Affinity Water

Your local supply, on tap

Investor Report

Affinity Water Limited ('Affinity Water')

Published on 27 July 2018

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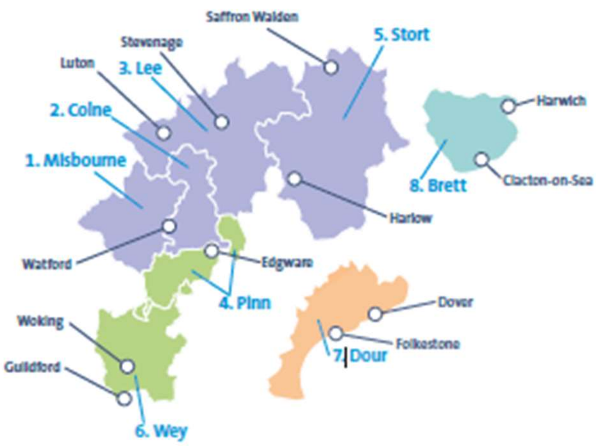
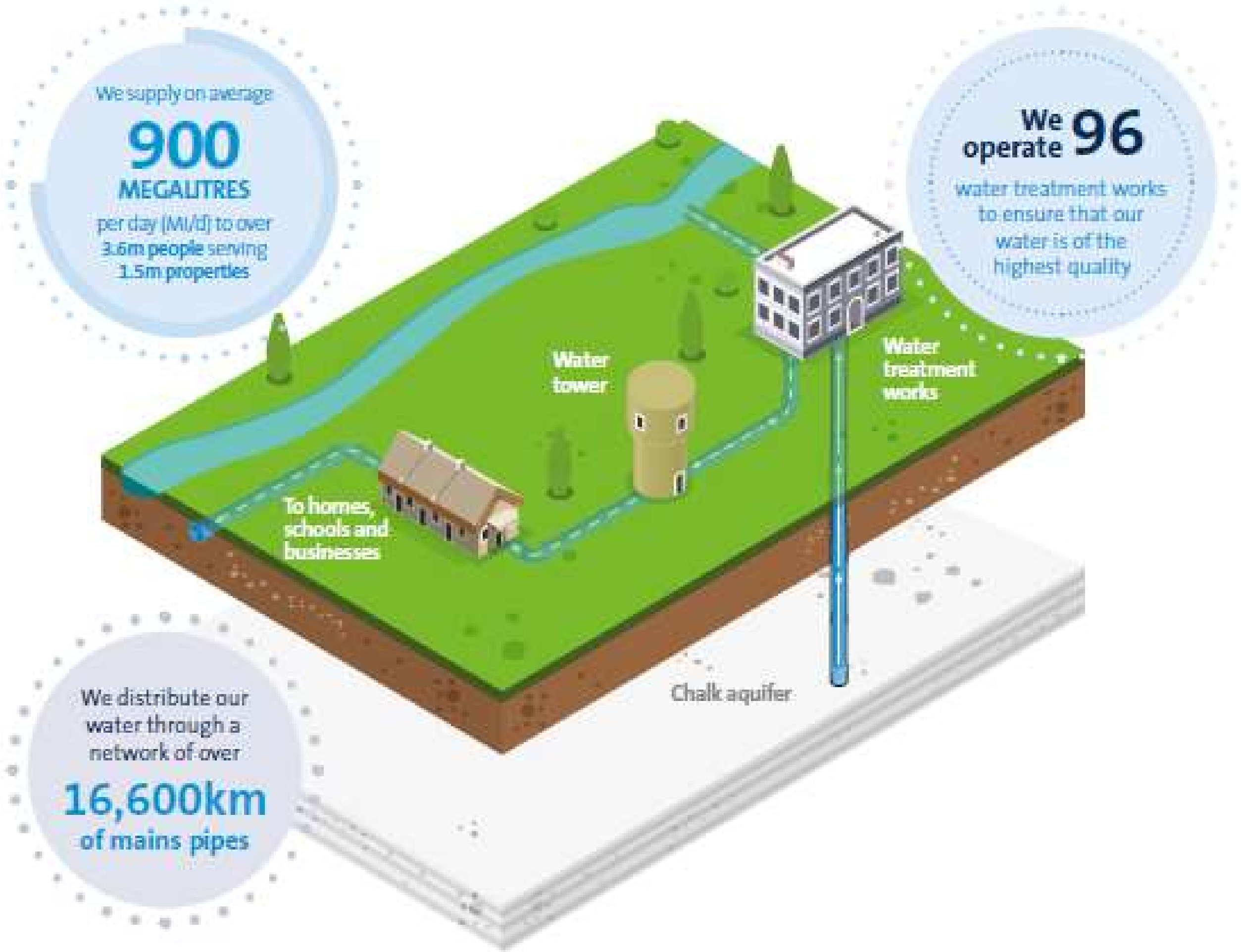
1 Affinity Water at a glance

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.





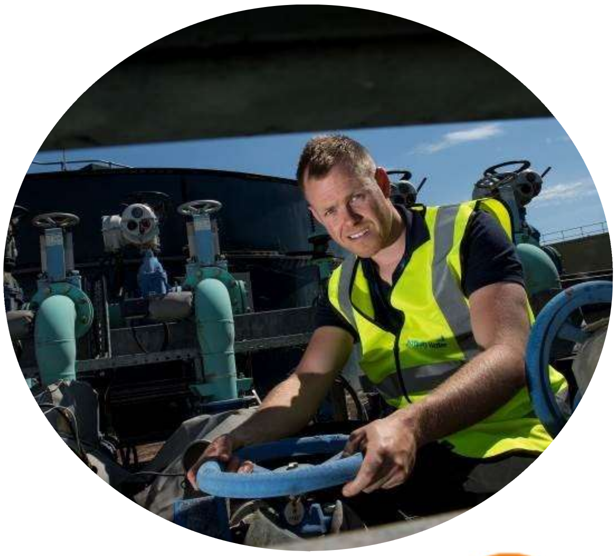
2 Operational highlights

Protecting our people

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

0.29 lost time injuries per 100,000 hours worked

compared to actual performance of 1.02 in 2014/15



Minimising disruption

We experienced

2,923 bursts

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

Managing our water resources

We have reduced leakage for the last three years and have reduced our customers' average water use (per person, per day) by

8.0 litres

to 151.7 litres, compared to our 2016/17 performance

Supplying high quality water

We continued to provide high quality water in terms of our mean zonal compliance ('MZC') of

99.96%

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

Value for money customer service

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

32% reduction

in complaints and

34% reduction

in escalated complaints

3 Financial highlights

Revenue (£m)	306.3 2017: 308.7
Profit after tax (£m)	29.6 2017: 30.9
Regulatory Capital Value (RCV) (£m)	1,207.1 2017: 1,156.2
Senior Net Indebtedness (£m)	949.0 2017: 885.2
Gearing (%)	78.6% 2017: 76.6%
Conformed Senior Adjusted Interest Cover (times)	1.5 2017: 1.7

4 Our vision and commitments

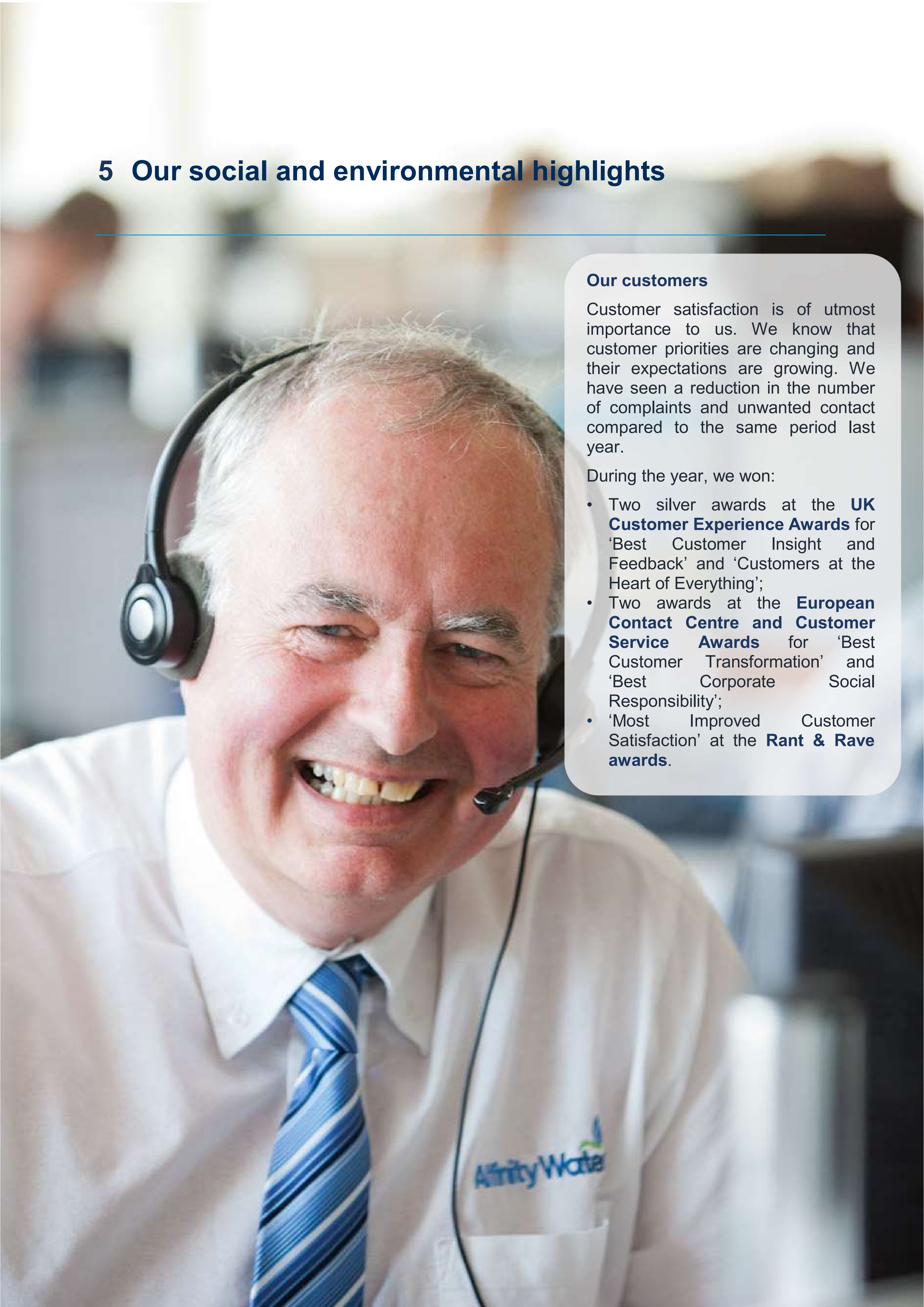
Our enduring vision to be the UK's leading community focused water company reflects the importance we place on the way our people work within the communities we serve. It also reflects the emphasis we place on understanding and responding to the needs of different communities, helping our customers connect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

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. 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

5 Our social and environmental highlights



Our customers

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.

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’;
- ‘Most Improved Customer Satisfaction’ at the **Rant & Rave awards**.

Our community

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.

In 2018, we established a **Community Committee** as a subcommittee of the Board to oversee and continue to enhance our Community Engagement Strategy.

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**.

Our environment

All three of our supply regions have been designated as areas of 'serious water stress'. Government and regulators have emphasised the importance of resilience and long-term planning in adapting to increased water stress.

Our Water Resources Management Plan ('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.

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. 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 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.

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 science, technology, engineering and mathematics ('STEM') experiences each year for young people aged nine to 21 across the UK.

Our gender pay report published in April 2018 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. Since then, we have increased the proportion of females on our Board.

6 Operational performance

We have aligned our operational key performance indicators (‘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.

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

During the current regulatory period, we are particularly focused on enhancing our environment by reducing the abstraction of water from environmentally sensitive sites. 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.

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.

Supplying high quality water our customers can trust

Customers continued to benefit from high quality drinking water during the year. 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%, 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.

Minimising disruption to our customers and communities

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 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, 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. 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.

Providing a value for money service

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 24% reduction in unwanted contacts, 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.

7 Financial performance

Financial results for the year ended 31 March 2018

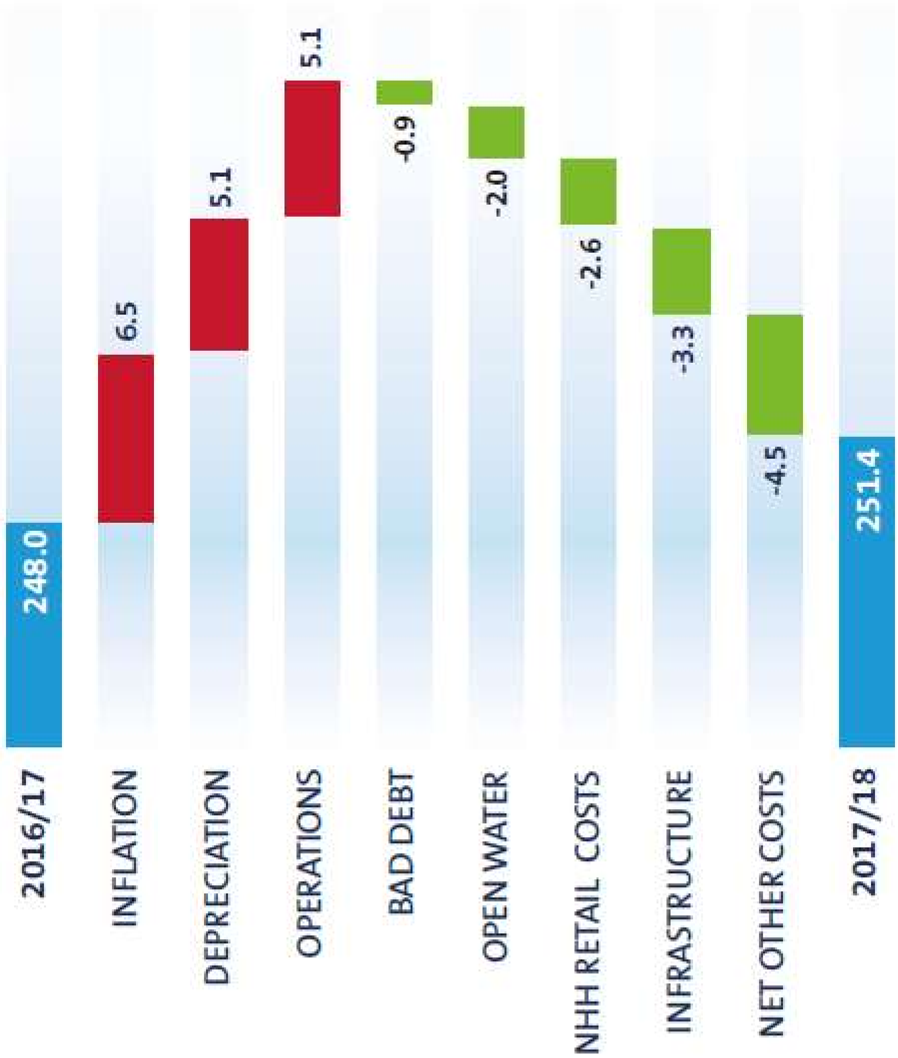
This year has been a challenging year operationally with several significant events causing disruption on our network, which have impacted our financial performance. In particular the severe weather event in early March 2018 led to additional expenditure being incurred to ensure interruptions to supply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

	2018 **£000**	2017 £000
Revenue	**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	**72,268**	77,789
Profit on disposal of non-household retail business	**10,958**	-
Finance income	**2,208**	3,050
Finance costs	**(49,496)**	(54,073)
Finance costs – net	**(47,288)**	(51,023)
Profit before tax	**35,938**	26,766
Tax (expense)/credit	**(6,303)**	4,135
Profit for the year	**29,635**	30,901

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 expenditure

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



Finance costs

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.

Profit before tax

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.

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.

Dividends

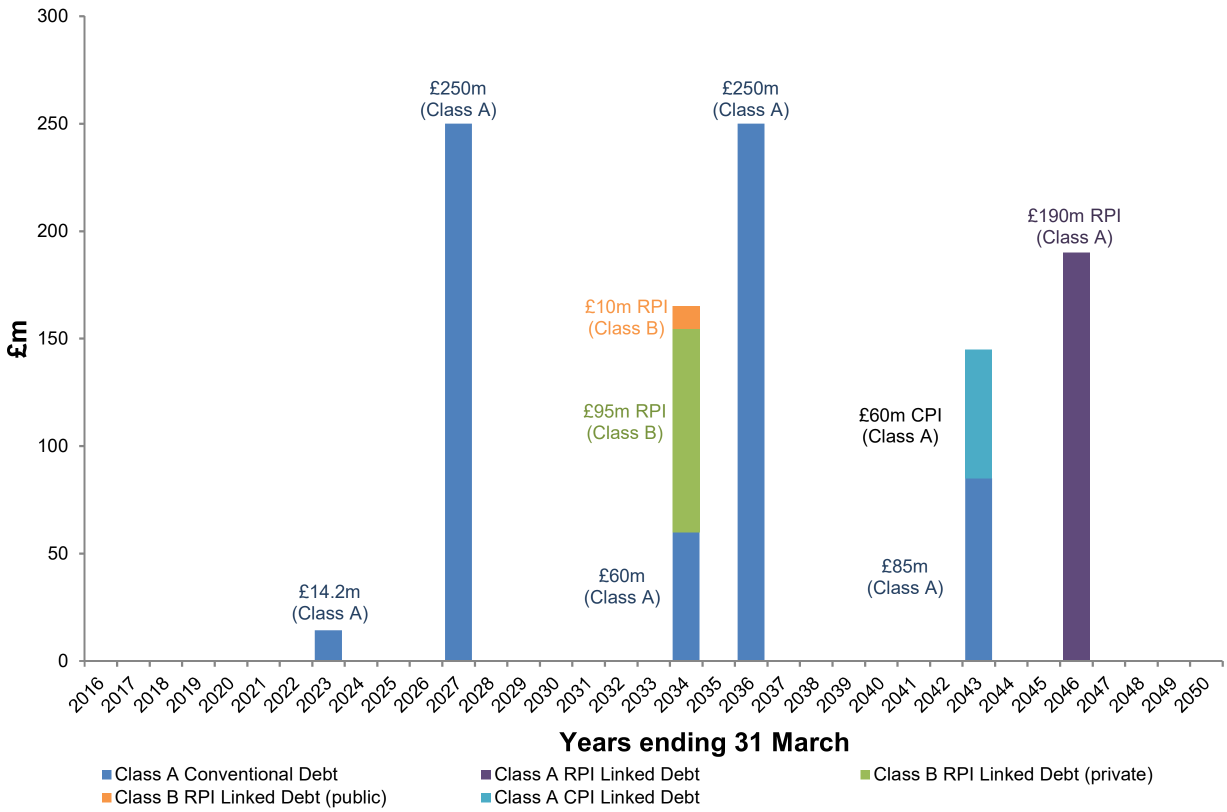
Equity dividends of £58.5m were paid during the year (2017: £50.5m), of which £50.5m relates to the regulated business (2017: £43.0m). The increase in dividends year on year can be attributed to the increase in retail price index ('RPI') on the company's RCV and proceeds from the disposal of the company's 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).

8 Financing Update

On 3 November 2017, Affinity Water Programme Finance Limited announced its intention to raise fixed and CPI-linked bonds of up to £120m from the capital markets, utilising the Euro Medium Term Note (‘EMTN’) programme.

The bonds were priced on the 15 November 2017 with settlement date of 22 November 2017, resulting in £60m Class A Consumer Price Index (‘CPI’)-linked bond with 0.230% real coupon with a maturity date of 22 November 2042 and £60m Class A fixed bond with 2.699% coupon with a maturity date of 22 November 2033. The proceeds meet Affinity Water’s funding requirements for the remainder of AMP6 and the beginning of the 2020-2025 price control period (Asset Management Plan 7, ‘AMP7’).

The chart below shows the maturity profile of all the bonds issued by Affinity Water’s financing subsidiaries, including the recent bond issuances.



Moody’s rating outlook

Following the announcement of a lower weighted average cost of capital (‘WACC’) in AMP7, Moody’s have changed their UK Water 2018 outlook to ‘Negative’ in their publication on 15 January 2018. Even though highly geared companies remain most exposed, the UK regulated water sector as a whole will be under pressure. Lower returns and potentially more volatile cash flows may require adjustments to companies’ capital structures.

The cash flow impact of lower returns will be somewhat softened by Ofwat switching indexation measures, with 50% of companies' RCV growing with CPIH. The increase in cash flow relative to a purely RPI-linked return will come, however, at the expense of slower future RCV growth.

In Moody's risk matrix under different return scenarios, Affinity Water have been placed under 'amber' for both 2.8% and 3.1% 'blended' return scenarios for AMP7, signalling that some outperformance or balance sheet strengthening may be necessary. It also highlighted that despite cheaper financing, the majority of Affinity Water's debts have fixed coupons.

Subsequently, in May 2018, Moody's have changed the outlook for Affinity Water and three other water companies from 'Stable' to 'Negative'. The change reflects Affinity Water's exposure to a likely significant cut in allowed returns in AMP7; the proposed financing cost sharing requirements to reduce earnings of companies with highly leveraged capital structure; and Moody's revised financial ratio guidance for the sector.

The outlook could be stabilised if Moody's deems that Affinity Water's risk exposure to the lower return environment is adequately mitigated by a combination of a favourable price determination outcome, strong outperformance ability and/or strengthened balance sheet.

9 Regulatory update

Price Review 19 ('PR19')

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. It 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.

Our PR19 programme and governance arrangements were established early in 2017 and this has enabled the development of our plan for 2020-2025 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.

10 Governance update

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. During the year the Board has continued to focus on the company's risk management and internal control systems.

Executive appointments

Pauline Walsh joined Affinity Water as Chief Executive Officer on 1 May 2018, replacing Simon Cocks who now serves as a non-executive director of Affinity Water. 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.

Another significant addition to our senior Management is Sara Roden, our Health, Safety, Environmental and Quality Director. Sara joined the business from the Mace Group, where she held the position of Associate Director – Strategic Health & Safety.

We have also appointed Marie Whaley as Interim Director of Asset Strategy. Marie joined on 3 July 2018 and will assume leadership when Mike Pocock, our current Director of Asset Strategy, retires in September 2018.

Board appointments

On 15 January 2018, Tony Cocker joined the Affinity Water Board, succeeding Dr Philip Nolan as Chairman on 30 January 2018. 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.

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.

11 CTA compliance

Calculation of financial ratios

Test period		Year 1 1 April 2017 to 31 March 2018 Actual	Year 2 1 April 2018 to 31 March 2019 Forecast	Year 3 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow divided by	£m	127.0	121.7	135.0
Class A Debt Interest	£m	33.7	35.7	35.9
Class A ICR	**Ratio**	**3.8**	**3.4**	**3.8**
Net Cash Flow less	£m	127.0	121.7	135.0
CCD and IRC	£m	0	0	0
Adjusted Net Cash Flow divided by	£m	127.0	121.7	135.0
Class A Debt Interest	£m	33.7	35.7	35.9
Class A Adjusted ICR	**Ratio**	**3.8**	**3.4**	**3.8**

Test period		Year 1 1 April 2017 to 31 March 2018 Actual	Year 2 1 April 2018 to 31 March 2019 Forecast	Year 3 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow less	£m	127.0	121.7	135.0
CCD and IRC	£m	0	0	0
Adjusted Net Cash Flow divided by	£m	127.0	121.7	135.0
Senior Debt Interest	£m	37.3	39.3	39.7
Senior Adjusted ICR	**Ratio**	**3.4**	**3.1**	**3.4**
Year 1	Ratio	3.8	3.8	3.8
Year 2	Ratio	3.4	3.4	3.4
Year 3	Ratio	3.8	3.8	3.8
Class A Average Adjusted ICR	**Average**	**3.6**	**3.6**	**3.6**
Year 1	Ratio	3.4	3.4	3.4
Year 2	Ratio	3.1	3.1	3.1
Year 3	Ratio	3.4	3.4	3.4
Senior Average Adjusted ICR	**Average**	**3.3**	**3.3**	**3.3**

Test period		Year 1 1 April 2017 to 31 March 2018 Actual	Year 2 1 April 2018 to 31 March 2019 Forecast	Year 3 1 April 2019 to 31 March 2020 Forecast
Net Cash Flow less	£m	127.0	121.7	135.0
RCV Depreciation and Capitalised IRE	£m	69.8	65.6	70.9
Conformed Adjusted Net Cash Flow divided by	£m	57.2	56.1	64.2
Class A Debt Interest	£m	33.7	35.7	35.9
Conformed Class A Adjusted ICR	**Ratio**	**1.7**	**1.6**	**1.8**
Net Cash Flow less	£m	127.0	121.7	135.0
RCV Depreciation & Capitalised IRE	£m	69.8	65.6	70.9
Conformed Adjusted Net Cash Flow divided by	£m	57.2	56.1	64.2
Senior Debt Interest	£m	37.3	39.3	39.7
Conformed Senior Adjusted ICR	**Ratio**	**1.5**	**1.4**	**1.6**
Year 1	Ratio	1.7	1.7	1.7
Year 2	Ratio	1.6	1.6	1.6
Year 3	Ratio	1.8	1.8	1.8
Conformed Class A Average Adjusted ICR	**Average**	**1.7**	**1.7**	**1.7**

Test period		Year 1 1 April 2017 to 31 March 2018 Actual	Year 2 1 April 2018 to 31 March 2019 Forecast	Year 3 1 April 2019 to 31 March 2020 Forecast
Year 1	Ratio	1.5	1.5	1.5
Year 2	Ratio	1.4	1.4	1.4
Year 3	Ratio	1.6	1.6	1.6
Conformed Senior Average Adjusted ICR	**Average**	**1.5**	**1.5**	**1.5**

Date		31 March 2018 Actual	31 March 2019 Forecast	31 March 2020 Forecast
Class A Net Indebtedness divided by	£m	830.5	854.4	836.6
RCV	£m	1,207.1	1,234.7	1,245.7
Class A RAR	**Ratio**	**0.69**	**0.69**	**0.67**
Senior Net Indebtedness divided by	£m	949.0	976.7	962.6
RCV	£m	1,207.1	1,234.7	1,245.7
Senior RAR	**Ratio**	**0.79**	**0.79**	**0.77**

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

Date	31 March 2018 £m
Borrowings	1,072.5
Exclude Permitted Legacy Loan	(3.6)
Add Back Unamortised Debt Issue Costs and Bond Premium	(18.8)
Add Accrued Interest	13.7
Less Cash and cash equivalents	(114.8)
Senior Net Indebtedness	**949.0**
Remove Class B Debt Amounts	(118.5)
Class A Net Indebtedness	**830.5**

12 Further certifications

Debt Service Reserve Accounts

There is no balance in each of the Debt Service Reserve Accounts as at 31 March 2018. The required debt service reserve is provided by a liquidity facility from HSBC Bank PLC totalling £38.0m.

Permitted Subsidiaries acquired

There were no Permitted Subsidiaries acquired pursuant to a Permitted Acquisition in the period to 31 March 2018.

Annual Finance Charge

Affinity Water Limited has calculated the Annual Finance Charge for the period from 1 April 2018 to 31 March 2019 as £36.5m and the Monthly Payment Amount to be £3.0m. 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	38.1
Forecast interest paid on loans	0.0
Other recurring finance fees paid	0.4
Total	**38.5**

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)