Investor Report

Affinity Water Limited ('Affinity Water')

Six month period ended 30 September 2018

Published on 24 December 2018

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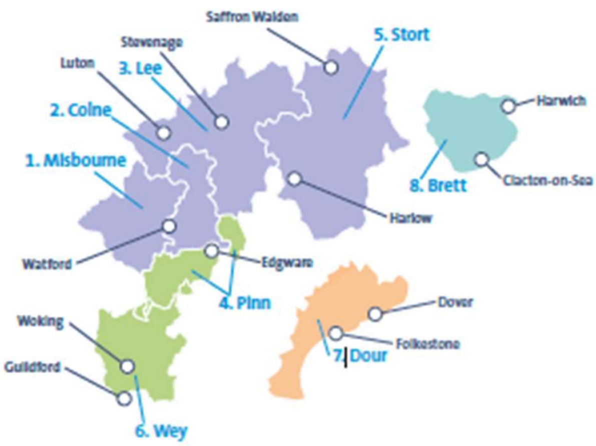
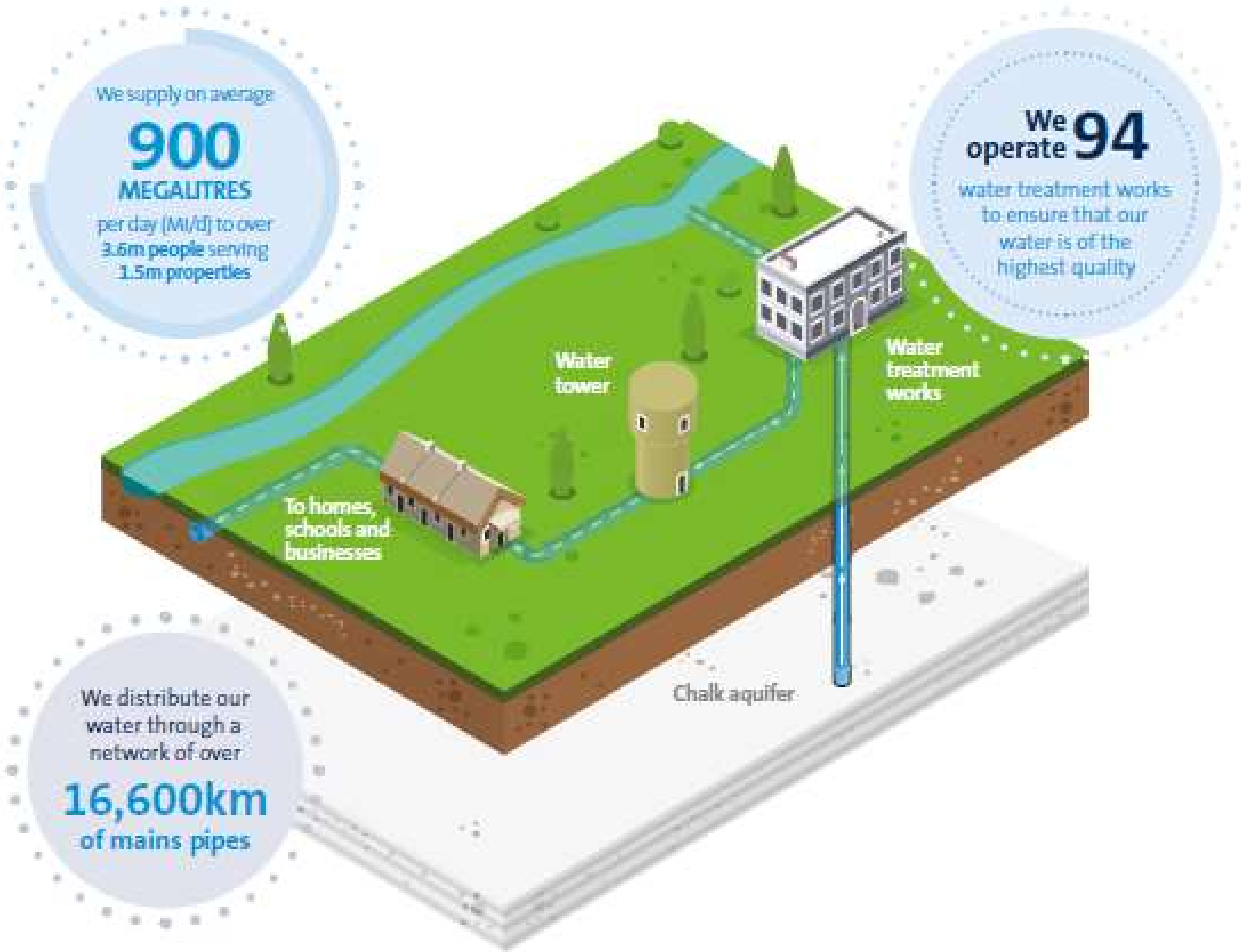
1 Affinity Water at a glance

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

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





2 Our commitments

As part the price review process for AMP6 (‘Asset Management Plan 6’, ‘PR14’), we agreed a number of performance commitments with Ofwat, which were shaped by the expectations of our customers. These stretching targets are to respond to the significant social and environmental challenges we face – a rising population and increased demand for water, as well as a reduction in the availability of water in years ahead.

We want our customers and stakeholders to be able to measure our success and hold us to account. The table below summarises our customers’ four expectations and the performance commitments we have made for AMP6.

Our AMP6 commitments	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, reducing average water use by 7%. This includes installing 280,000 meters by the end of AMP6. 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
Average household bills will reduce before inflation between 2015 and 2020. We will promote our social tariff (LIFT) 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

We publish our performance on our website so our customers can see exactly how we are performing against the commitments we have made for AMP6. Our supply area is broken down into 8 water resource zones, which we call communities and we are now publishing performance at the community level as well. More information can be found at:

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

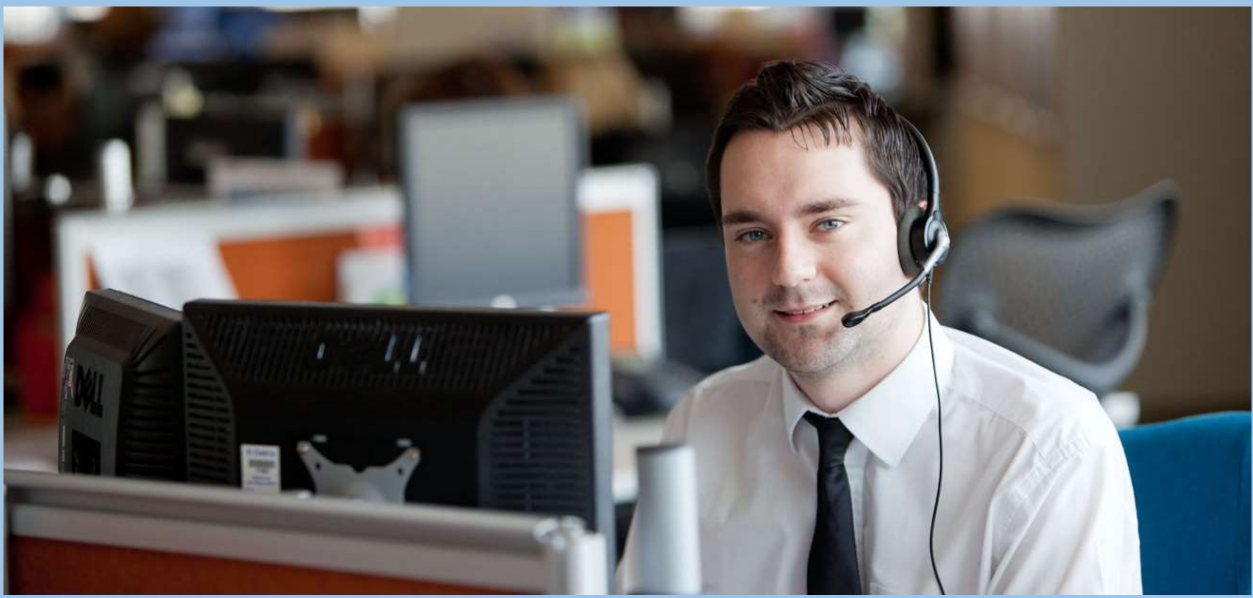
3 Operational performance

We continue to align our operational key performance indicators and targets to key performance commitments made in our Business Plan in response to our customer outcomes. These are necessarily stretching targets to respond to the significant social and environmental challenges we face – a rising population and increased demand for water, as well as a reduction in the availability of water in the years ahead.

Our customers and communities

Over the first six months of this year we have worked to develop the Community Committee and following submission of our draft Community Model and Measurement Framework in our Asset Management Plan 7 (‘AMP7’) Business Plan, the Committee are now focusing on how we can co-create our community-focused goals with our customers and stakeholders.

Customer satisfaction is of utmost importance to us. While we acknowledge there is still more to do, there have been positive movements in our customer satisfaction measure, increasing each year from an average of 4.42 (out of 5) in 2015/16 to 4.63 in September 2018. The numbers of customers rating themselves satisfied or very satisfied with us grew from 86% in 2015/16 to 91% in September 2018 reflecting improvements in the service levels customers are receiving.



From an external position, we won two European Contact Centre and Customer Service Awards for ‘Best Customer Insight Initiative’ and ‘Most Effective Business Transformation Programme in Customer Service’.

The key focus for the remainder of 2018/19 will be on reducing the volume of escalated complaints across all areas of the business. 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.

Our environment

As a community-focused organisation we remain committed to those issues which our customers and stakeholders feel strongly about. Through our industry leading abstraction reductions initiative, we are addressing the environmental challenges of protecting our precious local rivers and habitats while encouraging behavioral change.

We are investing £500m over AMP6 to improve our infrastructure to ensure we meet our commitment to make sure our customers have enough water, whilst leaving more water in the environment. We have committed to reducing leakage by 14% by 2020, the largest percentage reductions of any water company in England and Wales. We are targeting a further 15% reduction in leakage by 2025. We deployed extra leakage teams in areas of high demand during the hot weather period to fix leaks where they occurred. However the strain on the network and operation of the business has resulted in higher leakage than planned at this stage of the year. We have employed additional resource to bring the levels back on target. We also continue to use the latest leakage detection technology to identify and fix leaks.

As outlined in our AMP6 Business Plan, all customers receiving a water meter as part of our Water Saving Programme ('WSP') can opt to switch to a measured tariff or remain on their unmeasured tariff for a period of two years. More than 26,000 customers have elected to switch onto a measured tariff before the end of the two-year period. We anticipate around two thirds of our customers will be financially better off with a meter and being on a metered tariff will encourage customers to reduce their consumption. We will continue to support the remaining customers to reduce their consumption and value of their bill through initiatives such as our "Keep Track of the Tap" campaign.

Our people

We have created a strong culture of learning and development and are building a culture of coaching and mentoring to release the potential of our people. We are investing in training and up-skilling to maximise our own internal talent through development and succession planning. A new digital learning portal was launched in April 2018 offering a catalogue of online training courses. Through this platform, all our team members completed General Data Protection Regulations training ahead of the new legislation coming into effect in May 2018.

We take the safety, health and wellbeing of our people and suppliers very seriously. We are committed to operating our business without harm and our vision and our customer outcomes are all set in this context. During the period, we recorded two work related lost time injuries maintaining our accident frequency rate of 0.29 lost time injuries per 100,000 hours worked for the 12 month period ended 30 September 2018, the same as for the year ended 31 March 2018.

We are committed to promoting equality of opportunity in all areas of employment including recruitment, promotion, opportunities for training and pay and benefits. The following table provides a breakdown of the gender of directors and employees as at 30 September 2018:

	Men	Women
Our Board	7	4
Executive Management Team	3	3
All other employees	857	523

Our people play a critical role in creating long-term value. They are our ambassadors, living and working in the communities we serve. They have the local knowledge and understanding to make sure we deliver what our communities expect of us and ensure our contribution to those communities makes a difference.

Our assets and sites

Our assets allow our people to make use of the water resources provided by the environment to supply our customers. Our above ground assets collect water from groundwater or river sources and delivers it to treatment works where we convert raw water into high quality wholesome drinking water. Our below ground network of assets takes water from treatment works and deliver it to homes and commercial premises through more than 16,600km of mains.

We continuously invest in our network and are making steady progress against our mains renewals target of 46km by 31 March 2019, as well as replacing 9.8km of trunk mains this year. We aim to survey and complete 3,235 lead pipe replacements this year as part of our £25m AMP6 lead pipe replacement programme.

We are constantly innovating and explaining new ideas and techniques to check whether our assets are running at optimum efficiency. We can now monitor our pumps in real time and identify the optimum mix of pumps to use by measuring small temperature changes across a pump to within one thousandth of a degree. We have also developed an instrument that monitors bacterial sized particles at our production sites. This will help us gain a better understanding of what comes through our filters and whether there is a possibility of bacterial regrowth in our distribution system.

We have also completed upgrades or renovation works on several of our sites including a major infrastructure programme at our Heronsgate Pumping Station to enable us to move water around our network more effectively, to compensate for the planned abstraction reductions. We have also made improvements to our Education Centre, which has engaged with over 250,000 children since it was built 20 years ago. We have installed a second 400-gallon water butt to collect rain water from the roof of the Education Centre, which is then used to keep our dipping pond topped up. We have also constructed a sheltered outdoor teaching space.

Our finances

We have secured financing for the remainder of AMP6 and into the beginning of AMP7. We have issued debt with a book value of £1,014.2m in total with only £14.2m of debt maturing in AMP7 and a spread of maturity beyond this.

We want to provide water at affordable prices to all our customers. Our support for financially vulnerable customers who have a low household income or are claiming benefits has grown in the period with 50,000 households now supported by our social tariffs (LIFT and Watersure). We plan to introduce a Customer Assistance Fund by 2020 and aim to expand our social tariff offering by an additional 30,000 customers in AMP7.

We have worked hard to keep our bills low whilst maintaining a high quality and trusted service. Our water bills are consistently lower than the industry average, and will have reduced in real terms by almost 7% across AMP6.

Our plan for AMP7 keeps customers' bills as low as possible and ensures our business is financeable and able to withstand financial shocks. We have assessed these through stress testing our plan, whilst maintaining the ratios within our covenants at a level consistent with our family credit rating of BBB+/Baa1. The plan is built on the strong financial structure the company has in place and on access to the long-term financing needed for investment during the first half of AMP7.

4 Financial performance

Financial results for the period ended 30 September 2018

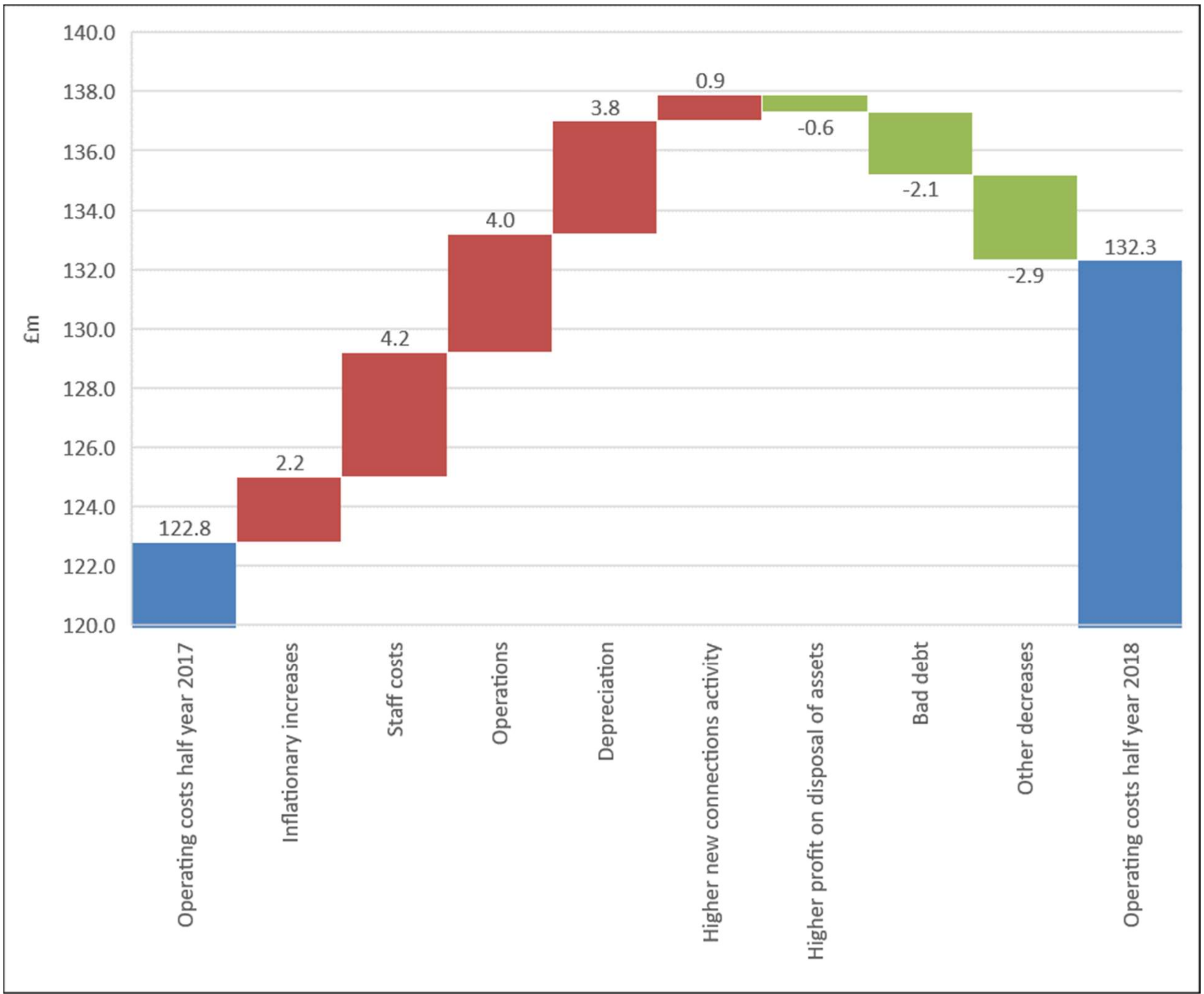
Our financial results are prepared in accordance with the recognition and measurement requirements of EU-adopted International Financial Reporting Standards ('IFRS'). Our unaudited financial results for the six months to 30 September 2018 are summarised as follows:

	2018 £m	2017 £m
Revenue	**155.3**	154.6
Operating costs	**(132.3)**	(122.8)
Other income	**9.6**	9.5
Operating profit	**32.6**	41.3
Profit on disposal of non-household retail business	**-**	11.0
Net finance costs	**(25.7)**	(25.9)
Fair value loss on financial instrument	**(4.5)**	-
Profit before tax	**2.4**	26.4
Tax expense	**(0.5)**	(4.2)
Profit for the period	**1.9**	22.2

Revenue for the first six months of the year was £155.3m, being a 0.5% increase on the same period last year (2017: £154.6m). The increase is primarily due to higher summer consumption and higher new connections activity, partially offset by lower household prices.

Operating expenditure

Total operating costs of £132.3m for the first half of the year were £9.5m higher than for the same period last year (2017: £122.8m). The variance is explained in the graph below:



Other income of £9.6m consisting largely of commission earned from billing and collecting charges in respect of sewerage and infrastructure on behalf of other companies was £0.1m higher than the prior period.

Finance costs

The net finance expense of £25.7m was £0.2m lower than the first half of last year primarily due to £0.8m higher finance income partially offset by £0.6m higher interest payable on the bonds. The £4.5m fair value loss on financial instrument was due to the RPI linked inflation swap which was entered into in August 2018.

Profit before tax

Profit before tax decreased by £24.0m (90.9%) to £2.4m (2017: £26.4m), primarily due to the increase in operating costs and the fair value loss on financial instrument, as well as the effect of the disposal of the non-household retail business in the prior year.

Taxation

Income tax expense is £3.7m lower than the prior period primarily due to lower operating profit. The effective tax rate of 21.2% is higher than the current corporation tax rate of 19.0% and higher than the effective tax rate for the prior year, which was impacted by the non-taxable sale of the non-household retail business.

We overpaid corporation tax in respect of the prior year, and are, therefore, not required to make any corporation tax payments during the current year. The prior year tax charge was lower than expected due to claiming Enhanced Capital Allowances on our investment in water and energy saving technology.

All our profits are taxed in the UK, and we do not use artificial tax avoidance schemes or tax havens to reduce our tax liabilities. We comply with what we understand to be both the letter and the spirit of tax legislation.

Capital expenditure

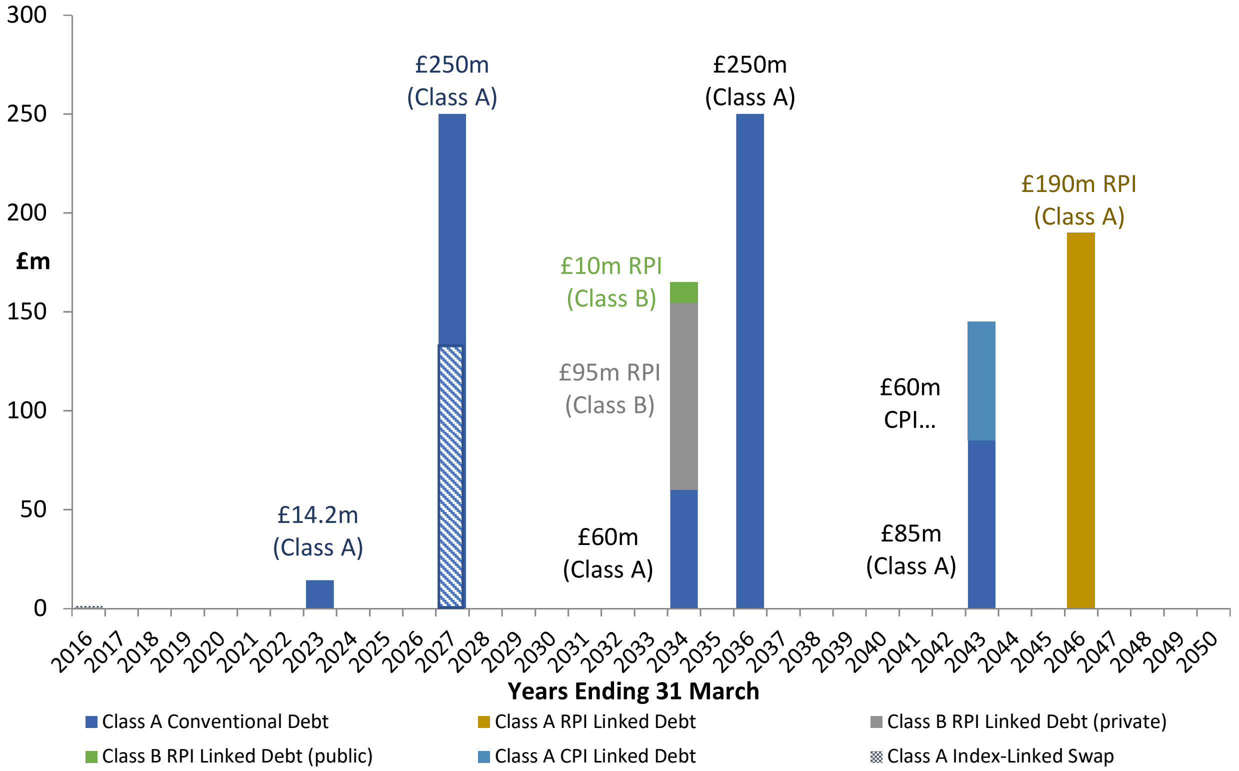
Capital expenditure in the period was £45.9m (2017: £66.5m), and was incurred principally on our mains renewals, trunk main replacement, water saving and lead pipe replacement AMP6 programmes. The total excludes £7.7m (2017: £6.7m) of infrastructure renewals expenditure, which is treated as an operating cost under the recognition and measurement requirements of IFRS.

The lower capital expenditure in the first half of this year compared to the same period last year reflects a temporary deceleration in the pace of our investment programmes, as the business focused on the operational running of the business to meet the higher demand experienced due to the hot weather period. Capital expenditure is expected to accelerate in the second half of the year, although the total spend is forecast to remain lower than the prior year.

5 Financing update

On 29 August 2018, Affinity Water transacted its first swap in the form of £135.0m RPI linked super senior swap aligned with the terms of the Affinity Water Finance (2004) Plc (‘AWF (2004)’) £250.0m bond which matures on 13 July 2026. The swap was executed within the Whole Business Securitisation (‘WBS’) structure and will result in a substantial increase in the Interest Cover Ratio headroom. The transaction is expected to help the business with the challenges faced by the water industry for the rest of the current AMP and throughout PR19.

The chart below shows the maturity profile of all the bonds issued by Affinity Water’s financing subsidiaries.



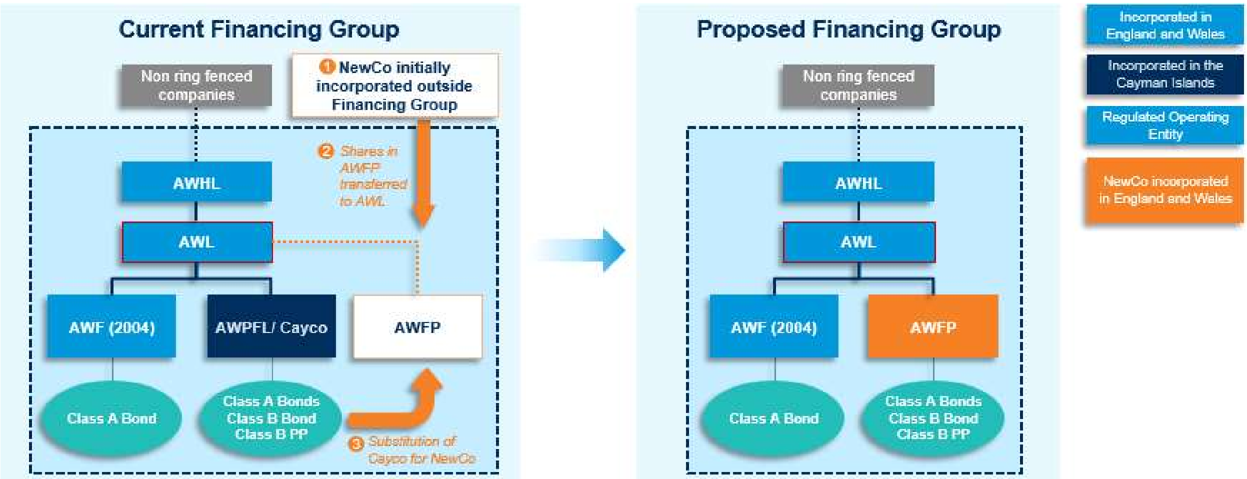
There has been no change during the period in credit ratings for the Class A bonds, rated A3 and A- by Moody’s and Standard & Poors respectively, or the Class B bonds, rated Baa3 and BBB.

Cayman Islands Substitution

On 23 August 2018, the directors released an announcement through Regulatory News Service on their intention to substitute Affinity Water Programme Finance Limited ('AWPFL'), a wholly owned subsidiary of the company registered in the Cayman Islands, with a UK registered entity. Following this, a special purpose vehicle, Affinity Water Finance Plc ('AWFP'), was incorporated on 13 November 2018.

On 7 December 2018 Affinity Water announced the result of the STID proposal relating to the substitution of AWPFL. The Majority Creditors voted in favour of the STID proposal which will allow Affinity Water to replace the Cayman Islands entity with AWFP, the UK incorporated entity. It is expected that the assets and liabilities of AWPFL will be transferred to the new entity in the near future. The change has been approved by our regulator, Ofwat, and the rating agencies have been engaged with to ensure that it will have no impact on the current ratings of the public issuances. Furthermore, the substitution will not affect the current tax status of the financing group and is tax neutral.

The below charts illustrate the current and projected structure of the WBS once the transfers have been effected.



6 Regulatory and business update

Price Review 19 (‘PR19’)

In September 2018 we submitted our AMP7 Business Plan to Ofwat. It builds on our vision to be the UK’s leading community focused water company, setting out our plans and the funding we require, to meet the expectations of our customers and stakeholders. We will help customers understand the true value of water, support them to manage and reduce their consumption and so support the ongoing protection of the environment and future resilience of supplies.

We have undertaken an extensive and multi-phased programme of customer and stakeholder engagement to ensure our Plan focuses on the things that matter most to customers. We have engaged with over 15,300 customers and stakeholders and taken account of over 5 million day-to-day customer contacts as part of a combined engagement programme.

Highlights of our AMP7 Business Plan include:

- reducing leakage by 15% in AMP7, equivalent to 24.5 ML/d and building on the 14% reduction in AMP6 compared to the industry average of 4%;
- reducing the amount of water abstracted from the environment by 36 ML/d in AMP7, following the successful delivery of 42 ML/d reductions since 2015;
- continuing to protect the quality of water resources through our catchment management and river restoration programmes, to help habitats and biodiversity of rivers in our supply area;
- continuing our WSP, helping customers to manage their water use, with the aim of reducing average water consumption from 147 litres to 129 litres per person per day;
- investing £1.37 billion across the five-year period, to maintain core network assets to keep services running 24 hours a day, 7 days a week and 365 days a year, investing in local level assets such as pumps, mains upgrades, new mains and investment in service reservoirs that allow us to move water to where we need it;
- improving the sharing of regional resources with other water companies and the investment in upgraded treatment and conditioning works to allow the transfer of water from and to other water companies; and
- increasing the help we provide to customers in vulnerable circumstances, building on the support we currently deliver to more than 50,000 customers through a number of different schemes.

Our Plan means that, on average, household bills will increase by 71p per year between 2019/20 and 2024/25, starting at £170.90 and rising to £174.44, a total increase of £3.54, before allowing for inflation. This equates to a 2.07% increase over the five years, or 0.41% per year, and means that the average bill in 2024/25, without allowing for inflation, will be the same as the average household bill in 2017/18.

We have tested our proposals with customers. We found that 82% of customers consider the final plan to be acceptable and more than three-quarters find it acceptable for bills to be increased by an extra £3-£5 a year to make sure there is enough water in the future.

In developing this Plan, we have been challenged and held to account by both our Board and our Customer Challenge Group ('CCG'). The CCG has submitted their report alongside this Plan setting out its assessment of our customer engagement evidence base and how this has informed our Plan, including the extent to which customers find this Plan acceptable. Furthermore, the Board has assured itself that our Plan is of high quality, is stretching and delivers for customers, stakeholders and the environment. The Board has also set out how it will oversee and monitor the delivery of this Plan within its Board Assurance Statement.

We are currently awaiting a response from Ofwat before entering into negotiations, which must be completed by December 2019.

Further information on the business plan can be found at our website:

https://stakeholder.affinitywater.co.uk/business-plan.aspx

Out in the cold: Ofwat review

Following the water supply issues during the period of cold weather in late February and early March 2018, better known as 'Beast from the East', Ofwat launched a review in which they asked detailed explanations from each water company on what happened. They also worked closely with Consumer Council for Water who carried out customer research on the incident and engaged various stakeholders to better gauge their views and experiences.

During the incident, Affinity Water demonstrated good practices such as having staffed key water treatment works 24 hour a day to reduce any possible loss of production and having had detailed information on the supply interruptions experienced by customers in vulnerable circumstances. However, we recognise there are still areas of improvement with a number of assets being offline for refurbishment when the incident arose, reducing the company's overall output.

Affinity Water's response to Ofwat, published in September 2018, can be found below:

https://stakeholder.affinitywater.co.uk/docs/reports-publications/Ofwat-Out-In-The-Cold-Response-Sep-2018.pdf

7 Governance update

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.

Executive management team appointments

Peter Rowland has taken the role of CIO, Change and Capital Programmes Director.

Board changes

On 25 July 2018, Anthony Charles Roper was appointed as a Director, replacing Gareth Irons Craig who resigned.

On 1 October 2018, Simon Cocks stepped down from his role as Non-Executive Director.

8 Common Terms Agreement compliance

Calculation of financial ratios

Test period		Year 1 1 April 2018 to 31 March 2019 Forecast	Year 2 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow divided by	£m	116.4	131.2
Class A Debt Interest	£m	32.8	31.0
Class A ICR	**Ratio**	**3.6**	**4.2**
Net Cash Flow less	£m	116.4	131.2
CCD and IRC	£m	0	0
Adjusted Net Cash Flow divided by	£m	116.4	131.2
Class A Debt Interest	£m	32.8	31.0
Class A Adjusted ICR	**Ratio**	**3.6**	**4.2**

Test period		Year 1 1 April 2018 to 31 March 2019 Forecast	Year 2 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow less	£m	116.4	131.2
CCD and IRC	£m	0	0
Adjusted Net Cash Flow divided by	£m	116.4	131.2
Senior Debt Interest	£m	36.5	34.8
Senior Adjusted ICR	**Ratio**	**3.2**	**3.8**
Year 1	Ratio	3.6	3.6
Year 2	Ratio	4.2	4.2
Class A Average Adjusted ICR	**Average**	**3.9**	**3.9**
Year 1	Ratio	3.2	3.2
Year 2	Ratio	3.8	3.8
Senior Average Adjusted ICR	**Average**	**3.5**	**3.5**

Test period		Year 1 1 April 2018 to 31 March 2019 Forecast	Year 2 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow less	£m	116.4	131.2
RCV Depreciation and Capitalised IRE	£m	57.5	71.0
Conformed Adjusted Net Cash Flow divided by	£m	58.9	60.2
Class A Debt Interest	£m	32.8	31.0
Conformed Class A Adjusted ICR	**Ratio**	**1.8**	**1.9**
Net Cash Flow less	£m	116.4	131.2
RCV Depreciation & Capitalised IRE	£m	57.5	71.0
Conformed Adjusted Net Cash Flow divided by	£m	58.9	60.2
Senior Debt Interest	£m	36.5	34.8
Conformed Senior Adjusted ICR	**Ratio**	**1.6**	**1.7**
Year 1	Ratio	1.8	1.8
Year 2	Ratio	1.9	1.9
Conformed Class A Average Adjusted ICR	**Average**	**1.9**	**1.9**

Test period		Year 1 1 April 2018 to 31 March 2019 Forecast	Year 2 1 April 2019 to 31 March 2020 Forecast
Year 1	Ratio	1.6	1.6
Year 2	Ratio	1.7	1.7
Conformed Senior Average Adjusted ICR	**Average**	**1.7**	**1.7**

Date		30 September 2018 Actual	31 March 2019 Forecast	31 March 2020 Forecast
Class A Net Indebtedness divided by	£m	839.6	851.0	846.2
RCV	£m	1,227.0	1,237.1	1,249.4
Class A RAR	**Ratio**	**0.68**	**0.69**	**0.68**
Senior Net Indebtedness divided by	£m	960.5	973.3	972.2
RCV	£m	1,227.0	1,237.1	1,249.4
Senior RAR	**Ratio**	**0.78**	**0.79**	**0.78**

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

Date	**30 September 2018 £m**
Borrowings	1,079.8
Exclude Permitted Legacy Loan	(3.6)
Add Back Unamortised Debt Issue Costs and Bond Premium	(18.4)
Add Accrued Interest	6.0
Add Swap Accretion	1.3
Less Cash and cash equivalents	(104.5)
Senior Net Indebtedness	**960.5**
Remove Class B Debt Amounts	(120.9)
Class A Net Indebtedness	**839.6**

9 Further certifications

Surplus

Our Board has approved revised dividend and executive remuneration policies that provide for dividends and executive remuneration proportionate with long-term returns and performance of the company, whilst not impairing its longer term financeability. The performance of the company comprises our financial performance as well as an assessment of performance in the following areas: customer service, operational commitments, community commitments and people.

For the 6 month period to 30 September 2018, Affinity Water Limited paid dividends totalling £5.0 million (6 months to 30 September 2017: £28.5 million).

Authorised Investments

Terms	Bank Deposits (£m)	Liquidity Funds (£m)	Total (£m)
Overnight	10.0	42.0	52.0
3 Months	15.0	-	15.0
6 Months	15.0	-	15.0
9 Months	5.0	-	5.0
1 Year	10.0	-	10.0
Total	55.0	42.0	97.0

Annual Finance Charge

Post the swap entered into in August 2018 (refer to our financing update on page 14), due to the payable leg of the swap not fully aligned with the receivable leg, the Annual Finance Charge payable for the year will increase to £39.6m and the Monthly Payment Amount will be £3.391m. However, the total interest costs have decreased to £34.9m after taking into account the accrued receivable costs. The Calculation of the Annual Finance Charge is set out in the table to the right.

	1 April 2018 to 31 March 2019 (£m)
Forecast interest paid on bonds	39.1
Forecast interest paid on loans	0.0
Other recurring finance fees paid	0.5
Total Payable	**39.6**
£135m swap interest net receivable leg	(4.7)
Total Actual Finance Charge	**34.9**

Additional confirmations

Affinity Water Limited also confirms that:

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

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

Yours faithfully,

Stuart Ledger

Chief Financial Officer

For and on behalf of

Affinity Water Limited

(in its capacity as Transaction Agent)

Your local supply, on tap

Appendix

Additional periodic information

We have included links below to the following documents which may be of further interest to investors.

Affinity Water Limited's annual charges scheme and details of tariffs

https://www.affinitywater.co.uk/docs/charges-scheme-2018-19.pdf

Affinity Water Limited's annual drinking water quality report

https://www.affinitywater.co.uk/docs/Water_Quality_Report_2017_hi-res.pdf

Affinity Water Limited's conservation and access report

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

Risk, Strengths and Weaknesses Statement

https://stakeholder.affinitywater.co.uk/docs/Risk-Strengths-and-Weaknesses-Statement-2017-18.pdf

Customer Performance Report

https://stakeholder.affinitywater.co.uk/docs/Our-Year-In-Review-2017-18.pdf