

AFFINITY WATER ACQUISITIONS (INVESTMENTS) LIMITED

**ANNUAL REPORT AND FINANCIAL STATEMENTS
FOR THE PERIOD ENDED 31 MARCH 2013**

(Registered Number 08101550)



Affinity Water Acquisitions (Investments) Limited

Contents

	Page
ANNUAL REPORT AND FINANCIAL STATEMENTS	
Directors and advisers	1
Directors' report	2
Independent auditor's report	23
Consolidated profit and loss account	25
Statement of group total recognised gains and losses	26
Consolidated balance sheet	27
Company balance sheet	28
Consolidated cash flow statement	29
Notes to the consolidated cash flow statement	30
Notes to the financial statements	31

Affinity Water Acquisitions (Investments) Limited

Directors and advisers

Directors

P Nolan (Chairman)	(appointed 1 April 2013)
KE Bradbury	(appointed 17 July 2012)
J Wilmott	(appointed 17 July 2012)
A Botija	(appointed 17 July 2012)
AA Donzelli	(appointed 12 June 2012)
MA Bryan	(appointed 17 July 2012)
DA Karnik	(appointed 17 July 2012, resigned 8 March 2013)
M Lief	(appointed 12 June 2012, resigned 22 April 2013)
Y Saidji	(appointed 12 June 2012)
B Schumacher	(appointed 12 June 2012)

Company Secretary

TJW Monod (appointed 17 July 2012)

Registered Office

Tamblin Way
Hatfield
Hertfordshire
AL10 9EZ

Registered Auditors

Ernst & Young LLP
1 More London Place
London
SE1 2AF

Registered Number

008101550

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013

Introduction

The directors submit their first annual report and the audited consolidated financial statements of Affinity Water Acquisitions (Investments) Limited for the period ended 31 March 2013

The company was incorporated as Rift Acquisitions (Investments) Limited on 12 June 2012. The name of the company was changed from Rift Acquisitions (Investments) Limited to Affinity Water Acquisitions (Investments) Limited on 1 October 2012.

Principal activity

The principal activities of Affinity Water Acquisitions (Investments) Limited is the investment in and management of long term interests in the water industry in the United Kingdom.

Affinity Water Limited is the principal trading subsidiary of the group. Affinity Water Limited supplies 900 million litres of water each day to a population of more than 3.5 million people. Affinity Water Limited operates in an area of approximately 4,515km² split into three regions in the south east of England (which represent the three regions in which it operated as separate entities prior to the unification of these businesses on 27 July 2012, as set out in the section on significant events occurring during the year below): southeast (412km²) (the Southeast region), central (3,721km²) (the Central region) and east (382km²) (the East region). The Central region covers North London and the Home Counties both north and west of the capital including key urban centres such as Luton, Harlow, Stevenage, Watford and Woking. The Southeast region includes the urban centres of Folkestone and Dover and the East region includes the urban centre of Clacton. All three regions are determined by the Secretary of State for the Environment to be areas of serious water stress with current or future household demand for water being or likely to be a high proportion of effective rainfall available to meet current or future demand. Consequently, Affinity Water Limited has invested and continues to invest considerable resources in maintaining its water resources and managing demand to seek to ensure demand and supply remain in balance.

Significant events during the period

Acquisition

Affinity Water Acquisitions Limited, a subsidiary of the group, was incorporated on 31 May 2012 as an acquisition vehicle formed by a consortium of investors led by Infracapital Partners II, the infrastructure investment fund managed by M&G (the European Investment arm of Prudential Plc), and Morgan Stanley Infrastructure Partners. On 28 June 2012 the company acquired Affinity Water Capital Funds Limited (formerly Veolia Water Capital Funds Limited) and its subsidiaries from Veolia Water UK Limited (formerly Veolia Water UK Plc), for a total consideration of £1,021.1m. Veolia Environnement S.A. has retained a 10 per cent minority shareholding through its subsidiary Veolia Water UK Limited.

Refinancing

The group has since refinanced the acquisition debt by way of a securitisation of Affinity Water Limited. The refinancing was achieved by reorganising the group to create the desired securitisation structure and the existing debt was repaid using the proceeds of bonds issued. As a part of the refinancing, Affinity Water Limited was financially and operationally "ring-fenced" from the rest of the group. This was effected by the transfer of the equity of the Affinity Water Limited from Affinity Water Capital Funds Limited to a newly created holding company, Affinity Water Holdings Limited. The principal business of Affinity Water Holdings Limited is holding the shares of Affinity Water Limited and it is a wholly owned subsidiary of Affinity Water Capital Funds Limited. Affinity Water Limited also incorporated Affinity Water Programme Finance Limited as a special purpose vehicle for the purpose of issuing asset backed securities. The external bonds were issued on 4 February 2013. The group believes that the ring-fencing structure will provide significant benefits, providing better access to long-term debt markets and an opportunity to reduce the cost of capital employed in the regulated business.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Affinity Water Programme Finance Limited is incorporated in the Cayman Islands and resident in the United Kingdom for tax purposes. This was necessary because restrictions under the Companies Act 2006 relating to the provision of financial assistance prevented the use of a company registered in the United Kingdom to raise financing that would, in part, be used to discharge financing put in place to make the acquisition.

Drought

During the two consecutive autumn and winter periods from 2010 to 2012 there was below average rainfall in the area supplied by the group, resulting in very low groundwater recharge (two-thirds of the group's resources are groundwater). During the previous financial period the group's groundwater declined to the level classed as severe drought. The group responded as required by its drought management plan, which sets out the measures the group needed to take to manage water supplies, depending on the severity of the drought conditions. As a result, a temporary use ban was introduced on 5 April 2012 along with six other water companies in the South East of England. The group stepped up publicity about drought and water efficiency measures to increase awareness amongst customers and encouraged them to use water carefully. Over the summer months the group made greater use of surface water sources in order to alleviate the environmental effects of its groundwater abstraction on chalk rivers and streams in the group's area. Together with the increased rainfall that followed, this resulted in the temporary use ban being lifted on 9 July 2012.

Unification

Following discussions with Ofwat during 2011, Affinity Water Limited had made a formal application to Ofwat on 23 February 2012 to unify the licences of the formerly named companies Veolia Water Central Limited, Veolia Water East Limited and Veolia Water Southeast Limited so as to operate the three areas under a single licence. Approval was received from Ofwat following a period of formal public consultation. The unification of the regulated businesses was effected on 27 July 2012. Affinity Water Limited borrowed £131.2m from Affinity Water Capital Funds Limited to fund the acquisition of the net assets of the East and Southeast regions on that date.

As part of the unification the licence conditions of Affinity Water Limited were updated. This included updating provisions to reflect the combined 2013/14 and 2014/15 price limits, to prevent differing service levels for customers in the regions served by the group, to ensure separate information continues to be held for the three supply areas for comparative purposes, to maintain an investment grade issuer credit rating, and to clarify the fees position. In addition, the ring-fencing provisions were updated to bring them in line with Ofwat's current standard. These changes were made with effect from 27 July 2012.

A cash lock-up provision was also introduced which prohibits, subject to certain limited exceptions, the transferring, leasing, licensing or lending of any sum of cash or other assets to an associated company when Affinity Water Limited no longer holds an investment grade rating or has not maintained the required investment grade rating.

Olympics

During the year, London hosted the Olympic and Paralympic Games, which included events taking place in the group's regions of water supply. The group mobilised a number of teams across the business in order to ensure that effective plans were in place in the eventuality of significant bursts or interruptions to supply that would impact the venues, increased population or travel routes. There were no issues of this nature experienced.

Rebranding

As a part of the rebranding of the whole acquired group post divestment from Veolia Water UK Limited, the name of the company changed to Affinity Water Acquisitions (Investments) Limited on 1 October 2012.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Proposed changes to future price controls

In November 2011, Ofwat published 'Future price limits – a consultation on the framework', ('Future Price Limits') a consultation on how Ofwat might set price limits that come into effect from 2015. Following the consultation, Ofwat set out its high-level framework for setting price limits from 2015 and beyond in the 'Future Price Limits – statement of principles' ('FPL Principles') in May 2012. The proposals set out include moves to

- split price controls for retail and wholesale, rather than using a single price control,
- regulate outcomes with appropriate measures of success and incentives, rather than outputs, and
- use a total expenditure ('totex') approach for cost assessment, cost recovery and incentives, rather than maintaining the current distinction between capex and opex

The impacts of these changes are uncertain as Ofwat has not yet defined its regulatory policies and methodology. The proposed changes could have a material impact on the group's business and cash flows.

Following the publication of Future Price Limits, Ofwat issued Section 13 Notices in both December 2011 and October 2012, each of which set out proposed modifications to each water company's licence which would allow Ofwat significantly more flexibility in how it sets price limits in the future.

Affinity Water Limited responded to each Section 13 Notice stating that it was unable to accept the proposals made but was broadly in favour of the separation of the 'retail' and 'wholesale' price limits. In the response to the October 2012 Section 13 Notice, it stated that it was prepared to accept alternative licence modifications which would allow Ofwat to set separate retail and wholesale price controls from 1 April 2015 and conveyed its willingness to engage in further discussions with Ofwat.

Following a period of consultation with undertakers, Ofwat issued a third Section 13 Notice on 21 December 2012, which proposed modifications to each water company's licence but limited the flexibility sought by Ofwat as to the number, form and length of controls to 'retail' controls. On 16 January 2013, Affinity Water Limited notified Ofwat that it accepted the licence modification proposed in the December 2012 Section 13 Notice.

Pensions

The new Affinity Water Pension Plan was established in February 2013, set up as an identical scheme to the VUKPP, the scheme in which the group participated until 28 March 2013. The benefits of employees and former employees of the group, and its predecessor companies, were transferred into the Affinity Water Pension Plan with effect from 28 March 2013.

The VUKPP was a multiemployer sectionalised pension plan with defined benefits and defined contribution sections. The defined benefit section was closed to new entrants in 2004 since which new members have only been eligible to join the defined contribution section.

Review of the business and financial performance

Affinity Water Limited, the principal trading subsidiary of the group, is committed to being the leading community-focused water company. This subsidiary aims to provide its customers with the best possible water service, using the group's expertise and knowledge for the benefit of the environment and the community. Affinity Water Limited has pursued five strategic priorities in order to be successful in that ambition. These five priorities are detailed further in Affinity Water Limited's own annual report and financial statements.

The group incurred a loss on ordinary activities after tax for the period of £1,479,000. The results of the group are primarily determined by the results of its principal trading subsidiary, Affinity Water Limited, during the period since acquisition, but have also been impacted in this first year of incorporation by

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

significant acquisition and debt raising fees, as well as interest on the bank debt itself prior to the refinancing of the group in February 2013

The balance sheets detailed on pages 27 and 28 shows shareholders' funds amounting to £352,388,000 for the group and £340,777,000 for the company

The financial performance of Affinity Water Limited is provided in some detail in its own annual report and financial statements for the year ended 31 March 2013, together with its non financial performance. Detailed information relating to this company, its strategy, the operation of its business, including its performance indicators, their measurement and reporting, can be specifically found in the Chief Executive's business review in Affinity Water Limited's annual report and financial statements

Dividends and dividend policy

The group's dividend policy is primarily based on maintaining a target level of gearing of 80 per cent in Affinity Water Limited, the group's principal trading subsidiary. The scale of the dividend is dependent on the level of success of this subsidiary to generate cash flows and achieving its regulatory outputs in the reported period. The policy distributes earnings equal to the amount necessary to maintain net debt to regulatory capital value ('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.

The directors have declared and paid the following ordinary dividends during the period ended 31 March 2013

	£000
Interim – December 2012	<u>8,001</u>
	<u>8,001</u>

No final dividend is proposed

Debt financing

The £200m 22-year bond, issued by Affinity Water Finance (2004) Limited in 2004 at 5.875 per cent, remained in issue.

As a part of the refinancing in February 2013 all other existing loans and revolver facilities were replaced by the following four new bonds issued on 4 February by the group's subsidiary, Affinity Water Programme Finance Limited:

- £80m Class A guaranteed notes maturing in September 2022 with a coupon rate of 3.625 per cent,
- £250m Class A guaranteed notes maturing in March 2036 with a coupon rate of 4.50 per cent,
- £150m Class A guaranteed RPI index-linked notes maturing in June 2045 with a coupon rate of 1.548 per cent, and
- £95m Class B guaranteed RPI index-linked notes maturing in June 2033 with a coupon rate of 3.249 per cent.

The amount outstanding at year end, net of amortised debt issuance costs of £9.3m, is £565.9m. For further details refer also to note 28.

The credit-ratings given to the long-term bonds issued by the group by the credit rating agencies Moody's and Standard and Poor's supports the credit-worthiness of the group. Moody's A3 for Class A bonds and Baa3 for Class B bonds, Standard and Poor's A- for Class A bonds and BBB for Class B. The balance

Affinity Water Acquisitions (Investments) Limited

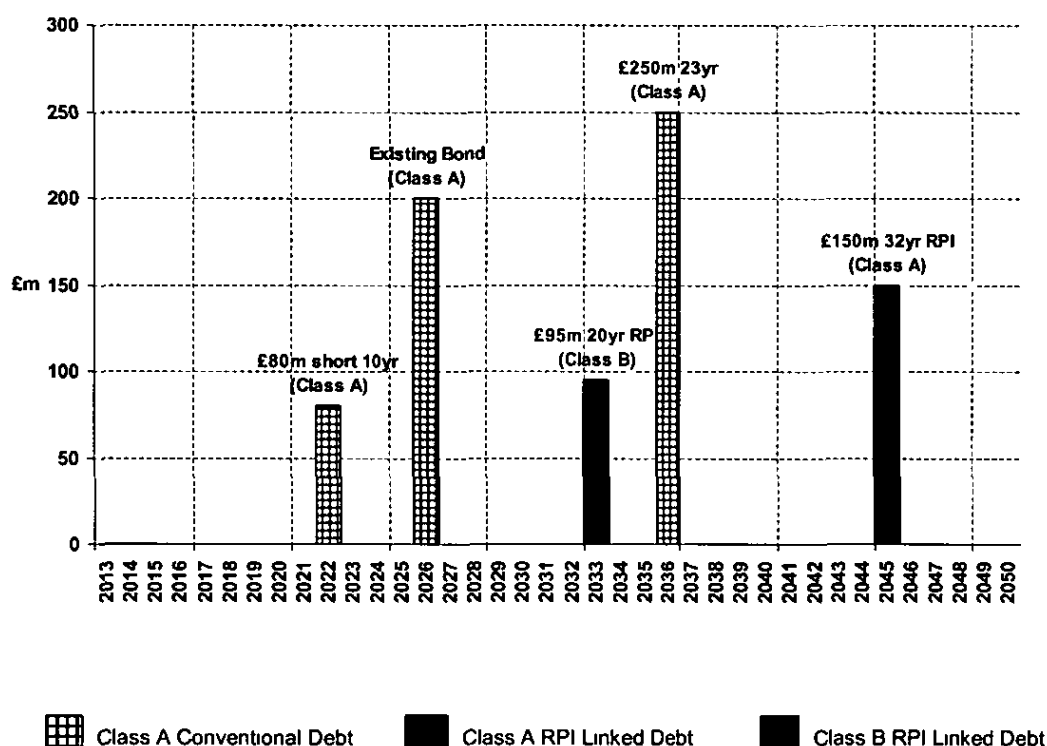
Directors' report for the period ended 31 March 2013 (continued)

sheet remains strong, with compliance debt (of Affinity Water Limited, the group's principal trading subsidiary) at around 77 per cent of regulatory capital value

The bonds issued by the company's subsidiaries can be summarised as follows

Debt	Bond £m	Cost	Maturity Date
Existing bond (2004)	200 0	5.88%	July 2026
Class A index linked (IL) refinancing bond	150 0	1.548% (real)	June 2045
Class A fixed rate refinancing bond (1)	250 0	4.501%	March 2036
Class A fixed rate refinancing bond (2)	80 0	3.686%	September 2022
Total Class A	680 0		
Class B			
USS confirmed Class B IL refinancing bond	95 0	3.249% (real)	June 2033
Total Class B	95 0		
Total	775 0		

The following chart shows the maturity profile of the bonds



Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

The total value of the issued bonds can be reconciled to the group's net debt position at 31 March 2013 as follows

	£000
Nominal value of fixed interest bonds issued	530,000
Nominal value of index linked bonds issued	245,000
Total nominal value of bonds issued	775,000
Accretion on index linked bonds	151
Capitalised bond issue costs	(12,387)
Debentures	36
Financing of shared reservoir assets	17,278
Loan from parent undertaking	130,020
Cash in hand	(44,545)
Net debt	865,553

For the remainder of the current price review period, AMP5, the group anticipates that it will have a positive net cash inflow before equity dividends paid to shareholders and financing

To the extent that additional funding is required during the period, the group has access to undrawn borrowing facilities totalling £100m, comprising a £70m capital expenditure facility and a £30m working capital facility (both with a tenure of five years from 28 June 2012)

Further, the group has available 364-day revolving structural facilities totalling £57.5m, comprising a Debt Service Reserve Liquidity Facility of £37.5m and an Operations and Maintenance Reserve Facility of £20m

Ownership

The group recognises the importance of transparency with respect to its ownership and governance arrangements in order to maintain trust and legitimacy with its customers, regulators and other stakeholders. To this end, the sections that follow explain the ownership of the group, the structure of the group in which it operates and the governance arrangements that are in place. The period ended 31 March 2013 has seen significant change in ownership and the governance arrangements of the group and it is anticipated that governance arrangements will be further refined over the course of the next 12 months.

The effective equity interest in the group is as follows

Infracapital Partners II	40%
Morgan Stanley Infrastructure Partners	40%
Beryl Datura Investment Limited	10%
Veolia Water UK Limited	10%

Infracapital Partners II

Infracapital Partners II has made its investment in the group through 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.

Infracapital Partners II is one of a number of European infrastructure funds managed by M&G Investment Management Limited, a subsidiary of Prudential Plc. It was established in 2010 to make investments in income-generative infrastructure assets and businesses, including electricity and gas networks, water companies, transport infrastructure and renewable energy.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Morgan Stanley Infrastructure Partners

Morgan Stanley Infrastructure Partners has made its investment in the group indirectly through MSIP Dalis B V. MSIP Dalis B V is incorporated in the Netherlands.

Morgan Stanley Infrastructure Partners 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.

Beryl Datura Investment Limited

Beryl Datura Investment Limited has made its investment in the group through Infracapital F2 Rift Holdings S à r l. It is a company established by the State Administration of Foreign Exchange of the People's Republic of China. It is managed by Ginkgo 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.

Veolia Water UK Limited

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 has made its investment in the group through its shareholding in Affinity Water Acquisitions (Holdco) Limited and has established with the group a capability sharing arrangement. This arrangement gives it access to the group's knowhow, experience and expertise while the group has access to Veolia Water's advice on global water technologies and developments.

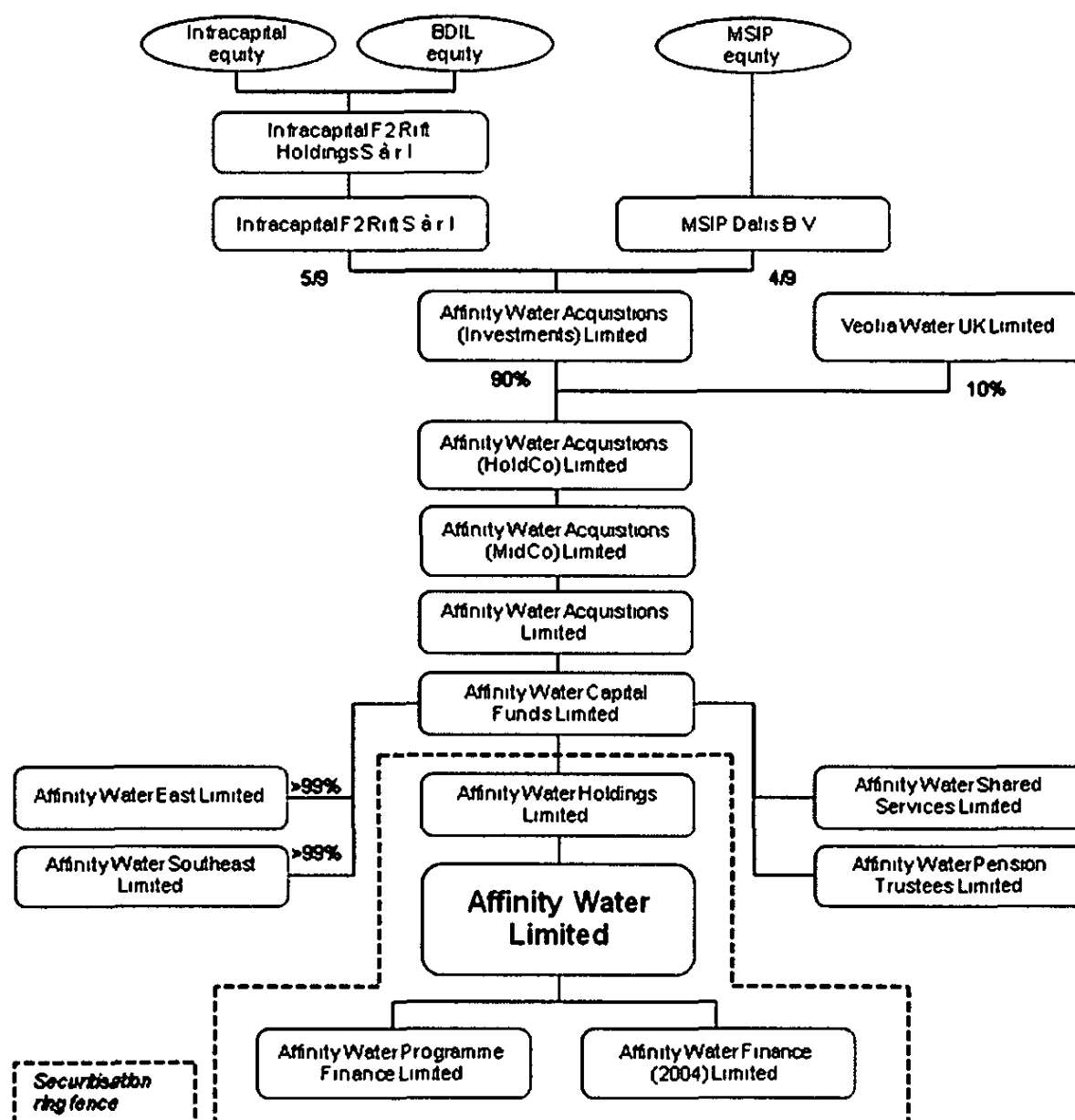
The chart on the following page shows the ownership and the group structure, excluding dormant subsidiaries. Unless otherwise indicated, all companies are wholly owned by the parent company shown.

The group has two wholly owned financing subsidiaries: Affinity Water Finance (2004) Limited and Affinity Water Programme Finance Limited. The latter is incorporated in the Cayman Islands and resident in the United Kingdom for tax purposes. This was necessary because restrictions under the Companies Act 2006 relating to the provision of financial assistance prevented the use of a company registered in the United Kingdom to raise financing that would, in part, be used to discharge financing put in place to make the acquisition.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Ownership and group structure



Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Board of directors

The directors of Affinity Water Acquisitions (Investments) Limited are shown on page 1

The table below sets out attendance at meetings for period ended 31 March 2013

	Board
Number of meetings in period	8
Antonio Botija*	2
Kenton Bradbury*	1
Andrew Dench*	4
Yacine Saidji*	6
Bernd Schumacher	4
James Wilmott*	3
Former directors	
Alberto Donzelli*	7
Deven Karnik*	3
Mathieu Lief	8

* denotes not a member of the Board for the whole period

Corporate governance

The group and company benefits from the corporate governance arrangements established by Affinity Water Limited, full details of which can be found in Affinity Water Limited's own annual report and financial statements, together with more detailed corporate reporting disclosures

The Board has overall responsibility for the group's and company's systems of internal control and for reviewing the effectiveness of these systems. It is responsible for ensuring the group and company meets its obligations to its shareholders and meets from time to time to facilitate this.

Market environment

Competition in the water industry

Each regulated company effectively holds a geographic monopoly within its appointed area for the provision of water services or water and sewerage services although there is some limited competition. Ofwat has stated that it will use its powers under the Competition Act to investigate and prohibit anticompetitive practices and abuses of a dominant position to ensure a level playing field in the industry.

The current main methods for introducing competition are

- inset appointments which allow one company to replace another as the statutory undertaker for water or sewerage services in a specified geographical area within the other regulated company's appointed territory. An inset appointment can be granted to a company seeking to provide water and/or sewerage services on an unserved site, or in respect of a site with water and/or sewerage services within an existing regulated company's area where 50 megalitres of water are supplied or likely to be supplied to particular premises in any 12 month period or where the incumbent regulated company consents to the variation. The inset mechanism continues alongside the regime for licensing new entrants under the Water Act,
- facilitating developers, or their contractors, to provide new water mains and service pipes instead of asking regulated companies to do the work ('self-lay'). The Water Act introduced a statutory framework for self-lay,

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

- (c) water supply licence (retail) – when a holder of a water supply licence purchases wholesale supplies of water from the existing water undertaker and supplies water to a customer's eligible premises (i.e. using more than five megalitres per annum) Regulated companies have published indicative access prices, based on the "cost principle" which indicate the approximate scale of discount they would offer to licensees,
- (d) water supply licence (combined) – when a holder of a water supply licence introduces water into the supply system and supplies water to its customer's eligible premises using a regulated company's network (referred to as 'common carriage') All regulated companies maintain access codes which set out the conditions under which licensees may introduce water into their networks, and
- (e) cross-border supplies (raw/treated water) where a customer in an area adjacent to a neighbouring regulated company's territory can connect to another regulated company's network and receive a supply

Future developments

During the period, Affinity Water Limited, the principal trading subsidiary of the group, indicated to Ofwat it would accept modifications to its instrument of appointment to facilitate the setting of separate price controls for wholesale and retail activities at the price review in 2014. These changes allow incentives for water companies to be better targeted and preserve features of the current regime that have allowed water companies to deliver continued investment at costs which customers have found acceptable. The group is facing significant challenges from population growth, the need for improved resilience, sustainability reductions and climate change and is supportive of legal and regulatory reform that addresses these challenges, delivers clear benefits to customers and builds on the recognised strengths of the existing regulatory framework.

Affinity Water Limited has been working to prepare its Business Plan for the next regulatory period which will run from 2015 to 2020. Ofwat's commitment to placing greater responsibility on companies to develop their plans in consultation with their customers and to rewarding companies whose business plans are well balanced and well evidenced has been welcomed by the company.

Affinity Water Limited is committed to placing customers at the heart of its future plans and, during the year, established an independently-chaired Customer Challenge Group to advise, challenge and support the company in the development of its plans to ensure they reflect customers' priorities. The Board recognises the need to produce a plan which balances the efficient cost of financing investment and operating the business over the longer term, with appropriate risk and reward sharing with customers who may face significant challenges of bill affordability at this time.

As part of the proposals to unify the three former separate operating businesses, the group is already committed to ensuring that customers benefit from annual savings in operating costs from 1 April 2015.

Principal risks and uncertainties

The group has a formal and continuous process for identifying, evaluating and managing the key risks faced. The main risks of the group are centred around its principal trading subsidiary, Affinity Water Limited, and hence this section focuses on the risks and uncertainties of Affinity Water Limited (referred to as the 'subsidiary' throughout the remainder of this section).

Risks for Affinity Water Limited, both strategic and operational, are reviewed and discussed by the executive management team. A key aim is to foster a culture in which staff throughout the business manage all risks as part of their management of day to day operations. The Audit Committee reviews the executive management team's work on risk management and reports to the Board on significant risks.

Each of the key risks has a 'risk owner' from the senior management team who is responsible for establishing appropriate controls to mitigate the risks as far as possible.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

In addition, and in accordance with regulatory obligations, Affinity Water Limited produces an annual Risk and Compliance Statement for both Ofwat and other stakeholders

The key areas in which risks are identified and reported on are

- Economic and regulatory
- Competition
- Revenue and cost
- Operational
- Security
- Environmental
- Health and safety
- Financial

Further information on these can be found in the sections below

Economic and regulatory risk

The regulated water industry in the United Kingdom comprises a number of regional monopolies which are subject to economic and technical regulation. Water charges are subject to price controls set by Ofwat on a five year cycle. Price determinations made by Ofwat can have a significant impact on profits and cash flows.

The water industry is subject to extensive legal and regulatory controls with which the subsidiary must comply. The application of the laws, regulations and standards and the policies published by Ofwat, the Environment Agency, the Department for the Environment, Food and Rural Affairs ('DEFRA'), the Drinking Water Inspectorate, Natural England and other regulators could have an adverse impact on the business, financial condition or operational performance of the subsidiary.

In this context the following areas of risk should be considered

Instrument of appointment modifications

The conditions of the subsidiary's Instrument of Appointment may be modified by Ofwat with the consent of the subsidiary, or without the subsidiary's consent where, following a reference to the Competition Commission, the Competition Commission concludes that there are effects adverse to the public interest which can be remedied or prevented by modifications. Modifications could also result from a decision on a merger or market investigation reference by the Competition Commission. Modifications to the conditions of the Instrument of Appointment may also be made without the subsidiary's consent by the Secretary of State for the Environment by order following an adverse finding by the Competition Commission after it has investigated and reported on a monopoly or merger situation under other amendments.

Any modification to the conditions of the Instrument of Appointment could have an adverse impact on the business, financial condition or operational performance of the subsidiary.

Breach of conditions of the Instrument of Appointment

A failure by the subsidiary to comply with the conditions of its Instrument of Appointment or certain statutory duties may lead to the making of an enforcement order or the imposition of financial penalties of up to 10 per cent of the subsidiary's turnover. Failure by the subsidiary to comply with any enforcement order (as well as certain other defaults) may lead to the making of a special administration order, which could have an adverse impact on its business and cash flows.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Termination of the Instrument of Appointment

There are certain circumstances under which the subsidiary could cease to hold its Instrument of Appointment for all or part of its three regions. The termination, non-renewal or transfer of the Instrument of Appointment could have an adverse impact on the subsidiary.

If the Secretary of State for the Environment or Ofwat were to make an appointment or variation replacing the subsidiary as the regulated water undertaker for its currently appointed area, they would have a duty to ensure (so far as consistent with their other duties under the Water Industry Act 1991) that the interests of the subsidiary's creditors were not unfairly prejudiced by the terms on which the successor regulated subsidiary (or companies) replacing the subsidiary could accept transfers of its property, rights and liabilities.

Competition

Ofwat has taken steps to introduce competition into the water supply market via inset appointments and the water supply licensing ('WSL') regime.

Inset appointments

Inset appointments allow one regulated company to replace another as the provider of water in a specified geographical area within another regulated company's appointed territory. There are currently no inset appointments within the subsidiary's regions, an inset appointment made in 2000 in respect of the Kodak site in the subsidiary's Central region having been reversed in 2004. Should any inset appointments be made in any of the subsidiary's regions in the future, this would lead to a reduction in revenue from any customers within an inset area that would otherwise have been supplied by the subsidiary and may potentially result in an adverse effect on its business.

Water supply licensing regime

The water supply licensing regime allows the holder of a retail or combined water supply licence to supply water to a non-household customer's premises where more than five megalitres per annum is being used at those premises. The Government is proposing to reduce the threshold level further to zero megalitres. The ability of these customers to obtain their water supply from a different supplier could adversely affect the subsidiary's turnover, which could adversely affect its business, operational performance, profitability or financial condition.

Revenue and cost risks

The significant capital expenditure required to maintain the subsidiary's assets presents the risk that the operating revenues generated by the subsidiary from its water business may not be sufficient to enable it to make full and timely payment of amounts due to creditors.

Periodic review

The turnover, profitability and cash flow of the appointed business is substantially influenced by the service levels, regulatory targets and price limits established by Ofwat in its periodic review, and Ofwat's assessment of delivery against those factors.

Although Ofwat has a duty to exercise and perform its powers and duties in the manner that it considers is best calculated to, amongst other primary duties, secure that companies are able (in particular, by securing reasonable returns on capital) to finance the proper carrying out of their functions, an adverse price determination (which would adversely affect turnover, profitability and cash flow for the subsidiary) may occur as a result of a number of factors. These include an inadequate allowed cost of capital or regulatory assumptions concerning operating expenses and required capital expenditure as well as turnover forecasts proving not to be sufficiently accurate. In addition, unforeseen financial obligations or costs may arise (for example, as a result of ensuring regulatory compliance or changes to legislation or

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

regulatory requirements, some instances of which are provided below) after a periodic review which were not taken into account by Ofwat in setting price limits and are consequently not compensated for, which could materially adversely affect the financial performance and profitability of the subsidiary

An additional consideration is the current uncertainty around how Ofwat will apply some of the regulatory mechanisms it introduced for AMP5. In particular, there remains uncertainty around how Ofwat will calculate the rewards or penalties from its Capital Expenditure Incentive Scheme ('CIS') at the end of AMP5 and therefore uncertainty around the impact of this mechanism on business cash flows. This uncertainty means it is difficult to predict how the subsidiary's business might be affected in the near future.

Interim determinations

An interim determination of price limits (an 'IDOK') may be made between periodic reviews in specified circumstances, including the Shipwreck Clause (also known as the substantial effects clause) in the Instrument of Appointment.

There is however no assurance that any IDOK sought by the subsidiary will be made or, if an IDOK or a determination pursuant to the provisions of the Shipwreck Clause is made, that such adjustment or determination, as the case may be, will provide adequate revenue compensation to the subsidiary. In such an event, the subsidiary would have to bear any additional cost from its own resources which could have an adverse impact on its profitability, cash flow and ultimate financial performance.

Where funding is considered during an interim determination, Ofwat may determine that the appropriate and reasonable level of cost of fulfilling certain obligations is likely to be less than the cost actually incurred by the subsidiary in fulfilling those obligations. In these circumstances, the funding allowed by Ofwat may not totally cover the actual costs and the subsidiary would bear this additional element from its own resources which could have an adverse impact on its profitability, cash flow and ultimate financial performance.

Failure by the subsidiary to deliver its capital investment programme

The appointed business requires significant capital expenditure for additions to, or replacement of, its assets. The price limits set by Ofwat take into account Ofwat's view of the level of capital expenditure expected to be incurred during the relevant periodic review period and the associated funding costs and operating costs.

If the subsidiary is unable to deliver its capital investment programme at expected expenditure levels or secure the expected level of efficiency savings on its capital investment programme, or the programme falls behind schedule or contains incorrect assumptions by the subsidiary as to the capital investment required, the subsidiary's profitability or performance might suffer because of a need for increased capital expenditure. Ofwat may also factor such failure into future periodic reviews by seeking to recover amounts equivalent to the "allowed costs" of any parts of the programme that are not delivered. The subsidiary's ability to meet regulatory output targets and environmental performance standards could also be adversely affected by such failure, which may result in fines imposed by Ofwat of an amount up to 10 per cent of turnover or other sanctions and further increases in capital expenditure and operating expenditure. Such consequences could impact on the subsidiary's financial performance.

Changes in the rate of inflation

The subsidiary's turnover and RCV are linked to the underlying rate of inflation (linked to the Retail Price Index or RPI) and as such are subject to fluctuations in line with changes in the rate of inflation. In addition, changes in the rate of inflation are likely to impact on the operating costs and capital expenditure of the subsidiary and on customers' ability to pay any increased charges. This element of unpredictability means that the subsidiary is exposed to such risks which it cannot accurately predict and provide for in its operations, and thus could lead to adverse consequences on its financial performance.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Construction Output Prices Index

Under the 2009 Final Determination, the allowed annual capital expenditure was indexed using the Construction Output Prices Index ('COPI'). There is a risk that the actual costs of capital investment in AMP5 will be higher than the ex-post COPI-adjusted allowed capital expenditure, resulting in a revenue penalty applied in the periodic review process for the next AMP period through the CIS mechanism. This may arise where contract conditions do not allow for index tracking (e.g. fixed cost contracts or contracts which are linked to RPI) and could lead to material, adverse consequences on the subsidiary's financial performance.

Non-recovery of customer debt

Non-recovery of customer debt is a risk to the subsidiary and may cause its profitability to suffer. This risk is exacerbated by the Water Industry Act 1991, which prohibits the disconnection for non-payment of a water supply for domestic use in any premises and the limiting of a supply with the intention of enforcing payment for domestic use in any premises, although allowance is made by Ofwat – in the price limits at

each periodic review – for a proportion of debt deemed to be irrecoverable. To achieve a re-setting of its price limits through an IDOK during a periodic review period when changes in the regulatory assumptions as to the level of non-recoverable debt are material, the subsidiary would need to demonstrate that

- (a) the increase was due to a deterioration in the economy, and
- (b) the subsidiary has put in place appropriate procedures and measures to mitigate the increase in debt levels.

The subsidiary may therefore suffer losses from its inability to recover its debts fully, which could adversely affect its business, operational performance, profitability or financial condition.

Operational risks

Water shortages

In the event of water shortages, additional costs may be incurred by the subsidiary in order to provide emergency reinforcement to supplies in areas of shortage which may adversely affect its business, results of operations, profitability or financial condition. In addition, restrictions on the use or supply of water (including temporary use bans and drought orders) may adversely affect the subsidiary's turnover and may, in extreme circumstances, require an emergency drought order (such circumstances have never been experienced by the subsidiary). Any of this could lead to significant compensation becoming due to customers because of interruptions to supply, which could adversely affect the subsidiary's business, operational performance, profitability or financial condition.

Potential water shortages may be exacerbated by reductions imposed by the Environment Agency in the volume of water licensed to be abstracted to mitigate environmental damage or to achieve sustainable levels of abstraction. Costs may be incurred by the subsidiary in implementing replacement sources for which it may not be compensated and abstraction charges could be increased by the Environment Agency to cover compensation payments made to other abstractors whose abstraction licences are revoked or varied to alleviate environmental impact, each of which could adversely affect the subsidiary's business, operational performance, profitability or financial condition.

Service interruptions due to key site or installation disruption

Unexpected failure of or disruption (including criminal acts or a major health and safety incident) at a key site or installation operated by the subsidiary or third parties (including a reservoir or treatment works) could cause a more significant interruption to the supply of services (in terms of duration or number of customers affected), materially affecting the way that the subsidiary operates, prejudicing its reputation.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

and resulting in additional costs including liability to customers or loss of revenue, each of which could have an adverse effect on its business, operational performance, profitability or financial condition

Contamination of water supplies

Water supplies may be subject to contamination, including contamination from the presence of naturally occurring compounds and pollution from man-made substances or criminal acts. In the event that the subsidiary's water supply is contaminated and the subsidiary is not aware of the contamination, the analysis of the contamination takes several days to complete or the subsidiary is unable to substitute water supply from an uncontaminated water source, or to treat the contaminated water source in a cost-effective manner, there may be an adverse effect on its business, operational performance, profitability or financial condition because of the resulting prejudice to reputation and required capital and operational expenditures. The subsidiary could also be fined for breaches of statutory requirements or regulations, or held liable for human exposure to hazardous substances in its water supplies or other environmental damage, which may also adversely affect the subsidiary's business, operational performance, profitability or financial condition.

Such operational costs may be partly recoverable through regulation mechanisms or future periodic reviews but, in the event that such recovery is not possible, such costs could be significant and could have an adverse effect on the subsidiary's business, operational performance, profitability or financial condition. The subsidiary maintains insurance policies in relation to legal liabilities likely to be associated with these risks. However, all the costs of any such liabilities may not be covered by insurance and insurance coverage may not continue to be available in the future. In addition, contamination of supplies could exacerbate water shortages, giving rise to the issues described above.

Catastrophe risk

Catastrophic events such as dam bursts, fires, earthquakes, floods, droughts, terrorist attacks, diseases, plant failure or other similar events could result in personal injury, loss of life, pollution or environmental damage, severe damage to or destruction of the subsidiary's operational assets. Subject to a possible IDOK under the Shipwreck Clause in the Instrument of Appointment, any costs resulting from suspension of operations of the subsidiary could have an adverse effect on the ability of the subsidiary to meet its financing obligations.

Although the subsidiary is required to maintain insurance against all risks which are required to be insured against under any applicable law or regulation and any additional risks which a prudent owner would insure against, provided an appropriate insurance is available on commercially reasonable terms, the proceeds from such insurance may not be adequate to cover reduced revenues, increased expenses or other losses or liabilities arising from the occurrence of any of the events described above. Moreover, there can be no assurance that such insurance coverage will be available for some or all of these risks in the future at commercially reasonable rates or at all. Any such catastrophic event could therefore have materially adverse consequences for the subsidiary's business.

Security risks

Security of supply

A large part of the water business operates in some of the driest and water stressed regions in the country. Combined with the growth of house building in the subsidiary's operating regions, these factors place pressures on the supply and demand balance, heightening the risk of having insufficient water to supply customers.

The subsidiary has a number of operational measures to address this risk. In addition the subsidiary actively promotes water efficiency amongst its customers, and has an active drought management plan to address risk of supply shortage.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Threats of terrorism

Acts of terrorism that threaten the subsidiary's operational sites, offices and mains infrastructure and water supply would severely disrupt business and operations

Environmental risks

Environmental risk

The subsidiary's water supply operations are subject to a significant number of European Union and domestic laws and regulations concerning, among other factors, the quality of treated water supplied, the protection of the environment and human health. The subsidiary and other regulated companies can incur significant costs in order to comply with such requirements imposed under existing or future environmental laws and regulations. Where such costs were not considered as part of a periodic review, in certain limited circumstances, the subsidiary may apply for an interim determination. With the frequency of legislative changes, it is not always certain how future environmental laws will impact the subsidiary and its financial condition.

The environmental legislation governing the subsidiary's business means that the subsidiary is at risk of enforcement action, prosecution, substantial fines to third parties, requirements to deal with the effects of contamination and/or upgrade plant and equipment, in the event of incidents such as a breach of water quality standards. This could materially and adversely affect the subsidiary's reputation and/or financial position.

Water quality risk

The subsidiary is required to provide potable water of the highest standard compliant with relevant legislation (including the Water Framework Directive).

Failure to provide an uninterrupted water supply fit for consumption could result in significant public health issues, environmental damage, loss of reputation and fines.

Climate change risk

Climate change will directly impact the water industry. The subsidiary's draft Water Resources Management Plan makes provision for the anticipated effect of climate change on the availability of water resources over a 25-year period and the subsidiary has reported to the Secretary of State how it is adapting to climate change.

Health and safety risk

The risk to the group is that the health and safety of employees is adversely impacted through performance of their duties. The risk ranges from an injury resulting in the loss of working days to an incident leading to compensation payments for negligence. The group has a dedicated health and safety team who work towards identifying and mitigating these risks.

Financial risks

Financial instruments

The group's financial instruments comprise borrowings, debentures, cash and liquid resources, and various items, such as trade debtors and trade creditors that arise directly from operations. The main purpose of these financial instruments is to raise finance for the group's operations. It is the group's policy, and has been throughout the period under review, that no trading in financial instruments shall be undertaken.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

The main risks arising from the group's financial instruments are interest rate risk and liquidity risk. The Board reviews and agrees policies for managing each of these risks. These policies have remained unchanged during the period.

The group finances its operations through a mixture of retained profits, external bond issues, borrowings from its parent company and debentures. Treasury policies are agreed in conjunction with the wider Affinity Water group (including liquidity and interest rate risks). The group does not undertake speculative transactions. Interest rate exposure is primarily managed by using a mixture of fixed and floating rate borrowings. The group has access to a further undrawn borrowing facility of £100m with a tenure of five years from 28 June 2012. This facility consists of a £70m capital expenditure facility and a £30m working capital facility.

For further details on financial instruments refer to note 28 of the financial statements.

High leverage

As at the date of these financial statements, the indebtedness of Affinity Water Limited is substantial in relation to its RCV. Under the external financing agreements, Affinity Water Limited is entitled to increase its leverage to 90 per cent. However, a percentage exceeding 85 per cent will result in a restriction on certain payments, such as dividends. The ability of the group to improve its operating performance and financial results will depend upon economic, financial, regulatory and other factors, including fluctuations in interest rates and general economic conditions in the United Kingdom.

Affinity Water Limited is subject to a number of covenants in relation to its borrowings, which would result in its loans becoming immediately repayable if breached. 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 group was not in breach of any financial covenants.

Hedging risks

The group is required to manage its exposure to interest rate and currency risks and may manage its inflation exposure and to that effect, will (and in the case of inflation risks, may) be required to enter into hedging transactions in accordance with the hedging policy. Any hedging agreement and the related hedging transactions may be terminated early, including as a result of a default by or insolvency of a hedging counterparty. The group will be required to maintain its total outstanding liability profile so that for Affinity Water Limited at all times at least 85 per cent of its total outstanding liability profile is not exposed to interest rate volatility for the current periodic review period to the next periodic review and at least 75 per cent of its total outstanding liability profile is not so exposed in the next periodic review period. In the event that any hedging agreement and the related hedging transactions entered into by the group are terminated early and is unable to find a replacement hedging counterparty, the group may be left exposed to interest rates, currency or inflation risks and, as a result, the funds available may be insufficient to meet the obligations of its subsidiaries under the external financing arrangements.

Financial liquidity risk

The group is required to deliver mandatory capital investment requirements generating an ongoing need for financing. The group is subject to variability of cash flow due to the billing cycle and the uncertainty of timing of customer payments. Disclosure on the management of liquidity risk is included in note 28 of the financial statements.

Financial credit risk

The group's main credit risk is in relation to trade debtors. There is a statutory requirement to provide a water supply to domestic water customers with no rights to terminate the service in the event of non payment. This risk is spread over a large number of low value customer accounts. The group ensures that sufficient resources are allocated to credit management to reduce the impact of this risk.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Research and development activities

The development and application of new techniques and technology is an important part of the group's activities

Charitable and political contributions

The charitable contributions made by the group during the period amounted to £450,386, largely to water-related and local organisations which aim to

- improve opportunities and create worthwhile experiences for the disadvantaged
- improve the quality of life of senior citizens and the vulnerable within the community
- educate young people about water and sustainability issues
- assist customers who have serious financial difficulties in paying their water bills

During the period £427,125 has been paid to the Affinity Water Trust. This trust seeks to assist customers whom it deems need help with their water debts. Affinity Water Limited has committed to donate £2.6m to the Trust in the five years to March 2014.

The group has a policy of not making political contributions.

Creditor payment policy

The group's policy is to negotiate the terms of payment with suppliers when agreeing terms of business and to pay in accordance with contractual and other legal obligations. The payment policy applies to all payments to creditors for revenue and capital supplies of goods and services. The average number of creditor days for the group is 69. The company has no creditors.

The group's people, community and environment

The group consults and informs its employees on all aspects of business performance through formal and informal consultation bodies, regular team meetings and the intranet. The group constantly discusses ways to enhance and improve its communications and consultation channels with its Trade Unions. Several initiatives have also been introduced with the aim of improving the health and well-being of the group's employees.

The group aims to ensure that each employee or applicant for employment receives the same treatment irrespective of race, gender, disability, sexual orientation, religious beliefs, 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 group are actively encouraged to find appropriate employment within the business.

The group continued to increase employee awareness of safety and health issues. The total number of accidents across the unified business including the shared services company was 77 in 2012/13. On the same basis the overall number of accidents resulting in more than three days' lost time was 8 in 2012/13. The group continues to provide, and where possible improve, employee health and safety training associated with their operational role.

The health and safety of staff is paramount. Staff are trained and continually urged to work safely. Following a comprehensive review of the group's health and safety performance, the culture has changed to one of "zero harm". The group can only be successful if everything is achieved without harm to the group's people, the environment or property.

The health and safety of the public who may be affected by the group's operations is of equal importance. In addition to training, the group's staff is continually reminded of the need to work safely within the

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

community The group also works closely with the police, local authorities, crime prevention groups and the media to tackle the nuisance caused by bogus callers

The group is committed to creating a learning environment where its employees are able to release their potential and be the best they can be The group provides training and development to ensure its people are able to successfully fulfil their roles and the emphasis for the last 12 months has been on the provision of core technical and health and safety training which has also coincided with a review of external training providers and an improvement in quality of training overall Opportunities have also been explored to increase the amount of training delivered in-house, and team leader training and toolkits will be developed during 2013/14

During the period, the group spent over £112,500 across its businesses The group's investment in training and development doesn't stop there as learning is also encouraged through vocational learning such as National Vocational Qualifications, and its graduate and apprenticeship schemes, which have structured learning and development programmes to support them, have been further reviewed and developed

For the fourth year in succession all employees received an annual bonus aligned to the group's performance The group continues to operate a group-wide flexible working scheme, which aims to meet the changing demands of its employees

As a responsible business the group is committed to managing its impact on the environment The group is focusing its efforts on reducing the amount of energy consumed, reducing, reusing or recycling resources, reducing the amount of waste going to landfill and maintaining improvements in fuel consumption

The group's Education Centre, located in South Watford, has communicated water efficiency and wider sustainability messages to over 177,000 adults and schoolchildren since it was founded in 1998 It welcomes in the region of 200 schools to its classroom and outdoor facilities at Bushey each year, with visiting children numbers reaching almost 6,000 for 2012/13 The group visited around 30 schools in its supply area as part of the outreach programme The educational activities help to raise awareness of the environment and the need to save water with these children

The group is a responsible local business which cares about the community and continues to support environmental projects within the regions it serves In order to assist in the vision to be the leading community-focused water company, a full review has been conducted of community engagement over the past year, with a view to increasing the benefit offered by supporting organisations and charities in the future Following this review, a new Community Engagement Programme will be launched in July 2013 with the aim of providing maximum benefit and increased engagement by the group in the community, through the use of group assets, donations, employee time and expertise

A monthly 'Time to Give Friday' is an on-going initiative to encourage staff to collect money for local charities, which is match funded by the group During the period ended 31 March 2013 the charities received a total of £10,400 Affinity Water is a strong supporter of WaterAid, the water industry's flagship charity, which aims to help in providing safe, clean water and sanitation to the world's poorest people

The Affinity Water Trust was established at the end of March 2009 The group has made contributions to the trust annually as outlined in the section on charitable and political contributions

Going concern

The group has adequate resources to meet its current operational and financial obligations, and the directors have a reasonable expectation that this will continue for the foreseeable future This assessment is based on the consideration of the group's budgeted cash flows, long term forecasts and related assumptions, and available debt facilities For this reason, the directors continue to adopt the going concern basis in the statutory financial statements

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Post balance sheet events

North Surrey Water Limited, a dormant subsidiary put into members' voluntary liquidation on 5 November 2009, was dissolved on 13 May 2013

On 1 April 2013, Affinity Water Limited entered into a Business Transfer Agreement with Affinity Water Shared Services Limited. The fixed assets and stock were purchased from Affinity Water Shared Services Limited for a value of £1.9m with the remaining assets due to be transferred at book value during the period.

On 2 April 2013, transitional service arrangements provided by Affinity Water Shared Services Limited since 28 June 2012 were terminated by Veolia Water UK Limited and Veolia Water Outsourcing Limited, with the exception of water quality, laboratory, and IT services, the latter of which were terminated in June 2013.

Statement of directors' responsibilities

The directors are responsible for preparing the annual report and the financial statements in accordance with applicable laws and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the directors have prepared the group and parent company financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). 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 group and the company, and of the profit or loss of the group for that period.

In preparing those 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 UK Accounting Standards have been followed, subject to any material departures disclosed and explained in 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, disclose with reasonable accuracy at any time the financial position of the company and the group, 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 the group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Disclosure of information to auditors

So far as each person who was a director at the date of approving this report is aware, there is no relevant audit information, being information needed by the auditor in connection with preparing its report, of which the auditor is unaware. Having made enquiries of fellow directors and the company's auditor, each director has taken all the steps that he or she is obliged to take as a director in order to make himself or herself aware of any relevant audit information and to establish that the auditor is aware of that information.

Affinity Water Acquisitions (Investments) Limited

Directors' report for the period ended 31 March 2013 (continued)

Auditors

In accordance with Section 485 of the Companies Act 2006, Ernst and Young LLP are not seeking reappointment and a resolution to appoint the auditors, PricewaterhouseCoopers LLP, will be proposed at the annual general meeting

By order of the Board



TJW Monod
Company Secretary
23 October 2013

Independent auditor's report to the members of Affinity Water Acquisitions (Investments) Limited for period ended 31 March 2013

We have audited the financial statements of Affinity Water Acquisitions (Investments) Limited for the period ended 31 March 2013 which comprise the Consolidated profit and loss account, the Statement of group total recognised gains and losses, the Consolidated balance sheet and Company balance sheet, the Consolidated cash flow statement, and the related notes 1 to 33. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

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 Statement of directors' responsibilities set out on page 21, 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 group's and the parent 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 and financial statements to identify material inconsistencies with the audited financial statements. 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 group's and of the parent company's affairs as at 31 March 2013 and of the group's loss for the period 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.

Opinion on other matter prescribed by the Companies Act 2006

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

**Independent auditor's report to the members of Affinity Water
Acquisitions (Investments) Limited for period ended 31 March 2013
(continued)**

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

Ernst & Young LLP

Steven Dobson (Senior statutory auditor)
for and on behalf of Ernst & Young LLP, Statutory Auditor
London
25 October 2013

Affinity Water Acquisitions (Investments) Limited

Consolidated profit and loss account for the period ended 31 March 2013 (Registered Number 08101550)

	Note	2013 £000
Turnover		
Continuing operations	2	-
- Existing		-
- Acquisitions		219,790
Cost of sales		(137,609)
Gross profit		82,181
Customer services and administrative expenses		(55,147)
Other operating income	3	7,240
Continuing operations:	4	
- Existing		(22,652)
- Acquisitions		56,926
Group operating profit		34,274
Profit on disposal of fixed assets		3,762
Profit on ordinary activities before interest and taxation		38,036
Interest receivable and similar income	6	72
Interest payable and similar charges	7	(33,977)
Other finance income	8	252
Profit on ordinary activities before taxation		4,383
Tax on profit of ordinary activities		(5,862)
Loss on ordinary activities after taxation		(1,479)
Equity minority interests		(1,710)
Non-equity minority interests		-
Loss for the period	24	(3,189)

All profits of the company are from continuing operations

There is no difference between the profit on ordinary activities before taxation and the profit for the financial period stated above and their historical cost equivalents

The notes on pages 31 to 59 form part of these financial statements

Affinity Water Acquisitions (Investments) Limited

Statement of group total recognised gains and losses for the period ended 31 March 2013

(Registered Number 08101550)

	Note	2013 £000
Loss for the period		(3,189)
Actuarial loss recognised in the pension scheme	29	(19,400)
Deferred tax movement relating to the actuarial loss	29	4,443
Total recognised losses for the period		(18,146)

The notes on pages 31 to 59 form part of these financial statements

Affinity Water Acquisitions (Investments) Limited

Consolidated balance sheet as at 31 March 2013 (Registered Number 08101550)

	Note	2013 £000
Intangible assets	11	133,929
Tangible assets	12	1,189,345
Investments	13	1
		<u>1,323,275</u>
Current assets		
Stocks	15	1,648
Debtors	16	82,974
Cash at bank and in hand		<u>44,545</u>
		129,167
Creditors – amounts falling due within one year	17	(121,403)
Net current assets		<u>7,764</u>
Total assets less current liabilities		1,331,039
Creditors – amounts falling due after more than one year	18	(912,575)
Provisions for liabilities	19	(55,127)
Net assets excluding pension liability		<u>363,337</u>
Net pension liability	29	(10,949)
Net assets including pension liability		<u>352,388</u>
Capital and reserves		
Called up share capital	23	3,408
Profit and loss account	24	311,222
Shareholders' funds	26	<u>314,630</u>
Equity minority interests		37,750
Non-equity minority interests		8
		<u>352,388</u>

The notes on pages 31 to 59 form part of these financial statements. The statutory financial statements on pages 25 to 59 have been approved by the Board of Directors and were signed on 23 October 2013 on its behalf by



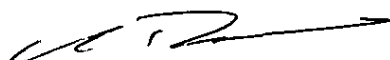
K Bradbury
Director

Affinity Water Acquisitions (Investments) Limited

Company balance sheet as at 31 March 2013 (Registered Number 08101550)

	Note	2013 £000
Investments	13	<u>340,777</u> <u>340,777</u>
Net assets		<u>340,777</u>
Capital and reserves		
Called up share capital	23	<u>3,408</u>
Profit and loss account	24	<u>337,369</u>
Shareholders' funds	26	<u>340,777</u>

The notes on pages 31 to 59 form part of these financial statements. The statutory financial statements on pages 25 to 59 have been approved by the Board of Directors and were signed on 23 October 2013 on its behalf by



K Bradbury
Director

Affinity Water Acquisitions (Investments) Limited

Consolidated cash flow statement for the period ended 31 March 2013 (Registered Number 08101550)

	Note	Period ended 31 March 2013 £000
Net cash inflow from operating activities	(a)	91,108
Returns on investments and servicing of finance		
Interest paid		(33,101)
Interest element of finance lease payments		(95)
Dividends paid to minority shareholdings in subsidiary undertakings		(889)
Net cash outflow from returns on investments and servicing of finance		(34,085)
Taxation		(4,184)
Capital expenditure and financial investment		
Purchase of tangible fixed assets		(83,032)
Capital contributions		12,479
Proceeds on disposal of tangible fixed assets		8,009
Net cash outflow from capital expenditure and financial investment		(62,544)
Acquisitions		
Purchase of assets and liabilities of Affinity Water Capital Funds and its subsidiaries		
- external bond acquired	(196,728)	
- financing of assets used by the company and operated by other parties	(17,607)	
- debentures	(32)	
- others	(339,877)	
		(554,244)
Net debt acquired from the Veolia group relating to Affinity Water Capital Funds and its subsidiaries		(466,952)
Cash acquired from Affinity Water Capital Funds and its subsidiaries		26,074
Purchase of shares in subsidiary		(12,542)
Net cash outflow for acquisitions		(1,007,664)
Equity dividends		(8,001)
Net cash outflow before financing		(1,025,370)
Financing		
Proceeds on issue of share capital of the group		375,930
Capital element of finance lease payments		(1,591)
Proceeds from new bond issue		565,885
Loan from parent company		130,020
Financing of assets operated by other parties		(329)
Net cash inflow from financing		1,069,915
Increase in net cash	(b)/(c)	44,545

The notes on pages 31 to 59 form part of these financial statements

Affinity Water Acquisitions (Investments) Limited

Notes to the consolidated cash flow statement for the period ended 31 March 2013

(a) Reconciliation of operating profit to net cash inflow from operating activities

	2013 £000
Operating profit	34,274
Depreciation of tangible fixed assets	58,743
Amortisation of goodwill	5,218
Amortisation of deferred credit	(236)
Increase in stocks	(244)
Decrease in debtors	87,764
Increase in provisions	481
Decrease in creditors	(91,571)
Decrease in pension liability	(3,321)
Net cash inflow from operating activities	<u>91,108</u>

(b) Reconciliation of net cash flow to movement in net debt

	2013 £000
Increase in cash in the period	44,545
Cash inflow from increase in debt and finance leasing	(909,943)
Non cash inflow from increase in debt and finance leasing	(155)
Movement in net debt in the period	<u>(865,553)</u>
Net debt at the beginning of the period	-
Net debt at the end of the period	<u>(865,553)</u>

(c) Analysis of net debt

	At 12 June 2012 £000	Acquisition £000	Cash flow £000	Non cash flow £000	At 31 March 2013 £000
Net cash					
Bank	-	27,010	17,535	-	44,545
Debt					
Bond issue	-	(196,728)	(565,885)	(151)	(762,764)
Loan from parent company	-	-	(130,020)	-	(130,020)
Debentures	-	(32)	-	(4)	(36)
Finance leases (including sale and leaseback)	-	(1,591)	1,591	-	-
Financing of assets used by the company and operated by other parties	-	(17,607)	329	-	(17,278)
	-	(215,958)	(693,985)	(155)	(910,098)
Net debt	-	(188,948)	(676,450)	(155)	(865,553)

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013

1. Statement of accounting policies

Basis of preparation

These financial statements have been prepared on the going concern basis as included in the directors' report on page 20, under the historical cost convention, as modified by the revaluation of certain tangible fixed assets described below, and in accordance with the Large and Medium-sized Companies and Groups Regulations 2008 (SI 2008/410), which forms part of the Companies Act 2006, and applicable UK accounting standards, except for the treatment of certain grants and contributions, described below

As this is the first accounting period since the incorporation of the company, no comparative information has been provided

Basis of consolidation

The group financial statements consolidate the accounts of Affinity Water Acquisitions (Investments) Limited and its subsidiaries from the date of the acquisition of the Affinity Water Capital Funds Limited group. The subsidiary companies have been included in the group financial statements using the acquisition method of accounting. Accordingly, the consolidated profit and loss account and cash flow statement include the results and cash flows of these entities for the 9 month period from their acquisition on 28 June 2012. The purchase consideration has been allocated to the assets and liabilities on the basis of fair value at the date of acquisition.

As permitted by Section 408 of the Companies Act 2006, the parent company's profit and loss account has not been included in the financial statements.

In the company financial statements investments in subsidiaries are accounted for at the lower of cost and net realisable value.

Use of estimates

The preparation of accounts in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the accounts and the reported amounts of revenues and expenses during the reporting period. Actual outcomes could differ from those estimates.

Revenue recognition

Revenue is recognised in accordance with Financial Reporting Standard 5 'Reporting the substance of transactions' in the period in which it is earned. The group does not recognise revenue where payment is received in advance. However, payments made in the previous period in respect of the current period will be recorded as revenue in the current period. In accordance with Application Note G of Financial Reporting Standard 5, the group does not recognise revenue where historic evidence indicates that the group will probably never be able to collect the revenue billed. Where relevant, this includes an estimate of the sales value of water supplied to customers between the date of the last meter reading and the period end, exclusive of value added tax.

Bad debt provisioning

At each reporting date, the group evaluates the collectability of debtors and records provisions for doubtful debts based on experience. The bad debt provision is calculated by applying a range of different percentages to debt of different ages. These percentages also vary between categories of debt. Higher percentages are applied to those categories of debt which are considered to be of greater risk and also to debt of greater age. The value of the debt provision is sensitive to the specific percentages applied.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

1. Statement of accounting policies (continued)

Dividends

Revenue is recognised when the group's right to receive payment is established

Financial instruments

Income and expenditure arising on financial instruments is recognised on an accruals basis and credited or charged to the profit and loss in the financial period in which it arises

Issue costs on capital instruments are allocated to accounting periods over the term of the debt as a consistent proportion of the outstanding amount of the related debt in accordance with the requirements of Financial Reporting Standard 4 'Capital instruments'

Research and development

The costs of research and development are written off in the year in which they are incurred

Current taxation

Current taxation is corporation tax in the United Kingdom based on the taxable profit for the period and is provided at amounts expected to be paid or recovered using tax rates and laws that have been enacted or substantively enacted at the balance sheet date

Taxable profit differs from the net profit as reported in the profit and loss account as it excludes items of income or expenditure that are taxable or deductible in other years and it further excludes items that are never taxable or deductible

Deferred taxation

Deferred tax is provided, except as noted below, on timing differences that have arisen but not reversed by the balance sheet date, where the timing differences result in an obligation to pay more tax, or a right to pay less tax, in the future. Timing differences arise because of differences between the treatment of certain items for accounting and taxation purposes. Deferred tax assets are recognised to the extent that it is regarded as more likely than not that they will be recovered

In accordance with Financial Reporting Standard 19 'Deferred tax', deferred tax is not provided on timing differences arising from

- (a) revaluation gains on land and buildings, unless there is a binding agreement to sell them at the balance sheet date,
- (b) gains on the sale of non-monetary assets, where on the basis of all available evidence it is more likely than not that the taxable gain will be rolled over into replacement assets, and
- (c) fair value adjustment gains to fixed assets and stock to uplift prices to those ruling when an acquisition is made

Deferred tax is measured at the tax rates that are expected to apply in the periods when the timing differences are expected to reverse, based on tax rates and law enacted or substantively enacted at the balance sheet date

Where law or accounting standards require gains and losses to be recognised in the statement of total recognised gains and losses, the related taxation is also taken directly to the statement of total recognised gains and losses in due course

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

1. Statement of accounting policies (continued)

Deferred taxation (continued)

The group has adopted a policy of discounting deferred tax assets and liabilities to reflect the time value of money. Deferred tax assets and liabilities are discounted using a discount rate equivalent to the post tax yield that could be obtained at the balance sheet date on government bonds with similar maturity dates and currencies. The increase or decrease in the discount deducted in arriving at the deferred tax balance is included in the deferred tax charge or credit in the profit and loss account.

Pension costs

The group operates a pension scheme providing benefits based on final pensionable salary. The scheme closed to new members in April 1996 and September 2004. The assets of the scheme are held separately from those of the group.

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 in profit or loss on a straight-line basis over the vesting period or immediately if the benefits have vested. When a settlement or a curtailment occurs, the change in the present value of the scheme liabilities and the fair value of the plan assets reflects the gain or loss which is recognised in the profit and loss account. 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 interest element of the defined benefit cost represents the change in present value of scheme obligations resulting from the passage of time, and is determined by applying the discount rate to the opening present value of the benefit obligation, taking into account material changes in the obligation during the year. The expected return on plan assets is based on an assessment made at the beginning of the year of long-term market returns on scheme assets, adjusted for the effect on the fair value of plan assets of contributions received and benefits paid during the year. The difference between the expected return on plan assets and the interest cost is recognised in the profit and loss account as other finance income or expense. Actuarial gains and losses are recognised in full in the statement of total recognised gains and losses in the period in which they occur.

The defined benefit pension asset or liability in the balance sheet comprises the total for each plan of the present value of the defined benefit obligation (using a discount rate based on high quality corporate bonds that have been rated at AA or equivalent status), 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. The value of a net pension benefit asset is limited to the amount that may be recovered either through reduced contributions or agreed refunds from the scheme.

Contributions to defined contribution schemes are recognised in the profit and loss account in the period in which they become payable.

The group also has an unfunded obligation to pay pensions to former non-executive directors. A provision in respect of the obligation is included within the net pension liability.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

1. Statement of accounting policies (continued)

Goodwill and amortisation

Positive goodwill arising on acquisitions since 1 January 1998 is capitalised, classified as an asset on the balance sheet and amortised on a straight line basis over its useful economic life up to a maximum of 20 years. It is reviewed for impairment at the end of the first full financial year following the acquisition and in other periods if events or changes in circumstances indicate that the carrying value may not be recoverable.

Positive goodwill is the excess of the cost of the acquired entity over the aggregate of the fair values of that entity's identifiable assets and liabilities. In estimating the useful economic life of goodwill, account has been taken of the nature of the unified business and the stability of the industry.

If a subsidiary, associate or business is subsequently sold or closed, any goodwill arising on acquisition that was written off directly to reserves or that has not been amortised through the profit and loss account is taken into account in determining the profit or loss on sale or closure.

Tangible fixed assets and depreciation

Financial Reporting Standard 15 'Tangible fixed assets' requires fixed assets which are carried at revalued amounts to be shown at their current value at the balance sheet date. To achieve this, all tangible fixed assets are subject to a full valuation every five years with an interim valuation carried out in the third year of this cycle.

Tangible fixed assets comprise

- Infrastructure assets – mains and associated underground pipe-work
- Other assets – land and buildings, operational structures, fixed plant, vehicles and mobile plant

Infrastructure assets (being mains and associated underground pipe-work) comprise a network of systems. Expenditure on infrastructure assets, including renewals, is treated as an addition and included at cost after deducting grants and contributions.

The depreciation charge for infrastructure assets is the estimated level of annual expenditure required to maintain the operating capability of the network which is based on the group's independently certified asset management plan. Disposals of infrastructure assets are calculated based on the estimated lives of the assets before they are replaced.

Depreciation is provided on all other fixed assets except freehold land and is calculated to write off their cost over their estimated useful lives on a straight-line basis. Assets acquired under finance leases are depreciated over the shorter of their useful life or the lease term. The performance of assets is continually monitored and where impairment is identified, fixed assets are written down to their recoverable amount. Tangible fixed assets are reviewed for impairment at the end of each reporting period when the estimated remaining useful economic life of the assets exceeds 50 years. Information on the condition of assets is also provided to the Regulator every five years as part of the price review mechanism.

The estimated useful lives of these assets are

Buildings	40 - 60 years
Operational structures	15 - 100 years
Fixed plant - Short life	3 - 10 years
- Other	10 - 30 years
Vehicles and mobile plant	3 - 10 years

Land is not depreciated

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

1. Statement of accounting policies (continued)

Tangible fixed assets and depreciation (continued)

Any revaluation surplus is credited to the revaluation reserve in equity except to the extent that it reverses a decrease in the carrying value of the same asset previously recognised in profit or loss, in which case the increase is recognised in profit or loss. A revaluation deficit is recognised in profit or loss, except to the extent of any existing surplus in respect of that asset in the revaluation reserve.

Capital contributions

Infrastructure charges received in respect of connections to the mains network are allocated to fixed assets, surface and infrastructure, in accordance with the basis on which the charges are calculated.

Grants and contributions receivable relating to infrastructure assets have been deducted from the cost of tangible fixed assets. This is not in accordance with Large and Medium-sized Companies and Groups Regulations 2008 (SI 2008/410) which forms part of the Companies Act 2006, which requires tangible fixed assets to be shown at cost, and hence grants and contributions are accounted for as deferred income. This departure from the requirements of the Companies Act 2006 is, in the opinion of the directors, necessary for the financial statements to show a true and fair view as, while a provision is made for depreciation of infrastructure assets, these assets have indefinite economic lives and therefore no basis exists on which to recognise grants and contributions in the profit and loss account. The effect of this treatment on the book value of tangible fixed assets is disclosed in **Error! Reference source not found.**note 12.

Capital contributions received in respect of tangible fixed assets, other than infrastructure assets, are deferred and credited to the profit and loss account by instalments over the expected useful lives of the related assets.

Leased assets

Assets financed by leasing are included in tangible fixed assets and the net obligation to pay future rentals is included within creditors. Instalments are apportioned between the finance element, which is charged to the profit and loss account as interest, and the capital element, which reduces the outstanding obligation for future instalments.

Rentals paid under an operating lease are charged against profits on a straight-line basis over the life of the lease.

Assets held under finance leases, which are leases where substantially all the risks and rewards of ownership of the asset have passed to the group, and hire purchase contracts are capitalised in the balance sheet and are depreciated over the shorter of the lease term and the asset's useful lives. The capital elements of future obligations under leases and hire purchase contracts are included as liabilities in the balance sheet. The interest elements of the rental obligations are charged in the profit and loss account over the periods of the leases and hire purchase contracts and represent a constant proportion of the balance of capital repayments outstanding.

Fixed asset investments

Fixed asset investments are stated at cost less any provisions in respect of permanent diminution in value.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

1. Statement of accounting policies (continued)

Grafham reservoir

Under the Great Ouse Water Act of 1961, Affinity Water Limited, a subsidiary of the group, has an entitlement to water from the Grafham reservoir owned and operated by Anglian Water Services Limited

Affinity Water Limited includes within its fixed assets (and RCV) a proportion of the original cost of the reservoir and annual increments related to capital expenditure made by Anglian Water Services Limited on the reservoir. The credit entry related to this accounting treatment of the assets is an obligation of around £17m related to the original embedded debt of Anglian Water Services Limited as incremented by the subsequent asset additions

This amount is treated as a quasi-finance lease within these financial statements under the category of 'financing of assets operated by third parties' (see notes 21 and 28)

The model utilised for allocating the costs between the group and Anglian Water as required by the legislation includes an interest charge and capital repayment on this quasi-finance lease. The maturity period of the quasi-finance lease is currently assessed as being 28 years, assuming no further capital expenditure on the reservoir by Anglian Water. In practice, both the value of the lease obligation and the maturity period have remained broadly constant for a number of years as the capital repayments made have been similar to the company's proportion of the incremental expenditure by Anglian Water on the reservoir

Ardleigh reservoir

The group and Anglian Water Services Limited own the reservoir and ancillary works jointly in approximately equal shares, the group's share of the capital expenditure being included in tangible fixed assets in note 12. The reservoir is operated on behalf of both undertakings through the Ardleigh Reservoir Committee, and the company's share of the expense is included within abstraction licences and bulk purchase

Stocks and work in progress

Stocks 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. Work in progress for chargeable services is valued at cost

Loans

All loans held with the group's subsidiaries 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 profit and loss account is allocated to accounting periods over the term of the debt using the effective interest method

Provision for liabilities

A provision is recognised when the group has a legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

2. Turnover and segmental analysis

Turnover represents income from the supply of water and other chargeable services exclusive of VAT arising wholly within the United Kingdom. Turnover relating to unmeasured supplies comprises amounts due to the company for the accounting period.

	2013 £000
Acquired business	
Unmeasured supplies	119,267
Measured supplies	97,860
Chargeable services	424
Other revenue	2,239
	219,790

There is no turnover from the existing business.

3. Other operating income

	2013 £000
Commission and rentals	7,240

4. Group operating profit

Operating profit is stated after charging/(crediting)	2013 £000
<u>Existing business</u>	
Fees paid on acquisition (see note 14)	11,972
Debt arrangement fees	7,909
Stamp duty	2,771
<u>Acquisition</u>	
Depreciation of infrastructure assets	35,620
Depreciation of tangible fixed assets - owned	22,571
Depreciation of tangible fixed assets - leased	552
Amortisation of goodwill	5,218
Research and development	166
Restructuring costs arising from the unification of the water licences	732
Other costs arising from the unification of the water licences	310
Costs relating to rebranding	728
Operating lease rentals - land and buildings	1,160
Operating lease rentals - other	728
Amortisation of deferred credit	(236)
Pension scheme set up costs	620

Auditors' remuneration	
Audit of the financial statements	186
<i>Other fees</i>	
Audit-related assurance services	35
Services relating to corporate finance*	61
Other non-audit services	7

These items are included under operating costs in the profit and loss account.

* included in this amount is £49,000 of costs that have been capitalised as part of the transaction fees in relation to the issue of bonds in Affinity Water Limited. These costs are amortised over the debt term.

These items are included within the cost of sales, customer service and administrative expenses in the profit and loss account.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

5. Employees and directors

	2013 £000
Staff costs (including executive directors) consist of	
Wages and salaries	29,304
Social security costs	2,741
Defined benefit pension costs	3,681
Defined contribution pension costs	488
Other pension costs	512
Effect of pension asset limit	(1,617)
	<u>35,109</u>

The average number of employees in the period ended 31 March 2013 was analysed under the following categories

	2013 Number
Operations	507
Customer service	360
Administration	200
	<u>1,067</u>

Directors' remuneration

The disclosure is provided in respect of the directors of Affinity Water Acquisitions (Investments) Limited and their services in respect of the Affinity Water Acquisitions (Investments) Limited group

	2013 £000
Aggregate remuneration in respect of qualifying services	<u>550,447</u>
Company pension contributions to money purchase schemes (included in the above)	<u>7,050</u>
Members of defined benefit schemes	2
Members of money purchase schemes	<u>2</u>

Aggregate remuneration in respect of qualifying services include compensation for loss of office of £199,763. As the company is a wholly owned subsidiary, there are no listed shares and no directors are offered any share incentives. There are no other long term incentive schemes for directors. The directors who sit on the Board as representatives of Morgan Stanley Infrastructure, Infracapital Partners II and Veolia Water UK Limited have recharged £90,000 to the group for the services rendered.

Highest paid director	2013 £000
Aggregate remuneration (excluding gains on exercise of share options)	<u>151,131</u>
Company pension contributions to money purchase schemes (included in the above)	<u>6,630</u>

The amount of accrued pension under defined benefit schemes was £49,600. The highest paid director did not exercise any share options during the period and did not have any benefits accruing under any other long term incentive schemes.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

6. Interest receivable and similar income

	2013 £000
Other interest	<u>72</u>

7. Interest payable and similar charges

	2013 £000
Interest payable to parent company	8,050
Interest payable to associate	894
Financing costs of assets used by the company and operated by other parties	721
Finance lease charges	65
Debenture interest	1
Interest payable to subsidiary in respect of bond issue	12,083
Other interest	<u>12,163</u>
	<u>33,977</u>

The other interest includes a fair value loss on interest rate swaps amounting to £4 1m (see note 28) and interest on the senior bank debt payable to the date of refinancing. Interest payable to associate relates to the 10% share of Veolia Water UK Limited in the shareholder loan of £130m

8. Other finance income

	2013 £000
Expected return on pension scheme	11,956
Interest on pension scheme liabilities	<u>(11,704)</u>
	<u>252</u>

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

9. Taxation on profit on ordinary activities

	2013 £000
Taxation relates to the following	
Current taxation	
Current tax on profit for the period	4,476
Current tax charge	<u>4,476</u>
Deferred taxation	
Origination of timing differences	4,690
Decrease in discounting	958
Impact of change in tax rate	(4,262)
Deferred tax charge for the period	<u>1,386</u>
Taxation on profit on ordinary activities	<u>5,862</u>

The tax assessed for the period is more than the standard effective rate of corporation tax in the UK of 24%
The differences are explained below

	2013 £000
Profit on ordinary activities before taxation	<u>4,383</u>
Theoretical tax at UK corporation tax rate of 24%	1,052
Effects of	
Accelerated capital allowances	(1,860)
Other short term timing differences	2,081
Other timing differences	(1,589)
Permanent differences	4,792
Actual current taxation charge	<u>4,476</u>

Factors that may affect future tax charges

A change in the main corporation tax rate in the United Kingdom from 24 per cent to 23 per cent was substantively enacted on 3 July 2012 to become effective from 1 April 2013

Further reductions announced in the March 2013 Budget were expected to be enacted separately each year with the intention of reducing the rate to 20 per cent effective from 1 April 2015. Future changes in the main corporation tax rate from 23 per cent to 20 per cent were substantively enacted in the July 2013 Finance Act

10. Dividend

	2013 £000
Paid Ordinary – first interim of 2 35p per share	<u>8,001</u>

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

11. Intangible assets

	Goodwill 2013 £000
Cost	
At 12 June 2012	-
Additions during the period (note 14)	139,147
At 31 March 2013	139,147
Amortisation	
At 12 June 2012	-
Amortisation during the period	(5,218)
At 31 March 2013	(5,218)
Net book value	
At 31 March 2013	133,929

Additions during the period comprise £139,147,000 arising on the acquisition of Affinity Water Capital Funds Limited and its subsidiaries on 28 June 2012. The directors consider that this goodwill has a life of 20 years and it has been amortised accordingly. In estimating the useful economic life of goodwill, account has been taken of the nature of the business and the stability of the industry. The company has no intangible assets.

12. Tangible assets

	Freehold land, buildings and reservoirs £000	Mains and other infrastructure assets £000	Vehicles, plant and machinery £000	Assets in the course of construction £000	Total £000
Cost					
At 31 May 2012	-	-	-	-	-
Transferred in	215,611	699,146	209,489	54,913	1,179,159
Additions	210	29,972	8,472	43,922	82,576
Transfers to complete	2,447	6,833	10,768	(20,048)	-
Capital contributions	-	(10,849)	-	-	(10,849)
Disposals	(2,750)	-	(395)	-	(3,145)
At 31 March 2013	215,518	725,102	228,334	78,787	1,247,741
Depreciation					
At 31 May 2012	-	-	-	-	-
Charge for the period	7,397	35,620	15,726	-	58,743
Disposals	(33)	-	(314)	-	(347)
At 31 March 2013	7,364	35,620	15,412	-	58,396
Net book value					
At 31 March 2013	208,154	689,482	212,922	78,787	1,189,345

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

12. Tangible assets (continued)

The company has no tangible assets

Finance leases have been arranged for assets included above at 31 March 2013 as follows

	Land, buildings and operational structures £000	Mains and other infrastructure assets £000	Fixed plant £000	Vehicles and mobile plant £000	Assets in the course of construction £000	Total £000
31 March 2013						
Cost	8,419	23,165	63,874	4,834	-	100,292
Depreciation	(7,811)	(10,930)	(63,305)	(4,834)	-	(86,880)
Net book value	608	12,235	569	-	-	13,412

The net book value of mains and other infrastructure assets for the company is stated after the deduction of grants and contributions received since April 1990 amounting to £174.0m in order to give a true and fair view. All land and buildings are held as freehold.

Certain classes of the acquired tangible fixed assets were professionally valued at October 2009 and March 2010 by independent qualified valuers, PricewaterhouseCoopers LLP ('PwC'), a firm of independent chartered accountants. These valuations were performed in accordance with Financial Reporting Standard 15 which requires that assets subject to a policy of revaluation should be carried at their current value. Current value is defined in Financial Reporting Standard 15 as the lower of replacement cost and recoverable amount. The recoverable amount is further defined as the higher of Net Realisable Value ('NRV') and Value in Use ('VIU').

Having considered the above definitions of value, PwC concluded that the most reliable valuation method to determine the current value for the tangible fixed assets of a water company in the United Kingdom was a two step approach:

- Step 1: Estimating the business VIU, using a discounted cash flow ('DCF') model to determine the business enterprise value, cross-checked against the regulatory capital value ('RCV'), followed by
- Step 2: Allocating the VIU of the business (less relevant working capital balances, deferred tax liabilities and other adjustments) to individual classes of tangible fixed assets.

Such valuations were incorporated into the financial statements with the resulting revaluation adjustments taken to the revaluation reserve.

PwC carried out an interim valuation using a consistent basis during the period ended 31 March 2013. The revaluation surplus of £119.2m was attributable to infrastructure assets and was allocated to the fixed assets acquired as a fair value adjustment (note 14). Deferred tax has not been provided on timing differences arising from the revaluation of fixed assets unless, by the balance sheet date, a binding commitment to sell the asset has been entered into and it is unlikely that any gain will be rolled over.

If the revalued assets were stated on a historical cost basis, the historic cost before depreciation would be £1,579.6m. If the revalued assets were stated on a historical cost basis, the net book value would be £650.4m.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

13. Investments

	Group 2013 £000	Company 2013 £000
At 31 May 2012	-	-
Acquisition during the period	1	340,777
At 31 March 2013	1	340,777

The group has an investment by way of shares in the Water Resource Committee (WRC) amounting to £572. The principle activity of the WRC is to undertake projects on behalf of all water companies, aimed at the improvement of water services and water quality.

The investment balance in the company relates to Affinity Water Acquisitions (Holdco) Limited.

The following were the principal trading subsidiary undertakings of the company.

Name of company	Nature of business	Type of holding	Proportion of voting rights and shares held
Affinity Water Acquisitions (Holdco) Limited*	Holding company	Ordinary shares	90%
Affinity Water Acquisitions (Midco) Limited	Holding company	Ordinary shares	100%
Affinity Water Acquisitions Limited	Holding company	Ordinary shares	100%
Affinity Water Capital Funds Limited (formerly Veolia Water Capital Funds Limited)	Holding company	Ordinary shares	100%
Affinity Water Holdings Limited	Holding company	Ordinary shares	100%
Affinity Water Limited (formerly Veolia Water Central Limited)	Water supply	Ordinary shares	100%
Affinity Water Finance (2004) Limited (formerly Veolia Water Central Finance Plc)	Finance company	Ordinary shares	100%
Affinity Water Programme Finance Limited	Finance company	Ordinary shares	100%
Affinity Water East Limited ** (formerly Veolia Water East Limited)	Investment company	Ordinary shares Ordinary non-voting shares 10% preference shares	99% 88% 98%
Affinity Water Southeast Limited ** (formerly Veolia Water Southeast Limited)	Investment company	Ordinary shares Ordinary non-voting shares 14% preference shares	99% 92% 98%
Affinity Water Shared Services Limited (formerly Veolia Water Shared Services Limited)	Group support services	Ordinary shares	100%
North Surrey Water Limited *** (in liquidation)	Investment company	Ordinary shares Ordinary non-voting shares 10% preference shares	99% 99% 99%

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

13. Investments (continued)

* held directly by Affinity Water Acquisitions (Investments) Limited

** following the sale of all the company's trade, assets and liabilities to Affinity Water Limited on 27 July 2012 (refer to note 14), the company's main activity is to manage its financial resources to maximise returns to the company's shareholders

*** following the sale of all the company's assets and liabilities to Affinity Water Limited on 1 October 2000, the company's main activity was to manage its financial resources to maximise returns to the company's shareholders. The company was put into members' voluntary liquidation on 5 November 2009 and was dissolved on 13 May 2013

All the above companies are registered in England and Wales, with the exception of Affinity Water Programme Finance Limited (incorporated in the Cayman Islands and resident in the United Kingdom for tax purposes). Affinity Water Capital Funds Limited is the holding company for the water supply interests of Affinity Water Acquisitions (Investments) Limited

14. Acquisition

Affinity Water Acquisitions Limited, a subsidiary of the group, was incorporated as Rift Acquisitions Limited on 31 May 2012 as an acquisition vehicle formed by a consortium of investors led by Infracapital Partners II, the infrastructure investment fund managed by M&G (the European Investment arm of Prudential Plc), and Morgan Stanley Infrastructure Partners

On 28 June 2012 the company acquired the entire shareholding of Affinity Water Capital Funds Limited (formerly Veolia Water Capital Funds Limited) from Veolia Water UK Limited, for a total consideration of £1,021.1m. The total adjustments required to the book values of the assets and liabilities of the companies acquired in order to present the net assets of those companies at fair values in accordance with group accounting principles were £119.2m, details of which are set out below, together with the resultant amount of goodwill arising. All of these purchases have been accounted for as acquisitions

	Assets on acquisition £000	Fair value adjustment £000	Fair values £000
Tangible assets (note 12)	1,059,959	119,200	1,179,159
Investments	1	-	1
Stock	1,435	-	1,435
Debtors	164,503	-	164,503
Creditors	(431,569)	-	(431,569)
Provisions (note 19)	(55,589)	-	(55,589)
Pensions liability	(150)	-	(150)
Cash	26,074	-	26,074
Net assets			883,864
Less minority interests			(1,815)
Net assets acquired			882,049
Goodwill (refer to note 11)			139,147
Consideration			1,021,196

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

14. Acquisition (continued)

Satisfied by

Cash (funded by bank debt)

554,244

Debt *

466,952

1,021,196

* Affinity Water Acquisitions Limited, the acquisition vehicle of the group, took over debt amounting to £205.8m due from Affinity Water Limited to Veolia Environnement S A and £261.1m due from Affinity Water Capital Funds Limited to Veolia Water UK Limited

For the period to the date of acquisition, the management accounts of the Affinity Water Capital Funds Limited group show the following results

Financial period from 1 April 2012 to 28 June 2012

£000

Turnover

74,330

Operating profit

17,275

Profit before taxation

10,701

Taxation and minority interests

(2,324)

Profit for the period

8,377

Financial year ended 31 March 2012

Profit for the year

40,763

Since the date of acquisition, these entities have contributed £103.8m to the group's net operating cash flows, paid £12.9m in respect of interest, utilised £60m in capital expenditure and £4.1m in respect of taxation

15. Stocks

Group

2013

£000

Raw Materials and consumables

1,648

1,648

The company has no stock

16. Debtors – amounts falling due within one year

Group

2013

£000

Trade debtors and customers' water charges

30,689

Accrual for unbilled metered customers

36,044

Amounts due from associates

3,292

Other debtors

7,781

Prepayments and accrued income

4,088

Corporation tax

1,080

82,974

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

16. Debtors – amounts falling due within one year (continued)

Amounts due from associates relate to amounts due from Veolia Water UK Limited to the group, for services provided to the Veolia businesses during the transition period

The company has no debtors

17. Creditors – amounts falling due within one year

	Group 2013 £000
Payments received in advance	39,091
Financing of assets operated by other parties	1,093
Trade creditors	8,238
Interest payable	11,418
Amounts owed to associates	3,280
Other taxes and social security	1,527
Other creditors	7,976
Capital accruals	20,181
Accruals and deferred income	28,599
	<hr/> 121,403 <hr/>

Amounts due to associates relate to amounts due to Veolia Water UK Limited the group

The company has no creditors – amounts falling due within one year

18. Creditors – amounts falling due after more than one year

	Group 2013 £000
Debenture stock	36
Bond issue	762,764
Financing of assets operated by other parties	16,185
Loan from group undertakings	117,018
Loan from associate	13,002
Deferred credit – contributions to surface assets	3,570
Total	<hr/> 912,575 <hr/>

The company has no creditors – amounts falling due after more than one year

On 13 July 2004 Affinity Water Finance (2004) Limited, a subsidiary of the group, issued a £200 million bond at an interest rate of 5.875% and repayable in July 2026

On 4 February 2013, as a part of the refinancing, Affinity Water Programme Finance Limited, a subsidiary of the group, issued £80m Class A Guaranteed Notes maturing in September 2022 with a coupon rate of 3.625 per cent, £250m Class A Guaranteed Notes maturing in March 2036 with a coupon rate of 4.50 per cent, £150m Class A Guaranteed RPI index-linked Notes maturing in June 2045 with a coupon rate of 1.548 per cent and £95m Class B Guaranteed RPI index-linked Notes maturing in June 2033 with a coupon rate of 3.249 per cent (together 'Bonds')

Proceeds from both the above issues were then lent by these companies to their immediate parent undertaking, Affinity Water Limited

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

18. Creditors – amounts falling due after more than one year (continued)

Affinity Water Limited, a subsidiary of the group, has unconditionally and irrevocably guaranteed the due and punctual payment of all sums from time to time payable by Affinity Water Finance (2004) Limited 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 guaranteed by Affinity Water Holdings Limited, the immediate parent undertaking of Affinity Water Limited.

All loans held with the group 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 profit and loss account is allocated to accounting periods over the term of the debt using the effective interest method.

Affinity Water Limited, a subsidiary of the group, is subject to a number of covenants in relation to its borrowings, which would result in its loans becoming immediately repayable if breached. 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 period end Affinity Water Limited was not in breach of any financial covenants.

The loan from group undertaking relates to a £65,010,000 loan from Infracapital F2 Rift S à r l and £52,008,000 from MSIP Dalis B V. The loan from associate relates to the loan from Veolia Water UK Limited.

19. Provisions for liabilities

Group	Deferred tax £000	Insurance £000	Other £000	Total £000
At 31 May 2012	-	-	-	-
Acquisition	51,041	3,091	1,457	55,589
Charged/credit to the profit and loss account	(132)	(271)	108	(295)
Utilised in the period	-	(25)	(142)	(167)
At 31 March 2013	50,909	2,795	1,423	55,127

Deferred tax

	2013 £000
Accelerated capital allowances	99,469
Other timing differences	(3,080)
Undiscounted provision for deferred tax	96,389
Discount	(45,480)
Discounted provision for deferred tax	50,909
Deferred tax asset on pension liability (see note 29)	(3,271)
Provision at the end of the period including deferred tax on pension liability	47,638

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

19. Provisions for liabilities (continued)

Deferred tax asset relating to pension liability

	2013 £000
At 31 May 2012	-
Acquisition	(46)
Deferred tax charge to the profit and loss account	1,218
Deferred tax (credit) to the statement of total recognised gains and losses (see note 29)	
- on actuarial loss	(4,443)
At 31 March 2013	<u>(3,271)</u>

The deferred tax asset of £3.2m has been deducted in arriving at the net pension liability on the balance sheet

Factors that may affect future tax charges:

Based on current capital investment plans, the group expects to continue to claim capital allowances in excess of depreciation in future years at a similar level to the current year

Reference should also be made to note 9 regarding recently proposed changes to the UK tax system

Insurance

Insurance represents the amount of the group's liability in respect of excesses on individual claims. This is based upon data provided by loss adjusters to insurers on levels of reserve and is calculated on settlement experience. It is expected that this provision will be utilised within 24 months.

Other provisions

Other provisions include £0.2m covering the risk of remedy to the buyer of St George's Hill land due to an encroachment issue and £0.2m for the charitable trust both of which are anticipated to be utilised within 12 months. In addition there is a £0.7m provision in relation to unfunded pension liabilities for former directors which will be utilised over the 20 years from January 2019.

The company has no provision for liabilities.

20. Borrowings analysis

Loans and bank overdrafts outstanding at the period end comprise

	Group 2013 £000
Amounts repayable after one year	
Debentures	36
Loans from group undertakings	117,018
Loans from associate	13,002
Bonds	762,764
	<u>892,820</u>

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

20. Borrowings analysis (continued)

Loans not wholly repayable within five years comprise

	Group 2013 £000
Bond issue of 5.875% guaranteed notes due 2026 (issued by Affinity Water Finance (2004) Limited in 2004)*	196,879
Bond issue of 3.625% guaranteed notes due 2022 (issued by Affinity Water Programme Finance Limited in 2013)*	78,534
Bond issue of 3.249% guaranteed notes due 2033 (issued by Affinity Water Programme Finance Limited in 2013)	93,587
Bond issue of 4.500% guaranteed notes due 2036 (issued by Affinity Water Programme Finance Limited in 2013)*	246,042
Bond issue of 1.548% guaranteed notes due 2045 (issued by Affinity Water Programme Finance Limited in 2013)*	147,722
Irredeemable debenture stock carrying interest of between 3.50% and 5.25%	36
Loan from group undertakings	117,018
Loans from associate	13,002
	<u>892,820</u>

* listed on London Stock Exchange

The loan from group undertakings relates to a £65,010,000 loan from Infracapital F2 Rift S à r l and £52,008,000 from MSIP Dalis B V. The loan from associate relates to the loan from Veolia Water UK Limited. All the above loans carry an interest rate of 9 per cent per annum and are due for repayment on 28 June 2027.

21. Commitments under finance and operating leases

The group has no outstanding obligations under finance leases. Financing of assets operated by third parties are as follows:

Group	2013 £000
In one year or less, but on demand	1,093
In more than one year but not more than two years	1,029
In more than two years but not more than five years	2,682
In more than five years	12,474
Net obligations due	<u>17,278</u>

The group had annual commitments under non-cancellable operating leases as follows:

	2013 Land and buildings £000	2013 Other £000
Operating leases which expire		
Within one year	-	123
In two to five years	-	862
After five years	1,547	-
	<u>1,547</u>	<u>985</u>

The company has no commitments under finance or operating leases.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

22. Minority Interests

In the case of holdings in ordinary stock the minority interests are stated as a relevant proportion of net assets. Non-equity interests primarily represent irredeemable preference shares which hold no voting rights.

23. Called up share capital

Group and Company	2013 £000
Allotted, called up and fully paid share capital	
Ordinary shares (340,776,655 of £0.01 each)	<u>3,408</u>

The company was incorporated on 12 June 2012 with a share capital of 316,382,004 ordinary shares of £1 each. There was a further capital injection on 18 July 2012 for an amount of £24,394,651 upon the issuance of 24,394,651 additional ordinary shares of £1 each. On 21 December 2012, the directors approved a capital reduction by reducing the share capital from £340,776,655 divided into 340,776,655 ordinary shares of £1 each to £3,407,767 divided into 340,776,655 ordinary shares of £0.01.

Infracapital Partners II owns 189,320,364 of the above shares and Morgan Stanley Infrastructure Partners owns the remaining 151,456,291.

24. Reserves

Group	Profit and loss account £000
At 12 June 2012	-
Actuarial gain recognised in the pension scheme	(19,400)
Deferred tax arising thereon	4,443
Loss for the financial period	(3,189)
Dividends paid	(8,001)
Capital reduction	337,369
At 31 March 2013	<u>311,222</u>

The company was incorporated on 12 June 2012 with a share capital of 316,382,004 ordinary shares of £1 each. There was a further capital injection on 18 July 2012 for an amount of £24,394,651 upon the issuance of 24,394,651 additional ordinary shares of £1 each. On 21 December 2012, the directors approved a capital reduction by reducing the share capital from £340,776,655 divided into 340,776,655 ordinary shares of £1 each to £3,407,767 divided into 340,776,655 ordinary shares of £0.01.

A dividend of £8,001,000 was paid to Infracapital Partners II and Morgan Stanley Infrastructure Partners in proportion of their shareholding in the company.

Company	Profit and loss account £000
At 12 June 2012	-
Profit for the financial period	8,001
Dividends paid	(8,001)
Capital reduction	337,369
At 31 March 2013	<u>337,369</u>

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

25. Profit for the period

As permitted by Section 408 of the Companies Act 2006, the company's profit and loss account has not been included in the financial statements. The company's profit for the period after tax was £8,001,000.

26. Reconciliation of movements in shareholders' funds

	Group 2013 £000	Company 2013 £000
(Loss)/profit for the period	(3,189)	8,001
Actuarial loss	(19,400)	-
Deferred tax on group actuarial gain	4,443	-
Total losses recognised for the period	(18,146)	8,001
Dividends paid	(8,001)	(8,001)
Issue of share capital	340,777	340,777
Movement in shareholders' funds	314,630	340,777
Closing shareholders' funds	314,630	340,777

The company was incorporated on 12 June 2012 with a share capital of 316,382,004 ordinary shares of £1 each. There was a further capital injection on 18 July 2012 for an amount of £24,394,651 upon the issuance of 24,394,651 additional ordinary shares of £1 each. On 21 December 2012, the directors approved a capital reduction by reducing the share capital from £340,776,655 divided into 340,776,655 ordinary shares of £1 each to £3,407,767 divided into 340,776,655 ordinary shares of £0.01. There was no impact of the capital reduction on total shareholders' funds.

27. Capital commitments

The directors have authorised a programme of capital expenditure (including infrastructure renewals), of which the contracted element not provided for in the accounts of Affinity Water Limited, a subsidiary of the group, amounts to £20.2m. No other company in the group has any other capital commitments.

28. Financial instruments and risk management

The group's financial instruments comprise borrowings, debentures, cash and liquid resources, and various items, such as trade debtors and trade creditors that arise directly from operations. The main purpose of these financial instruments is to raise finance for the group's operations.

It is the group's policy, and has been throughout the period under review, that no trading in financial instruments shall be undertaken.

The main risks arising from the group's financial instruments are interest rate risk and liquidity risk. The Board reviews and agrees policies for managing each of these risks. These policies have remained unchanged during the period.

The group finances its operations through a mixture of retained profits, borrowings from its subsidiary companies, borrowings from its parent company and debentures. Treasury policies are agreed in conjunction with the wider Affinity Water group (including liquidity and interest rate risks). The group does not undertake speculative transactions. Interest rate exposure is primarily managed by using a mixture of fixed rate, floating rate and RPI linked borrowings.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

28. Financial instruments and risk management (continued)

As a part of the refinancing, all existing loans and revolver facilities were replaced by the following four new bonds issued on 4 February 2013 by Affinity Water Programme Finance Limited, a subsidiary of the group: £80m Class A Guaranteed Notes maturing in September 2022 with a coupon rate of 3.625 per cent, £250m Class A Guaranteed Notes maturing in March 2036 with a coupon rate of 4.50 per cent, £150m Class A Guaranteed RPI index-linked Notes maturing in June 2045 with a coupon rate of 1.548 per cent and £95m Class B Guaranteed RPI index-linked Notes maturing in June 2033 with a coupon rate of 3.249 per cent (together 'Bonds').

Further disclosures are included in notes 17, 18 and 20.

Financial assets, excluding non-debt receivables due within one year

The group has no financial assets excluding non-debt receivables due within one year.

Financial liabilities: excluding non-debt current liabilities

The interest rate profile of the group's financial liabilities excluding non-debt current liabilities and deferred credits at 31 March 2013 was as follows:

	Total £000	Floating rate financial liabilities £000	Fixed rate financial liabilities £000	RPI Linked Financial liabilities £000
31 March 2013	910,097	-	668,788	241,309

Fixed rate liabilities represent the bonds issued by the subsidiaries of the group, Affinity Water Finance (2004) Limited and Affinity Water Programme Finance Limited, irredeemable debenture stock, loan from the group's parent undertakings and the financing of assets used by the group and operated by other parties. The RPI linked liabilities represent the bonds issued by Affinity Water Programme Finance Limited.

Fixed rate financial liabilities (including RPI linked)

As at	Weighted average interest rate %	Weighted average period for which rate is fixed* Years	Weighted average period until maturity Years
31 March 2013			
- Bond issue	4.2	20.5	20.5
- Loan from group undertakings	9.0	15.0	15.0
- Other	5.3	28.8	28.8

*This calculation excludes the irredeemable debenture stock where the interest rate is fixed in perpetuity and varies between 3.5 per cent and 5.25 per cent.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

28. Financial instruments and risk management (continued)

The maturity profile for the group's financial liabilities at 31 March 2013 was as follows

	2013 £000
In one year or less or on demand	1,093
In more than one year but not more than two years	1,029
In more than two years but not more than five years	2,682
In more than five years	905,293
	<hr/> 910,097 <hr/>

All financial liabilities due within one year comprise financing of assets used by the group and operated by other parties. All financial liabilities due after one year comprise financing of assets used by the group and operated by other parties, irredeemable debenture stock, bond issue and amounts due to group undertakings.

The group has various undrawn committed borrowing facilities. The undrawn facilities available at 31 March 2013 in respect of which all conditions precedent had been met were as follows

	2013 £000
Expiring in one year or less	57,500
Expiring in more than one year but not more than two years	-
Expiring in more than two years	100,000
	<hr/> 157,500 <hr/>

The group has access to an undrawn borrowing facility of £100m with a tenure of five years from 28 June 2012. This facility consists of a £70.0m capital expenditure facility and a £30.0m working capital facility.

The group has available a 364 day revolving Debt Service Reserve Liquidity Facility of £37.5m. The facility is intended for the purpose of funding any debt service payments in the event of a liquidity shortfall that would otherwise prevent such payments being made.

The group has also available a 364 day revolving Operations and Maintenance Reserve Facility of £20.0m. The facility is intended for the purpose of funding any general liquidity shortfall.

Fair values of financial liabilities

Set out below is a comparison by category of book values and fair values of the financial liabilities of the group as at 31 March 2013, with the exception of the fixed rate liability in respect of the financing of assets by the group operated by other parties, where the fair value calculated by market interest rates of the financial instrument is not expected to be materially different from book value.

	Book value £m	Fair value £m
Primary financial instruments held or issued to finance the group's operations		
Long-term borrowings	762.8	829.9
	<hr/> 762.8	<hr/> 829.9 <hr/>

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

28. Financial instruments and risk management (continued)

The fair value of the Bonds, having a combined book value of £762.8m, has been determined by reference to published and other information, as well as prices from the active markets on which the instruments involved are traded

On 28 June 2012, the majority shareholding in the group of companies of which Affinity Water Capital Funds Limited was the ultimate parent undertaking, was sold by Veolia Water UK Limited to Affinity Water Acquisitions Limited, a subsidiary of the group. Veolia Environnement SA has retained a 10 per cent minority shareholding through its subsidiary Veolia Water UK Limited. This acquisition was primarily funded by external bank debt of £552.1m.

Affinity Water Acquisitions Limited had entered into swap agreements with certain financial institutions in order to swap the variable interest arising on the external bank debt with fixed interest. The hedging profile ensured that at least 75 per cent of the floating rate bank debt was swapped to fixed.

The group has since refinanced the acquisition debt by way of a securitisation of its subsidiary, Affinity Water Limited, the main trading subsidiary. The refinancing was achieved by reorganising the group to create the desired securitisation structure and the existing debt was repaid using the proceeds of bonds issued. As a part of the refinancing, Affinity Water Limited was financially and operationally "ring-fenced" from the rest of the group. Affinity Water Limited also incorporated Affinity Water Programme Finance Limited as a special purpose vehicle for the purpose of issuing asset backed securities. The external bonds were issued on 4 February 2013. The group believes that the ring-fencing structure will provide significant benefits, providing better access to long-term debt markets and an opportunity to reduce the cost of capital employed in the regulated business.

At the time of repayment of the bank debt, the interest rate swaps were terminated resulting in a fair value loss of £4.1m which was included within interest payable and similar charges and charged to the profit and loss account.

29. Pensions

Composition of the pension scheme

The new Affinity Water Pension Plan was established in February 2013, set up as an identical scheme to the Veolia UK Pension Plan ('VUKPP'), the scheme in which the group participated until 28 March 2013. The benefits of employees and former employees of the company, and its predecessor companies, were transferred into the Affinity Water Pension Plan with effect from 28 March 2013.

The VUKPP was a multiemployer sectionalised pension plan with defined benefits and defined contribution sections. The defined benefit section was closed to new entrants in 2004 since which new members have only been eligible to join the defined contribution section. The sectionalised plan has separate Central, East, Southeast and Shared Services divisions.

Veolia UK Pension Plan

Until 31 March 1996, the group was a member of The Water Companies' Association Pension Scheme, which provided benefits based on final pensionable pay. On 1 April 1996 the assets and liabilities of the General Utilities Plc subsidiaries which participated in the Water Companies' Association Scheme were transferred to a "mirror image" plan called the Veolia Water Supply Companies' Pension Plan ('VWSCPP') which was closed to new members. This plan continued to provide benefits on a no less favourable basis than those previously provided for existing members of the scheme.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

29. Pensions (continued)

A new scheme was inaugurated as at 1 April 1996, the Générale des Eaux UK Retirement Benefits Scheme. This scheme was merged with the Générale des Eaux UK Pension Plan on 1 April 1998 to form the VUKPP, which was open to all new staff and existing members. The scheme provided a selection of benefits based upon final pensionable pay or money purchase according to the members' wishes. The final salary section was closed to new members on 30 September 2004.

On 31 May 2011, each of the divisions of the VWSCPP was merged into its corresponding division of the VUKPP.

The latest formal valuation of the plan for the group, determined by an independent qualified actuary, was at 31 December 2010, prior to the merger. The following disclosure is therefore presented for both the VWSCPP and VUKPP schemes combined. The actuarial valuation was made on the "attained age" funding method, based on the following assumptions:

Rate of investment return	6.2% (pre-retirement), 5.2% (post-retirement)
Rate of increase in remuneration	4.8%
Rate of pension increase	2.8% (former members of VWSCPP scheme)
Rate of pension increase	3.3% (VUKPP other members)

The valuation as at 31 December 2010 stated the market valuations of the plan to be £219.0m with a funding level of 90 per cent for the Central division, £16.6m with a funding level of 93 per cent for the East division, and £23.7m with a funding level of 119 per cent for the Southeast division. As the Shared Services division formed part of the 'UK' division in its entirety at that time, a standalone valuation or funding levels for that division are not available.

Contributions to the VUKPP over the period ended 31 March 2013 were paid by members in accordance with the rules of the plan and by the group expressed as fixed monetary amounts according to the size of the relevant payroll and any surplus or deficit in the relevant division of the plan.

The contributions expected to be paid in the year from the balance sheet date are £9.7m.

Principal assumptions

The present values of pension liabilities are estimated by discounting pension commitments, including salary growth, at an AA corporate bond yield.

In calculating the liabilities of the plan, the following financial assumptions have been used:

	2013
Discount rate	4.20% pa
Salary growth	4.20% pa
RPI	3.20% pa
CPI	2.50% pa
Life expectancy for a male pensioner from age 65 (years)	23
Life expectancy for a female pensioner from age 65 (years)	25
Life expectancy from age 65 (years) for a male participant currently aged 40 (years)	25
Life expectancy from age 65 (years) for a female participant currently aged 40 (years)	27

Deferred pensions are revalued to retirement age in line with the CPI assumption of 2.5 per cent per annum unless otherwise prescribed by statutory requirements or the plan rules.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

29. Pensions (continued)

The assets of the plan are held separately to those of the group, being invested by independent fund managers. Contributions to the plan are charged to the profit and loss account so as to spread the cost of pensions over the employees' working lives with the group.

The total pensions charge including the defined contributions scheme for the period ended 31 March 2013 was £4.2m. The effect of the asset limit credited to the profit and loss account is £1.6m. This has arisen from a change in the maximum allowable surplus relating to the net asset position of the Southeast division.

The assets of the scheme and the weighted average expected rate of return were

	At 31 March 2013	
	Value	Long term rate of return expected
	£m	(% pa)
Equities	156.6	6.24%
Bonds	61.5	4.10%
Property	10.9	6.75%
Cash and cash equivalents	124.9	2.96%
Fair value of assets	<u>353.9</u>	

The amounts for 31 March 2013 are as follows

	Affinity Water Limited	Affinity Water Shared Services Limited
Defined benefit obligation (£m)	(340.2)	(27.4)
Plan assets (£m)	323.9	30.0
Effect of asset limit (£m)	0.6	-
Surplus/(deficit) (£m)	(16.9)	2.6
Difference between expected and actual return on plan assets		
Percentage of plan assets	4.9%	7.3%
Experience gains/(losses) on plan liabilities		
Percentage of plan liabilities	0%	0%

Reconciliation of present value of scheme liabilities

	£000
At 12 June 2012	-
Acquisition	317,570
Current service cost	3,681
Interest cost	11,704
Settlement	-
Actuarial loss	42,776
Benefits paid	(8,855)
Contributions by scheme participants	680
At 31 March 2013	<u>367,556</u>

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

29. Pensions (continued)

Reconciliation of fair value of scheme assets

	£000
At 12 June 2012	-
Acquisition	319,564
Contributions paid by employer	7,182
Contribution by scheme participants	680
Expected return on scheme assets	11,956
Settlement	-
Actuarial gain	23,376
Benefits paid	(8,855)
At 31 March 2013	353,903
Deficit of funded plan liabilities	(13,653)
Effect of asset limit	567
Pension liability before deferred tax	(14,220)
Related deferred tax	3,271
Net pension liability at 31 March 2013	(10,949)

The amounts recognised in the profit and loss account are as follows

	2013 £000
For the period ended 31 March 2013	
Current service cost	(3,681)
Expected return on scheme assets	11,956
Interest on pension scheme liabilities	(11,704)
Net settlement credit	1,617

Total actuarial gains and losses recognised in the statement of total gains and losses

	2013 £000
For the period ended 31 March 2013	
Actuarial gains on scheme assets	23,376
Actuarial losses on scheme liabilities	(42,776)
Total charge	(19,400)
Deferred tax arising thereon	4,443
Charge after deferred tax	(14,957)

30. Billing on behalf of Thames Water and Anglian Water

The group bills and collects charges in respect of sewerage and infrastructure within its area on behalf of Anglian Water Services Limited and Thames Water Utilities Limited. No amounts are included in the accounts in respect of uncollected sewerage and sewerage infrastructure charges at 31 March 2013.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

31. Related party transactions

Group Purchases	Nature of relationship	In respect of	Value £000	2013 Balance outstanding £000
				£000
Infracapital F2 Rift S à r l and MSIP Dalis B V	Parent undertakings	Interest paid on loan	8,050	(16)*
Infracapital F2 Rift S à r l and MSIP Dalis B V	Parent undertakings	Dividend	8,001	-
Veolia Water UK Limited	Associate	Interest paid on loan	894	-
Veolia Water UK Limited	Associate	Dividend	889	-
Veolia Water UK Limited	Associate	Transitional services and capability sharing agreement	1,153	3,059
Other Veolia entities	Associate	Waste water disposal	186	221
Southern Water	Associate	Bulk water supply	250	-
Morgan Stanley Infrastructure Partners/ Infracapital Partners II/Veolia Water UK Limited	Group undertaking	Support services	90	90
Sales	Nature of relationship	In respect of	Value £000	2013 Balance outstanding £000
				£000
Veolia Water UK Limited	Associate	Transitional services and capability sharing agreement	1,545	1,291
Other Veolia entities	Associate	Transitional services and capability sharing agreement	3,854	2,020
Southern Water	Associate	Metered billing and GIS plans	238	0

* this was the amount of interest prepaid outstanding at period end

Loans payable outstanding at 31 March 2013 were with Infracapital F2 Rift S à r l for £65,010,000, MSIP Dalis B V for £52,008,000 and Veolia Water UK Limited for £13,002,000

The company does not have any related party transactions that do not eliminate on consolidation

32. Post balance sheet events

North Surrey Water Limited, a dormant subsidiary put into members' voluntary liquidation on 5 November 2009, was dissolved on 13 May 2013

On 1 April 2013, Affinity Water Limited entered into a Business Transfer Agreement with Affinity Water Shared Services Limited. The fixed assets and stock were purchased from Affinity Water Shared Services Limited for a value of £1.9m with the remaining assets due to be transferred at book value during the period.

On 2 April 2013, transitional service arrangements provided by Affinity Water Shared Services Limited since 28 June 2012 were terminated by Veolia Water UK Limited and Veolia Water Outsourcing Limited, with the exception of water quality, laboratory, and IT services, the latter of which were terminated in June 2013.

Affinity Water Acquisitions (Investments) Limited

Notes to the financial statements for the period ended 31 March 2013 (continued)

33. Ultimate parent company and controlling party

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

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 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, the infrastructure investment fund managed by M&G (the European Investment arm of Prudential Plc), and Morgan Stanley Infrastructure Partners. Veolia Environnement S A has retained a 10 per cent minority shareholding through its subsidiary Veolia Water UK Limited. The directors do not consider there to be an ultimate parent or controlling party.

Infracapital Partners II is one of a number of European infrastructure funds managed by M&G Investment Management Limited, a subsidiary of Prudential Plc. It was established in 2010 to make investments in income-generative infrastructure assets and business, including electricity and gas networks, water companies, transport infrastructure and renewable energy.

Morgan Stanley Infrastructure Partners is a leading global infrastructure investment fund. It is managed by Morgan Stanley Infrastructure Inc., part of the investment management division of Morgan Stanley. Morgan Stanley Infrastructure Partners 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.