 4 5 6 7 8 9 10 16 19 R N

Appointment to the Board: 19 May 2017

Qualifications: Jaroslava has a law degree from the University of Cambridge, and is a member of the New York bar and a solicitor of the Supreme Court of England and Wales.

Skills and career experience: Jaroslava is Managing Director at Allianz Capital Partners and heads up the London office. 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 several debt and equity investments, including the acquisition and management of London City Airport.

Other current directorships/business interests: Jaroslava is also on the Boards of the gas distribution company, Cadent Gas, and Net4Gas, the gas transmission company of the Czech Republic.

Governance continued

Board leadership, transparency and governance (continued)

BOARD OF DIRECTORS (CONTINUED)

Non-executive directors (continued)

Angela Roshier 2 3 4 5 6 7 8 9 10 17 19 A R C

Appointment to the Board: 19 May 2017

Qualifications: Angela has a MA from the University of Cambridge and a MBA from London Business School.

Skills and career experience: For more than 20 years Angela has contributed to the origination and asset management of a wide variety of infrastructure assets in the public-private partnerships, water, oil tanking and railway sectors worldwide.

Other current directorships/business interests: Currently DIF's Partner and Head of Asset Management, Angela joined in 2010 and oversees the asset management of DIF's global portfolio of public-private partnerships, regulated assets and renewable energy investments. Prior to DIF, Angela was a member of 3i Plc and Actis's Infrastructure teams.

Simon Cocks C

Appointment to the Board: 1 June 2015

Qualifications: Simon has a BA (Hons) from the University of East London.

Skills and career experience: Simon is an electrical engineer with extensive experience of the water and energy industries. Simon was CEO of Affinity Water Limited until 30 April 2018 and his role became non-executive on 22 May 2018. He was previously Severn Trent's Managing Director of Wholesale Operations. Prior to joining Severn Trent in 2009, he was a senior executive at National Grid and started his career at London Electricity.

Other current directorships/business interests: Simon is Chairman of the Water Resources in the South East group, a member of the Supervisory Board of Thyssengas GmbH, and director and owner of BetterandBeyond Limited.

Executive Directors

Pauline Walsh – Chief Executive Officer ('CEO') 2 3

Appointment to the Board: 1 May 2018

Qualifications: Pauline has a degree in mechanical engineering from University College Dublin and a MBA.

Skills and career experience: Pauline previously worked as a Director for National Grid where she was responsible for building and maintaining the assets of the UK's high pressure national gas transmission system. Prior to joining National Grid in 2015, Pauline held senior leadership roles at Havells-Sylvania, Fred Olsen, Philips Electronics and the Ford Motor Company.

Other current directorships/business interests: Pauline is a non-executive director on the Board of Buccleuch, an enterprise representing the business interests of the Buccleuch family and focused on appropriate land use.

Stuart Ledger – Chief Financial Officer ('CFO') 2 3 4 12 13 14

Appointment to the Board: 9 October 2017

Qualifications: Stuart has a BA from Liverpool John Moores University, is a Chartered Accountant and a member of the Pensions Management Institute.

Skills and career experience: Stuart has significant experience in utilities and has held a number of senior finance roles, most recently Chief Financial Officer for Retail at Thames Water. Before joining Thames Water in 2008 as the Group Financial Controller, he was the financial controller at Wolseley and started his career at EDF Energy.

Other current directorships/business interests: Stuart is a director of Landlord Tap Limited, which provides a website for landlords and managing agents of residential properties to provide water companies with details of those responsible for the payment of water and/or sewerage charges for their tenanted properties.

Former directors

Name	Former Role	Period of service
Dr Phillip Nolan	Chairman	1 April 2013 to 30 January 2018
Duncan Bates	Chief Financial Officer	20 September 2012 to 31 July 2017
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 continued

Board leadership, transparency and governance (continued)

GOVERNANCE INFORMATION

Leadership

There is a clear division of responsibility between the non-executive directors whose role is to challenge and advise and the executive directors who have the responsibility of running the day-to-day operational business.

The Board sets the tone for the culture, values and behaviour within the organisation.

Roles of the Chairman and Chief Executive Officer

The roles of Chairman and the Chief Executive Officer are separate. The division of responsibilities is clearly set out in writing, approved by the Board and published on our website.

Transparency

We are committed to being accountable to customers and our communities. We aim to maintain legitimacy with them by being open and transparent about our governance. Our Governance Code is published on our website.

CODE PRINCIPLE – LEADERSHIP

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. The Board safeguards both the long-term success and customers' interests and creates shareholder value.

Our Chairman, Tony Cocker, leads our Board and is responsible for ensuring its effectiveness in all aspects of its role and that all directors are cognisant of their statutory duties.

The Board's role 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.

The Board leads the company within a framework of effective controls which enable risk to be assessed and managed and is responsible to all stakeholders, including the shareholders, for the approval of the strategic objectives. Responsibility for the implementation and development of the strategies and overall commercial objectives is delegated to the Chief Executive Officer who is supported by the Executive Management Team.

SENIOR INDEPENDENT NON-EXECUTIVE DIRECTOR

The Board intends to appoint a SID during 2018/19. Their role will be to provide a sounding board for the Chairman and act as an intermediary for the other directors where necessary.

CODE PRINCIPLE – EFFECTIVENESS

THE COMPANY SECRETARY

The Company Secretary is responsible for advising the Board through the Chairman on all governance matters and ensuring 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 effectively.

The Company Secretary works with the Chairman and respective Committee Chairs to develop and agree a forward agenda for the year ahead for the Board and Committee meetings.

Facilitating good information flows within the Board and its Committees and between senior management and non-executive directors is a key role of the Company Secretary. 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.

CONFLICTS OF INTEREST

Directors are required to notify the Chairman of any potential conflict or potential new appointment or directorship in accordance with their statutory duties. The company's Articles of Association contain provisions which permit those directors who are not conflicted to authorise any situation giving rise to a known or potential conflict. All the directors are required to notify the Company Secretary if they believe a conflict situation might arise and directors are required to consider any conflicts at each board meeting. The Board reviews the position of each director annually along with the company's auditors.

The directors do not consider that during the financial year, any actual conflicts of interest have arisen between the roles of the directors as directors of the Company, and any other roles which they may hold.

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
- Dividends
- Key regulatory reports and submissions
- Delegations of authority
- Corporate governance matters
- Key corporate policies

Board Committee Terms of Reference

The Terms of Reference for each of the Board Committees are reviewed periodically and published on our website.

Re-appointment of directors

The company's articles provide that at each Annual General Meeting ('AGM') any director appointed since the previous AGM, or any director appointed since the previous two AGMs without retiring or being re-elected, must retire and seek re-election. While these arrangements depart from the Code with respect to annual re-election of all directors, the Board considers these arrangements for re-election appropriate for a company owned by private investors.

The following directors required to retire from office and seek re-election at this year's AGM are:

- Tony Cocker;
- Pauline Walsh;
- Stuart Ledger;
- Chris Bolt; and
- Simon Cocks

The terms of appointment for our independent non-executive directors are available on our website at: **stakeholder.affinitywater.co.uk/our-governance.aspx**.

Governance continued

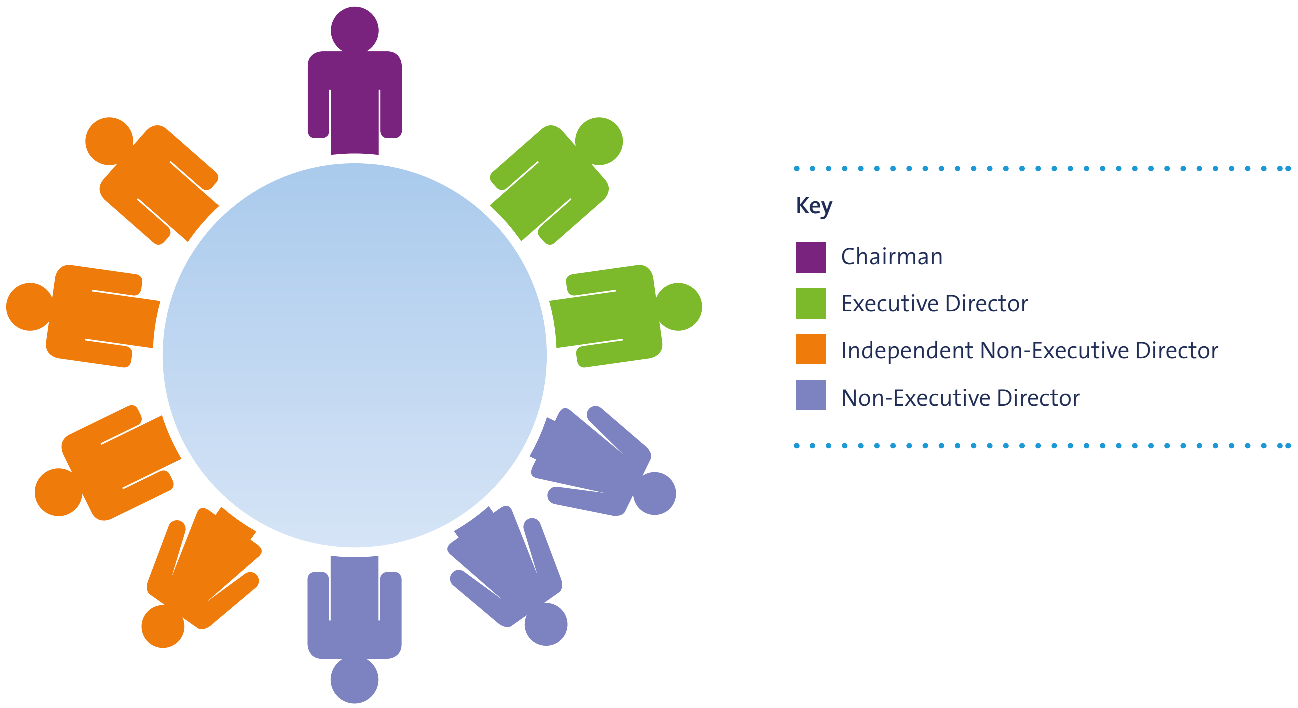
Board leadership, transparency and governance (continued)

BOARD COMPOSITION AND BALANCE

We consider that the 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 are of sufficient calibre and experience for their views to carry sufficient weight in Board decisions and they constructively challenge and help develop the strategy of our business.

During the year the company met Ofwat's expectation that independent non-executive directors should be the largest single group on the Board. Although there is a departure from the Code provision for 'at least half the Board, excluding the Chairman, to comprise non-executive directors determined by the Board to be independent', the Board considers the current composition appropriate for a company owned by private investors and that the composition of the Board is appropriate for balancing the needs of customers, the environment and our shareholders. No single director or group of directors can dominate the Board's decision making.

The composition of the Board at 31 March 2018 is illustrated in the diagram below:



Board composition at 31 March 2018	Directors	Independent (including Chairman)	Male	Female
	10	5	7	3

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 reviews 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 AND ITS COMMITTEES

The Board has established four standing principal committees: the Audit Committee, the Remuneration Committee, the Nomination Committee and the Community Committee, which assist the Board in discharging its duties. Composition of these Committees at 31 March 2018 is listed in the table below.

Audit Committee	Remuneration Committee	Nomination Committee	Community Committee
Patrick O'D Bourke (Chair)	Susan Hooper (Chair)	Tony Cocker (Chair)	Tony Cocker (Chair)
Chris Bolt	Chris Bolt	Patrick O'D Bourke	Susan Hooper
Trevor Didcock	Tony Cocker	Gareth Craig	Trevor Didcock
Gareth Craig	Jaroslava Korpanec	Jaroslava Korpanec	Angela Roshier
Angela Roshier	Angela Roshier		Simon Cocks

Susan Hooper was appointed a member of the Nomination Committee on 30 April 2018, thereby making independent members (including the Chairman) the majority and meeting the Code provision for nomination committees to comprise a majority of independent non-executive directors.

Each committee operates in accordance with Terms of Reference approved by the Board and published on our website. Other committees are formed as and when required to deal with specific issues and appropriate terms of reference are established by the Board at the time.

INDEPENDENCE AND DIVERSITY

The composition of our Board Committees at 31 March 2018, in terms of independence and gender, is shown in the table below.

Composition at 31 March 2018	Members	Independent (including Chairman)	Male	Female
Audit Committee	5	3	4	1
Remuneration Committee	5	3	2	3
Nomination Committee	4	2	3	1
Community Committee	5	3	3	2

Our directors have extensive professional experience in senior roles across the utilities and regulated assets industries, as well as in finance, operational roles and infrastructure. There is a wide range of skills and experiences to ensure a diversity of perspective that helps promote the company's long-term success. This is integral to effective oversight of the company's strategy, risk mitigation and management performance.

Governance continued

Board leadership, transparency and governance (continued)

BOARD ACTIVITY FOR 2017/18

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

Aspect	Matters considered
Environment	• Preparations for drought in case it occurs following second successive dry winter and approval of drought management plan submission • Reviewed progress in meeting AMP6 performance commitments for drinking water quality, sustainability reductions, reductions in leakage and reductions in per capita consumption • Development of draft WRMP to balance supply and demand over 60-year planning period
Assets	• Reviewed progress in delivering the AMP6 capital programme, including the spend on IT infrastructure • Reviewed the company's preparations for managing and mitigating risk arising from the HS2 programme of works
Customers and communities	• Reviewed performance as a wholesaler in the non-household retail market • Reviewed customer satisfaction, in particular performance against the SIM and Water UK service levels set for developer services • Reviewed the strategy for reducing supply interruptions greater than 12 hours • Reviewed the Customer Challenge Group's annual report
People	• Approved the health and safety strategy and improvement plan and reviewed incidents in the year • Reviewed gender pay gap information • Reviewed progress of pay negotiations with trade unions
Finances	• Approved interim and full-year financial statements and the Regulatory Annual Performance Report, including viability statement and regulatory certificates • Approved issuing £60.0m fixed coupon bonds and £60.0m CPI-linked bonds to meet medium term financing requirements • Approved simplification of the corporate structure, including substitution of Cayman Islands financing company with a UK entity
Regulation and PR19	• Reviewed charges publications for 2018/19 • Reviewed development of the PR19 Business Plan submission
Risk Management	• Reviewed the principal risks of the company • Reviewed the effectiveness of the company's internal control systems and risk management processes, including those relating to cyber security and information strategies
Governance	• Approved the appointments of a new chairman, new chief executive officer and shareholder non-executive directors • Approved and updated policies relating to modern slavery and human trafficking, anti-bribery and corruption, and board diversity • Reviewed the company's governance arrangements regarding the requirements of the UK Corporate Governance Code and Ofwat's governance principles

BOARD AND COMMITTEE ATTENDANCE

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

The table sets out attendance at meetings for the year ended 31 March 2018:

	Board	Audit Committee	Remuneration Committee	Nomination Committee	Community Committee
Number of meetings	**14**	**4**	**6**	**6**	**1**
Chairman					
Tony Cocker*	4/4	–	1/1	1/1	1/1
Dr Philip Nolan*	11/11	–	5/5	4/5	–
Independent non-executive directors					
Chris Bolt	13/14	4/4	6/6	–	–
Patrick O'D Bourke	14/14	4/4	–	6/6	–
Trevor Didcock	13/14	4/4	–	–	1/1
Susan Hooper	10/14	–	6/6	–	1/1
Executive directors					
Simon Cocks	14/14	–	–	–	1/1
Stuart Ledger*	7/7	–	–	–	–
Duncan Bates*	4/5	–	–	–	–
Non-executive directors					
Gareth Craig*	10/11	3/3	–	4/5	–
Jaroslava Korpanec*	11/11	–	4/4	5/5	–
Angela Roshier*	9/11	2/3	4/4	–	1/1
Stephen Nelson*	1/3	–	1/1	–	–
Nigel Paterson*	3/3	–	–	–	–
Jim Wilmott*	3/3	–	1/1	–	–

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

Governance continued

Board leadership, transparency and governance (continued)

INDUCTION

Non-executive directors (including the chairman) who have been nominated for appointment are expected to attend a pre-appointment meeting with Ofwat. This meeting allows nominated directors to get an understanding of Ofwat's expectations for the role of non-executive directors of a regulated company and any other issues which Ofwat considers appropriate. It provides an opportunity to ask Ofwat any questions ahead of their appointment.

On appointment to the Board, directors follow a comprehensive induction process. This includes briefing directors about the company's business model, its key operations and processes, its strategy and business plans together with details of the company's governance framework and information regarding their duties as directors. Induction includes visits to water treatment works and time spent with frontline employees.

TRAINING AND CONTINUING PROFESSIONAL DEVELOPMENT

Board members receive updates on relevant issues, including legislative, regulatory and reporting matters to help improve their understanding and knowledge of the business and, in particular, its regulatory environment. Non-executive directors are conscious of the importance of remaining properly briefed and informed about current issues. Training and updates for non-executive directors in relation to specific topics or key areas of interest include:

- attending regulatory working group meetings;
- attending forums for senior leaders in the business; and
- tours of water treatment works and other facilities.

Non-executive directors also participate in industry events, including annual Ofwat events for non-executive directors

EFFECTIVENESS REVIEW

The Board planned to review its effectiveness in 2017/18 by means of an externally facilitated process. Due to the number of changes to the composition of the Board during the year, it was decided to defer the review to 2018/19 to allow time for directors to work together. This represents a departure from the provision of the Code for Board evaluation to be externally facilitated at least every three years.

Evaluation of the performance of individual directors will be undertaken ahead of the AGM. The Chairman, Tony Cocker, will lead the evaluation, while Patrick O'D Bourke will lead the evaluation of the Chairman.

Details of the Audit Committee's performance evaluation are provided in the Audit Committee's report on **pages 74 to 78**.

The performance of the Remuneration Committee, Nomination Committee and Community Committee was evaluated informally.

CODE PRINCIPLE – ACCOUNTABILITY

FINANCIAL AND BUSINESS REPORTING

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 46** 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

The company's systems of internal control 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.

GOVERNANCE INFORMATION

Board accountability

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.

Our Board has overall responsibility for monitoring the company's internal control systems and is advised by the Audit Committee on these matters. The Board is responsible for reviewing the effectiveness of these control systems, including:

- financial, operational and compliance controls; and
- risk management.

Board Committees' accountability

The Board and its Committees have an appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their duties effectively.

Committee membership is assessed and refreshed periodically when necessary to ensure that undue reliance is not placed on any one individual.

Only the Committee Chairman and its members are entitled to be present at the Audit, Remuneration, Nomination and Community Committees, however, others may attend by invitation of the Committee.

The Terms of Reference for the Board Committees are available on the governance pages of our website: **stakeholder.affinitywater.co.uk/our-governance.aspx**.

The Audit Committee and Remuneration Committee reviewed their Terms of Reference and these were subsequently approved by the Board in September 2017.

Governance continued

Board leadership, transparency and governance (continued)

RISK MANAGEMENT AND INTERNAL CONTROL (CONTINUED)

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 36** 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.

BOARD COMMITTEES

Audit Committee

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

Audit Committee Members	Independence	Notes
Patrick O'D Bourke (Chair)	Independent	
Chris Bolt	Independent	
Trevor Didcock	Independent	
Gareth Craig	Shareholder appointed	Appointed 28 June 2017
Angela Roshier	Shareholder appointed	Appointed 28 June 2017
Stephen Nelson	Shareholder appointed	Resigned 19 May 2017
Jim Wilmott	Shareholder appointed	Resigned 19 May 2017

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 reviews the company's position and performance, business model and strategy to ensure the company is operating efficiently and is providing value for money for customers. This resultantly leads to higher returns for our investors. The Committee also 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 March 2018 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 and the following areas were highlighted as requiring further focus:

- training to be increased with consideration given to individual Committee member proposals; and
- assess the risk management process and consider the introduction of a risk appetite statement.

The duties of the Audit Committee and activities in the year are contained in the Audit Committee report on **pages 74 to 78**.

Governance continued

Board leadership, transparency and governance (continued)

BOARD COMMITTEES (CONTINUED)

Remuneration Committee

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

Remuneration Committee Members	Independence	Notes
Susan Hooper (Chair)	Independent	
Chris Bolt	Independent	
Dr Philip Nolan	Independent	Resigned 30 January 2018
Tony Cocker	Independent	Appointed 30 January 2018
Jaroslava Korpanec	Shareholder appointed	Appointed 28 June 2017
Angela Roshier	Shareholder appointed	Appointed 28 June 2017
Stephen Nelson	Shareholder appointed	Resigned 19 May 2017
Jim Wilmott	Shareholder appointed	Resigned 19 May 2017

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. 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.

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 full Remuneration Report on **pages 79 to 91**.

Nomination Committee

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

Nomination Committee Members	Independence	Notes
Dr Philip Nolan (Chair)	Independent	Resigned 30 January 2018
Tony Cocker (Chair)	Independent	Appointed 30 January 2018
Patrick O'D Bourke	Independent	
Jaroslava Korpanec	Shareholder appointed	Appointed 28 June 2017
Gareth Craig	Shareholder appointed	Appointed 28 June 2017
Stephen Nelson	Shareholder appointed	Resigned 19 May 2017
Jim Wilmott	Shareholder appointed	Resigned 19 May 2017

The Committee was chaired by Dr Philip Nolan up to 30 January 2018 when he stepped down as Chairman and director of the company. The Chairman does not chair any Nomination Committee meetings relating to the appointment of his successor. In these circumstances, the Committee is chaired by an independent non-executive director agreed by the remaining Committee members.

While the Code provision for nomination committees to comprise a majority of independent non-executive directors is not met, the Board notes that composition during the year achieved a balance between the two shareholder members and two independent members. In April 2018, the Board appointed Susan Hooper a member of the Committee, thereby making independent members (including the Chairman) the majority.

The main responsibilities of the Committee are:

- considering succession planning for directors and other senior executives including reviewing board performance, paying specific attention to the structure, size and composition of the Board including skills, independence, knowledge and diversity needed;
- 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 Committee oversees the preparation of a role specification that is then provided to an independent search firm. In addition to the specific skills, knowledge, independence and experience deemed essential, other criteria set out in the role specification include:

- a commitment to the highest standards of governance;
- strategic focus and a clear, independent point of view;
- a diversity of experience;
- a proven track record of creating shareholder value; and
- having the time and availability to manage the role.

The Board has approved a diversity policy and the company strives for a genuine diversity of its directors and employees. The Board is mindful that continued focus in this area will ensure that progress is made about ethnicity, gender, disability and age within the organisation. At Board level, the Nomination Committee has not set a specific male or female quota for Board members. All appointments are based on the diversity of contribution and required competencies, irrespective of gender, age or any other personal characteristics. The company is similarly committed to appointing the best available person to roles across the organisation, regardless of age, gender, disability or ethnicity. See **page 25** of the strategic report for the split between males and females within the business and how we are improving diversity across the talent pool.

The Committee met six times during the year to consider the appointment of the Chief Financial Officer, Chairman, Chief Executive Officer and succession planning for senior executive roles. The Committee evaluated the balance of skills, experience, independence and knowledge on the Board and within the executive management team 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.

Russell Reynolds Associates, which is unconnected to the company, was used to identify candidates for the Chief Financial Officer position. Korn Ferry, which is also unconnected to the company, was used to identify candidates for the CEO and CFO positions. Both search firms are members of the Voluntary Code of Conduct for Executive Search Firms.

The Nomination Committee reviewed lists of candidates for each Board role and those identified for the short-list were invited to interview with members of the Committee. Following completion of the shortlisting and interviewing process, the Nomination Committee met to make its recommendations to the Board which subsequently approved those recommendations.

In June 2017, the company announced the appointment of Stuart Ledger as CFO. Stuart took up his role in October 2017.

In January 2018, the company announced the appointment of Tony Cocker as Chairman. Tony was appointed a non-executive director on 15 January 2018 and took over as Chairman from Dr Philip Nolan on 30 January 2018.

In February 2018, the company announced the appointment of Pauline Walsh as CEO. Pauline joined the business on 25 April 2018 and was appointed a director on 1 May 2018. Simon Cocks was CEO until 30 April 2018 and his role became non-executive on 22 May 2018. The company will thereby continue to benefit from Simon's extensive knowledge of and operational experience in the utilities sector.

Governance continued

Board leadership, transparency and governance (continued)

BOARD COMMITTEES (CONTINUED)

Community Committee

In 2018 the Board established a Community Committee. Its inaugural meeting was in March 2018. Membership of the Community Committee is as follows:

Community Committee Members	Independence
Tony Cocker (Chair)	Independent
Trevor Didcock	Independent
Susan Hooper	Independent
Angela Roshier	Shareholder appointed
Simon Cocks	Executive

The purpose of the Committee is to seek to ensure that:

- that the company develops and implements a community strategy that supports delivery of its vision to be the leading community focused water company;
- short and long-term objectives for the community strategy are set and reported on; and
- the company holds itself to account with the communities it serves in respect of the provision of its services.

CODE PRINCIPLE – REMUNERATION

Our Remuneration Report can be found on **pages 79 to 91**.

CODE PRINCIPLE – RELATIONS WITH SHAREHOLDERS

RELATIONSHIP WITH OUR SHAREHOLDERS

The company has an open and transparent approach to its shareholders and at the end of this first full year with our new shareholder investors, this relationship is strong, with shareholders having clear access to the Chairman, executive and non-executive directors and senior executives.

The company recognises the importance of representing and promoting the interests of its shareholders through the presence of directors appointed by our shareholders on its Board. The Board is accountable to its shareholders for the performance and activities of the company and regularly facilitates effective face-to-face dialogue with shareholders to allow all the members of the Board, in particular the independent non-executive directors, to develop an understanding of 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 those matters in 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.
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.

By order of the Board

Tim Monod

Company Secretary
20 June 2018

GOVERNANCE INFORMATION

Shareholder engagement

Mechanisms are in place to ensure shareholders are kept in touch with key activities and developments, including:

- shareholders may attend quarterly Leaders' Forums and regulatory working group meetings on business and regulatory strategy;
- key company notices and external communications are shared with shareholders;
- presentations and reports from the CEO and CFO are standard agenda items for Board meetings which are attended by shareholder directors;
- seeking shareholder approval for the limited number of matters reserved for shareholder approval Details of these matters are published in: Engaging with our shareholders, available on the governance pages of our website

Our shareholders discharge their responsibilities as shareholders through their representation on our Board and through their participation in, Board decisions to the extent not prohibited by condition F6A of the company's Instrument of Appointment (refer to **page 153** for further details). Executive management hold ad hoc meetings with shareholders as required.

Governance continued

Ownership and financing

OWNERSHIP

Until 19 May 2017, 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. Subsequent to the initial sale, HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited) sold down 3.4% of their interest to a small group of co-investors, comprising UK local authority pension funds in June 2017. Following this, the effective equity interests in the company have been:

DIF	26.8%
HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited)	33.2%
Allianz Capital Partners on behalf of the Allianz Group	36.6%
Group of co-investors comprising UK local authority pension funds	3.4%

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:

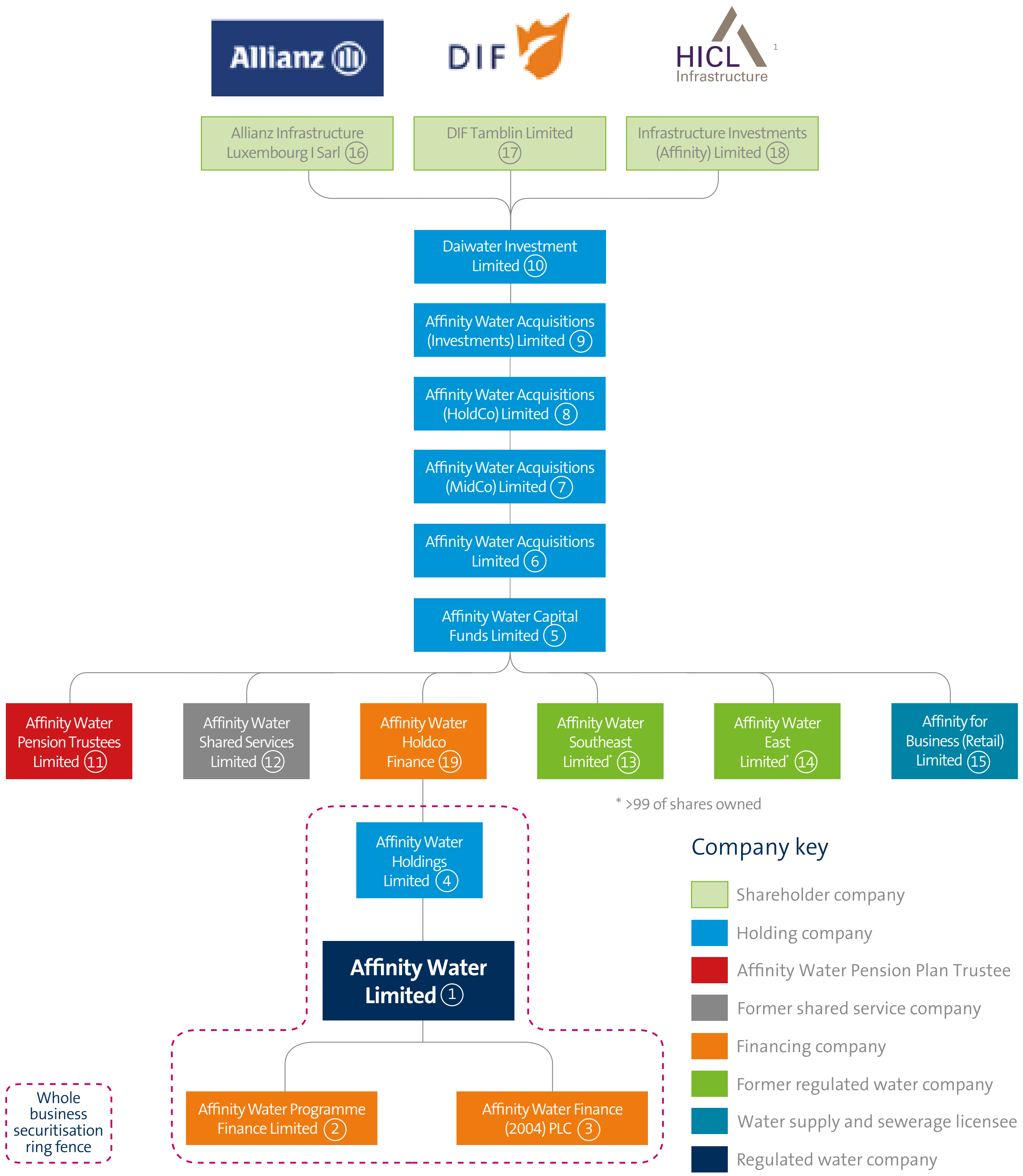
- Allianz Infrastructure Luxembourg I Sarl
- DIF Management Holding BV
- DIF Management UK Limited
- HICL Infrastructure Company Limited
- InfraRed Capital Partners (Management) LLP

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 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.

The chart below shows the equity interests held by each owner and the structure of the group, excluding dormant subsidiaries, as at 31 March 2018. 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 48 to 53**.



[1] HICL Infrastructure sold down 3.4% of their interest to a small group of co-investors, comprising UK local authority pension funds in June 2017.

Governance continued

Ownership and financing (continued)

OWNERSHIP (CONTINUED)

The following table provides further explanation of the group structure.

Structure chart reference	Name	Description	Place of registration
1	Affinity Water Limited	A water undertaker holding an appointment under the Water Industry Act 1991, supplying water to a population of around 3.6 million people in the southeast of England. It is the principal trading company of the group.	England and Wales
2	Affinity Water Programme Finance Limited	A financing subsidiary of Affinity Water Limited established in 2013 to issue bonds under a Euro Medium Term Note ('EMTN') programme. It lends monies raised from its bonds to Affinity Water Limited.	Cayman Islands
3	Affinity Water Finance (2004) PLC	A financing subsidiary of Affinity Water Limited established in 2004 to issue a bond. It lends monies raised from its bond to Affinity Water Limited.	England and Wales
4	Affinity Water Holdings Limited	Affinity Water Limited's immediate holding company. Its equity is provided as security to bondholders in the event of default.	England and Wales
5	Affinity Water Capital Funds Limited	The original holding company for Veolia's regulated water businesses, which was acquired by the group in June 2012 through Affinity Water Acquisitions Limited (the "target" company), which provides management services to the company.	England and Wales
6	Affinity Water Acquisitions Limited	The company which bid for and acquired Affinity Water Capital Funds Limited and its subsidiaries from Veolia Water UK Limited in 2012 (the "bid" company). It issued subordinated debt notes to Affinity Water Acquisitions (Midco) Limited as part of the acquisition finance.	England and Wales
7	Affinity Water Acquisitions (Midco) Limited	The holding company of Affinity Water Acquisitions Limited which holds subordinated debt notes issued by Affinity Water Acquisitions Limited. It issued subordinated debt notes and exists to enable the introduction or withdrawal of shareholder subordinated debt without impacting on agreements between the original acquisition consortia and Veolia Water UK Limited.	England and Wales
8	Affinity Water Acquisitions (Holdco) Limited	The holding company of Affinity Water Acquisitions (Midco) Limited. The inclusion of a holding company between Affinity Water Acquisitions (Midco) Limited and Daiwater Investment Limited enables the introduction or withdrawal of additional shareholders without impacting on shareholder agreements between the original acquisition consortia.	England and Wales
9	Affinity Water Acquisitions (Investments) Limited	The ultimate holding company of the group in the United Kingdom up until 19 May 2017.	England and Wales
10	Daiwater Investment Limited	The ultimate holding company of the group in the United Kingdom, paying dividends to the acquisition consortia subsidiaries.	England and Wales
11	Affinity Water Pension Trustees Limited	The trustee company of the Affinity Water Pension Plan.	England and Wales
12	Affinity Water Shared Services Limited	A company which provided administrative and technical services solely to Affinity Water Limited until 31 March 2015. Prior to the acquisition of Veolia Water UK Limited's 90% equity interest in the group in June 2012 (and for a 12 month transitional period following), the company also provided services to the non-regulated businesses of Veolia Water UK Limited.	England and Wales
13	Affinity Water Southeast Limited	A company which formerly held an Instrument of Appointment as water undertaker for the Dour community of Affinity Water Limited's water supply area. The appointment was transferred to Affinity Water Limited on 27 July 2012. The company is no longer trading but continues to honour income assurances made to minority shareholders on transfer of its water undertaking to Affinity Water Limited.	England and Wales
14	Affinity Water East Limited	A company which formerly held an Instrument of Appointment as water undertaker for the Brett community of Affinity Water Limited's water supply area. The appointment was transferred to Affinity Water Limited on 27 July 2012. The company is no longer trading but continues to honour income assurances made to minority shareholders on transfer of its water undertaking to Affinity Water Limited.	England and Wales
15	Affinity for Business (Retail) Limited	A subsidiary of Affinity Water Capital Funds Limited operating as a water and wastewater retailer in the non-household retail market.	England and Wales
16	Allianz Infrastructure Luxembourg I Sarl	A company which holds indirectly Allianz Capital Partners' investment in the group.	Luxembourg
17	DIF Tamblin Limited	A company established in 2017 to hold indirectly DIF's investment in the group.	England and Wales
18	Infrastructure Investments (Affinity) Limited	A company established in 2017 to hold indirectly HICL Infrastructure Company Limited's investment in the group.	England and Wales
19	Affinity Water Holdco Finance Limited	A financing subsidiary of Affinity Water Capital Funds Limited established in 2017. It lends monies raised to Affinity Water Capital Funds Limited.	England and Wales

Governance continued

Ownership and financing (continued)

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 £764.2m.

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.

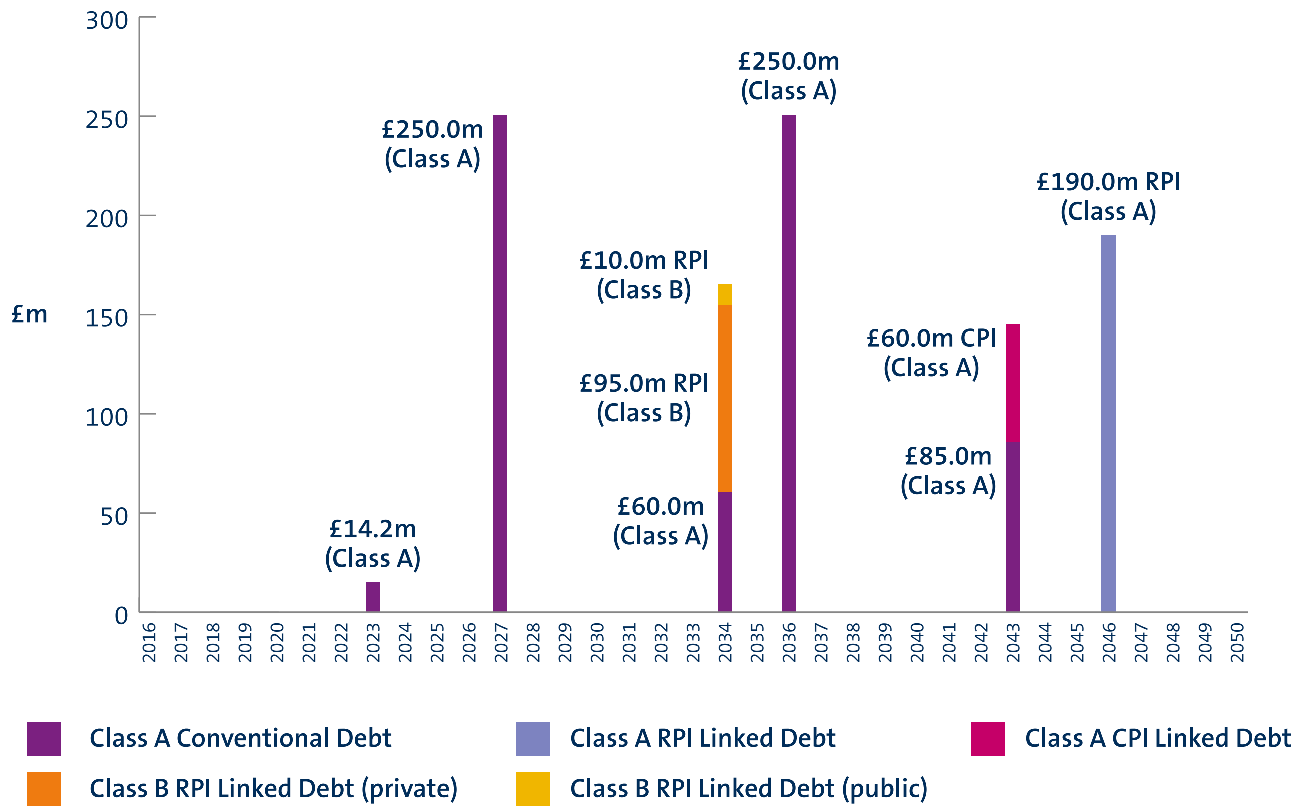
By being resident in the United Kingdom for tax purposes we are clear that this arrangement does not avoid UK tax and brings no tax benefit. Further, there are no funds which are held off-shore with all finance being raised and held within the UK. It is our intention to seek to substitute the Cayman Islands entity with a UK entity and we have commissioned advisers to support us through this process over the coming months.

The bonds issued by the company's subsidiaries at 31 March 2018 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 2033*	60.0	2.699%	November 2033
Class A CPI linked bond 2042*	60.0	0.230% (real)	November 2042
Class A fixed rate bond 2022*	14.2	3.625%	September 2022
Total Class A	**909.2**		
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	**1,014.2**		

* Listed on the London Stock Exchange

The following chart shows the maturity profile of the bonds at 31 March 2018:



The credit ratings for our subsidiaries' bonds assigned by the rating agencies, Moody's and Standard & Poors, at 31 March 2018 were as follows:

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

Governance

Governance continued

Audit Committee report

PATRICK O'D BOURKE

AUDIT COMMITTEE MEMBERS

- Patrick O'D Bourke
- Chris Bolt
- Trevor Didcock
- Gareth Craig*
- Angela Roshier*
- Stephen Nelson*
- Jim Wilmott*

In addition to the members set out above, the CEO and CFO, Head of Audit, Risk and Compliance, and the external Auditor normally attend, by invitation, all meetings of the Committee. Other members of senior management are also invited to attend, as appropriate.

For more information on the responsibilities of the Audit Committee and the qualifications of the Chairman, refer to **page 63**. The biographies of the remaining current Committee members are presented on **pages 48 to 53**.

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.

* 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. They were replaced on the Audit Committee by Gareth Craig and Angela Roshier.

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. Some 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, and reports to the Board on how the Committee discharges its responsibilities in accordance with its terms of reference, available on the governance pages of our website: **stakeholder.affinitywater.co.uk/our-governance.aspx**.

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 2017/18 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.

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

The significant matters considered by the Committee in relation to the 2017/18 financial statements were consistent with those identified by the external Auditor in its report on **pages 100 to 106**. 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 Committee also met without management present, with both internal and external auditors during the year.

The table below highlights a summary of business considered since the beginning of 2017/18:

External Auditor	Recommended to the Board the re-appointment of PricewaterhouseCoopers LLP ('PwC') as external Auditor. Reviewed and agreed the scope of the audit work to be undertaken by PwC. Agreed the fees to be paid to PwC for its review of the September 2017 half-yearly report and its audit of the March 2018 financial statements, and fees for non-audit services above pre-approved limits. 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. Agreed the non-audit services provided to the company did not impact PwC's independence, including the work to be completed on the PR19 Business Plan in 2018/19.
Internal Audit	Agreed a programme of work for the Internal Audit function. Reviewed 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. Monitored and reviewed the effectiveness of the Internal Audit function.
Financial and Other Reporting	Reviewed the September 2017 half-yearly financial results and the March 2018 annual report and financial statements. Agreed to adopt the principles of the International Integrated Reporting Framework. Reviewed the March 2018 regulatory Annual Performance Report to ensure that the information meets Ofwat's reporting requirements. 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. Reviewed the viability statement and stress test scenarios.
General	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. Reviewed compliance certificates and investor reports required under the company's debt facilities. Received presentations across the year on: • tax matters, • the company's insurance programme and renewal, • 2018/19 tariffs and charging scheme, • non-financial regulatory reporting management plan and requirements for 2017/18, • Ofwat's company monitoring framework, • compliance work carried out by the Level Playing Field Committee, • the impact of HS2 on the company and the accounting treatment, • 2016/17 regulatory Annual Performance Report feedback and new requirements for 2017/18, • Whistleblowing and Bribery Act update, • directors' and officers' liability insurance, • the company's gender pay gap • the company's progress in relation to implementing GDPR • the company's viability statement, and • information security IT general controls. Evaluated the effectiveness of the Committee by means of a questionnaire covering the range of its responsibilities and procedures as well as the understanding of its members. Approved the non-audit fee policy.

Governance continued

Audit Committee report (continued)

SIGNIFICANT ISSUES CONSIDERED BY THE AUDIT COMMITTEE IN RELATION TO THE 2017/18 FINANCIAL STATEMENTS

The Committee considered the appropriateness of the company's accounting policies and any requirement to adopt new financial reporting standards applicable in the 2017/18 accounting period.

We discussed the critical accounting judgements and key sources of estimation for the relevant aspects of the financial statements and concluded based on the information available that the estimates, judgements and assumptions used were reasonable and that they had been used appropriately in applying the company's accounting policies. The company's viability statement, including information on the company's approach to preparing it, can be found on **pages 44 to 46**.

In relation to the company's existing accounting policies and the following principal areas of judgements and estimates, for all matters described below, the Committee concluded that the treatment adopted in the financial statements was appropriate:

Issue	How the issue was addressed by the Committee
Revenue recognition	The Committee reviewed during the year the methodology for the recognition of revenue, specifically the measured income accrual, and the impact of IFRS 15 and concluded that the approach and conclusions made were appropriate.
Policy for the provision of doubtful debt	The Committee reviewed the policy for providing for doubtful debts and it was concluded that the approach taken was appropriate.
Capitalisation policy	The Committee reviewed the processes and policies to distinguish between maintenance and enhancement costs and it was concluded that these would result in cost capitalisation in line with the company's policy and applicable accounting standards.
Defined benefit pension assumptions	The Committee reviewed the assumptions used in calculating the defined benefit pension surplus.
Adoption of the going concern basis in the financial statements	The Committee reviewed 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 12 months from the date of signing the financial statements.
Viability statement	The 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.

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.

Owen Mackney has been the senior statutory audit partner since 1 January 2017.

To fulfil the Audit Committee's responsibility regarding the independence and objectivity of PwC, the Committee 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 in the following areas:

- delivery of a technical accounting session for the company's finance team;
- assisting with management's valuation of the company's non-household retail business operations; and
- providing a legally privileged review of the company's gender pay gap reporting.

PwC was engaged to provide these services as it is recognised as having expertise in these areas.

PwC further provided agreed upon procedures in relation to the accuracy of the company's forecast water charges.

PwC has also been appointed to provide assurance on our PR19 Business Plan submission in September 2018.

PwC was engaged to provide agreed upon procedures as part of the company's regulatory compliance and annual reporting to Thames Water Utilities Limited and Anglian Water Services Limited. PwC was further engaged to provide letters of comfort in respect of the bond issue by Affinity Water Programme Finance Limited in November 2017. None of the procedures performed were advisory in nature.

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 are not involved in the statutory audit of the financial statements where the information is used for the purposes of the company's statutory financial statements.

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 2019.

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.

Governance continued

Audit Committee report (continued)

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
20 June 2018

Remuneration report

SUSAN HOOPER

REMUNERATION COMMITTEE MEMBERS

- Susan Hooper
- Chris Bolt
- Stephen Nelson*
- Jim Wilmott*
- Jaroslava Korpanec*
- Angela Roshier*
- Dr Philip Nolan*
- Tony Cocker*

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 2018/19 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.

During the year, we reviewed and approved a revised structure for the LTIP for 2018/19 with the objective of better incentivising the delivery of long term sustainable performance for customers and communities, employees and shareholders.

* 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. They were replaced on the Remuneration Committee by Jaroslava Korpanec and Angela Roshier.

Dr Philip Nolan resigned from the Remuneration Committee on 30 January 2018. He was replaced by Tony Cocker.

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 2018, and changes to the remuneration policy, as presented in last year's report, for 2017/18.

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 customers by incentivising financial efficiencies. We offer competitive salaries and link directors' annual bonuses and long-term incentive plan ('LTIP') payments 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 2017/18 to the commitments for AMP6 in our Business Plan. These are ambitious commitments made to both Ofwat and customers, and they reflect our desire to continue to improve on what we do.

We also have a 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 Herbert Smith Freehills LLP, both unconnected to the company, to provide advice on the future design of the LTIP for our executive directors and other senior managers, to perform a benchmarking exercise on employee salaries and to advise on compensation incentives for new directors.

See **page 152** for a signed statement from the Board confirming the transparency of our disclosures.

Governance continued

Remuneration report (continued)

INTRODUCTION

We have prepared this report in accordance with the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (the 'Regulations'), which are applicable to companies whose equity shares are listed. The Regulations are not applicable to the company. The 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 2017 AGM, the single available vote was cast in favour of the resolution to approve the remuneration policy report, which is subject to a binding vote every year. A resolution to approve the remuneration implementation report, which is subject to an annual advisory vote, was also approved at our 2017 AGM.

The Regulations require the external Auditor to report to the members of a quoted company 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 executives. The Committee met on six occasions during the year, and was chaired by Susan Hooper.

Membership of the Committee during the year is shown in the table below:

Director	Notes
Susan Hooper (Chair)	
Chris Bolt	
Dr Philip Nolan	Resigned 30 January 2018
Tony Cocker	Appointed 30 January 2018
Jaroslava Korpanec	Appointed 28 June 2017
Angela Roshier	Appointed 28 June 2017
Stephen Nelson	Resigned 19 May 2017
Jim Wilmott	Resigned 19 May 2017

Simon Cocks, Chief Executive Officer until 30 April 2018, Pauline Walsh, Chief Executive Officer from 1 May 2018, Duncan Bates, Chief Financial Officer until 31 July 2017, Stuart Ledger, Chief Financial Officer from 9 October 2017 and Debbie Ryan, 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.

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 resigned as director and Chairman on 30 January 2018. He received a fixed annual fee for his services which was reflective of the time commitment and responsibilities of the role.

He also benefited from a remuneration arrangement, which aligned his interests with the longer term interests of the previous 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 was aligned as closely as possible to the key features of a shareholding in a listed company.

We have departed from the Regulations in not providing full disclosure of the terms of the arrangements to protect commercial confidentiality but have disclosed the award made in respect of 2017/18 in the remuneration implementation report.

Tony Cocker was appointed as Chairman of the company on 30 January 2018 for an initial period of three years. Tony Cocker receives a fixed annual fee for his services, reflecting the time commitment and responsibilities of the role.

The other non-executive directors in office at 31 March 2018 fell into two groups.

Group A	Group B
Patrick O'D Bourke	Gareth Craig
Chris Bolt	Jaroslava Korpanec
Trevor Didcock	Angela Roshier
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. 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 appointment of the directors may be terminated by either the director or the company giving to the other three months' written notice.

The fee policy for the Group A directors in 2017/18 remained unchanged from that reported in the 2016/17 remuneration policy report and will apply during 2018/19, 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.

At each AGM any director appointed since the previous AGM, or any director appointed since the previous two AGMs without retiring or being re-elected, must retire and seek re-election.

Governance continued

Remuneration report (continued)

REMUNERATION POLICY REPORT (CONTINUED)

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 2017/18 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 Simon Cocks presented in the 2016/17 remuneration policy report remained unchanged during 2017/18. Duncan Bates was not eligible for the 2017/18 performance related bonus following his resignation in July 2017, other key elements of his remuneration remained unchanged for the period. The remuneration package for Stuart Ledger, appointed Chief Financial Officer during the year, and Pauline Walsh, appointed Chief Executive Officer in May 2018, are in line with the company remuneration policies previously reported.

Following the change in ownership of the business on 19 May 2017, a change of control clause in the LTIP scheme triggered and previously unvested LTIP awards for 2015/16, 2016//17 and 2017/18 vested fully. The remuneration paid to executive directors under the LTIP scheme are shown in the table on **page 90**.

During the year, the Committee reviewed and approved a revised structure for the LTIP for 2018/19 with the objective of better incentivising the delivery of long term sustainable performance for customers and communities, employees and shareholders. Key changes from the previous LTIP include:

- giving more weight to non-financial performance measures;
- a cap on the award payable (150% of salary (CEO) and 125% of salary (CFO));
- staged payment of vested awards with the final payment made at the end of the fifth year of each LTIP; and
- no automatic vesting of unvested awards in the event of change of control.

For the 2018/19 LTIP the performance conditions for 2018/19 and 2019/20 have been set and the performance conditions for 2020/21 will be set on agreement of AMP7 performance commitments.

During the year the arrangements for the 2017/18 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 2018/19
LTIP				
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. Base awards include clawback and malus provisions, as detailed below. Awards vested in full on a change of control.	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. The change of control provision applied following completion of sale of the business on 19 May 2017. The Remuneration Committee was required to determine the extent to which performance measures would be satisfied over the remaining portion of 2017/18 to 2019/20.	Performance measures for 2018/19 and 2019/20 have been set and the performance conditions for 2020/21 will be set on agreement of performance commitments in the AMP7 Business Plan.

Other elements of executive directors remuneration are included in the table below:

Purpose and link to strategy	Policy and approach	Maximum potential value (as percentage of base pay)	Performance metrics	Changes for 2018/19
Base salary				
To provide competitive fixed remuneration that will attract and retain key employees and reflect their experience and position in the company.	To target around market median, dependent on experience in the role	N/A	N/A	No changes were made to the policy for 2018/19 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 2018/19 up to the date of approval of this annual report and financial statements.

Governance

Governance continued

Remuneration report (continued)

REMUNERATION POLICY REPORT (CONTINUED)

Remuneration policy for executive directors (continued)

Purpose and link to strategy	Policy and approach	Maximum potential value (as percentage of base pay)	Performance metrics	Changes for 2018/19
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. 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 Stuart Ledger and up to 100% of base salary for both Simon Cocks and Pauline Walsh. Simon Cocks will be eligible for the annual bonus in 2017/18 only following his resignation as executive director on 21 May 2018.	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. 25% of the total bonus is determined on the achievement of operational and customer and community performance targets. 25% of the total bonus is determined on the achievement of personal objectives.	No changes were made to the nature of the policy for 2018/19 up to the date of approval of this annual report and financial statements. Internal performance measures based on financial, operational and personal objectives have been agreed in principle by the Remuneration Committee.
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. No current executives joined prior to this date. Under the defined contribution scheme, the executive contributes at a rate of 7% of salary and the company contributes at 20%.	In lieu of being a member of the company's retirement benefit schemes, Duncan Bates received a taxable allowance of approximately 26% of base pay to 31 July 2017. 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 2018/19 up to the date of approval of this annual report and financial statements.
Compensation for the forfeit of variable remuneration from previous employer				
To provide compensation of forfeited remuneration from previous employers	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.	N/A	N/A	No changes were made to the policy for 2018/19 up to the date of approval of this annual report and financial statements.

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 (resigned as executive director 21 May 2018) Pauline Walsh (appointed 1 May 2018)	Chief Financial Officer Duncan Bates (resigned 31 July 2017) Stuart Ledger (appointed 9 October 2017)
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 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, 2016/17 and 2017/18 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 results in significant losses to the company, material failure of related management or business units, material misstatement in the audited financial statements, and reputational damage.

Duncan Bates resigned as Chief Financial Officer of Affinity Water Limited on 31 July 2017. Duncan Bates remained as an executive director of other group entities and received a fixed fee for this role. These fees are detailed in the individual financial statements of the other group entities and are paid by Affinity Water Limited. There are no other arrangements in place for the remuneration of directors by any holding company or other company in the group.

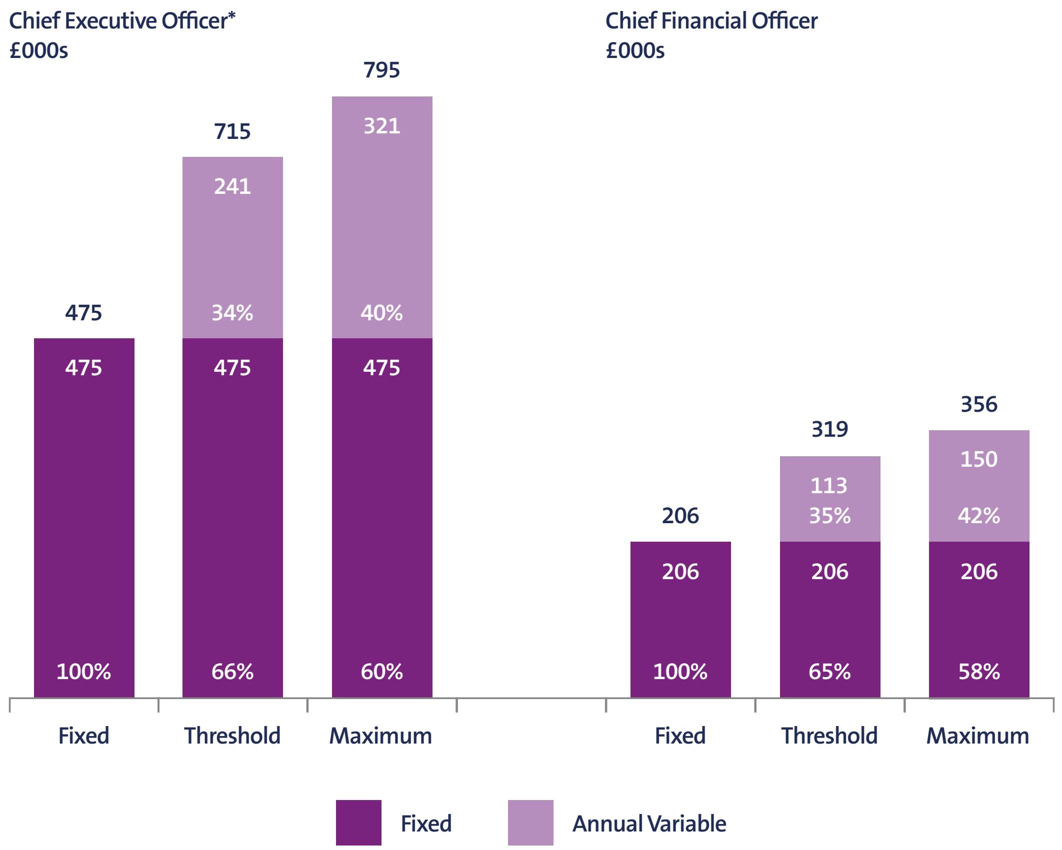
Governance continued

Remuneration report (continued)

REMUNERATION POLICY REPORT (CONTINUED)

Payouts under different scenarios

The following charts show the potential remuneration in respect of 2018/19 under the proposed arrangements for the Chief Executive Officer and Chief Financial Officer under different scenarios.



* Pauline Walsh will receive compensation for the forfeit of variable remuneration arrangements with her previous employer. This is excluded from the figures in the remuneration chart above.

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	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	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)

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	2017/18*	2016/17*
Our people	Wages, salaries and pensions	**18p**	17p
Our assets	Investment in our assets	**31p**	39p
Our shareholders	Dividends and interest on shareholder debt	**11p**	9p

* Figures are based on our regulatory financial statements for 2017/18 and 2016/17 and have been rounded.

Further details of where each pound of our customers' bills is spent are presented on **page 31**.

Governance continued

Remuneration report (continued)

REMUNERATION IMPLEMENTATION REPORT

Directors' remuneration 2017/18 (audited)

The following table shows directors' remuneration in respect of 2017/18.

	Base salary/ fees £000		Taxable benefits[1] £000		Pension related benefits[2] £000		Annual bonus £000		LTIP[3] £000		Other[4] £000		Total £000	
	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17
Non-executive														
Patrick O'D Bourke	**48**	47	**–**	–	**–**	–	**–**	–	**–**	–	**–**	–	**48**	47
Chris Bolt	**43**	42	**–**	–	**–**	–	**–**	–	**–**	–	**–**	–	**43**	42
Trevor Didcock	**43**	42	**–**	–	**–**	–	**–**	–	**–**	–	**–**	–	**43**	42
Susan Hooper	**46**	45	**–**	–	**–**	–	**–**	–	**–**	–	**–**	–	**46**	45
Chairman														
Current														
Tony Cocker	**42**	–	**–**	–	**–**	–	**–**	–	**–**	–	**–**	–	**42**	–
Former														
Dr Philip Nolan	**183**	220	**–**	–	**–**	–	**–**	–	**–**	–	**860**	178	**1,043**	398
Executive														
Current														
Stuart Ledger	**96**	–	**3**	–	**10**	–	**57**	–	–	–	**41**	–	**207**	–
Former														
Duncan Bates	**57**	171	**4**	12	**15**	44	**–**	115	**434**	276	**500**	**–**	**1,010**	618
Simon Cocks	**350**	335	**14**	14	**80**	80	**268**	300	**1,228**	–	**1,000**	**388**	**2,940**	1,117
	908	902	**21**	26	**105**	124	**325**	415	**1,662**	276	**2,401**	566	**5,422**	2,309

Neither the company nor its immediate parent entities have any listed shares and so the directors have not been offered any share incentives. The directors appointed by Allianz Capital Partners on behalf of the Allianz Group, DIF and HICL Infrastructure Company Limited and 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 operational, customer and financial performance, and the level of bonus awarded, although award and payment remain discretionary. The table on the next page shows transparently the percentage of maximum annual bonus potential awarded in relation to the 2017/18 year for Stuart Ledger and Simon Cocks for each of the performance measures. No amounts in relation to these bonuses have been deferred.

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

[2] Pension related benefits for Simon Cocks include an allowance of £80,000 in lieu of being a member of the company's retirement benefit schemes (2017: £80,000). The same pension related benefits for Duncan Bates include an allowance of £15,000 (2017: £44,000). Pension related benefits for Stuart Ledger comprise £10,000 of contributions paid to money purchase schemes; there were no amounts outstanding at year end.

[3] 2017/18 LTIP remuneration includes the 2014/15 LTIP amount paid which vested fully on 31 March 2017, and the 2015/16, 2016/17 and 2017/18 LTIP amounts paid which vested fully following the sale of the group on 19 May 2017.

[4] Other remuneration in 2017/18 for Dr Philip Nolan consists of remuneration received in relation to the arrangement described on **page 81** of the remuneration policy report. Other remuneration in 2017/18 for both Simon Cocks and Duncan Bates consists of remuneration received in relation to the successful completion of the sale of the group on 19 May 2017, funded by former shareholders. Other remuneration for Stuart Ledger in 2017/18 and Simon Cocks in 2016/17 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 their previous employers.

Performance measure		Link to strategy (refer to page 15)	2017/18 target	Weighting for 2017/18 (as a % of base salary)		2017/18 achievement (as a % of base salary)	
				Simon Cocks	Stuart Ledger	Simon Cocks	Stuart Ledger
Financial measure	Cash generated by operations (annual target): net cash outflow before taxation and financing[1]	Value creation imperative	£82.6m	50.00%	37.50%	37.40%	28.05%
Operational measures	Leakage (annual target): volume of water lost through leaks on the network (ML/d)	Customer outcome	173.1	3.57%	2.68%	3.02%	2.27%
	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%	3.02%	2.27%
	Water quality (quarterly targets): number of water quality compliance failures	Customer outcome	Q1: 7 Q2: 8 Q3: 10 Q4: 7	3.57%	2.68%	0.00%	0.00%
	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 per quarter	3.57%	2.68%	0.76%	0.57%
	Water Saving Programme (quarterly targets): number of meters installed	Customer outcome	16,500 per quarter	3.57%	2.68%	2.27%	1.70%
Customer and community measures	SIM[2] (annual target): our lowest score in the qualitative element of SIM	Customer outcome	80	3.57%	2.68%	3.02%	2.27%
	Cash collections (annual target): the amount of cash collected through billing in respect of water revenue	Customer outcome	£229.0m	3.57%	2.68%	3.02%	2.27%
Personal performance[3]				25.00%	18.75%	23.00%	17.81%
Total % of base salary				**100.00%**	**75.00%**	**75.51%**	**57.21%**
Base salary						**£355,000**	**£100,000[4]**
Bonus paid						**£268,00**	**£57,000**

[1] This "non-GAAP" measure is calculated as the total of the following line items per the statement of cash flows (refer to **page 111**): cash generated from operations; purchases of property, plant and equipment; capital contributions; proceeds on disposal of property, plant and equipment; and purchase of intangibles.

[2] 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).

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

[4] Stuart Ledger's annual bonus was calculated as a percentage of six months of his base salary.

Governance continued

Remuneration report (continued)

REMUNERATION IMPLEMENTATION REPORT (CONTINUED)

Director's remuneration relating to the change of control

Following the change in ownership of the business on 19 May 2017 previously unvested LTIP totals for 2015/16, 2016/17 and 2017/18 became vested in full in accordance with the rules of the scheme and were paid in the year. The table below shows the additional LTIP and other remuneration paid to directors as a result of the change in ownership.

	LTIP £000	Other £000	Total £000
Simon Cocks	1,228	1,000	2,228
Duncan Bates	159	500	659
Dr Philip Nolan	–	832	832
Total	**1,387**	**2,332**	**3,719**

Amounts paid to Simon Cocks and Duncan Bates included in other remuneration in the table above were paid by the exiting shareholders from the proceeds of the sale and were not funded by customers.

2014/15, 2015/16, 2016/17 and 2017/18 LTIP

Duncan Bates received base awards under the 2014/15 LTIP scheme, which related to the three year performance period that ended on 31 March 2017. The 2015/16, 2016/17 and 2017/18 LTIP schemes were due to vest in the years to 31 March 2018, 31 March 2019 and 31 March 2020 respectively however these vested fully in the year to 31 March 2018 following the sale of the group on 19 May 2017 in accordance with the provisions of the scheme's rules relating to change of control clause.

During the year, the Committee reviewed and approved a revised structure for the LTIP for 2018/19 with the objective of better incentivising the delivery of long term sustainable performance for customers and communities, employees and shareholders. Key changes from the previous LTIP include:

- giving more weight to non-financial performance measures;
- a cap on the award payable (150% of salary (CEO) and 125% of salary (CFO));
- staged payment of vested awards with the final payment made at the end of the fifth year; and
- no automatic vesting of unvested awards in the event of change of control.

For the 2018/19 LTIP the performance conditions for 2018/19 and 2019/20 have been set and the performance conditions for 2020/21 will be set on agreement of AMP7 performance commitments.

Percentage change in remuneration of CEO

Excluding LTIP payments and remuneration received representing compensation for the forfeit of a variable remuneration arrangement with previous employers, the salary increase of the CEO compared to other company employees is detailed in the table below.

	Base salary increase from 2016/17
Chief Executive Officer	4.5%
General employee population	1.2%

In line with the remuneration policy, the base salary of directors is targeted at market median, depending on experience in the role. Following the remuneration benchmarking exercise in the year, it was determined that the salary of the Chief Executive Officer was below the market median salary for the role. The Remuneration Committee agreed to increase the base salary of the Chief Executive Officer to bring it closer to the market median.

Salaries for the general employee population in 2017/18 were in the third year of a three year fixed deal, negotiated with GMB and Unison, where employees benefit from annual increases to their salary in line with the previous November Consumer Price Index.

Statutory requirements

This remuneration report has been prepared on behalf of the Board by the Remuneration Committee. The report was approved by the Board on 20 June 2018 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 2018.

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 Daiwater Investment Limited was the ultimate holding and controlling company in the United Kingdom at 31 March 2018. Details of the ownership of the company and the group structure are set out on **pages 68 to 69** of the governance section and note 24 of the financial statements. The address of the principal place of business is Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

The strategic report on **pages 66 to 46** 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 2018. Details of the risks and principal uncertainties facing the company are set out on **pages 36 to 44**.

DIRECTORS

The directors of the company, together with their periods of office and their biographical details, are shown on **pages 48 to 53**.

SIGNIFICANT EVENTS DURING THE YEAR

Details of the significant events that occurred during the year are set out in the Chief Executive Officer's introduction on **page 8**.

RESULTS AND FINANCIAL PERFORMANCE

Profit for the year was £29.6m (2017: £30.9m).

The statement of financial position detailed on **page 109** shows total equity amounting to £211.9m (2017: £216.7m).

Further analysis of our financial performance can be found in the Chief Financial Officer's review on **page 11** of the strategic report.

INFORMATION REQUIRED UNDER THE LISTING RULES

During the year no interest was capitalised by the company (2017: £nil).

For disclosures in relation to relevant requirements of the Listing Rules refer to the remuneration report on **pages 79 to 91**.

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

GHG emission source	2017/18 Gross[2] (tCO_2e)	2017/18 Intensity[3] ($kgCO_2e/Ml$)	2016/17 Gross (tCO_2e)	2016/17 Intensity ($kgCO_2e/Ml$)
Scope 1	**6,204**	**18.7**	**6,141**	**18.8**
Fuel combustion	1,501	4.5	1,722	5.3
Process and fugitive emissions	2,524	7.6	2,322	7.1
Vehicle fleet	2,179	6.6	2,097	6.4
Scope 2	**75,580**	**228.4**	**89,927**	**275.2**
Purchased electricity	75,580	228.4	89,927	275.2
Statutory total (scope 1 & 2)[4]	**81,784**	**247.1**	**96,068**	**294.0**
Scope 3	**7,325**	**22.2**	**8,538**	**26.1**
Business travel in other vehicles	32	0.1	40	0.1
Outsourced IT activities	226	0.7	364	1.1
Electricity- transmission and distribution	7,067	21.4	8,134	24.9
Total gross emissions	**89,109**	**269.3**	**104,606**	**320.1**

Our total gross GHG emissions decreased by over 10% this year, as the emissions associated with our purchased electricity (accounting for over 80% of our total) benefited from more renewable generation. There was a small increase in the gross GHG emissions associated with our fleet and associated outsourced business travel but this is offset by the larger reduction in the purchased electricity emissions. We continue to support the deployment of renewable energy by flexing our electrical demand at times of supply stress and through our participation in the National Grid's Power Responsive Programme. We are also continuing the migration of our outsourced IT services to the cloud, which has resulted in a reduction in our emissions for four years in a row.

Our electricity usage (kWh) and intensity (kWh/ML) both reduced despite increased supply demand and the water levels lowering in our underground aquifers.

[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 ('tCO2e').

[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 CO2e per megalitre ('kgCO2e/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 2018:

	£m
Paid: First interim of 2.45p per share in April 2017	6.5
Paid: Second interim of 8.30p per share in September 2017	22.0
Paid: Third interim of 6.79p per share in December 2017	18.0
Paid: Fourth interim of 4.53p per share in March 2018	12.0
	58.5

This compares to interim dividends of £50.5m declared and paid in the year ended 31 March 2017.

No final dividend is proposed (2017: £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 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. The company is also a member of other water industry research and innovation groups: TAG, Sensor for Water Interest Group, WRAS and Cranfield Water Network. In addition, the company carried out more specific research in the fields of pump efficiency, cost modelling, risk of discolouration, leakage detection and contaminant removal during the year.

POLITICAL CONTRIBUTIONS

No political contributions were made during the year (2017: £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 14 on **page 43** 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 14**.

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 48 to 67** 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

There were no significant events that took place after the reporting period.

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 IN RESPECT OF THE FINANCIAL STATEMENTS

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulation.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards, comprising FRS 101 "Reduced Disclosure Framework", and applicable law). Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing the financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- state whether applicable United Kingdom Accounting Standards, comprising FRS 101, have been followed, subject to any material departures disclosed and explained in the financial statements;
- make judgements and accounting estimates that are reasonable and prudent; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006.

The directors 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.

In the case of each director in office at the date the Directors' Report is approved:

- so far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and
- they have taken all the steps that they ought to have taken as a director in order to make themselves aware of any relevant audit information and to establish that the company's auditors are 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
20 June 2018

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

Back Row
Trevor Didcock, Jaroslava Korpanec, Chris Bolt, Patrick O'D Bourke, Susan Hooper, Gareth Craig, Angela Roshier, Simon Cocks

Front Row
Stuart Ledger, Tony Cocker, Pauline Walsh, Tim Monod

Governance

Statutory financial statements

for the year ended 31 March 2018

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Affinity Water Limited
(Registered Number 02546950)

Pond dipping at our Environment & Education Centre

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Independent auditors' report to the member of Affinity Water Limited

Report on the audit of the financial statements

Opinion

In our opinion, Affinity Water Limited's financial statements:

- give a true and fair view of the state of the company's affairs as at 31 March 2018 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 (United Kingdom Accounting Standards, comprising FRS 101 "Reduced Disclosure Framework", and applicable law); and
- have been prepared in accordance with the requirements of the Companies Act 2006.

We have audited the financial statements included within the Annual Report and Financial Statements (the "Annual Report"), which comprise: the statement of financial position as at 31 March 2018; the income statement and statement of comprehensive income, the statement of cash flows, the statement of changes in equity for the year then ended; and the notes to the financial statements, which include a description of the significant accounting policies.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

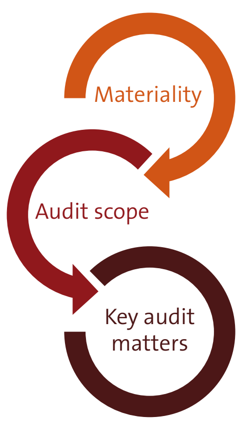
We remained independent of the company in accordance with the ethical requirements that are relevant to our audit of the financial statements in the UK, which includes the FRC's Ethical Standard, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

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: £3.4 million (2017: £3.3 million), based on 2.5% of earnings before interest, tax, depreciation and amortisation ('EBITDA').
- The company has one finance function and operates a single general ledger system. The audit was carried out by one team at the UK headquarters in Hatfield, Hertfordshire.
- Accuracy of the measured income accrual.
- Adequacy of the bad debt provision.
- Assessment of cost capitalisation.
- Assessment of pension assumptions applied in the valuation of the pension scheme.

The scope of our audit

As part of designing our audit, we determined materiality and assessed 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.

Key audit matters

Key audit matters are those matters that, in the auditors' professional judgement, were of most significance in the audit of the financial statements of the current period and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by the auditors, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. These matters, and any comments we make on the results of our procedures thereon, were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. This is not a complete list of all risks identified by our audit.

Key audit matter	*How our audit addressed the key audit matter*
Measured income accrual Refer to **page 74** (Audit Committee Report), **page 112** (accounting policies) and **page 124** (note 12). The directors have recorded a measured income accrual of £29.0 million (2017: £40.4 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. 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. 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. 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 the Retail Price Index ('RPI') inflation representing the standard tariff increase. 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 differed by 4.5% (£1.3m) to the actual readings taken post year end. We have reviewed the customer amounts accrued at 31 March 2018 which have subsequently been billed and noted immaterial differences. At the time of our testing, the total amounts billed represent 22% of the year-end accrual. We have extrapolated this across the remaining accrual and noted no material difference. We have assessed the year on year movement in the measured income accrual and agreed the material movements to the disposal of the company's non-household retail business to Affinity for Business (Retail) Limited.

Statutory Financial Statements continued

Independent auditors' report to the member of Affinity Water Limited (continued)

Key audit matter	How our audit addressed the key audit matter
Provision for impairment of trade debt receivables Refer to **page 74** (Audit Committee Report) and **page 112** (accounting policies). The company estimates the recoverable value of its trade receivables and records a provision for impairment based on experience. The provision is calculated by applying a percentage based on historical cash collection rates to individual aged debt categories. 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 debts not being collected. 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 measurement basis (measured v unmeasured) and ageing of debt. To ensure the appropriate classification of customers into ageing categories we selected a sample of debtors and ensured this had been correctly treated based on ageing, customer type and measurement basis. 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 2018 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 is consistent year on year for household customers. We consider the level of provisioning to be materially accurate, based on historical cash collection rates and current ageing of the debt.
Cost capitalisation Refer to **page 74** (Audit Committee Report), **page 112** (accounting policies) and **page 121** (note 7). 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. 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 and the allocation of overheads. Given the magnitude of capital spend at £118.9m there is a risk that incorrect classification could give rise to material misstatement.	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. 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. In addition, we evaluated the nature of overheads capitalised and found these materially relate directly to the asset construction operations of the business and therefore are appropriately capitalised.

Key audit matter	How our audit addressed the key audit matter
Assumptions relating to retirement benefit surplus Refer to **page 74** (Audit Committee Report), **page 112** (accounting policies), **page 123** (note 10) and **pages 144 to 147** (note A5). The company has a defined benefit pension plan and has recognised a net retirement benefit surplus of £105.6m (2017: £73.0m). The plan liabilities decreased from £434.0m to £406.4m mainly as a result of an increase in discount rates. In addition, the plan assets increased from £507.0m to £511.9m. The valuation of the plan liabilities 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. 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. 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. We agreed the salaries increase to be within our expected range based on the Consumer Price Index ('CPI') and 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 structure of the company, the accounting processes and controls, and the industry in which it operates.

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 in aggregate 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	£3.4 million (2017: £3.3 million).
How we determined it	2.5% of 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. 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 (2017: £0.2 million) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Statutory Financial Statements continued

Independent auditors' report to the member of Affinity Water Limited (continued)

Going concern

In accordance with ISAs (UK) we report as follows:

Reporting obligation	*Outcome*
We are required to report if we have anything material to add or draw attention to in respect of the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements and the directors' identification of any material uncertainties to the company's ability to continue as a going concern over a period of at least twelve months from the date of approval of the financial statements.	We have nothing material to add or to draw attention to. However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the company's ability to continue as a going concern.

Reporting on other information

The other information comprises all of the information in the Annual Report other than the financial statements and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except to the extent otherwise explicitly stated in this report, any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the financial statements or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

With respect to the Strategic Report, Directors' Report and Corporate Governance Statement, we also considered whether the disclosures required by the UK Companies Act 2006 have been included.

Based on the responsibilities described above and our work undertaken in the course of the audit, the Companies Act 2006 (CA06) and ISAs (UK) require us also to report certain opinions and matters as described below (required by ISAs (UK) unless otherwise stated).

Strategic Report and Directors' Report

In our opinion, based on the work undertaken in the course of the audit, the information given in the Strategic Report and Directors' Report for the year ended 31 March 2018 is consistent with the financial statements and has been prepared in accordance with applicable legal requirements. (CA06)

In light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we did not identify any material misstatements in the Strategic Report and Directors' Report. (CA06)

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 UK Corporate Governance Code (the "Code"), we are required to report to you if we have anything material to add or draw attention to regarding:

- The directors' confirmation on **page 61** of the Annual Report 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.
- The disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.
- The directors' explanation on **pages 44 to 46** of the Annual Report 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 to report in respect of this responsibility.

Other Code Provisions

As a result of the directors' voluntary reporting on how they have applied the Code, we are required to report to you if, in our opinion:

- The statement given by the directors, on **page 61**, that they consider the Annual Report taken as a whole to be fair, balanced and understandable, and provides the information necessary for the members to assess the company's position and performance, business model and strategy is materially inconsistent with our knowledge of the company obtained in the course of performing our audit.
- The section of the Annual Report on **page 74** describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.

We have nothing to report in respect of this responsibility.

Statutory Financial Statements continued

Independent auditors' report to the member of Affinity Water Limited (continued)

Responsibilities for the financial statements and the audit

Responsibilities of the directors for the financial statements

As explained more fully in the Statement of Directors' Responsibilities set out on **page 96**, the directors are responsible for the preparation of the financial statements in accordance with the applicable framework and for being satisfied that they give a true and fair view. The directors are also responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located on the FRC's website at: **www.frc.org.uk/auditorsresponsibilities**. This description forms part of our auditors' report.

Use of this report

This report, including the opinions, has been prepared for and only for the company's members as a body 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.

Other required reporting

Companies Act 2006 exception reporting

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 by the company, or returns adequate for our audit have not been received from branches not visited by us; or
- certain disclosures of directors' remuneration specified by law are not made; or
- the financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Owen Mackney (Senior Statutory Auditor)

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

Uxbridge

21 June 2018

Income statement for the year ended 31 March 2018

(Registered Number 02546950)

	Note	2018 £000	2017 £000
Revenue	1	**306,302**	308,662
Cost of sales		**(200,417)**	(193,638)
Gross profit		**105,885**	115,024
Administrative expenses		**(50,996)**	(54,368)
Other income		**17,379**	17,133
Operating profit	2	**72,268**	77,789
Profit on disposal of non-household retail business	3	**10,958**	–
Finance income	5	**2,208**	3,050
Finance costs	5	**(49,496)**	(54,073)
Finance costs – net		**(47,288)**	(51,023)
Profit before tax		**35,938**	26,766
Tax (expense)/credit	6	**(6,303)**	4,135
Profit for the year		**29,635**	30,901

All profits of the company in the current period and prior period are from continuing operations[1]. The notes on **pages 112 to 149** are an integral part of these financial statements.

[1] The profit of the prior period includes results for the non-household retail business which was transferred to Affinity for Business (Retail) Limited, a fellow group company, effective 1 April 2017. As disclosed in the accounting policies for the year ended 31 March 2017, these operations were not presented as discontinued as they were not considered to represent a material and separate major line of the company's business. Profit for the current period includes the gain on disposal of the non-household retail business to Affinity for Business (Retail) Limited.

Statutory Financial Statements continued

Statement of comprehensive income for the year ended 31 March 2018
(Registered Number 02546950)

	Note	2018 £000	2017 £000
Profit for the year		**29,635**	30,901
Other comprehensive income/(expense) for the year which will not be reclassified to profit or loss:			
Remeasurements of post-employment benefit assets	10	**28,990**	(3,780)
Deferred tax on items that will not be reclassified	6	**(4,928)**	643
Other comprehensive income/(expense) for the year, net of tax		**24,062**	(3,137)
Total comprehensive income for the year		**53,697**	27,764

The notes on **pages 112 to 149** are an integral part of these financial statements.

Statement of financial position as at 31 March 2018
(Registered Number 02546950)

	Note	2018 £000	2017 £000
Assets			
Non-current assets			
Property, plant and equipment	7	**1,375,366**	1,320,792
Intangible assets	8	**51,356**	51,689
Investments	9	**60**	60
Retirement benefit surplus	10	**105,558**	72,997
		1,532,340	1,445,538
Current assets			
Inventories	11	**1,631**	1,430
Trade and other receivables	12	**65,066**	89,682
Cash and cash equivalents	13	**114,842**	45,129
		181,539	136,241
Total assets		**1,713,879**	1,581,779
Equity and liabilities			
Equity			
Ordinary shares	14	**26,506**	26,506
Share premium	14	**1,400**	1,400
Capital contribution reserve	14	**30,150**	30,150
Retained earnings		**153,860**	158,661
Total equity		**211,916**	216,717
Liabilities			
Non-current liabilities			
Trade and other payables	15	**99,291**	94,190
Borrowings	16	**1,072,543**	941,428
Deferred tax liabilities	17	**181,266**	172,736
Provisions for other liabilities and charges	18	**3,232**	2,462
		1,356,332	1,210,816
Current liabilities			
Trade and other payables	15	**145,347**	146,010
Current tax liabilities		**284**	8,236
		145,631	154,246
Total liabilities		**1,501,963**	1,365,062
Total equity and liabilities		**1,713,879**	1,581,779

The notes on **pages 112 to 149** are an integral part of these financial statements. The statutory financial statements on **pages 107 to 149** were approved by the Board of Directors and were signed and authorised for issue on 20 June 2018 on its behalf by:

Pauline Walsh **Stuart Ledger**

Statutory Financial Statements

Statutory Financial Statements continued

Statement of changes in equity for the year ended 31 March 2018

(Registered Number 02546950)

	Note	Share capital £000	Share premium £000	Capital contribution reserve £000	Retained earnings £000	Total equity £000
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	19	–	–	–	(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
Balance as at 1 April 2017		**26,506**	**1,400**	**30,150**	**158,661**	**216,717**
Profit for the year		**–**	**–**	**–**	**29,635**	**29,635**
Other comprehensive income		**–**	**–**	**–**	**24,062**	**24,062**
Total comprehensive income		**–**	**–**	**–**	**53,697**	**53,697**
Dividends	**19**	**–**	**–**	**–**	**(58,498)**	**(58,498)**
Total transactions with owners recognised directly in equity		**–**	**–**	**–**	**(58,498)**	**(58,498)**
Balance as at 31 March 2018		**26,506**	**1,400**	**30,150**	**153,860**	**211,916**

The notes on **pages 112 to 149** are an integral part of these financial statements.

Statement of cash flows for the year ended 31 March 2018

(Registered Number 02546950)

	Note	2018 £000	2017 £000
Cash flows from operating activities			
Cash generated from operations	20.1	**137,689**	140,076
Interest paid		**(36,772)**	(45,484)
Tax paid		**(8,652)**	(915)
Group relief paid		**(2,000)**	–
Net cash generated from operating activities		**90,265**	93,677
Cash flows from investing activities			
Purchases of property, plant and equipment		**(114,529)**	(118,000)
Capital contributions		**14,337**	8,918
Proceeds from sale of property, plant and equipment		**558**	65
Proceeds on disposal of non-household business	3	**27,000**	–
Purchases of intangible assets		**(8,757)**	(13,700)
Interest received		**254**	309
Net cash used in investing activities		**(81,137)**	(122,408)
Cash flows from financing activities			
Proceeds from loan from subsidiary undertaking	20.2	**119,083**	30,916
Equity dividends	19	**(58,498)**	(50,500)
Net cash generated from/(used in) financing activities		**60,585**	(19,584)
Net increase/(decrease) in cash and cash equivalents		**69,713**	(48,315)
Cash and cash equivalents at beginning of year		**45,129**	93,444
Cash and cash equivalents at end of year	13	**114,842**	45,129

The notes on **pages 112 to 149** 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 44 to 46**, 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 2018, 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 standard is not deemed to have a material impact on the company's revenue streams detailed in note 1 of these financial statements or grants and contributions received in respect of property, plant and equipment.
- 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. Management have concluded that IFRS 16 will have a material impact on the recognition, measurement, presentation and disclosure of the company's lease arrangements in its financial statements with effect from 1 April 2019. The most significant impact has been assessed as the recognition of a right-of-use asset and lease liability for the company's land and buildings lease detailed in note 21.2 of these financial statements. Following adoption of IFRS 16 the operating expense related to this lease will be replaced in the income statement by interest and depreciation charges.
- 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 have concluded that given the nature of the company's financing arrangements, the procedure currently in place to assess the impairment of financial instruments using historical data is deemed sufficient under the expected credit loss model; historical recoverability of trade receivables has shown to be a good indicator of future expected losses. Therefore, the new standard will not have a material impact on the financial statements.

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':
  - 16 (statement of compliance with all IFRS);
  - 38B-D (additional comparative information); and
- 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

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 on the following page.

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 on the following page.

Statutory Financial Statements continued

Accounting policies (continued)

CRITICAL ACCOUNTING ESTIMATES (CONTINUED)

Measured income accrual

The company records an accrual for measured consumption of water that has not yet been billed (refer to note 12). 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 12). 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; therefore no adjustment has been made to the retirement benefit surplus recognised in accordance with International Financial Reporting Interpretations Committee 14: 'The limit on a defined benefit asset, minimum funding requirements and their interaction'.

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 7 for the carrying amount of property, plant and equipment and note A3 for the useful economic lives for each class of assets.

CRITICAL JUDGEMENTS 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 7 for the carrying amount of property, plant and equipment.

Notes to the financial statements

1. REVENUE

	2018 £000	2017 £000
Unmeasured supplies	**125,138**	128,810
Measured supplies	**173,299**	171,627
Connection charges	**7,687**	7,542
Chargeable services	**178**	683
	306,302	308,662

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:

	2018 £000	2017 £000
Staff costs (note 4.1)	**63,042**	60,191
Profit on disposal of property, plant and equipment	**(558)**	(65)
Loss on disposal of infrastructure assets	**1,928**	3,073
Abandonment of fixed assets	**803**	–
Purchase of bulk water and water supplied under statutory entitlement	**7,586**	6,727
Water abstraction charges	**3,981**	4,157
Business rates	**16,178**	16,576
Chargeable services direct expenditure	**134**	222
Depreciation of infrastructure assets (note 7)	**11,226**	10,972
Depreciation of other property, plant and equipment (note 7)	**41,451**	39,751
Amortisation of intangible assets (note 8)	**9,276**	5,971
Amortisation of deferred grants and contributions	**(1,667)**	(1,480)
Impairment of trade receivables (note 12)	**8,884**	9,547
Research and development	**193**	177
Operating lease rentals – land and buildings	**1,547**	1,547
Operating lease rentals – other	**2,478**	2,155
Auditor's remuneration (note 2.3)	**400**	315
Cost of inventories used	**1,511**	1,226

2.2 Other income

	2018 £000	2017 £000
Commission and rentals	**17,379**	17,133

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 22).

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:

	2018 £000	2017 £000
Fees payable to the company's auditor and its associates for the audit of the financial statements	**137**	133
Fees payable to the company's auditor and its associates for other services:		
Audit of the company's associates	**101**	70
Audit-related assurance services		
– regulatory reporting	**55**	49
– Thames Water and Anglian Water annual returns	**9**	8
– audit related assurance service - other	**33**	22
Tax advisory services	**–**	8
Other assurance services including services related to bond issue	**61**	15
All other non-audit services	**4**	10
Total auditor's remuneration	**400**	315

3. PROFIT ON DISPOSAL OF NON-HOUSEHOLD RETAIL BUSINESS

Affinity Water Limited used the Exit Regulations laid out by the Department for the Environment, Food and Rural Affairs ('Defra') to transfer its existing non-household retail base to Affinity for Business (Retail) Limited, a member of the wider Affinity Water group, on 1 April 2017. The company received £27,000,000 in consideration for the non-household debt book and associated customer base, and recognised a £10,958,000 gain on disposal. No other assets were transferred as part of the sale.

4. EMPLOYEES

4.1 Employee benefit expense (including executive directors)

	2018 £000	2017 £000
Wages and salaries	**60,120**	57,336
Social security costs	**5,797**	5,213
Defined benefit pension costs (note 10)	**4,713**	3,853
Defined contribution pension costs (note A5)	**2,276**	1,712
Other pension administration costs	**1,213**	1,281
Staff costs	**74,119**	69,395
Staff costs capitalised	**(11,077)**	(9,204)
Staff costs recognised in the income statement	**63,042**	60,191

4.2 Average number of people employed

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

By activity	2018 Number	2017 Number
Operations	**816**	707
Customer service	**290**	310
Administration	**251**	225
	1,357	1,242

4.3 Directors' remuneration

The Directors' emoluments were as follows:

	2018 £000	2017 £000
Aggregate emoluments	**3,751**	2,032

Aggregate amounts receivable under long-term incentive schemes were £1,662,000 (2017: £276,000), not included within aggregate emoluments above.

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 up until the sale on 19 May 2017, and by Allianz Capital Partners, HICL Infrastructure Company Limited and DIF from that date, 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:

	2018 £000	2017 £000
Aggregate emoluments	**1,712**	1,117

Amounts receivable by the highest paid director under long-term incentive schemes were £1,228,000 (2017: £nil), not included within aggregate emoluments above.

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 79 to 91**.

Statutory Financial Statements continued

Notes to the financial statements (continued)

5. FINANCE INCOME AND COSTS

	2018 £000	2017 £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	**(35,962)**	(35,899)
Accretion payable in respect of borrowings held at amortised cost with subsidiary undertaking	**(12,807)**	(8,029)
Interest payable on borrowings held at amortised cost	**(48,929)**	(44,088)
Other interest expense	**(567)**	(534)
Transaction costs expensed on extinguishment of bond	**–**	(9,451)
Finance costs	**(49,496)**	(54, 073)
Net income from post-employment benefits	**1,971**	2,757
Bank interest income	**237**	293
Finance income	**2,208**	3,050
Net finance cost	**(47,288)**	(51,023)

6. TAX EXPENSE/(CREDIT)

6.1 Tax expense/(credit) included in the income statement

	2018 £000	2017 £000
Current tax:		
– UK Corporation tax on profits for the year	**6,054**	5,222
– Adjustment in respect of prior years	**(3,353)**	1,916
Total current tax	**2,701**	7,138
Deferred tax:		
– Origination and reversal of temporary differences	**(346)**	411
– Impact of change in tax rate	**–**	(10,199)
– Adjustment in respect of prior years	**3,948**	(1,485)
Total deferred tax	**3,602**	(11,273)
Tax expense/(credit)	**6,303**	(4,135)

Tax expense assessed for the period is lower (2017: lower) than the standard rate of corporation tax in the UK for the year ended 31 March 2018 of 19% (2017: 20%). The differences are explained below:

	2018 £000	2017 £000
Profit before tax	**35,938**	26,766
Tax calculated at the standard rate of tax in the UK of 19% (2017: 20%)	**6,828**	5,353
Tax effects of:		
– Adjustments in respect of prior years	**595**	431
– Non-taxable profit on disposal of the non-household retail business	**(2,082)**	–
– Expenses not deductible for tax purposes	**962**	280
– Impact of change in tax rate on deferred tax	**–**	(10,199)
Tax expense/(credit)	**6,303**	(4,135)

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

	2018 £000	2017 £000
Deferred tax:		
– Origination and reversal of temporary differences on retirement benefit surplus	**4,928**	(643)

6.3 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 prior 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. TAX EXPENSE/(CREDIT) (CONTINUED)

6.4 Reconciliation of current and deferred tax charge

	2018 £000	2018 %	2017 £000	2017 %
Profit before tax	**35,938**	**–**	26,766	–
Tax on profit on ordinary activities at standard UK tax rate of 19% (2017: 20%)	**6,828**	**19.00%**	5,353	20.00%
Tax effect of:				
– Depreciation in excess of capital allowances	**1,809**	**5.00%**	263	1.00%
– Pension movements	**(678)**	**(1.90%)**	(838)	(3.10%)
– Increase in provisions	**126**	**0.40%**	367	1.40%
– Expenses not deductible for tax purposes	**51**	**0.10%**	77	0.30%
– Non-taxable profit on sale of trade and assets to Affinity for Business (Retail) Limited	**(2,082)**	**(5.80%)**	–	–
– Adjustment to tax charge in respect of prior years	**(3,353)**	**(9.30%)**	1,916	7.20%
Reported current tax charge and effective rate	**2,701**	**7.50%**	7,138	26.70%
Depreciation in excess of capital allowances	**(840)**	**(2.30%)**	(14)	(0.10%)
Increase in provisions	**(113)**	**(0.30%)**	(329)	(1.20%)
Pension movements	**607**	**1.70%**	754	2.80%
Change in rate of UK corporation tax – recalculation of deferred tax liability at lower rate	**–**	**–**	(10,199)	(38.10%)
Adjustments to tax charge in respect of prior years	**3,948**	**10.90%**	(1,485)	(5.50%)
Reported deferred tax charge and effective rate	**3,602**	**10.00%**	(11,273)	(42.10%)
Total tax charge/(credit) and effective rate	**6,303**	**17.50%**	(4,135)	(15.40%)

Taxable profits have been reduced this year by a one-off non-taxable profit on the sale of the company's non-household retail business. The trade and assets were sold to another group company, therefore the profit is not subject to tax.

All other significant adjustments to taxable profits are timing differences, such that tax payments are deferred to later years rather than being permanently reduced. The largest of these adjustments is in respect of tax allowances on the company's capital expenditure, including enhanced allowances on investment in research and development, and water and energy saving technology. These allowances are yet to be finalised, and are therefore not reflected in the current year's tax provision. The current tax credit and deferred tax charge in respect of prior years are mainly due to capital allowances on prior year investment.

7. 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 2017	286,086	725,125	18,534	665,823	35,400	177,738	**1,908,706**
Additions	–	–	–	–	–	109,431	**109,431**
Transfers	9,204	57,963	692	47,857	19,423	(135,139)	**–**
Disposals	(300)	(2,013)	(3)	–	(75)	–	**(2,391)**
At 31 March 2018	294,990	781,075	19,223	713,680	54,748	152,030	**2,015,746**
Accumulated depreciation							
At 1 April 2017	(83,305)	(32,142)	(739)	(450,129)	(21,599)	–	**(587,914)**
Charge for the year	(4,594)	(10,899)	(327)	(33,581)	(3,276)	–	**(52,677)**
Disposals	46	90	–	–	75	–	**211**
At 31 March 2018	(87,853)	(42,951)	(1,066)	(483,710)	(24,800)	–	**(640,380)**
Net book amount							
At 1 April 2017	202,781	692,983	17,795	215,694	13,801	177,738	**1,320,792**
Movement in year	4,356	45,141	362	14,276	16,147	(25,708)	**54,574**
At 31 March 2018	207,137	738,124	18,157	229,970	29,948	152,030	**1,375,366**

All land and buildings are held as freehold.

Statutory Financial Statements continued

Notes to the financial statements (continued)

8. INTANGIBLE ASSETS

	Goodwill £000	Computer software development costs £000	Total £000
Cost			
At 1 April 2017	14,961	60,855	**75,816**
Additions	–	9,494	**9,494**
Disposals	–	(1,317)	**(1,317)**
At 31 March 2018	14,961	69,032	**83,993**
Accumulated amortisation			
At 1 April 2017	–	(24,127)	**(24,127)**
Charge for the year	–	(9,276)	**(9,276)**
Disposals	–	766	**766**
At 31 March 2018	–	(32,637)	**(32,637)**
Net book amount			
At 1 April 2017	14,961	36,728	**51,689**
Movement in year	–	(333)	**(333)**
At 31 March 2018	14,961	36,395	**51,356**

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 inflows for the entity, by means of supplying drinking water to customers. The recoverable amount has been determined using the RCV of Affinity Water Limited at 31 March 2018. 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 £4,933,000 (2017: £2,639,000) of expenditure in relation to a new work management information system.

9. INVESTMENTS

	2018 £000	2017 £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.

10. 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:

	2018 £000	2017 £000
Total current service cost of the Affinity Water Pension Plan	**(4,800)**	(3,853)
Contributions from participating employer	**87**	–
Pension expense charged to operating profit	**(4,713)**	(3,853)
Net pension interest income credited to finance income (note 5)	**1,971**	2,757
Net pension expense charged before taxation	**(2,742)**	(1,096)

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

	2018 £000	2017 £000
At 1 April	**72,997**	72,588
Principal employer contributions	**6,313**	5,285
Net current service cost (per above)	**(4,713)**	(3,853)
Net interest income	**1,971**	2,757
Net re-measurement gain/(loss)	**28,990**	(3,780)
At 31 March	**105,558**	72,997

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

	2018 £000	2017 £000
Re-measurement gains on plan assets	**316**	80,190
Re-measurement gains/(losses) on plan liabilities	**28,674**	(83,970)
	28,990	(3,780)

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

11. INVENTORIES

	2018 £000	2017 £000
Raw materials and consumables	**1,631**	1,430

Inventories are stated after provisions for impairment of £538,000 (2017: £511,000).

Statutory Financial Statements continued

Notes to the financial statements (continued)

12. TRADE AND OTHER RECEIVABLES

	2018 £000	2017 £000
Trade receivables	**54,970**	60,135
Less: provision for impairment of trade receivables	**(28,070)**	(27,879)
Trade receivables - net	**26,900**	32,256
Amounts owed by group undertakings	**483**	5,284
Amounts owed by related parties	**–**	195
Other receivables	**3,209**	5,242
Unbilled accrual for metered customers	**29,028**	40,413
Prepayments and accrued income	**5,446**	6,292
	65,066	89,682

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

12.1 Provision for impairment of trade receivables

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

	2018 £000	2017 £000
At 1 April	**27,879**	26,313
Provision for receivables impairment charged to income statement	**8,884**	9,547
Receivables written off during the year as uncollectable	**(7,299)**	(7,981)
Provision transferred to Affinity for Business (Retail) Limited	**(1,394)**	–
At 31 March	**28,070**	27,879

12.2 Ageing analysis of trade receivables

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

	2018 £000	2017 £000
Aged less than one year	**15,666**	20,921
Aged between one year and two years	**10,081**	10,590
Aged greater than two years	**1,153**	745
	26,900	32,256

13. CASH AND CASH EQUIVALENTS

	2018 £000	2017 £000
Cash at bank and in hand	**22,751**	15,102
Term deposits	**92,091**	30,027
	114,842	45,129

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

14. 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 2017 and 31 March 2018	265,058	26,506	1,400	30,150	**58,056**

All shares rank pari passu in all respects.

15. TRADE AND OTHER PAYABLES

	2018 £000	2017 £000
Non-current		
Amounts falling due after more than one year:		
Deferred grants and contributions	**6,456**	6,183
Amounts falling due after more than five years:		
Deferred grants and contributions	**92,835**	88,007
	99,291	94,190
Current		
Amounts falling due within one year:		
Trade payables	**15,319**	18,620
Amounts due to group undertakings	**245**	176
Amounts due to related parties	**–**	35
Interest payable to subsidiary companies	**13,701**	12,987
Interest payable to external parties	**55**	62
Social security and other taxes	**1,588**	1,491
Other payables	**7,673**	8,286
Capital accruals	**10,045**	14,406
Deferred grants and contributions	**1,224**	1,251
Payments received in advance	**55,405**	48,400
Other accruals and deferred income	**40,092**	40,296
	145,347	146,010
	244,638	240,200

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

Statutory Financial Statements continued

Notes to the financial statements (continued)

16. BORROWINGS

	2018 £000	2017 £000
Borrowings measured at amortised cost:		
Loan from Affinity Water Finance (2004) PLC financed by bond issue	**254,346**	254,747
Loan from Affinity Water Programme Finance Limited financed by bond issue	**814,613**	683,097
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
	1,072,543	941,428

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 Notes due 2022 for a new issue of 3.278% Guaranteed Notes due 2042. An additional £19,200,000 of 3.278% Guaranteed Notes due 2042 were issued at the same time.

On 22 November 2017, Affinity Water Programme Finance Limited issued £60,000,000 Class A Guaranteed Notes maturing in November 2033 with a coupon of 2.699% and £60,000,000 Class A Guaranteed CPI linked Notes maturing in November 2042 with a coupon of 0.230%.

The net proceeds of the bond issues and the tap issue were lent to the company on the same terms.

On 4 February 2013, the company borrowed an amount of £3,550,000 from Affinity Water Capital Funds Limited, the company's intermediate parent company. The final repayment date of this loan is 31 March 2036, with interest terms having been set at 4.500%.

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. These guarantees constitute 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 company's immediate parent undertaking.

The fair value of the bonds on-lent from the two financing subsidiaries at 31 March 2018 is £1,338,059,000 (2017: £1,188,729,000), 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)

17. DEFERRED TAX LIABILITIES

17.1 Analysis of deferred tax assets and deferred tax liabilities

	2018 £000	2017 £000
Deferred tax assets:		
Deferred tax asset to be recovered after more than 12 months	**(588)**	(982)
	(588)	(982)
Deferred tax liabilities:		
Deferred tax liability to be settled after more than 12 months	**181,854**	173,718
	181,854	173,718
Deferred tax liabilities - net	**181,266**	172,736

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

	2018 £000	2017 £000
At 1 April	**172,736**	184,652
Charged/(credited) to the income statement	**3,602**	(11,273)
Charged/(credited) to other comprehensive income	**4,928**	(643)
At 31 March	**181,266**	172,736

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

17.2 Deferred tax liabilities

	Accelerated capital allowances £000	Retirement benefit obligations £000	Total £000
At 1 April 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**
Charged to the income statement	2,601	607	**3,208**
Charged to other comprehensive income	–	4,928	**4,928**
At 31 March 2018	163,910	17,944	**181,854**

17.3 Deferred tax assets

	Provisions £000
At 1 April 2016	(881)
Credited to the income statement	(101)
At 31 March 2017	(982)
Charged to the income statement	394
At 31 March 2018	(588)

Statutory Financial Statements continued

Notes to the financial statements (continued)

18. PROVISIONS FOR OTHER LIABILITIES AND CHARGES

	Insurance £000	Other £000	Total £000
At 1 April 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**
Charged to the income statement	1,854	–	**1,854**
Utilised in the year	(1,084)	–	**(1,084)**
At 31 March 2018	2,562	670	**3,232**

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 (2017: £670,000) in relation to unfunded pension liabilities for a former non-executive director, which it is expected will be utilised over the 20 years from January 2019.

19. DIVIDENDS

	2018 £000	2017 £000
First interim paid of 2.45p per share (2017: 11.32p)	**6,500**	30,000
Second interim paid of 8.30p per share (2017: 2.26p)	**22,000**	6,000
Third interim paid of 6.79p per share (2017: 5.47p)	**17,998**	14,500
Fourth interim paid of 4.53p per share	**12,000**	–
	58,498	50,500

20. NOTES TO THE STATEMENT OF CASH FLOWS

20.1 Cash generated from operations

		2018 £000	2017 £000
Profit before tax		**35,938**	26,766
Adjustments for:			
Depreciation of property, plant and equipment (note 7)		**52,677**	50,723
Amortisation of grants and contributions		**(1,667)**	(1,480)
Amortisation of intangible fixed assets (note 8)		**9,276**	5,971
Profit on disposal of non-household retail business		**(10,958)**	–
Profit on disposal of property, plant and equipment		**(558)**	(65)
Loss on disposal of infrastructure assets		**1,928**	3,073
Abandonment of fixed assets		**803**	–
Post-employment benefits		**(1,600)**	(1,432)
Finance costs – net (note 5)		**47,288**	51,023
Changes in working capital:			
– Inventories		**(201)**	(208)
– Trade and other receivables		**24,616**	(9,781)
– Trade and other payables:	- provision element	**770**	(423)
	- other	**(20,623)**	15,909
Cash generated from operations		**137,689**	140,076

20.2 Reconciliation of liabilities arising from financing activities

	At 1 April 2017 £000	Cash flow £000	Non cash flows £000	At 31 March 2018 £000
Loan from Affinity Water Finance (2004) PLC financed by bond issue	254,747	–	(401)	254,346
Loan from Affinity Water Programme Finance Limited financed by bond issue	683,097	119,083	12,433	814,613
Loan from intermediate parent company	3,550	–	–	3,550
Debenture stock	34	–	–	34
Total liabilities arising from financing activities	**941,428**	**119,083**	**12,032**	**1,072,543**

Non cash flows relate to loan indexation and amortisation of bond issuance costs.

Statutory Financial Statements continued

Notes to the financial statements (continued)

21. COMMITMENTS

21.1 Capital commitments

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

	2018 £000	2017 £000
Property, plant and equipment	**17,678**	29,651
Intangible assets	**1,699**	2,691
	19,377	32,342

21.2 Commitments under operating leases

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

	2018		2017	
	Land and buildings £000	Other £000	Land and buildings £000	Other £000
No later than one year	**1,547**	**2,253**	1,547	1,858
Later than one year and no later than five years	**6,187**	**4,134**	6,187	2,892
Later than five years	**3,738**	**–**	5,285	1
	11,472	**6,387**	13,019	4,751

22. 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 2018 (2017: £nil).

23. EVENTS AFTER THE REPORTING PERIOD

There were no significant events that took place after the reporting period.

24. 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 wholly owned by Daiwater Investment Limited, a company registered in England and Wales. Daiwater Investment Limited is the parent undertaking of the largest group to consolidate the statutory financial statements of this company for the period ended 31 March 2018. These financial statements are also consolidated in the financial statements of Affinity Water Holdco Finance Limited for the period ended 31 March 2018, the smallest group to consolidate the financial statements of the company.

The directors consider that Daiwater Investment Limited has been the ultimate holding and controlling company in the United Kingdom since 19 May 2017 and that Affinity Water Acquisitions (Investments) Limited was the ultimate holding and controlling company in the United Kingdom up until this date. Copies of the group financial statements of Daiwater Investment Limited and Affinity Water Holdco Finance Limited for the period ended 31 March 2018 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 that 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.

On 19 May 2017, Affinity Water Acquisitions (Investments) Limited was acquired by a consortium comprising Allianz Capital Partners on behalf of the Allianz Group, DIF and HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited). As part of the transaction, the consortium also acquired Veolia Water UK Limited's 10% equity interest stake in the company. Subsequent to the initial sale, HICL Infrastructure Company Limited (advised by InfraRed Capital Partners Limited) sold down 3.4% of their interest to a small group of co-investors, comprising UK local authority pension funds in June 2017.

The consortium made its investment through Daiwater Investment Limited, which is now the company's UK holding company. The directors consider the following entities to be the company's ultimate controllers, as they are in a position to exercise material influence over the company's 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

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.

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.

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.

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 24 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 Daiwater Investment Limited, which is the parent undertaking of the largest group to consolidate the statutory financial statements. It is included in the consolidated financial statements of Daiwater Investment Limited, which will be made 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 2015/16 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 twelve months or less. Term deposits with original maturities longer than three months can be redeemed early, subject to the interest income being forfeited or reduced to reimburse any cost incurred by the counterparty. These are classed as cash and cash equivalents if the deposit can be redeemed 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 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.
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'), as the AWPP's Principal Employer, 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.

Fellow group company Affinity for Business (Retail) Limited is a Participating Employer of the AWPP and contributes to the AWPP on behalf of its eligible employees. As the Principal Employer, Affinity Water Limited recognises all the remeasurement gains and losses on the plan assets and liabilities. Affinity Water Limited recognises current service costs net of contributions from Affinity for Business (Retail) Limited.

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.

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 our principal risks and uncertainties section beginning on **page 36** 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 treasurer. A treasury report is provided monthly to the Board, which summarises treasury activities and includes details on the company's position in regard 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 12 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 2018, the company had £272,842,000 (2017: £203,129,000) of available liquidity, which comprised £114,842,000 (2017: £45,129,000) of cash and term deposits and £158,000,000 (2017: £158,000,000) of undrawn committed borrowing facilities.

Undrawn borrowing facilities:

	2018 £000	2017 £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 2018	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	**1,692,625**	**37,998**	**38,226**	**38,467**	**38,718**	**52,922**	**1,486,294**
Loan from intermediate parent	**6,426**	**160**	**160**	**160**	**160**	**160**	**5,626**
Borrowings	**1,699,051**	**38,158**	**38,386**	**38,627**	**38,878**	**53,082**	**1,491,920**
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

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 12).

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 2018 and 31 March 2017, the maximum exposure to credit risk was represented by the carrying amount of each financial asset in the statement of financial position:

	2018 £000	2017 £000
Cash and term deposits (note 13)	**114,842**	45,129
Trade and other receivables (excluding prepayments)	**60,654**	85,068
	175,496	130,197

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 inflation, form a partial economic hedge of the company's regulatory assets, which are also linked to 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	CPI-linked debt £000	Total £000
31 March 2018	**674,227**	**338,543**	**59,773**	**1,072,543**
31 March 2017	615,254	326,174	–	941,428

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 2018. The following table details the sensitivity of profit before taxation to changes in RPI and CPI 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.

	2018 £000	2017 £000
1% increase in RPI	**(3,364)**	(3,236)
1% decrease in RPI	**3,363**	3,236
1% increase in CPI	**(603)**	–
1% decrease in CPI	**603**	–

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 78.6% at 31 March 2018 (76.6% at 31 March 2017).

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). However, the Trustee has increased the level of interest rate and inflation hedging provided by the plan's assets through Liability Driven Investment.

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 1.0% 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.

Defined benefit section – employer contributions

Based on the latest actuarial valuation at 31 December 2015, the contributions expected to be paid into the AWPP for the year ending 31 March 2019 are £9,928,500 by the company (£6,313,000 in the year ended 31 March 2018) and £10,050,000 by both participating employers (£6,400,000 in the year ended 31 March 2018).

The weighted average duration of the defined benefit obligation is 16.9 years (2017: 18.0 years).

Defined benefit section - financial and demographic assumptions

Adjustments to valuation at 31 December 2015 have been made based on the following assumptions:

	2018	2017
Discount rate	**2.60% pa**	2.55% pa
Salary growth	**3.05% pa**	3.10% pa
RPI	**3.05% pa**	3.10% pa
CPI	**2.05% pa**	2.10% pa
Life expectancy for a male pensioner from age 65 (years)	**22**	22
Life expectancy for a female pensioner from age 65 (years)	**24**	25
Life expectancy from age 65 (years) for a male participant currently aged 45 (years)	**23**	24
Life expectancy from age 65 (years) for a female participant currently aged 45 (years)	**25**	26

Deferred pensions are revalued to retirement age in line with the CPI assumption of 2.05% per annum (2017: 2.10% 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
2018				
Discount rate	**0.5% decrease**	**8.8% increase**	**0.5% increase**	**8.8% decrease**
Salary growth	**0.5% increase**	**1.0% increase**	**0.5% decrease**	**1.0% decrease**
Pension growth rate	**0.5% increase**	**7.5% increase**	**0.5% decrease**	**7.5% decrease**
Life expectancy	**1 year increase**	**3.0% increase**	**1 year decrease**	**3.0% decrease**
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

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 %	2018 £000	Plan assets %	2017 £000
Equity securities	**10%**	**50,819**	14%	70,510
Debt securities	**21%**	**108,319**	20%	103,460
Diversified growth funds	**13%**	**65,540**	23%	113,450
Property	**1%**	**2,070**	1%	4,920
Infrastructure	**2%**	**11,972**	2%	11,230
Liability driven investments	**53%**	**271,428**	40%	202,060
Cash and cash equivalents	**0%**	**1,795**	0%	1,370
Total fair value of the plan's assets	**100%**	**511,943**	100%	507,000
Present value of defined benefit obligations		**(406,385)**		(434,003)
Net retirement benefit surplus		**105,558**		72,997

Defined benefit section - fair value of plan assets

Movements in the fair value of the plan's assets were as follows:

	2018 £000	2017 £000
At 1 April	**507,000**	422,500
Benefits paid	**(15,192)**	(16,615)
Principal employer contributions	**6,313**	5,285
Contributions by plan participants	**662**	738
Interest income	**12,844**	14,902
Re-measurement gains	**316**	80,190
At 31 March	**511,943**	507,000

Defined benefit section - present value of plan liabilities

Movements in the present value of the defined benefit liabilities are as follows:

	2018 £000	2017 £000
At 1 April	**(434,003)**	(349,912)
Benefits paid	**15,192**	16,615
Contributions by plan participants	**(662)**	(738)
Net current service cost	**(4,713)**	(3,853)
Interest expense	**(10,873)**	(12,145)
Re-measurement gains/(losses)	**28,674**	(83,970)
At 31 March	**(406,385)**	(434,003)

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 2018 was £2,276,000 (2017: £1,712,000). There are no amounts prepaid or outstanding in respect of the defined contribution section at 31 March 2018 (2017: 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 2018 (2017: £1,000), relating to bond management fees charged to Affinity Water Limited.

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 £6,000 in the year ended 31 March 2018 (2017: £5,000), relating to bond management fees charged to Affinity Water Limited.

The four dormant subsidiaries listed above file accounts at Companies House.

A7. RELATED PARTY TRANSACTIONS

a) Purchases of goods and services

			2018		2017	
Related party	Nature of Relationship	In respect of	Value £000	Balance £000	Value £000	Balance £000
Veolia Water UK Limited*	Former shareholder	Management and technical support	**20**	**–**	50	15
Veolia Environmental Services (UK) Limited*	Former partial common ownership	Waste water disposal	**24**	**–**	304	20
VWS (UK) Limited*	Former partial common ownership	Transport and other services	**4**	**–**	47	–

b) Sales of goods and services

			2018		2017	
Related party	Nature of Relationship	In respect of	Value £000	Balance £000	Value £000	Balance £000
Veolia Water UK Limited*	Former shareholder	Transitional services, capability sharing agreement and other support	**–**	**–**	216	138
Veolia Environmental Services (UK) Limited*	Former partial common ownership	Waste water disposal	**12**	**–**	20	3
Other Veolia entities*	Former partial common ownership	Transitional services, capability sharing agreement and laboratory services	**7**	**–**	108	54

c) Term deposit

			2018		2017	
Related party	Nature of Relationship	In respect of	Value £000	Balance £000	Value £000	Balance £000
Morgan Stanley Liquidity Funds*	Former common ownership	Term deposit and interest thereon	**4**	**–**	36	10,000

* Transactions disclosed are for the period up to the date of sale on 19 May 2017. At 31 March 2018, these entities were not related parties and therefore nil balances are shown for amounts receivable from or payable to these entities at the balance sheet date.

See note 4.3 for disclosure of the directors' remuneration.

Statutory Financial Statements

Regulatory Annual Performance Report

for the year ended 31 March 2018

Contents

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)

Maintaining our assets at a pumping station

Regulatory annual performance report

Statement on direction and performance

We are pleased to introduce our Regulatory Annual Performance Report for the year ended 31 March 2018. The industry has been under scrutiny in recent months and we wholeheartedly welcome the opportunity to address the concerns and contribute constructively to discussions on the long term legitimacy of the industry.

As a Board, we spend a significant amount of time aligning our company plans to the interests of customers, employees and wider stakeholders. We have set challenging targets to become the UK's leading community focused water company and to ensure that customers have enough water, whilst leaving more water in the environment.
We have recently strengthened our Board, carefully selecting individuals with relevant skills and experiences to challenge and support the executives and focus closely on regulatory, customer and sector priorities. We discuss at length how we can make our company more resilient, how we have achieved against our targets and our plans to address our shortcomings. For further details of matters considered by the Board during the year, refer to **page 58** of our Corporate Governance Report.

We recognise the need to continue to put customers first and to invest in new infrastructure to ensure we can meet the growing demand for water in the South East and manage the long term impact of climate change in our region. We are committed to reducing leakage and water abstractions, and are encouraging customers to minimise their water usage through our metering program.
Our customers expect us to lead the way and we are committed to doing so. Our Customer Challenge Group, consisting of representatives with experience representing household customers, holds us to account on how we are performing against our commitments and our plans for the future.

Our business was acquired in May 2017 by a consortium of highly regarded shareholders who have experience of longer term asset ownership, and who are continuing to support our plans to invest and enhance our infrastructure to ensure future resilience. We have put in place the finance required to deliver our expected investment programme over the next AMP and to deliver high levels of service whilst maintaining gearing at a level lower than 80%.

Our salary and benefit pay policy for executives is based on the market median, with a remuneration benchmarking exercise undertaken during the year by independent external advisers. Executive annual bonuses are linked to in year delivery of regulatory, customer and business plan performance targets, aligned to the company wide bonus scheme. The Board has provided full transparency, detailing the breakdown of executive bonuses in our Remuneration Report on **pages 79 to 91**. Executives are also entitled to take part in a Long Term Incentive Plan, which is balanced between financial and regulatory performance along with long term value creation. The Board is reassured that the pay structure incentivises executives to put customers first and ensure the long term resilience of the company.

This annual report and financial statements includes full and transparent disclosure of our performance in the year and the Board are confident that the plans put in place ensure a stable future for our company.

On behalf of the Board

Tony Cocker
Chairman

Certificates of compliance

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

Certificate of compliance with licence condition F6A

This is to certify that on 20 June 2018 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 the Regulated Activities (including the investment programme necessary to fulfil the Appointee's obligations under the Appointment); 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.

Regulatory annual performance report continued

Certificates of compliance (continued)

In giving this certificate the main factors which the directors have taken into account are:

- the net worth of the company as shown in the financial statements and the budget for the forthcoming year supported by long-term plans for both operating and investment expenditure;
- the financing arrangements available to the company and management of associated risks (refer to notes 16 and A4 of the company's statutory financial statements and the principal risks and uncertainties section of the company's strategic report beginning on **page 36** for further details);
- the results of the stress-testing performed in relation to the company's viability statement for the year ended 31 March 2018 (refer to **pages 44 to 46**);
- the adequacy of the senior management team and management resources, including the ability of the senior management team to focus their teams on delivering on a number of complex and high-profile projects during 2017/18 without any obvious detriment to the other services provided to its customers and the review of succession planning being performed by the Nomination Committee along with the company's People Team;
- the comprehensive suite of internal control procedures across both operational and financial matters, supported by delegated authority procedures, an Internal Audit team reporting to the Audit Committee, and the availability of specialist planning teams who are deployed to major projects and utilise the resources of acknowledged external specialists in such matters;
- the company is subject to considerable external assurance review, both fiscal and operational;
- an examination of the contracts with Associated Companies;
- with the exception of the company's contract to supply wholesale water and the service agreement with Affinity for Business (Retail) Limited, there are only limited contractual arrangements with associated companies; and
- any transactions with Associated Companies are disclosed in the Transactions with associated companies note in section 4 of the company's Regulatory Annual Performance Report for the year ended 31 March 2018 (refer to **page 205**), which is subject to external assurance.

In this certificate, the terms "Appointment", "Associated Company" and "Regulated Activities" have the meanings given in the Appointee's Instrument of Appointment.

Tim Monod

Company Secretary
20 June 2018

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 2018 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 2017/18, as presented in section 3 of this regulatory Annual Performance Report on **pages 189 to 191**.

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 2018, which include a summary of the company's financial and operational performance for 2017/18 on **pages 30 to 35** and sets out how the company manages risk and uncertainty from **page 36**.

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 Reporter has identified the following area for consideration. The Reporter considers that this is not a material risk to regulatory compliance or reporting of performance this year but is an area the company will consider to address to mitigate compliance and performance risks in the longer term:

- Leakage (W-A1): The non-household retail market separation process and associated reliance on billed non-household data from the market operator has created an uncertainty in the non-household night use figure. The Reporter considers that the company has taken reasonable steps to quantify the uncertainty and has selected a sub-set of the data that provides consistent billing data with the prior year. There is a risk that if a different sub-set had been used, the leakage reduction target could be theoretically missed.

The Reporter's report is available on the company's stakeholder website: **stakeholder.affinitywater.co.uk/reports-publications.aspx**.

Regulatory annual performance report continued

Statement of risk and compliance (continued)

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 were assumed in its Final Determination for PR14.

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 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:

Tony Cocker
Chairman

Patrick O'D Bourke
Independent non-executive director

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

Report on the Annual Performance Report

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 (RAG1.08, RAG2.07, RAG3.10, RAG4.07 and RAG5.07) and the accounting policies (including the company's published accounting methodology statement, as defined in RAG 3.10, appendix 3) set out on **page 173 to 175**.

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), the net debt analysis (table 1E) and the financial flows (table 1F) 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), the revenue analysis by customer type (table 2I) and the infrastructure network reinforcement costs (table 2J) and the related notes.

We have not audited the Outcome performance tables (tables 3A to 3D) and the additional regulatory information in tables 4A to 4W.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)"), including ISA (UK) 800, and applicable law, except as stated in the section on Auditors' responsibilities for the audit of the Annual Performance Report 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.

Our responsibilities under ISAs (UK) are further described in the Auditors' responsibilities for the audit of the Annual Performance Report section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We remained independent of the Affinity Water Limited in accordance with the ethical requirements that are relevant to our audit of the Regulatory Accounting Statements within the Annual Performance Report in the UK.

Regulatory annual performance report continued

Independent Auditors' report to the Water Services Regulation Authority (the WSRA) and the Directors of Affinity Water Limited (continued)

Emphasis of matter – basis of preparation

In forming our opinion on the Regulatory Accounting Statements within the Annual Performance Report, which is not modified, 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 statements, as defined in RAG 3.10, 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 163 to 204** 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 GAAP in the company's statutory financial statements is included in the tables within section 1.

The Regulatory Accounting Statements are prepared in accordance with a special purpose framework for the specific purpose as described in the Responsibilities for the Annual Performance Statement and the audit section below. As a result, the Regulatory Accounting Statements may not be suitable for another purpose.

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which ISAs (UK) require us to report to you when:

- the directors' use of the going concern basis of accounting in the preparation of the Regulatory Accounting Statements is not appropriate; or
- the directors have not disclosed in the Regulatory Accounting Statements any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the Regulatory Accounting Statements are authorised for issue.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the company's ability to continue as a going concern.

Reporting on other information

The other information comprises all of the information in the Annual Performance Report other than the Regulatory Accounting Statements within the Annual Performance Report and our auditors' report thereon. The directors are responsible for the other information. Our opinion on the Regulatory Accounting Statements within the Annual Performance Report does not cover the other information and, accordingly, we do not express an audit opinion or any form of assurance thereon.

In connection with our audit of the Regulatory Accounting Statements within the Annual Performance Report, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the Regulatory Accounting Statements within the Annual Performance Report or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify an apparent material inconsistency or material misstatement, we are required to perform procedures to conclude whether there is a material misstatement of the Regulatory Accounting Statements within the Annual Performance Report or a material misstatement of the other information. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report based on these responsibilities.

Responsibilities for the Annual Performance Report and the audit

Responsibilities of the Directors for the Annual Performance Report

As explained more fully in the Statement of Directors' Responsibilities set out on **page 156**, 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 3.10, appendix 3).

The directors are also responsible for such internal control as they determine is necessary to enable the preparation of the Annual Performance Report that is free from material misstatement, whether due to fraud or error.

In preparing the Annual Performance Report, the directors are responsible for assessing the company's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

Auditors' responsibilities for the Audit of the Annual Performance Report

Our objectives are to obtain reasonable assurance about whether the Annual Performance Report as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this Annual Performance Report.

A further description of our responsibilities for the audit of the Regulatory Accounting Statements within the Annual Performance Report is located on the FRC's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' 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 the 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).

The company has presented the allocation of operating costs and assets in accordance with the accounting separation policy set out in Sections 3 and 4 and its accounting methodology statement published on the company's website in June 2018.

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 ISAs (UK).

Regulatory annual performance report continued

Independent Auditors' report to the Water Services Regulation Authority (the WSRA) and the Directors of Affinity Water Limited (continued)

Use of this report

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

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 2018 on which we reported on 21 June 2018, 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.

Other required reporting

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.

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors

Uxbridge

21 June 2018

Section 1 – Regulatory financial reporting

1A - INCOME STATEMENT FOR THE 12 MONTHS ENDED 31 MARCH 2018

		Adjustments			
	Statutory £000	Differences between statutory and RAG definitions £000	Less: non-appointed £000	Total adjustments £000	Total appointed activities £000
Revenue	**306,302**	**(5,310)**	**–**	**(5,310)**	**300,992**
Operating costs	(251,413)	(1,157)	(2,958)	1,801	(249,612)
Other operating income	17,379	(4,647)	12,792	(17,439)	(60)
Operating profit	**72,268**	**(11,114)**	**9,834**	**(20,948)**	**51,320**
Other income	10,958	11,114	–	11,114	22,072
Interest income	237	–	–	–	237
Interest expense	(49,496)	–	–	–	(49,496)
Other interest expense	1,971	–	–	–	1,971
Profit before tax and fair value movements	**35,938**	**–**	**9,834**	**(9,834)**	**26,104**
Fair value gains/ (losses) on financial instruments	–	–	–	–	–
Profit before tax	**35,938**	**–**	**9,834**	**(9,834)**	**26,104**
UK Corporation tax	(2,701)	–	(1,868)	1,868	(833)
Deferred tax	(3,602)	–	–	–	(3,602)
Profit for the year	**29,635**	**–**	**7,966**	**(7,966)**	**21,669**
Dividends	**(58,498)**	**–**	**(7,966)**	**7,966**	**(50,532)**
Tax analysis					
Current year	6,054	–	1,868	(1,868)	4,186
Adjustments in respect of prior years	(3,353)	–	–	–	(3,353)
UK Corporation tax	**2,701**	**–**	**1,868**	**(1,868)**	**833**

Regulatory Annual Performance Report

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

1A - INCOME STATEMENT FOR THE 12 MONTHS ENDED 31 MARCH 2018 (CONTINUED)

The table below summarises the differences between statutory and RAG definitions:

	Revenue recognition £000	Income from providing developer information and administration of new connections £000	Connection charges income £000	Amortisation of deferred grants and contribution £000	Loss on disposal of fixed assets £000	Meter reading commission £000	Rental and sundry income £000	Total £000
Revenue	2,377	(680)	(7,007)	–	–	–	–	(5,310)
Operating costs	(2,377)	–	–	(1,667)	2,302	585	–	(1,157)
Other operating income	–	–	–	–	(2,302)	(585)	(1,760)	(4,647)
Other income	–	680	7,007	1,667	–	–	1,760	11,114
Total	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**

£2,377,000 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 173**). This difference is offset by the reclassification of £7,007,000 of connection charges income and £680,000 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 £2,377,000 and the reclassification of £1,667,000 of amortisation associated with deferred grants and contributions, which is presented within other income in the Regulatory Accounts, offset by the reclassification of a £2,302,000 net loss on disposal of fixed assets which is presented within other operating income in the Regulatory Accounts. In addition, £585,000 of meter reading 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 £2,302,000 and the reclassification of £1,760,000 of rental and sundry income, which is presented within other income in the Regulatory Accounts. £585,000 of meter reading 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 £7,007,000 of connection charges income, £680,000 of income from providing developer information and the administration of new connections, £1,667,000 of amortisation associated with deferred grants and contributions and £1,760,000 of rental and sundry income described in the previous paragraphs.

1B - STATEMENT OF COMPREHENSIVE INCOME FOR THE 12 MONTHS ENDED 31 MARCH 2018

		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	29,635	–	7,966	(7,966)	21,669
Actuarial gains/(losses) on post employment plans	28,990	–	–	–	28,990
Other comprehensive income	(4,928)	–	–	–	(4,928)
Total comprehensive income for the year	**53,697**	**–**	**7,966**	**(7,966)**	**45,731**

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

1C - STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2018

	Statutory £000	Adjustments: Differences between statutory and RAG definitions £000	Adjustments: Less: non-appointed £000	Adjustments: Total adjustments £000	Total appointed activities £000
Non-current assets					
Fixed assets	1,375,366	–	–	–	1,375,366
Intangible assets	51,356	–	–	–	51,356
Investments – loans to group companies	–	–	–	–	–
Investments – other	60	–	–	–	60
Financial instruments	–	–	–	–	–
Retirement benefit assets	105,558	–	–	–	105,558
Total	**1,532,340**	**–**	**–**	**–**	**1,532,340**
Current assets					
Inventories	1,631	–	–	–	1,631
Trade and other receivables	65,066	–	881	(881)	64,185
Financial instruments	–	–	–	–	–
Cash and cash equivalents	114,842	–	3,991	(3,991)	110,851
Total	**181,539**	**–**	**4,872**	**(4,872)**	**176,667**
Current liabilities					
Trade and other payables	(134,078)	9,256	(2,506)	11,762	(122,316)
Capex creditor	(10,045)	–	–	–	(10,045)
Borrowings	–	–	–	–	–
Financial instruments	–	–	–	–	–
Current tax liabilities	(284)	–	(2,366)	2,366	2,082
Provisions	(1,224)	1,224	–	1,224	–
Total	**(145,631)**	**10,480**	**(4,872)**	**15,352**	**(130,279)**
Net current assets/(liabilities)	**35,908**	**10,480**	**–**	**10,480**	**46,388**
Non-current liabilities					
Trade and other payables	–	–	–	–	–
Borrowings	(1,072,543)	–	–	–	(1,072,543)
Financial instruments	–	–	–	–	–
Retirement benefit obligations	–	–	–	–	–
Provisions	(3,232)	–	–	–	(3,232)
Deferred income – grants and contributions ('G&C's')	(99,291)	(10,480)	–	(10,480)	(109,771)
Deferred income – adopted assets	–	–	–	–	–
Preference share capital	–	–	–	–	–
Deferred tax	(181,266)	–	–	–	(181,266)
Total	**(1,356,332)**	**(10,480)**	**–**	**(10,480)**	**(1,366,812)**
Net assets	**211,916**	**–**	**–**	**–**	**211,916**

	Statutory £000	Adjustments: Differences between statutory and RAG definitions £000	Adjustments: Less: non-appointed £000	Adjustments: Total adjustments £000	Total appointed activities £000
Equity					
Called up share capital	26,506	–	–	–	26,506
Retained earnings and other reserves	185,410	–	–	–	185,410
Total equity	**211,916**	**–**	**–**	**–**	**211,916**

The £9,256,000 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 2018, 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 £7,638,000 of payments received in the year are included in the totex tables to offset the expenditure incurred in the year. The payments received in the year have also been included in the diversions line within the analysis of capital contributions and land sales table (table 2E).

The £1,224,000 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 £10,480,000 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 2018

		Adjustments			
	Statutory £000	Differences between statutory and RAG definitions £000	Less: non-appointed £000	Total adjustments £000	Total appointed activities £000
Operating profit	**72,268**	**(11,114)**	**9,834**	**(20,948)**	**51,320**
Other income	10,958	11,114	–	11,114	22,072
Depreciation	61,953	–	–	–	61,953
Amortisation – G&C's	(1,667)	–	–	–	(1,667)
Changes in working capital	3,792	–	(1,099)	1,099	4,891
Pension contributions	(8,000)	–	–	–	(8,000)
Movement in provisions	7,170	–	–	–	7,170
Profit on sale of fixed assets	(8,785)	–	–	–	(8,785)
Cash generated from operations	**137,689**	**–**	**8,735**	**(8,735)**	**128,954**
Net interest paid	(36,772)	–	–	–	(36,772)
Tax paid	(10,652)	–	(1,874)	1,874	(8,778)
Net cash generated from operating activities	**90,265**	**–**	**6,861**	**(6,861)**	**83,404**
Investing activities					
Capital expenditure	(123,286)	–	–	–	(123,286)
Grants and contributions	14,337	–	–	–	14,337
Disposal of fixed assets	558	–	–	–	558
Other[1]	27,254	–	–	–	27,254
Net cash used in investing activities	**(81,137)**	–	–	–	**(81,137)**
Net cash generated before financing activities	**9,128**	–	**6,861**	**(6,861)**	**2,267**
Cashflows from financing activities					
Equity dividends paid	(58,498)	–	(7,966)	7,966	(50,532)
Net loans received	119,083	–	–	–	119,083
Cash inflow from equity financing	–	–	–	–	–
Net cash generated from financing activities	**60,585**	–	**(7,966)**	**7,966**	**68,551**
Increase/(decrease) in net cash	**69,713**	–	**(1,105)**	**1,105**	**70,818**

The difference between statutory and RAG defined operating profit consists of the reclassification of £7,007,000 of connection charges income, £680,000 of income from providing developer information and the administration of new connections, £1,667,000 of amortisation associated with deferred grants and contributions and £1,760,000 of rental and sundry income all of which are shown in other income.

[1] Other cash flows from investing activities includes £27,000,000 of proceeds from sale of the non-household business to Affinity for Business (Retail) Limited on 1 April 2017. See note 3 in the statutory financial statements for more details.

1E - NET DEBT ANALYSIS AT 31 MARCH 2018

	Fixed rate £000	Floating rate £000	Index linked £000	Total £000
Borrowings (excluding preference shares)	674,227	–	398,316	**1,072,543**
Preference share capital				–
Total borrowings				**1,072,543**
Cash				**(110,851)**
Short term deposits				–
Net debt				**961,692**
Gearing				79.67%
Adjusted gearing				78.62%
Full year equivalent nominal interest cost	31,018	–	19,772	**50,790**
Full year equivalent cash interest payment	31,018	–	7,017	**38,035**
Indicative interest rates:				
Indicative weighted average nominal interest rate (%)	4.68	–	5.06	**4.82**
Indicative weighted average cash interest rate (%)	4.68	–	1.80	**3.61**
Weighted average years to maturity	14.66	–	23.21	**17.84**

There are no differences between total borrowings presented in the above table and total borrowings presented in note 16 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.

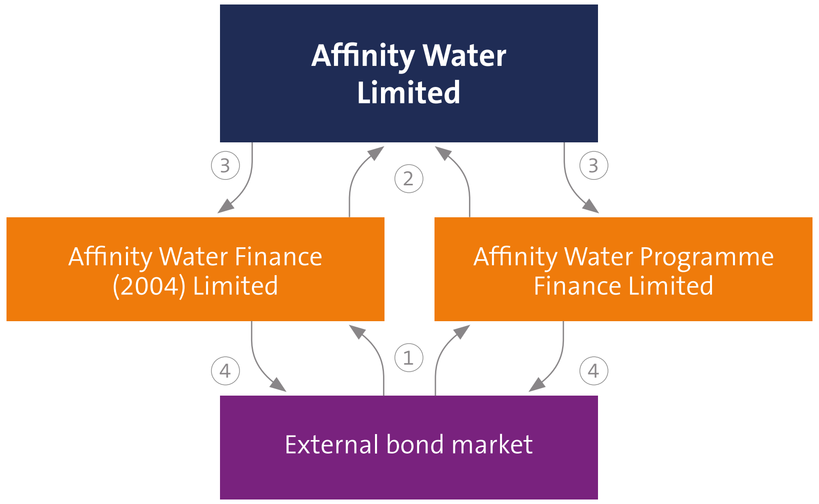
	Fixed rate £000	Floating rate £000	Index linked £000	Total £000
Borrowings (excluding preference shares)	674,227	-	398,316	**1,072,543**
Preference share capital				-
Less: capitalised bond issue costs				**(18,818)**
Less: loan from intermediate parent company				**(3,550)**
				1,050,175
Add: accrued interest on borrowings				**13,701**
Total borrowings				**1,063,876**
Cash				
Short term deposits (including non-appointed cash)				**(114,842)**
Net debt				**949,034**

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

1E - NET DEBT ANALYSIS AT 31 MARCH 2018 (CONTINUED)

Affinity Water Limited has two financing subsidiaries which have issued bonds listed by the UK Listing Authority. Affinity Water Finance (2004) PLC has issued an external bond of £250.0m and Affinity Water Programme Finance Limited has issued external bonds totalling £764.2m, the proceeds of which have been lent on to and are guaranteed by Affinity Water Limited, as shown in the diagram below. Please refer to **pages 72 and 73** for more information on our financing arrangements.



1. Affinity Water Programme Finance Limited and Affinity Water Finance (2004) Limited have raised debt from the external bond market in the form of several bond issuances.
2. The financing subsidiaries have on-lent the debt to Affinity Water Limited on the same terms.
3. Affinity Water Limited pays interest payments annually to the financing subsidiaries, and will repay the principal debt upon maturity of the bond.
4. Affinity Water Programme Finance Limited and Affinity Water Finance (2004) Limited pay interest payments annually to the bondholders, and will repay the principal debt upon maturity of the bond.

1F - FINANCIAL FLOWS FOR THE 12 MONTHS ENDED 31 MARCH 2018

	%			£		
	Notional returns and notional regulatory equity	Actual returns and notional regulatory equity	Actual returns and actual regulatory equity	Notional returns and notional regulatory equity	Actual returns and notional regulatory equity	Actual returns and actual regulatory equity
Regulatory return on equity	5.65	3.19	5.65	22,765,111.51	12,861,586.40	12,861,586.40
Actual performance adjustment 2010-2015	(0.61)	(0.35)	(0.61)	(2,465,611.96)	(1,392,994.77)	(1,392,994.77)
Adjusted return on regulatory equity	5.04	2.84	5.04	20,299,499.55	11,468,591.63	11,468,591.63
Regulatory equity base (£)	402,922,328	402,922,328	227,638,697	–	–	–
Financing						
Gearing	–	1.26	2.23	–	5,083,225.28	5,083,225.28
Variance in corporation tax	–	(0.43)	(0.76)	–	(1,727,765.37)	(1,727,765.37)
Group relief	–	–	–	–	–	–
Cost of debt	–	(1.10)	(1.94)	–	(4,418,092.23)	(4,418,092.23)
Hedging instruments	–	–	–	–	–	–
Sub total	**5.04**	**2.57**	**4.57**	**20,299,499.55**	**10,405,959.31**	**10,405,959.31**
Operational Performance						
Totex out / (under) performance	–	–	–	–	–	–
ODI out / (under) performance	–	(0.08)	(0.15)	–	(331,844.89)	(331,844.89)
Retail out / (under) performance	–	(1.05)	(1.85)	–	(4,213,041.47)	(4,213,041.47)
Sub total	**–**	**(1.13)**	**(2.00)**	**–**	**(4,544,886.36)**	**(4,544,886.36)**
Total earnings	5.04	1.45	2.57	20,299,499.55	5,861,072.95	5,861,072.95
RCV growth	3.74	3.74	3.74	15,052,569.97	15,052,569.97	8,504,238.13
Total shareholder return	8.78	5.19	6.31	35,352,069.52	20,913,642.92	14,365,311.08
Net dividend	4.00	11.16	19.76	16,116,893.10	44,980,648.96	44,980,648.96
Retained value	4.77	(5.97)	(13.45)	19,235,176.41	(24,067,006.04)	(30,615,337.89)
Dividends reconciliation						
Gross dividend	4.00	11.16	19.76	16,116,893.10	44,980,648.96	44,980,648.96
Interest receivable on intercompany loans	–	–	–	–	–	–
Net dividend	4.00	11.16	19.76	16,116,893.10	44,980,648.96	44,980,648.96

Amounts stated are in 2012/13 prices.

Regulatory Annual Performance Report

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

1F - FINANCIAL FLOWS FOR THE 12 MONTHS ENDED 31 MARCH 2018 (CONTINUED)

The regulatory return on equity of 5.65% as determined in PR14 decreases to 5.04% after adjusting for AMP5 performance adjustments. It increases to 7.27% after adjusting for the company's actual capital structure. The PR14 determination was carried out on a notional capital structure with 62.5% net debt to RCV gearing, the actual average level of gearing of 78.81% creates a favourable adjustment of +2.23%. This is offset by an adverse adjustment of -1.94% resulting from the company's actual cost of debt underperforming against the 2.75% allowed in the PR14 determination after taking into account the movement in RPI during the year (3.34%). The variance in corporation tax (refer to the reconciliation on **page 208**) further offsets the favourable adjustment by -0.76%.

The 4.57% regulatory return on equity adjusted for financing is reduced to 2.57% when considering the impact of operational performance. ODI underperformance in the year (refer to table 3A) results in a -0.15% reduction and the performance of the retail business unit (refer to table 2C) creates a -1.85% adverse adjustment. After factoring in RCV growth due to indexation, the total shareholder return for the year is 6.31%.

A dividend of £45.0m (£50.5m in 2017/18 prices) was paid out by the regulated business, this equates to a 19.76% return on equity which compares to the 6.31% covered above. The total shareholder return of 6.31% does not reflect the restructuring of the business to facilitate the operation within the newly created non-household retail market that occurred in the year. This restructuring created value in the regulated business as any transaction within the process, such as the transfer of the outstanding customer debts and a payment for the fair value of the business, was carried out on a cash basis. The overall impact of this on the return on equity is +10.56% which covers the key difference between the net dividend paid and the calculated total shareholder return. Excluding the impact of this, the difference between the net dividend paid and the calculated total shareholder return is -2.89%.

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, 4E, 4K, 4M, 4N, 4O, 4R, 4S, 4T, 4U and 4W 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 2017 included a measured income accrual of £29,459,000. The value of billing recognised in the year ended 31 March 2018 for consumption in the prior year was £30,637,000. This resulted in an increase of £1,178,000 in the current year's revenue due to the under-estimation of the prior year's revenue. This represented 0.39% of 2017/18 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.

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

STATEMENT OF ACCOUNTING POLICIES (CONTINUED)

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'.

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 £27,879,000 at 31 March 2017 to £28,070,000 at 31 March 2018.

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 decreased from £7,981,000 in 2016/17 to £7,299,000 in 2017/18 primarily due to the removal of non-household customer accounts.

There has been an decrease in trade receivables from £32,256,000 at 31 March 2017 to £26,900,000 at 31 March 2018 as a result of the transfer of non-household retail customers and corresponding receivables to Affinity for Business (Retail) Limited on 1 April 2017.

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 3.10. The elements of the 2017/18 remuneration arrangements for executive directors were established by the company's Remuneration Committee in meetings in 2014/15, 2015/16, 2016/17 and 2017/18.

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 2018/19
Base salary				
To provide competitive fixed remuneration that will attract and retain key employees and reflect their experience and position in the company.	To target around market median, dependent on experience in the role.	N/A	N/A	No changes were made to the policy for 2018/19 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 2018/19 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. 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 Stuart Ledger and up to 100% of base salary for both Simon Cocks and Pauline Walsh.	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. 25% of the total bonus is determined on the achievement of operational and customer and community performance targets. 25% of the total bonus is determined on the achievement of personal objectives.	No changes were made to the nature of the policy for 2018/19 up to the date of approval of this annual report and financial statements. Internal performance measures based on financial, operational and personal objectives have been agreed in principle by the Remuneration Committee.
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. No current executives joined prior to this date. Under the defined contribution scheme, the executive contributes at a rate of 7% of salary and the company contributes at 20%.	In lieu of being a member of the company's retirement benefit schemes, Duncan Bates received a taxable allowance of approximately 26% of base pay to 31 July 2017. In lieu of being a member of the company's retirement benefit schemes, Simon Cocks received a taxable allowance of approximately 24% of base pay.	N/A	No changes were made to the policy for 2018/19 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 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. Base awards include clawback and malus provisions, as detailed below. Awards vested in full on a change of control.	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. The change of control provision applied following completion of sale of the business on 19 May 2017. The Remuneration Committee was required to determine the extent to which performance measures would be satisfied over the remaining portion of 2017/18 to 2019/20.	Performance measures for 2018/19 and 2019/20 have been set and the performance conditions for 2020/21 will be set on agreement of performance commitments in the AMP7 Business Plan.
Compensation for the forfeit of variable remuneration from previous employer				
To provide compensation of forfeited remuneration from previous employers	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.	N/A	N/A	No changes were made to the policy for 2018/19 up to the date of approval of this annual report and financial statements.

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 of the company in April 2013 for a term of three years, and reappointed for a further three year term on 1 April 2016. Dr Philip Nolan resigned as Chairman effective 30 January 2018. Dr Philip Nolan received a fixed annual fee for his services which was reflective of the time commitment and responsibilities of the role.

He also benefited from a remuneration arrangement, which aligned 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 was aligned as closely as possible to the key features of a shareholding in a listed company.

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 2017/18 in the remuneration implementation report.

Tony Cocker was appointed as Chairman of the company on 30 January 2018 for an initial period of three years. Tony Cocker receives a fixed annual fee for his services, reflecting the time commitment and responsibilities of the role.

	Base salary/fees £000		Taxable benefits[1] £000		Pension related benefits[2] £000		Annual bonus £000		LTIP[3] £000		Other[4] £000		Total £000	
	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17	17/18	16/17
Non-executive														
Patrick O'D Bourke	48	47	–	–	–	–	–	–	–	–	–	–	48	47
Chris Bolt	43	42	–	–	–	–	–	–	–	–	–	–	43	42
Trevor Didcock	43	42	–	–	–	–	–	–	–	–	–	–	43	42
Susan Hooper	46	45	–	–	–	–	–	–	–	–	–	–	46	45
Chairman														
Current														
Tony Cocker	42	–	–	–	–	–	–	–	–	–	–	–	42	–
Former														
Dr Philip Nolan	183	220	–	–	–	–	–	–	–	–	860	178	1,043	398
Executive														
Current														
Stuart Ledger	96	–	3	–	10	–	57	–	–	–	41	–	207	–
Former														
Duncan Bates	57	171	4	12	15	44	–	115	434	276	500	-	1,010	618
Simon Cocks	350	335	14	14	80	80	268	300	1,228	–	1,000	388	2,940	1,117
	908	902	21	26	105	124	325	415	1,662	276	2,401	566	5,422	2,309

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

[2] Pension related benefits for Simon Cocks include an allowance of £80,000 in lieu of being a member of the company's retirement benefit schemes (2017: £80,000). The same pension related benefits for Duncan Bates include an allowance of £15,000 (2017: £44,000). Pension related benefits for Stuart Ledger comprise £10,000 of contributions paid to money purchase schemes; there were no amounts outstanding at year end.

[3] 2017/18 LTIP remuneration includes the 2014/15 LTIP amount paid which vested fully on 31 March 2017, and the 2015/16, 2016/17 and 2017/18 LTIP amounts paid which vested fully following the sale of the group on 19 May 2017.

[4] Other remuneration in 2017/18 for Dr Philip Nolan consists of remuneration received in relation to the arrangement described on **page 81** of the remuneration policy report. Other remuneration in 2017/18 for both Simon Cocks and Duncan Bates consists of remuneration received in relation to the successful completion of the sale of the group on 19 May 2017, funded by former shareholders. Other remuneration for Stuart Ledger in 2017/18 and Simon Cocks in 2016/17 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 their previous employers.

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 table below shows the percentage of maximum annual bonus potential awarded in relation to the 2017/18 year for Stuart Ledger and Simon Cocks. No amounts in relation to these bonuses have been deferred.

Performance measure		Link to strategy (refer to page 15)	2017/18 target	Weighting for 2017/18 (as a % of base salary)		2017/18 achievement (as a % of base salary)	
				Simon Cocks	Stuart Ledger	Simon Cocks	Stuart Ledger
Financial measure	Cash generated by operations (annual target): net cash outflow before taxation and financing[1]	Value creation imperative	£82.6m	50.00%	37.50%	37.40%	28.05%
Operational measures	Leakage (annual target): volume of water lost through leaks on the network (ML/d)	Customer outcome	173.1	3.57%	2.68%	3.02%	2.27%
	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%	3.02%	2.27%
	Water quality (quarterly targets): number of water quality compliance failures	Customer outcome	Q1: 7 Q2: 8 Q3: 10 Q4: 7	3.57%	2.68%	0.00%	0.00%
	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 per quarter	3.57%	2.68%	0.76%	0.57%
	Water Saving Programme (quarterly targets): number of meters installed	Customer outcome	16,500 per quarter	3.57%	2.68%	2.27%	1.70%
Customer and community measures	SIM[2] (annual target): our lowest score in the qualitative element of SIM	Customer outcome	80	3.57%	2.68%	3.02%	2.27%
	Cash collections (annual target): the amount of cash collected through billing in respect of water revenue	Customer outcome	£229.0m	3.57%	2.68%	3.02%	2.27%
Personal performance[3]				25.00%	18.75%	23.00%	17.81%
Total % of base salary				100.00%	75.00%	75.51%	57.21%
Base salary						£355,000	£100,000[4]
Bonus paid						£268,000	£57,000

[1] This "non-GAAP" measure is calculated as the total of the following line items per the statement of cash flows (refer to **page 111**): cash generated from operations; purchases of property, plant and equipment; capital contributions; proceeds on disposal of property, plant and equipment; and purchase of intangibles

[2] 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).

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

[4] Stuart Ledger's annual bonus was calculated as a percentage of six months of his base salary.

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, 2015/16, 2016/17 and 2017/18 LTIP)

Duncan Bates received base awards under the 2014/15 LTIP scheme, which related to the three year performance period that ended on 31 March 2017. The 2015/16, 2016/17 and 2017/18 LTIP schemes were due to vest in the years to 31 March 2018, 31 March 2019 and 31 March 2020 respectively however these vested fully in the year to 31 March 2018 following the sale of the group on 19 May 2017 in accordance with the provisions of the scheme's rules relating to change of control clause.

During the year, the Committee reviewed and approved a revised structure for the LTIP for 2018/19 with the objective of better incentivising the delivery of long term sustainable performance for customers and communities, employees and shareholders. Key changes from the previous LTIP include:

- giving more weight to non-financial performance measures;
- a cap on the award payable (150% of salary (CEO) and 125% of salary (CFO));
- staged payment of vested awards with the final payment made at the end of the fifth year; and
- no automatic vesting of unvested awards in the event of change of control.

For the 2018/19 LTIP the performance conditions for 2018/19 and 2019/20 have been set and the performance conditions for 2020/21 will be set on agreement of AMP7 performance commitments.

Further information regarding directors' remuneration during the year and future policy can be found within the remuneration report on **pages 79 to 91**.

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 2.07, as detailed in the company's Accounting Separation Methodology Statement, which can be found on the company's stakeholder website: **stakeholder.affinitywater.co.uk/reports-publications.aspx**. 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 2018

	Retail		Wholesale			
	Household £000	Non-household £000	Water resources £000	Water network+ £000	Water Total £000	Total £000
Revenue – price control	27,364	–	–	271,171	271,171	298,535
Revenue – non price control	–	–	–	2,457	2,457	2,457
Operating expenditure	(30,318)	–	(15,545)	(141,796)	(157,341)	(187,659)
Depreciation – tangible fixed assets	(16)	–	(1,120)	(51,541)	(52,661)	(52,677)
Amortisation – intangible fixed assets	(1,408)	–	–	(7,868)	(7,868)	(9,276)
Other operating income	1,108	–	133	(1,301)	(1,168)	(60)
Operating profit before recharges	**(3,270)**	**–**	**(16,532)**	**71,122**	**54,590**	**51,320**
Recharges from other segments	(1,914)	–	(331)	–	(331)	(2,245)
Recharges to other segments	–	–	–	2,245	2,245	2,245
Operating profit	**(5,184)**	**–**	**(16,863)**	**73,367**	**56,504**	**51,320**

Regulatory annual performance report continued

Section 2 – Price review and other segmental reporting (continued)

2B - TOTEX ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2018 – WHOLESALE WATER

	Water resources £000	Water network+ £000	Total £000
Operating expenditure			
Power	2,889	17,758	20,647
Income treated as negative expenditure	(44)	(267)	(311)
Abstraction charges / discharge consents	3,805	–	3,805
Bulk supply / bulk discharge	1,274	6,271	7,545
Other operating expenditure			
Renewals expensed in the year (Infrastructure)	–	14,643	14,643
Renewals expensed in the year (Non-Infrastructure)	–	–	–
Other operating expenditure excluding renewals	5,619	87,415	93,034
Local authority and Cumulo rates	2,002	13,854	15,856
Total operating expenditure excluding third party services	**15,545**	**139,674**	**155,219**
Third party services	–	**2,122**	**2,122**
Total operating expenditure	**15,545**	**141,796**	**157,341**
Capital expenditure			
Maintaining the long term capability of the assets - infra	–	27,250	27,250
Maintaining the long term capability of the assets – non-infra	212	45,275	45,487
Other capital expenditure – infra	–	5,796	5,796
Other capital expenditure – non-infra	3,881	32,357	36,238
Infrastructure network reinforcement	–	3,200	3,200
Total gross capital expenditure (excluding third party)	**4,093**	**113,878**	**117,971**
Third party services	–	**(146)**	**(146)**
Total gross capital expenditure	**4,093**	**113,732**	**117,825**
Grants and contributions			
Less: Grants and contributions	–	21,386	21,386
Totex	**19,638**	**234,142**	**253,780**
Cash expenditure			
Pension deficit recovery payments	153	1,645	1,798
Other cash items	–	–	–
Totex including cash items	**19,791**	**235,787**	**255,578**

2C - OPERATING COST ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2018 – RETAIL

	Household £000	Non-household £000	Total £000
Operating expenditure			
Customer services	7,650	–	7,650
Debt management	2,041	–	2,041
Doubtful debts	8,627	–	8,627
Meter reading	2,894	–	2,894
Services to developers	–	–	–
Other operating expenditure	9,106	–	9,106
Total operating expenditure excluding third party services	**30,318**	-	**30,318**
Third party services operating expenditure	–	–	–
Total operating expenditure	**30,318**	**–**	**30,318**
Depreciation – tangible fixed assets	16	–	16
Amortisation – intangible fixed assets	1,408	–	1,408
Total operating costs	**31,742**	**–**	**31,742**
Debt written off	**7,299**	**–**	**7,299**

Household operating costs and other operating income (refer to table 2A) are £2,068,000 greater than revenue allowed in the PR14 determination. This variance was due in part to assumptions in our allocation methodologies for household costs, in the PR14 determination compared to actual household costs following the non-household retail market opening on 1 April 2017. The primary driver, however, was that cost efficiencies assumed in the PR14 determination were not fully achieved.

Non-household operating costs and other operating income (refer to table 2A) are £3,610,000 less than revenue allowed in the PR14 determination. This is due to exiting the non-household retail market on 1 April 2017.

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 2017	23,213	1,881,326	4,167	—	1,908,706
Disposals	—	(2,391)	—	—	(2,391)
Additions	4,093	105,070	268	—	109,431
Adjustments	—	—	—	—	—
Assets adopted at nil cost	—	—	—	—	—
At 31 March 2018	**27,306**	**1,984,005**	**4,435**	**—**	**2,015,746**
Depreciation					
At 1 April 2017	(10,844)	(576,087)	(983)	—	(587,914)
Disposals	—	211	—	—	211
Adjustments	—	—	—	—	—
Charge for the year	(1,120)	(51,541)	(16)	—	(52,677)
At 31 March 2018	**(11,964)**	**(627,417)**	**(999)**	**—**	**(640,380)**
Net book amount at 31 March 2018	**15,342**	**1,356,588**	**3,436**	**—**	**1,375,366**
Net book amount at 1 April 2017	12,369	1,305,239	3,184	—	1,320,792
Depreciation charge for year					
Principal services	(1,120)	(50,797)	(16)	—	(51,933)
Third party services	—	(744)	—	—	(744)
Total	(1,120)	(51,541)	(16)	—	(52,677)

The net book value includes £152,030,000 in respect of assets in the course of construction.

2E - ANALYSIS OF CAPITAL CONTRIBUTIONS AND LAND SALES FOR THE 12 MONTHS ENDED 31 MARCH 2018 – 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)	7,007	–	–	**7,007**
Infrastructure charge receipts (s146)	–	4,742	–	**4,742**
Requisitioned mains (s43, s55 and s56)	–	1,336	–	**1,336**
Other contributions (price control)	–	–	–	–
Diversions (s185)	–	8,301	–	**8,301**
Other contributions (non-price control)	–	–	–	–
Total	7,007	14,379	–	**21,386**
Value of adopted assets	–	–	–	–

Movements in capitalised grants and contributions	
Brought forward	**97,059**
Capitalised in year	**14,379**
Amortisation (in income statement)	**(1,667)**
Carried forward	**109,771**

Land sales	
Proceeds from disposals of protected land	**467**

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	111,273	12,528	123,801	636,973	19.67
Measured water only customer	105,496	14,836	120,332	727,593	20.39
Total	**216,769**	**27,364**	**244,133**	**1,364,566**	**20.05**

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 customer £
Non-default tariffs					
Total non-default tariffs	**20**	**–**	**20**	**2**	**–**
Default tariffs					
AFW Metered 0-5 Ml, including assessed customers and unmeasured RV customers	30,887	–	30,887	71,882	–
Water supplies 5 to 50 Ml	18,196	–	18,196	2,307	–
Water supplies 50 Ml and over	5,299	–	5,299	78	–
Total default tariffs	**54,382**	**–**	**54,382**	**74,267**	**–**
Total	**54,402**	**–**	**54,402**	**74,269**	**–**

	Number of customers	Average non-household retail revenue per customer £
Revenue per customer		
Total	**74,269**	**–**

2I - REVENUE ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2018

	Household £000	Non-household £000	Total £000
Wholesale charge – water			
Unmeasured	111,273	2,401	113,674
Measured	105,496	52,001	157,497
Third party revenue	–	–	–
Wholesale total	**216,769**	**54,402**	**271,171**
Retail revenue			
Unmeasured	12,528	–	12,528
Measured	14,836	–	14,836
Other third party revenue	–	–	–
Retail total	**27,364**	**–**	**27,364**
Third party revenue – non-price control			
Bulk supplies			2,280
Other third party revenue			177
Principal services – non-price control			
Other appointed revenue			–
Total appointed revenue			**300,992**

	Total £000
Wholesale revenue governed by price control	271,171
Grants & contributions[1]	13,085
Total revenue governed by wholesale price control	**284,256**
Amount assumed in wholesale determination	277,577
Adjustment for in-period ODI revenue	–
Adjustment for WRFIM[2]	(96)
Total assumed revenue	**277,481**
Difference	**6,775**

£4,157,000 of the variance between allowed and actual revenue under the wholesale price control relates to increased grants and contributions received following increased developer services work during the year. The remaining variance relates to non-household volume data being higher than anticipated in the company's Business Plan. Following market reform and the opening of the non-household retail market, new reports of billing/volume data have been created by the market operator in accordance with the operating code of the market. Non-household volume data within these reports include estimates that will not be 'firm' until sometime after the end of any period. This means an inherent additional uncertainty in non-household wholesale revenue recognised while the market and billing/volume data settles over time through to a full and final reconciliation. This issue will improve as the length of the billing record has several read cycles to assess volumes in a specific period.

[1] Relevant capital contributions as defined in the company's final determination for PR14.

[2] This amount consists of a £1,338,000 WRFIM adjustment relating to 2015/16 and a (£1,433,000) revenue correction mechanism adjustment relating to AMP5.

Regulatory annual performance report continued

Section 2 – Price review and other segmental reporting (continued)

2J – INFRASTRUCTURE NETWORK REINFORCEMENT COSTS FOR THE 12 MONTHS ENDED 31 MARCH 2018

Wholesale water network+ (treated water distribution)	Network reinforcement capex £000	On site/site specific capex (memo only) £000
Distribution and trunk mains	1,890	–
Pumping and storage facilities	1,310	–
Other	–	–
Total	**3,200**	**–**

Section 3 - Performance summary

3A - OUTCOME PERFORMANCE TABLE

Unique ID	Performance commitment	Unit (decimal places)	2016-17 performance level - actual	2017-18 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 (1)	173.0	172.7	Yes	N/A	N/A	None	£nil	None	£nil
PR14AF WWSW _W-A2	Average water use	l/person/d (1)	159.7	151.7	Yes	N/A	N/A	None	£nil	None	£nil
PR14AF WWSW _W-A3	Water available for use	ML/d (1)	1,153.0	1,135.6	Yes	N/A	N/A	None	£nil	None	£nil
PR14AF WWSW _W-A4	Sustainable abstraction reduction	ML/d (1)	-12.5	-32.7	Yes	N/A	N/A	Outperformance payment	1,264.800	Outperformance payment	1,264.800
PR14AF WWSW _W-A5	Abstraction incentive mechanism	N/A (N/A)	-2.55	-5.106	–	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	99.96	Yes	N/A	N/A	None	£nil	None	£nil
PR14AF WWSW _W-B2	Customer contacts for discolouration	Number per 1,000 people (2)	0.28	0.27	Yes	N/A	N/A	None	£nil	None	£nil
PR14AF WWSW _W-C1	Unplanned interruptions to supply over 12 hours	Number of properties (0)	1,840	7,890	No	N/A	N/A	Underperformance penalty	(1,637.600)	Underperformance penalty	(4,912.800)
PR14AF WWSW _W-C2	Mains bursts	Number of bursts (0)	3,077	2,923	Yes	N/A	N/A	None	£nil	None	£nil
PR14AF WWSW _W-C3	Customers not being notified of planned interruptions	Number of properties (0)	111	282	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	484	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 (2)	78.51	80.91	—	N/A	N/A	None	£nil	None	£nil
PR14AF WHHR _R-A2	Value for money survey	Score out of 100 (1)	69.6	67.7	–	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.

Regulatory annual performance report continued

Section 3 - Performance summary (continued)

3A - OUTCOME PERFORMANCE TABLE (CONTINUED)

The company set itself 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 2017/18 the company met or exceeded these targets. There was one exception where the target was not met, explained below. The company exceeded its target for sustainable abstraction reduction in the year.

Unplanned interruptions to supply over 12 hours

We have not met our performance commitment for unplanned interruptions to supply over 12 hours. As a result we have incurred a penalty through our ODI regime. This is the fourth successive year we have not achieved this KPI.

Performance against this metric is very disappointing and we are aware that we need to make significant improvements. In order to reduce interruptions we are focusing on how prevention and restoring supplies can be improved.

During the year we launched our 24 hour network control desk the role of which is to provide a central coordination point for all network activities, including emergencies. If it had not been for the severe weather event in early March 2018, the business would have achieved its performance commitments for the whole of the second half of the year and we are optimistic that we can achieve our targets going forwards.

3B – SUB-MEASURE PERFORMANCE TABLE

This table has not been presented, as the company does not have any sub-measures to report.

3C – ABSTRACTION INCENTIVE MECHANISM ('AIM')

Abstraction site	Decimal places	2017-18 AIM performance	2017-18 normalised AIM performance	Cumulative AIM performance 2017-18	Cumulative normalised AIM performance	Contextual information relating to performance on the AIM
BRIC	1	88.4	0.13	321.6	0.26	AIM calculated for BRIC and NETH combined
NETH	1	0.0	0.00	0.0	0.00	AIM calculated for BRIC and NETH combined
WELL	1	4.0	0.37	4.0	0.37	
OUGH	1	-55.8	-0.85	-55.8	-0.85	AIM calculated for OUGH and OFFS combined
OFFS	1	0.0	0.00	0.0	0.00	AIM calculated for OUGH and OFFS combined
DIGS	1	23.1	0.05	23.1	0.05	
FULL	1	N/A	N/A	N/A	N/A	Sustainability Reduction implemented as of 1st April 2017 so the site will be removed from AIM going forward.
BOWB	1	N/A	N/A	N/A	N/A	Sustainability Reduction implemented as of 1st April 2016 so the site will be removed from AIM going forward.
HOLY	1	13.1	0.01	13.1	0.01	AIM calculated for HOLY and MUDD combined
MUDL	1	0.0	0.00	0.0	0.00	AIM calculated for HOLY and MUDD combined
MARL	1	-102.9	-0.07	-102.8	-0.07	AIM calculated for MARL and PICC combined
PICC	1	0.0	0.00	0.0	0.00	AIM calculated for MARL and PICC combined
AMER	1	-172.9	-0.18	-172.9	-0.18	AIM calculated for AMER and CHAL combined
CHAL	1	0.0	0.00	0.0	0.00	AIM calculated for AMER and CHAL combined
WHIT	1	N/A	N/A	-14.9	-0.39	
CHES	1	-154.9	-0.43	-154.9	-0.43	
HUGH	1	N/A	N/A	-181.3	-0.60	Sustainability Reduction implemented as of 1st April 2017 so the site will be removed from AIM going forward.
PERI	1	-1,919.1	-0.65	-3,542.6	-1.31	AIM calculated for PERI and RUNL combined
RUNL	1	0.0	0.00	0.0	0.00	AIM calculated for PERI and RUNL combined
SLIP	1	-122.0	-0.31	-124.9	-1.12	
SPRI	1	-568.2	-0.41	-568.2	-0.41	AIM calculated for SPRI and SBUC combined
SBUC	1	0.0	0.00	0.0	0.00	AIM calculated for SPRI and SBUC combined
SDNG	1	-79.9	-0.22	-112.9	-0.44	
Total	**1**	**-3,047.0**	**-2.56**	**-4,669.2**	**-5.11**	

3D – SIM SCORE TABLE

Row	Line description	Units	Decimal places	Score
1	1st survey score	score	2	4.14
2	2nd survey score	score	2	4.38
3	3rd survey score	score	2	4.17
4	4th survey score	score	2	4.35
5	Qualitative SIM score (out of 75)	calc	2	61.13
6	Total contact score	score	2	104.32
7	Quantitative SIM score (out of 25)	calc	2	19.78
8	Total annual SIM score (out of 100)	calc	2	80.91

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information

ACCOUNTING SEPARATION POLICY

Tables 4B, 4C, 4D, 4F, 4G, 4J and 4L 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/reports-publications.aspx**. 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 2018

	Unmeasured	Measured
Retail - household		
Number of void households	24,309	31,059
Per capita consumption (excluding supply pipe leakage) l/h/d	168.61	134.84
		Water
Wholesale		
Volume (ML/d)		
Bulk supply export		17.381
Bulk supply import		31.263
Distribution input		916.726

4B - WHOLESALE TOTEX ANALYSIS

	2018 £000	Cumulative £000
Actual totex	**255,578**	**753,666**
Less: Items excluded from the menu		
Third party costs	**1,976**	9,160
Pension deficit recovery payments	**1,798**	7,702
Other 'Rule book' adjustments	**429**	502
Total costs excluded from the menu	**4,203**	17,364
Add: Transition expenditure		
Transition expenditure	**–**	–
Adjusted actual totex	**251,375**	736,302
Adjusted actual totex – base year prices	**223,730**	679,855
Allowed totex based on final menu choice – base year prices	**212,300**	698,400

The difference between actual and allowed cumulative totex on a cumulative basis 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. However, these programmes of work were running at full capacity in 2017/18, resulting in an in year overspend in 2017/18 that has made up for some of the deficit built up in years 1 and 2 of AMP6. 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

	2018 £000
Cumulative totex over/underspend so far in the price control period	**48,466**
Customer share of cumulative totex over/underspend	**21,296**
RCV element of cumulative totex over/underspend so far in the price control period	**5,287**
Adjustment for ODI rewards or penalties	**(4,099)**
RCV determined at final determination at 31 March	**1,207,135**
Projected 'shadow' RCV	**1,208,323**

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

4D - TOTEX ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2018 – 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	–	2,889	2,889	–	2,280	12,589	20,647
Income treated as negative expenditure	–	(44)	(44)	–	(34)	(189)	(311)
Abstraction charges / discharge consents	3,805	–	–	–	–	–	3,805
Bulk supply	915	359	–	–	6,271	–	7,545
Other operating expenditure							
Renewals expensed in the year (Infrastructure)	–	–	–	–	–	14,643	14,643
Renewals expensed in the year (Non-Infrastructure)	–	–	–	–	–	–	–
Other operating expenditure excluding renewals	918	4,701	3,956	685	16,433	66,341	93,034
Local authority and Cumulo rates	3	1,999	341	–	2,922	10,591	15,856
Total operating expenditure excluding third party services	**5,641**	**9,904**	**7,142**	**685**	**27,872**	**103,975**	**155,219**
Third party services	–	–	–	–	–	2,122	2,122
Total operating expenditure	**5,641**	**9,904**	**7,142**	**685**	**27,872**	**106,097**	**157,341**
Capital expenditure							
Maintaining the long-term capability of the assets – infra	–	–	101	–	–	27,149	27,250
Maintaining the long-term capability of the assets – non-infra	–	212	639	–	17,673	26,963	45,487
Other capital expenditure – infra	–	–	–	–	10	5,786	5,796
Other capital expenditure – non-infra	–	3,881	472	–	13,039	18,846	36,238
Infrastructure network reinforcement	–	–	–	–	474	2,726	3,200
Total gross capital expenditure (excluding third party)	**–**	**4,093**	**1,212**	**–**	**31,196**	**81,470**	**117,971**
Third party services	–	–	–	–	(181)	35	(146)
Total gross capital expenditure	**–**	**4,093**	**1,212**	**–**	**31,015**	**81,505**	**117,825**
Less: Grants and contributions	–	–	–	–	–	21,386	21,386
Totex	**5,641**	**13,997**	**8,354**	**685**	**58,887**	**166,216**	**253,780**
Cash expenditure							
Pension deficit recovery payments	19	134	61	8	394	1,182	1,798
Other cash items	–	–	–	–	–	–	–
Totex including cash items	**5,660**	**14,131**	**8,415**	**693**	**59,281**	**167,398**	**255,578**

Unit cost information (operating expenditure)

	Water resources		Network+			
	Licensed volume available	Volume abstracted	Volume transported	Average volume stored	Distribution input volume	Distribution input volume
Volume (ML)	424,091	341,614	109,684	–	334,605	334,605
Unit cost (£/ML)	13.30	28.99	65.11	–	83.30	317.08
Population	3,719,697	3,719,697	3,719,697	3,719,697	3,719,697	3,719,697
Unit cost (£/pop)	1.52	2.66	1.92	0.18	7.49	28.52

4F – OPERATING COST ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2018 – HOUSEHOLD RETAIL

	Unmeasured £000	Measured £000	Total £000
Operating expenditure			
Customer services	3,111	4,539	7,650
Debt management	1,035	1,006	2,041
Doubtful debts	3,129	5,498	8,627
Meter reading	–	2,894	2,894
Other operating expenditure	4,251	4,855	9,106
Total operating expenditure excluding third party services	**11,526**	**18,792**	**30,318**
Third party services operating expenditure	–	–	–
Total operating expenditure	**11,526**	**18,792**	**30,318**
Depreciation – tangible fixed assets			
– on assets existing at 31 March 2015	7	9	16
– on assets acquired since 1 April 2015	–	–	–
Amortisation – intangible fixed assets			
– on assets existing at 31 March 2015	304	348	652
– on assets acquired since 1 April 2015	352	404	756
Total operating costs	**12,189**	**19,553**	**31,742**
Capital expenditure	**517**	**593**	**1,110**

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	1,963
Demand-side water efficiency – expenditure funded by wholesale	(1,498)
Demand-side water efficiency – net retail expenditure	**465**
Customer-side leak repairs – gross expenditure	742
Customer-side leak repairs – expenditure funded by wholesale	–
Customer-side leak repairs – net retail expenditure	**742**

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 2018

Income Statement	Total £000
Revenue	**273,628**
Operating expenditure	(157,341)
Capital maintenance charges	(88,938)
Other operating income	(1,168)
Current cost operating profit	**26,181**
Other income	22,072
Interest income	237
Interest expense	(49,496)
Other interest expense	1,971
Current cost profit before tax and fair value movements	**965**
Fair value gains/(losses) on financial instruments	–
Current cost profit before tax	**965**

4H - FINANCIAL METRICS FOR THE 12 MONTHS ENDED 31 MARCH 2018

Financial indicators	
Net debt	£961.692m
Regulated equity	£245.443m
Regulated gearing	79.67%
Post tax return on regulated equity	10.40%
RORE (return on regulated equity)	5.61%
Dividend yield	20.59%
Retail profit margin – Household	(1.79)%
Retail profit margin – Non household	–
Credit rating	Baa1
Return on RCV	6.12%
Dividend cover	0.43
Funds from operations (FFO)	£78.513m
Interest cover (cash)	3.14
Adjusted interest cover (cash)	1.79
FFO/Debt	0.08
Effective tax rate	16.04%
Free cash flow (RCF)	£27.981m
RCF/capex	0.23

4H - FINANCIAL METRICS FOR THE 12 MONTHS ENDED 31 MARCH 2018 (CONTINUED)

Revenue and earnings	
Revenue (actual)	£298.535m
EBITDA (actual)	£110.876m
Borrowings	
Proportion of borrowings which are fixed rate	62.86%
Proportion of borrowings which are floating rate	–
Proportion of borrowings which are index linked	37.14%
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	1.31%
Proportion of borrowings due in more than 5 years but no more than 20 years	63.07%
Proportion of borrowings due in more than 20 years	35.62%

4H - FINANCIAL METRICS – RETURN ON REGULATED EQUITY

Breakdown of RORE components	2015/16	2016/17	2017/18	To date
Base RORE – appointee	6.19%	6.19%	6.12%	6.17%
1 - Company share of totex out/(under) performance[1]	+0.00%	(0.40%)	+0.00%	(0.13%)
2 - Company share of out/(under) performance on retail costs	(1.16%)	(0.99%)	(1.02%)	(1.06%)
3 - Impact on RCV runoff of the out/(under) performance of totex	+0.00%	+0.01%	+0.00%	+0.00%
4 - Impact on ODI/SIM in year	(0.36%)	(0.35%)	(0.08%)	(0.26%)
5 - Difference between actual interest charge and allowed on notional debt	(0.54%)	+1.28%	+1.93%	0.89%
Outturn RORE	**4.13%**	**5.74%**	**6.95%**	**5.61%**

The key components driving the reduction in base RORE set at the last price review, from 6.17% to 5.56%, are higher retail service costs of £11.6m and the impact of a failed ODI in each year of the AMP with a resultant cumulative penalty of £3.9m, being partly offset by a £1.0m ODI reward in the current year and £9.4m lower real cost of debt across the three years. An adjustment in the current year has been made for the timing of £13.9m of total expenditure overspend in the year which was delayed from 2015/16.

4I - FINANCIAL DERIVATIVES FOR THE 12 MONTHS ENDED 31 MARCH 2018

This table has not been presented, as the company did not hold any financial derivatives during the year ended 31 March 2018.

[1] No totex out/(under) performance in 2015/16 or 2017/18 as variance was due to timing of expenditure expected to be incurred in the remaining years of the AMP.

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

4J - ATYPICAL EXPENDITURE BY BUSINESS UNIT FOR THE 12 MONTHS ENDED 31 MARCH 2018 - 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 (excluding atypicals)							
Power	–	2,889	2,889	–	2,280	12,589	20,647
Income treated as negative expenditure	–	(44)	(44)	–	(34)	(189)	(311)
Abstraction charges	3,805	–	–	–	–	–	3,805
Bulk supply	915	359	–	–	6,271	–	7,545
Other operating expenditure							
Renewals expensed in the year (Infrastructure)	–	–	–	–	–	14,643	14,643
Renewals expensed in the year (Non-Infrastructure)	–	–	–	–	–	–	–
Other operating expenditure excluding renewals	918	4,701	3,956	685	16,433	66,341	93,034
Local authority and Cumulo rates	3	1,999	341	–	2,922	10,591	15,856
Total operating expenditure excluding third party services	**5,641**	**9,904**	**7,142**	**685**	**27,872**	**103,975**	**155,219**
Third party services	–	–	–	–	–	2,122	2,122
Total operating expenditure	**5,641**	**9,904**	**7,142**	**685**	**27,872**	**106,097**	**157,341**
Capital expenditure (excl. atypicals)							
Maintaining the long-term capability of the assets – infra	–	–	101	–	–	27,149	27,250
Maintaining the long-term capability of the assets – non-infra	–	212	639	–	17,673	26,963	45,487
Other capital expenditure – infra	–	–	–	–	10	5,786	5,796
Other capital expenditure – non-infra	–	3,881	472	–	13,039	18,846	36,238
Infrastructure network reinforcement	–	–	–	–	474	2,726	3,200
Total gross capital expenditure (excluding third party)	**–**	**4,093**	**1,212**	**–**	**31,196**	**81,470**	**117,971**
Third party services	–	–	–	–	(181)	35	(146)
Total gross capital expenditure	**–**	**4,093**	**1,212**	**–**	**31,015**	**81,505**	**117,825**
Less: Grants and contributions	–	–	–	–	–	21,386	21,386
Totex	**5,641**	**13,997**	**8,354**	**685**	**58,887**	**166,216**	**253,780**
Cash expenditure (excl. atypicals)							
Pension deficit recovery payments	19	134	61	8	394	1,182	1,798
Other cash items	–	–	–	–	–	–	–
Totex including cash items	**5,660**	**14,131**	**8,415**	**693**	**59,281**	**167,398**	**255,578**
Atypical expenditure							
Item 1	–	–	–	–	–	–	–
Total atypical expenditure	**–**	**–**	**–**	**–**	**–**	**–**	**–**
Total expenditure	**5,660**	**14,131**	**8,415**	**693**	**59,281**	**167,398**	**255,578**

4L - ENHANCEMENT CAPITAL EXPENDITURE BY PURPOSE FOR THE 12 MONTHS ENDED 31 MARCH 2018 - WHOLESALE WATER

	Expenditure in report year							Cumulative expenditure on schemes completed in the report year						
	Water resources		Network+					Water resources		Network+				
Enhancement capital expenditure by purpose	Abstraction licences	Raw water abstraction	Raw water transport	Raw water storage	Water treatment	Treated water distribution	Total	Abstraction licences	Raw water abstraction	Raw water transport	Raw water storage	Water treatment	Treated water distribution	Total
NEP - Making ecological improvements at abstractions (Habitats Directive, SSSI, NERC, BAPs)	–	2,016	–	–	–	–	2,016	–	–	–	–	–	–	–
NEP - Eels Regulations (measures at intakes)	–	253	–	–	–	–	253	–	–	–	–	–	–	–
Addressing low pressure	–	–	–	–	–	1,256	1,256	–	–	–	–	–	–	–
Improving taste/odour/colour	–	–	–	–	232	381	613	–	–	–	–	197	–	197
Meeting lead standards	–	–	–	–	–	2,142	2,142	–	–	–	–	–	2,745	2,745
Supply side enhancements to the supply/demand balance (dry year critical/ peak conditions)	–	–	–	–	–	1,195	1,195	–	–	–	–	–	–	–
Supply side enhancements to the supply/demand balance (dry year annual average conditions)	–	1,010	–	–	–	(288)	722	–	848	–	–	–	332	1,180
Demand side enhancements to the supply/demand balance (dry year critical/ peak conditions)	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Demand side enhancements to the supply/demand balance (dry year annual average conditions)	–	–	–	–	–	–	–	–	–	–	–	–	–	–
New developments	–	–	–	–	484	6,173	6,657	–	–	–	–	–	1,933	1,933
New connections element of new development (CPs, meters)	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Investment to address raw water deterioration (THM, nitrates, Crypto, pesticides, others)	–	112	–	–	10,679	–	10,791	–	–	–	–	32	–	32
Resilience	–	111	472	–	327	4,137	5,047	–	–	–	–	553	2,487	3,040
SEMD	–	–	–	–	1,801	433	2,234	–	–	–	–	2,943	–	2,943
NEP - Investigations	–	379	–	–	–	–	379	–	–	–	–	–	–	–
Improvements to river flows	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Metering (excluding cost of providing metering to new service connections) - meters requested by optants	–	–	–	–	–	259	259	–	–	–	–	–	489	489
Metering (excluding cost of providing metering to new service connections) - meters introduced by companies	–	–	–	–	–	11,670	11,670	–	–	–	–	–	6,283	6,283
Metering (excluding cost of providing metering to new service connections) - other	–	–	–	–	–	–	–	–	–	–	–	–	–	–
Total enhancement capital expenditure	**–**	**3,881**	**472**	**–**	**13,523**	**27,358**	**45,234**	**–**	**848**	**–**	**–**	**3,725**	**14,269**	**18,842**

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

4P - NON-FINANCIAL DATA FOR WR, WT AND WD FOR THE 12 MONTHS ENDED 31 MARCH 2018 - WHOLESALE WATER

Water resources	Units	Input
Proportion of distribution input derived from impounding reservoirs	Propn 0 to 1	**0.002**
Proportion of distribution input derived from pumped storage reservoirs	Propn 0 to 1	**0.006**
Proportion of distribution input derived from river abstractions	Propn 0 to 1	**0.351**
Proportion of distribution input derived from groundwater works, excluding managed aquifer recharge (MAR) water supply schemes	Propn 0 to 1	**0.641**
Proportion of distribution input derived from artificial recharge (AR) water supply schemes	Propn 0 to 1	**–**
Proportion of distribution input derived from aquifer storage and recovery (ASR) water supply schemes	Propn 0 to 1	**–**
Number of impounding reservoirs	Nr	**2**
Number of pumped storage reservoirs	Nr	**1**
Number of river abstractions	Nr	**4**
Number of groundwater works excluding managed aquifer recharge (MAR) water supply schemes	Nr	**117**
Number of artificial recharge (AR) water supply schemes	Nr	**–**
Number of aquifer storage and recovery (ASR) water supply schemes	Nr	**–**
Total number of sources	Nr	**124**
Total number of water reservoirs	Nr	**4**
Total capacity of water reservoirs	ML	**4,154**
Total number of intake and source pumping stations	Nr	**123**
Total number of raw water transfer stations	Nr	**2**
Total capacity of intake and source pumping stations	kW	**24,073**
Total capacity of raw water transfer pumping stations	kW	**2,546**
Total length of raw water mains and conveyors	km	**13.15**
Average pumping head – resources	m.hd	**17.62**
Average pumping head – raw water transport	m.hd	**17.68**

Water treatment	Units	Input
Total water treated at all SW simple disinfection works	ML/d	**–**
Total water treated at all SW1 works	ML/d	**–**
Total water treated at all SW2 works	ML/d	**–**
Total water treated at all SW3 works	ML/d	**–**
Total water treated at all SW4 works	ML/d	**–**
Total water treated at all SW5 works	ML/d	**345.88**
Total water treated at all SW6 works	ML/d	**–**
Total water treated at all GW simple disinfection works	ML/d	**32.83**
Total water treated at all GW1 works	ML/d	**–**
Total water treated at all GW2 works	ML/d	**10.35**
Total water treated at all GW3 works	ML/d	**65.23**
Total water treated at all GW4 works	ML/d	**266.07**
Total water treated at all GW5 works	ML/d	**182.49**
Total water treated at all GW6 works	ML/d	**–**
Total water treated at more than one type of works	ML/d	**–**
Total number of SW simple disinfection works	Nr	**–**
Total number of SW1 works	Nr	**–**
Total number of SW2 works	Nr	**–**
Total number of SW3 works	Nr	**–**
Total number of SW4 works	Nr	**–**
Total number of SW5 works	Nr	**5**
Total number of SW6 works	Nr	**–**
Total number of GW simple disinfection works	Nr	**8**
Total number of GW1 works	Nr	**–**
Total number of GW2 works	Nr	**5**
Total number of GW3 works	Nr	**6**
Total number of GW4 works	Nr	**55**
Total number of GW5 works	Nr	**15**
Total number of GW6 works	Nr	**–**
Number of treatment works requiring remedial action because of raw water deterioration	Nr	**6**
Zonal population receiving water treated with orthophosphate	Nr	**2,791,612**
Average pumping head – treatment	m.hd	**13.32**

Water distribution	Units	Input
Total length of potable mains as at 31 March	km	**16,682.3**
Total length of mains relined	km	**–**
Total length of mains renewed	km	**72.3**
Total length of new mains	km	**51.5**
Potable water mains (<320mm)	km	**15,409.6**
Potable water mains 320mm - 450mm	km	**602.7**
Potable water mains 450mm - 610mm	km	**495.7**
Potable water mains > 610mm	km	**174.8**

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

4P - NON-FINANCIAL DATA FOR WR, WT AND WD FOR THE 12 MONTHS ENDED 31 MARCH 2018 - WHOLESALE WATER (CONTINUED)

Water distribution (continued)	Units	Input
Total length of non-potable and partially treated main for supplying customers	km	5.4
Total length of non-potable and partially treated main for treatment	km	227.1
Capacity of booster pumping stations	kW	46,823
Capacity of service reservoirs	ML	1,525
Capacity of water towers	ML	39
Distribution input	ML/d	916.73
Water delivered (non-potable)	ML/d	0.06
Water delivered (potable)	ML/d	787.69
Water delivered (billed measured residential)	ML/d	252.21
Water delivered (billed measured business)	ML/d	170.55
Total leakage	ML/d	172.67
Distribution losses	ML/d	128.28
Water taken unbilled	ML/d	10.48
Number of lead communication pipes	Nr	323,913
Number of galvanised iron communication pipes	Nr	247,285
Number of other communication pipes	Nr	454,763
Number of booster pumping stations	Nr	212
Total number of service reservoirs	Nr	110
Number of water towers	Nr	45
Total length of mains laid or structurally refurbished pre-1880	km	77.6
Total length of mains laid or structurally refurbished between 1881 and 1900	km	205.9
Total length of mains laid or structurally refurbished between 1901 and 1920	km	619.4
Total length of mains laid or structurally refurbished between 1921 and 1940	km	2,540.0
Total length of mains laid or structurally refurbished between 1941 and 1960	km	3,932.5
Total length of mains laid or structurally refurbished between 1961 and 1980	km	3,787.3
Total length of mains laid or structurally refurbished between 1981 and 2000	km	2,761.2
Total length of mains laid or structurally refurbished post 2001	km	2,758.7
Average pumping head – distribution	m.hd	76.91

Band disclosure (nr)	Units	Input
WTWs in size band 1	Nr	31
WTWs in size band 2	Nr	25
WTWs in size band 3	Nr	18
WTWs in size band 4	Nr	11
WTWs in size band 5	Nr	6
WTWs in size band 6	Nr	0
WTWs in size band 7	Nr	2
WTWs in size band 8	Nr	1

Band disclosure (%)	Units	Input
Proportion of Total DI band 1	%	3.8%
Proportion of Total DI band 2	%	10.9%
Proportion of Total DI band 3	%	11.4%
Proportion of Total DI band 4	%	14.3%
Proportion of Total DI band 5	%	15.6%
Proportion of Total DI band 6	%	0.0%
Proportion of Total DI band 7	%	22.5%
Proportion of Total DI band 8	%	21.6%

4Q - NON-FINANCIAL DATA - PROPERTIES, POPULATION AND OTHER FOR THE 12 MONTHS ENDED 31 MARCH 2018 - WHOLESALE WATER

Properties and population	Units	Input
Residential properties billed for measured water (external meter)	000s	655.267
Residential properties billed for measured water (not external meter)	000s	72.325
Business properties billed measured water	000s	56.278
Residential properties billed for unmeasured water	000s	636.973
Business properties billed unmeasured water	000s	8.693
Total business connected properties at year end	000s	74.401
Total residential connected properties at year end	000s	1,425.795
Total connected properties at year end	000s	1,500.196
Number of residential meters renewed	000s	12.938
Number of business meters renewed	000s	0.217
Number of meter optants	000s	3.689
Number of meters installed at the request of optants	000s	55.214
Total number of new business connections	000s	0.754
Total number of new residential connections	000s	13.947
Total population served	000s	3,719.697
Number of business meters (billed properties)	000s	64.733
Number of residential meters (billed properties)	000s	860.486
Company area	km^2	4,515

Other	Units	Input
Number of lead communication pipes replaced for water quality	Nr	1,120
Total supply side enhancements to the supply demand balance (dry year critical / peak conditions)	ML/d	5.00
Total supply side enhancements to the supply demand balance (dry year annual average conditions)	ML/d	5.00
Total demand side enhancements to the supply demand balance (dry year critical / peak conditions)	ML/d	29.64
Total demand side enhancements to the supply demand balance (dry year annual average conditions)	ML/d	29.64
Energy consumption - network plus	kWh	186,931
Energy consumption - water resources	kWh	47,581
Energy consumption - wholesale	kWh	234,512
Peak factor	%	124.93%
Mean Zonal Compliance	%	99.96%
Volume of Leakage above or below the Sustainable Economic Level	ML/d	-48.349

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

4V - OPERATING COST ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2018 - WATER RESOURCES

	Impounding Reservoir £000	Pumped Storage £000	River Abstractions £000	Ground-water excluding MAR water supply schemes £000	Artificial Recharge (AR) water supply schemes £000	Aquifer Storage and Recovery (ASR) water supply schemes £000	Total £000
Power	6	17	1,014	1,852	–	–	2,889
Income treated as negative expenditure	–	–	(16)	(28)	–	–	(44)
Local authority and Cumulo rates	4	12	703	1,283	–	–	2,002
Other direct operating expenditure	16	47	2,770	5,056	–	–	7,889
Other indirect operating expenditure	6	17	986	1,800	–	–	2,809
Total operating expenditure (excluding 3rd party)	32	93	5,457	9,963	–	–	15,545
Depreciation	2	7	393	718	–	–	1,120
Total operating costs (excluding 3rd party)	**34**	**100**	**5,850**	**10,681**	**–**	**–**	**16,665**

OTHER EXPENDITURE FOR THE 12 MONTHS ENDED 31 MARCH 2018 - WHOLESALE WATER

	Water resources	Raw water distribution	Water treatment	Treated water distribution	Total
Item					
Employment costs - directly attributable (£000)	1,271	869	4,633	14,473	21,246
Employment costs - indirectly attributed (£000)	1,669	701	3,718	11,669	17,757
Number FTEs consistent with 4V.9 above	75	24	143	480	722
Number FTEs consistent with 4V.10 above	30	13	69	222	334
Costs associated with Traffic Management Act (£000)	–	–	–	1,978	1,978
Service charges					
Canal & River Trust service charges and discharge consents (£000)	–	–	–	–	–
Environment Agency service charges/ discharge consents (£000)	3,774	–	–	–	3,774
Other service charges / permits (£000)	31	–	–	–	31
Statutory water softening (£000)	–	–	–	–	–

TRANSACTIONS WITH ASSOCIATED COMPANIES

Company	Service	Turnover of associate £000	Terms of supply	Value £000
Expenditure				
Affinity Water Capital Funds Limited*	Interest paid on loan	–	Market rate at time of loan inception	160
Affinity Water Holdings Limited*	Dividends paid	–	No market – amount paid in line with dividend policy	58,498
Affinity Water Finance (2004) PLC*	Interest paid on loan	–	At market rate, on-lent by associate on the same terms	14,287
Affinity Water Programme Finance Limited*	Interest paid on loan	–	At market rate, on-lent by associate on the same terms	34,482
Income				
Affinity for Business (Retail) Limited	Wholesale water charges	58,512	At market rate from MOSL reports	50,909
	Recharges for support services – facilities	58,512	No market – actual costs either recharged by time allocation or at a fixed rate for service based on cost	150
	Recharges for support services – finance	58,512	No market – actual costs either recharged by time allocation or at a fixed rate for service based on cost	174
	Recharges for support services – Information Technology	58,512	No market – actual costs either recharged by time allocation or at a fixed rate for service based on cost	663
	Recharges for support services – HR, legal, and other support recharges	58,512	No market – actual costs either recharged by time allocation or at a fixed rate for service based on cost	159
	Recharges for meter read costs	58,512	Actual costs to the company recharged	417

* These companies do not have turnover.

The company has applied a materiality threshold of £100,000 for disclosing transactions with individual related parties. No contracts individually exceeded this threshold.

Regulatory Annual Performance Report

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

TRANSACTIONS WITH ASSOCIATED COMPANIES (CONTINUED)

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 £254,346,000 (2017: £254,747,000).

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 Notes due 2022 for a new issue of 3.278% Guaranteed Notes due 2042. An additional £19,200,000 of 3.278% Guaranteed Notes due 2042 were issued at the same time.

On 22 November 2017, Affinity Water Programme Finance Limited issued £60,000,000 Class A Guaranteed Notes maturing in November 2033 with a coupon of 2.699% and £60,000,000 Class A Guaranteed CPI linked Notes maturing in November 2042 with a coupon of 0.230%.

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 £814,613,000 (2017: £683,097,000).

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.

Affinity Water Limited also acquired tax losses from fellow group company Affinity Water Acquisitions Limited, amounting to £2,000,000 during the year.

It is intended that Affinity Water Limited will also acquire tax losses amounting to £411,000 from fellow group company Affinity for Business (Retail) Limited at fair value to offset its 2017/18 tax charge.

Payments for group relief are made at the headline tax rate.

TRANSFER OF ASSETS AND LIABILITIES BY THE APPOINTEE

At the start of the year the company exited the non-household retail market by a sale of that business segment, and now only operates in the retail household and wholesale price controls. The following assets and liabilities were transferred from Affinity Water Limited to Affinity for Business (Retail) Limited, an associated group company operating in the non-household retail market, at their fair value in exchange for cash.

	Value £000
Transfer of non-household receivables on market opening	17,380
Transfer of cash received in advance from non-household customers on market opening	(1,338)
Net assets transferred	**16,042**

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 or below 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 £58,498,000 during the year ended 31 March 2018. This compares to £50,500,000 declared and paid in the year ended 31 March 2017.

The increase in dividends year on year can be attributed to the increase in RPI on RCV and proceeds from the disposal of the company's non-household retail business to Affinity for Business (Retail) Limited.

No final dividend is proposed (2017: £nil).

VIABILITY STATEMENT

The company's viability statement, including information on the company's approach to producing this statement and which captures Ofwat guidance, can be found within the strategic report on **pages 44 to 46**. The sensitivities used in stress-testing the base case cash flow forecast were in some instances more severe than those proposed by Ofwat to be used in stress-testing AMP7 business plans. There were not any concerns arising from the results of the stress tests requiring disclosure of an action plan.

Details of the third party assurance obtained over the viability statement can be found within our Data Assurance Report, which is published on our stakeholder website: **stakeholder.affinitywater.co.uk**. PwC did not include any matters in their independent auditor's report on **pages 100 to 106** in relation to the viability statement.

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 lower than the standard rate of corporation tax in the UK of 19% for the year ended 31 March 2018. The differences are explained below:

	£000
Profit on appointed activities before tax	**26,104**
Tax calculated at the standard rate of tax in the UK of 19%	4,960
Tax effects of:	
- Adjustments in respect of prior years	(3,353)
- Expenses not deductible for tax purposes	51
- Accelerated capital allowances	1,809
- Other timing differences - pension	(678)
- Other timing differences - provisions	126
- Non-taxable profit on disposal of non-household business	(2,082)
Appointed current tax charge	**833**

Significant variations between the appointed current tax charge and the total current tax charge for the year ended 31 March 2018 allowed in the company's price limits are explained below:

	£000
Appointed current tax charge	**833**
Variance in profit before tax excluding profit on disposal of non-household business	(2,655)
Non-taxable profit on disposal of non-household business	2,082
Adjustments in respect of prior years	3,353
Variance in assumptions - capital allowances	(3,466)
Other timing differences - pensions	163
Other	(6)
Total current tax charge allowed in price limits	**304**

FACTORS AFFECTING FUTURE TAX CHARGES

In September 2016 changes were enacted to the main rate of corporation tax in the UK to reduce it 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 our customers are based here. All 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 **page 61**.

For further information on our assurance procedures and results, please refer to our Data Assurance Report, which is published on our stakeholder website: **stakeholder.affinitywater.co.uk**.

Areas of supply

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