



Your local supply, on tap

Investor Report

Six Month Period ended
30 September 2016

Affinity Water Limited
("Affinity Water")

Published on
23 December 2016

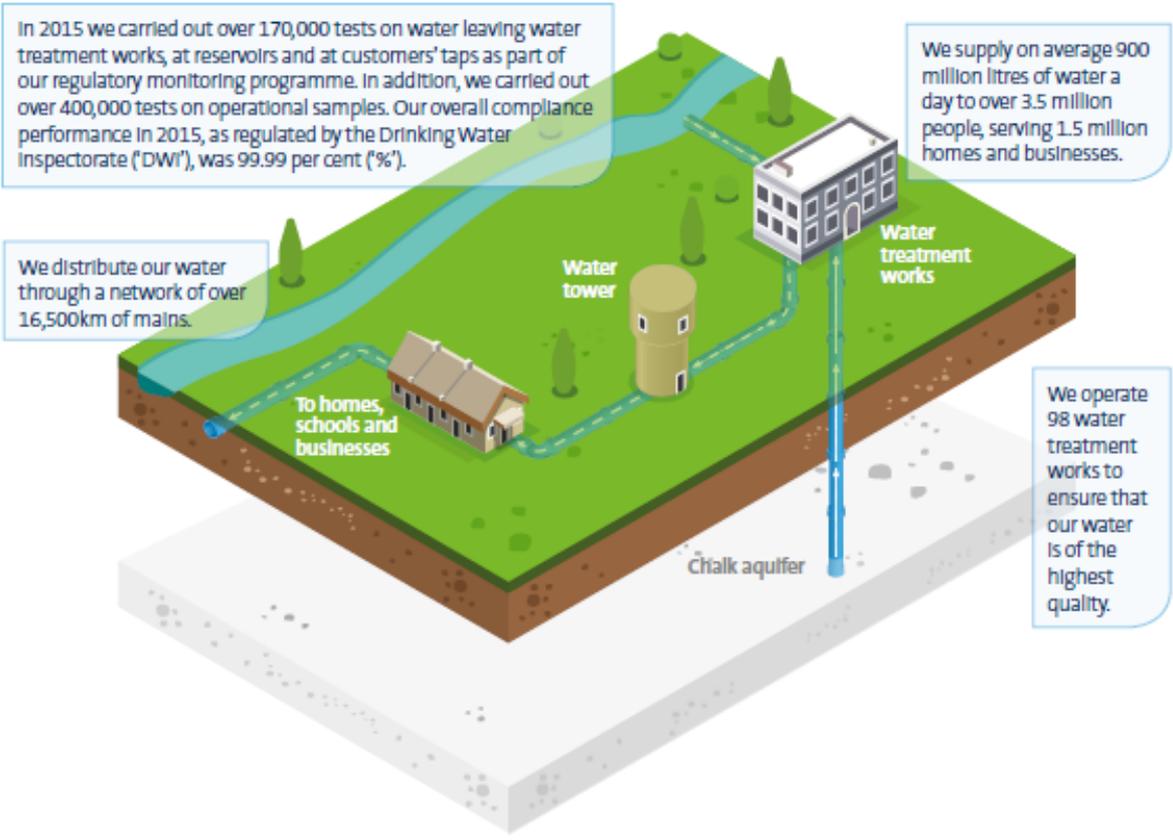
Contents

| | |
|----|--------------------------------------|
| 3 | Affinity Water at a glance |
| 4 | Our commitments |
| 5 | Open Water and Affinity for Business |
| 6 | Operational performance |
| 8 | Financial performance |
| 10 | Financing update |
| 11 | Regulatory update |
| 11 | Governance update |
| 12 | CTA compliance |
| 16 | Further certifications |

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 4,515km² split over three regions in the southeast of England. We divide our supply area into eight different communities, based on our existing water resource zones and have named each of them after a local river, allowing us to tailor a high quality service to customers at a local level. We are the sole supplier of drinking water in these areas.

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



Our commitments

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

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

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

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>

Open Water and Affinity for Business

From April 2017 all business customers, charities and public sector organisations will be able to choose their retailers for water and wastewater services. We are embracing the opportunity this represents and have been progressing with the internal organisational changes required to our business. These changes will help us deliver a better service for customers and ensure that we organise ourselves more efficiently. Our business is now split into three distinct operating units as follows:



Within our Wholesale business, we have established a Wholesale Operations Service Desk, which will be the main point of contact with all retailers.

In September 2016, we rebranded our retail non-household services as Affinity for Business. Our dedicated team continue to work with our business customers to save water, save energy and save money, reducing the environmental impact of their operations in the process.



In advance of April 2017, a Shadow Market opened on 3 October 2016. This gives us the opportunity to test our processes and systems for six months and ensure our staff are trained, in order to demonstrate that we are fully compliant in all aspects ahead of the market opening to competition next April.

Outside of the ring-fenced whole business securitisation structure, an affiliated company, Affinity for Business (Retail) Limited, has been established and granted a licence to provide water supply and wastewater services throughout England. Affinity Water Limited intends to use the Exit Regulations laid out by the Department for Environment, Food and Rural Affairs to transfer our existing non-household retail customer base to this new organisation when the market opens.

Operational performance

At the end of the first year of AMP6, we recognised that there was more to do to deliver on all of our commitments, reflecting the genuinely challenging targets we have set ourselves. In the first six months of the current financial year we have made good progress in delivering on a number of our key programmes: leakage, our Water Savings Programme, water quality and mains cleaning. We have also been reviewing the progress and priorities of our Customer Experience Improvement Programme to ensure we are continuing to put our customers at the heart of everything we do.

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

Our region is one of the most water-stressed in the country. We have a growing population to serve and we have challenged ourselves to take less water from the environment to help safeguard the future. We have committed to reduce the amount of water we take from the environment by 42 million litres per day by the end of AMP6.

In September, we carried out a sustainability reduction trial which involved making a number of alterations to our network to mimic the water reductions that we have committed to in our Business Plan. This trial allowed us to gather important performance data which will now feed into our various work programmes and help us understand how our network will be operating in the future.

We have recently established a new leakage management team and are investing £500m to improve our infrastructure to ensure we meet our commitment to make sure our customers have enough water, whilst leaving more water in the environment, which includes a commitment to reduce leakage on our network by 14% over AMP6. We estimate that around a third of total network leakage occurs from customers' supply pipes. Installing meters for these customers may allow the leaks to be more readily identified. Our aim is to install over 280,000 meters by 2020 and in August 2016 we carried out our 50,000th meter installation under our Water Saving Programme.

We have also been trialling a new and innovative way of identifying leaks by using satellites to detect water. This technology uses the same principles that were used to search for water on Mars, and is the first large-scale trial of this system in the world. In the trial, we covered over 1,000 square miles of land, representing two thirds of our supply area. Our initial findings have been promising, and we are continuing to analyse the results to enable us to focus our work as part of our leakage strategy.

Supplying high quality water our customers can trust

Throughout the period, we have been lining or replacing all our lead pipes in Watford and Finchley, and also proactively investigating the water supply arrangements for high risk groups (nurseries, primary and junior schools, maternity and health centres) across our entire supply area. We aim to survey and complete 10,550 lead pipe replacements this year as part of our £25m AMP6 lead pipe replacement programme.

The mains cleaning programme is currently progressing in line with its timetable within our Stort and Pinn communities. We have completed 520km of cleaning to remove manganese and iron

deposits in our strategic and distribution mains pipes situated within Blackford and Harlow. We have also been continuing with our programme of mains flushing in our Wey and Pinn communities to remove aluminium and other loose deposits, which can result in discoloured water and sample failures. So far this year, we have flushed over 50km of pipe across five district meter areas.

We continue to face new pressures to maintain the high quality of our water and the increased use of existing and new pesticides puts additional stresses on our treatment processes. We are managing the risks using a dual approach: using effective catchment management targeting pesticides at source, as well as enhancing our existing treatment and carrying out additional treatment where necessary. Trials at our Iver Water Treatment Works to investigate three treatment solutions for the pesticide, metaldehyde, concluded in July. We will assess each technology in terms of effectiveness, constructability and costs with the outcome of these trials being to support water quality schemes for our 2019 Price Review.

Minimising disruption to our customers and communities

In June 2016 we experienced a major burst on a trunk main in Edgware. 772 properties (0.05% of total properties in supply) were without water for a period in excess of twelve hours. This incident, along with others, will result in an ODI penalty for 2016/17. The stretch of main in question was a known single point of failure that could not be bypassed. A project designed to eliminate this network weak spot had been designed and planned, and was scheduled to be completed by the end of 2016.

We are continuously investing in the network in an attempt to prevent unplanned interruptions to supply. Our mains renewals programme is slightly behind our planned timeframe at this stage in the year, although we still plan to achieve our 105km target for the year. We have also set ourselves a target to replace 14.5km of trunk mains this year. In August, our trunk main replacement team completed an eight month project to replace the water main between Wall Hall Pump Station and Bricket Wood Pump Station. This successful replacement of 2km of pipe will reduce risk on a key part of our network, which has had a history of bursts.

Providing a value for money service

We want to provide water at affordable prices to all our customers. Our support for vulnerable customers who have a low household income or are claiming benefits has grown in the period with more than 40,000 customers supported by our 'LIFT' social tariff as at 30 September 2016. Customers benefiting from this tariff receive a reduced rate for the year.

Customer satisfaction is of utmost importance to us. We know that customer priorities are changing and their expectations are growing, so we are seeking new ways to anticipate demand and deliver the best possible experience for our customers. Since the launch of the Customer Experience Improvement Programme we have seen a reduction in the number of complaints compared to the same period last year.

Financial performance

Financial results for the period ended 30 September 2016

| | 2016 £m | 2015 £m |
|---------------------------------|---------------|------------|
| Revenue | 155.9 | 152.7 |
| Operating costs | (122.2) | (114.2) |
| Other income | 8.4 | 8.7 |
| Operating profit | 42.1 | 47.2 |
| Net finance costs | (32.1) | (19.8) |
| Profit before income tax | 10.0 | 27.4 |
| Income tax credit/(expense) | 8.3 | (5.6) |
| Profit for the period | 18.3 | 21.8 |
| Dividends | (36.0) | (28.0) |
| Transfer to reserves | (17.7) | (6.2) |

Revenue for the first six months of the year was £155.9m, being a 2% increase on the same period last year (6 months to 30 September 2015: £152.7m). The increase is primarily due to inflationary price adjustments allowed by Ofwat in our last regulatory determination, as well as higher new connections activity.

Operating expenditure

Total operating costs of £122.2m for the first half of the year were 7% higher than in the same period last year (6 months to 30 September 2015: £114.2m). The variance is explained in the table below:

| Increases/(decreases) in operating costs | £m |
|--|------------|
| Inflation | 1.6 |
| Higher depreciation | 3.7 |
| Higher infrastructure renewals activity | 2.5 |
| Higher employment costs | 1.6 |
| Higher market opening preparation costs | 1.3 |
| Higher new connections activity | 0.9 |
| IT transformation project costs incurred in the prior period | (2.0) |
| Others and efficiencies | (1.6) |
| Net increase in operating costs | 8.0 |

Financial performance (continued)

Finance costs

Net finance expense of £32.1m was £12.3m higher than the first half of last year largely as a result of the additional finance costs associated with the £40.0m Class A 2045 bonds issued in October 2015 and the £10.0m Class B 2033 bonds issued in February 2016 as well as the one off expense of £9.5m in the current period as a result of the bond exchange which completed in August 2016 (see Financing Update for further details).

Capital expenditure

Capital expenditure in the period was £54.3m (2015: £29.9m), and was incurred principally in our mains renewals, trunk main replacement, sustainability reduction, water saving and lead pipe replacement AMP6 programmes. This excludes £8.7m (2015: £6.2m) of infrastructure renewals expenditure, which is treated as an operating cost under the recognition and measurement requirements of IFRS.

The higher capital expenditure in the first half of this year compared to the same period last year reflects higher run rates on our capital programmes in this second year of AMP6.

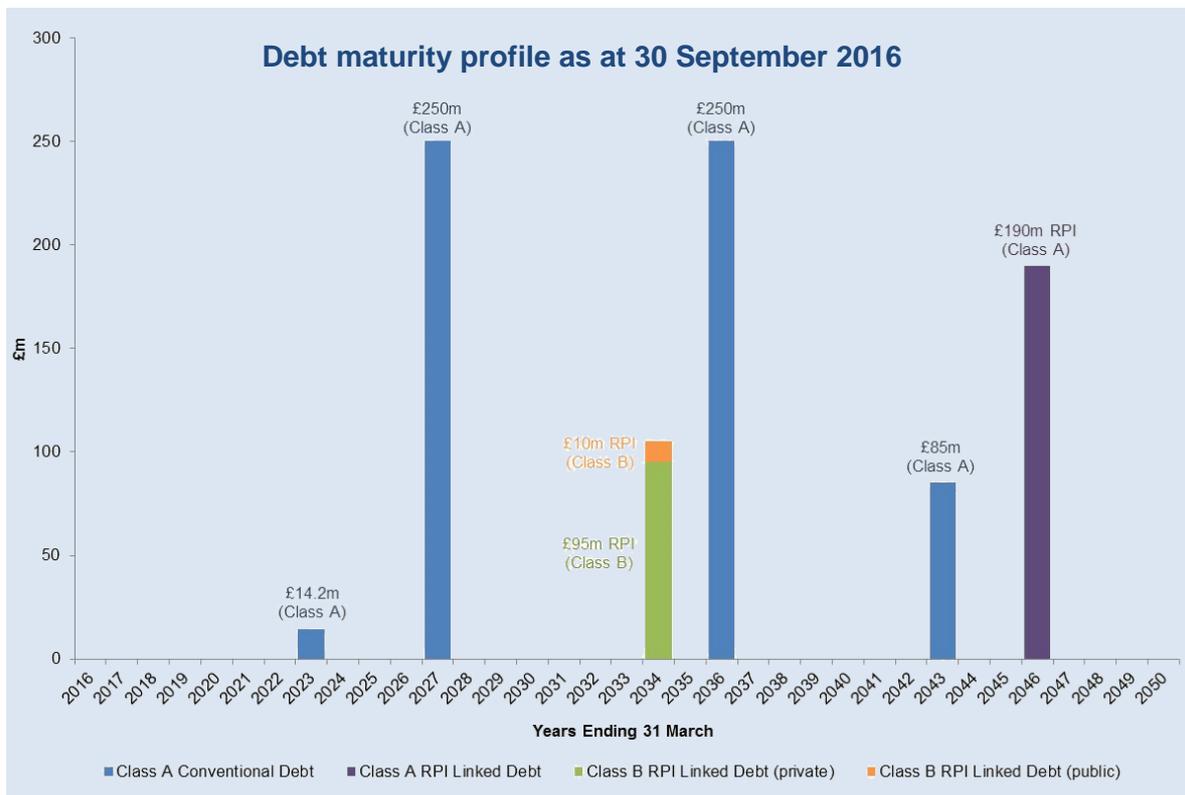


Financing update

On 9 August 2016, Affinity Water Programme Finance Limited announced an invitation to holders of the Sub-Class A1 £80,000,000 3.625 per cent. Guaranteed Bonds due 2022 to offer to exchange any and all of their holdings for a new fixed rate bond due 2042.

Affinity Water Programme Finance Limited was offered £65,796,000 in bonds which were accepted in full for exchange. The new bond, Sub-Class A4, was issued with a coupon of 3.278 per cent, reflecting the mechanics of the bond exchange and a final maturity date of 22 August 2042. At the same time, Affinity Water Programme Finance Limited issued a further £19,204,000 of the new Sub-Class A4 bond, taking the total amount of the new bond issue to £85,000,000.

The chart below shows the maturity profile of all the bonds issued by Affinity Water's financing subsidiaries, including the recent bond exchange and additional issuance.



Regulatory update

Water 2020

In July 2015 Ofwat launched “Towards Water 2020” and, following on from this, launched a consultation in December 2015 on its preferred approach to the design of the regulatory framework for the water industry at the next price review (‘PR19’)

In May 2016 Ofwat published further thinking confirming its preferred approach to the design of the future regulatory framework for the water industry for PR19. The new framework aims to make greater use of markets in relation to the areas of sludge and water resources with separate binding revenue controls for each. For PR19 Ofwat has also set out its intention to use the Consumer Price Index (‘CPI’) or ‘CPIH’ (which includes owner occupier housing costs) rather than RPI for indexing allowed revenues (and therefore customers’ bills). RCV is also to be indexed using a combination of CPI/CPIH and RPI.

In November 2016, Ofwat launched a consultation, under Section 13 of the Water Industry Act 1991, regarding proposed modifications of the conditions of the appointment of each of the 17 largest water companies including Affinity Water Limited. The modifications are to enable the implementation of key policy decisions published in Water 2020 including the move to CPI/CPIH as well as in-period adjustments to price control revenue for ODI rewards and penalties.

Household Competition

Ofwat has published its findings on the costs and benefits of introducing competition to the household retail water market in England. It concluded that competition could offer some small savings for household customers as well as better customer service, innovation in offers and products, and environmental benefits. However it still remains uncertain whether there will be a competitive household retail market in the near future.

We continue to fully engage with all our regulators regarding developments impacting the sector and are always happy to discuss publicly available information on this with our investors.

Governance update

Executive appointments

It was announced on 28 October 2016 that Duncan Bates would step down from his full time role as Chief Financial Officer at the end of the current financial year. A search for his successor as CFO has started. Duncan will continue his involvement with the wider Affinity Water Group, working on a part time basis until March 2018, supporting his successor and on projects outside the regulated business as Group Financial Officer.

We have strengthened our senior management team with Debbie Ryan joining us as our new People Director. Debbie has previous experience within HR roles at Homeserve, Barclaycard and Tech Data and is also a Non-Executive Director on the Board of England Netball.

Common Terms Agreement compliance

Calculation of financial ratios

| Test Period | | Year 1 1 April 2016 to 31 March 2017 Forecast | Year 2 1 April 2017 to 31 March 2018 Forecast | Year 3 1 April 2018 to 31 March 2019 Forecast | Year 4 1 April 2019 to 31 March 2020 Forecast |
|-----------------------------------|--------------|--|--|--|--|
| Net Cash Flow divided by | £m | 120.9 | 126.6 | 132.9 | 140.5 |
| Class A Debt Interest | £m | 33.5 | 33.7 | 34.6 | 35.3 |
| Class A ICR | Ratio | 3.6 | 3.8 | 3.8 | 4.0 |
| Net Cash Flow less | £m | 120.9 | 126.6 | 132.9 | 140.5 |
| CCD and IRC | £m | 0 | 0 | 0 | 0 |
| Adjusted Net Cash Flow divided by | £m | 120.9 | 126.6 | 132.9 | 140.5 |
| Class A Debt Interest | £m | 33.5 | 33.7 | 34.6 | 35.3 |
| Class A Adjusted ICR | Ratio | 3.6 | 3.8 | 3.8 | 4.0 |
| Net Cash Flow less | £m | 120.9 | 126.6 | 132.9 | 140.5 |
| CCD and IRC | £m | 0 | 0 | 0 | 0 |
| Adjusted Net Cash Flow divided by | £m | 120.9 | 126.6 | 132.9 | 140.5 |
| Senior Debt Interest | £m | 36,900 | 37,200 | 38,100 | 39,000 |
| Senior Adjusted ICR | Ratio | 3.3 | 3.4 | 3.5 | 3.6 |

| Test Period | | Year 1 1 April 2016 to 31 March 2017 Forecast | Year 2 1 April 2017 to 31 March 2018 Forecast | Year 3 1 April 2018 to 31 March 2019 Forecast | Year 4 1 April 2019 to 31 March 2020 Forecast |
|--|----------------|--|--|--|--|
| Year 1 | Ratio | 3.6 | | | |
| Year 2 | Ratio | 3.8 | 3.8 | 3.8 | 3.8 |
| Year 3 | Ratio | 3.8 | 3.8 | 3.8 | 3.8 |
| Year 4 | Ratio | | 4.0 | 4.0 | 4.0 |
| Class A Average Adjusted ICR | Average | 3.7 | 3.9 | 3.9 | 3.9 |
| Year 1 | Ratio | 3.3 | | | |
| Year 2 | Ratio | 3.4 | 3.4 | 3.4 | 3.4 |
| Year 3 | Ratio | 3.5 | 3.5 | 3.5 | 3.5 |
| Year 4 | Ratio | | 3.6 | 3.6 | 3.6 |
| Senior Average Adjusted ICR | Average | 3.4 | 3.5 | 3.5 | 3.5 |
| Net Cash Flow less | £m | 120.9 | 126.6 | 132.9 | 140.5 |
| RCV Depreciation and Capitalised IRE | £m | 61.9 | 63.3 | 64.3 | 69.8 |
| Conformed Adjusted Net Cash Flow divided by | £m | 59.0 | 63.3 | 68.6 | 70.7 |
| Class A Debt Interest | £m | 33.5 | 33.7 | 34.6 | 35.3 |
| Conformed Class A Adjusted ICR | Ratio | 1.8 | 1.9 | 2.0 | 2.0 |

| | | | | | |
|---|----------------|------------|------------|------------|------------|
| Net Cash Flow less | £m | 120.9 | 126.6 | 132.9 | 140.5 |
| RCV Depreciation & Capitalised IRE | £m | 61.9 | 63.3 | 64.3 | 69.8 |
| Conformed Adjusted Net Cash Flow divided by | £m | 59.0 | 63.3 | 68.6 | 70.7 |
| Senior Debt Interest | £m | 36.9 | 37.2 | 38.1 | 39.0 |
| Conformed Senior Adjusted ICR | Ratio | 1.6 | 1.7 | 1.8 | 1.8 |
| Year 1 | Ratio | 1.8 | | | |
| Year 2 | Ratio | 1.9 | 1.9 | 1.9 | 1.9 |
| Year 3 | Ratio | 2.0 | 2.0 | 2.0 | 2.0 |
| Year 4 | Ratio | | 2.0 | 2.0 | 2.0 |
| Conformed Class A Average Adjusted ICR | Average | 1.9 | 2.0 | 2.0 | 2.0 |
| Year 1 | Ratio | 1.6 | | | |
| Year 2 | Ratio | 1.7 | 1.7 | 1.7 | 1.7 |
| Year 3 | Ratio | 1.8 | 1.8 | 1.8 | 1.8 |
| Year 4 | Ratio | | 1.8 | 1.8 | 1.8 |
| Conformed Senior Average Adjusted ICR | Average | 1.7 | 1.8 | 1.8 | 1.8 |

| Date | | 30 September 2016 Actual | 31 March 2017 Forecast | 31 March 2018 Forecast | 31 March 2019 Forecast | 31 March 2020 Forecast |
|-------------------------------------|--------------|-----------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| Class A Net Indebtedness divided by | £m | 741.2 | 761.7 | 811.7 | 838.0 | 846.4 |
| RCV | £m | 1,116.6 | 1,143.4 | 1,187.0 | 1,209.1 | 1,217.0 |
| Class A RAR | Ratio | 0.66 | 0.67 | 0.68 | 0.69 | 0.70 |
| Senior Net Indebtedness divided by | £m | 854.3 | 874.9 | 928.0 | 957.5 | 969.2 |
| RCV | £m | 1,116.6 | 1,143.4 | 1,187.0 | 1,209.1 | 1,217.0 |
| Senior RAR | Ratio | 0.77 | 0.77 | 0.78 | 0.79 | 0.80 |

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

| Date | 30 September 2016 £m |
|--|-------------------------|
| Borrowings | 939.3 |
| Exclude Permitted Legacy Loan | (3.6) |
| Add Back Unamortised Debt Issue Costs and Bond Premium | (20.9) |
| Add Accrued Interest | 5.7 |
| Less Cash and cash equivalents | (66.2) |
| Senior Net Indebtedness | 854.3 |
| Remove Class B Debt Amounts | (113.1) |
| Class A Net Indebtedness | 741.2 |

Further certifications

Surplus

Affinity Water Limited's dividend policy is to pay dividends that target a Senior RAR of 80% at each of the compliance test dates as well as remaining consistent with the requirements of Condition F of the licence. Condition F states that any dividends declared or paid will not impair the ability of the Appointee to finance the Appointed Business; and under a system of incentive regulation dividends would be expected to reward efficiency and the management of economic risk.

For the 6 month period to 30 September 2016, Affinity Water Limited paid dividends totalling £36.0 million (6 months to 30 September 2015: £28.0 million).

Debt Service Reserve Accounts

There is no balance in each of the Debt Service Reserve Accounts as at 30 September 2016. The required debt service reserve is provided by a liquidity facility from HSBC Bank PLC totalling £38.0 million.

Authorised Investments

| Counterparty | Bank Deposits (£m) | Liquidity Funds (£m) | Total (£m) |
|---|--------------------|----------------------|-------------|
| HSBC Sterling Liquidity Fund | - | 4.0 | 4.0 |
| Lloyds Bank plc | 10.0 | - | 10.0 |
| Santander UK plc | 10.1 | | 10.1 |
| Morgan Stanley Sterling Liquidity Fund | - | 10.0 | 10.0 |
| BNP Paribas Insticash Sterling Liquidity Fund | - | 5.0 | 5.0 |
| LGIM Sterling Liquidity Fund | - | 5.0 | 5.0 |
| Total | 20.1 | 24.0 | 44.1 |

Permitted Subsidiaries Acquired

There were no Permitted Subsidiaries acquired pursuant to a Permitted Acquisition in the period to 30 September 2016.

Annual Finance Charge

Following the bond exchange, Affinity Water Limited recalculated the Annual Finance Charge for the period from 1 April 2016 to 31 March 2017 as £35.8 million and the Monthly Payment Amount to be £2.979 million. Calculation of the Annual Finance Charge is set out in the table to the right.

| | 1 April 2016 to 31 March 2017 (£m) |
|-----------------------------------|---------------------------------------|
| Forecast interest paid on bonds | 35.3 |
| Forecast interest paid on loans | 0.0 |
| Other recurring finance fees paid | 0.5 |
| Total | 35.8 |

Additional Confirmations

Affinity Water Limited also confirms that:

- (a) no Default or Potential Trigger Event is outstanding; and
- (b) that Affinity Water Limited's insurances are being maintained in accordance with the Common Terms Agreement.

Further Periodic Information

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

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

Yours faithfully,

Duncan Bates
 Chief Financial Officer
 For and on behalf of
 Affinity Water Limited
 (in its capacity as Transaction Agent)

