Affinity Water

Annual Report and Financial Statements

for the year ended 31 March 2016

Affinity Water Limited
(Registered Number 02546950)

Affinity Water at a glance

Where we operate

Where we operate

- Affinity Water area
- Other water only company area
- Water and sewage company area

Our Registered Office

Tamblin Way,
Hatfield,
Hertfordshire
AL10 9EZ

COVER: Heron Lake, in our Wey community, is the only dedicated disabled water skiing facility in the country. Please refer to our case study on page 16 for further details.

Affinity Water is the United Kingdom’s (‘UK’) largest water only supply company.

Affinity Water Limited owns and manages the water assets and network in an area of approximately 4,515km^2 split over three regions, comprising eight separate water resource zones, in the southeast of England. We are the sole supplier of drinking water in these areas.

Our vision, to be the UK’s leading community focused water company, 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. Our economic regulator, Ofwat, has acknowledged, through awarding us ‘enhanced status’ for our Price Review 2014 (‘PR14’) Business Plan (our ‘Business Plan’) for the 2015-2020 price control period (Asset Management Plan 6, ‘AMP6’), that our vision and approach is something that sets us apart.

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.

Annual report and financial statements

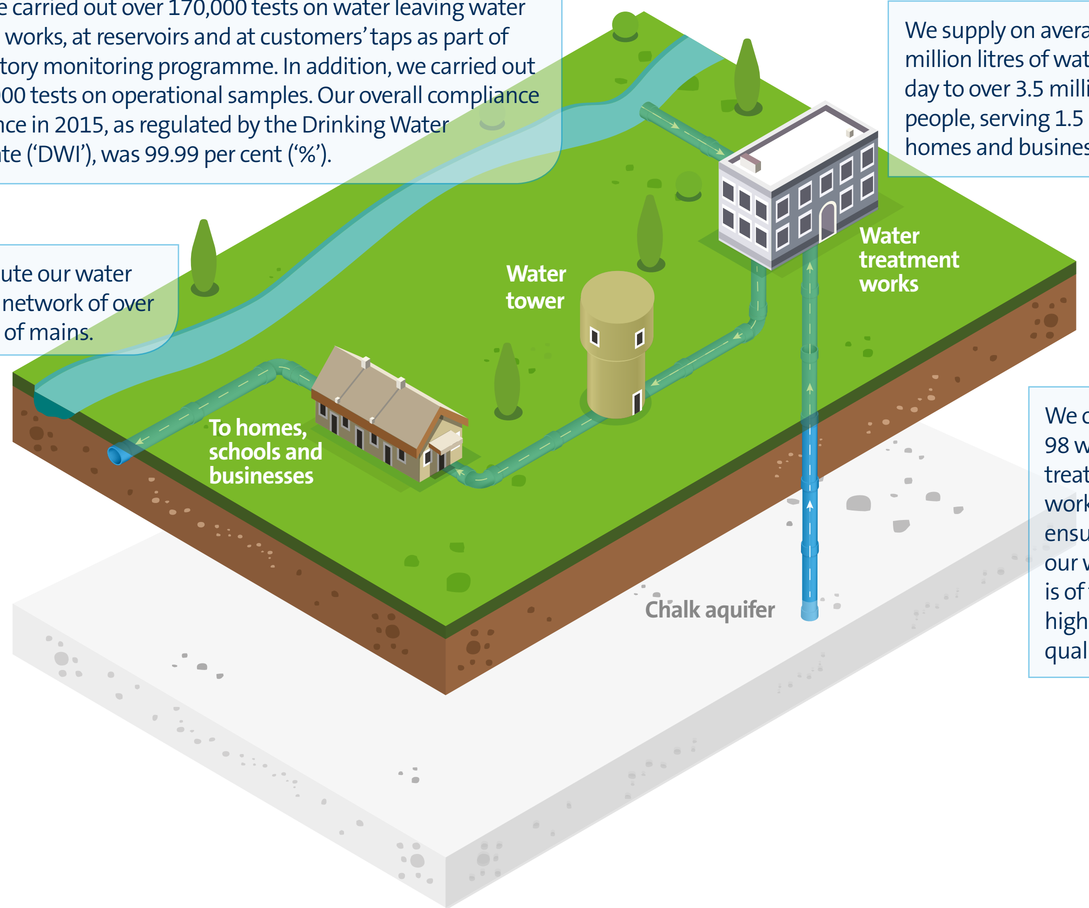
Affinity Water at a glance continued

Facts and figures

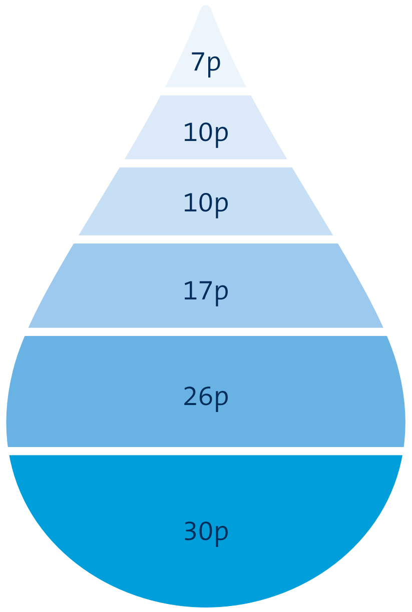
In 2015 we carried out over 170,000 tests on water leaving water treatment works, at reservoirs and at customers' taps as part of our regulatory monitoring programme. In addition, we carried out over 400,000 tests on operational samples. Our overall compliance performance in 2015, as regulated by the Drinking Water Inspectorate ('DWI'), was 99.99 per cent ('%').

We supply on average 900 million litres of water a day to over 3.5 million people, serving 1.5 million homes and businesses.

We distribute our water through a network of over 16,500km of mains.



We operate 98 water treatment works to ensure that our water is of the highest quality.



Where each pound of our customers' bills is spent:

Our shareholders
Dividends

Our bondholders
Interest paid on debt financing

Local and central government
Corporation tax, business rates, abstraction charges, employer's national insurance, Climate Change Levy and streetworks permits

Our people
Wages, salaries and pensions

Our suppliers for operating services
Operational cost of suppliers' services

Our suppliers for assets
Investment in our assets

Figures are based on our statutory financial statements for the year ended 31 March 2016 on pages 73 to 125 and have been rounded.

Contents

Page 10

Our vision and business model sections

Information about our vision and what our business model looks like for us and for our customers and communities.

Page 26

Our performance

A summary of our operational and financial performance for 2015/16, including our corporate social responsibility highlights.

Page 44

Board of directors

Details about our Board members, their responsibilities and experience

See further information online:
stakeholder.affinitywater.co.uk

Important information

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.

Terms used in this report:
The 'company', 'Affinity Water' or 'AWL' means Affinity Water Limited; the 'regulated business' or 'regulated activities' means the licensed water activities undertaken by Affinity Water Limited in the southeast of England.

Highlights

Operational highlights 2015/16

Progress made in delivering on our commitments for 2015-2020

Protecting our people

Implemented a number of initiatives aimed at significantly reducing our accident frequency rate, recording

0.27 lost time injuries per **100,000** compared to a target of 0.7 and actual performance of 1.02 in 2014/15.

Managing our water resources

Achieved our stretching regulatory leakage target, reducing leakage by

2 megalitres per day

compared to our 2014/15 performance

Minimising disruption

Strengthened the resilience of our network, reducing mains bursts by

9% compared to our 2014/15 performance, 29% lower than our regulatory target

Supplying high quality water

Recorded our best ever performance in terms of mean zonal compliance,

99.99%

for the 2015 calendar year compared to a target of 99.95% and 99.97% for 2014

Value for money customer service

Introduced an innovative value for money index, achieving a score of

71.6 out of 100

higher than our baseline performance assessed in 2014/15, providing a basis for setting targets in subsequent years

For further information on our operational performance, see pages 26 to 29.
For our 2015/16 corporate social responsibility highlights, see page 30.

Shortlisted for the ASDA Environmental Leadership Award.

Engineer of the Year winner and finalists in two categories: People recruitment of the Year and Water Resource Management Initiative of the Year.

Two of our team members won awards for their contribution to promoting water efficiency.

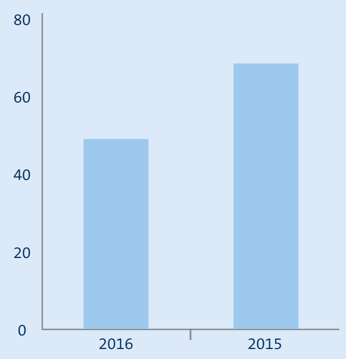
Financial highlights 2015/16

Net cash inflow before tax and financing[1]

£51m

Target: £14m

2015: £71m



We met our internal target for the year largely as a result of lower than targeted asset-related expenditure. This was primarily due to a slower than anticipated start to our metering programme and delays in technology selection for water quality projects. Programmes of work are expected to accelerate in 2016/17.

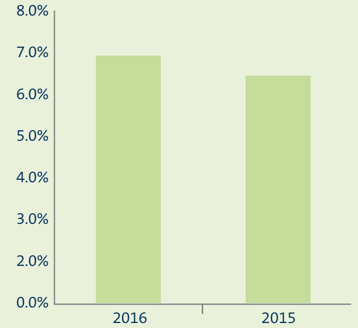
Post tax return on regulatory capital value

Our post tax return on capital assumed in price controls for 2015/16 remained consistent with last year.

6.9%

Target: 7.5%

2015: 6.4%



Credit ratings

A-/A3

Target: A-/A3 2015: A-/A3

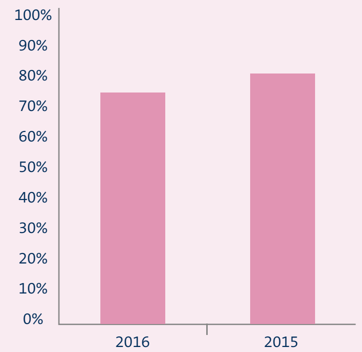
We have continued to maintain stable investment grade credit ratings in line with those of our peers in the water sector.

Gearing

75%

Target: 80%

2015: 80%



Gearing remained below the Board-approved gearing level of 80% during the year. This allows sufficient headroom within our financial covenants, the first trigger of which is a restricted payment condition at a gearing level of more than 85%

[1] This "non-GAAP" measure, which is used internally to evaluate our financial performance, is calculated as the total of the following line items per the statement of cash flows in our statutory financial statements on page 86: cash generated from operations; purchases of property, plant and equipment; capital contributions; proceeds on disposal of property, plant and equipment; and purchase of intangibles.

For further information on our financial performance, see pages 32 to 34.

Chairman's statement

Dr Philip Nolan, Chairman

I am delighted to present Affinity Water's annual report and financial statements for the year ended 31 March 2016.

Our vision is to be the UK's leading community focused water company and I am pleased that, in the first year of AMP6, we are making progress on that ambition.

For us, community focused means playing an active role in the communities we serve, keeping our customers informed of our activities and giving them a real opportunity to give us their thoughts on how we are performing.

Our vision captures our response to three overriding imperatives.

Firstly, as a private provider of a public utility, we recognise how important it is that our customers trust the service we provide. That is why we will continue to invest in building relationships with our customers and the communities we serve.

Secondly, our customers and stakeholders must have confidence that we are operating in a responsible and accountable way. To achieve this, we will be publishing our performance on our website so our customers can see exactly how we are performing against the commitments we have made for AMP6.

Thirdly, it is vital to us that we create value. We create value by performing efficiently and by maintaining our local environment, sustaining our local communities and supporting our local economies. By doing this, we will achieve value for our investors while delivering the standards of service our customers expect along with the performance commitments we included in our Business Plan. Refer to our business model on page 23 for further information.

Our Customer Scrutiny Group ('CSG'), which consists of representatives with experience of representing household customers, commercial customers and working for special interest groups, holds us to account on how we are performing against our AMP6 commitments.

Our CSG is chaired independently and I would like to thank Robin Dahlberg, who served as chair until June 2016, for his valuable contribution over a number of years. I am delighted that Teresa Perchard has succeeded Robin as the new chair. Teresa is a non-executive director with 30 years of experience in consumer advocacy, consumer protection and regulatory roles.

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

We absolutely recognise that water is essential for economic development. We have an important role to play in supporting our local economies and regional growth whilst working with our customers to reduce water use and to ensure a sustainable supply.

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 are delivering what our communities expect of us and ensure our contribution to those communities really makes a difference.

Attracting and retaining highly motivated people is central to our ability to deliver an outstanding service for our customers. We want to make Affinity Water a fantastic place to work and help our people develop. We are making sure we invest time and resources to achieve this.

Looking ahead, we are preparing for the biggest transformation of the water industry in England since privatisation.

In April 2017 the competitive retail market for all non-household customers in England is expected to open. New entrants are already signalling their intention to join this market.

For the first time, many of our non-household customers will have the chance to choose their retail service provider. This is a significant change and over the course of 2016/17 we will be working to ensure that our non-household customers are aware and informed of the changes that will be taking place.

We expect there to be further reform of the market in addition to this. The government has asked our economic regulator, Ofwat, to consider the extension of retail competition into the household market and, while this is in the early stages of assessment, it is something of which we have to be mindful.

You may have seen that we appointed Trevor Didcock and Susan Hooper to the Board as independent non-executive directors in the year, following the retirement of Baroness Peta Buscombe and Dr Jeffrey Herbert, who we thank for their significant contributions. Trevor and Susan specifically bring customer, retail and technology transformation skills to the team, which will be highly relevant to our future. Their appointments complete the building of a strong, experienced and balanced Board.

We have set ourselves ambitious performance commitments for AMP6. Our teams are passionate about delivering against these to ensure a sustainable supply for future generations along with meeting the standards of service our customers expect. Our partnership with our communities and customers will help us realise that vision.

You can read more about how we are planning for the future by visiting our website:

stakeholder.affinitywater.co.uk/our-future-plans.aspx

Strategic report

Chief Executive Officer's introduction

This year's annual report marks my one year anniversary with Affinity Water. It is really pleasing for me to look back and highlight our achievements, and the progress we have made over the last year.

We are in great shape to deliver on our ambitious commitments for AMP6. In addition we have made a number of positive changes within our organisation.

We took our vision to be the leading community focused water company one step further in January 2016 by launching 'The Affinity Way'. We believe this is something that separates us from the industry. The Affinity Way runs through our business, clearly summing up who we are, the responsibility we have for the services we provide and the behaviours we are looking for from our people and business partners that support us.

When I look back at our performance for 2015/16, the first year of our five year Business Plan, I recognise that there is more to do in the coming years to deliver on all our commitments, but this is a reflection of the genuinely stretching targets we have set ourselves.

In particular we face a huge challenge to use our water resources more efficiently. 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.

That is why the work of our leakage task force has been so important. This year we have reduced leakage on our network to 181 megalitres. By achieving this we have met our regulatory target as well as the high standards we set ourselves.

Our customers continue to benefit from high quality drinking water.

Our Mean Zonal Compliance ('MZC') was 99.99%, making this our best year ever.

I am also proud to report that the number of bursts on our network this year fell to 2,201, which was under our target of 3,100 and also lower than the level of bursts we experienced last year. At a time when we are asking our customers to save water, 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 our customers.

However there is more work we can do to ensure that bursts on our network do not result in prolonged interruptions to supply for our customers. On this latter measure, we have fallen short of the target we set for ourselves, which means we have incurred a penalty that will be realised as part of our next regulatory price review.

I am really proud of the team at Affinity Water and I am delighted that we have made a strong start in the first year of our ambitious five year plan for our customers and communities.

I am pleased that we have improved our Service Incentive Mechanism ('SIM') score for the provision of customer services in billing and operation water supply. In the second half of the year, we also moved up three places to thirteenth position relative to the industry in respect of our qualitative SIM score.

These results demonstrate that the steps we are taking to improve our service are beginning to have an impact. However I know that for this to become sustainable we need to take on board our customers' rising expectations. They expect a simple, low effort service when they contact us for help and it is important we listen to them and resolve their issues.

Our Business Plan was awarded 'enhanced status' by Ofwat, in part because of the extensive consultation we undertook with our customers. During AMP6 we are determined to maintain this engagement. That is why we are publishing our performance online for our customers to view and giving our customers and stakeholders the chance to comment on our performance through events in each of our eight communities.

We have also developed a customer experience improvement programme based on direct customer feedback combined with our desire to ensure our customers have great service from us. We further have a new Customer Engagement and Operational Excellence team, established to deliver improvements to our customer service.

These changes in 2015/16 were part of a wider restructuring of our company so that we can improve our community focus and position ourselves as a leader in our sector. I believe this will help us deliver a better service for customers and ensure that we are prepared for future challenges where competition and commercial success are going to be the norm.

To help drive through these changes we have strengthened our senior management team with three new appointments.

Amanda Reynolds joined as our Director of Customer Relations (Household), bringing with her 20 years of experience in customer services and a passion for improving the customer experience. Helen Gillet joined as our Director of Retail Non-Household and will use her experience in operational and strategic leadership to drive forward our sales and business development strategy for our retail non-household business. Andrew Ritchie, in his appointment as the new Managing Director of Wholesale Operations, brings a wealth of experience to our business, including extensive hands-on exposure across the full value chain, capital projects, improvement programmes, operations and business development.

When I look back at my first year I am extremely pleased with the progress we have made and everyone in the Affinity Water team who contributed to it. But I am confident that we can do more.

We can do more to improve our performance on leakage. We also need to improve the rollout of our water saving programme to give our customers the chance to save water, energy and money, and we must maintain our incredibly high standards in providing high quality drinking water our customers can trust.

On behalf of the senior management team and the Board, I would like to thank all our people for their hard work, commitment and achievements.

Strategic report continued

Summary of our strategic report - providing a clear line of sight

Our vision Our vision is to be the UK's leading community focused water company. This vision captures our response to three overriding imperatives:	**as a private provider of a public utility service, to retain trust and legitimacy;**	**to operate in a responsible and accountable way by complying with all applicable laws and regulations; and**	**to create value by performing efficiently and securing investor value, and by maintaining our local environment, sustaining our local communities and supporting our local economies.**
Our business model Our business model recognises the need to satisfy these three overriding imperatives while providing all processes and capabilities needed to achieve: page 23	our customers' expectations by: making sure our customers have enough water, whilst leaving more water in the environment; supplying high quality water our customers can trust; minimising disruption to our customers and community; providing a value for money service;	assurance to stakeholders of our compliance with all applicable laws and regulations; and	value creation for investors while achieving value for money for customers.
2015/16 performance Our operational and customer service performance measures and targets are aligned to key commitments for AMP6 made in our regulatory Business Plan. pages 26-34	Leakage: **180.9 Ml/d;** Sustainable abstraction reductions: **6.7 Ml/d** Mean zonal compliance: **99.99%** Mains bursts: **2,201 bursts** Unplanned interruptions to supply over 12 hours: **1,771 properties** SIM: **13th position**	Accident frequency rate: **0.27 lost time accidents per 100,000 hours worked**	Net cash inflow before tax and financing: **£51m**
Principal risks and uncertainties We have in place an established framework in order to identify, evaluate and manage the key risks we face. Our principal risks and uncertainties are: pages 35-42	• injuries and accidents to our people and the public; • failure to supply wholesome water; • unavailability of resources (people and materials); • information security or privacy failure;	• adverse changes to the regulatory framework • adverse change in the social and/or political climate; • failure to be compliant with laws, our instrument of appointment and other recognised standards; • failure to deliver our business plan obligations; • being required to undertake unremunerated activity; • failure to prepare for market reform;	• liquidity risk; • macro economic risk (interest rate, inflation and tax risks); • breach of and changes to our borrowing covenants; and • revenue and debt risk.

Strategic report continued

Our vision and The Affinity Way

Our vision 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.

Our vision | **To be the UK's leading community focused water company**

Extract from our business model diagram presented on page 23.

THE AFFINITY WAY – HOW WE WORK

Underpinning our vision to be the UK's leading community focused water company is the responsible approach we take to doing business, 'The Affinity Way'.

We believe that The Affinity Way, set out below, separates us from the industry. It clearly sums up who we are, the responsibility we have for the services we provide and the behaviours we are looking for from our people and the business partners that support us.

The Affinity Way

It starts and ends with our name. Affinity Water.

There are many things that make us different as a company.

It starts with our dedication and focus on supplying high quality drinking water.

Our empathy with our customers and commitment to always being effective, efficient and safe.

It's a driving force that shapes our attitude and approach.

From the way we talk and listen to our customers and stakeholders.

To the way we talk and listen to each other.

It's the pride we take in our delivery and our performance.

Affinity for our colleagues, customers and the environment we serve.

A vision to be the leading, community-focused water company.

It starts and ends with our name.
And flows through everything we do.

The Affinity Way is centred on issues which are material to our customers and stakeholders, and to the responsible delivery of our five year and longer term business plans. We must be able to articulate, measure and report our performance to ensure there is a clear line of sight between the activities we undertake and the social, economic and environmental impacts we have.

Our responsible approach to doing business is reflected in the industry-leading commitments we have made for AMP6 on sustainable abstraction, reducing leakage and working with customers to reduce household water consumption. We have been recognised for our leading approach to customer consultation and innovation in water efficiency, and are addressing affordability issues through social tariff, value for money and living wage commitments.

The Affinity Way also provides the context for our Corporate Social Responsibility ('CSR') programme that brings further focus to:

- protecting local rivers and habitats;
- building stronger community-based partnerships;
- investing in Science, Technology, Engineering and Mathematics ('STEM') education and future skills;
- working with our supply chain to improve CSR impacts; and
- providing access, recreation and conservation on our land and lakes.

We set out on page 30 our CSR performance highlights in 2015/16 in relation to issues that we understand matter most to our stakeholders and those which have the most profound effect on our business. Our greenhouse gas statement is presented on page 70 of the directors' report.

case study

Affinity for our colleagues, customers and the environment we serve.

By working with local delivery partner White Cliffs Countryside Partnership at Samphire Hoe Nature Reserve we have expanded our education service beyond the locality of our in house education centre and into our Dour Community.

Our approach ensures the education programme is relevant to the local community, uses the inspiring outside environment and meets the curriculum.

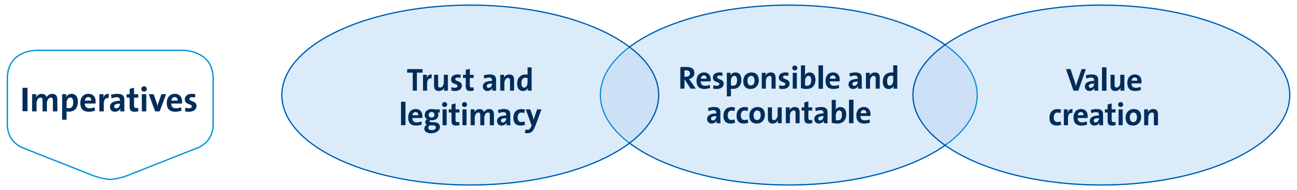
We believe that education and engaging with the next generation are key to ensuring the right skills are available and behaviours are developed to build a sustainable future for water and the environment.

Strategic report continued

Our imperatives

As a private provider of an essential public service we have three overriding imperatives:

- **retaining trust and legitimacy;**
- **responsible and accountable operational performance that complies with all applicable laws and regulations; and**
- **value creation by performing efficiently and securing investor value, and by maintaining our local environment, sustaining our local communities and supporting our local economies.**



Extract from our business model diagram presented on page 23.

Our vision balances potentially competing imperatives and ensures alignment between our customers, investors and stakeholders.

TRUST AND LEGITIMACY

We are privileged to serve our communities. Being the supplier and the 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 in their communities. This is central to achieving our vision.

Expectations of service and customer experience

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 have access to information enabling them to 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.

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

Affordability and value for money

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 domestic customers and which we collect on behalf of other companies, can exacerbate underlying affordability concerns.

RESPONSIBLE AND ACCOUNTABLE

Being held to account by our customers

We want our 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 the Department for the Environment, Food and Rural Affairs ('Defra'). These targets are annual at the level of the whole company. Such targets include the performance commitments we made in our Business Plan.

To shape our Business Plan for this regulatory period, we undertook extensive research with input from more than 12,500 customers. The table below summarises our customers' four expectations (or 'customer outcomes' in regulatory language) and the performance commitments we made for AMP6.

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

Strategic report continued

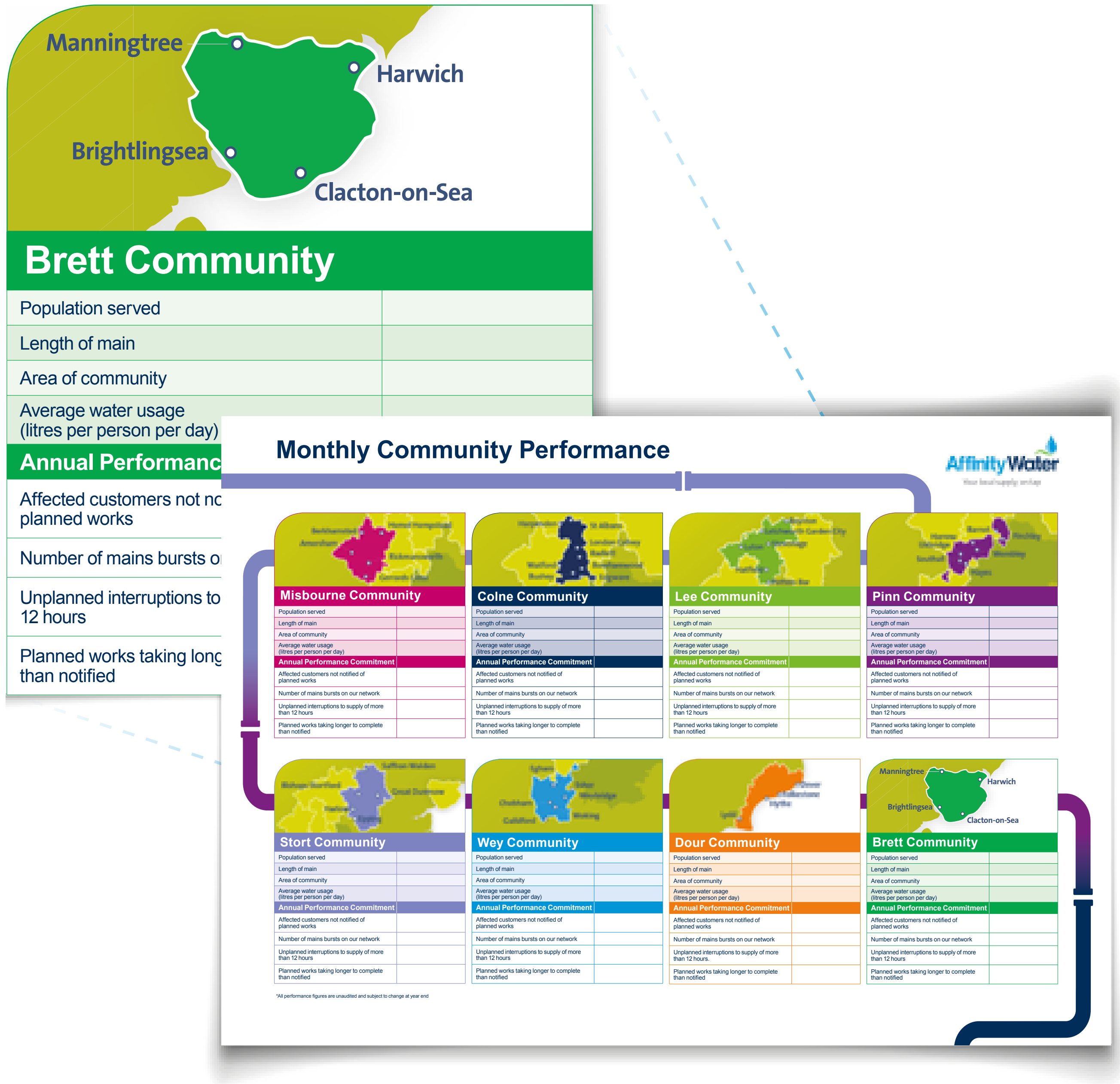
Our imperatives (continued)

RESPONSIBLE AND ACCOUNTABLE (CONTINUED)

We also have been reporting online our performance for each of our eight communities using community dashboards (refer to the template dashboard below).

The introduction of the dashboards is just the start of the community reporting commitment we made in our Business Plan. They represent our commitment to our customers that we intend to be transparent and communicate in a meaningful way so that they understand how we are performing in their community. For further information refer to the Our Performance page of our stakeholder website:

stakeholder.affinitywater.co.uk



RESPONSIBLE AND ACCOUNTABLE (CONTINUED)

Political and regulatory environment

The industry in which we operate is subject to extensive legal and regulatory controls with which we must comply. We need to comply with the laws, regulations and standards, and the policies published by Ofwat, the Environment Agency ('EA'), Defra, the DWI, Natural England and other regulators.

The water industry is undertaking progressive reform of its market to facilitate greater competition. This will result in new entrants to the retail water market and allow non-household customers to exercise choice. These changes present opportunities as well as challenges. We operate on the principle that for all our customers we should work hard to be their supplier of choice.

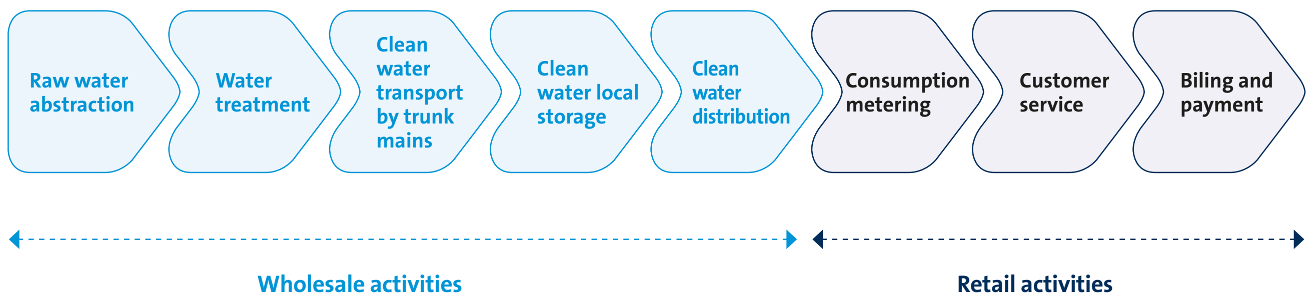
In April 2017 the competitive retail market for all non-household water and sewerage customers in England is expected to open. The work needed to introduce changes to open the market is being delivered by the Open Water Programme, working with market participants, Ofwat and Defra. The programme will define the overall market architecture and deliver operational and market codes, central systems and contracts required for the market to function effectively and efficiently. With less than twelve months to go before market opening, the industry, including ourselves, is entering the final stages of implementation of new market arrangements.

The Water Act 2014 has paved the way for further reform of upstream activities. Whilst the reforms are not expected to be implemented before 2020, Ofwat and Defra are considering how principles of contestability might be introduced. We remain closely involved in debates on this issue, with Ofwat having published its proposals and thinking in May 2016 ahead of price setting methodology consultations in 2017.

We operate on the principle that for all our customers we should work hard to be their supplier of choice

Additionally in November 2015 the government announced that Ofwat would consider the case for the extension of retail competition into the household market. Ofwat published the terms of reference for its review in January 2016 and issued a call for evidence from the industry and interested stakeholders. Ofwat is expected to publish the outcome of its review during the late summer/early autumn of 2016.

Our value chain



Strategic report continued

Our imperatives (continued)

VALUE CREATION

Our challenge is to achieve value creation for investors by performing efficiently while 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 rewards for doing so (refer to the information box below), and through effective risk management to reduce cash flow volatility (i.e. offering more predictable cash returns) at the same time as delivering our commitments. Value for money for customers is achieved by delivering the standards of service our customers expect along with the performance commitments we included in our Business Plan (refer to the table on page 13).

Economic regulation

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, created to drive efficient investment decisions and facilitate the introduction of retail competition for our non-domestic customers from April 2017. 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.

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. Non-household controls serve as protection for customers as competition develops in the retail market and have been set for the period prior to market opening and are under review by Ofwat for the period between 1 April 2017 and 31 March 2020.

For AMP6, Ofwat is assessing companies' operational performance against agreed performance commitments ('PCs'). Each PC 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. They can also be reputational.

case study

A vision to be the leading, community-focused water company.

We provide access to our sites with amenity value for the benefit of our Wey and Pinn communities. We are a proud supporter of the British Disabled Water Ski Association, making one of our production sites, Heron Lake, available on a long term lease. Our long standing relationship with the association is creating great recreational opportunities for people who have not previously considered this water sport to be accessible because of their disability.

The collaborative work with other charities such as Mencap and Help for Heroes attracts people from across the country.

On average the organisation hosts 2,000 to 3,000 visitors each year, with the majority visiting from the local community. It makes it the only dedicated disabled water skiing facility in the country.

Our key resources

Our business model, presented on page 23, recognises the need to satisfy our three overriding imperatives mentioned previously, while providing all processes and capabilities needed to deliver value for all of our stakeholders.

Resources	ENVIRONMENT	ASSETS	PEOPLE	FINANCING
	Rivers	Reservoirs	Staff	Equity
	Groundwater	Treatment works	Suppliers	Capital market debt
	Catchment land	Network	Contractors	Revolving credit facilities

Extract from our business model diagram presented on page 23.

Environment

Maintaining the high quality of the water we supply to customers is vital in the face of pressures and obligations. Increased use of pesticides and an enhancement to the lead compliance standard means that it is important that we promote effective catchment management, implement improvements to our treatment processes and remove lead pipes using a risk based approach.

Our Business Plan sets out how we plan to ensure that our customers continue to receive the high quality of water that they expect in AMP6 and beyond by investing in our treatment works, targeting lead pipe replacement and enhancing our current programme of catchment management. We continue to work in partnership with the EA and environmental groups.

case study

From the way we talk and listen to our customers and stakeholders.

We are working in partnership with local environmental groups and catchment partnerships raising awareness of the issues affecting drinking water quality. We are also engaging with our communities to find innovative ways to prevent pollution and maintain the same level of service we provide now for generations to come.

In 2015/16 we have been monitoring rivers across our region to identify high risk areas for diffuse pollution. We have collaborated with neighbouring water companies, the EA, Natural England, farmers, agronomists, environmental groups and product manufacturers to understand why pollutants are getting into rivers and developing innovative approaches to prevent pollution at the source.

For one of our pilot projects in the Lee community, we invited local farmers and agronomists to our water treatment works to discuss the effect of agricultural pollution and the treatment required to produce wholesome drinking water. We also provided training, assessment, machinery calibration and testing to farmers to help them reduce their impact on drinking water and the natural environment.

Strategic report continued

Our key resources (continued)

Assets

Assets allow our people to make use of the water resources provided by the environment to supply our 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 treatment works where we convert raw water into high quality wholesome drinking water. Our below ground network of assets take water from treatment works and deliver it to homes and commercial premises through more than 16,500km of mains (a greater distance than the diameter of the earth). Particularly strict standards of hygiene need to be applied to these assets.

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 capability 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.

Asset-related expenditure to maintain, enhance and create assets is a major cost of our business. Our asset-related expenditure programme is designed to meet our four key customer expectations. During the current regulatory period we are particularly focused on enhancing our environment by reducing the abstraction of water from environmentally sensitive sites and further increasing the resilience of our network.

People

Our people play a critical role in creating long-term value. They are our ambassadors, living and working in the communities we serve. They have the local knowledge and understanding to make sure we deliver what our communities expect of us and ensure our contribution to those communities 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 our customers, and we strive to make Affinity Water a fantastic place to work. We have created a strong culture of learning and development, investing in training, and building a culture of coaching and mentoring to release the potential of our people.

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 people play a critical role in creating long-term value

The following table provides a breakdown of the gender of directors and employees at 31 March 2016:

	2016		2015	
	Men	Women	Men	Women
Company directors[1]	9	1	8	1
Other senior managers[2]	4	2	5	-
All other employees	716	422	698	397

[1] Company directors consist of our Board members, as detailed on pages 44 to 47.

[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.

Our position on human rights

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. We do not believe this information is necessary for such an understanding and have therefore not included it.

However the safety, health and wellbeing of our people and suppliers is something 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 believe that all accidents are preventable and that nothing is so important we cannot take the time to do it safely. For further information on our safety and health performance in 2015/16, refer to page 29.

Financing

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 £575m 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 £100m. See pages 55 to 56 for further details of our current financing arrangements.

We believe that all accidents are preventable and that nothing is so important we cannot take the time to do it safely

case study

Our empathy with our customers and commitment to always being effective, efficient and safe.

We are committed to achieving zero harm and that means everyone works, gets home safely and returns fit for work, everyday. To reduce the number of injuries we first needed to improve compliance with safety standards.

Our aim was to make it easier for managers to comply with our safety standards and to drive improvement at a local level. Key safety standards were re-written in a simple format. Managers were asked to self-assess against a maturity matrix and deliver improvement plans. In addition a number of company level improvements were made.

Compliance with our safety standards improved over the twelve month period to February 2016 from 60% to 80%. Refer to page 29 for further details of our 2015/16 safety and health performance.

Strategic report continued

Our long term planning

We know that the future will provide new challenges – a rising population and increased demand for water, as well as a reduction in the availability of water in the years ahead. This means we may need to do things differently if we are to maintain the levels of service we currently provide. Our Water Resource Management Plan ('WRMP'), published in June 2014, sets out our 25-year plan to meet these resource challenges.

25-year plans | Maintain our local environment | Sustain our local communities | Support our local economies

Extract from our business model diagram presented on page 23.

Our customers tell us they expect us to work hard to safeguard the environment. We need to ensure that we undertake our work to meet our customers' expectations in a sustainable and environmentally sound way. Our Strategic Direction Statement provides our strategy for meeting the expectations of our customers today and over the next 25 years in a sustainable manner. During the coming year we will start work on updating our WRMP as well as refreshing our Strategic Direction Statement to verify if customer expectations have evolved or not.

Maintaining our local environment

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

We have a high dependency on groundwater sources, which account for around 64% of our water, and need to be replenished each year by winter rainfall. Other than natural aquifers, we do not have significant storage for untreated water. This means we are particularly susceptible to drought and pollution events as well as being vulnerable to the effects of planned sustainability abstraction reductions.

Most of the world's chalk streams are in the southeast 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.

We have a responsibility to protect the chalk stream ecosystems and their biodiversity by leaving more water in the environment.

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 the environment by 42 megalitres per day 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 improve flows and habitats in local chalk streams.

We also have to contend with a less predictable and more variable climate, further increasing the pressure to improve the resilience and sustainability of our operations.

We have a responsibility to protect the chalk stream ecosystems and their biodiversity

[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.

Sustaining our local communities

The population in our supply area is forecast to increase by 0.7% per year over the next 25 years. This means that if consumption per head remains constant, total domestic water demand in our licence area will increase and our customers' demand for water could exceed the supplies we have available.

Our five year and longer term plans include a number of planned measures to ensure our customers have enough water whilst ensuring we comply with our obligation to leave more water in the environment. This means we have to compensate for lower abstraction by reducing leakage and encouraging our customers to use water more efficiently.

Supporting our local economies

We serve one of the most economically active regions in the UK. Our ambition to be the UK's leading community focused water company extends to ensuring that we play an active role in supporting the growth and development of our local economies.

Our people are essential to improving the service our customers receive. In the last year we have been awarded Continuous Professional Development ('CPD') Approved Employer status and have been recognised as an Employer Champion by the Science Council. These accolades recognise our commitment to professional standards.

We also continue to invest in our infrastructure and assets to ensure they are resilient and can support economic growth. We have invested over £103m enhancing and maintaining our infrastructure and assets in 2015/16. This has gone into projects such as our extensive programme of mains cleaning on Romney Marsh in our Dour community. The project was part of a two stage plan to minimise the build up of sediment in the future. We first invested £4m to upgrade our Denge water treatment works and followed this up with the cleaning programme, which related to mains pipes serving around 8,700 properties in the area.

We have invested over £103m enhancing and maintaining our infrastructure and assets in 2015/16

case study

It's the pride we take in our delivery and our performance.

As a community focused business we recognise the need to support our local economy and ensure the next generation have the skills and opportunities for future employment.

Working with Kent County Council and local further education providers we have developed a pioneering customer service apprentice scheme combining hands-on experience and expert coaching from our customer contact teams with classroom learning to achieve transferable qualifications.

Our range of apprenticeship placements now better reflects the employment opportunities within our communities enabling students to gain work-based qualifications across that range.

Strategic report continued

Customer expectations

The expectations of our customers determined the shape and pace of investment set out in our Business Plan for AMP6. Key elements of our five-year plan include the performance commitments that we made in our Business Plan in relation to these expectations (refer to the table on page 13).

Customer outcomes

AMP6 5-year plan

Making sure our customers have enough water, whilst leaving more water in the environment	Supplying high quality water our customers can trust	Minimising disruption to our customers and community	Providing a value for money service
Water saving programme Abstraction reduction Catchment management	Prioritise investment to maintain network stability Lead pipe replacement programme	Create a safe working environment Provide a personal, proactive customer service	Charges balance fairness, value for money and affordability Perform efficiently

Extract from our business model diagram presented on page 23.

case study

It starts with our dedication and focus on supplying high quality drinking water.

Our water saving squad is helping our customers to use less water and save money. The squad attends community events and undertakes home based water efficiency checks offering free of charge bespoke advice to reduce water use.

The popular water saving squad stands offer free water saving devices and a chance to ask questions or discuss concerns around the water saving programme.

The programme supports our commitment to leave more water in the environment, improve river flows and protect sensitive chalk stream habitats while providing our customers with the water they need.

Our business model

Our vision: To be the UK's leading community focused water company

Imperatives: Trust and legitimacy · Responsible and accountable · Value creation

Resources:

ENVIRONMENT	ASSETS	PEOPLE	FINANCING
Rivers Groundwater Catchment land	Reservoirs Treatment works Network	Staff Suppliers Contractors	Equity Capital market debt Revolving credit facilities

25-year plans: Maintain our local environment · Sustain our local communities · Support our local economies

Customer outcomes / **AMP6 5-year plan:**

Making sure our customers have enough water, whilst leaving more water in the environment	Supplying high quality water our customers can trust	Minimising disruption to our customers and community	Providing a value for money service
Water saving programme Abstraction reduction Catchment management	Prioritise investment to maintain network stability Lead pipe replacement programme	Create a safe working environment Provide a personal, proactive customer service	Charges balance fairness, value for money and affordability Perform efficiently

Provide an appropriate return for our shareholders

Strategic report continued

Our operating model

During 2015/16 we made changes to our organisation design so that we can improve our community strategy and position ourselves as a leader in our sector. These changes, which came into effect from January 2016, will help us deliver a better service for customers and ensure that we organise ourselves more efficiently in a world where competition and commercial success are going to be the norm (refer to page 15).

Our business is split into three distinct operating units (not separate legal entities) as follows:

Wholesale
Responsible for water abstraction, treatment and distribution

Retail household
Provides customer-facing activities for household customers

Retail non-household
Responsible for retail service delivery to non-household customers

Support services
Responsible for corporate services

Wholesale

A distinct wholesale operating unit was created during 2015/16 with an aim of focusing wholesale operations as a safe, efficient business that delivers water to customers 24 hours a day, each and every day across our eight communities.

Progress has already been made towards improving safety and health culture and behaviours. This is evidenced by a significant improvement in our safety and health performance during 2015/16 (refer to page 29 for further details); however there is always more that we can do as part of achieving zero harm.

Under our customer improvement programme we have validated and prioritised our work streams and are now focused on being in the top half of companies within the water sector in terms of overall SIM score.

We are also in the process of moving away from traditional supplier relationships, through partnering towards alliancing. Current contractor partners are fully engaged with us on this journey. We are striving to be leaner, more efficient and much more effective. A number of our business processes are being reengineered and reconfigured with the customer at their core.

Customer and community focus are key pillars for 2016/17 and there is much more that we can do

Retail Household

We have made progress towards becoming a much more customer centric business during 2015/16. We have developed a customer experience improvement programme based on direct feedback combined with our desire to ensure our customers have great service from us.

The many improvements we have put into place during 2015/16 include:

- an option of text alerts to keep our customers informed;
- a pro-active team of staff contacting our customers with information such as essential repairs on our pipes leading to potential short term impact in their community;
- a new team to help customers improve their usage and to identify and fix leaks as quickly as possible;
- creation of a dedicated team of specially skilled staff to deal with more complex queries; and
- a new "queue for you" function - when our phone lines are exceptionally busy, we hold a customer's place in the queue and ring them back.

For our vision to become a sustainable reality, we need to take on board our customers' expectations. They expect to be able to contact us when they need to as well as get value for money. The new operating model has been designed with our customers in mind. We have a new Customer Engagement and Operational Excellence team established to deliver an improved service offering to our customers.

Retail Non-household

We have made a strong commitment to participate in the competitive retail market from April 2017 and our plans for Retail Non-household are focused on implementing the systems and processes we need to operate effectively in the market. The introduction of retail competition presents significant complexity, but also many exciting opportunities for innovation and improvement.

Business development activities within Retail Non-household are governed under our wider market reform programme. This is to ensure that all parts of the business are compliant with regulatory requirements and are able to operate effectively in the market. The programme has also been designed to ensure that operational performance and customer service standards are maintained during the change process.

case study

To the way we talk and listen to each other.

Supporting local community based organisations and partnering with our suppliers and contractors are key to our vision to be the leading community focused water company.

In 2015/16, by collaborating with our supply chain, we made a real difference to the eco-site used by children at a local school in our Lee community. The improvements that consisted of construction of a chicken run, garden raised beds and planting and also a vital safety feature around the pond area, have all been highly praised by the head teacher.

This was made possible thanks to the common effort from major supply chain partners, who provided their expert knowledge, tools and materials, and Affinity Water teams, who participated in the event.

Strategic report continued

Our performance

Our vision, our business model and our customer outcomes are linked through a series of indicators against which we measure our performance.

We have aligned our operational key performance indicators ('KPIs') and targets to key performance commitments made in our Business Plan in response to our customer expectations. Our performance in relation to these targets for 2015/16 is analysed in the table below. Refer to page 154 of our regulatory annual performance report for information on our performance for 2015/16 in relation to all performance commitments we made in our Business Plan, together with our 2015/16 Annual Performance Report publication available on the Reports and Publications page of our website:

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

Operational KPIs:

KPI	Link to strategy	2015/16 target	Performance		2016/17 target
Leakage: average annual water leakage from our network quantified in megalitres per day (Ml/d)	Trust and legitimacy imperative Customer outcome AMP6 PC	**183.9**	**180.9** 2014/15: 183	We attach a high priority to meeting leakage 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. Our 2015/16 performance is at our best level yet; however we have a very ambitious target of reducing leakage by 14% by 2020.	178.5
Sustainable abstraction reductions: average annual reduction in water abstracted from our river catchments quantified in Ml/d	Trust and legitimacy imperative Customer outcome AMP6 PC	**6.7**	**6.7** 2014/15: Not measured	We are delivering the reduction in abstraction in line with our Business Plan, whilst implementing changes in our infrastructure to maintain security of supply and unaffected level of services for all our customers. By reducing abstraction, we leave more water for the environment and we have in place an extensive environmental monitoring programme so that we measure the benefits in river flows and on the local ecology. We complement the benefit of the reductions in abstraction with our work on morphological changes, which includes river structures' modifications to enable unobstructed flows and fish passes.	12.5

KPI	Link to strategy	2015/16 target	Performance		2016/17 target
Water quality: mean zonal compliance ('MZC')[1] (%)	Trust and legitimacy imperative Customer outcome AMP6 PC	**99.95**	**99.99** 2014: 99.97	In the calendar year 2015 there were only 32 exceedances of standards from our sites and consumer properties (2014: 44 exceedances), making 2015 our best ever year. Of these, 11 exceedances (2014: 24 exceedances) contributed to the MZC calculation. Another measure of our performance is the number of serious and significant incidents. During 2015 nine events notified to the DWI were classified as serious or significant (2014: five events). This included the loss of supply at Egham water treatment works in July 2015, which was classified as a serious event. Following each event, we have made improvements to reduce the number of failures and events. These improvements are being delivered through improvements to our asset resilience, coaching and developing our people, adherence to processes and procedures and through further auditing and control/ completion of planned programmes such as mains cleaning.	99.95
Mains bursts (number)	Trust and legitimacy imperative Customer outcome AMP6 PC	**3,100**	**2,201** 2014/15: 2,414	Burst mains in 2015/16 were below the PC target of 3,100. On a comparative basis we are slightly below the 2014/15 figure. However there is more work we can do to ensure that bursts on our network do not result in prolonged interruptions to supply for our customers (refer to our unplanned interruptions KPI).	3,100
Unplanned interruptions to supply over 12 hours (number of properties)	Trust and legitimacy imperative Customer outcome AMP6 PC	**320**	**1,771** 2014/15: 1,687	In the first six months of 2015/16 our response to a number of incidents was slow and repair was prioritised over the restoration of supplies. This resulted in the failure to meet the 2015/16 target, with over 90% of unplanned interruptions to supply over 12 hours in 2015/16 occurring during this six month period. No compromises with customer safety were made. As a result of our failure to meet this performance commitment, we have incurred a penalty through the ODI regime that will be realised as part of the next price review (refer to page 16 for further information). Our approach to reducing unplanned interruptions has now been re-focused on prevention, restoring supplies and fixing the problem quickly. We have acquired new high volume emergency pumping equipment and are improving processes and competencies to reduce the impact we have on customers when we have bursts.	320

[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 our 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 DWI.

Strategic report continued

Our performance (continued)

Operational KPIs (continued):

KPI	Link to strategy	2015/16 target	Performance		2016/17 target
SIM[1] (relative position)	Trust and legitimacy imperative Customer outcome AMP6 PC	**2nd quartile**	**13th position out of 18 companies**[2] 2014/15: N/A[3]	Our SIM score is one of the indicators we use to assess how well we are performing for our customers. It provides a snapshot in time using feedback from 800 of our customers obtained four times a year. During the year we launched our customer experience improvement programme based on direct feedback received from 79,000 customers combined with our desire to ensure our customers have great service from us (refer to page 25 for further details). We have already seen a decrease in the number of complaints and unwanted contact over the second half of the year. The improvements we have made have been reflected in our position in the SIM league table, moving us up to 13th position in the final qualitative SIM survey of 2015/16, compared to 16th position at the end of the second quarter of the year. Our target for next year is to build upon this momentum and achieve a second quartile position for SIM overall. We have introduced an innovative value for money index, which we will also use to evaluate our performance in relation to providing a value for money survey for our customers.	2nd quartile

KPI	Link to strategy	2015/16 target	Performance		2016/17 target
Accident frequency rate: number of lost time injuries per 100,000 hours worked	Responsible and accountable imperative	**Less than 0.7**	**0.27** 2014/15: 1.02	During 2015/16 we reduced our lost time injuries by 73% (2015/16: 6 injuries; 2014/15: 22 injuries). We delivered this using a revised strategy and improvement plan focussed on: • improving safety leadership through engagement with employees at all levels of the organisation; • changing individual beliefs and behaviours through implementing key safe behaviours and safety awards; • understanding and improving safety and health competencies; and • improving compliance with safety standards by simplifying documentation and self-assessing compliance. In 2016/17 we will continue to build on the above strategy along with developing closer relationships with the supply chain to share best practice.	Less than 0.3

case study

It's a driving force that shapes our attitude and approach.

We are very proud of the effort and commitment our employees put into raising funds for good causes. Each year we support a range of local and national charities. A highlight of our fundraising year is the Ricky Road Run, a 10 mile road race held for the last 32 years in our Misbourne community. The event attracts over 500 entrants and is well regarded by serious runners and amateurs alike.

Since its inception the Ricky Road Run has raised well over £350,000 for good causes. Funds raised support the work of WaterAid, KitAid and a local charity, this year Watford Mencap. It is WaterAid's longest running charity event. Staff involvement includes race organisation, gaining sponsorship, marshalling and of course quite a few runners too.

[1] SIM is a customer experience performance measure with a qualitative element, produced by independent market research surveys of customer satisfaction, and a quantitative element based on the number of 'unwanted' phone calls received, combined with the number of complaints received and the company's effectiveness at resolving those complaints. Unwanted calls are those where customers express any dissatisfaction with the service, including customers who hang up while in call queues, plus any calls that could have been avoided if service had fully met customer expectations.

[2] This is our position relative to the industry in the final qualitative SIM survey of 2015/16. The overall SIM league table will be published once all companies have submitted their regulatory annual performance reports for the year ended 31 March 2016 to Ofwat.

[3] A relative position for 2014/15 is unavailable, as there was no formal reporting of 2014/15 SIM.

Strategic report continued

Our performance (continued)

2015/16 Corporate Social Responsibility Highlights

AWARDS 2016 SHORTLISTED BUSINESS IN THE COMMUNITY

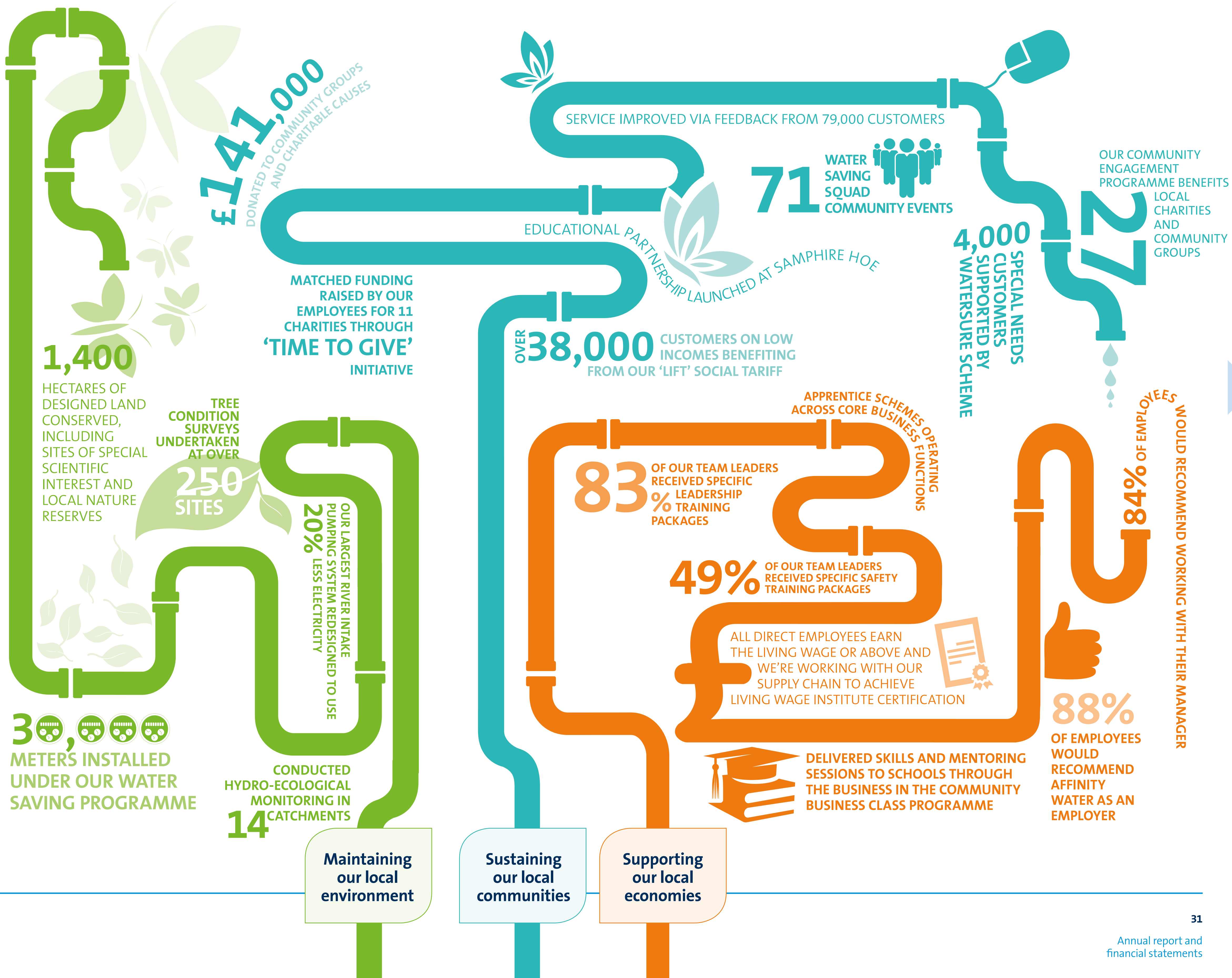
Shortlisted for the ASDA Environmental Leadership Award at Business in the Community's Responsible Business Awards 2016

WATER INDUSTRY ACHIEVEMENT AWARDS 2016

Engineer of the Year winner and finalists in two further categories at the Water Industry Achievement Awards 2016: People recruitment of the Year and Water Resource Management Initiative of the Year.

Waterwise UK Water Efficiency Awards 2016

Two of our team members won awards for their contribution to promoting water efficiency.



Strategic report continued

Our performance (continued)

FINANCIAL PERFORMANCE

Financial results

This is the first year that our financial results are being prepared in accordance with Financial Reporting Standard 101: 'Reduced disclosure framework' ('FRS 101'; refer to the basis of preparation and note A8 of our statutory financial statements for further details), the date of transition being 1 April 2014. Our financial results are summarised in the table below:

	2016 £m	2015 £m
Revenue	**302.6**	296.1
Operating costs	**(237.5)**	(211.2)
Other income	**17.2**	12.5
Operating profit	**82.3**	97.4
Net finance costs	**(36.7)**	(37.2)
Profit before income tax	**45.6**	60.2
Income tax credit/(expense)	**14.1**	(11.3)
Profit for the period	**59.7**	48.9
Dividends	**(40.0)**	(30.8)
Transfer to reserves	**19.7**	18.1

Revenue was £302.6m, being a 2% increase on last year (£296.1m). This increase is primarily due to inflationary price adjustments allowed by Ofwat in our last regulatory determination.

Operating costs for the year increased by £26.3m (12.5%) to £237.5m (2015: £211.2m), as explained in the table below:

Increases in operating costs	£m
Inflationary increases	2.2
Major operational incidents (refer to pages 26-29)	0.4
One-off costs of senior management changes (refer to page 24)	0.7
Customer experience improvement programme costs (refer to page 25)	1.3
Market opening preparation costs (refer to page 15)	1.4
Higher depreciation due to newly commissioned assets	2.2
Higher costs associated with new customer connections	2.5
Costs associated with increased leakage detection and prevention activity	2.8
Higher power consumption	2.9
IT transformation costs	3.3
Reimbursement of Environmental Improvement Unit Charges ('EIUC') and credit notes received from the EA in respect of EIUC recognised in 2014/15 operating costs	5.5
Other increases	1.1
Net increase in operating costs	**26.3**

The net finance expense of £36.7m was £0.5m lower than last year, with the full year effect of the £50.0m bond tap issue in July 2014 and the £50.0m bond and tap issues during the year partially offsetting the impact of lower retail price index ('RPI') inflation on the company's index-linked debt and higher net income from post-employment benefits (refer to note 4 of the statutory financial statements for further details).

Taxation

The total income tax credit of £14.1m (2015: an income tax expense of £11.3m) comprised a current tax expense of £1.6m (2015: £8.7m) and a deferred tax credit of £15.7m (2015: a deferred tax expense of £2.6m).

The current tax expense on profit before income tax of £45.6m (2015: £60.2m) was £1.6m (2015: £8.7m). The effective current tax rate (3.5%; 2015: 14.5%) was lower than the UK corporation tax rate of 20% (2015: 21%) mainly as a result of preparing financial statements in accordance with FRS 101 for the first time this year. Under FRS 101, grants and contributions that have been received and taxed in previous years in respect of assets constructed are now recognised as income and taxed in future years. In order to avoid this income being taxed twice, the tax previously paid is now repayable. This results in a current tax credit, and corresponding deferred tax charge, of £5.7m.

In the current year we had a large deferred tax credit due to the impact on our deferred tax liability of reductions in the UK corporation tax rate enacted in October 2015.

Total tax paid or collected in the year to 31 March 2016, other than corporation tax, amounted to £28.0m (2015: £27.9m) consisting of employer's national insurance, business rates, environmental taxes and streetworks permits.

Capital expenditure

Capital expenditure in the year was £83.7m (2015: £88.8m), and occurred principally in our mains renewal, sustainability eduction and lead pipe replacement AMP6 programmes, as well as on undertaking trials and design work with a view to establishing a treatment solution for the pesticide, metaldehyde, at both our North Mymms and Iver water treatment works. This excluded £19.5m (2015: £19.0m) of infrastructure renewals expenditure, which is treated as an operating cost under FRS 101.

In aggregate, asset-related expenditure for the year was lower than the amount for 2015/16 allowed in our Business Plan. However this was primarily due to a slower than anticipated start to our metering programme and delays in technology selection for water quality projects. Programmes of work are expected to accelerate in 2016/17, in particular for increased meter coverage associated with our water saving programme.

Cash flow

Net cash inflow before tax and financing[1] for the year was £50.8m being a 28% decrease on last year (2015: £70.6m). The decrease is due to £22.1m lower cash generated from operations (£129.2m; 2015: £151.3m) as a result of higher operating expenditure (refer to the previous page), offset by £2.3m lower fixed asset net expenditure[2] (£78.4m; 2015: £80.7m).

Equity dividends of £40.0m were paid during the year (2015: £30.8m) reflecting the significant improvements we made to our business during AMP5, which contributed towards us achieving enhanced status for our Business Plan. These resulted in favourable adjustments to our regulatory capital value ('RCV') at the start of AMP6, some of the benefit of which has been distributed to our shareholders through the payment of dividends. Our customers benefitted during AMP5 from the improvements made, which drove up service levels whilst realising £26.0m in operating cost net efficiencies, through lower bills and better service.

Our dividend policy

The Board approves the company's dividend policy. The amount of the dividend is dependent on the success of the company in generating cash flows and achieving its regulatory outputs in the reported period. Under the policy the company distributes earnings equal to the amount required to maintain net debt to RCV at the targeted gearing ratio of 80%. This is consistent with 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.

[1] This "non-GAAP" measure, which is used internally to evaluate our financial performance, is calculated as the total of the following line items per the statement of cash flows (refer to page 86): 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] Calculated as the total of the following line items per the statement of cash flows (refer to page 86): purchases of property, plant and equipment; capital contributions; proceeds on disposal of property, plant and equipment; and purchase of intangibles.

Strategic report continued

Our performance (continued)

FINANCIAL PERFORMANCE (CONTINUED)

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 2016, we had cash balances of £93.4m (2015: £58.9m). The increase in cash held compared to the prior year primarily reflects £64.6m of proceeds from the bond and bond tap issues referred to in previous paragraphs. The proceeds of the issues are being used to fund our capital expenditure programmes.

The maturity profile of the bonds issued by our subsidiaries is set out on page 56. The maturity profile of all our borrowings is set out in note A4 of our statutory financial statements.

To the extent that additional funding is required, we have access to £100.0m of facilities (2015: £100.0m), which were undrawn at 31 March 2016 (2015: undrawn), to finance capital expenditure and working capital requirements. In addition, we have access to a further £58.0m of liquidity facilities (2015: £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 2016, net debt, as defined in the financial covenants in the company's securitisation documentation ('compliance net debt'), was £809.3m (at 31 March 2015: £788.1m). Gearing of compliance net debt to RCV at 31 March 2016 of 74.9% (31 March 2015: 79.8%; refer to note 1E of our regulatory annual performance report) remains within the Board-approved gearing level of 80.0%. This allows sufficient headroom within financial covenants, which are only triggered at a level of more than 90.0%.

Interest rates

Interest rate exposure is primarily managed by using a mixture of fixed rate, floating rate and RPI-linked borrowings (refer to note A4 of our statutory financial statements). At the year-end, 64.7% of our borrowings were at fixed rates (2015: 69.9%), 35.3% (2015: 30.1%) at rates indexed to RPI and none (2015: none) were at floating rates.

Pension funding

The retirement benefit surplus under International Accounting Standard ('IAS') 19: 'Employee benefits' at 31 March 2016 stood at £72.6m compared to a surplus of £45.1m at 31 March 2015. This increase largely reflects a decrease in the pension plan's liabilities primarily caused by an increase in the discount rate and a reduction in inflation.

Principal risks and uncertainties

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 an action plan is prepared, if necessary, for 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 presented to 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 (refer to page 48 for further information on the responsibilities of the Board and the Audit Committee in relation to risk management and internal control).

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.

Key:

◆ Unchanged during the year ▲ Increased during the year ▼ Decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to page 42)
[b] Risk included in the scenario stress testing for the viability statement (refer to page 42)

Risk	Commentary	Mitigation
Operational		
Injuries and accidents to our people and the public[a] ◆	Failing to manage this risk may result in disruption to operations, reputational damage, criminal fines, civil damages and regulatory penalties.	We seek to operate our business to the OHSAS18001 safety standard and help our employees to take personal responsibility for their own safety and the safety of others. We have been implementing a number of initiatives aimed at significantly reducing our accident frequency rate over AMP6. We have already seen a reduction in lost time injuries in 2015/16 compared to the previous year (refer to page 29 for further information on our safety and health performance in 2015/16).

Strategic report continued

Principal risks and uncertainties (continued)

Key:

Unchanged during the year ▲ Increased during the year ▼ Decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to page 42)
[b] Risk included in the scenario stress testing for the viability statement (refer to page 42)

Risk	Commentary	Mitigation
Operational (continued)		
Failure to supply wholesome water[b] ▼	We are required to maintain a continuous supply of high quality water for our customers. Interruptions to supply caused by the contamination of water supplies, pollution and flooding events, and water resource restrictions could impact on the health, safety and security of our people or communities, or on our financial position and our reputation. The risk has decreased in the year, as we have reached an agreement with the Secretary of State for Transport, which requires the High Speed 2 promoter to protect our aquifer sources, provide treatment for any interim effects and compensate us for any long-term impacts. The risk in respect of availability of water remains relatively high for us, as we operate in an area of serious water stress. Plans for a third runway at Heathrow Airport and the Western Rail Link to Heathrow may further increase this risk in the future.	We manage this risk through: • our WRMP which identifies, over a 25 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. To provide assurance of the quality of water we supply, we carry out over 150,000 tests on water leaving water treatment works, at reservoirs and at customers' taps. In addition, we carry out over 400,000 tests on operational samples; • our investment in our trunk main assets to keep the 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 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.
Unavailability of resources (people and materials)[a] ▲	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 continued to increase during the year with ongoing significant construction activity around London, including construction of the Thames Tideway Tunnel now underway, reducing contractor availability.	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 the Joint Negotiating and Consultative Committee, succession planning and investing in our employees through training and apprenticeship schemes. We have recently launched our "Leading The Affinity Way" leadership programme, specifically designed to help us develop a high performing leadership environment.
Information security or privacy failure[a] ▲	We must protect customer information and our data from unauthorised disclosure and improper use. Failure to do so 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 continues to increase, so too does the risk of cyber attack.	During the year we continued to strengthen our capabilities to ensure that our technical and organisational controls against the unauthorised disclosure, loss or improper use of data are kept under review and improved where appropriate. We have made significant progress in implementing a robust information security management system with a view to protecting ourselves against current and future threats. We have also commenced adoption of the General Data Protection Regulation ('GDPR') which will come into force in 2018.

Strategic report continued

Principal risks and uncertainties (continued)

Key:

◀▶ Unchanged during the year ▲ Increased during the year ▼ Decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to page 42)
[b] Risk included in the scenario stress testing for the viability statement (refer to page 42)

Risk	Commentary	Mitigation
Regulatory		
Adverse changes to the regulatory framework[a] ▲	Changes to the regulatory framework by Ofwat or the government may have an adverse effect on our operational or financial performance. The risk has increased in the year, as a result of Ofwat's launch of "Towards Water 2020" in July 2015 and a consultation in December 2015 on its preferred approach to the design of the future regulatory framework for the water industry for the next price review ('PR19'). Ofwat published further thinking in May 2016 confirming its preferred approach following the December 2015 consultation and setting out specific areas for further consultation. The new 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 set out its intention to use the Consumer Price Index ('CPI'), rather than RPI, for indexing revenues (and therefore prices) and RCV to be indexed using a combination of CPI and RPI.	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.
Adverse change in the social and/or political climate[a] ◀▶	We are exposed to risks arising from the general social and political climate, for example, political pressure to restrain price increases and other issues, such as some objections to universal metering. These pressures may lead to a reduction in revenue or have a reputational impact.	We continue to engage with our customers and their representatives to understand and respond to their issues and concerns.
Failure to comply with laws, our instrument of appointment and other recognised standards[a] ◀▶	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.	We have policies, processes and controls in place that seek to ensure that applicable regulation, laws and standards are fully understood and complied with. We continue to operate our abstraction, treatment and supply activities to environmental standard ISO14001.
Failure to deliver our business plan obligations[a] ◀▶	We have made a number of performance commitments in our Business Plan which, if not met, may result in us incurring financial penalties. 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. Whilst we have not met all our very challenging AMP6 year 1 performance commitments, we have robust plans to address those challenges going forward and are confident that we will deliver the required outcomes over the remainder of AMP6.	We have an established programme management function with the responsibility for delivering the investment programme. The Board and senior management team monitor performance and ensure that corrective action is taken when required.
Being required to undertake unremunerated activity[a] ▲	We may experience unforeseen financial, regulatory or legal obligations or costs which were not taken into account by Ofwat in setting our price controls. For example, we are incurring greater costs on delivery of the Market Reform programme than allowed for in the AMP6 price controls.	Our Instrument of Appointment provides some protection against unforeseen financial risks materialising during a price control period. We can ask Ofwat to undertake an interim determination of price limits in certain circumstances. Ofwat will make an interim determination only where it is satisfied that a 10% cost threshold has been met. There is no assurance that Ofwat will make an interim determination or that any determination made would provide adequate revenue compensation. Refer to the financial risks section of the table for details of our mitigation in relation to liquidity risks.
Market reform		
Failure to prepare for market reform[a] ▲	The requirements for implementing the retail market for non-household customers on 1 April 2017 are developed but not finalised. Delays to the Open Water Programme could affect our preparation, which may lead to additional costs, loss of revenue and regulatory enforcement action. This risk has heightened during the year, as the market entry assurance requirements have become known and there have been delays to the Open Water Programme.	We continue to take an active role in the Open Water Programme and with Market Operator Services Limited ('MOSL') directly. We have put in place a business transformation programme supported by a cross-functional team to manage the organisational, cultural and behavioural change needed to be ready for the new market arrangements.

Strategic report continued

Principal risks and uncertainties (continued)

Key:
Unchanged during the year — Increased during the year — Decreased during the year

[a] Risks included in the sensitivity stress testing for the viability statement (refer to page 42)
[b] Risk included in the scenario stress testing for the viability statement (refer to page 42)

Risk	Commentary	Mitigation
Financial		
Liquidity risk[a]	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 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 twelve months' forecast cash flow requirements. Longer term financing needs are sourced from the private and public bond markets. 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.
Macro economic risk (interest rate, inflation and tax risks)[a]	Movements in interest rates can result in an increase in the cost of our debt. We have a financial covenant within our Whole Business Securitisation ('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. In addition, our RCV is also linked to RPI 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 defined benefit pension plan. During the year the government introduced proposals to take effect from 1 April 2017 that will limit the amount of interest that may be deductible for corporation tax purposes for the largest UK businesses. This may increase our corporation tax payments.	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 are linked to RPI and therefore offsets an element of the reduction in revenue and RCV that results from lower inflation. The defined benefits 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 contribute fully to consultations with HMRC and HM Treasury through Water UK to avoid any unintended tax burden on the water industry.

Risk	Commentary	Mitigation
Breach of and changes to our borrowing covenants	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.	We have a regular monitoring and certification process of the covenants within our 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.
Revenue and debtor risk[a]	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.	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.

Strategic report continued

Principal risks and uncertainties (continued)

VIABILITY STATEMENT

The directors have assessed the company's financial viability over the five-year period to 31 March 2021 (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 25 year period how we will balance available supplies and required demand with sufficient headroom for unplanned outage (refer to page 20 for further information).

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 35 to 41 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 but plausible 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 year ending 31 March 2021 (the first year of the next price control period, AMP7). The projections assume that regulatory price setting mechanisms remain unchanged from PR14 with an updated weighted average cost of debt calculation for return on RCV to reflect the company's forecast debt structure.

The expectation that revenue will be indexed in relation to CPI and RCV a combination of CPI and RPI (refer to the adverse changes to the regulatory framework risk in the principal risk table) with effect from 1 April 2020 is reflected in the projections.

The following sensitivities were used in stress-testing the base case cash flow forecast:

- 10% increase in total expenditure;
- 1% increase in interest rates;
- 1% decrease in RPI;
- 1% decrease in the November RPI forecast impacting revenue only;
- replacing the base RPI forecast with a negative 1% forecast, while maintaining a 1% increase in expenditure; and
- 5% decrease in revenue, 1% decrease in RPI, 5% increase in total expenditure and 5% increase in unpaid water customer bills.

The sensitivities applied in relation to total expenditure, interest rates, 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 RPI sensitivities reflect severe but plausible 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 any revenue decreases as a result of RPI reduction.

For the principal risk identified in the principal risk table on pages 35 to 41 with the icon (b), the directors considered that this risk might in isolation threaten financial viability in the event of a major asset failure, 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.

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 around 80%;
- the maturity dates of the company's existing long-term bonds, which are matched to its long-term outlook and expenditure commitments, that fall outside of the lookout period;
- the company's ability to renew its short-term borrowing facilities under most market conditions;
- the ability to restrict dividend payments as a key mitigating action; 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.

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

Dr Philip Nolan
Chairman
27 June 2016

Governance

Letter from the Chairman

DR PHILIP NOLAN

Our shareholders have an important role to play and a direct interest in the strong and effective governance and stewardship of our business.

We remain committed to the highest standards of governance and support the principles of good corporate governance set out in the 2014 UK Corporate Governance Code ('the Code') and the UK Stewardship Code. Our business is owned by private investors and we therefore apply the principles of the Code in this context, having regard to the Guidelines for Disclosure and Transparency in Private Equity (the Walker Guidelines) and the work of the Private Equity Reporting Group (formerly the Walker Guidelines Monitoring Group).

We consider that the company complies with the principles of the Code, except in terms of board composition, membership of committees, appointment of a senior independent director, re-election of directors and externally facilitated board evaluation. Our non-compliance arises principally because of our ownership structure and is explained further in this section of the annual report.

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*.

Our Governance Code, updated in March 2016, sets out for our customers, investors, regulators and other stakeholders how we govern and operate our business to high standards of governance and transparency.

Board composition

In my role as Chairman of the Board, I am responsible for ensuring that our directors have a diverse range of backgrounds and skills and that they all contribute to our decision making. As a Board, we value the contribution that all our non-executive directors bring to the governance of the company, and believe that their balance of skills, experience, independence and knowledge of the company ensures strong leadership and governance.

We 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.

Board changes

Simon Cocks joined the Board on 1 June 2015 as Chief Executive Officer bringing with him extensive cross sector experience and a strong track record in leadership roles in utilities.

On 30 November 2015, Trevor Didcock and Susan Hooper were appointed to the Board as independent non-executive directors following the retirement of Baroness Peta Buscombe and Dr Jeffrey Herbert at the Annual General Meeting ('AGM') in September 2015, who we thank for their services.

Trevor and Susan have strong records of accomplishment with technology and customer backgrounds respectively and their skills and experience complement those of the existing Board members. Their appointments complete the building of a strong, experienced and balanced Board.

Governance continued

Board leadership, transparency and governance

BOARD OF DIRECTORS

Biographies for our directors are shown below. Where a director holds other directorships within the Affinity Water Group of companies, the numbers listed alongside his or her name may be cross referenced to the relevant company shown on the structure chart on page 54. Membership of our Audit Committee: A, Remuneration Committee: R and Nomination Committee: N is also listed alongside his or her name.

All directors declare their position when they have a possible conflict of interest and do not vote on any contract, arrangement or proposal in which they have an interest by virtue of other directorships. Directors have access to the advice and services of the Company Secretary and are able to obtain access to independent professional advice where they think it necessary.

CHAIRMAN

Dr Philip Nolan R N 12

Dr Philip Nolan was appointed to the Board as Chairman in April 2013 and reappointed for a further three year term from 1 April 2016[1]. Philip is also Chairman of John Laing Group plc., a specialist investor and manager of infrastructure assets and Ulster Bank Limited. He is also a non-executive director at Providence Resources plc. and EnQuest plc. He was previously Chief Executive of Eircom, Ireland's national telecommunications supplier from 2002 to 2006. Prior to that, he served as an executive director of BG Group and Chief Executive of Transco from 1998 and in 2000, led the demerger of Transco as Chief Executive of the Lattice Group.

INDEPENDENT NON-EXECUTIVE DIRECTORS

Chris Bolt A R[2]

Chris Bolt has worked in the field of economic regulation for more than twenty years, holding senior roles in both the public and private sectors. His regulation experience has included Ofwat (from 1989 to 1994), the Office of the Rail Regulator (from 1994 to 1999) and Transco plc. (from 1999 to 2002). More recently, 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). Chris now provides independent regulatory advice to the government, companies and regulators.

Patrick O'D Bourke A N

Patrick O'D Bourke was appointed to the Board in July 2013. Patrick is a Chartered Accountant and is Group Finance Director of John Laing Group plc. He was previously Chief Executive of Viridian Group, having first undertaken the role of Group Finance Director and formerly was Group Treasurer of Powergen plc. He chairs our Audit Committee and has a wide range of experience in regulated businesses operating within the private and quoted sectors. Our Board is satisfied that the cross directorship with Dr Philip Nolan does not compromise his ability to act independently.[3]

Trevor Didcock A

Trevor Didcock was appointed to the Board in November 2015. Trevor was Chief Information Officer at EasyJet plc. from 2010 to 2015, HomeServe plc. from 2008 to 2010, the Automobile Association ('AA') 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 transformation programme delivery and is a non-executive member of the Risk and Assurance Board at the Civil Aviation Authority.

Susan Hooper R

Susan Hooper joined the Board in November 2015. She is a non-executive director at Rank Group plc. and Wizz Air Holdings plc., a Professor of Practice at the LUISS Business School in Rome with a special focus on Customer Centricity and 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.

EXECUTIVE DIRECTORS

Simon Cocks – Chief Executive Officer 1 2 3

Simon Cocks was appointed to the Board in June 2015. Simon is an electrical engineer with extensive experience of the water and energy industries. He was previously Severn Trent's Managing Director of Wholesale Operations and has extensive cross sector experience in leadership roles in the utility sector. Prior to joining Severn Trent in 2009, Simon was a senior executive at National Grid and started his career at London Electricity.

Duncan Bates – Chief Financial Officer 1 2 3 4 5 7

Duncan Bates is Chief Financial Officer of Affinity Water Limited, having joined the company in March 2012 and been appointed to the Board in September of that year. He began his career in Veolia in 1992 and held a number of financial posts until his appointment as Veolia Environnement UK's Group Financial Controller in 1999. In 2007, he became Finance Director of Veolia Water's non-regulated business, a post he held until joining Affinity Water. He is a Fellow of the Chartered Institute of Management Accountants.

[1] To support the senior management team pending the appointment of Simon Cocks as Chief Executive Officer, Dr Philip Nolan agreed to serve as executive Chairman from 1 January 2015 to 31 May 2015.

[2] Chris Bolt was appointed to all three committees on 30 September 2015, and stepped down from the Nomination Committee on 28 January 2016.

[3] On appointment, our Board recognised the existence of a cross directorship relationship with Dr Philip Nolan. Taking into account Patrick O'D Bourke's considerable experience of senior roles within the regulated utility sector and his personal qualities and character, our Board is satisfied that the cross directorship does not compromise his ability to act independently. Arrangements have been established to ensure that Dr Philip Nolan and Patrick O'D Bourke are not involved in the evaluation of each other's performance.

Governance continued

Board leadership, transparency and governance (continued)

NON-EXECUTIVE DIRECTORS

Stephen Nelson A R N 1 2 3 8 9 10 11 12

Stephen Nelson was appointed a director on 31 March 2015. Stephen is Asset Management Director at Infracapital and has more than 15 years of operating and main board experience encompassing transport infrastructure, regulation as well as extensive experience of consumer businesses. Stephen was Chief Executive of BAA Limited (now Heathrow Airport Holdings Limited) between 2006 and 2008 and prior to this he was Group Retail Director at BAA. He was previously a non-executive director of the Office of Rail Regulation. He has appointed Bernd Schumacher as his alternate[1].

Nigel Paterson 1 2 3 8 9 10 11 13

Nigel Paterson was appointed a director on 25 July 2014. He is the Investment Director for Veolia Water UK and is responsible for its portfolio of investments in the UK, also holding a number of directorships of companies within the Veolia group. He is a Chartered Civil Engineer with many years' experience of asset management and asset operations in the water industry.

James Wilmott A R N 8 9 10 11 12

Jim Wilmott was appointed a director in 2012. He became a member of the Audit Committee on 31 March 2015 and is a Managing Director and Head of Europe of Morgan Stanley Infrastructure. He has appointed Yacine Saidji as his alternate.

[1] Georgina Dellacha served as his alternate until 30 July 2015.

FORMER DIRECTORS

Name	Former role	Period of service
Baroness Peta Buscombe	Independent non-executive director	2006 to September 2015
Dr Jeffrey Herbert	Independent non-executive director	2012 to September 2015

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.

Our Chairman, Dr Philip Nolan, leads our Board and is responsible for ensuring its effectiveness in all aspects of its role. This includes regulatory interactions concerning governance matters that would, for a listed company, be discharged by a senior independent non-executive director. Dr Philip Nolan is also Chairman of our ultimate UK holding company, Affinity Water Acquisitions (Investments) Limited.

The roles of Chairman and Chief Executive Officer are separated, set out in writing and agreed by the Board. Information on the division of responsibilities between the Chairman and Chief Executive Officer is available on the governance pages of our website:

stakeholder.affinitywater.co.uk/our-governance.aspx

Dr Philip Nolan acted as executive Chairman from 1 January 2015 to 31 May 2015, pending the appointment of Simon Cocks as Chief Executive Officer.

The Chairman meets our independent non-executive directors without executives present. He also meets regularly with our shareholders to listen to their views and any concerns they may have about governance or other matters. In view of the representation of our major investors on our Board we do not consider that the appointment of a senior independent non-executive director is required. This is a departure from the relevant provision of the Code.

The Board's role is to lead and control the company and to set corporate strategy, objectives and major plans bearing on the success of the business. It 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 are working effectively. It also reviews performance, resources and standards of conduct.

The Board reserves to itself the approval of certain key matters such as strategy and management, changes to the company's structure and capital, annual capital and operating budgets, financial statements, declaration of interim dividends and key regulatory submissions, reports and plans. It also approves key policies relating to safety, health and the environment, corporate responsibility and ethical conduct, risk management and business continuity planning. These matters, together with the terms of reference for the Board Committees discussed below, are published on the governance pages of our website:

stakeholder.affinitywater.co.uk/our-governance.aspx

Governance continued

Board leadership, transparency and governance (continued)

BOARD COMPOSITION AND BALANCE

With the exception of the months of October and November 2015, during which replacements for Baroness Peta Buscombe and Dr Jeffrey Herbert were being recruited following their retirement at the AGM in September 2015, arrangements met Ofwat's expectation that the independent non-executive directors should be the largest single group on the Board. The Board considers this composition appropriate for a company owned by private investors, while noting it is a departure from the Code provision for at least half of the Board, excluding the Chairman, to comprise non-executive directors determined by the Board to be independent.

We consider that the composition of our Board is appropriate for balancing the needs of customers, the environment and our shareholders, as the composition of our Board is such that no single director or group of directors can dominate the Board's decision making.

We consider that our 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 constructively challenge and help develop the strategy of our business. They are of sufficient calibre and have sufficient experience for their views to carry significant weight in Board decisions. The Board is in the process of establishing a formal process for succession planning.

Where potential conflict exists between the interests of the company as a water undertaker and those of other companies in the group, each director has regard exclusively to the interests of the company as a water undertaker.

Duncan Bates, Dr Philip Nolan, Jim Wilmott, Susan Hooper and Trevor Didcock are required to retire from office and seek re-election at this year's AGM. While these arrangements depart from the Code provision with respect to annual re-election of all directors, the Board considers these arrangements for re-election are appropriate for a company owned by private investors.

The terms of appointment of our independent non-executive directors are available on the governance pages of our website:

stakeholder.affinitywater.co.uk/our-governance.aspx

BOARD ACCOUNTABILITY

Financial and business reporting

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.

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.

The Board believes that the disclosures set out on pages 6 to 40 of the annual report provide the information necessary for shareholders to assess the company's performance, business model and strategy.

Our non-executive directors constructively challenge and help develop the strategy of our business

Risk management and internal control

Our Board has overall responsibility for monitoring the company's systems of internal control and for reviewing the effectiveness of these systems, including financial, operational and compliance controls and risk management, and is advised by its Audit Committee on these matters. The systems 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.

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 35 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 biannual review of the strategic risk register;
- the oversight of treasury matters; and
- reports from the Audit Committee, external auditors and other assurance providers, and the Internal Audit function in relation to internal control systems.

BOARD COMMITTEES

Our Board has established an Audit Committee, Remuneration Committee and Nomination Committee to assist it in discharging its responsibilities. Each Committee operates in accordance with terms of reference approved by our Board and which are published on the governance pages of our website:

stakeholder.affinitywater.co.uk/our-governance.aspx

Membership of our Board Committees is noted in the biographies of our directors on pages 44 to 47.

During the year we increased the number of independent non-executive directors on the Audit Committee, thereby meeting the Code provision for the Audit Committee to comprise three independent non-executive directors. The composition did not meet this Code provision until the appointment of Trevor Didcock to the Audit Committee in November 2015 as Dr Jeffrey Herbert's replacement following his retirement in September 2015.

The composition of our Remuneration Committee and Nomination Committee does not meet the relevant Code provisions:

- for the Remuneration Committee to comprise at least three independent non-executive directors; and
- for a majority of the members of the Nomination Committee to be independent non-executive directors.

However, our independent non-executive directors are strongly represented on each Committee and this ensures an independent voice and perspective are brought to bear on their work and decision-making.

Further information about our Board Committees is provided in the following sections.

We have an established framework for identifying, evaluating and managing the principal risks the company faces

Governance continued

Board leadership, transparency and governance (continued)

Audit Committee

The Audit Committee is chaired by Patrick O'D Bourke, an independent non-executive director who has relevant and up to date financial experience. The Chief Financial Officer, Head of Audit, Risk and Compliance, external auditor and other parties are invited to attend meetings as appropriate.

The Committee reviews the company's statutory annual financial statements and regulatory annual performance report before submission to the Board to ensure that the report and financial statements meet the obligations of the directors and give a true and fair representation of the company's financial position. The key areas of audit focus agreed with the external auditor for the year ended 31 March 2016 related to revenue recognition (specifically the measured income accrual), bad debt provisioning, cost capitalisation, loan covenants, pension assumptions and adoption of FRS 101. The Committee considers the matters identified by the external auditor in its report to the Committee and, where significant, reports these to the Board. The Committee further provides advice to 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.

The Committee is responsible for drawing the attention of the Board to, and advising on, any matters which should appropriately be decided by the Board as a whole. It also keeps under review and advises the Board on the adequacy and effectiveness of the company's financial controls, and internal control and risk management systems.

Further information on the work of the Audit Committee is contained in the Audit Committee report on pages 57 to 59.

The Audit Committee advises the Board on the adequacy and effectiveness of the company's financial controls, and internal control and risk management systems

Remuneration Committee

Our Remuneration 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 was chaired by Dr Philip Nolan until the appointment of Susan Hooper to the Board in November 2015. Since then, the provision of the Code, which stipulates that a company's chairman may not chair its remuneration committee, has been met.

The Committee is responsible, in consultation with the Chief Executive Officer, for determining the total individual remuneration package including bonuses and incentive payments of the executive directors and other members of the senior management team. 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 remuneration report on pages 60 to 68.

Nomination Committee

The Nomination Committee is established to keep under review the skills and balance of our Board to ensure the right skills and experience which are best able to balance the needs of our business, customers, shareholders, the environment and other stakeholders. The Committee is chaired by Dr Philip Nolan and met once during the year. During the year the Committee comprised Dr Philip Nolan, Patrick O'D Bourke, Baroness Peta Buscombe (until 30 September 2015), Chris Bolt (from 30 September 2015 to 28 January 2016), Stephen Nelson and Jim Wilmott.

During the year, the Nomination Committee oversaw the process to select and recommend to the Board the appointment of Trevor Didcock and Susan Hooper as independent non-executive directors following the retirement of Baroness Peta Buscombe and Dr Jeffrey Herbert at the AGM in September 2015. An executive recruitment consulting firm, Heidrick & Struggles LLP, which is unconnected to the company, was used to identify candidates. Candidate briefs were prepared by Heidrick & Struggles LLP who were requested for one of the roles to identify candidates with a strong customer background and for the other role, candidates with a strong technology background. Additionally, they were asked to identify candidates with the potential to chair the Remuneration Committee. After interviewing short-listed candidates, members of the Nomination Committee recommended the appointments of Trevor Didcock and Susan Hooper to the Board.

The Nomination Committee has not developed a diversity policy for the Board's adoption.

BOARD AND COMMITTEE ATTENDANCE, EFFECTIVENESS AND EVALUATION

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 following table sets out attendance at meetings for the year ended 31 March 2016.

	Board	Audit Committee	Remuneration Committee	Nomination Committee
Number of meetings in year	**9**	**5**	**3**	**1**
Chairman				
Dr Philip Nolan	9/9	-	3/3	1/1
Independent non-executive directors				
Patrick O'D Bourke	9/9	5/5	-	1/1
Chris Bolt	8/9	2/2*	1/1*	1/1*
Trevor Didcock	2/2*	0/0*	-	-
Susan Hooper	3/3*	-	1/1*	-
Executive directors				
Duncan Bates	8/9	-	-	-
Simon Cocks	7/7*	-	-	-
Non-executive directors				
Stephen Nelson	8/9[1]	4/5	3/3	1/1
Nigel Paterson	8/9	-	-	-
Jim Wilmott	9/9	5/5	3/3	1/1
Former directors				
Baroness Peta Buscombe	4/5*	-	2/2*	0/0*
Jeffrey Herbert	4/5*	2/2*	1/2*	-

- denotes non-membership of that Committee

* denotes not a member of the Board or Committee for the whole 12 months

The Company Secretary is responsible for ensuring that the Board and its Committees receive regular written reports from management of sufficient quality to enable them to discharge their duties. The Company Secretary also advises the Board on governance matters and facilitates information flows between management and the directors. 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.

[1] On the occasion that Stephen Nelson could not attend, his alternate, Bernd Schumacher, attended the Board meeting on his behalf.

Governance continued

Board leadership, transparency and governance (continued)

BOARD AND COMMITTEE ATTENDANCE, EFFECTIVENESS AND EVALUATION (CONTINUED)

The Board evaluated its performance during 2015/16 by means of a questionnaire completed by the directors covering the range of their responsibilities and procedures. This process, while considered appropriate for a company owned by private investors, did not meet the provision of the Code for the Board evaluation to be externally facilitated at least every three years.

The Board determined it was working effectively and identified opportunities to improve in the following areas: establishing a Board diversity policy; succession planning for key Board members and senior managers; induction on appointment and ongoing training to meet development needs of Board members; and ensuring there is effective external facilitation of Board performance evaluation at least every third year.

Details of the Audit Committee's evaluation of its performance are provided in the Audit Committee's report. The performance of the Remuneration Committee and Nomination Committee has been evaluated informally.

Evaluation of the performance of individual directors will be performed ahead of the AGM. Dr Philip Nolan will lead the evaluation of the performance of individual directors, while another independent non-executive director will lead the evaluation of Dr Philip Nolan and Patrick O'D Bourke, in view of their cross directorship.

RELATIONSHIP WITH OUR SHAREHOLDERS

There are a limited number of matters requiring shareholder approval, reflecting the matters on which a company with listed equity shares would typically involve shareholders in decision-making. These matters are explained in our publication: Engaging with our shareholders, which is available on the governance pages of our website:

stakeholder.affinitywater.co.uk/our-governance.aspx

The presence on our Board of directors appointed by our shareholders facilitates effective dialogue with our shareholders and allows all the members of the Board, in particular the independent non-executive directors, to develop an understanding of their views.

Further information about our shareholders and their ownership is provided on pages 53 to 55.

TRANSPARENCY

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

stakeholder.affinitywater.co.uk/our-governance.aspx

By order of the Board

Tim Monod
Company Secretary
27 June 2016

Ownership and financing

OWNERSHIP

The effective equity interests in Affinity Water Limited at 31 March 2016 are shown below:

Infracapital Partners II (35%)

Infracapital Partners II (consisting of Infracapital Partners II LP and Infracapital Partners (NT) II LP) is a European infrastructure fund managed by M&G Alternatives Investment Management Limited, a subsidiary of Prudential plc. The fund was established to make investments in income-generative infrastructure assets and businesses, including electricity and gas networks, water companies, transport infrastructure and renewable energy. The fund holds its investment in the company indirectly through subsidiaries including Infracapital F2 Rift S.à.r.l., which is a wholly owned subsidiary of Infracapital F2 Rift Holdings S.à.r.l.. Both Infracapital F2 Rift S.à.r.l. and Infracapital F2 Rift Holdings S.à.r.l. are incorporated in Luxembourg.

Beryl Datura Investment Limited (10%)

Beryl Datura Investment Limited (BDIL) is a company established by the State Administration of Foreign Exchange of the People's Republic of China. It is managed by Gingko Tree Investments Limited which focuses on investments in real assets such as infrastructure and real estate and is attracted to relatively stable, predictable, long-term investments. It holds its investment in the company indirectly through Infracapital F2 Rift Holdings S.à.r.l., which is managed by Infracapital Partners II.

Partners Group (5%)

Partners Group is a global private markets investment management firm. It has investment programmes under management in private equity, private real estate, private infrastructure and private debt. The firm is listed on the SIX Swiss Exchange. Its investment is held through Partners Group Global Infrastructure 2012 LP Inc., incorporated in the United States, and Partners Group Direct Infrastructure 2011 LP, registered in Guernsey. It holds its investment in the company indirectly through Rift SLP 2 LP, which is managed by Infracapital Partners II.

North Haven Infrastructure Partners LP (40%)

North Haven Infrastructure Partners LP is a global infrastructure investment fund managed by Morgan Stanley Infrastructure Inc., part of the investment management division of Morgan Stanley. It was established in 2007 to make investments in core infrastructure assets that provide essential public goods and services to societies across the globe and seeks to improve asset performance using active management. It holds its investment in the company indirectly through MSIP Dalis B.V., which is incorporated in the Netherlands.

Veolia Water UK Limited (10%)

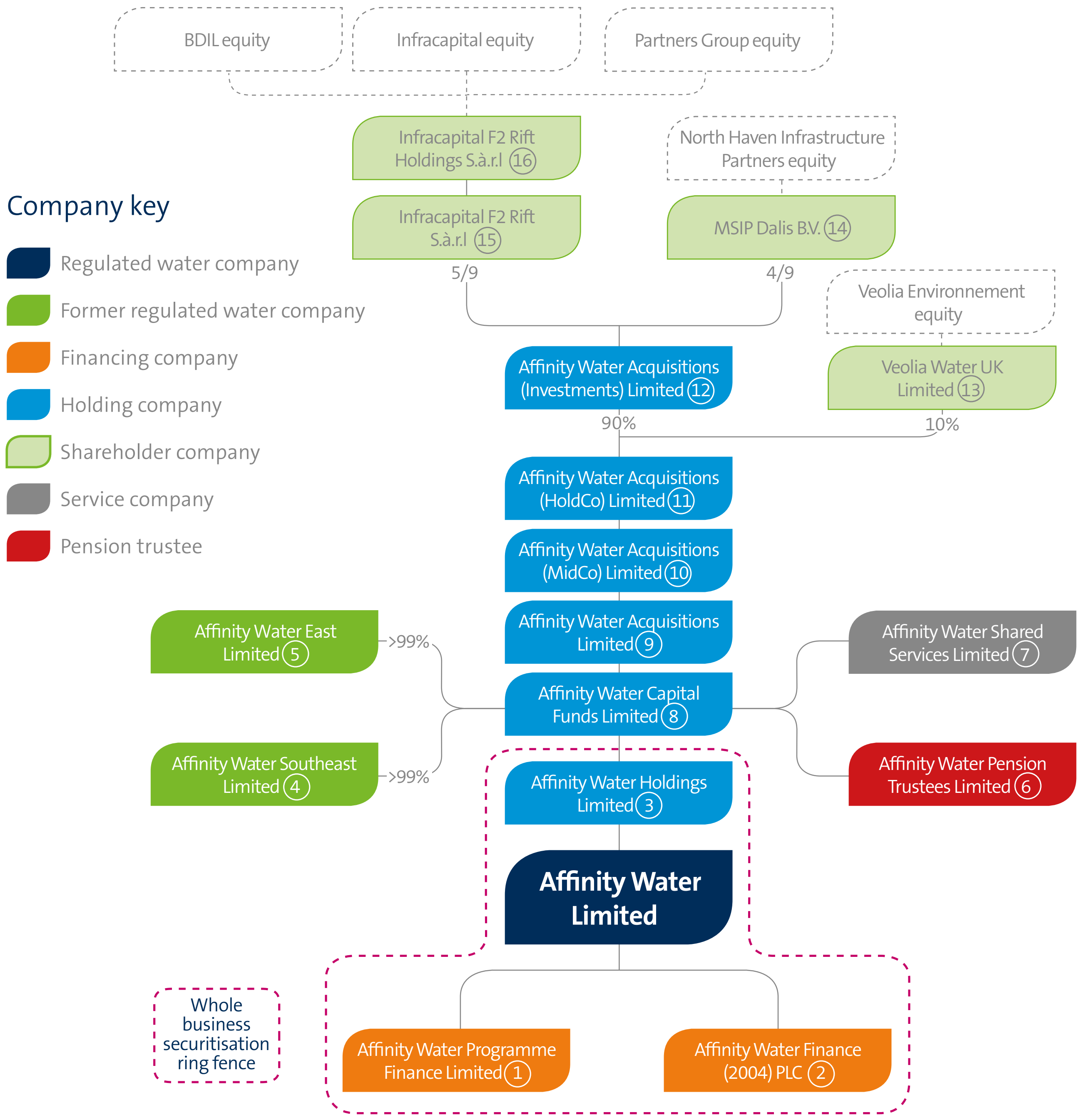
Veolia Water UK Limited is incorporated in England and Wales and is a subsidiary of Veolia Environnement S.A. which is listed on the Paris and New York Stock Exchanges. It holds its investment in the company through its shareholding in Affinity Water Acquisitions (Holdco) Limited and has established with the company a capability sharing arrangement. This arrangement gives it access to the company's knowhow, experience and expertise while the company has access to Veolia Water's advice on global water technologies and developments.

Governance continued

Ownership and financing (continued)

OWNERSHIP (CONTINUED)

The following chart shows the ownership of the company and the group structure, excluding dormant subsidiaries except for Affinity Water Pension Trustees Limited. 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 44 to 47.



Our UK holding company is Affinity Water Acquisitions (Investments) Limited and we consider Infracapital Partners II (consisting of Infracapital Partners II LP and Infracapital Partners (NT) II LP) and North Haven Infrastructure Partners LP to be our ultimate controllers, as they are in a position to exercise material influence over our policy and affairs. These entities 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 the 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 our customers and how these can be respected and protected.

We are satisfied that these undertakings are being properly discharged and that we are able fully to 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.

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 has further enhanced 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 £250m; and
- Affinity Water Programme Finance Limited has issued external bonds totalling £625m.

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 by our investors in 2012 to finance their acquisition of the company. It was not possible for us to establish a UK company to act as issuer. 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 United Kingdom.

Governance continued

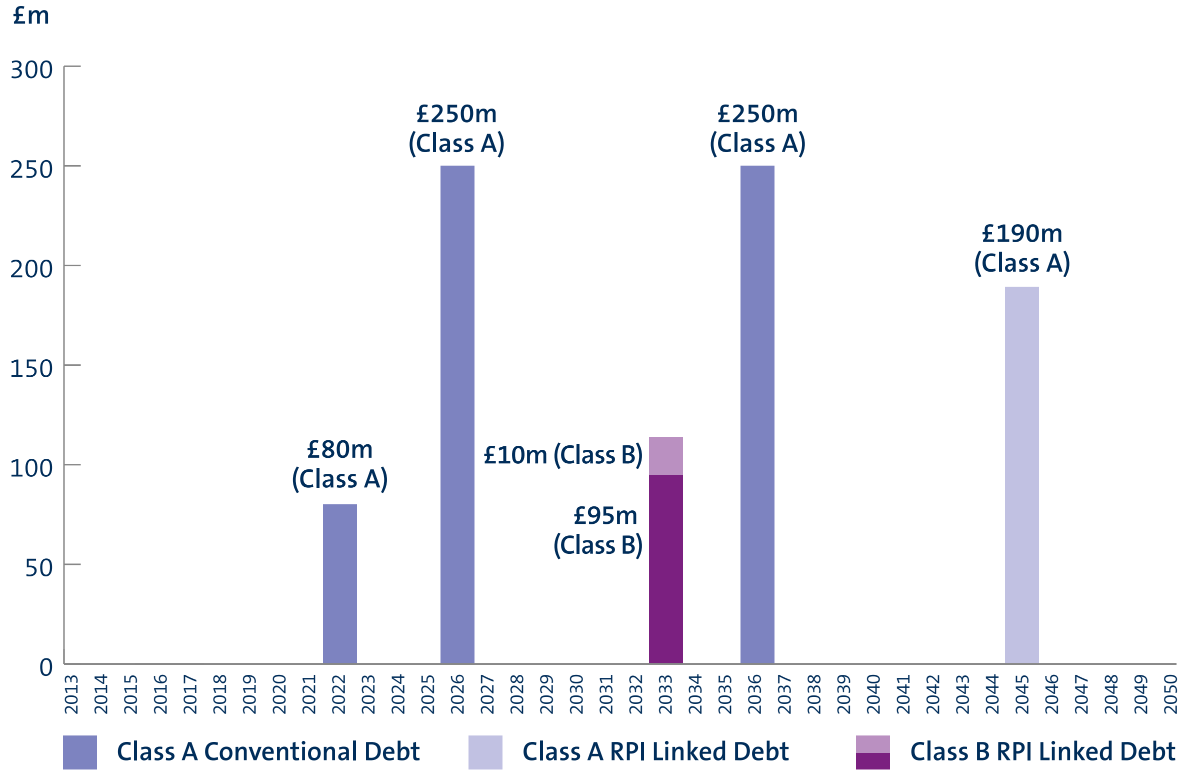
Ownership and financing (continued)

OUR FINANCING (CONTINUED)

The bonds issued by the company's subsidiaries at 31 March 2016 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 RPI linked bond 2045	190.0	1.548% (real)	June 2045
Class A fixed rate bond 2036	250.0	4.500%	March 2036
Class A fixed rate bond 2022	80.0	3.625%	September 2022
Total Class A	**770.0**		
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	**875.0**		

The following chart shows the maturity profile of the bonds at 31 March 2016:



The credit ratings for our bonds assigned by the rating agencies, Moody's and Standard & Poors are:

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

Audit Committee report

PATRICK O'D BOURKE

Current Committee members

- Patrick O'D Bourke (Chairman)
- Chris Bolt
- Trevor Didcock
- Stephen Nelson
- Jim Wilmott

Dr Jeffrey Herbert also served on the Audit Committee until 30 September 2015.

For further information on the responsibilities of the Audit Committee and the qualifications of the Chairman, please refer to page 50. The biographies of the remaining current Committee members are presented on pages 44 to 47.

Dear shareholder,

As part of our work over the last year, we concluded that effective risk management and internal control systems were in place throughout the year ended 31 March 2016.

The Committee was further satisfied that the 2015/16 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.

To make this assessment, members of the Committee received copies of the annual report and financial statements to review early in the drafting process to ensure that key messages set out in the annual report were aligned with the company's position, performance and strategy, and that the narrative sections of the annual report were consistent with the financial statements.

The significant issues considered by the Committee in relation to the 2015/16 financial statements were consistent with those identified by the external auditor in its report on pages 75 to 81.

The 2014 version of the Code introduced a new requirement for the Board to consider the period over which it is able to conclude that the Company will remain viable

Overview of the actions taken by the Audit Committee to discharge its duties

Since the beginning of 2015/16, we have:

- recommended to the Board the reappointment of PricewaterhouseCoopers LLP ('PwC') as external auditor;
- reviewed the September 2015 half-yearly financial results and the March 2016 annual report and financial statements, including significant financial reporting judgements contained in them. As part of this, we received a report from PwC on its review of the half-yearly financial results and audit of the annual report and financial statements;
- reviewed the March 2016 regulatory annual performance report to ensure that the information meets Ofwat's reporting requirements;
- 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 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 2015 half-yearly report and its audit of the March 2016 financial statements, and fees for non-audit services above pre-approved limits;
- agreed a programme of work for the Internal Audit function;
- received reports from the Head of Audit, Risk and Compliance on the work undertaken by Internal Audit,

Governance continued

Audit Committee report (continued)

Overview of the actions taken by the Audit Committee to discharge its duties (continued)

as well as management responses to proposals made in audit reports issued by the function during the year;

- monitored and reviewed the effectiveness of the Internal Audit function;
- undertaken an assessment of the qualification, expertise, resources and independence of PwC and the effectiveness of the audit process. This included consideration of a report on PwC's quality control procedures and its annual independence letter;
- reviewed compliance certificates and investor reports required under the company's debt facilities;
- received presentations on the company's adoption of FRS 101, tax matters, insurance programme, 2016/17 tariffs and charging scheme, preparations for new regulatory reporting requirements, risk and compliance statement management plan, readiness for market reform, finance controls, IT controls associated with the financial reporting process, risk management and risk assurance processes, viability statement, and information security;
- reviewed financial information included within a debt prospectus;
- provided advice to 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;
- received training presentations from PwC on the requirements of the 2014 version of the Code in relation to risk management and the viability statement, and on cyber security;
- evaluated our effectiveness as a Committee by means of a questionnaire covering the range of our responsibilities and procedures; and
- reported to the Board on how we have discharged our responsibilities in accordance with our terms of reference.

Significant issues considered by the Audit Committee in relation to the 2015/16 financial statements

We considered the approach taken to prepare the accounts in accordance with FRS 101 for the first time, taking into account the opening balance sheet at 1 April 2014 and other preparatory work undertaken in earlier years, and concluded that such an approach was appropriate.

We considered the appropriateness of the company's accounting policies and any requirement to adopt new financial reporting standards applicable in the 2015/16 accounting period. We also discussed the critical accounting judgements and key sources of estimation uncertainty, and concluded that the estimates, judgements and assumptions used were reasonable based on the information available and that these had been used appropriately in applying the company's accounting policies.

In relation to the company's existing accounting policies and the following principal areas of judgement:

- The estimation methodology for the recognition of revenue (specifically the measured income accrual) during the year was reviewed and it was concluded that the approach taken was appropriate.
- The policy for providing against doubtful debts was reviewed and it was concluded that the approach taken was appropriate.
- The processes and policies in place to distinguish between maintenance and enhancement costs were discussed and it was concluded that these would result in cost capitalisation that was in line with the company's policy and applicable accounting standards.
- The company's assumptions used in calculating the defined benefit pension asset were reviewed and the reasons for the improvement in the net position discussed.
- 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 twelve months from the date of signing the financial statements, were reviewed.

Viability

The 2014 version of the Code introduced a new requirement for the Board to consider the period over which it is able to conclude that the Company will remain viable. On account of this being a new requirement, the Audit Committee considered this to be a significant reporting matter.

The Committee spent time reviewing the process undertaken by management to support and allow the directors to make the company's viability statement. During these meetings, the Audit 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.

The company's viability statement, including information on the company's approach to producing it, can be found on page 42.

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.

To fulfil our responsibility regarding the independence and objectivity of PwC, we 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 non-audit 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, other than audit related services, in the form of consultancy services in relation to possible ways to reduce the company's exposure to inflation movements within its pension scheme, and contractual changes associated with a supplier framework. PwC further provided agreed upon procedures in relation to the accuracy of the company's forecast water charges. PwC was engaged to provide these services as it is recognised as having expertise in these areas.

Auditor objectivity and independence was safeguarded in these instances through the work being performed on a review and recommend basis with the final decision being taken by management (except for the agreed upon procedures), and through advice being provided by partners and staff who have no involvement in the statutory audit of the financial statements.

PwC was engaged to provide agreed upon procedures as part of the company's regulatory compliance and annual reporting to Thames Water and Anglian Water. PwC was further engaged to provide assurance over the financial information included within a debt prospectus and comfort letters to dealers in respect of debt issuance. None of the procedures performed were advisory in nature.

No services were provided pursuant to contingent fee arrangements.

The external auditor's role is considered annually by the Board for reappointment on the recommendation of the Audit Committee.

To assess the effectiveness of PwC, the Audit Committee reviewed:

- the arrangements for ensuring PwC's independence and objectivity;
- its fulfilment of the agreed audit plan and any variations from the plan;
- the robustness and perceptiveness of PwC in 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 2017.

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.

Internal Audit

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
27 June 2016

Governance continued

Remuneration report

SUSAN HOOPER

Committee members

- Susan Hooper (Chair)
- Chris Bolt
- Dr Philip Nolan
- Stephen Nelson
- Jim Wilmott

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 2016, and changes to the remuneration policy, as presented in last year's report, for 2016/17.

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 our customers by incentivising financial efficiencies. We therefore link directors' remuneration 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 provides the basis for determining the value of annual bonus awards.

We have strengthened the link between the remuneration of executive directors and the standards of performance experienced by customers by aligning the leakage and unplanned interruptions annual bonus plan targets for 2015/16 to the commitments for AMP6 in our Business Plan. These are ambitious commitments made to both our

We link directors' remuneration to the standards of performance we provide to customers as well as the value created for shareholders

regulator and our customers, and they reflect our desire to continue to improve on what we do.

We also have a long-term incentive plan ('LTIP') to incentivise executive directors and senior management to meet targets for cash available for distribution over the three year period and customer service in the final year of the period. To comply with the new requirement of the 2014 version of the Code, we have included provisions into 2015/16 awards under this plan to enable the company to recover sums paid or withhold the payment of any sum required under specific circumstances in which it would be appropriate to do so.

Remuneration in 2016/17

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 2016/17 we will continue to keep the reward packages for our executive directors and other senior managers under review to ensure that 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. To this end, in April 2016 we appointed Deloitte LLP, which is unconnected to the company, to provide advice on the design of the annual bonus plan and the long-term incentive plan for our executive directors and other senior managers.

INTRODUCTION

We have prepared this report in accordance with regulations made under Schedule 8 to the Accounting Regulations of the Companies Act 2006 (the 'Act'), which are applicable to companies whose equity shares are listed. 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 2015 AGM, the single available vote was cast in favour of the resolutions to approve the remuneration policy report, which is subject to a binding vote at least every three years, and the remuneration implementation report, which is subject to an annual advisory vote, presented in the annual report and financial statements for the year ended 31 March 2015.

The Act requires the auditor to report to the company's members 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 management. The Committee met on three occasions during the year, and was chaired by Dr Philip Nolan until 30 November 2015, when Susan Hooper was appointed Chair.

The other members of the Committee during the year were Jim Wilmott, Stephen Nelson, Chris Bolt, Baroness Peta Buscombe (until 30 September 2015) and Dr Jeffrey Herbert (until 30 September 2015). Simon Cocks, the Chief Executive Officer, 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. Their 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 receives a fixed annual fee for his services which is reflective of the time commitment and responsibilities of the role. He served as executive Chairman from 1 January 2015 until 31 May 2015 and thereafter his role reverted to non-executive.

He also benefits from a remuneration arrangement, which aligns 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 has been aligned as closely as possible to the key features of a shareholding in a listed company. Particulars of the arrangement were communicated at the 2015 AGM.

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 2015/16 in the remuneration implementation report.

The other non-executive directors in office at 31 March 2016 fall into two groups.

Group A	Group B
Patrick O'D Bourke	Stephen Nelson
Chris Bolt	Nigel Paterson
Trevor Didcock	Jim Wilmott
Susan Hooper	

Governance continued

Remuneration report (continued)

Remuneration policy for non-executive directors (continued)

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 long-term incentive plans. 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 directors are appointed until the conclusion of the next AGM, unless terminated earlier by either the director or the company giving to the other three months' written notice.

The fee policy for the Group A directors in 2015/16 remained unchanged from that reported in the 2014/15 remuneration policy report and will apply during 2016/17, unless the Committee agrees changes during the year.

The directors in Group B are appointed by our shareholders. They do not receive any fees or other forms of remuneration from the company in respect of their services and are not entitled to receive any payment on termination of their appointment.

The remuneration policy is designed to attract, retain and motivate executive directors of the calibre required to deliver the business strategy.

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 respectively. 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 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 are 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 Duncan Bates and Simon Cocks presented in the 2014/15 remuneration policy report remained unchanged during 2015/16.

From 1 April 2016, Duncan Bates ceased to be an active member of the company's retirement benefit schemes and, in lieu of being a member, receives a taxable allowance equivalent to the benefit he previously received. No further changes to the policy relating to these elements for 2016/17 were made up to the date of approval of this annual report and financial statements.

No changes have been made to the internal performance measures for the 2016/17 annual bonus scheme and at the date of approval of this annual report and financial statements, they continued to be aligned to our performance commitments for AMP6.

At the date of approval of this annual report and financial statements, 50% of the total bonus continued to be determined on the achievement of the financial performance target; 25% on the achievement of operational and customer performance targets; and 25% on the achievement of personal objectives. After the appointment of Simon Cocks, the Committee set Simon Cocks' entitlement to receive remuneration under the annual bonus scheme of up to 100% of his salary.

During the year the arrangements for the 2014/15 and 2015/16 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 2016/17
LTIP				
To incentivise executives to achieve long-term shareholder value whilst achieving high levels of customer experience performance, although award and payment are discretionary.	Base awards were 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.	Up to 100% of base salary (although outperformance of the financial performance target could cause this to be higher).	The award will be 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.	No changes were made to the policy for 2016/17 up to the date of approval of this annual report and financial statements.

Executive directors' service contracts

The executive directors each have service contracts, neither of which are fixed term, with notice periods as follows:

Chief Executive Officer – Simon Cocks	Chief Financial Officer – Duncan Bates
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 awards under the 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 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 resulted in significant losses to the company, material failure of related management or business units, material misstatement in the audited financial statements, and reputational damage.

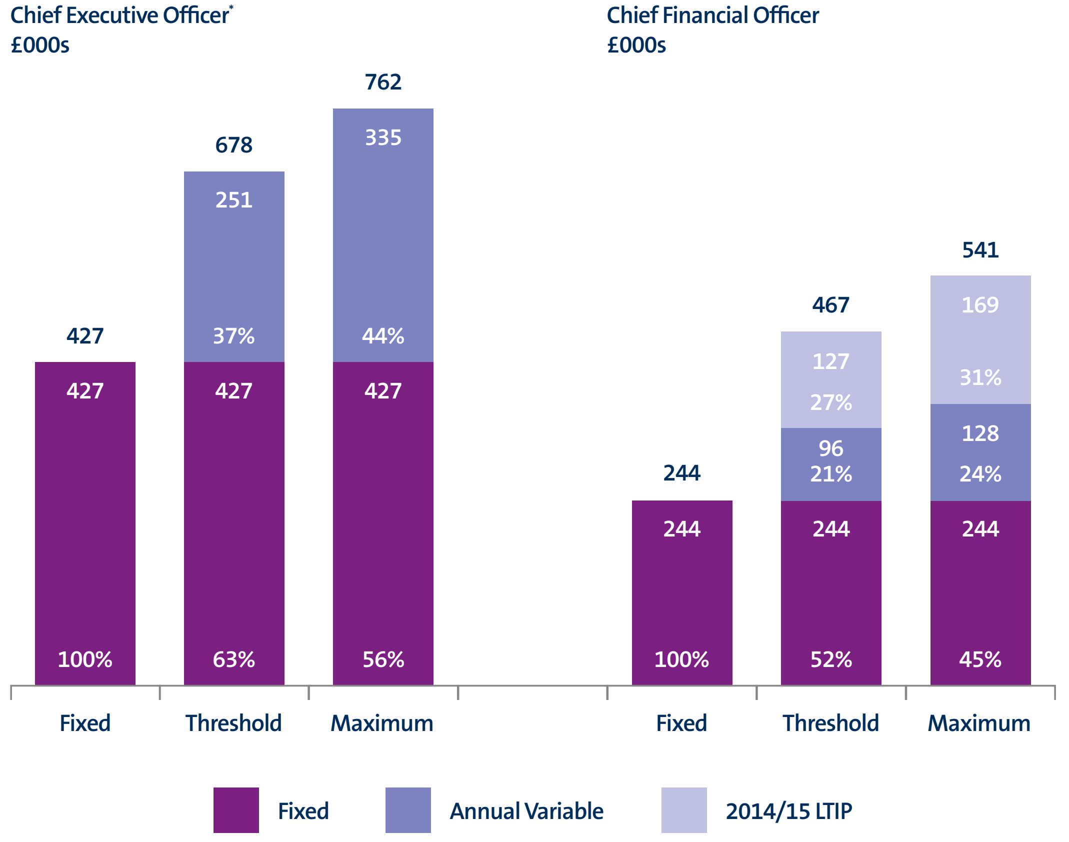
There are no arrangements in place for the remuneration of executive directors by any holding company or other company in the group.

Governance continued

Remuneration report (continued)

Payouts under different scenarios

The following charts show the potential remuneration in respect of 2016/17 under the proposed arrangements for the Chief Executive Officer and Chief Financial Officer under different scenarios.



*Simon Cocks will receive £388,000 in 2016/17 representing compensation for the forfeit of variable remuneration arrangements with his previous employer. This is not included in the maximum remuneration above.

In developing the scenarios the following assumptions have been made:

Fixed	Consists of base salary, taxable benefits and allowances in lieu of being members 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 and LTIP elements pay out at 75% of maximum (assuming the financial performance target for the 2014/15 LTIP is met)
Maximum	Based on what a director would receive if the highest level of performance were achieved: annual variable and LTIP elements pay out at 100% of maximum (assuming the financial performance target for the 2014/15 LTIP is met)[1]

Chief Executive Officer remuneration

We have not reported the percentage year-on-year change in the remuneration of the director undertaking the role of Chief Executive Officer compared to the percentage change in average employee remuneration, as the role was not filled for the full year.

[1] This scenario excludes the possibility of outperformance of the financial performance target.

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, they 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 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	2015/16*	2014/15*
Our people	Wages, salaries and pensions	**17p**	15p
Our suppliers for assets	Investment in our assets	**30p**	37p
Our shareholders	Dividends	**7p**	7p

*Figures are based on our financial statements for 2015/16 and 2014/15 and have been rounded.

Further details of where each pound of our customers' bills is spent are presented in the Affinity Water at a glance section of the annual report.

Governance continued

Remuneration report (continued)

REMUNERATION IMPLEMENTATION REPORT

Directors' remuneration 2015/16 (audited)

The following table shows the remuneration paid by the company to directors in respect of 2015/16.

	Base salary/ fees £000		Taxable benefits[1] £000		Pension related benefits[2] £000		Annual bonus £000		Other[3] £000		Total remuneration £000	
	15/16	14/15	15/16	14/15	15/16	14/15	15/16	14/15	15/16	14/15	15/16	14/15
Non-executive												
Current												
Patrick O'D Bourke	**47**	47	**-**	-	**-**	-	**-**	-	**-**	-	**47**	47
Chris Bolt	**41**	4	**-**	-	**-**	-	**-**	-	**-**	-	**41**	4
Trevor Didcock	**14**	-	**-**	-	**-**	-	**-**	-	**-**	-	**14**	-
Susan Hooper	**15**	-	**-**	-	**-**	-	**-**	-	**-**	-	**15**	-
Former												
Baroness Peta Buscombe	**22**	44	**-**	-	**-**	-	**-**	-	**-**	-	**22**	44
Jeffrey Herbert	**22**	44	**-**	-	**-**	-	**-**	-	**-**	-	**22**	44
Chairman												
Dr Philip Nolan	**200**	200	**-**	-	**-**	-	**-**	-	**210**	176	**410**	376
Executive												
Current												
Duncan Bates[4]	**170**	168	**13**	15	**35**	33	**111**	104	**-**	-	**329**	320
Simon Cocks	**279**	-	**10**	-	**67**	-	**242**	-	**207**	-	**805**	-
Former												
Richard Bienfait	**-**	180	**-**	7	**-**	59	**-**	-	**-**	509	**-**	755
	810	687	**23**	22	**102**	92	**353**	104	**417**	685	**1,705**	1,590

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 who sit on the Board appointed by Infracapital Partners II, North Haven Infrastructure Partners LP and Veolia Water UK Limited do 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 performance and the level of bonus awarded, although award and payment remain discretionary. The table on the next page shows the percentage of maximum annual bonus potential awarded in relation to the 2015/16 year for Duncan Bates and Simon Cocks. No amounts in relation to these bonuses have been deferred.

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

[2] Included in pension related benefits is £5,000 relating to contributions for Duncan Bates paid to money purchase pension schemes (2015: £4,000); there were no amounts outstanding at the year end. The amounts also include £30,000 accruing to Duncan Bates in relation to the company's defined benefit pension scheme. This amount has been calculated based on the change during the year of his accrued benefits in the defined benefit pension scheme multiplied by 20 less contributions made by the director in the financial year. The normal retirement date for Duncan Bates is 65 years. The accrued benefit at the start and end of the year for Duncan Bates was £42,000 and £44,000 respectively (change during the year: £2,000). Pension related benefits for Simon Cocks further include an allowance of £67,000 in lieu of being a member of the company's retirement benefit schemes (2015: £59,000 for Richard Bienfait).

[3] Other remuneration for Dr Philip Nolan consists of remuneration received in relation to the arrangement described on page 61 of the remuneration policy report. Other remuneration for Simon Cocks in 2015/16 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 his previous employer. Other remuneration for Richard Bienfait in 2014/15 relates to discretionary payments made in connection with termination of qualifying services during the year. The amount included a termination payment of £344,000, a bonus of £120,000 linked to company and personal performance during 2014/15 and the reimbursement of legal and outplacement costs of £45,000.

[4] Duncan Bates was the only executive director to have received base awards under the 2013/14 LTIP scheme, which relates to the three year performance period ended 31 March 2016. The Committee will determine and communicate to shareholders any awards under the 2013/14 LTIP before the AGM. Details of any awards determined by the Committee will be included in the 2016/17 remuneration implementation report.

Performance measure		Link to strategy (refer to page 23)	2015/16 target	Weighting for 2015/16 (% of base salary)		2015/16 achievement (as a % of base salary)	
				Simon Cocks	Duncan Bates	Simon Cocks	Duncan Bates
Financial measure	Cash generated by operations (annual target): net cash outflow before taxation and financing[1]	Value creation imperative	£14.4m	50.00%	37.50%	50.00%	37.50%
Operational measures	Leakage (quarterly targets): volume of water lost through leaks on the network in terms of millions of litres per day (Ml/d)	Customer outcome	Q1: 154 Q2: 153 Q3: 159 Q4: 162	3.57%	2.68%	0.00%	0.00%
	Water availability (quarterly targets): volume of water lost from distribution due to unplanned outages at production sites (Ml/d)	Customer outcome	Q1: 40 Q2: 35 Q3: 35 Q4: 40	3.57%	2.68%	3.57%	2.68%
	Water quality (quarterly targets): number of water quality compliance failures	Customer outcome	Q1: 8 Q2: 10 Q3: 7 Q4: 7	3.57%	2.68%	3.57%	2.68%
	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	3.57%	2.68%	0.00%	0.00%
	Water saving programme (quarterly targets): number of meters installed	Customer outcome	Q1: 4,300 Q2: 9,460 Q3: 15,878 Q4: 15,878	3.57%	2.68%	0.89%	0.67%
Customer and community measures	SIM[2] (annual target): performance for the qualitative element of SIM relative to the industry	Customer outcome	Top 9	3.57%	2.68%	0.00%	0.00%
	Cash collections (annual target): the amount of cash collected through billing in respect of water revenue	Customer outcome	£291.7m	3.57%	2.68%	3.57%	2.68%
Personal performance[3]				25.00%	18.75%	25.00%	18.75%
Total % base salary				**100.00%**	**75.00%**	**86.60%**	**64.96%**
Base salary						**£279,000[4]**	**£171,000**
Bonus paid						**£242,000**	**£111,000**

[1] This "non-GAAP" measure is calculated as the total of the following line items per the statement of cash flows (refer to page 86): 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] Simon Cocks' base salary at 31 March 2016 has been pro-rated to reflect his appointment partway through the year (on 1 June 2015).

Governance continued

Remuneration report (continued)

REMUNERATION IMPLEMENTATION REPORT (CONTINUED)

2013/14 LTIP

The 2013/14 LTIP scheme was designed to incentivise executives to achieve long-term shareholder value whilst achieving high levels of customer experience, although award and payment are discretionary. Arrangements for the scheme, as set out in the 2014/15 remuneration policy report, were finalised during the year ended 31 March 2015.

Duncan Bates was the only executive director to have received base awards under the 2013/14 LTIP scheme, which relates to the three year performance period ended 31 March 2016. The Committee will determine and communicate to shareholders any awards under the 2013/14 LTIP before the AGM. Details of any awards determined by the Committee will be included in the 2016/17 remuneration implementation report.

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 27 June 2016 and signed on its behalf by:

Susan Hooper

Chair of the Remuneration Committee

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 2016.

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 Affinity Water Acquisitions (Investments) Limited is the ultimate holding and controlling company in the United Kingdom. Details of the ownership of the company and the group structure are set out on pages 53 to 55 of the governance section and note 23 of the financial statements. The address of the principal place of business is Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

The strategic report on pages 6 to 34 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 2016. Details of the risks and principal uncertainties facing the company are set out on pages 35 to 41.

Directors

The directors of the company, together with their periods of office and their biographical details, are shown on pages 44 to 47.

Significant events during the year

Details of the significant events that occurred during the year are set out in the highlights, Chairman's statement and Board's introduction on pages 2 to 7.

On 29 October 2015, Affinity Water Programme Finance Limited, a wholly owned subsidiary of the company, completed a £40.0m tap issue of its 1.548% RPI linked guaranteed bond due 2045 on the same terms as the existing 2045 bond. On 19 February 2016, Affinity Water Programme Finance Limited issued £10.0m Class B guaranteed RPI linked notes maturing in June 2033 with a coupon rate of 1.024%. The net proceeds of the tap issue and bond issue have been lent to the company on the same terms.

Results and financial performance

Profit for the year was £59.7m (2015: £48.9m).

The statement of financial position detailed on page 84 shows total equity amounting to £239.5m (2015: £202.8m).

Further analysis of our financial performance can be found on pages 32 to 34 of the strategic report.

Information required under the Listing Rules

During the year no interest was capitalised by the company (2015: £nil).

Refer to the remuneration report on pages 60 to 68 for disclosures in relation to relevant requirements of the Listing Rules.

Governance continued

Directors' report (continued)

Greenhouse gas ('GHG') emissions statement[1]

GHG emission source	2015/16 Gross[3] (tCO_2e)	2015/16 Intensity[4] ($kgCO_2e$/Ml)	Restated[2] 2014/15 Gross (tCO_2e)	Restated[2] 2014/15 Intensity ($kgCO_2e$/Ml)	Restated[2] Baseline year - 2013/14 Gross (tCO_2e)	Restated[2] Baseline year - 2013/14 Intensity ($kgCO_2e$/Ml)
Scope 1	**5,888**	**18.1**	**6,260**	**19.4**	**7,011**	**21.5**
Fuel combustion	1,320	4.0	1,451	4.5	1,956	6.0
Process and fugitive emissions	2,558	7.9	2,616	8.1	2,713	8.3
Vehicle fleet	2,010	6.2	2,193	6.8	2,342	7.2
Scope 2	**101,770**	**313.2**	**105,813**	**328.2**	**98,073**	**300.2**
Purchased electricity	101,770	313.2	105,813	328.2	98,073	300.2
Statutory total (scope 1 & 2)[5]	**107,658**	**331.3**	**112,073**	**347.6**	**105,084**	**321.7**
Scope 3	**8,834**	**27.2**	**9,697**	**30.1**	**8,961**	**27.4**
Business travel in other vehicles	33	0.1	38	0.1	9	0.0
Outsourced IT activities	397	1.2	406	1.3	566	1.7
Electricity- transmission and distribution	8,404	25.9	9,253	28.7	8,386	25.7
Total gross emissions	**116,492**	**358.5**	**121,770**	**377.7**	**114,045**	**349.1**

Our gross GHG emissions have decreased by 4% in the year. Similar to businesses across the UK, our purchased electricity GHG emissions (accounting for 94% of our statutory total) were affected by a reduction in the carbon intensity of the grid (a factor beyond our control). Whilst over 45% of our electricity comes from renewable sources, we are required to report carbon emissions according to the UK grid average.

[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 have restated our 2014/15 and 2013/14 GHG intensity figures due to an improved understanding of the clean water volumetric data used in the calculations. This has increased our total gross GHG intensity figures by approximately 4% in both years.

[3] We measure our gross GHG emissions in tonnes of carbon dioxide equivalent ('tCO_2e').

[4] 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 CO_2e per megalitre ('$kgCO_2e$/Ml') of clean water supplied.

[5] Statutory carbon reporting disclosures required by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.

Dividends

The directors declared and paid the following ordinary dividends during the year ended 31 March 2016:

	£m
Paid: First interim of 3.40p per share in April 2015	9.0
Paid: Second interim of 2.08p per share in July 2015	5.5
Paid: Third interim of 5.09p per share in September 2015	13.5
Paid: Fourth interim of 3.02p per share in December 2015	8.0
Paid: Fifth interim of 1.51p per share in March 2016	4.0
	40.0

This compares to interim dividends of £30.8m declared and paid in the year ended 31 March 2015.

No final dividend is proposed (2015: £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 research 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 carried out more specific research in the fields of improving data, metaldehyde removal, pipeline materials and water resources during the year.

Political contributions

No political contributions were made during the year (2015: £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 and these were expanded on during 2015/16.

Employees are kept informed of changes in the business, 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 on page 40 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 15.

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 44 to 52 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.

Post balance sheet events

There were no significant post balance sheet events.

Directors' qualifying third party indemnity provisions

The company granted an indemnity to one of its former 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. This qualifying third party indemnity provision was in force during the financial year until the date of resignation of the former director.

Governance continued

Directors’ report (continued)

Statement of directors’ responsibilities

The directors are responsible for preparing the strategic report, directors’ report and the financial statements in accordance with applicable law and regulations.

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 applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice, ‘UK GAAP’), including FRS 101.

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 these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable United Kingdom Accounting Standards, including FRS 101, have been followed, subject to any material departures disclosed and explained in the financial statements;
- notify the company’s shareholder in writing about the use of disclosure exemptions, if any, of FRS 101 used in the preparation of the financial statements; 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. They 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.

Each of the directors, whose names and functions are listed on pages 44 to 47 confirms that, to the best of his/her knowledge:

- the financial statements, which have been prepared in accordance with UK GAAP, including FRS 101, give a true and fair view of the assets, liabilities, financial position and profit of the company; and
- the strategic report contained in the annual report includes a fair review of the development and performance of the business and the position of the company, together with a description of the principal risks and uncertainties that it faces.

Disclosure of information to auditors

In accordance with Section 418 of the Companies Act 2006:

a. so far as each director is aware, there is no relevant audit information of which the company’s auditor is unaware; and

b. he or she has taken all the steps that he or she ought to have taken as a director in order to make himself or herself aware of any relevant audit information and to establish that the company’s auditor is aware of that information.

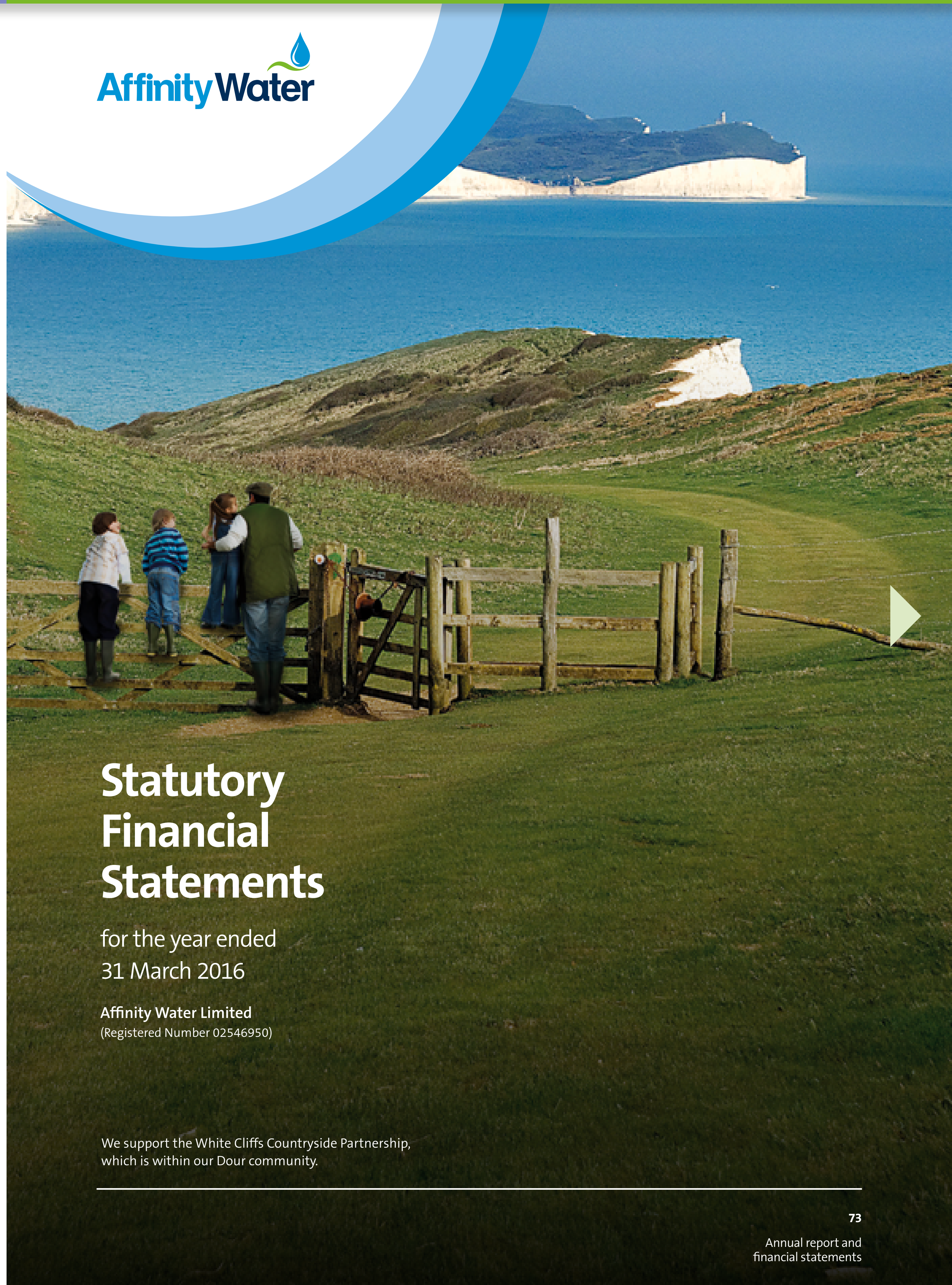
Independent auditor

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
27 June 2016

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



Statutory Financial Statements

for the year ended
31 March 2016

Affinity Water Limited
(Registered Number 02546950)

We support the White Cliffs Countryside Partnership, which is within our Dour community.

Statutory financial statements

Contents

Independent auditor's report to the member of Affinity Water Limited

Report on the financial statements

Our opinion

In our opinion, Affinity Water Limited's financial statements (the "financial statements"):

- give a true and fair view of the state of the company's affairs as at 31 March 2016 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; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

What we have audited

The financial statements, included within the Annual Report and Financial Statements (the "Annual Report"), comprise:

- the statement of financial position as at 31 March 2016;
- the income statement and statement of comprehensive income for the year then ended;
- the statement of cash flows for the year then ended;
- the statement of changes in equity for the year then ended;
- the accounting policies; and
- the notes to the financial statements, which include other explanatory information.

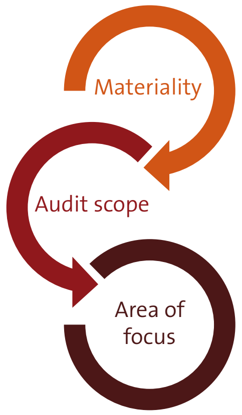
Certain required disclosures have been presented elsewhere in the Annual Report, rather than in the notes to the financial statements. These are cross-referenced from the financial statements and are identified as audited.

The financial reporting framework that has been applied in the preparation of the financial statements is United Kingdom Accounting Standards, comprising FRS 101 "Reduced Disclosure Framework", and applicable law (United Kingdom Generally Accepted Accounting Practice).

Our audit approach

Overview

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 on the company's adoption of FRS 101 'Reduced disclosure framework - Disclosure exemptions from EU-adopted IFRS for qualifying entities'. This required the company to re-present the reserves as at 1 April 2014 and the comparative statement of financial position and statement of comprehensive income for the year ended 31 March 2015 under FRS 101 accounting policies.



Materiality

- Overall materiality: £3.3 million (2015: £4.2 million) which represents 2.5% of earnings before interest, tax, depreciation and amortisation ('EBITDA').

Audit scope

- The company has one finance function and operates a single ledger system
- The audit was carried out by one team at the UK headquarters in Hatfield, Hertfordshire.

Areas of focus

- Measured income accrual relating to revenue from the provision of water services to customers on water meters that had not been read at the year end date
- Bad debt provision, particularly judgements used in its calculation
- Cost capitalisation, particularly the allocation of costs between capital and non-capital spend
- Pension assumptions, particularly the key assumptions used in the valuation of the pension obligation and return on the assets
- Adoption of FRS 101, 'Reduced disclosure framework - Disclosure exemptions from EU-adopted IFRS for qualifying entities'.

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

Our audit approach (continued)

The scope of our audit and our areas of focus

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)").

We designed our audit by determining materiality and assessing 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.

The risks of material misstatement that had the greatest effect on our audit, including the allocation of our resources and effort, are identified as "areas of focus" in the table below. We have also set out how we tailored our audit to address these specific areas in order to provide an opinion on the financial statements as a whole, and any comments we make on the results of our procedures should be read in this context. This is not a complete list of all risks identified by our audit.

Area of focus	*How our audit addressed the area of focus*
Measured income accrual Refer to **page 57** (Audit Committee Report), **page 110** (accounting policies) and **page 98** (**note 11**). The directors recorded a measured income accrual of £41.5 million (2015: £39.9 million) relating to revenue from the provision of water services to customers on water meters that had not been read as at the year end date. The calculation of the measured income accrual was based on the historical usage of water by groups of similar customers in the same geographical region ('books') and when the books were last read and billed. Given the range of factors underlying the estimate, there is a risk that the measured income accrual and revenue could be misstated.	We checked that a sample of the data used in the calculation of the measured income accrual agreed to the billing system where applicable and we were able to reperform the calculation successfully using management's assumptions and data. The key assumption affecting the measured income accrual is that the historical usage is an appropriate basis for the current year accrual. As the measured income accrual is based on a six month average consumption for each book, we assessed the impact of seasonality on management's calculations and considered there to be no significant impact. We were also able to obtain satisfactory explanations from management for any changes since the prior year in the measured revenue. We assessed management's responses in light of audit work performed over revenue and concluded that the year-on-year movement appeared reasonable. We evaluated the measured income accrual as a proportion of the measured revenue against the prior year, taking into account the timing difference in the reading of books. We were satisfied that the proportion was materially consistent. We evaluated the historical accuracy of the estimation process by checking bills raised in the current year for all books accrued at the prior year end. We also evaluated the accuracy of the current year end accrual by checking post year end bills raised for books accrued at the year end though only 33% of these books had been billed by the time of our audit. We found that the differences between the estimated accruals and the subsequent billings were insignificant, being less than 2% in each case.

Area of focus	*How our audit addressed the area of focus*
Bad debt provision Refer to **page 57** (Audit Committee Report) and **page 109** (accounting policies). The bad debt provision is based on a detailed calculation that applies a percentage provision to individual aged debt categories based on historical cash collection rates. 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 older debt being more difficult to collect. The company has introduced its social tariff, LIFT, to encourage regular payment of more affordable bills. The provision needs to reflect all these factors and accordingly could be materially misstated.	We agreed the calculation of the bad debt provision to the general ledger and performed testing to confirm the appropriateness of the ageing with no exceptions arising from this work. We recalculated the bad debt provision and evaluated the reasonableness of the provision, taking into account the following: • collections made against old balances and year on year movement of aged debt categories; • trends in cash receipts compared to billings; • the debt write off policy; and • the calculation of the expected collection period for overdue debts based on historical cash collection rates. We considered the level of provisioning to be acceptable, based on historical cash collection rates.
Cost capitalisation Refer to **page 57** (Audit Committee Report), **pages 107** (accounting policies) and **page 95** (**note 6**). The allocation of costs between capital and non-capital spend can be subjective. The key judgement is management's assessment of what constitutes enhancement from maintenance expenditure (which is capitalised). Given the magnitude of capital spend at £83.7 million there is a risk that incorrect classification could give rise to material misstatements.	We checked that a sample of items being capitalised was in line with both the company's accounting policy and accounting standards, for expenditure performed by external and internal contractors. In addition, we evaluated the nature of overheads that were being capitalised and found these to relate to the asset management operations of the business and considered them to be appropriately capitalised. We also scanned the repairs and maintenance expenditure and tested items to assess appropriate classification as an operating expense and there were no material issues with our testing of the classification.
Pension assumptions Refer to **page 57** (Audit Committee Report), **page 110** (accounting policies), **page 97** (**note 9**) and **pages 115 to 118** (**note A5**). The company has a defined benefit pension plan net asset of £72.3 million (2015: £45.1 million). The plan liabilities decreased from £374.1 million to £349.9 million mainly as a result of an increase in discount rates. In addition, the plan assets increased from £419.2 million to £422.5 million. The valuation of the net pension asset requires significant levels of judgement and technical expertise in choosing appropriate assumptions. Changes in a number of key assumptions (including salaries increase, inflation, discount rates, expected rates of return on plan assets and mortality rates) can have a material impact on the calculation of the net asset.	We agreed the valuation of the pension assets to the valuation reports that we obtained from the fund's investment manager and performed procedures to independently value the assets, noting no material differences. We also agreed the actuarial information for a sample of active scheme members to the payroll data held by the company and noted no exceptions in our testing. In addition, we obtained detailed information regarding the pensioners and deferred members and performed a bridge in member numbers year on year. We noted no significant unexplained movement in the number of members in either group. We assessed the competence and independence of the actuary by confirming that it 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. The mortality rates and the allowance for future improvements in longevity were consistent with our internally developed benchmarks. We agreed the salaries increase to be within our expected range based on the Consumer Price Index ('CPI') and Retail Price Index ('RPI').

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

Area of focus	*How our audit addressed the area of focus*
Adoption of FRS 101 'Reduced disclosure framework -Disclosure exemptions from EU-adopted IFRS for qualifying entities' Refer to **page 57** (Audit Committee Report), **page 87** (accounting policies) and **pages 120 to 124** (**note A8**). The company's date of transition to FRS 101 is 1 April 2014, the first day of the comparative period. This has required the re-presentation of the reserves as at 1 April 2014 and re-presentation of the comparative statement of financial position and statement of comprehensive income for the year ended 31 March 2015 under FRS 101 accounting policies. There is therefore a risk in respect of the completeness and accuracy of the financial disclosures, and appropriate accounting for transactions and balances under the new reporting standards.	We audited the adjustments recorded by the client on transition from UK GAAP to FRS 101 and considered the appropriateness of the new accounting policy. Adjustments arising from this work were recorded by management in their opening reserves and/or comparative income statement and statement of financial position as applicable. We tested the completeness of the adjustments made through our independent assessment of the applicability of the IFRS accounting standards for presentation of the financial statements under FRS 101, noting no material adjustments. We tested the completeness of the disclosures in the year end financial statements by checking the disclosures made against the disclosure requirements of FRS 101 and Part 15 of the Companies Act 2006 and 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008' (SI 2008/410), noting minor disclosure amendments which have been reflected in the year end financial statements.

How we tailored the audit scope

We tailored the scope and approach 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 geographic structure of the company, the nature of the IT systems, the accounting processes and controls, and the industry in which the company operates.

The company operates as a single entity and has a central finance function, with a single general ledger system, and all audit work was carried out by one team.

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 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	£3.3 million (2015: £4.2 million).
How we determined it	2.5% of earnings before interest, tax, depreciation and amortisation ('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, due to the capital-intensive nature of the business. 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 (2015: £0.2 million) as well as misstatements below that amount that, in our view, warranted reporting for qualitative reasons.

Going concern

The directors have chosen to voluntarily report how they have applied the UK Corporate Governance Code (the "Code") as if the company were a premium listed company. Under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to the directors' statement about whether they considered it appropriate to adopt the going concern basis in preparing the financial statements. We have nothing material to add or to draw attention to.

As noted in the directors' statement, the directors have concluded that it is appropriate to adopt the going concern basis in preparing the financial statements. The going concern basis presumes that the company has adequate resources to remain in operation, and that the directors intend it to do so, for at least one year from the date the financial statements were signed. As part of our audit we have concluded that the directors' use of the going concern basis is appropriate. However, because not all future events or conditions can be predicted, these statements are not a guarantee as to the company's ability to continue as a going concern.

Other required reporting

Consistency of other information

Companies Act 2006 opinion

In our opinion, the information given in the Strategic Report and the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

ISAs (UK & Ireland) reporting

As a result of the directors' voluntary reporting on how they have applied the Code, under ISAs (UK & Ireland) we are required to report to you if, in our opinion:

information in the Annual Report is: • materially inconsistent with the information in the audited financial statements; or • apparently materially incorrect based on, or materially inconsistent with, our knowledge of the company acquired in the course of performing our audit; or • otherwise misleading.	We have no exceptions to report.
the statement given by the directors on **page 48**, in accordance with provision C.1.1 of the Code, that they consider the Annual Report taken as a whole to be fair, balanced and understandable and provides the information necessary for members to assess the company's position and performance, business model and strategy is materially inconsistent with our knowledge of the company acquired in the course of performing our audit.	We have no exceptions to report.
the section of the Annual Report on **page 57**, as required by provision C.3.8 of the Code, describing the work of the Audit Committee does not appropriately address matters communicated by us to the Audit Committee.	We have no exceptions to report.

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

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 Code, under ISAs (UK & Ireland) we are required to report to you if we have anything material to add or to draw attention to in relation to:

the directors' confirmation on **page 48** of the Annual Report, in accordance with provision C.2.1 of the Code, 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.	We have nothing material to add or to draw attention to.
the disclosures in the Annual Report that describe those risks and explain how they are being managed or mitigated.	We have nothing material to add or to draw attention to.
the directors' explanation on **pages 42** of the Annual Report, in accordance with provision C.2.2 of the Code, 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 material to add or to draw attention to.

Adequacy of accounting records and information and explanations received

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, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns.

We have no exceptions to report arising from this responsibility.

Directors' remuneration

Under the Companies Act 2006 we are required to report to you if, in our opinion, certain disclosures of directors' remuneration specified by law are not made. We have no exceptions to report arising from this responsibility.

Responsibilities for the financial statements and the audit

Our responsibilities and those of the directors

As explained more fully in the Statement of Directors' Responsibilities set out on **page 72**, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view.

Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and ISAs (UK & Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's member 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.

What an audit of financial statements involves

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of:

- whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed;
- the reasonableness of significant accounting estimates made by the directors; and
- the overall presentation of the financial statements.

We primarily focus our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

We test and examine information, using sampling and other auditing techniques, to the extent we consider necessary to provide a reasonable basis for us to draw conclusions. We obtain audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Charles Joseland (Senior Statutory Auditor)

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

Cambridge

27 June 2016

Statutory financial statements continued

Income statement for the year ended 31 March 2016 (Registered Number 02546950)

	Note	2016 £000	2015 £000
Revenue	1	**302,622**	296,136
Cost of sales		**(184,521)**	(165,554)
Gross profit		**118,101**	130,582
Administrative expenses		**(52,962)**	(45,688)
Other income		**17,195**	12,536
Operating profit	2	**82,334**	97,430
Finance income	4	**1,978**	628
Finance costs	4	**(38,681)**	(37,801)
Finance costs – net		**(36,703)**	(37,173)
Profit before income tax		**45,631**	60,257
Income tax credit/(expense)	5	**14,101**	(11,330)
Profit for the year		**59,732**	48,927

All profits of the company in the current period and prior period are from continuing operations.
The notes on pages 90 to 124 are an integral part of these financial statements.

Statement of comprehensive income for the year ended 31 March 2016 (Registered Number 02546950)

	Note	2016 £000	2015 £000
Profit for the year		**59,732**	48,927
Other comprehensive income for the year which will not be reclassified to profit or loss:			
Remeasurements of post-employment benefit assets	9	**20,667**	28,595
Deferred income tax on items that will not be reclassified	5	**(3,720)**	(5,719)
Other comprehensive income for the year, net of tax		**16,947**	22,876
Total comprehensive income for the year		**76,679**	71,803

The notes on pages 90 to 124 are an integral part of these financial statements.

Statutory financial statements continued

Statement of financial position as at 31 March 2016 (Registered Number 02546950)

	Note	2016 £000	2015 £000
Assets			
Non-current assets			
Property, plant and equipment	6	**1,259,527**	1,234,907
Intangible assets	7	**43,634**	37,554
Investments	8	**60**	60
Retirement benefit surplus	9	**72,588**	45,098
		1,375,809	1,317,619
Current assets			
Inventories	10	**1,222**	1,262
Trade and other receivables	11	**79,901**	80,573
Cash and cash equivalents	12	**93,444**	58,928
		174,567	140,763
Total assets		**1,550,376**	1,458,382
Equity and liabilities			
Equity			
Ordinary shares	13	**26,506**	26,506
Share premium	13	**1,400**	1,400
Capital contribution reserve	13	**30,150**	30,150
Retained earnings		**181,397**	144,718
Total equity		**239,453**	202,774
Liabilities			
Non-current liabilities			
Trade and other payables	14	**87,977**	84,958
Borrowings	15	**902,243**	835,076
Deferred income tax liabilities	16	**184,652**	196,617
Provisions for other liabilities and charges	17	**2,885**	2,748
		1,177,757	1,119,399
Current liabilities			
Trade and other payables	14	**131,153**	130,587
Current income tax liabilities		**2,013**	5,622
		133,166	136,209
Total liabilities		**1,310,923**	1,255,608
Total equity and liabilities		**1,550,376**	1,458,382

The notes on pages 90 to 124 are an integral part of these financial statements. The statutory financial statements on pages 73 to 125 were approved by the Board of Directors and were signed and authorised for issue on 27 June 2016 on its behalf by:

Simon Cocks **Duncan Bates**

Statement of changes in equity for the year ended 31 March 2016 (Registered Number 02546950)

	Note	Share capital £000	Share premium £000	Capital contribution reserve £000	Retained earnings £000	Total £000
Balance as at 1 April 2014		**26,506**	**1,400**	**30,150**	**103,715**	**161,771**
Profit for the year		-	-	-	48,927	48,927
Other comprehensive income		-	-	-	22,876	22,876
Total comprehensive income		**-**	**-**	**-**	**71,803**	**71,803**
Dividends	18	-	-	-	(30,800)	(30,800)
Total transactions with owners recognised directly in equity		-	-	**-**	**(30,800)**	**(30,800)**
Balance as at 31 March 2015		**26,506**	**1,400**	**30,150**	**144,718**	**202,774**
Balance as at 1 April 2015		**26,506**	**1,400**	**30,150**	**144,718**	**202,774**
Profit for the year		-	-	-	59,732	59,732
Other comprehensive income		-	-	-	16,947	16,947
Total comprehensive income		**-**	**-**	**-**	**76,679**	**76,679**
Dividends	18	-	-	-	(40,000)	(40,000)
Total transactions with owners recognised directly in equity		**-**	**-**	**-**	**(40,000)**	**(40,000)**
Balance as at 31 March 2016		**26,506**	**1,400**	**30,150**	**181,397**	**239,453**

The notes on pages 90 to 124 are an integral part of these financial statements.

Statutory financial statements continued

Statement of cash flows for the year ended 31 March 2016 (Registered Number 02546950)

	Note	2016 £000	2015 £000
Cash flows from operating activities			
Cash generated from operations	19	**129,210**	151,349
Interest paid		**(36,107)**	(32,722)
Income tax paid		**(3,384)**	(1,817)
Group relief paid		**(1,809)**	(4,700)
Net cash generated from operating activities		**87,910**	112,110
Cash flows from investing activities			
Purchases of property, plant and equipment		**(70,924)**	(78,796)
Capital contributions		**4,959**	4,085
Proceeds from sale of property, plant and equipment		**91**	58
Purchases of intangible assets		**(12,545)**	(6,089)
Interest received		**390**	167
Net cash used in investing activities		**(78,029)**	(80,575)
Cash flows from financing activities			
Repurchase of debentures		**-**	(1)
Repayments of borrowings		**-**	(17,200)
Proceeds from loan from subsidiary undertaking		**64,635**	58,568
Equity dividends	18	**(40,000)**	(30,800)
Net cash generated from financing activities		**24,635**	10,567
Net increase in cash and cash equivalents		**34,516**	42,102
Cash and cash equivalents at beginning of year		**58,928**	16,826
Cash and cash equivalents at end of year	12	**93,444**	58,928

The notes on pages 90 to 124 are an integral part of these financial statements.

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. These financial statements are the first statutory financial statements prepared by the company in accordance with FRS 101.

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). For further information on the material adjustments on adoption of FRS 101, see note A8. The adjustments on adoption of FRS 101 take account of the requirements and options in International Financial Reporting Standard 1: 'First-time adoption of International Financial Reporting Standards' ('IFRS 1').

Going concern

Having assessed the principal risks of the company and the other matters discussed in connection with the viability statement on page 42, 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.

ADOPTION OF NEW AND REVISED STANDARDS

The following standards have been adopted by the company for the first time for the financial year beginning on 1 April 2015 and did not have any impact on the current year or any prior year and are not likely to affect future years.

Topic	Key requirements	Effective date
Improvements to IFRS (2012) and IFRS (2013)	This is a collection of amendments to 11 standards as part of the International Accounting Standards Board's programme of annual improvements.	1 July 2014 (EU endorsed from 1 February 2015 and 1 January 2015 respectively)
Amendment to International Accounting Standard ('IAS') 19: 'Employee benefits'	The amendments to IAS 19: 'Employee benefits' permit contributions that are independent of the number of years of service to be recognised as a reduction in the service cost in the period in which the service is rendered, instead of allocating the contributions to periods of service. Other contributions by employees or third parties are required to be attributed to periods of service either using the plan's contribution formula or on a straight-line basis.	1 July 2014 (EU endorsed from 1 February 2015)

Statutory financial statements continued

Accounting policies (continued)

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':
  - 10(f) (a statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements);
  - 16 (statement of compliance with all IFRS);
  - 38B-D (additional comparative information); and
  - 40A-D (requirements for a third statement of financial position)
- Paragraph 30 and 31 of IAS 8: 'Accounting policies, changes in accounting estimates and errors' (requirement for the disclosure of information when an entity has not applied a new IFRS that has been issued but is not yet effective)
- 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 AND JUDGEMENTS

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 below.

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 below.

Measured income accrual

The company records an accrual for measured consumption of water that has not yet been billed (refer to note 11). 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 11). 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.

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

CRITICAL JUDGMENTS 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 6 for the carrying amount of property, plant and equipment.

Statutory financial statements continued

Notes to the financial statements

1. REVENUE

	2016 £000	2015 £000
Unmeasured supplies	**130,448**	129,975
Measured supplies	**165,825**	161,182
Connection charges	**5,564**	4,695
Chargeable services	**785**	284
	302,622	296,136

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:

	2016 £000	2015 £000
Staff costs (note 3.1)	**51,865**	38,342
(Gain)/loss on disposal of property, plant and equipment	**(91)**	24
Purchase of bulk water and water supplied under statutory entitlement	**6,466**	5,497
Water abstraction charges	**3,817**	4,069
Business rates	**16,342**	16,305
Chargeable services direct expenditure	**668**	617
Credit notes received from the Environment Agency in respect of Environmental Impact Unit Charges ('EIUC') levied in 2013/14	**-**	(1,700)
Reimbursement of EIUC levied from 2008 to 2013	**-**	(3,840)
Depreciation of infrastructure assets (note 6)	**10,906**	11,202
Depreciation of other property, plant and equipment (note 6)	**35,533**	33,320
Amortisation of intangible assets (note 7)	**5,019**	4,769
Amortisation of deferred grants and contributions	**(1,447)**	(1,475)
Impairment of trade receivables	**9,286**	9,770
Research and development	**287**	162
Operating lease rentals – land and buildings	**1,547**	1,547
Operating lease rentals – other	**1,908**	2,196
Auditor's remuneration (note 2.3)	**541**	431

2.2 Other income

	2016 £000	2015 £000
Commission and rentals	**17,195**	12,536

The majority of other income relates to commission earned by the company 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 21).

2.3 Auditor's remuneration

During the year the company obtained the following services from its auditor and its associates:

	2016 £000	2015 £000
Fees payable to the company's auditor and its associates for the audit of the financial statements	**130**	147
Fees payable to the company's auditor and its associates for other services:		
Audit of the company's associates	**69**	66
Audit-related assurance services:		
– regulatory reporting	**57**	40
– Thames Water and Anglian Water annual returns	**8**	8
– audit related assurance service - other	**22**	22
Other assurance services including related to bond issue	**137**	28
All other non-audit services	**118**	120
Total auditor's remuneration	**541**	431

3. EMPLOYEES

3.1 Employee benefit expense (including executive directors)

	2016 £000	2015 £000
Wages and salaries	**47,409**	35,936
Social security costs	**4,337**	3,346
Defined benefit pension costs (note 9)	**4,543**	4,132
Defined contribution pension costs (note A5)	**1,355**	974
Other pension administration costs	**1,275**	696
Staff costs	**58,919**	45,084
Staff costs capitalised	**(7,054)**	(6,742)
Staff costs recognised in the income statement	**51,865**	38,342

Statutory financial statements continued

Notes to the financial statements (continued)

3. EMPLOYEES (CONTINUED)

3.2 Average number of people employed

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

By activity	2016	2015
Operations	**645**	541
Customer service	**349**	315
Administration	**200**	100
	1,194	956

160 employees of Affinity Water Shared Service Limited, another group undertaking, were transferred over to the company on 31 March 2015. The company paid Affinity Water Shared Service Limited an amount equal to the salaries of its employees under a Business Transfer Agreement until that date, although Affinity Water Shared Service Limited remained responsible for any employment claims and issuing payslips to employees until 31 March 2015 when the employees were transferred to the company.

3.3 Directors' remuneration

The directors' emoluments were as follows:

	2016 £000	2015 £000
Aggregate emoluments	**1,670**	1,557

Aggregate emoluments in 2015 included £509,000 of discretionary payments paid to a former director in connection with termination of qualifying services during the year. The amount included a termination payment of £344,000, a bonus of £120,000 linked to company and personal performance during 2014/15 and the reimbursement of legal and outplacement costs of £45,000.

At 31 March 2016, post-employment benefits were accruing for one director under a defined benefit plan (31 March 2015: one).

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 sit on the Board and have been appointed by Infracapital Partners II, North Haven Infrastructure Partners LP and Veolia Water UK Limited do 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:

	2016 £000	2015 £000
Aggregate emoluments	**805**	755

Aggregate emoluments include £207,000 of discretionary payments in connection with commencement of qualifying services during the year, representing compensation for the forfeit of variable remuneration arrangements with the relevant director's previous employer.

The highest paid director did not have any amounts accruing under the defined benefit pension plan at 31 March 2016 or 31 March 2015 and 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 and did not have any benefits accruing under any long term incentive schemes.

Further information regarding directors' remuneration during the year can be found within the remuneration report on pages 60 to 68.

4. FINANCE INCOME AND COSTS

	2016 £000	2015 £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	**(34,754)**	(33,795)
Accretion payable in respect of borrowings held at amortised cost with subsidiary undertaking	**(3,189)**	(2,791)
Interest payable on borrowings held at amortised cost	**(38,103)**	(36,746)
Debenture interest	**-**	(1)
Other interest expense	**(578)**	(1,054)
Finance costs	**(38,681)**	(37,801)
Net income from post-employment benefits	**1,588**	461
Bank interest income	**390**	167
Finance income	**1,978**	628
Net finance cost	**(36,703)**	(37,173)

Statutory financial statements continued

Notes to the financial statements (continued)

5. INCOME TAX EXPENSE

5.1 Tax expense included in the income statement

	2016 £000	2015 £000
Current tax:		
– UK Corporation tax on profits for the year	**2,340**	9,097
– Adjustment in respect of prior years	**(756)**	(372)
Total current tax	**1,584**	8,725
Deferred tax:		
– Origination and reversal of temporary differences	**7,129**	2,596
– Impact of change in tax rate	**(19,949)**	-
– Adjustment in respect of prior years	**(2,865)**	9
Total deferred tax	**(15,685)**	2,605
Income tax (credit)/expense	**(14,101)**	11,330

Tax expense assessed for the period is lower (2015: lower) than the standard rate of corporation tax in the UK for the year ended 31 March 2016 of 20% (2015: 21%). The differences are explained below:

	2016 £000	2015 £000
Profit before income tax	**45,631**	60,257
Tax calculated at the standard rate of tax in the UK of 20% (2015: 21%)	**9,126**	12,654
Tax effects of:		
– Adjustments in respect of prior years	**(3,621)**	(363)
– Expenses not deductible for tax purposes	**343**	(961)
– Impact of change in tax rate on deferred tax	**(19,949)**	-
Income tax (credit)/expense	**(14,101)**	11,330

5.2 Tax expense included in the statement of comprehensive income

	2016 £000	2015 £000
Deferred tax:		
– Origination and reversal of temporary differences on retirement benefit surplus	**3,720**	5,719

5.3 Factors that may affect future tax charges

The tax rate for the current year is lower than the prior year due to changes in the UK Corporation tax rate which decreased from 21% to 20% from 1 April 2015.

In October 2015 changes were enacted to the main rate of corporation tax in the UK from 20% to 19% effective from 1 April 2017 and from 19% to 18% effective from 1 April 2020.

In March 2016 a further change was announced to the main rate of corporation tax in the UK from 18% to 17% effective from 1 April 2020. As the change to 17% had not been substantively enacted at the balance sheet date its effects are not included in these financial statements. The overall effect of that change, if it had been applied to the deferred tax balance at the balance sheet date, would be to reduce the net deferred tax liability by an additional £10,140,000 and decrease the expense for the period by £10,140,000.

6. 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 2015	274,508	717,325	18,851	583,563	21,474	111,121	**1,726,842**
Additions	272	1,831	-	1,220	103	69,210	**72,636**
Transfers	7,915	2,610	-	45,624	5,467	(61,616)	**-**
Disposals	-	(1,614)	(4)	-	(565)	-	**(2,183)**
At 31 March 2016	282,695	720,152	18,847	630,407	26,479	118,715	**1,797,295**
Accumulated depreciation							
At 1 April 2015	(73,775)	(11,043)	(127)	(389,263)	(17,727)	-	**(491,935)**
Charge for the year	(4,641)	(10,590)	(316)	(28,571)	(2,321)	-	**(46,439)**
Disposals	-	41	-	-	565	-	**606**
At 31 March 2016	(78,416)	(21,592)	(443)	(417,834)	(19,483)	-	**(537,768)**
Net book amount							
At 1 April 2015	200,733	706,282	18,724	194,300	3,747	111,121	**1,234,907**
Movement in year	3,546	(7,722)	(320)	18,273	3,249	7,594	**24,620**
At 31 March 2016	204,279	698,560	18,404	212,573	6,996	118,715	**1,259,527**

All land and buildings are held as freehold.

Statutory financial statements continued

Notes to the financial statements (continued)

7. INTANGIBLE ASSETS

	Goodwill £000	Internally generated software development costs £000	Total £000
Cost			
At 1 April 2015	14,961	35,730	**50,691**
Additions	-	11,099	**11,099**
At 31 March 2016	14,961	46,829	**61,790**
Accumulated amortisation			
At 1 April 2015	-	(13,137)	**(13,137)**
Charge for the year	-	(5,019)	**(5,019)**
At 31 March 2016	-	(18,156)	**(18,156)**
Net book amount			
At 1 April 2015	14,961	22,593	**37,554**
Movement in year	-	6,080	**6,080**
At 31 March 2016	14,961	28,673	**43,634**

Goodwill includes £8,283,000 relating to the unification of the 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.

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 flows for the entity, by means of supplying drinking water to customers. The recoverable amount has been determined using the regulatory capital value of Affinity Water Limited at 31 March 2016. 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.

Internally generated software development costs include £5,535,000 (2015: £1,293,000) of expenditure in relation to a new work management information system.

8. INVESTMENTS

	2016 £000	2015 £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.

9. 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:

	2016 £000	2015 £000
Current service cost	**(4,543)**	(4,132)
Pension expense charged to operating profit	**(4,543)**	(4,132)
Net pension interest income credited to finance income	**1,588**	461
Net pension expense charged before taxation	**(2,955)**	(3,671)

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

	2016 £000	2015 £000
At 1 April	**45,098**	6,611
Employer contributions	**9,778**	7,979
Current service cost	**(4,543)**	(4,132)
Net asset assumed from pension plan transfer	**-**	5,584
Net interest income	**1,588**	461
Net re-measurement gain	**20,667**	28,595
At 31 March	**72,588**	45,098

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

	2016 £000	2015 £000
Re-measurement (losses)/gains on plan assets	**(5,311)**	55,664
Re-measurement gains/(losses) on plan liabilities	**25,978**	(27,069)
	20,667	28,595

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

Statutory financial statements continued

Notes to the financial statements (continued)

10. INVENTORIES

	2016 £000	2015 £000
Raw materials and consumables	**1,222**	1,262

Inventories are stated after provisions for impairment of £603,000 (2015: £517,000).

11. TRADE AND OTHER RECEIVABLES

	2016 £000	2015 £000
Trade receivables	**54,883**	55,364
Less: provision for impairment of trade receivables	**(26,313)**	(24,645)
Trade receivables - net	**28,570**	30,719
Amounts owed by group undertakings	**-**	403
Amounts owed by related parties	**583**	309
Other receivables	**3,478**	3,774
Unbilled accrual for metered customers	**41,455**	39,876
Prepayments and accrued income	**5,815**	5,492
	79,901	80,573

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

11.1 Provision for impairment of trade receivables

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

	2016 £000	2015 £000
At 1 April	**24,645**	24,324
Provision for receivables impairment charged to income statement	**9,286**	9,770
Receivables written off during the year as uncollectable	**(7,618)**	(9,449)
At 31 March	**26,313**	24,645

At 31 March 2016 and 2015, the company had no trade receivables that were overdue and not individually impaired.

11.2 Aging analysis of trade receivables

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

	2016 £000	2015 £000
Aged less than one year	**16,996**	19,990
Aged between one year and two years	**10,687**	9,813
Aged greater than two years	**887**	916
	28,570	30,719

12. CASH AND CASH EQUIVALENTS

	2016 £000	2015 £000
Cash at bank and in hand	**23,275**	28,928
Term deposits	**70,169**	30,000
	93,444	58,928

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

13. 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 2015 and 31 March 2016	265,058	26,506	1,400	30,150	**58,056**

All shares rank pari passu in all respects.

Statutory financial statements continued

Notes to the financial statements (continued)

14. TRADE AND OTHER PAYABLES

	2016 £000	2015 £000
Non-current		
Amounts falling due after more than one year		
Deferred grants and contributions	**5,807**	6,133
Amounts falling due after more than five years		
Deferred grants and contributions	**82,170**	78,825
	87,977	84,958
Current		
Amounts falling due within one year:		
Trade payables	**8,120**	14,216
Amounts due to group undertakings	**308**	116
Amounts due to related parties	**206**	-
Interest payable to subsidiary companies	**12,642**	12,346
Interest payable to intermediate parent company	**-**	80
Interest payable to external parties	**63**	159
Social security and other taxes	**1,237**	1,276
Other payables	**8,111**	12,805
Capital accruals	**17,022**	16,755
Deferred grants and contributions	**1,187**	1,166
Payments received in advance	**47,522**	41,951
Other accruals and deferred income	**34,735**	29,717
	131,153	130,587
	219,130	215,545

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

15. BORROWINGS

	2016 £000	2015 £000
Borrowings measured at amortised cost:		
Loan from Affinity Water Finance (2004) PLC financed by bond issue	**255,045**	255,411
Loan from Affinity Water Programme Finance Limited financed by bond issue	**643,614**	576,081
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
	902,243	835,076

On 13 July 2004, 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, 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 index-linked Notes maturing in June 2045 with a coupon of 1.548% and £95,000,000 Class B Guaranteed RPI index-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 index-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%. 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 issued bonds. This guarantee constitutes 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. These issues are also guaranteed by Affinity Water Holdings Limited, the immediate parent undertaking of Affinity Water Limited.

The fair value of the bonds on-lent from the two financing subsidiaries at 31 March 2016 is £1,056,079,000 (2015: £1,006,791,000), 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)

16. DEFERRED INCOME TAX LIABILITIES

16.1 Analysis of deferred tax assets and deferred tax liabilities

	2016 £000	2015 £000
Deferred tax assets:		
Deferred tax asset to be recovered after more than 12 months	**(881)**	(857)
Deferred tax asset to be recovered within 12 months	**-**	(6,289)
	(881)	(7,146)
Deferred tax liabilities:		
Deferred tax liability to be recovered after more than 12 months	**185,533**	203,763
	185,533	203,763
Deferred tax liabilities - net	**184,652**	196,617

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

	2016 £000	2015 £000
At 1 April	**196,617**	187,176
(Credited)/charged to the income statement	**(15,685)**	2,605
Charged to other comprehensive income	**3,720**	5,719
Transferred from group undertaking	**-**	1,117
At 31 March	**184,652**	196,617

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

16.2 Deferred tax liabilities

	Accelerated capital allowances £000	Retirement benefit obligations £000	Total £000
At 1 April 2014	193,345	1,322	**194,667**
Charged to the income statement	1,398	862	**2,260**
Charged to other comprehensive income	-	5,719	**5,719**
Transferred from group undertaking	-	1,117	**1,117**
At 31 March 2015	194,743	9,020	**203,763**
(Credited)/charged to the income statement	(22,276)	326	**(21,950)**
Charged to other comprehensive income	-	3,720	**3,720**
At 31 March 2016	172,467	13,066	**185,533**

16.3 Deferred tax assets

	Provisions £000	Other £000	Total £000
At 1 April 2014	(2,032)	(5,460)	**(7,492)**
Charged/(credited) to the income statement	559	(213)	**346**
At 31 March 2015	(1,473)	(5,673)	**(7,146)**
Charged to the income statement	592	5,673	**6,265**
At 31 March 2016	(881)	-	**(881)**

Statutory financial statements continued

Notes to the financial statements (continued)

17. PROVISIONS FOR OTHER LIABILITIES AND CHARGES

	Insurance £000	Other £000	Total £000
At 1 April 2014	1,609	2,217	**3,826**
Charged to the income statement	15	-	**15**
Utilised in the year	-	(1,093)	**(1,093)**
At 31 March 2015	1,624	1,124	**2,748**
Charged to the income statement	126	251	**377**
Utilised in the year	(240)	-	**(240)**
At 31 March 2016	1,510	1,375	**2,885**

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 (2015: £670,000) in relation to unfunded pension liabilities for a former non-executive director, which will be utilised over the 20 years from January 2019. The remaining balance relates to outstanding legal claims at 31 March 2016.

18. DIVIDENDS

	2016 £000	2015 £000
First interim paid of 3.40p per share (2015: 4.26p)	**9,000**	11,300
Second interim paid of 2.08p per share (2015: 2.45p)	**5,500**	6,500
Third interim paid of 5.09p per share (2015: 2.64p)	**13,500**	7,000
Fourth interim paid of 3.02p per share (2015: 2.26p)	**8,000**	6,000
Fifth interim paid of 1.51p per share (2015: nil)	**4,000**	-
	40,000	30,800

19. CASH GENERATED FROM OPERATIONS

	2016 £000	2015 £000
Profit before income tax	**45,631**	60,257
Adjustments for:		
Depreciation of property, plant and equipment (note 6)	**46,439**	44,522
Amortisation of grants and contributions	**(1,447)**	(1,475)
Amortisation of intangible fixed assets (note 7)	**5,019**	4,769
(Profit)/loss on disposal of property, plant and equipment	**(91)**	24
Loss on disposal of infrastructure assets	**1,577**	2,670
Post-employment benefits	**(5,235)**	(3,847)
Finance costs – net (note 4)	**36,703**	37,173
Changes in working capital:		
– Inventories	**40**	150
– Trade and other receivables	**(672)**	(3,835)
– Trade and other payables: - provision element	**137**	(1,078)
- other	**1,109**	12,019
Cash generated from operations	**129,210**	151,349

20. COMMITMENTS

20.1 Capital commitments

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

	2016 £000	2015 £000
Property, plant and equipment	**22,333**	9,454
Intangible assets	**900**	946
	23,233	10,400

20.2 Commitments under operating leases

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

	2016		2015	
	Land and buildings £000	Other £000	Land and buildings £000	Other £000
No later than one year	**1,547**	**1,751**	1,547	1,497
Later than 1 year and no later than 5 years	**6,187**	**2,721**	6,187	2,550
Later than 5 years	**6,832**	**2**	8,379	-
	14,566	**4,474**	16,113	4,047

Statutory financial statements continued

Notes to the financial statements (continued)

21. 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 2016 (2015: £nil).

22. EVENTS AFTER THE REPORTING PERIOD

There were no significant events after the end of the reporting period.

23. 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 majority owned by Affinity Water Acquisitions (Investments) Limited, a company registered in England and Wales. Affinity Water Acquisitions (Investments) Limited is the parent undertaking of the smallest and largest group to consolidate the statutory financial statements of this company.

The directors consider that Affinity Water Acquisitions (Investments) Limited is the ultimate holding and controlling company in the United Kingdom.

Copies of the group financial statements of Affinity Water Acquisitions (Investments) Limited for the year ended 31 March 2016 may be obtained from the Company Secretary, Tamblin Way, Hatfield, Hertfordshire, AL10 9EZ.

Affinity Water Acquisitions (Investments) Limited is 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. Veolia Environnement S.A. holds 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. The directors consider Infracapital Partners II and North Haven Infrastructure Partners LP to be the company's ultimate controllers, as they are in a position to exercise material influence over the company's policy and affairs.

Infracapital Partners II is a European infrastructure fund managed by M&G Alternatives Investment Management Limited, a subsidiary of Prudential plc. Infracapital Partners II LP was established in 2010 and Infracapital Partners (NT) II LP was established in 2012, to make investments in income-generative infrastructure assets and businesses, including electricity and gas networks, water companies, transport infrastructure and renewable energy.

North Haven Infrastructure Partners LP is a leading global infrastructure investment fund. It is managed by Morgan Stanley Infrastructure Inc., part of the investment management division of Morgan Stanley. North Haven Infrastructure Partners LP targets core infrastructure assets that provide essential public goods and services to societies across the globe and seeks to improve asset performance using active management.

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 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 23 for details of the company's parent company and ultimate parent company.

A2. SEGMENTAL REPORTING

As financial information was reported 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 Affinity Water Acquisitions (Investments) Limited, which is the parent undertaking of the smallest and largest group to consolidate the statutory financial statements. It is included in the consolidated financial statements of Affinity Water Acquisitions (Investments) Limited which are 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 (or deemed cost for infrastructure assets held on transition to FRS 101, refer to note A8) 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 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 for other property, plant and equipment includes own work capitalised comprising the direct costs of materials, labour and applicable overheads.

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A3. ACCOUNTING POLICIES (CONTINUED)

Property, plant and equipment (continued)

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 CGU 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 fixed 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.

Computer software

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 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 three months or less. Term deposits with original maturities longer than three months that can be redeemed, subject to the interest income being forfeited, are classed as cash and cash equivalents if the deposit is held to meet short term cash needs and there is no risk of a significant change in value as a result of an early withdrawal.

Current and deferred income 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 income 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 income 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.

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.

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A3. ACCOUNTING POLICIES (CONTINUED)

Revenue recognition

Revenue represents the fair value of the 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.

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.

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 ('Anglian Water'). 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 AWPP) providing defined benefits based on final pensionable salary. The plan had separate Central, East and Southeast divisions until 31 March 2015 when the Shared Services division was transferred to the company and its pension plan consolidated with these divisions into one final salary section. 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.

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 by the company's shareholder.

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 page 35 of the strategic report 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 regards 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 twelve 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 2016, the company had £251,444,000 (2015: £216,928,000) of available liquidity, which comprised £93,444,000 (2015: £58,928,000) of cash and term deposits and £158,000,000 (2015: £158,000,000) of undrawn committed borrowing facilities.

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A4. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTINUED)

Liquidity risk (continued)

The company had available the following undrawn borrowing facilities:

	2016 £000	2015 £000
Floating rate:		
Expiring within one year	**58,000**	58,000
Expiring in more than one year but not more than two years	**-**	-
Expiring in more than five years	**100,000**	100,000
	158,000	158,000

In July 2015 the company refinanced its existing £100,000,000 syndicated facility provided by five banks. The facility has been replaced with 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 company also has available 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 2016	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	**1,509,856**	**35,361**	**35,533**	**35,717**	**35,907**	**36,101**	**1,331,237**
Loan from intermediate parent	**6,745**	**160**	**160**	**160**	**160**	**160**	**5,945**
Borrowings	**1,516,601**	**35,521**	**35,693**	**35,877**	**36,067**	**36,261**	**1,337,182**
At 31 March 2015	**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	1,458,586	34,530	34,643	34,780	34,943	35,111	1,284,579
Loan from intermediate parent	6,905	160	160	160	160	160	6,105
Borrowings	1,465,491	34,690	34,803	34,940	35,103	35,271	1,290,684

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 the water industry economic regulator 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 11).

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 2016 and 31 March 2015, the maximum exposure to credit risk was represented by the carrying amount of each financial asset in the statement of financial position:

	2016 £000	2015 £000
Cash and term deposits (note 12)	**93,444**	58,928
Trade and other receivables (note 11)	**79,901**	80,573
	173,345	139,501

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 RPI inflation, form a partial economic hedge of the company's regulatory assets, which are also linked to RPI inflation.

Interest rate and inflation risk is 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	Total £000
31 March 2016	**583,888**	**318,355**	**902,243**
31 March 2015	584,003	251,073	835,076

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A4. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTINUED)

Interest rate and inflation risk (continued)

Sensitivity analysis

Sensitivity analysis has not been performed on movements in interest rates as the company's borrowings had no exposure to interest rates as at 31 March 2016.

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

	2016 £000	2015 £000
1 per cent increase in RPI	**(3,156)**	(2,621)
1 per cent decrease in RPI	**3,154**	2,621

The analysis assumes a one per cent change in RPI having a corresponding one per cent impact on this position over the next 12-month period.

Currency risk

The company has no material net exposure to movements in currency rates.

Capital risk management

The policy approved by the Board is a target gearing, 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 75% at 31 March 2016 (80% at 31 March 2015).

Assuming no significant changes to existing credit rating agencies' methodologies or sector risk assessments, the company aims to maintain the existing credit ratings of A3 with Moody's and A- with Standard & Poors 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.

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 plan holds 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 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 the 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 March 2013. 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 0.15% per annum;
CPI inflation:	measured by reference to the RPI inflation curve described above less 0.7% 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% 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.

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A5. RETIREMENT BENEFITS (CONTINUED)

Defined benefit section – employer contributions

Based on the actuarial valuation at 31 March 2013, the contributions expected to be paid in the year ending 31 March 2017 are £9,656,000 (£9,174,000 in the year ended 31 March 2016). A formal actuarial valuation of the defined benefit section of the AWPP at 31 December 2015 was in the process of being carried out at the date of approval of these financial statements. This will form the basis of future funding arrangements and the funding policy affecting future contributions.

The weighted average duration of the defined benefit obligation is 17.1 years (2015: 17.9 years).

Defined benefit section - financial and demographic assumptions

Adjustments to the valuation at 31 March 2013 have been made based on the following assumptions:

	2016	2015
Discount rate	**3.55% pa**	3.15% pa
Salary growth	**2.85% pa**	2.90% pa
RPI	**2.85% pa**	2.90% pa
CPI	**1.85% pa**	1.90% 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)	**24**	24
Life expectancy from age 65 (years) for a female participant currently aged 45 (years)	**26**	27

Deferred pensions are revalued to retirement age in line with the CPI assumption of 1.85% per annum (2015: 1.90% per annum) unless otherwise prescribed by statutory requirements or the plan rules.

Defined benefit section - sensitivity analysis

	Change in assumption	Impact on defined benefit obligation	Change in assumption	Impact on defined benefit obligation
2016				
Discount rate	**0.5% decrease**	**8.1% increase**	**0.5% increase**	**8.1% decrease**
Salary growth	**0.5% increase**	**0.9% increase**	**0.5% decrease**	**0.9% decrease**
Pension growth rate	**0.5% increase**	**6.7% increase**	**0.5% decrease**	**6.7% decrease**
Life expectancy	**1 year increase**	**3.0% increase**	**1 year decrease**	**3.0% decrease**
2015				
Discount rate	0.5% decrease	8.9% increase	0.5% increase	8.2% decrease
Salary growth	0.5% increase	1.6% increase	0.5% decrease	1.5% decrease
Pension growth rate	0.5% increase	8.9% increase	0.5% decrease	8.2% decrease
Life expectancy	1 year increase	3.0% increase	1 year decrease	3.1% 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 %	2016 £000	Plan assets %	2015 £000
Equity securities	**15%**	**64,980**	17%	71,432
Debt securities	**27%**	**113,920**	24%	100,990
Diversified growth funds	**24%**	**99,000**	19%	77,810
Property	**1%**	**4,370**	1%	4,037
Infrastructure	**2%**	**10,240**	2%	10,193
Liability driven investments	**31%**	**129,110**	36%	151,920
Cash and cash equivalents	**0%**	**880**	1%	2,840
Total fair value of the plan's assets	**100%**	**422,500**	100%	419,222
Present value of defined benefit obligations		**(349,912)**		(374,124)
Net retirement benefit surplus		**72,588**		45,098

Defined benefit section - fair value of plan assets

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

	2016 £000	2015 £000
At 1 April	**419,222**	320,330
Benefits paid	**(15,167)**	(13,714)
Employer contributions	**9,778**	7,979
Contributions by plan participants	**844**	745
Assets assumed from pension plan transfer	**-**	34,562
Interest income	**13,134**	13,656
Re-measurement (losses)/gains	**(5,311)**	55,664
At 31 March	**422,500**	419,222

Defined benefit section - present value of plan liabilities

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

	2016 £000	2015 £000
At 1 April	**(374,124)**	(313,719)
Benefits paid	**15,167**	13,714
Contributions by plan participants	**(844)**	(745)
Current service cost	**(4,543)**	(4,132)
Liabilities assumed from pension plan transfer	**-**	(28,978)
Interest expense	**(11,546)**	(13,195)
Re-measurement gains/(losses)	**25,978**	(27,069)
At 31 March	**(349,912)**	(374,124)

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A5. RETIREMENT BENEFITS (CONTINUED)

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 new employees.

The total pension charge for the defined contribution section of the Affinity Water Pension Plan ('AWPP') for the year ended 31 March 2016 was £1,355,000 (2015: £974,000). There are no amounts prepaid or outstanding in respect of the defined contribution section at 31 March 2016 (2015: nil).

A6. SUBSIDIARIES

Name of company	Country of registration/ incorporation	Nature of business	Type of holding	Proportion of voting rights and shares held
Affinity Water Finance (2004) PLC	United Kingdom	Financing company	Ordinary shares	100%
Affinity Water Programme Finance Limited	Cayman Islands	Financing company	Ordinary shares	100%
Three Valleys Water Limited	United Kingdom	Dormant company	Ordinary shares	100%
Tendring Hundred Water Services Limited	United Kingdom	Dormant company	Ordinary shares	100%
Folkestone and Dover Water Services Limited	United Kingdom	Dormant company	Ordinary shares	100%
White Cliffs Water Limited	United Kingdom	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 2016 (2015: £2,000).

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 £3,000 in the year ended 31 March 2016 (2015: £4,000).

A7. RELATED PARTY TRANSACTIONS

a) Purchases of goods and services

			2016		2015	
Related party	Nature of Relationship	In respect of	Value £000	Balance £000	Value £000	Balance £000
Veolia Water UK Limited	Shareholder	Management and technical support	**256**	**206**	50	-
Veolia Environmental Services (UK) Limited	Partial common ownership	Waste water disposal	**350**	**-**	254	-
VWS (UK) Limited	Partial common ownership	Transport and other services	**715**	**-**	114	-
Veolia Water Organics Recycling Limited	Partial common ownership	Waste disposal	**-**	**-**	41	-

b) Sales of goods and services

			2016		2015	
Related party	Nature of Relationship	In respect of	Value £000	Balance £000	Value £000	Balance £000
Veolia Water UK Limited	Shareholder	Transitional services, capability sharing agreement and other support	**302**	**334**	178	17
Veolia Environmental Services (UK) Limited	Partial common ownership	Waste water disposal	**22**	**2**	-	-
Other Veolia entities	Partial common ownership	Transitional services, capability sharing agreement and laboratory services	**84**	**247**	112	292

c) Term deposit

			2016		2015	
Related party	Nature of Relationship	In respect of	Value £000	Balance £000	Value £000	Balance £000
Morgan Stanley Liquidity Funds	Common ownership	Term deposit and interest thereon	**9**	**10,000**	-	-

See note 3 for disclosure of the directors' remuneration.

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A8. EXPLANATION OF TRANSITION TO FRS 101

This is the first year that the company has presented its financial statements in accordance with FRS 101. Comparative information for the year ended 31 March 2016, the year ended 31 March 2015, has been represented under FRS 101, the date of transition being 1 April 2014.

The company has elected to continue to prepare its financial statements under FRS 101 for the year ending 31 March 2017, taking the disclosure exemptions applied in the preparation of the financial statements for the year ended 31 March 2016.

Reconciliation of equity

	1 April 2014 £000	31 March 2015 £000
Equity reported under UK GAAP (as previously reported)	352,317	372,370
Opening adjustments to equity on transition to FRS 101 (see Opening adjustments to equity at 1 April 2014 section)	(190,546)	(190,546)
Reversal of goodwill amortisation (see note a)	-	452
Treatment of infrastructure assets (see note b)	-	3,247
Treatment of grants and contributions (see note c)	-	1,686
Treatment of Grafham reservoir (see note d)	-	(87)
Removal of pension asset limit (see note e)	-	2,746
Reversal of discounting deferred tax liability under UK GAAP (see note f)	-	10,435
Other adjustments to deferred tax liability under IAS 12 (see note f)	-	2,471
Equity reported under FRS 101	**161,771**	**202,774**

Opening adjustments to equity at 1 April 2014

Initial exemptions on first time adoption

In preparing its opening statement of financial position and adjusting amounts reported previously in accordance with UK GAAP, the company applied IFRS 1, which contains a number of voluntary exemptions and mandatory exceptions from the requirement to apply IFRS retrospectively.

The company applied the following exemptions and exceptions:

- Estimates – Hindsight has not been used to create or revise estimates. The estimates previously made by the company under UK GAAP have not been revised for the application of IFRS except where necessary to reflect any difference in accounting policies.
- Business combinations - Under IFRS 1, a first-time adopter may elect not to apply IFRS 3: 'Business combination' retrospectively to past business combinations that occurred before the date of transition to IFRS. The company has elected to apply IFRS 3 prospectively from the date of transition. Accordingly, business combinations completed prior to the transition date have not been restated, thus any goodwill arising from business combinations which took place before the date of transition is recognised at the carrying amount based on UK GAAP.
- Deemed cost of property, plant and equipment – As described below, the company has measured the opening position of its infrastructure assets at their deemed cost, derived from an event driven fair value.

Intangible assets

Under IAS 38: 'Intangible assets', software and development costs, which were capitalised as tangible fixed assets under the previous reporting framework, are classified as intangible assets. This led to a reclassification of £21,571,000 at 1 April 2014.

Infrastructure assets

Under UK GAAP, the company's infrastructure assets were accounted for in accordance with the renewals accounting provisions of Financial Reporting Standard ('FRS') 15: 'Tangible fixed assets'. Such provisions are not present within IAS 16: 'Property, plant and equipment'.

Under renewals accounting, the infrastructure network was assumed to be a single asset. Expenditure on infrastructure assets relating to increases in capacity or enhancements to the network and on maintaining the operating capability of the network in accordance with defined standards of service was capitalised. The depreciation charged was effectively the estimated anticipated level of annual expenditure required to maintain the operating capability of the network. Grants and contributions relating to the infrastructure network were deducted from the cost of infrastructure assets.

Under IAS 16: 'Property, plant and equipment' this treatment may not be applied. Significant parts within the infrastructure network, principally water pipes, were identified and useful lives and residual values determined so that each significant part could be depreciated individually.

The opening position of infrastructure assets on transition is their deemed cost, derived from an event-driven fair value established in June 2012 and adjusted for subsequent depreciation, capital expenditure, transfers at cost from assets in the course of construction and disposals.

The significant parts recognised were based on the material used to construct the water pipe concerned. These were assigned zero residual values at the end of their useful lives, which range from 50 to 150 years.

Historical grants and contributions at 1 April 2014 of £94,438,000 relating to the enhancement of the infrastructure network were removed from the cost of infrastructure assets and recognised as deferred income at their amortised amount of £80,643,000 (£1,120,000 due within one year and £79,523,000 due after more than one year), with the amortisation of £13,795,000 recognised in the income statement. £87,734,000 of historical grants and contributions at 1 April 2014 given in compensation for expenses incurred with no future related costs were removed from the cost of infrastructure assets and recognised in the income statement. Infrastructure assets were subsequently revalued downwards to the opening position at 1 April 2014 determined through the process described above.

£4,691,000 of costs in work in progress at 1 April 2014 relating to the aforementioned historical grants and contributions recognised in the income statement were written off from the cost of tangible fixed assets and recognised in the income statement.

Grafham reservoir

The accounting treatment for the entitlement to water from the Grafham reservoir owned and operated by Anglian Water was revisited on adoption of FRS 101, as International Financial Reporting Interpretations Committee ('IFRIC') 4: 'Determining whether an arrangement contains a lease' provides specific guidance, not provided in UK GAAP accounting standards, on determining whether an arrangement contains a lease.

On assessment, the Grafham arrangement was found not to contain a lease under IFRIC 4: 'Determining whether an arrangement contains a lease'. Furthermore the arrangement did not meet the definition of a joint arrangement in order to be accounted for as such in accordance with IFRIC 11: 'Joint arrangements'. The arrangement was considered to be a purchase contract for the supply of goods under IFRS and the treatment of the arrangement as a quasi-finance lease under UK GAAP was reversed on adoption of FRS 101. This led to a reduction in current liabilities of £1,005,000 and in non-current liabilities of £18,396,000 at 1 April 2014.

Retirement benefit obligations

Under UK GAAP, the company applied an asset limit to its net pension asset at 1 April 2014 of £3,500,000. This asset limit was removed on assessment of the pension assets and liabilities under IFRIC 14: 'The limit on a defined benefit asset, minimum funding requirements and their interaction', as the company has an unconditional right to a refund of surplus in the event of a plan wind-up.

In addition, IAS 19: 'Employee benefits' requires that pension assets or liabilities are presented gross of the related deferred tax.

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A8. EXPLANATION OF TRANSITION TO FRS 101 (CONTINUED)

Deferred tax

Under UK GAAP, the company had elected to apply discounting to its deferred tax liability. Under IAS 12: 'Income taxes', discounting is not permitted. The impact of eliminating discounting from the accounting for deferred tax was to increase the deferred tax liability at 1 April 2014 by £44,169,000.

IAS 12: 'Income taxes' takes a different approach to deferred tax from that applied by FRS 19: 'Deferred tax'. Under IAS 12: 'Income taxes' deferred tax must be provided for on all temporary differences between the carrying amount of an asset or liability in the statement of financial position and its tax base, whereas under FRS 19: 'Deferred tax' deferred tax must be provided for on timing differences between the treatment of items in the tax computation and the income statement. This change in approach results in deferred tax provisions under IAS 12 for items which under FRS 19: 'Deferred tax' would be permanent differences and hence would not be provided for.

The difference in approach results in deferred tax being provided on previous revaluations to the tangible fixed assets owned by the company, including those revalued prior to the business combination with Affinity Water East Limited and Affinity Water Southeast Limited. For the purposes of IAS 12, revaluation of the assets results in an increase in their carrying amount on the statement of financial position with no corresponding increase in their tax base, as tax relief is not given for the revalued amount, therefore giving rise to a temporary difference on which a deferred tax liability is recognised. The impact on the company's statement of financial position under IFRS was to increase the deferred tax liability at 1 April 2014 by £101,573,000.

Other IAS 12 adjustments resulted in a decrease in the deferred tax liability at 1 April 2014 of £4,146,000.

The net impact of the above adjustments, and the reclassification of deferred tax on the pension asset of £622,000 from the retirement benefit obligation to deferred tax provisions, was to increase the deferred tax liability as at 1 April 2014 by £142,218,000.

Reconciliation of total comprehensive income

	Year ended 31 March 2015 £000
Total comprehensive income for the financial year under UK GAAP	**50,853**
Adjustments to profit for the year	
Reversal of goodwill amortisation (see note a)	452
Treatment of infrastructure assets (see note b)	3,247
Treatment of grants and contributions (see note c)	1,686
Treatment of Grafham reservoir (see note d)	(87)
Application of IAS 19 (revised) (see note e)	(2,131)
Reversal of discounting deferred tax liability under UK GAAP (see note f)	10,435
Other adjustments to deferred tax liability under IAS 12 (see note f)	2,471
Total adjustments to profit for the year	16,073
Adjustments to other comprehensive income	
Application of IAS 19 (revised) (see note e)	2,131
Removal of pension asset limit (see note e)	2,746
Total adjustments to other comprehensive income	4,877
Total comprehensive income for the financial year under FRS 101	**71,803**

Statutory financial statements continued

Notes to the financial statements – appendices (continued)

A8. EXPLANATION OF TRANSITION TO FRS 101 (CONTINUED)

a) Intangible assets

Software and development costs with a net book value of £22,593,000 at 31 March 2015, which were capitalised as tangible fixed assets under UK GAAP, were reclassified as intangible assets under IAS 38: 'Intangible assets'. The change in treatment did not have an impact on net profit for the year ended 31 March 2015.

£6,089,000 of software and development expenditure was reclassified in the statement of cash flows for the year ended 31 March 2015 from purchases of property, plant and equipment to purchases of intangible assets.

Goodwill is considered to have an indefinite useful economic life under IAS 38: 'Intangible assets'. Therefore amortisation of £452,000 was not recognised in the income statement under FRS 101.

b) Infrastructure assets

As described previously, the renewals accounting provisions of FRS 15: 'Tangible fixed assets' are not present in IAS 16: 'Property, plant and equipment'. The infrastructure renewals charge of £36,092,000 recognised in cost of sales and infrastructure renewals expenditure included within tangible fixed assets under UK GAAP for the year ended 31 March 2015 was not recognised under FRS 101.

£17,120,000 of expenditure on infrastructure assets during the year ended 31 March 2015 relating to increases in capacity, enhancements or material replacements of network components was capitalised to tangible fixed assets in accordance with IAS 16: 'Property, plant and equipment' with the remaining amount of £18,972,000 being recognised within cost of sales under FRS 101. Furthermore, £21,132,000 of expenditure was reclassified in the statement of cash flows for the year ended 31 March 2015 from purchases of property, plant and equipment to reduce cash generated from operations.

Infrastructure assets are depreciated on a straight-line basis over their useful economic lives under FRS 101, and are:

Potable water distribution mains	50-150 years
Raw water pipes	50-150 years

Depreciation of £11,203,000 was recognised in cost of sales under FRS 101, together with £2,670,000 of costs associated with abandoning infrastructure assets before the end of their useful economic lives.

The net impact of the change in treatment of infrastructure assets was to increase net profit for the year ended 31 March 2015 under FRS 101 by £3,247,000.

c) Grants and contributions

£98,120,000 of grants and contributions netted against infrastructure assets at 31 March 2015 under UK GAAP relating to the enhancement of the infrastructure network were removed from the cost of infrastructure assets and recognised as deferred income at their amortised amount of £83,099,000 under FRS 101, with amortisation of £1,227,000 recognised in net profit for the year ended 31 March 2015.

£92,430,000 of grants and contributions at 31 March 2015 netted against infrastructure assets at 31 March 2015 under UK GAAP given in compensation for expenses incurred with no future related costs were removed from the cost of infrastructure assets and recognised in the income statement under FRS 101. £4,695,000 relating to the year ended 31 March 2015 was recognised in revenue in the income statement prepared under FRS 101 with associated expenditure of £4,236,000 recognised in cost of sales.

Infrastructure assets were subsequently revalued downwards to their position at 31 March 2015 determined through applying the treatment described in the paragraphs preceding those relating to the treatment of grants and contributions to the opening position at 1 April 2014.

The net impact of the change in treatment of grants and contributions was to increase net profit for the year ended 31 March 2015 under FRS 101 by £1,686,000.

£7,605,000 of cash received relating to grants and contributions given in compensation for expenses incurred with no future related costs was reclassified in the statement of cash flows for the year ended 31 March 2015 from capital contributions to increase cash generated from operations. £4,236,000 of associated expenditure was also reclassified in the statement of cash flows for the year ended 31 March 2015 from purchases of property, plant and equipment to reduce cash generated from operations.

d) Grafham reservoir

The treatment of the arrangement as a quasi-finance lease under UK GAAP was reversed under FRS 101. This led to a reduction in current liabilities of £1,201,000 and in non-current liabilities of £19,600,000 at 31 March 2015.

As a result of treating the arrangement as a purchase contract for the supply of goods, an additional £1,029,000 of costs relating to the arrangement were recognised in cost of sales in the income statement for the year ended 31 March 2015 prepared under FRS 101. This included a reclassification of £942,000 of costs recognised as interest payable in the income statement for the year ended 31 March 2015 prepared under UK GAAP. £1,019,000 of depreciation charged on expenditure capitalised in tangible fixed assets under UK GAAP was reclassified to bulk water purchases within cost of sales under FRS 101. The change in treatment of this arrangement reduced net profit for the year ended 31 March 2015 by £87,000 under FRS 101.

The impact of this adjustment on the statement of cash flows for the year ended 31 March 2015 was not material.

e) Retirement benefit obligations

Under UK GAAP, the company applied an asset limit to its net pension asset at 31 March 2015 of £6,932,000. This asset limit and the associated deferred tax liability of £1,386,000 were removed on assessment of the pension assets and liabilities under IFRIC 14: 'The limit on a defined benefit asset, minimum funding requirements and their interaction'. The reversal of the £2,746,000 movement in the asset limit net of deferred tax in the year ended 31 March 2015 increased other comprehensive income under FRS 101.

Under IAS 19 (revised): 'Employee Benefits' the expected return on scheme assets was made equal to the discount rate used to calculate present value of scheme liabilities. The impact was a £2,131,000 reclassification between profit and other comprehensive income.

In addition, IAS 19: 'Employee benefits' requires that pension assets or liabilities are presented gross of the related deferred tax amounting to a deferred tax liability of £9,019,000.

f) Deferred tax

Under IAS 12: 'Income taxes', discounting is not permitted. The impact of reversing the discounting of the deferred tax liability under UK GAAP at 31 March 2015 was to reduce the deferred tax charge under International Accounting Standard 12: 'Income taxes' by £10,435,000 for the year ended 31 March 2015.

Other FRS 101 adjustments resulted in a further £2,471,000 reduction of the deferred tax charge for the year ended 31 March 2015 under IAS 12: 'Income taxes'.

g) Cash and cash equivalents

Under UK GAAP, the company presented £15,000,000 of cash deposits with a maturity of greater than one day but less than twelve months within liquid resources at 31 March 2015 for the purposes of the statement of cash flows. These cash deposits were included as cash and cash equivalents within the statement of cash flows prepared under IAS 7: 'Statement of cash flows'. Refer to note A3 for details of the company's cash and cash equivalents accounting policy under FRS 101.

Affinity Water

Regulatory Annual Performance Report

for the year ended 31 March 2016

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)

Team members at our Education Centre in Bushey, in our Colne community, which welcomes over 6,000 school children a year.

Regulatory annual performance report

Contents

Regulatory annual performance report continued

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 27 June 2016 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 those functions; 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.

These statements are based on:

- the net worth of the company as shown in the financial statements, the budget and plan for the forthcoming year, and the financing arrangements available to the company;
- the adequacy of the senior management team and management resources, robust internal control and delegated authority procedures, an internal audit team reporting to the Audit Committee, the availability of specialist planning teams, as well as the information from point 1) above itself; the company is also subject to considerable external assurance review, both fiscal and operational;
- an examination of the contracts with associated companies.

Tim Monod
Company Secretary
27 June 2016

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 2016 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.

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 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.

Regulatory annual performance report continued

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 2015/16, as presented in section 3 of this regulatory annual performance report on page 154.

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 2016, which include a summary of the company's operational and financial performance for 2015/16 on pages 26 to 34 and set out how the company manages risk and uncertainty on page 35.

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 company has identified the following areas for improvement. Neither of these are material risks to regulatory compliance or reporting of performance this year but are areas the company wishes to address to mitigate compliance and performance risks in the longer term:

- Average Water Use (W-A2): Improve clarity around the use of 2011/12 data as the basis of 'normalisation'.
- Water Available for Use (W-A3): Amend the recording system such that it records the failure of production assets rather than shortfalls against production targets.

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 material differences between the outputs that the company has delivered in the year and those that are 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 our 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:

Simon Cocks
Chief Executive Officer

Duncan Bates
Chief Financial Officer

Independent auditor's report to the Water Services Regulation Authority (the 'WSRA') and the directors of Affinity Water Limited

Opinion on Regulatory Annual Performance Report

In our opinion, Affinity Water Limited's Regulatory Accounting Statements within the Regulatory Annual Performance Report (the "Regulatory Accounts"):

- fairly present in accordance with Condition F, the Regulatory Accounting Guidelines issued by the WSRA and the accounting policies set out on **pages 139 to 141** (including the accounting separation methodology), the state of the Company's affairs at 31 March 2016 and its profit and cash flow for the year then ended; and
- have been properly prepared in accordance with Condition F, the Regulatory Accounting Guidelines and the accounting policies (including the accounting separation methodology).

Basis of preparation

Financial information other than that prepared on the basis of IFRS 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 Annual Performance Report is separate from the statutory financial statements of the Company and has not been prepared under the basis of IFRS.

In forming our opinion on the Regulatory Accounts, which is not modified, we draw attention to the fact that the Regulatory Annual Performance Report has been prepared in accordance with Condition F, the Regulatory Accounting Guidelines, the accounting policies (including the accounting separation method) set out in the statement of accounting policies and under the historical cost convention.

The Regulatory Accounts on **pages 126 to 164** have been drawn up in accordance with Regulatory Accounting Guidelines with a number of departures from IFRS. A summary of the effect of these departures from Generally Accepted Accounting Practice in the Company's statutory financial statements is included in the tables within section 1 of the Regulatory Annual Performance Report.

What we have audited

The tables within Affinity Water Limited's Regulatory Accounts comprise:

- the regulatory 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**) and the net debt analysis (**table 1E**) 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 (**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**), and the revenue analysis by customer type (**table 2I**) and the related notes.

The financial reporting framework that has been applied in their preparation comprises the basis of preparation and accounting policies set out in the notes to the Regulatory Annual Performance Report.

In applying the financial reporting framework, the directors have made a number of subjective judgments, for example in respect of significant accounting estimates. In making such estimates, they have made assumptions and considered future events.

We have not audited the outcome performance table (**table 3A**) and the additional regulatory information in section 4.

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 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.

Independent auditor's report to the Water Services Regulation Authority (the 'WSRA') and the directors of Affinity Water Limited (continued)

Respective responsibilities of the WSRA, the Directors and Auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 129, the directors are responsible for the preparation of the Regulatory Accounts and for their fair presentation in accordance with the basis of preparation and accounting policies. Our responsibility is to audit and express an opinion on the Regulatory Accounts in accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK & Ireland)"), except as stated in the section on 'What an audit of the Regulatory Accounts involves' below, and having regard to the guidance contained in Audit 05/03 'Reporting to Regulators of Regulated Entities' issued by the Institute of Chartered Accountants in England and Wales. Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

What an audit of Regulatory Accounts involves

An audit involves obtaining evidence about the amounts and disclosures in the Regulatory Accounts sufficient to give reasonable assurance that the Regulatory Accounts are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the Regulatory Accounts. In addition, we read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited tables within the Regulatory Accounts and to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by us in the course of performing the audit. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our 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 Regulatory Accounts are consistent with those used in the preparation of the statutory financial statements of the company. Furthermore, as the nature, form and content of Regulatory Accounts are 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 ISAs (UK & Ireland).

The Company has presented the allocation of operating costs and assets in accordance with the accounting separation policy set out in section 2 and the Accounting Separation Methodology Statement published on its website in June 2016. 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 WRSA, which would have been required if we were to express an opinion under ISAs (UK & Ireland).

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 Accounts are in agreement with the accounting records and returns retained for the purpose of preparing the Regulatory Accounts.

Other matters

The nature, form and content of the Regulatory Accounts 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 WRSA's purposes. Accordingly we make no such assessment.

Our opinion on the Regulatory Accounts is separate from our opinion on the statutory financial statements of the Company for the year ended 31 March 2016 on which we reported on 27 June 2016, and 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 member 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 member those matters we are required to state to it 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.

PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
Cambridge
27 June 2016

Section 1 – Regulatory financial reporting

1A - INCOME STATEMENT FOR THE 12 MONTHS ENDED 31 MARCH 2016

		Adjustments			
	Statutory £000	Differences between statutory and RAG definitions £000	Less: non-appointed £000	Total adjustments £000	Total appointed activities £000
Revenue	**302,622**	**(4,154)**	**-**	**(4,154)**	**298,468**
Operating costs	(237,483)	(363)	(2,515)	2,152	(235,331)
Other operating income	17,195	2,354	12,560	(10,206)	6,989
Operating profit	**82,334**	**(2,163)**	**10,045**	**(12,208)**	**70,126**
Other income	-	2,163	-	2,163	2,163
Interest income	390	-	-	-	390
Interest expense	(38,681)	-	-	-	(38,681)
Other interest expense	1,588	-	-	-	1,588
Profit before tax and fair value movements	**45,631**	**-**	**10,045**	**(10,045)**	**35,586**
Fair value gains/ (losses) on financial instruments	-	-	-	-	-
Profit before tax	**45,631**	**-**	**10,045**	**(10,045)**	**35,586**
UK Corporation tax	(1,584)	-	(2,009)	2,009	425
Deferred tax	15,685	-	-	-	15,685
Profit for the year	**59,732**	**-**	**8,036**	**(8,036)**	**51,696**

£1,943,000 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 139). This difference is offset by the reclassification of £5,564,000 of connection charges income[1] and £533,000 of income from providing developer information and the administration of new connections, which are presented within other operating 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 £1,943,000 offset by the reclassification of a £1,580,000 net loss on disposal of fixed assets, which is presented within other operating income 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 £1,580,000 and the reclassification of £2,163,000 of rental income, which is presented within other income in the Regulatory Accounts, net against the reclassification of £5,564,000 of connection charges income and £533,000 of income from providing developer information and the administration of new connections described previously.

The difference between statutory and RAG defined other income consists of the reclassification of £2,163,000 of rental income described in the previous paragraph.

[1] This reclassification has been made as the income is included within grants and contributions in table 2I on page 153 rather than within wholesale revenue governed by price control.

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

1B - STATEMENT OF COMPREHENSIVE INCOME FOR THE 12 MONTHS ENDED 31 MARCH 2016

		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	**59,732**	**-**	**8,036**	**(8,036)**	**51,696**
Actuarial gains/(losses) on post employment plans	20,667	-	-	-	20,667
Other comprehensive income	(3,720)	-	-	-	(3,720)
Total comprehensive income for the year	**76,679**	**-**	**8,036**	**(8,036)**	**68,643**

1C - STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2016

		Adjustments			
	Statutory £000	Differences between statutory and RAG definitions £000	Less: non-appointed £000	Total £000	Total appointed activities £000
Non-current assets					
Fixed assets	1,259,527	-	-	-	1,259,527
Intangible assets	43,634	-	-	-	43,634
Investments – loans to group companies	-	-	-	-	-
Investments – other	60	-	-	-	60
Financial instruments	-	-	-	-	-
Retirement benefit assets	72,588	-	-	-	72,588
Total	**1,375,809**	**-**	**-**	**-**	**1,375,809**
Current assets					
Inventories	1,222	-	-	-	1,222
Trade and other receivables	79,901	-	535	(535)	79,366
Financial instruments	-	-	-	-	-
Cash and cash equivalents	93,444	-	5,424	(5,424)	88,020
Total	**174,567**	**-**	**5,959**	**(5,959)**	**168,608**
Current liabilities					
Trade and other payables	(112,944)	-	(3,522)	3,522	(109,422)
Capex creditor	(17,022)	-	-	-	(17,022)
Borrowings	-	-	-	-	-
Financial instruments	-	-	-	-	-
Current tax liabilities	(2,013)	-	(2,437)	2,437	424
Provisions	(1,187)	1,187	-	1,187	-
Total	**(133,166)**	**1,187**	**(5,959)**	**7,146**	**(126,020)**
Net current assets/(liabilities)	**41,401**	**1,187**	**-**	**1,187**	**42,588**
Non-current liabilities					
Trade and other payables	-	-	-	-	-
Borrowings	(902,243)	-	-	-	(902,243)
Financial instruments	-	-	-	-	-
Retirement benefit obligations	-	-	-	-	-
Provisions	(2,885)	-	-	-	(2,885)
Deferred income – grants and contributions ('G&C's')	(87,977)	(1,187)	-	(1,187)	(89,164)
Preference share capital	-	-	-	-	-
Deferred tax	(184,652)	-	-	-	(184,652)
Total	**(1,177,757)**	**(1,187)**	**-**	**(1,187)**	**(1,178,944)**
Net assets	**239,453**	**-**	**-**	**-**	**239,453**

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

1C - STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2016 (CONTINUED)

		Adjustments			
	Statutory £000	Differences between statutory and RAG definitions £000	Less: non-appointed £000	Total adjustments £000	Total appointed activities £000
Equity					
Called up share capital	26,506	-	-	-	26,506
Retained earnings and other reserves	212,947	-	-	-	212,947
Total equity	**239,453**	**-**	**-**	**-**	**239,453**

The £1,187,000 difference between statutory and RAG defined provisions within current liabilities, and deferred income – G&C's relates to the reclassification of current deferred G&C's.

1D - STATEMENT OF CASH FLOWS FOR THE 12 MONTHS ENDED 31 MARCH 2016

		Adjustments			
	Statutory £000	Differences between statutory and RAG definitions £000	Less: non-appointed £000	Total £000	Total appointed activities £000
Operating profit	**82,334**	**(2,163)**	**10,045**	**(12,208)**	**70,126**
Other income	-	2,163	-	2,163	2,163
Depreciation	51,458	-	-	-	51,458
Amortisation – G&C's	(1,447)	-	-	-	(1,447)
Changes in working capital	477	-	(4,206)	4,206	4,683
Pension contributions	(9,778)	-	-	-	(9,778)
Movement in provisions	4,680	-	-	-	4,680
Profit on sale of fixed assets	1,486	-	-	-	1,486
Cash generated from operations	**129,210**	**-**	**5,839**	**(5,839)**	**123,371**
Net interest paid	(36,107)	-	-	-	(36,107)
Tax paid	(5,193)	-	(1,592)	1,592	(3,601)
Net cash generated from operating activities	**87,910**	**-**	**4,247**	**(4,247)**	**83,663**
Investing activities:					
Capital expenditure	(83,469)	-	-	-	(83,469)
Grants and contributions	4,959	-	-	-	4,959
Disposal of fixed assets	91	-	-	-	91
Other	390	-	-	-	390
Net cash used in investing activities	**(78,029)**	**-**	**-**	**-**	**(78,029)**
Net cash generated before financing activities	**9,881**	**-**	**4,247**	**(4,247)**	**5,634**
Cashflows from financing activities					
Equity dividends paid	(40,000)	-	(8,036)	8,036	(31,964)
Net loans received	64,635	-	-	-	64,635
Cash inflow from equity financing	-	-	-	-	-
Net cash generated from financing activities	**24,635**	**-**	**(8,036)**	**8,036**	**32,671**
Increase/(decrease) in net cash	**34,516**	**-**	**(3,789)**	**3,789**	**38,305**

The £2,163,000 difference between statutory and RAG defined operating profit and other income relates to the reclassification of rental income, which is presented within other income in the regulatory financial statements.

Regulatory annual performance report continued

Section 1 – Regulatory financial reporting (continued)

1E - NET DEBT ANALYSIS AT 31 MARCH 2016

	Fixed rate £000	Floating rate £000	Index linked £000	Total £000
Borrowings (excluding preference shares)	583,854	-	318,355	**902,209**
Preference share capital				-
Total borrowings				**902,209**
Cash				**(88,020)**
Short term deposits				-
Net debt				**814,189**
Gearing				75.37%
Adjusted gearing				74.92%
Full year equivalent nominal interest cost	28,997	-	11,388	**40,386**
Full year equivalent cash interest payment	28,997	-	6,450	**35,447**
Indicative interest rates:				
Indicative weighted average nominal interest rate (%)	4.97	-	3.67	**4.52**
Indicative weighted average cash interest rate (%)	4.97	-	2.08	**3.97**

There are no differences between total borrowings presented in the above table and total borrowings presented in note 15 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)	583,854	-	318,355	**902,209**
Preference share capital				-
Less: capitalised bond issue costs				**(8,555)**
Less: loan from intermediate parent company				**(3,550)**
				890,104
Add: accrued interest on borrowings				**12,642**
Total borrowings				**902,746**
Cash				**(93,444)**
Short term deposits				-
Net debt				**809,302**

STATEMENT OF ACCOUNTING POLICIES

Basis of preparation

These accounts have been prepared in accordance with 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.

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 credited to operating costs. They are not 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 2015 included a measured income accrual of £39,876,000. The value of billing recognised in the year ended 31 March 2016 for consumption in the prior year was £39,715,000. This has resulted in a decrease in the current year's revenue due to the over-estimation of the prior year's revenue of £161,000. This represents 0.05% of current year 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 which are recorded as where 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)

Revenue recognition (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 the company 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 measured customers.

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 their 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 £24,645,000 at 31 March 2015 to £26,313,000 at 31 March 2016.

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 receivables 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 impaired receivables write-off policy has remained unchanged and has been consistently applied in the current year compared with the previous year. There has been a decrease in the level of debt written off from £9,448,000 in 2014/15 to £7,618,000 in 2015/16; this decrease is a result of a one off event taking place in 2014/15 following the implementation of a new debt management system in the year and the timing of recalling closed receivables back from the company's debt collection agency compared to the previous system.

There has not been a significant decrease in the trade receivables balance from £30,719,000 at 31 March 2015 to £28,570,000 at 31 March 2016.

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, therefore, in accordance with RAG 3.08. The elements of the 2015/16 remuneration arrangements for executive directors were established by the company's Remuneration Committee in meetings in 2013/14, 2014/15 and 2015/16.

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 2016/17
Base salary				
To provide competitive fixed remuneration that will attract and retain key employees and reflect their experience and position in the company.	Reviewed annually. Aims to position salaries for executive directors at slightly below mid-market levels, preferring to compensate total reward with variable remuneration.	N/A	N/A	No changes were made to the policy for 2016/17 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 2016/17 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 Duncan Bates and up to 100% of base salary for Simon Cocks.	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 policy for 2016/17 up to the date of approval of this annual report and financial statements.
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. Executives who joined the company prior to this date may be members of the company's defined benefit scheme. The defined benefit scheme provides retirement benefits up to a scheme cap. Where an executive's base salary is greater than the defined benefit scheme cap, the company invites the executive to join the company's defined contribution scheme to contribute a "top up" for the portion of base salary which exceeds the defined benefit cap. Under the defined contribution scheme, the executive contributes at a rate of 7% of salary and the company contributes at 20%. Duncan Bates was a member of the company's defined benefit scheme and defined contribution "top up" scheme until 31 March 2016. From 1 April 2016, Duncan Bates ceased to be a member of either pension scheme.	Under the company's defined benefit scheme, Duncan Bates is accruing service at 1/60th of pensionable salary for each year of pensionable service. 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	From 1 April 2016, in lieu of being a member of the company's retirement benefit schemes, Duncan Bates receives a taxable allowance equivalent to the benefit he previously received. No further changes were made to the policy for 2016/17 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 award and payment are discretionary.	Base awards were 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.	Up to 100% of base salary (although outperformance of the financial performance target may cause this to be higher).	The award will be 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.	No changes were made to the policy for 2016/17 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 in April 2013 for a term of three years, and reappointed for a further three year term on 1 April 2016. He receives a fixed annual fee for his services which is reflective of the time commitment and responsibilities of the role. He served as executive Chairman from 1 January 2015 until 31 May 2015 and thereafter his role reverted to non-executive.

He also benefits from a remuneration arrangement, which aligns his interests with the longer term interests of shareholders. To this end, 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 has been aligned as closely as possible to the key features of a shareholding in a listed company. Particulars of the arrangement were communicated at the 2015 AGM.

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 2015/16 in the table below.

The following table shows the remuneration paid to directors by the company in respect of 2015/16.

	Base salary/fees £000		Taxable benefits[1] £000		Pension related benefits[2] £000		Annual bonus £000		Other[3] £000		Total remuneration £000	
	15/16	14/15	15/16	14/15	15/16	14/15	15/16	14/15	15/16	14/15	15/16	14/15
Non-executive												
Current												
Patrick O'D Bourke	**47**	47	**-**	-	**-**	-	**-**	-	**-**	-	**47**	47
Chris Bolt	**41**	4	**-**	-	**-**	-	**-**	-	**-**	-	**41**	4
Trevor Didcock	**14**	-	**-**	-	**-**	-	**-**	-	**-**	-	**14**	-
Susan Hooper	**15**	-	**-**	-	**-**	-	**-**	-	**-**	-	**15**	-
Former												
Baroness Peta Buscombe	**22**	44	**-**	-	**-**	-	**-**	-	**-**	-	**22**	44
Jeffrey Herbert	**22**	44	**-**	-	**-**	-	**-**	-	**-**	-	**22**	44
Chairman												
Dr Philip Nolan	**200**	200	**-**	-	**-**	-	**-**	-	**210**	176	**410**	376
Executive												
Current												
Duncan Bates[4]	**170**	168	**13**	15	**35**	33	**111**	104	**-**	-	**329**	320
Simon Cocks	**279**	-	**10**	-	**67**	-	**242**	-	**207**	-	**805**	-
Former												
Richard Bienfait	**-**	180	**-**	7	**-**	59	**-**	-	**-**	509	**-**	755
	810	687	**23**	22	**102**	92	**353**	104	**417**	685	**1,705**	1,590

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

[2] Included in pension related benefits is £5,000 relating to contributions for Duncan Bates paid to money purchase pension schemes (2015: £4,000); there were no amounts outstanding at the year end. The amounts also include £30,000 accruing to Duncan Bates in relation to the company's defined benefit pension scheme. This amount has been calculated based on the change during the year of his accrued benefits in the defined benefit pension scheme multiplied by 20 less contributions made by the director in the financial year. The normal retirement date for Duncan Bates is 65 years. The accrued benefit at the start and end of the year for Duncan Bates was £42,000 and £44,000 respectively (change during the year: £2,000). Pension related benefits for Simon Cocks further include an allowance of £67,000 in lieu of being a member of the company's retirement benefit schemes (2015: £59,000 for Richard Bienfait).

3 Other remuneration for Dr Philip Nolan consists of remuneration received in relation to the arrangement described on page 61 of the remuneration report. Other remuneration for Simon Cocks in 2015/16 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 his previous employer. Other remuneration for Richard Bienfait in 2014/15 relates to discretionary payments made in connection with termination of qualifying services during the year. The amount included a termination payment of £344,000, a bonus of £120,000 linked to company and personal performance during 2014/15 and the reimbursement of legal and outplacement costs of £45,000.

[4] Base awards were made to Duncan Bates under the 2013/14 LTIP scheme, which relates to the three year performance period ended 31 March 2016. The Committee will determine and communicate to shareholders any awards under the 2013/14 LTIP before the AGM. Details of any awards determined by the Committee will be included in the 2016/17 remuneration implementation report.

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 following table shows the percentage of maximum annual bonus potential awarded in relation to the 2015/16 year for Simon Cocks and Duncan Bates. No amounts in relation to these bonuses have been deferred.

Performance measure		Link to strategy (refer to page 23)	2015/16 target	Weighting for 2015/16 (% of base salary)		2015/16 achievement (as a % of base salary)	
				Simon Cocks	Duncan Bates	Simon Cocks	Duncan Bates
Financial measure	Cash generated by operations (annual target): net cash outflow before taxation and financing[1]	Value creation imperative	£14.4m	50.00%	37.50%	50.00%	37.50%
Operational measures	Leakage (quarterly targets): volume of water lost through leaks on the network in terms of millions of litres per day (Ml/d)	Customer outcome	Q1: 154 Q2: 153 Q3: 159 Q4: 162	3.57%	2.68%	0.00%	0.00%
	Water availability (quarterly targets): volume of water lost from distribution due to unplanned outages at production sites (Ml/d)	Customer outcome	Q1: 40 Q2: 35 Q3: 35 Q4: 40	3.57%	2.68%	3.57%	2.68%
	Water quality (quarterly targets): number of water quality compliance failures	Customer outcome	Q1: 8 Q2: 10 Q3: 7 Q4: 7	3.57%	2.68%	3.57%	2.68%
	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	3.57%	2.68%	0.00%	0.00%
	Water saving programme (quarterly targets): number of meters installed	Customer outcome	Q1: 4,300 Q2: 9,460 Q3: 15,878 Q4: 15,878	3.57%	2.68%	0.89%	0.67%
Customer and community measures	Service Incentive Mechanism[2] (annual target): performance for the qualitative element of SIM relative to the industry	Customer outcome	Top 9	3.57%	2.68%	0.00%	0.00%
	Cash collections (annual target): the amount of cash collected through billing in respect of water revenue	Customer outcome	£291.7m	3.57%	2.68%	3.57%	2.68%
Personal performance[3]				25.00%	18.75%	25.00%	18.75%
Total % base salary				**100.00%**	**75.00%**	**86.60%**	**64.96%**
Base salary						**£279,000[4]**	**£171,000**
Bonus paid						**£242,000**	**£111,000**

[1] This "non-GAAP" measure is calculated as the total of the following line items per the statement of cash flows (refer to page 86): 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] Service Incentive Mechanism ('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] Simon Cocks' base salary at 31 March 2016 has been pro-rated to reflect his appointment partway through the year (on 1 June 2015).

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 (2013/14 LTIP)

The 2013/14 LTIP scheme was designed to incentivise executives to achieve long-term shareholder value whilst achieving high levels of customer experience, although award and payment are discretionary. Arrangements for the scheme were finalised during the year ended 31 March 2015.

Duncan Bates was the only executive director to have received base awards under the 2013/14 LTIP scheme, which relates to the three year performance period ended 31 March 2016. The Remuneration Committee will determine and communicate to shareholders any awards under the 2013/14 LTIP before the AGM. Details of any awards determined by the Remuneration Committee will be included in the 2016/17 remuneration implementation report.

Further information regarding directors' remuneration during the year and future policy can be found within the remuneration report on pages 60 to 68.

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 2.05, as detailed in the company's Accounting Separation Methodology Statement, which can be found on the company's website:

stakeholder.affinitywater.co.uk

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 2016

	Retail		Wholesale	
	Household £000	Non-household £000	Water £000	Total £000
Revenue – price control	27,371	5,347	263,274	295,992
Revenue – non price control	-	-	2,476	2,476
Operating costs	(31,255)	(3,959)	(200,117)	(235,331)
Other operating income	1,445	933	4,611	6,989
Operating profit before recharges	**(2,439)**	**2,321**	**70,244**	**70,126**
Recharges from other segments	(1,695)	(290)	-	(1,985)
Recharges to other segments	290	-	1,695	1,985
Operating profit	**(3,844)**	**2,031**	**71,939**	**70,126**

Regulatory annual performance report continued

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

2B - TOTEX ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2016 – WHOLESALE WATER

	Total £000
Operating expenditure	
Power	21,799
Income treated as negative expenditure	(66)
Service charges	3,806
Bulk supply	6,396
Other operating expenditure	100,581
Local authority rates	15,880
Total operating expenditure excluding third party services	**148,396**
Third party services	**2,410**
Total operating expenditure	**150,806**
Capital expenditure	
Maintaining the long term capability of the assets - infra	12,898
Maintaining the long term capability of the assets – non-infra	33,928
Other capital expenditure – infra	12,569
Other capital expenditure – non-infra	22,001
Total gross capital expenditure (excluding third party)	**81,396**
Third party services	**2,212**
Total gross capital expenditure	**83,608**
Less: grants and contributions (price control)	**8,816**
Totex	**225,598**
Cash expenditure	
Pension deficit recovery payments	3,760
Other cash items	-
Totex including cash items	**229,358**

2C - OPERATING COST ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2016 – RETAIL

	Household £000	Non-household £000	Total £000
Operating expenditure			
Customer services	8,246	404	8,650
Debt management	1,181	357	1,538
Doubtful debts	8,835	572	9,407
Meter reading	2,876	515	3,391
Services to developers	-	533	533
Other operating expenditure	9,416	1,578	10,994
Total operating expenditure excluding third party services	**30,554**	**3,959**	**34,513**
Third party services operating expenditure	-	-	-
Total operating expenditure	**30,554**	**3,959**	**34,513**
Depreciation	701	-	701
Total operating costs	**31,255**	**3,959**	**35,214**
Debt written off	**6,991**	**629**	**7,620**

Household operating costs and other operating income (refer to table 2A) are £901,000 adverse to revenue allowed in the PR14 price determination. This variance is due in part to a change in allocation methodologies between household and non-household activities for meter reading costs and the cost of handling non-network customer enquiries and complaints. The primary driver, however, was that cost efficiencies assumed in the price determination where not fully achieved.

Non-household operating costs and other operating income (refer to table 2A) are £2,274,000 favourable to revenue allowed in the PR14 price determination. This is due to the allocation changes discussed above together with a reduction in bad debt charge commensurate with improved cash collection.

Regulatory annual performance report continued

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

2D - HISTORIC COST ANALYSIS OF FIXED ASSETS - WHOLESALE AND RETAIL

	Wholesale	Retail		
	Water £000	Household £000	Non-household £000	Total £000
Cost				
At 1 April 2015	1,753,372	9,200	-	1,762,572
Disposals	(2,183)	-	-	(2,183)
Additions	83,627	108	-	83,735
At 31 March 2016	**1,834,816**	**9,308**	**-**	**1,844,124**
Depreciation				
At 1 April 2015	(503,019)	(2,053)	-	(505,072)
Disposals	606	-	-	606
Charge for the year	(50,757)	(701)	-	(51,458)
At 31 March 2016	**(553,170)**	**(2,754)**	**-**	**(555,924)**
Net book amount at 31 March 2016	**1,281,646**	**6,554**	**-**	**1,288,200**
Net book amount at 1 April 2015	1,250,353	7,147	-	1,257,500

The net book value includes £138,128,000 in respect of assets in the course of construction.

2E - ANALYSIS OF CAPITAL CONTRIBUTIONS AND LAND SALES FOR THE 12 MONTHS ENDED 31 MARCH 2016 – WHOLESALE

	Fully recognised in income statement £000	Capitalised and amortised against depreciation £000	Fully netted off capex £000	Total £000
Grants and contributions - water				
Connection charges (s45)	5,564	-	-	**5,564**
Infrastructure charge receipts (s146)	-	3,252	-	**3,252**
Requisitioned mains (s43, s55 and s56)	-	-	-	**-**
Diversions (s185)	-	852	-	**852**
Other contributions	-	383	-	**383**
Total	5,564	4,487	-	**10,051**

Balance sheet	
Brought forward	**86,124**
Capitalised in year	**4,487**
Amortisation (in income statement)	**(1,447)**
Carried forward	**89,164**

Land sales	
Proceeds from disposals of protected land	**-**

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	116,060	12,580	128,640	672,887	18.696
Measured water only customer	90,940	14,791	105,731	673,267	21.969
Total	**207,000**	**27,371**	**234,371**	**1,346,154**	**20.333**

Regulatory annual performance report continued

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

2G - NON-HOUSEHOLD – REVENUES BY CUSTOMER TYPE

	Wholesale charges revenue £000	Retail revenue £000	Total revenue £000	Number of customers	Average non-household retail revenue per customer £
Non default tariffs					
Total non-default tariffs	-	-	-	-	-
Default tariffs					
Measured half yearly	30,517	3,579	34,096	56,255	63.62
Measured monthly	22,440	1,480	23,920	2,244	659.54
Unmeasured	2,219	239	2,458	6,098	39.19
Assessed	131	18	149	1,737	10.36
Special agreements	967	31	998	7	4,428.57
Total default tariffs	**56,274**	**5,347**	**61,621**	**66,341**	**80.60**
Total	**56,274**	**5,347**	**61,621**	**66,341**	**80.60**

2I - REVENUE ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2016

	Household £000	Non-household £000	Total £000
Wholesale charge – water			
Unmeasured	116,060	2,350	118,410
Measured	90,940	53,924	144,864
Third party revenue	-	-	-
Wholesale total	**207,000**	**56,274**	**263,274**
Retail revenue			
Unmeasured	12,580	257	12,837
Measured	14,791	5,090	19,881
Other third party revenue	-	-	-
Retail total	**27,371**	**5,347**	**32,718**
Third party revenue – non-price control			
Bulk supplies			2,217
Other third party revenue			259
Other appointed revenue			-
Total appointed revenue			**298,468**

	Total £000
Wholesale revenue governed by price control	263,274
Grants & contributions[1]	8,816
Total revenue governed by wholesale price control	**272,090**
Amount assumed in wholesale determination	**273,297**
Difference	**(1,207)**

The adverse variance difference between allowed and actual revenue under the wholesale control was as a result of certain properties remaining empty for longer during the year than anticipated in the company's Business Plan. This is not anticipated to cause variations in revenue for future periods.

[1] Relevant capital contributions as defined in the company's final determination.

Regulatory annual performance report continued

Section 3 - Performance summary

3A - OUTCOME PERFORMANCE TABLE

Unique ID	Performance commitment	2014-15 performance level -actual	2015-16 performance level -actual	2015-16 CPL met?	2015-16 reward or penalty (in-period ODIs)	2015-16 reward or penalty (in-period ODIs) £m absolute value	Notional reward or penalty accrued at 31 March 2016	Notional reward or penalty accrued at 31 March 2016 £000 absolute value	Total AMP6 reward or 31 March 2020 forecast	Total AMP6 reward or 31 March 2020 forecast £000 absolute value
PR14AFWWSW_W-A1	Leakage	183.49 Ml/d	180.89 Ml/d	Yes	N/A	N/A	Reward deadband	£nil	None	£nil
PR14AFWWSW_W-A2	Average water use	154.9 l/person/d	154.4 l/person/d	Yes	N/A	N/A	None	£nil	None	£nil
PR14AFWWSW_W-A3	Water available for use	1,151.93 Ml/d	1,139.08 Ml/d	Yes	N/A	N/A	None	£nil	None	£nil
PR14AFWWSW_W-A4	Sustainable abstraction reduction	0.0 Ml/d	6.7 Ml/d	Yes	N/A	N/A	None	£nil	None	£nil
PR14AFWWSW_W-A5	Abstraction incentive mechanism	N/A[1]	N/A	-	N/A[2]	N/A	N/A	N/A	N/A	N/A
PR14AFWWSW_W-B1	Compliance with water quality standards	99.97%	99.99%	Yes	N/A	N/A	None	N/A	None	£nil
PR14AFWWSW_W-B2	Customer contacts for discolouration	0.34/1,000 people	0.31/1,000 people	Yes	N/A	N/A	None	N/A	None	£nil
PR14AFWWSW_W-C1	Unplanned interruptions to supply over 12 hours	1,687 properties	1,771 properties	No	N/A	N/A	Penalty	1,637.550	Penalty	1,637.550
PR14AFWWSW_W-C2	Mains bursts	2,414 bursts	2,201 bursts	Yes	N/A	N/A	None	N/A	None	£nil
PR14AFWWSW_W-C3	Customers not being notified of planned interruptions	378 properties	400 properties	No	N/A[2]	N/A	N/A	N/A	N/A	N/A
PR14AFWWSW_W-C4	Planned works taking longer than notified	495 events	266 events	Yes	N/A[2]	N/A	N/A	N/A	N/A	N/A
PR14AFWHHR_R-A1	Service Incentive Mechanism ('SIM')	N/A[3]	Score of 76.7 out of 100.0	-	N/A	N/A	None	£nil	None	£nil
PR14AFWHHR_R-A2	Value for money survey	N/A[4]	Score of 71.6 out of 100.0	-	N/A[2]	N/A	N/A	N/A	N/A	N/A

[1] The measurement of this performance commitment has not been finalised.

[2] These are reputational incentives and therefore do not have any associated financial rewards or penalties.

[3] There was no SIM in 2014/15. Prior year SIM scores are not comparable with the 2015/16 score as they were calculated on a different basis.

[4] The measurement of this performance commitment was not finalised until the current financial year.

The company set 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 the company has met or exceeded these targets. There are two exceptions:

Unplanned interruptions to supply over 12 hours

In the first six months of 2015/16 the company's response to a number of incidents was slow and repair was prioritised over the restoration of supplies. This resulted in the failure to meet the 2015/16 target, with over 90% of the company's unplanned interruptions to supply over 12 hours in 2015/16 occurring during this six month period. No compromises with customer safety were made.

The company's approach to reducing unplanned interruptions has now been re-focussed on prevention, restoring supplies and fixing the problem quickly. New high volume emergency pumping equipment has been acquired and the company is improving processes and competencies to reduce the impact on customers when bursts occur.

Customers not being notified of planned interruptions

This typically occurs from an unintended or unforeseen consequence of a planned action. The company continues to develop its systems and procedures to improve performance in this area and meet this challenging target.

Refer to the performance section of the annual report on pages 26 to 34 for further details of the company's performance in relation to the leakage, sustainable abstraction reduction, compliance with water quality standards, unplanned interruptions to supply over 12 hours, mains bursts and SIM performance commitments against targets set in the company's PR14 business plan.

Data included in the table on the previous page is included within the 2015-2016 Customer Performance Report publication available for customers to view on the Reports and Publications page of the company's website:

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

The company has also been reporting online its performance for each of its eight communities using community dashboards (refer to page 14 for further information).

The company has incurred a penalty in 2015/16 for the unplanned interruptions to supply over 12 hours performance commitment and forecasts this penalty will apply in full at 31 March 2020. No further penalties are forecast for the remainder of AMP6 in any of the performance commitment measures. At this stage no rewards are forecast for the period to 31 March 2020 in light of the challenging targets set.

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information

ACCOUNTING SEPARATION POLICY

Tables 4B, 4C, 4D, 4F and 4G 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

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 2016

	Unmeasured	Measured
Retail - household		
Number of households billed		
Water only connections	672,887	673,267
Total	**672,887**	**673,267**
Number of void households	23,721	20,697
Per capita consumption (excluding supply pipe leakage) l/h/d	165.44	134.32
		Water
Wholesale		
Volume (Ml/d)		
Bulk supply export		21.069
Bulk supply import		22.979
Distribution input		899.807

4B - WHOLESALE TOTEX ANALYSIS

	2016 £000	Cumulative £000
Actual totex		
Menu totex	**220,976**	220,976
Items excluded from the menu		
Pension deficit recovery payments	**3,760**	3,760
Third party costs	**4,622**	4,622
Other adjustments	**-**	-
Total costs excluded from the menu	**8,382**	8,382
Actual totex	**229,358**	229,358
Actual totex – base year prices	**216,311**	216,311
Allowed totex – base year prices	**244,700**	244,700

The difference between actual and allowed totex 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. Programmes of work are expected to accelerate in 2016/17, in particular for increased meter installation associated with the company's water saving programme.

4C - FORECAST IMPACT OF PERFORMANCE ON RCV

	2016 £000
RCV determined at final determination	**1,080,279**
RCV element of totex underspend	**(9,301)**
Allowance (rewards/penalties – ODI)	**(1,736)**
Projected 'shadow' RCV	**1,069,242**

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

4D - TOTEX ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2016 – WHOLESALE WATER

	Water resources		Raw water distribution				
	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	-	4,024	2,962	-	1,319	13,494	21,799
Income treated as negative expenditure	-	(12)	(9)	-	(4)	(41)	(66)
Abstraction charges	3,806	-	-	-	-	-	3,806
Bulk supply	-	-	-	-	6,396	-	6,396
Other operating expenditure	511	4,192	3,072	599	15,540	76,667	100,581
Local authority rates	-	2,047	347	-	2,986	10,500	15,880
Total operating expenditure excluding third party services	**4,317**	**10,251**	**6,372**	**599**	**26,237**	**100,620**	**148,396**
Third party services	-	-	-	-	-	2,410	2,410
Total operating expenditure	**4,317**	**10,251**	**6,372**	**599**	**26,237**	**103,030**	**150,806**
Capital expenditure							
Maintaining the long term capability of the assets - infra	-	-	-	-	-	12,898	12,898
Maintaining the long term capability of the assets – non-infra	-	3,299	705	-	17,463	12,461	33,928
Other capital expenditure – infra	-	-	-	-	-	12,569	12,569
Other capital expenditure – non-infra	-	8,842	-	-	9,634	3,525	22,001
Total gross capital expenditure (excluding third party)	**-**	**12,141**	**705**	**-**	**27,097**	**41,453**	**81,396**
Third party services	-	-	-	-	2,187	25	2,212
Total gross capital expenditure	**-**	**12,141**	**705**	**-**	**29,284**	**41,478**	**83,608**
Less: grants and contributions	-	-	-	-	-	8,816	8,816
Totex	**4,317**	**22,392**	**7,077**	**599**	**55,521**	**135,692**	**225,598**
Cash expenditure							
Pension deficit recovery payments	21	364	125	14	976	2,260	3,760
Other cash items	-	-	-	-	-	-	-
Totex (including cash items)	**4,338**	**22,756**	**7,202**	**613**	**56,497**	**137,952**	**229,358**

Unit cost information (operating expenditure)

	Licensed volume available	Volume abstracted	Volume transported	Average volume stored	Distribution input volume	Distribution input volume
Volume (Ml)	409,236	339,769	60,828	-	329,511	329,511
Unit cost (£/Ml)	11	30	105	-	80	313

4F - OPERATING COST ANALYSIS FOR THE 12 MONTHS ENDED 31 MARCH 2016 – HOUSEHOLD RETAIL

	Unmeasured £000	Measured £000	Total £000
Operating expenditure			
Customer services	3,540	4,706	8,246
Debt management	509	672	1,181
Doubtful debts	4,550	4,285	8,835
Meter reading	-	2,876	2,876
Other operating expenditure	4,707	4,709	9,416
Total operating expenditure excluding third party services	**13,306**	**17,248**	**30,554**
Depreciation	337	364	701
Total operating costs excluding third party services	**13,643**	**17,612**	**31,255**

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	1,246
Less: Demand-side water efficiency – expenditure funded by wholesale	757
Demand-side water efficiency – net retail expenditure	**489**
Customer-side leak repairs – gross expenditure	696
Less: Customer-side leak repairs – expenditure funded by wholesale	-
Customer-side leak repairs – net retail expenditure	**696**

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 2016

Income Statement	Total £000
Revenue	**265,750**
Operating expenditure	(150,806)
Capital maintenance charges	(69,480)
Other operating income	4,611
Current cost operating profit	**50,075**
Other income	2,163
Interest income	390
Interest expense	(38,681)
Other interest expense	1,588
Current profit before tax and fair value movements	**15,535**
Fair value gains/(losses) on financial instruments	-
Current profit before tax	**15,535**

4H - FINANCIAL METRICS FOR THE 12 MONTHS ENDED 31 MARCH 2016

Metric	
Net debt	£814.189m
Regulated equity	£266.090m
Regulated gearing	75.37%
Post tax return on regulated equity	32.55%
RORE (return on regulated equity)	3.30%
Dividend yield	12.01%
Retail profit margin – Household	(1.36)%
Retail profit margin - Non household	2.25%
Credit rating	Baa1
Return on RCV	6.89%
Dividend cover	1.62
Funds from operations (FFO)	£78.980m
Interest cover (cash)	3.19
Adjusted interest cover (cash)	1.99
FFO/Debt	0.10
Effective tax rate	(1.19)%
Free cash flow (RCF)	£47.016m
RCF/capex	0.56
Revenue (actual)	£295.992m
EBITDA (actual)	£113.57m
Proportion of borrowings which are fixed rate	64.71%
Proportion of borrowings which are floating rate	-
Proportion of borrowings which are index linked	35.29%
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	-
Proportion of borrowings due in more than 5 years but no more than 20 years	76.35%
Proportion of borrowings due in more than 20 years	23.65%

4I - FINANCIAL DERIVATIVES FOR THE 12 MONTHS ENDED 31 MARCH 2016

This table has not been presented, as the company did not hold any financial derivatives during the year ended 31 March 2016.

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

TRANSACTIONS WITH ASSOCIATED COMPANIES

Company	Service	Turnover of associate* £000	Terms of supply	Value £000
Expenditure				
Veolia Water UK Limited	Management and technical support	4,563	Market tested	256
Veolia Environmental Services (UK) Limited	Waste water disposal	832,617	Market tested	350
VWS (UK) Ltd	Transport and other services	68,310	Market tested	715
Affinity Water Capital Funds Limited**	Interest paid on loan	-	No market	160
Affinity Water Holdings Limited**	Dividends paid	-	No market	30,800
Affinity Water Finance (2004) PLC**	Interest paid on loan	-	No market	14,334
Affinity Water Programme Finance Limited**	Interest paid on loan	-	No market	23,584
Income				
Veolia Water UK Limited	Transitional services and capability sharing agreement and other services	4,563	Market tested	302

* from latest publicly available financial statements.
** these companies do not have turnover.

The company has applied a materiality threshold of £100,000 for disclosing transactions with individual related parties.

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 £255,045,000 (2015: £255,411,000).

As part of the WBS in February 2013, all existing loans and revolving 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 index-linked Notes maturing in June 2045 with a coupon of 1.548% and £95,000,000 Class B Guaranteed RPI index-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 index-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%. 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 £643,614,000 (2015: £576,081,000).

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.

At 31 March 2016, the company had £10,000,000 in a term deposit with Morgan Stanley Liquidity Funds, a fund under common ownership.

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 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 have declared and paid ordinary dividends of £40,000,000 during the year ended 31 March 2016. This compares to £30,800,000 declared and paid in the year ended 31 March 2015.

No final dividend is proposed (2015: £nil).

VIABILITY STATEMENT

The company's viability statement, including information on the company's approach to producing this statement, can be found within the strategic report on page 42. The approach taken considers sensitivities for stress-testing included in Ofwat's July 2015 consultation on a new financial monitoring framework.

CURRENT TAX RECONCILIATIONS

The appointed current tax charge assessed for the period is lower than the standard rate of corporation tax in the UK for the year ended 31 March 2016 of 20%. The differences are explained below:

	£000
Profit on appointed activities before tax	**35,586**
Tax calculated at the standard rate of tax in the UK of 20%	7,117
Tax effects of:	
- Adjustments in respect of prior years	(756)
- Expenses not deductible for tax purposes	194
- Accelerated capital allowances	511
- Change in accounting treatment - infrastructure charges	(5,674)
- Other timing differences - pension	(1,365)
- Other timing differences - provisions	(452)
Appointed current tax credit	**(425)**

Regulatory annual performance report continued

Section 4 – Non-audited additional regulatory information (continued)

CURRENT TAX RECONCILIATIONS (CONTINUED)

Significant variations between the appointed current tax charge and the total current tax charge for the year ended 31 March 2016 allowed in the company's price limits are explained below:

	£000
Appointed current tax credit	**(425)**
Variance in profit before tax	(2,770)
Adjustments in respect of prior years	756
Variance in assumptions - capital allowances	(2,976)
Variance in assumptions - treatment of grants and contributions	4,053
Variance in assumptions - allowable depreciation	2,735
Other	807
Total current tax charge allowed in price limits	**2,180**

The appointed current tax charge allowed within the wholesale revenue price control determined by Ofwat was accepted by the company "in the round" as an "enhanced company" within the PR14 determination process. However, the charge identified by Ofwat in its calculations was not reflective of the company's own calculations of the tax position as it applied to the company when considering other transactions within the price determination and this reconciliation should be viewed in this context.

Factors affecting future tax charges

In October 2015 changes were enacted to the main rate of corporation tax in the UK from 20% to 19% effective from 1 April 2017 and from 19% to 18% effective from 1 April 2020.

In March 2016 a further change was announced to the main rate of corporation tax in the UK from 18% to 17% effective from 1 April 2020.

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, the effectiveness of which is concluded on page 49. In addition, the following external assurance procedures have been commissioned:

Data	Assurance procedures performed	Results
Tables 1A, 1B, 1C, 1D, 1E, 2A, 2B, 2C, 2D, 2E, 2F, 2G and 2I	External audit	Refer to the independent auditor's report on pages 131 to 132
Tables 3A and 4A	External review of the procedures used to collect and report the information	Refer to the statement of risk and compliance on page 130
Tables 4B, 4C, 4D, 4F, 4G and 4H, transactions with associated companies, and current tax reconciliations	Agreed upon procedures performed by an external assurance provider.	The directors are satisfied with the accuracy of the data reported.
Viability statement	As part of their statutory audit of the company's annual report and financial statements, PwC report by exception if they do not agree with the Board's statement that the annual report, taken as a whole, is fair, balanced and understandable. The directors of the company also engaged an external assurance provider to perform agreed upon procedures in relation to the mathematical accuracy of the stress testing calculations underpinning the viability statement.	PwC's report is included on pages 75 to 81. The directors are satisfied with how the stress testing underpinning the statement has been carried out.

Areas of supply

Affinity Water Limited
Tamblin Way
Hatfield
Hertfordshire AL10 9EZ

Tel: 01707 268111 (main switchboard)
Fax: 01707 277333

www.affinitywater.co.uk