

**ARTESIAN FINANCE II PLC**

**Annual Report and Financial Statements**

**Year ended 31 March 2016**

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# **ARTESIAN FINANCE II PLC**

## **ANNUAL REPORT AND FINANCIAL STATEMENTS 2016**

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# **ARTESIAN FINANCE II PLC**

## **ANNUAL REPORT AND FINANCIAL STATEMENTS 2016**

### **OFFICERS AND PROFESSIONAL ADVISERS**

#### **DIRECTORS**

Colin Benford  
Capita Trust Corporate Limited  
Capita Trust Corporate Services Limited

#### **SECRETARY**

Capita Trust Corporate Limited  
The Registry  
34 Beckenham Road  
Beckenham  
Kent  
BR3 4TU

#### **REGISTERED OFFICE**

4th Floor  
40 Dukes Place  
London  
EC3A7NH

#### **BANKERS**

The Royal Bank of Scotland plc

#### **AUDITOR**

Deloitte LLP  
Chartered Accountants  
London

# ARTESIAN FINANCE II PLC

## STRATEGIC REPORT

The Directors present their strategic report for Artesian Finance II plc ("the Company") for the year ended 31 March 2016.

### ACTIVITIES

The Company was incorporated in the United Kingdom and commenced operations on 25 February 2003. It is registered as a public limited company under the Companies Act 2006.

The principal activity of the Company is to hold loans advanced to water companies.

### PRINCIPAL ACTIVITY, BUSINESS REVIEW AND FUTURE DEVELOPMENTS

The Company is authorised to issue loans and bonds up to £500,000,000 (2015: £500,000,000) ("the Bonds"). The Company has no intention to change the business activities. The Bonds are unconditionally and irrevocably guaranteed as to scheduled payments of principal and interest under the terms of a guarantee issued by Assured Guaranty (Europe) Limited (formerly Financial Security Assurance (U.K.) Limited).

The Directors do not anticipate any changes to the present level of activity or the nature of the Company's business in the near future.

### BUSINESS REVIEW

The loan portfolio of the Company consists of two fixed rate and three UK Retail Price Index ("RPI") linked loans which were funded through the issuance of the fixed rate bonds. Total return swaps were entered into by the Company to exchange RPI linked cash flows it receives on the loans for the fixed coupon amount payable on the Bonds. The total net fair value decrease on the bonds, total return swaps and loans is £53,000 (2015: £62,000 increase). Refer to Note 1 to the financial statements for details. Net interest income is a key performance indicator for the Company. The net interest income for 2016 is £43,000 (2015: £43,000).

### PRINCIPAL RISKS AND UNCERTAINTIES

The Directors acknowledge that even though the global macro-economic indicators and general business environment have been improving, there remains considerable challenge. The UK economy has been recovering at a relatively strong rate since early 2015.

The Directors consider the biggest risk relates to spillover effects from the macro-economic and political uncertainty in the UK. This could have an adverse impact on UK exports, which would pull down growth.

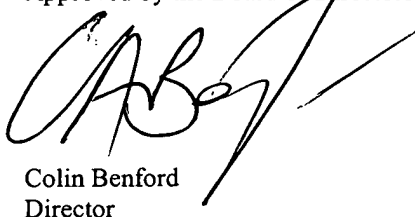
The principal risks facing the Company are liquidity risk, interest rate risk and credit risk. These risks have been monitored on an ongoing basis during the period and the Company has policies in place to mitigate these risks to enable it to continue as a going concern. Refer to Note 11 to the Financial Statements for details.

Notwithstanding the risks and uncertainties above, the financial statements have been prepared on a going concern basis as discussed in note 1.

### PAYMENT TO SUPPLIERS

Given the nature of the business, there are no trade creditors and therefore no policy or trade creditor days have been disclosed.

Approved by the Board of Directors and signed on behalf of the Board



Colin Benford  
Director

Date: 22 September 2016

# **ARTESIAN FINANCE II PLC**

## **DIRECTORS' REPORT**

The Directors present their annual report and the audited financial statements of the Company for the year ended 31 March 2016.

### **RESULTS AND DIVIDENDS**

The results for the year and the state of the Company's affairs as at 31 March 2016 are set out in the accompanying financial statements. The Directors do not recommend the payment of a dividend (2015: £nil).

### **DIRECTORS**

The Directors who served throughout the year are as follows:

Colin Benford  
Capita Trust Corporate Limited  
Capita Trust Corporate Services Limited

### **EVENTS SINCE YEAR END**

The loan to Bournemouth was transferred to South West Water Limited, effective from 1 April 2016.

### **EMPLOYEES**

The Company had no employees in the current year or prior year.

### **DIRECTORS' INDEMNITIES**

Capita Trust Corporate Limited provided third party indemnity provisions for the benefit of Colin Benford during the year. These indemnity provisions remain in force at the date of this report.

### **CORPORATE GOVERNANCE**

The board of directors has overall responsibility for the Company's internal controls systems and risk control which are managed in accordance with the terms of the Notes issued, as described in the Offering Circular for the Notes. These are monitored through regular meetings of the Board.

### **AUDITOR**

Deloitte LLP have expressed their willingness to continue in office as auditor and a resolution to reappoint them will be proposed at the forthcoming Annual General Meeting.

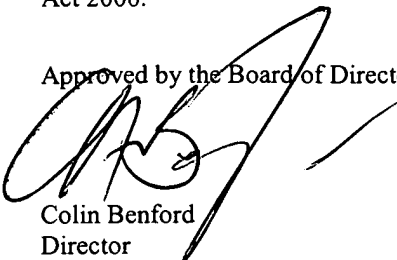
### **DISCLOSURE OF INFORMATION TO THE AUDITOR**

Each of the persons who is a director at the date of approval of this report confirms that:

- (1) so far as the director is aware, there is no relevant audit information of which the Company's auditor is unaware; and
- (2) the director 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 audit information and to establish that the Company's auditor is aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of s418 of the Companies Act 2006.

Approved by the Board of Directors and signed on behalf of the Board



Colin Benford  
Director

Date: 22 September 2016

## **DIRECTORS' RESPONSIBILITIES STATEMENT**

The Directors are responsible for preparing the Annual 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 elected to prepare the financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union. 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, International Accounting Standard 1 requires that directors:

- properly select and apply accounting policies;
- present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information;
- provide additional disclosures when compliance with the specific requirements in IFRSs are insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance; and
- make an assessment of the Company's ability to continue as a going concern.

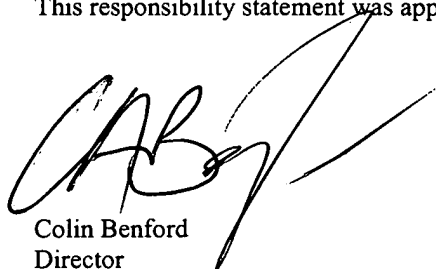
The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Company's transactions and disclose with reasonable accuracy at any time the financial position of the Company and enable them to ensure that the financial statements comply with the Companies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

### **Responsibility statement**

We confirm that to the best of our knowledge:

- the financial statements, prepared in accordance with International Financial Reporting Standards as adopted by the European Union, give a true and fair view of the assets, liabilities, financial position and profit or loss of the Company.
- the strategic 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 they face; and
- 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 performance, business model and strategy.

This responsibility statement was approved by the Board of Directors and is signed on its behalf by:



Colin Benford  
Director

22 September 2016

## **INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF ARTESIAN FINANCE II PLC**

We have audited the financial statements of Artesian Finance II plc for the year ended 31 March 2016, which comprise the statement of comprehensive income, the statement of financial position, the statement of changes in equity, the statement of cash flows and the related notes 1 to 14. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report 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 Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

### **Respective responsibilities of directors and auditor**

As explained more fully in the Directors' Responsibilities Statement, 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 International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

### **Scope of the audit of the financial statements**

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. 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.

### **Opinion on financial statements**

In our opinion 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 loss for the year then ended;
- have been properly prepared in accordance with IFRS as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

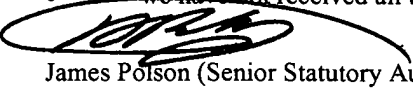
### **Opinion on other matter prescribed by the Companies Act 2006**

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.

### **Matters on which we are required to report by exception**

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept; or
- the financial statements are not in agreement with the accounting records; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.



James Polson (Senior Statutory Auditor)  
for and on behalf of Deloitte LLP  
Chartered Accountants and Statutory Auditor  
London, United Kingdom  
22 September 2016

# ARTESIAN FINANCE II PLC

## STATEMENT OF COMPREHENSIVE INCOME For the year ended 31 March 2016

	Notes	2016 £'000	2015 £'000
Interest income	3	20,800	20,800
Interest expense		(20,757)	(20,757)
Net interest income		43	43
Operating expenses	4	(93)	(55)
Other operating income		58	58
Change in fair value of loans	11	(41,031)	113,437
Change in fair value of bonds	11	13,918	(70,473)
Change in fair value of swaps	11	27,060	(42,902)
<b>(LOSS)/PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION</b>	5	(45)	108
Tax charge	6	(9)	(8)
<b>(LOSS)/PROFIT FOR THE YEAR AND TOTAL COMPREHENSIVE (LOSS)/INCOME FOR THE YEAR</b>		<b>(54)</b>	<b>100</b>

The accompanying notes form an integral part of these financial statements.

The results above arose wholly from continuing operations in the current and prior year.



# ARTESIAN FINANCE II PLC

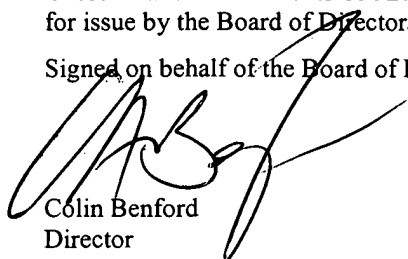
## STATEMENT OF FINANCIAL POSITION At 31 March 2016

	Notes	2016 £'000	2015 £'000
<b>NON-CURRENT ASSETS</b>			
Loans to customers	7	640,519	681,754
<b>CURRENT ASSETS</b>			
Loans to customers	7	16,985	16,781
Cash and cash equivalents		498	491
Derivatives at fair value	11	3,293	3,520
		<u>20,776</u>	<u>20,792</u>
<b>TOTAL ASSETS</b>		<u>661,295</u>	<u>702,546</u>
<b>CURRENT LIABILITIES</b>			
Other payables	8	37	31
Current tax liabilities		9	8
Bonds issued	9	22,758	23,160
		<u>22,804</u>	<u>23,199</u>
<b>NON-CURRENT LIABILITIES</b>			
Bonds issued	9	440,784	454,299
Derivatives at fair value	11	196,565	223,852
		<u>637,349</u>	<u>678,151</u>
<b>TOTAL LIABILITIES</b>		<u>660,153</u>	<u>701,350</u>
<b>EQUITY</b>			
Share capital	10	13	13
Retained earnings		1,129	1,183
<b>TOTAL EQUITY</b>		<u>1,142</u>	<u>1,196</u>
<b>TOTAL EQUITY AND LIABILITIES</b>		<u>661,295</u>	<u>702,546</u>

The accompanying notes form an integral part of these financial statements.

These financial statements of Artesian Finance II plc, registration number 4677985, were approved and authorised for issue by the Board of Directors on 22 September 2016.

Signed on behalf of the Board of Directors



Colin Benford  
Director

## ARTESIAN FINANCE II PLC

### STATEMENT OF CHANGES IN EQUITY For the year ended 31 March 2016

	Share capital £'000	Retained earnings £'000	Total £'000
Balance at 1 April 2014	13	1,083	1,096
Total comprehensive income for the financial year	-	100	100
Balance at 1 April 2015	13	1,183	1,196
Total comprehensive loss for the financial year	-	(54)	(54)
Balance at 31 March 2016	13	1,129	1,142

**STATEMENT OF CASH FLOWS**  
**For the year ended 31 March 2016**

	Notes	2016 £'000	2015 £'000
<b>Operating (loss)/profit before taxation</b>		(45)	108
Adjustments for:			
Fair value of swaps	11	(27,060)	42,902
Fair value of loans	11	41,031	(113,437)
Fair value of bonds	11	(13,918)	70,473
Changes in other payables		8	6
<b>Net cash flows from operating activities before tax</b>		16	52
Tax paid		(9)	(8)
<b>Net cash flows from operating activities after tax</b>		7	44
<b>Net increase in cash and cash equivalents</b>		7	44
Cash and cash equivalents at the beginning of the year		491	447
<b>Cash and cash equivalents at the end of the year</b>		498	491
<b>Supplemental information</b>			
Interest received		20,800	20,800
Interest paid		(20,757)	(20,757)

The accompanying notes form an integral part of these financial statements.

## NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 March 2016

### 1. ACCOUNTING POLICIES

#### General information

Artesian Finance II plc ("the Company") is a company incorporated in the United Kingdom under the Companies Act 2006. The address of the registered office is given on page 1. The nature of the Company's operations and its principal activities are set out in the Strategic Report.

#### Basis of accounting

The financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") adopted by the European Union ("EU") and under the historical cost convention as modified by International Accounting Standard 39 "Financial Instruments: Recognition and Measurement" ("IAS39").

At the date of authorisation of these financial statements, the following Standards and Amendments, which have not been applied in these financial statements were in issue but not yet effective (and in some cases have not yet been adopted by the EU):

Name of new Standards/amendments	Effective date
IFRS 9- Financial Instruments	Accounting periods beginning on or after 1 January 2018
Disclosure initiative (Amendments to IAS 7)	1 Jan 2017
IFRS 15 Revenue from Contracts with Customers	1 Jan 2018

The Directors are currently considering the potential impact of the adoption of IFRS 9 on the financial statements of the Company, but the Company does not believe that the adoption at any time in the future of the remaining Standards above will have any material impact on the amounts reported in these financial statements.

Due to the fact that the nature of the business is to provide finance, the Directors are of the opinion that it is more appropriate to use interest income and interest expense rather than turnover and cost of sales in preparing the statement of comprehensive income.

The accounting policies set out below have, unless otherwise stated, been applied consistently to all periods presented in these financial statements.

#### Going concern

The Company's business activities, performance and position, as well as principal risks and uncertainties are set out on page 2. In addition, note 11 to the financial statements includes the Company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments; and its exposures to credit risk and liquidity risk.

The Company has met its level of expected results for the financial period, and determined that its assets are performing as at the balance sheet date and therefore does not expect a shortfall in cash receipts from the borrowers. As at the balance sheet date, the Company has net assets of £1,142,000 (2015: £1,196,000). Currently the long-term assets are funded by long-term fixed rate bonds.

Total return swaps were entered into by the Company to exchange index-linked cash flows it receives on its loan assets for the fixed coupon amount payable on the bonds. The swap counterparties continue to have high credit ratings; therefore no significant credit issues are noted. In order to protect the Company and the bond holders in the event of a shortfall of funds available to pay amounts on the bonds, the Company has purchased a guarantee over the principal and the interest due on the bonds from Assured Guaranty (Europe) Limited, who are currently rated by S&P at AA.

After making enquiries, and considering the uncertainties set out on page 2, the Directors have a reasonable expectation that the Company has adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis in preparing the Annual Report and Financial Statements.

**NOTES TO THE FINANCIAL STATEMENTS**

**For the year ended 31 March 2016**

**1. ACCOUNTING POLICIES (CONTINUED)**

**Critical accounting judgements and key sources of estimation uncertainty**

The preparation of financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expense, in particular over recoverability of assets and fair value of financial instruments. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making judgements on carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from the estimates used in the financial statements.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both the current and future periods.

The method and assumptions used to calculate fair values are described below. Fair value classification disclosures are included in Note 11.

**Financial instruments**

Financial assets and financial liabilities are recognised in the Company's Statement of Financial Position when the Company becomes a party to the contractual provisions of the instrument.

The Company's financial instruments comprise Loans to customers, Bond liabilities, derivative financial instruments, cash, debtors and creditors, which arise directly from its operations and are part of its principal activity.

**Loans to customers**

Loans to customers were designated and are accounted for in these financial statements as financial assets 'at fair value through profit or loss' (FVTPL) with any gain or loss on re-measurement being recognised in the statement of comprehensive income. Loans to customers were designated at FVTPL to significantly reduce a measurement or recognition inconsistency that would otherwise arise. Interest earned on the Loans to customers is included in the interest income line item in the statement of comprehensive income. Fair value is determined in the manner described in Note 11.

**Bonds issued**

The bonds were designated and are accounted for at FVTPL with any gain or loss on re-measurement being recognised in the statement of comprehensive income. The Bonds were designated at FVTPL to significantly reduce a measurement or recognition inconsistency that would otherwise arise. Interest incurred on the bonds is included in the interest expense line item in the statement of comprehensive income.

The fair values of all the Company's financial instruments equate to their carrying amount. For the fixed rate bonds issued, market values have been used to determine fair values. However, the bonds are not actively traded due to the limited liquidity that exists in the market. For other financial instruments where no market values are available, fair values have been calculated by discounting cash flows at prevailing interest rates. In the calculation of discount factors for the fixed rate and RPI linked loans and total return swaps, a spread consistent with that implied on the fixed rate bonds issued has been applied. RPI linked cash flows have been forecast using rates derived from Sterling Index Linked Gilts.

**Derivative Instruments**

The Company does not enter into speculative derivative contracts. Derivative financial instruments are recorded at FVTPL, with any gain or loss on re-measurement being recognised in the statement of comprehensive income. The derivative instruments are classified as held for trading.

**Revenue recognition**

Financial assets and financial liabilities are recorded at fair value. Changes in fair value are recognised in profit or loss separately from interest income and expense.

**NOTES TO THE FINANCIAL STATEMENTS**

**For the year ended 31 March 2016**

**1. ACCOUNTING POLICIES (CONTINUED)**

**Segmental analysis**

All investment income arises in the United Kingdom.

**Taxation**

Provision is made for taxation at current enacted rates on taxable profits, arising in income or in equity, taking into account relief for overseas taxation where appropriate.

Deferred taxation is accounted for in full for all temporary differences between the carrying amount of an asset or liability for accounting purposes and its carrying amount for tax purposes.

Deferred tax assets are only recognised to the extent that it is probable that they will be recovered.

**2. DIRECTORS AND EMPLOYEES**

None of the Directors received any emoluments for their services to the Company during the year (2015: nil).

None of the Directors have any interests in the Company as at year end (2015: nil).

None of the Directors had any material interest in any contract of significance in relation to the business of the Company (2015: none).

The Company does not have any employees (2015: none).

**3. INTEREST INCOME**

	<b>2016</b>	<b>2015</b>
	<b>£'000</b>	<b>£'000</b>
Interest income on loans	17,205	17,061
Interest received on swaps	3,595	3,739
	<u>20,800</u>	<u>20,800</u>

**4. OPERATING EXPENSES**

	<b>2016</b>	<b>2015</b>
	<b>£'000</b>	<b>£'000</b>
Administrative expenses incurred	<u>93</u>	<u>55</u>

**5. OPERATING (LOSS)/PROFIT ON ORDINARY ACTIVITIES BEFORE TAXATION**

	<b>2016</b>	<b>2015</b>
	<b>£'000</b>	<b>£'000</b>
The (loss)/profit on ordinary activities before taxation is stated after charging:		
Auditor's fees for the audit of the Company's accounts	<u>31</u>	<u>31</u>

**NOTES TO THE FINANCIAL STATEMENTS**

**For the year ended 31 March 2016**

**6. TAXATION**

a) Tax on profits/losses on ordinary activities

	2016 £'000	2015 £'000
Current taxation:		
UK Corporation tax at 20% (2015: 20%)	9	8
Current tax charge for the year	9	8
Total tax charge to the statement of comprehensive income	9	8

b) Reconciliation of the total tax charge

The actual tax charge differs from the expected tax charge computed by applying the applicable rate of UK corporation tax rate of 20% (2015: 20%) as follows:

	2016 £'000	2015 £'000
(Loss)/profit before tax	(45)	108
(Loss)/profit before tax multiplied by the applicable rate of corporation tax at 20% (2015: 20%)	-	22
Effects of:		
Adjustment under s14(4) SI 2006/3296	-	(22)
Adjustment under s14(1)(a)(ii) SI 2006/3296	9	8
Total tax charge for the year	9	8

For UK corporation tax purposes, the Company has been considered as a securitisation company under the 'Taxation of Securitisation Companies Regulations 2006' (SI 2006/3296). Therefore, the Company is not required to pay corporation tax on its accounting profit or loss. Instead, the Company is required to pay tax on its retained profits as specified in the documentation governing the securitisation transaction into which the Company has entered.

**7. LOANS TO CUSTOMERS**

	2016 £'000	2015 £'000
Loans to customers – fixed rate	77,127	79,446
Loans to customers – RPI indexed	580,377	619,089
	657,504	698,535
Loans falling due within one year	16,985	16,781
Loans falling due after more than one year	640,519	681,754

The loan portfolio at year end has nominal values amounting to £321,500,000 (2015: £321,500,000) and comprises loans to four water companies. Three of them have RPI index-linked principal and interest rate characteristics while the remaining one has two fixed rates of interest (see Note 11). The loans are due to mature on 30 September 2033, but the borrowers have the right to make voluntary prepayments if they give no less than 45 days' written notice in accordance with the loan agreement.

**NOTES TO THE FINANCIAL STATEMENTS**

**For the year ended 31 March 2016**

**8. OTHER PAYABLES**

	<b>2016</b> <b>£'000</b>	<b>2015</b> <b>£'000</b>
Other payables	<u>37</u>	<u>31</u>

**9. BONDS ISSUED**

	<b>2016</b> <b>£'000</b>	<b>2015</b> <b>£'000</b>
Fixed rate bonds	<u>(463,542)</u>	<u>(477,459)</u>
Amounts falling due within one year	(22,758)	(23,160)
Amounts falling due after more than one year	<u>(440,784)</u>	<u>(454,299)</u>

The Company has issued fixed rate bonds which are listed on the London Stock Exchange with a nominal value of £345,950,000 under the Company's £500,000,000 bond issuance programme. The bonds bear interest of 6% with a legal maturity date of 30 September 2033. The bonds can be redeemed early under certain conditions described in the Offering Circular.

In order to protect the Company and the bond holders in the event of a shortfall of funds available to pay amounts to on the bonds, the Company has purchased a guarantee. The guarantee is provided by Assured Guaranty (Europe) Limited, who are rated by S&P at AA, which unconditionally and irrevocably guarantees all scheduled payments of principal and interest throughout the life of all related bonds issued.

**10. SHARE CAPITAL**

	<b>2016</b> <b>£'000</b>	<b>2015</b> <b>£'000</b>
<b>Authorised</b>		
50,000 (2015: 50,000) ordinary shares of £1 each	<u>50</u>	<u>50</u>
<b>Called up, allotted and partly paid</b>		
50,000 (2015: 50,000) ordinary shares		
partly paid up at 25p each	<u>13</u>	<u>13</u>

49,999 shares of the Company are held by Capita Trust Nominees No. 1 Limited on behalf of a Charitable Trust and one share by Capita Trust Company Limited on behalf of a Charitable Trust. These shares were issued on 1 March 2003 for a cash consideration of 25p each.



**NOTES TO THE FINANCIAL STATEMENTS**

**For the year ended 31 March 2016**

**11. FINANCIAL INSTRUMENTS**

The Company's financial instruments principally comprise loans advanced to water companies, bonds issued, total return swap contracts, cash and other items arising directly from the Company's operations.

It is, and has been throughout the year, the Company's policy that no trading in financial instruments shall be undertaken.

**Capital risk management**

The Company manages its capital to enable it to continue as a going concern.

The capital structure of the Company primarily comprises issued bonds. Other sources of funding consist of equity attributable to equity holders of the parent, comprising issued share capital and retained earnings.

The Company is not subject to any externally imposed capital requirements.

**Credit risk**

The main risk arising from the Company's financial instruments is credit risk. The Company faces the credit risk that customers might not be able to meet their obligations as they fall due. While the loans are secured by a fixed and floating charge over customers' assets and their immediate holding companies, the Company considered the customers' ability to service the loans to be the principal factor in assessing the credit risk and the decision to lend. With respect to the five loans to UK water board companies, the Directors conclude that there are no past due receivable balances at year-end (2015: £nil).

In addition the Company faces credit risk on the swap counterparties' obligations under the agreement. The swap counterparties Royal Bank of Scotland Plc and Belfius Bank SA (formerly known as Dexia Bank SA) continue to have high credit ratings by S&P, and the Directors and management will continue to monitor this exposure.

The maximum exposure to credit risk arising on the Company's financial assets at the reporting date is the balance sheet amount of Loans to customers of £657,504,000 (2015: £698,535,000).

The fixed and floating charge over the customers' assets, and their immediate holding companies, make up the primary collateral for the loans.

# NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 March 2016

## 11. FINANCIAL INSTRUMENTS (CONTINUED)

### Liquidity risk

Funding for purchase of the loan portfolio was obtained through issuance of fixed rate bonds to the market. The Company has entered into total return swaps to hedge the difference between amounts received on the loans to customers and amounts payable on the bonds. In order to ensure that the Company has sufficient cash at maturity to redeem the bonds, the swaps pay any difference between the principal repayment from the borrower and the total amount due to the bondholders.

The Company has in place a guarantee to ensure that sufficient liquidity is maintained to meet the obligations on the bonds. As such if the Company faces a shortfall in cash resources to pay interest or principal on the notes, the bondholders would receive the required amount from the guarantor.

The table below reflects the undiscounted contractual cash flows of financial liabilities at the balance sheet date.

As at 31 March 2016	Carrying amount £'000	Contractual cash flows £'000	<1 month £'000	1-3 months £'000	3 months- 1 year £'000	1-5 years £'000	5 years and over £'000
<b><u>Non-derivative financial liabilities</u></b>							
Bonds issued	(463,542)	(709,197)	-	-	(20,757)	(83,028)	(605,413)
Other creditors	(37)	(37)	(37)	-	-	-	-
Current tax liabilities	(9)	(9)	(9)	-	-	-	-
	<u>(463,588)</u>	<u>(709,243)</u>	<u>(46)</u>	<u>-</u>	<u>(20,757)</u>	<u>(83,028)</u>	<u>(605,413)</u>
<b><u>Derivative financial liabilities</u></b>							
Total return swaps	(193,272)	(355,417)	-	-	3,377	9,378	(368,172)
Total	<u>(656,860)</u>	<u>(1,064,660)</u>	<u>(46)</u>	<u>-</u>	<u>(17,380)</u>	<u>(73,650)</u>	<u>(973,585)</u>
As at 31 March 2015	Carrying amount £'000	Contractual cash flows £'000	<1 month £'000	1-3 months £'000	3 months -1 year £'000	1-5 years £'000	5 years and over £'000
<b><u>Non-derivative financial liabilities</u></b>							
Bonds issued	(477,459)	(729,954)	-	-	(20,757)	(83,028)	(626,169)
Other creditors	(31)	(31)	(31)	-	-	-	-
Current tax liabilities	(8)	(8)	(8)	-	-	-	-
	<u>(477,498)</u>	<u>(729,993)</u>	<u>(39)</u>	<u>-</u>	<u>(20,757)</u>	<u>(83,028)</u>	<u>(626,169)</u>
<b><u>Derivative financial liabilities</u></b>							
Total return swaps	(220,332)	(407,124)	-	-	3,606	10,578	(421,308)
Total	<u>(697,830)</u>	<u>(1,137,117)</u>	<u>(39)</u>	<u>-</u>	<u>(17,151)</u>	<u>(72,450)</u>	<u>(1,047,477)</u>

# NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 March 2016

## 11. FINANCIAL INSTRUMENTS (CONTINUED)

### Liquidity risk (continued)

The table below reflects the discounted contractual cash flows of financial derivatives at the balance sheet date.

	2016 £'000	2015 £'000
Total return swaps	(193,272)	(220,332)
Amounts falling due within one year	3,293	3,520
Amounts falling due after more than one year	(196,565)	(223,852)

### Interest rate risk

The Company finances its operations through the issue of bonds at a fixed rate of 6.00% per annum (p.a.). The loan to Bristol Water plc carries a fixed rate of interest of 6.01% p.a. The loans to Southern Water Services Limited, Bournemouth Water Limited and South East Water Limited (formerly known as Mid Kent Water Limited) carry a fixed rate of interest of 4.076% p.a., 3.083% p.a. and 2.801% p.a. respectively, adjusted for the UK RPI indexation on a semi-annual basis. However, the Company has entered into total return swaps in which the Company exchanges the indexation-linked interest it receives on the loans for the fixed coupon amount payable on the bond; hence no significant net interest rate risk exists. As such, no sensitivity analysis has been presented. The loans and bonds mature on 30 September 2033.

### Foreign exchange risk

All transactions and financial instruments are denominated in sterling and consequently no currency exposure arises.

### Fair values of financial assets and financial liabilities

The fair values of all the Company's financial instruments equate to their carrying amount. Fair values have been determined using the methods described in Note 1.

	Opening fair value £'000	Movement at cost £'000	Movement in fair value £'000	Closing fair value £'000
Cash and cash equivalents	491	7	-	498
Loans to customers – fixed rate	79,446	-	(2,319)	77,127
Loans to customers – RPI indexed	619,089	-	(38,712)	580,377
Fixed rate bonds	(477,459)	-	13,918	(463,541)
Total return swaps	(220,332)	-	27,059	(193,273)
	1,235	7	(54)	1,188

# NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 March 2016

## 11. FINANCIAL INSTRUMENTS (CONTINUED)

### Fair values of financial assets and financial liabilities (continued)

The Company classifies fair value measurements using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

- a) quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1);
- b) inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices) (Level 2); and
- c) inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3).

There have been no transfers between Level 1 and 2 during the year.

	Total £'000	Level 1 £'000	Level 2 £'000	Level 3 £'000
Financial assets				
Loans to customers – fixed rate	77,127	-	77,127	-
Loans to customers – RPI indexed	580,377	-	580,377	-
Total return swaps	3,293	-	3,293	-
	<u>660,797</u>	<u>-</u>	<u>660,797</u>	<u>-</u>
Financial liabilities				
Fixed rate bonds	463,541	-	463,541	-
Total return swaps	196,565	-	196,565	-
	<u>660,106</u>	<u>-</u>	<u>660,106</u>	<u>-</u>

## 12. RELATED PARTY TRANSACTIONS

Capita Trust Company Limited is the corporate service provider for the Company. During the year, fees incurred for these services were £19,015 (2015: £13,276).

## 13. ULTIMATE PARENT AND CONTROLLING PARTY

The ultimate parent company and controlling party is Capita Plc, a company listed on the London Stock Exchange.

Capita Trust Nominees No. 1 Limited, which holds a majority shareholding under the terms of a declaration of a Charitable Trust, is a wholly owned subsidiary of Capita Plc.

## 14. SUBSEQUENT EVENTS

The loan to Bournemouth was transferred to South West Water Limited, effective from 1 April 2016.