



AA INTERMEDIATE CO LIMITED

INTERIM REPORT

FOR THE SIX MONTHS ENDED 31 JULY 2018

Management discussion and analysis

Introduction

The directors present the condensed financial statements of AA Intermediate Co Limited (“the Company”) and its subsidiary undertakings (together “the Group”) for the period ended 31 July 2018. The Company is an Obligor and a parent company of each of the other Obligors that provide security and guarantees under the financing arrangements entered into by the AA on 2 July 2013. The Company’s immediate parent is AA Mid Co Limited. There is no material difference in the financial conditions and results of operations between the AA Intermediate Co Limited group and the AA Mid Co Limited group.

Principal activity and review of business developments

The Group provides AA branded goods and services across the UK and operates two segments. These are Roadside, which includes Roadside Assistance and Driving Services and Insurance, which includes our Insurance Broker and our Financial Services partnership with Bank of Ireland.

The AA’s principal activity is the provision of Roadside Assistance to its personal Members and business customers (which in aggregate makes up 81% of Group Revenue). The AA business strategy includes cross-selling Insurance Services to its Membership utilising its marketing database and multiple points of contact with its customers.

The AA is focused on delivering the highest possible standards of customer service, quality products, stable and predictable profits, strong operating margins and continued strong cash generation. The Group continued to demonstrate all of these qualities during the six-month period.

Key operating measures

We use several key operating measures to track the financial and operating performance of our business.

	July 2018	July 2017
Roadside		
Paid personal Members ¹ (000s)	3,254	3,325
Average income per paid personal Member ¹ (£)	159	156
Business customers ¹ (000s)	9,680	10,016
Average income per business customer ¹ (£)	21	20
Number of breakdowns (000s)	1,907	1,761
Number of driving instructors	2,747	2,669

¹ Last 12 months

Insurance

Total Motor policies (000s)	659	616
Total Home policies (000s)	816	844
Average income per policy ² (£)	73	73

¹ Last 12 months includes Home Services, but not Financial Services

² Average income of Motor and Home only

Management discussion and analysis (continued)

Key operating measures (continued)

Paid personal Members decreased 2% to 3,254,000 (H1 2018: 3,325,000), largely due to the reduction in the retention rate to 81%. The retention performance over the last 12 months has been impacted by regulatory pressures (including renewal price transparency), increased competitor activity and the re-phased marketing spend. New business volumes were steady, with sales broadly flat year on year. Looking ahead, the completion and implementation of the new membership IT system (CATHIE) as well as ongoing improvements to the 'Stay AA' customer retention proposition is expected to lead to improved retention rates and a growing paid membership base over the medium term.

We continue to make good progress with the deployment of CATHIE. New customers who purchase either online or through call centres can now do so through the new system. We expect to migrate existing customers in a phased approach commencing later this financial year to allow retention benefits from the new system to be realised in FY20. The phased approach to migration will help to minimise customer and data risk while optimising the retention benefit. The completion of this migration, together with investments in the already deployed Pega Marketing CRM system and breakdown app, will give us important capabilities to drive cost reduction and improve retention performance.

Average income per paid member was up 2% at £159 (H1 18 £156), broadly in line with inflation, and also includes the impact of a significant increase in the sales of ancillary products and services at the roadside due to the cold weather.

In the business-to-business segment, the 3% reduction in business customers to 9,680,000 (H1 2018: 10,016,000) was anticipated due to the continuing decline in Added Value Accounts across the banking sector and also the reduction in new car registrations across the automotive sector, in particular diesel car sales. Despite these challenges, we have done well to extend and renew all our contracts in the period. Since the year end, the AA has extended and renewed its contract with Jaguar Land Rover (JLR), Volkswagen and Suzuki. In addition, the AA won a three-year contract with Arval following a competitive tendering process, a significant win for the AA in the Fleet and Leasing sector. The higher workload in the period resulted in additional revenue being recognised under our pay-for-use B2B contracts, this alongside the new contract wins as well as the decline in the overall business customer base led to a 5% of increase in the average income per customer to £21 (H1 18: £20). By continuing to invest in improving our range of products and services including app penetration across our B2B base, we are confident that we can leverage our market leading position and generate additional revenue streams.

Total breakdowns increased in the period by 8% to 1.91m. This was significantly higher than both our expectations and the average over the last 15 years due to the extreme weather conditions. This resulted in increased costs of third-party garaging to supplement our own patrol availability which was partially offset by the additional revenue from our pay-for-use B2B contracts as noted above. To counter this, we have invested in our front line and were pleased to have achieved our target of recruiting an additional 65 new patrols in FY19, who have been allocated to high service areas. We have also exceeded our target of recruiting in excess of 200 planned contact agent staff. In addition, we are also developing strategies to enable us to monetise more referrals and better manage our workload through the App. In the longer term, increased utilisation of the breakdown services drives brand awareness and retention.

More than 1 million members are now registered for the App and it is used in 34% (H1 18: 28%) of the breakdowns that we service. During the second half of this financial year, we will be integrating additional functionality into the app including migrating our Car Genie app into the AA breakdown app thereby allowing our members to benefit fully from an integrated app platform that will drive higher levels of customer engagement.

We are also making good progress with testing the market for Connected car breakdown solutions initially through the roll-out of our award-winning product, Car Genie. As at end August, approximately 15,500 units were distributed to and activated by our personal member base and it continues to perform in line with our experience since launch, in predicting up to one third of breakdowns before they occur. During the second half of the year, we will continue to develop our connected car strategy working closely with our OEM partners.

Motor insurance policies grew 7% to 659,000 (H1 18: 616,000), benefitting from increased acquisition marketing spend, incremental sales and renewals through the AA plc group's in-house underwriter and its systems investments including Insurer Hosted Pricing (IHP). IHP has now been installed with five of our motor panel members. This has enabled us to price more competitively and convert a greater proportion of quotes on Price Comparison Websites (PCWs).

Management discussion and analysis (continued)

In relation to the home policy book, we are pleased to report that we are making good progress in stabilising the overall decline. Since the year-end, the home policy book has been broadly flat at 816,000 (FY18: 818,000, H1 18: 844,000). This was a strong performance as the home policy does not currently benefit from IHP which will improve our pricing agility. Looking beyond FY19, we are confident that the additional investments to our systems as well as the commencement of the roll-out of IHP can return the home policy book to growth.

Average income per motor and home policy was flat in the period at £73 (H1 18: £73), a good result in a weakening rate environment.

Refinancing

In July 2018 we successfully completed a further refinancing package which resulted in the extension of our effective near-term debt maturity until January 2022.

AA Bond Co Limited, a subsidiary of AA plc, issued £550m of new Sub-Class A7 Fixed Rate Notes with an expected maturity of 31 July 2024 and a final maturity of 31 July 2043, with a coupon of 4.875% payable semi-annually in arrears.

The proceeds from the issuance of the Class A7 Notes were used to repay in full the Group's previous £250m Senior Term Facility due 2021. The remaining £300m of the proceeds of the Class A7 Notes were used to redeem £300m of the outstanding £500m aggregate principal of Class A3 Notes.

The AA also entered into a £200m forward starting senior term facility due in July 2023 in order to secure committed funding to be able to redeem the £200m of Class A3 Notes left outstanding at their effective maturity on 31 July 2020. This forward starting facility replaces the Group's previous £250m Senior Term Facility.

A new working capital facility of £60m (together with a £15m accordion facility), has also been put in place to replace the previous £75m working capital facility, with a maturity to 31 July 2023 and with the same margin as the previous facility.

These refinancings are in line with the AA's disciplined and pro-active approach to managing its capital structure and reduce any refinancing risk in the near-term. The extension in maturity of debt will mean that the next repayment of borrowings (other than that to be funded by the committed forward starting senior facility) is not due until January 2022, providing significant runway for the business to focus on the recently-announced strategic plan.

Principal risks and uncertainties

The Company's Principal Risks were detailed in the Annual Report 2018 and are summarised below:

1. Outstanding service

We are unable to maintain an outstanding service: the AA's brand and its continued success, and in particular the loyalty of our customers, relies on delivering outstanding service that is superior to the rest of the market. Inadequate investment in technology, systems, people and processes would place the objective at increasing risk.

While our repair rate, single-task-completion and under-bonnet times are only slightly down on previous years, our resource has coped with the strain of the significant weather events both in winter and summer, with continued use of third party garages to support workload. Despite an 8% increase against forecast service levels, our customer service has only seen minor disruption and profitability has remained on target, albeit with an increase in complaint levels. We continue to increase the flexibility of the patrol force, improve our planning and delay related forecasting due to unexpected weather related demand to mitigate the costs of third party garage use in the future and be better placed to respond to extreme weather events.

Management discussion and analysis (continued)

2. Roadside market share and margin

We are unable to maintain our market share and an ability to command a price premium on our roadside services: competitors that provide roadside services at a lower price or have a different business model, together with changes in car technology, threaten our roadside market share. If we charge a price premium that is above what our service can sustain, we will not grow our member or B2B customer base and, in the long term, sustainably grow profits. We need to improve, innovate, demonstrate and deliver a superior proposition and ensure our pricing is competitive relative to this position.

Personal paid Membership numbers have remained relatively stable.

3. Insurance Broking business

Price comparison sites will further damage the insurance broker model: the consumer use of price comparison sites may continue to transfer value from our insurance broking business.

This remains on track to deliver forecast growth.

4. Business transformation

We are unable to successfully complete essential business transformation: we must continue to transform the AA to achieve the required efficient customer centric services and to develop the business. There is still much to do and the required improvements to process, embedded ways of working and culture, inherently involves risks in a customer facing service environment.

Significant investment in transformation resource and capability is driving structured, budgeted change across multiple areas of the business. There has been a focus on strengthening our call centres, improving our analytical skill base and achieving a more flexible patrol force.

5. IT transformation

We are unable to successfully deliver the essential IT transformation: an essential programme of renewal and enhancement of our IT estates is in progress to address the risks to our brand and our competitive capability. The IT transformation is extensive and involves a continuing complex programme of work. Given the scale and complexity, the programme involves inherent risks to the timely delivery of this implementation.

The business continues to review the timelines and priorities for the transformation of our systems as part of the review of declared strategy and its execution.

6. Safety

We are unable to maintain the safety of our workforce and our members: we must continue to effectively manage the risks to the safety of our workforce and members and ensure controls are deployed to achieve this. Accountability to take action is essential in this as is oversight, review and embracing continual improvement.

Incidents of safety issues for workforce and members remains very low.

7. Growing the business

We are unable to grow the business in a manner that complements and sustains the brand: we may be unable to develop and grow new profitable business products and lines that complement the customer experience and which demonstrate standards and values that underlie our core brand.

This remains on track for FY19 against strategy.

8. Our people

Ineffective human resources to achieve the AA objectives: failure to recruit, train, develop and retain employees who have the skills and experience required by the business. Employee costs excessive. Staff of insufficient calibre.

Significant investment in contact centre personnel, patrols and subject matter experts will see improvement in providing outstanding service in the next half year. Work on reward and career opportunities is expected to reduce attrition in contact centres.

Management discussion and analysis (continued)

9. Debt Leverage and Pensions

Debt: We are unable to manage our debt: the Company is unable to repay or refinance its debt at an acceptable price.

Pension: We are unable to meet our pension liabilities: the Company has a large defined benefit (DB) pension scheme, currently in deficit, whose assets and obligations are subject to future variation from investment returns, longevity and other similar factors.

- *Debt refinancing - The A3 notes were partially repaid and replaced with new debt at no significant cost to leverage, but providing certainty to 2022 which in turn will enable delivery of the strategy declared in February without the distraction of re-financing in the near term.*
- *Pension liabilities – these have reduced in the period reducing the risk.*

10. Information security/Cyber crime/Data breach

We are unable to protect ourselves from a significant data breach or cyber security incident: critical information is not available where and when it is needed. The integrity of critical information is corrupted or the confidentiality of commercially sensitive, private or customer information is compromised by inappropriate disclosure. A serious data breach occurs.

Improvement in patching, data access and third party supplier management will further reduce this risk by year end but the risk remains high.

11. Regulatory and legal environment

A changing regulatory environment may adversely affect our activities. Material litigation against the AA: the changing regulatory environment could cause currently compliant services to become non-compliant, with material implications to customer offerings, pricing and profitability. Failure to comply with regulatory obligations could result in fines and reputational damage. Changes in Government legislation or taxation could impact the business model.

- *Regulatory changes that impact on this risk include confirmation of the successful implementation of the FCA's Insurance Distribution Directive and preparing for the Senior Managers and Certification Regime in 2018.*
- *Although renewal processes to comply with the new requirements on price transparency were implemented, a small number of one-off breaches in certain insurance and Road populations were identified and declared to the FCA, with remediation activity agreed where necessary.*
- *GDPR (General Data Protection Regulation) – the new GDPR requirements came into force in May 2018. Work is being carried out to ensure continued compliance.*
- *There remains a potential financial and reputational risk pending finalisation of litigation with the former CEO, Bob Mackenzie.*

12. Brexit

Negative impact on the AA as a result of Brexit: at this stage of Brexit negotiations, it is difficult to fully identify and assess potential risks, but the following have been highlighted as of potential concern for the AA:

- *Passporting for insurers and other regulatory change*
- *Impact on EU nationals in the UK and potential skills shortages*
- *Increasing future costs of supplies and services received by the AA*
- *UK recession as a result of Brexit reducing the demand for AA products and services*

There has been minimal impact to date with a small loss of revenue on International Driving Permits as the government moves this to the Post Office, cutting out AA involvement.

The risks listed above do not comprise all those associated with the Group and are not set out in any order of priority. Additional risks and uncertainties, not presently known to management or currently deemed to be less material, may also have an adverse effect on the business. The Group risk profile will evolve as mitigating activities succeed in reducing the net risks over time, or as new risks emerge.

Management discussion and analysis (continued)

Post Balance Sheet Events

Pension buy-in

In the period since the balance sheet date, the Trustee of the AA UK Pension Scheme has purchased a bulk annuity policy from Canada Life which insures all the benefits payable under the scheme in respect of 2,510 pensioner and dependant members. The Trustee has invested in such a policy as the Scheme will see all financial and demographic risks exactly matched for the covered members.

The annuity policy has been purchased in the name of the Trustee and therefore remains an asset of the AA UK Pension Scheme. Under IAS 19, this policy is considered to be a qualifying insurance policy which exactly matches the amount and timing of certain benefits payable under the scheme. The fair value of the insurance policy is therefore deemed to be the present value of the related defined benefit obligations.

At 23 August 2018, the date of the risk transfer to Canada Life, the defined benefit obligation for the covered population was c.£47m less than the premium of c.£351m paid for the policy. This difference between premium paid and fair value of the insurance policy will be recognised on balance sheet at the 31 January 2019 year-end through other comprehensive income ("OCI") as an asset loss. It should be noted that this is separate to the measure of the funding deficit (used to set cash contributions to the Scheme) which we expect will be reduced as a result of this policy given the prudent nature of the funding measure.

There will be a final adjustment premium paid once a data cleanse has taken place to take account of differences between the data used for quotation purposes and the finalised data, which will be concluded within 24 months of the risk transfer date. Any further premiums, or refunds where relevant, will be recognised through OCI.

Management discussion and analysis (continued)

	Six months ended July 2018 £m	Six months ended July 2017 £m
Revenue	472	467
Cost of sales	(193)	(172)
Gross profit	279	295
Pension past service credit	-	34
Administrative & marketing expenses	(162)	(149)
Operating profit	117	180
Finance costs	(88)	(98)
Profit before tax	29	82
Tax expense	(6)	(17)
Profit for the period	23	65

Reconciliation of Trading EBITDA to Operating Profit

Trading EBITDA	161	194
Pension service charge adjustment	(3)	(7)
Share based payments	(3)	(5)
Amortisation and depreciation	(33)	(32)
Exceptional operating items	(5)	(30)
Operating profit	117	180

Revenue: Revenue increased by £5m to £472m during the period (H1 18: £467m).

Roadside Assistance: Revenue increased by £10m during the period to £380m (H1 18: £370m) despite the anticipated decline in personal memberships and business customers. This was largely due to the additional pay-for-use revenue from B2B as a result of the higher breakdowns and the benefit of consolidating the results of AA Cars. (AA Cars is the trading name of Used Car Sales Limited which we acquired on 1 March 2018.)

Driving Services: Revenue remained flat at £31m (H1 18: £31m). The 3% rise in driving instructor franchises to 2,747 (H1 18: 2,669) reflects the improvements to our franchise proposition and the strength of the AA and BSM brands. This partially offset the decline in the number of speed awareness courses for the police and delayed implementation of new contract wins for our corporate partners.

Insurance Services: Revenue fell 8% in the period to £61m (H1 18: £66m), in line with our expectations. We achieved 7% growth in motor policies to 659,000, benefitting from increased acquisition marketing spend, incremental sales and renewals through AA plc's in-house underwriter as well as its systems investments including Insurer Hosted Pricing (IHP). IHP has now been installed with five of our motor panel members. This has enabled us to price more competitively and convert a greater proportion of quotes on Price Comparison Websites (PCWs). Since the year end, we have stabilised the decline in the home policy book which was broadly flat at 816,000 (H1 18: 844,000, FY18: 818,000)

Management discussion and analysis (continued)

Cost of sales: Cost of sales increased by £21m during the period to £193m (H1 18: £172m) due to additional unplanned costs from third party garaging in Roadside Assistance due to the exceptionally higher number of breakdowns attended in the period.

Administrative and marketing expenses: Administrative and marketing expenses increased by £13m during the period to £162m (H1 18: £149m). The increase was driven by higher overall head office costs £35m (H1 18: £27m) due to additional IT software costs and higher planned strategic operational expenditure in our people and systems.

Operating profit: Operating profit decreased by £63m during the period to £117m (H1 18: £180m). £34m of the decrease in operating profit is due to a one-off pension past service credit in relation to changes made to the UK defined benefit pension scheme in the prior period. In addition, the decrease was driven by the increase of cost of sales and administrative expenses described above, partially offset by the increase in revenue.

Finance costs: Finance costs fell by £10m to £88m (H1 18: £98m), with benefits of £5m from lower interest on external borrowings following the refinancing in July 2017, £2m from lower finance charges payable under finance leases and £13m from the change in the non-cash adjustment to the cash flow hedge reserve compared to the prior period. These were partly offset by the early repayment penalties of £15m (H1 18: £10m) in relation to early repayment of £300m of A3 notes and an increase of £4m in debt issues fees written off as part of the refinancing completed in July 2018. In addition, there was a £4m increase in amortisation of debt issue fees.

Taxation: The tax charge for the period was £6m (H1 18: £17m), reflecting lower profit before tax.

Trading EBITDA

Trading EBITDA is a non-IFRS measure and is not a substitute for any International Financial Reporting Standards measure.

Trading EBITDA reduced by £33m during the period to £161m (H1 18: £194m). The Trading EBITDA margin at 34.1% was lower than last year (H1 18: 41.5%).

Roadside Assistance: Trading EBITDA decreased by 10.3% to £156m. This was largely due to the additional strategic opex investments including recruitment of additional patrols and call-centre staff as well as increased third-party garaging costs resulting from the significantly higher workload in the period.

Driving Services: Trading EBITDA decreased by 22.2% to £7m (H1 18: £9m), largely reflecting the impact of the decline in the number of speed awareness courses as well as the delayed earnings benefit of new contract wins from our corporate partners.

Insurance Services: Trading EBITDA decreased by 13.2% to £33m (H1 18: £38m) as a result of the increased acquisition marketing spend by the broker and falling contribution from the sale of the Home Emergency Services consumer book.

Head Office Costs: Head Office Costs during the period increased by £8m or 29.6% to £35m (H1 18: £27m) due to additional IT software costs and higher strategic operational expenditure on our people and system.

Management discussion and analysis (continued)

Consolidated statement of cash flows

	Six months ended July 2018 £m	Six months ended July 2017 £m
Net cash flows from operating activities before tax	143	180
Tax paid	(10)	(11)
Net cash flows from operating activities	133	169
Investing activities		
Capital expenditure	(36)	(26)
Proceeds from sale of fixed assets	9	10
Payment for acquisition of subsidiary, net of cash acquired	(13)	-
Dividends from joint ventures and associates	1	
Net cash flows used in investing activities	(39)	(16)
Financing activities		
Proceeds from borrowings	565	250
Issue costs on borrowings	(6)	(6)
Debt repayment premium and penalties	(17)	(11)
Repayment of borrowings	(550)	(328)
Financing transactions	(8)	(95)
Interest paid on borrowings	(61)	(72)
Payment of finance lease capital	(18)	(19)
Payment of finance lease interest	(2)	(3)
Dividend paid	-	(20)
Net cash flows from financing activities	(89)	(209)
Net increase / (decrease) in cash and cash equivalents	5	(56)

Change in working capital: The change in working capital represented a cash outflow of £9m during the period (H1 18: £37m), mainly due to timing differences in invoice payments and a lower pension adjustment.

Net cash flows from operating activities before tax: Net cash flow from operating activities before tax decreased to a cash inflow of £143m (H1 18: cash inflow £180m) during the period. This was driven by lower operating profit.

Tax paid: Cash outflow from tax paid was £10m for the period (H1 18: cash outflow £11m). This was due to lower profit before tax in the current period.

Investing activities: Cash outflow from investing activities was £39m for the period (H1 18: cash outflow £16m). The increase in cash outflow from investing activities was driven by the increase in capital expenditure and the acquisition of AA Cars.

Financing transactions: Net cash flow from financing transactions for the period was a cash outflow of £8m (H1 18: cash outflow £95m). The decrease in financing outflows relates to the lower repayment of debt in the current period compared to the refinancing in the prior period.

Management discussion and analysis (continued)

Interest paid on borrowings: Cash outflow from interest paid on borrowings was £61m (H1 18: £72m) for the period.

Debt repayment premium and penalties: Cash outflow from debt repayment premium and penalties was £17m (H1 18: £11m) for the period. This payment related to the £15m penalty on early redemption of £300m of Class A3 Notes and a £2m premium incurred from the issue of the Class A7 Notes in the current period.

Payment of finance lease capital and interest: Cash outflow from the payment of finance lease capital and interest was relatively stable at £20m (H1 18: £22m).

Dividend: The Group has paid £nil (H1 18: £20m) dividend to AA plc during the period.

Management discussion and analysis (continued)

Net debt and covenants	As at 31 July 2018 £m	As at 31 July 2017 £m
Senior Term Facility	-	250
Class A notes	2,200	1,950
Less: cash and cash equivalents	(55)	(80)
Net Senior Secured Debt ¹	2,145	2,120
Class B notes	570	570
Finance lease obligations	53	56
Net Debt ²	2,768	2,746
Trading EBITDA for the last twelve months	360	406
Class B2 Leverage ratio ³	7.7x	6.8x
Senior leverage ratio ⁴	6.0x	5.2x
Class A Free Cash Flow: Debt Service ⁵	3.3x	3.1x
Class B Free Cash Flow: Debt Service ⁶	2.4x	2.2x

1 Principal amounts of the Senior Term Facility and Class A notes less cash and cash equivalents

2 Principal amounts of the Senior Term Facility, Class A notes, Class B notes and finance leases less cash and cash equivalents

3 Ratio of Net Debt to Trading EBITDA for the last twelve months

4 Ratio of Net Senior Secured Debt to Trading EBITDA for the last twelve months

5 Ratio of last twelve months free cash flow to proforma debt service relating to the Senior Term Facility and Class A notes

6 Ratio of last twelve months free cash flow to proforma debt service

Cash generation for the Group has remained strong with net cash inflows from operating activities before exceptional items and tax of £161m in the six months ended 31 July 2018 compared to £196m in the six months to 31 July 2017. Net debt to Trading EBITDA for the last 12 months stood at 7.7 times and net senior secured debt to Trading EBITDA has increased to 6.0 times as at 31 July 2018.

Class A free cash flow to debt service was 3.3 times as at 31 July 2018 and Class B free cash flow to debt service was 2.4 times, showing substantial covenant headroom.

The cash within the ring-fenced group headed by AA Mid Co Limited is part of the whole business securitisation (WBS). A dividend cannot be paid from the ring-fenced group until a number of criteria have been met. These include:

- Class A Free Cash Flow: Debt Service is above 1.35x
- Class B Free Cash Flow: Debt Service is above 1.00x
- The Senior Leverage ratio is less than 5.5x
- Finance charges: Trading EBITDA is above 2x where finance charges relate to the ring-fenced group and are on a proforma basis based on the Group's borrowings at the time of the test and exclude the amortisation of debt issue fees and net finance expense on defined benefit schemes
- The Group is also subject to a maximum cumulative dividend payout related to the cumulative cash generation and cumulative net income since the WBS was established, which are significantly higher than the proposed dividends. These calculations are adjusted for items required by the financing documents.

The Group has a cash balance of £55m, invested in AAA money market funds, giving overnight access and high liquidity. The Group drew £15m of its Working Capital Facility on 30 July 2018 and repaid it on 29 August 2018. The Group does not currently envisage needing to draw on this facility again in the foreseeable future.

The Group is required to hold segregated funds as 'restricted cash' in order to satisfy regulatory requirements governing our insurance regulated business. These restricted cash balances were £8m at 31 July 2018 (2017: £7m).

Consolidated income statement

	Note	Six months ended July 2018 £m	Six months ended July 2017 £m
Revenue	2	472	467
Cost of sales		(193)	(172)
Gross profit		279	295
Pension past service credit		-	34
Administrative & marketing expenses		(162)	(149)
Operating profit		117	180
Finance costs	4	(88)	(98)
Profit before tax		29	82
Tax expense	5	(6)	(17)
Profit for the period		23	65

Reconciliation of Trading EBITDA to Operating Profit

Trading EBITDA	2	161	194
Pension service charge adjustment		(3)	(7)
Share based payments		(3)	(5)
Amortisation and depreciation	6,7	(33)	(32)
Exceptional operating items	3	(5)	30
Operating Profit		117	180

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

Consolidated statement of comprehensive income

	Note	Six months ended July 2018 £m	Six months ended July 2017 £m
Profit for the period		23	65
Other comprehensive income on items that are or may be reclassified to profit and loss in subsequent years			
Exchange differences on translation of foreign operations		-	(1)
Effective portion of changes in fair value of cash flow hedges		(5)	8
Tax effect		1	(1)
		(4)	6
Other comprehensive income on items that are not to be reclassified to profit and loss in subsequent years			
Remeasurement losses on defined benefit schemes	16	147	2
Tax effect		(25)	-
		122	2
Total other comprehensive income		118	8
Total comprehensive income for the period		141	73

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

Consolidated statement of financial position

	Note	July 2018 £m	July 2017 £m	January 2018 £m
Non-current assets				
Goodwill and other intangible assets	6	1,312	1,285	1,296
Property, plant and equipment	7	110	113	127
Investments in joint ventures and associates		5	6	6
Deferred tax assets		2	56	30
Other receivables		-	-	3
Derivative financial instruments	15	2	-	-
		1,431	1,460	1,462
Current assets				
Inventories		7	7	7
Trade and other receivables	8	182	169	173
Amounts owed by parent undertakings	9	1,214	1,213	1,214
Cash and cash equivalents	10	55	80	50
		1,458	1,469	1,444
Total assets		2,889	2,929	2,906
Current liabilities				
Trade and other payables	11	(455)	(442)	(449)
Amounts due to parent undertakings		(32)	(21)	(22)
Finance lease obligations		(39)	(39)	(48)
Current tax payable		(1)	(12)	(10)
Borrowings and loans	13	(15)	-	-
Provisions	12	(1)	(10)	(13)
		(543)	(524)	(542)
Non-current liabilities				
Borrowings and loans	13	(2,718)	(2,722)	(2,727)
Derivative financial instruments	15	-	(17)	(9)
Finance lease obligations		(14)	(17)	(16)
Defined benefit pension scheme liabilities	16	(86)	(364)	(240)
Provisions		(5)	(9)	(4)
Deferred consideration		(11)	-	(11)
		(2,834)	(3,129)	(3,007)
Total liabilities		(3,377)	(3,653)	(3,549)
Net liabilities		(488)	(724)	(643)
Equity				
Cash flow hedge reserve		1	9	5
Retained earnings		(489)	(733)	(648)
Total equity attributable to equity holders of the parent		(488)	(724)	(643)

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

Consolidated statement of changes in equity

Attributable to the equity holders of the parent

	Share capital £m	Currency translation reserve £m	Cash flow hedge reserve £m	Retained earnings £m	Total £m
At 1 February 2017	-	1	2	(785)	(782)
Profit for the period	-	-	-	65	65
Other comprehensive income	-	(1)	7	2	8
Total comprehensive income	-	(1)	7	67	73
Share-based payments	-	-	-	5	5
Dividends	-	-	-	(20)	(20)
At 31 July 2017	-	-	9	(733)	(724)
At 1 February 2018	-	-	5	(648)	(643)
Profit for the period	-	-	-	23	23
Other comprehensive income	-	-	(4)	122	118
Total comprehensive income	-	-	(4)	145	141
Share-based payments	-	-	-	3	3
IFRS 9 conversion	-	-	-	13	13
IFRS 9 deferred tax impact	-	-	-	(2)	(2)
At 31 July 2018	-	-	1	(489)	(488)

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

Consolidated statement of cash flows

	Note	Six months ended July 2018 £m	Six months ended July 2017 £m
Profit before tax		29	82
Amortisation and depreciation		33	32
Net finance costs		88	98
Other adjustments to profit before tax		2	5
Working capital:			
(Increase) in trade and other receivables		(6)	(5)
Increase in trade and other payables		28	13
(Decrease) / increase in provisions		(12)	(11)
Difference between pension charge and cash contributions		(19)	(34)
Total working capital adjustments		(9)	(37)
Net cash flows from operating activities before tax		143	180
Tax paid		(10)	(11)
Net cash flows from operating activities		133	169
Investing activities			
Capital expenditure		(36)	(26)
Proceeds from sale of fixed assets		9	10
Payment for acquisition of subsidiary, net of cash acquired		(13)	-
Dividends from joint ventures and associates		1	-
Net cash flows used in investing activities		(39)	(16)
Financing activities			
Proceeds from borrowings		565	250
Issue costs on borrowings		(6)	(6)
Debt repayment premium and penalties		(17)	(11)
Repayment of borrowings		(550)	(328)
Financing transactions		(8)	(95)
Interest paid on borrowings		(61)	(72)
Payment of finance lease capital		(18)	(19)
Payment of finance lease interest		(2)	(3)
Dividend paid		-	(20)
Net cash flows from financing activities		(89)	(209)
Net increase / (decrease) in cash and cash equivalents		5	(56)
Cash and cash equivalents at the beginning of the period		50	136
Cash and cash equivalents	10	55	80

The cash flows from operating activities are stated net of cash outflows relating to exceptional items of £18m (2017: £16m). This relates to the cost of business transformation of £14m (2017: £8m), non-recurring costs of IT system implementation and other restructuring activities of £1m (2017: £1m), duplicate cover reimbursements of £1m (2017: £6m) and onerous property provision lease costs in respect of vacant properties of £2m (2017: £1m).

Other adjustments to profit before tax relate to share-based payments £3m (2017: £3m) and profit on sale of fixed assets £1m (2017: £nil).

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

Notes to the financial statements

1 Basis of preparation

a) Accounting policies

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with International Accounting Standard 34 'Interim Financial Reporting' (IAS 34). Accordingly, they do not include all the information and disclosures required in the annual financial statements and should be read in conjunction with the Group's annual financial statements as at 31 January 2018.

The accounting policies adopted in the preparation of the interim condensed consolidated financial statements are consistent with those followed in the preparation of the Group's annual consolidated financial statements for the year ended 31 January 2018 which were prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union and have been applied consistently across all periods.

These financial statements do not constitute statutory accounts within the meaning of Section 435 of the Companies Act 2006. Statutory accounts for the year to 31 January 2018 were approved by the board of directors on 14 June 2018 and delivered to the Registrar of Companies. The report of the auditors on those accounts was unqualified and did not contain any statement under Section 498 of the Companies Act 2006.

b) Going concern

The Group has long-term contracts with a number of suppliers across different industries and is strongly cash generative. The Group's borrowings are long-term in nature and in addition to the cash balances at the reporting date the Group has agreed undrawn credit facilities in place. The directors have considered this along with the projected future cash flows and have concluded that the Group has sufficient funds to continue trading for the foreseeable future. Therefore, the interim condensed consolidated financial statements have been prepared using the going concern basis.

c) Segmental analysis

The nature of the Group's operations means that for management's decision making and internal performance management the key performance metric is earnings before net finance costs, tax, depreciation and amortisation, exceptional operating items, share-based payments and pension service charge adjustments (referred to as Trading EBITDA). This better reflects the Group's underlying performance. Trading EBITDA is further analysed as part of the segmental analysis in note 2.

d) Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company and entities controlled by the Company (its subsidiaries). Control is achieved where the Company has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate. Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies into line with those used by the Group. All intra-group transactions, balances, income and expenses are eliminated on consolidation.

e) Critical accounting estimates and judgements

The principal estimates and assumptions that have a risk of causing an adjustment to the carrying value amounts of assets and liabilities within the next financial period are consistent with those disclosed in the financial statements for the year ended 31 January 2018.

Notes to the financial statements (continued)

2 Segmental information

For management purposes, the Group is organised into business units based on their products and services.

The Group has two reportable operating segments as follows:

- *Roadside*: This segment is the largest part of the AA business. The AA provides a nationwide service, sending patrols out to Members stranded at the side of the road, repairing their vehicles where possible and getting them back on their way quickly and safely. In addition, this segment includes the Group's publishing and hotels business, the AA and BSM driving schools and Drivetech which provides driver training and educative programs.
- *Insurance*: This segment includes the insurance brokerage activities of the AA, primarily in arranging motor and home insurance for customers, its home emergency activities and its intermediary financial services business.

	Six months ended July 2018 £m	Six months ended July 2017 £m
Revenue		
Roadside	411	401
Insurance	61	66
Revenue	472	467
Trading EBITDA		
Roadside	132	159
Insurance	29	35
Trading EBITDA	161	194
Share-based payments	(3)	(5)
Pension service charge adjustment	(3)	(7)
Amortisation and depreciation	(33)	(32)
Operating profit before exceptional items	122	150
Exceptional operating items	(5)	30
Operating profit	117	180
Net finance costs	(88)	(98)
Profit before tax	29	82

Segment performance is primarily evaluated using the Group's key performance measures of Revenue and Trading EBITDA as well as operating profit before exceptional costs.

Revenue is revenue on a continuing basis. Trading EBITDA is profit after tax on a continuing basis as reported, adjusted for depreciation, amortisation, exceptional operating items, share based payments, pension service charge adjustments, net finance costs and tax expense. This better reflects the Group's underlying performance.

The pension service charge adjustment relates to the difference between the cash contributions to the pension scheme for ongoing contributions and the calculated annual service costs.

Exceptional items, net finance costs and tax expense are not allocated to individual segments as they are managed on a group basis.

Segmental information is not presented for items in the Statement of Financial Position as management do not view this information on a segmental basis.

Notes to the financial statements (continued)

2 Segmental information (continued)

The segmental analysis based on the previous segmental view is as follows:

	Six months ended July 2018 £m	Six months ended July 2017 £m
Revenue		
Roadside Assistance	380	370
Driving Services	31	31
Insurance Services	61	66
Total Revenue	472	467
Trading EBITDA		
Roadside Assistance	156	174
Driving Services	7	9
Insurance Services	33	38
Head Office costs	(35)	(27)
Total Trading EBITDA	161	194

Reconciliation of new segmental analysis

Revenue

	Roadside		Insurance	
	Six months ended July 2018 £m	Six months ended July 2017 £m	Six months ended July 2018 £m	Six months ended July 2017 £m
Former segment presentation				
Roadside Assistance	380	370	-	-
Driving Services	31	31	-	-
Insurance Services	-	-	61	66
Trading Revenue	411	401	61	66

Notes to the financial statements (continued)

2 Segmental information (continued)

Operating profit before exceptional items	Roadside		Insurance	
	Six months ended July 2018 £m	Six months ended July 2017 £m	Six months ended July 2018 £m	Six months ended July 2017 £m
Former segment presentation				
Roadside Assistance	156	174	-	-
Driving Services	7	9	-	-
Insurance Services	-	-	33	38
Head Office costs	(31)	(24)	(4)	(3)
Trading EBITDA	132	159	29	35
Share-based payments	(2)	(4)	(1)	(1)
Pension service charge adjustment	(3)	(6)	-	(1)
Amortisation and depreciation	(31)	(30)	(2)	(2)
Operating profit before exceptional items	96	119	26	31

3 Exceptional operating items

	Six months ended July 2018 £m	Six months ended July 2017 £m
Pension past service credit	-	(34)
Other exceptional operating items	5	4
Total exceptional operating items	5	(30)

Exceptional operating items incurred in the six months ended 31 July 2018 consisted of £5m relating to business transformation, £1m relating to IT systems transformation being partially offset by a £1m profit on disposal of fixed assets.

In the prior period, exceptional operating items included £6m relating to business transformation and £1m relating to IT systems transformation, being partially offset by £2m income from an onerous property and £1m profit on disposal of fixed assets.

The pension past service credit £34m was the one-off gain from the pension scheme restructuring in the prior period.

Notes to the financial statements (continued)

4 Finance costs

	Six months ended July 2018 £m	Six months ended July 2017 £m
Interest on external borrowings	63	68
Finance charges payable under finance leases	2	4
Total ongoing cash finance costs	65	72
Ongoing amortisation of debt issue fees	9	5
Net finance expense on defined benefit pension schemes	3	5
Total ongoing non-cash finance costs	12	10
Transfer from cash flow hedge reserve for extinguishment of cash flow hedge	(8)	5
Gain on unhedged derivative	(1)	-
Early repayment penalty	15	10
Debt issue fees immediately written off following repayment of borrowings	5	1
One-off finance costs due to refinancing	11	16
Total finance costs	88	98

During the period, the group repaid £300m of Class A3 notes. As a result, the group incurred an early repayment penalty of £15m.

During the period, £5m (2017: £1m) of amortised debt issue fees were immediately written off following the refinancing.

During the period, the Group also repaid £250m (2017: £98m) of the Senior Term Facility and transferred the £8m gain (2017: £5m loss) fair value of the cash flow hedges related to the repayment to the income statement.

During the prior period, the Group repaid Class A1 notes of £175m and Class A4 notes of £55m. As a result, the Group incurred an early repayment penalty of £10m.

Notes to the financial statements (continued)

5 Tax

The major components of the income tax expense are:

	Six months ended July 2018 £m	Six months ended July 2017 £m
Consolidated income statement		
Current income tax		
Current income tax charge	2	12
	2	12
Deferred tax		
Relating to origination and reversal of temporary differences – current year	4	5
	4	5
Tax charge in the income statement	6	17

Tax for the period has been calculated by applying the forecast effective tax rate for the full year, excluding some exceptional items, to the profit before tax result for the period.

UK deferred tax has been recognised at the enacted rates of 17% and 19% depending on the expected reversal profile. The UK corporation tax rate will be reducing to 17% in April 2020.

Notes to the financial statements (continued)

6 Goodwill and other intangible assets

	Goodwill £m	Software £m	Total £m
Cost			
At 1 February 2017	1,172	197	1,369
Additions	-	23	23
At 31 July 2017	1,172	220	1,392
At 1 February 2018	1,197	248	1,445
Additions	-	29	29
At 31 July 2018	1,197	277	1,474
Amortisation and impairment			
At 1 February 2017	-	93	93
Amortisation	-	14	14
At 31 July 2017	-	107	107
At 1 February 2018	27	122	149
Amortisation	-	13	13
At 31 July 2018	27	135	162
Net book value			
At 31 July 2018	1,170	142	1,312
At 31 July 2017	1,172	113	1,285
At 31 January 2018	1,170	126	1,296

Notes to the financial statements (continued)

7 Property, plant and equipment

	Freehold Land & Buildings £m	Long Leasehold Land & Buildings £m	Vehicles £m	Plant & equipment £m	Total £m
Cost or valuation					
At 1 February 2017	24	7	98	90	219
Additions	-	-	6	3	9
Disposals	-	-	(12)	-	(12)
At 31 July 2017	24	7	92	93	216
At 1 February 2018	24	7	104	104	239
Additions	-	-	9	-	9
Disposals	-	-	(18)	-	(18)
At 31 July 2018	24	7	95	104	230
Depreciation and impairment					
At 1 February 2017	7	3	26	52	88
Charge for the period	1	-	11	6	18
Disposals	-	-	(3)	-	(3)
At 31 July 2017	8	3	34	58	103
At 1 February 2018	8	4	36	64	112
Charge for the period	-	-	14	6	20
Disposals	-	-	(12)	-	(12)
At 31 July 2018	8	4	38	70	120
Net book value					
At 31 July 2018	16	3	57	34	110
At 31 July 2017	16	4	58	35	113
At 31 January 2018	16	3	68	40	127

Notes to the financial statements (continued)

8 Trade and other receivables

	July 2018 £m	July 2017 £m	January 2018 £m
Current			
Trade receivables	135	138	135
Prepayments and accrued income	35	28	31
Other receivables	6	3	4
Deferred consideration	6	-	3
	182	169	173

9 Amounts owed by parent undertakings

	July 2018 £m	July 2017 £m	January 2018 £m
Amounts owed by parent undertakings	1,214	1,213	1,214

Amounts owed by parent undertakings are unsecured, have no repayment terms and bear no interest.

10 Cash and cash equivalents

	July 2018 £m	July 2017 £m	January 2018 £m
Cash at bank and in hand – available	47	73	42
Cash at bank and in hand – restricted	8	7	8
Cash and cash equivalents	55	80	50

Cash at bank and in hand - restricted includes £8m (July 2017: £7m, January 2018: £8m) held by and on behalf of the Group's insurance businesses which are subject to contractual or regulatory restrictions. These amounts are readily available to be used within the insurance business to meet short term needs, however are not readily available for remittance to other Group companies to be used for other purposes within the Group.

Notes to the financial statements (continued)

11 Trade and other payables

	July 2018 £m	July 2017 £m	January 2018 £m
Current			
Trade payables	104	100	100
Other taxes and social security costs	18	8	16
Accruals	62	60	56
Deferred income	238	244	233
Deferred consideration	-	-	15
Other payables	33	29	29
Interest payable	-	1	-
	455	442	449

12 Provisions (current)

	July 2018 £m	July 2017 £m	January 2018 £m
Duplicate breakdown cover	-	4	1
Property leases	-	6	2
Restructuring	1	-	10
	1	10	13

During the period, £1m of the duplicate breakdown cover provision was utilised (2017: £6m) and no additional provision was made (2017: £nil). In addition, £8m of the restructuring provision was utilised (2017: £nil) and £1m (2017: £nil) was released.

13 Borrowings and loans

	July 2018 £m	July 2017 £m	January 2018 £m
Current			
Borrowing and loans (see note 14)	15	-	-
Non-current			
Borrowings (see note 14)	2,718	2,722	2,727
	2,733	2,722	2,727

Notes to the financial statements (continued)

14 Borrowings

	Expected maturity date	Interest rate	Principal £m	Issue costs £m	Amortised issue costs £m	Total as at 31 July 2018 £m	Total as at 31 July 2017 £m	Total as at 31 January 2018 £m
Senior Term Facility	31 July 2021	5.71%	250	-	-	-	249	249
Class A2 notes	31 July 2025	6.27%	500	(1)	1	500	499	500
Class A3 notes	31 July 2020	4.25%	500	(1)	1	200	499	499
Class A5 notes	31 January 2022	2.88%	700	(47)	13	666	667	671
Class A6 notes	31 July 2023	2.75%	250	(4)	1	247	246	246
Class A7 notes	31 July 2024	4.88%	550	(8)	-	542		-
Class B2 notes	31 July 2022	5.50%	570	(16)	9	563	562	562
		4.51%	2,770	(77)	25	2,718	2,722	2,727

At 31 July 2018, all borrowings have fixed interest rates. The weighted average interest rate for all borrowings of 4.51% has been calculated using the effective interest rate and carrying values on 31 July 2018.

	Senior term facility £m	Class A2 £m	Class A3 £m	Class A5 £m	Class A6 £m	Class A7 £m	Class B2 £m	Total £m
As at 1 February 2018	250	500	500	700	250	-	570	2,770
Issue/ repayment date:								
17 July 2018	(250)	-	(300)	-	-	550	-	-
Total	-	500	200	700	250	550	570	2,770

In order to show the Group's net borrowings, the notes and the issue costs have been offset. Issue costs are shown net of any premium on the issue of borrowings. Interest rate swaps are recognised in the Balance Sheet at fair value at the period end (see note 15 and below).

All of the Class A notes are secured by first ranking security in respect of the undertakings and assets of AA Intermediate Co Limited and its subsidiaries. The Class A facility security over the AA Intermediate Co Limited group's assets ranks ahead of the Class B2 notes. The Class B2 notes have first ranking security over the assets of the immediate parent undertaking of the AA Intermediate Co Limited group, AA Mid Co Limited. AA Mid Co Limited group can only pay a dividend when certain net debt to EBITDA and cash flow criteria are met.

Any voluntary repayment of the class B2 notes would be made at a fixed premium based on the date of redemption. Any voluntary early repayments of the Class A notes would incur a make-whole payment of all interest due to expected maturity date, except the Class A5, Class A6 and Class A7 notes which can be settled without penalty within 3 months, 2 months and 3 months respectively of the expected maturity date.

On 17 July 2018, the Group issued £550m of Class A7 notes at an interest rate of 4.88%. £8m of costs associated with the issue of the A7 notes were capitalised. This consisted of £2m of premium and £6m of new issue fees.

From the proceeds of the A7 notes, the Group repaid £300m of A3 notes incurring a premium of £15m and the £250m Senior Term Facility (STF). In line with the Group accounting policy, this was accounted for as an extinguishment of debt and therefore issue costs associated with the A3 notes and the STF have been written off totalling £5m.

On 17 July 2018 a new undrawn STF of £200m was incepted and the working capital facility was reduced from £65m to £60m. The fees associated with this were £3m and were written off.

Notes to the financial statements (continued)

14 Borrowings (continued)

Following the repayment of the STF, the outstanding interest rate swaps scheduled to conclude post 31 July 2018 were settled for £7m. A future dated interest rate swap was left in place to cover the undrawn STF. Following the settlement of the interest rate swaps and the repayment of the original STF, there is no longer an interest rate hedge on the original STF so the cash flow hedge reserve was also released back through Other Comprehensive Income.

All of the Group's loan notes are listed on the Irish Stock Exchange.

In order to comply with the requirements of the Class A notes, we are required to maintain the Class A free cash flow to debt service ratio in excess of 1.35x and the senior leverage ratio below 5.5x (see page 12). The Class B2 notes require us to maintain the Class B2 free cash flow to debt service ratio in excess of 1x (see page 12).

The Class A and Class B2 notes therefore place restrictions on the Group's ability to upstream cash from the key trading companies to pay external dividends and finance activities unconstrained by the restrictions embedded in the debts.

The Class A notes only permit the release of cash providing the senior leverage ratio after payment is less than 5.5x and providing there is sufficient excess cash flow to cover the payment. The Class B2 notes restrictions only permit the release of cash providing the fixed charge cover ratio after payment is more than 2:1 and providing that the aggregate payments do not exceed 50% of the accumulated consolidated net income.

The current borrowing relates to a £15m draw down of the Working Capital Facility on 30 July 2018 which was repaid on 29 August 2018. The Group does not currently envisage needing to draw on this facility again in the foreseeable future.

15 Derivative financial instruments

	July 2018 £m	July 2017 £m	January 2018 £m
Assets			
Interest rate swap derivatives	1	-	-
Forward fuel contracts	1	-	-
Liabilities			
Interest rate swap derivatives	-	(17)	(9)
	2	(17)	(9)

Notes to the financial statements (continued)

16 Defined benefit pension scheme liabilities

The Group operates two funded defined benefit pension schemes: the AA UK Pension Scheme (AAUK) and the AA Ireland Pension Scheme (AAI). The assets of the schemes are held separately from those of the Group in independently administered funds. The AAUK scheme has final salary sections and a Career Average Revalued Earnings (CARE) section. The CARE section provides for benefits to accrue on an average salary basis. Since 2004, new entrants to the AAUK scheme accrue benefits in the CARE section but the Scheme was closed to new entrants from 1 October 2016. On 1 July 2017 accrual ceased under the final salary sections and members were moved to the CARE section for future accrual of benefits. This preserved defined benefits for current scheme members. In addition, pension indexation in the CARE section is based on CPI inflation, rather than RPI inflation, from April 2018 onwards. The AAI scheme is closed to new entrants and future accrual of benefits. AA Corporation Limited, a UK subsidiary of the Group, is the sponsor of the AAI scheme. The Group also operates an unfunded post-retirement Private Medical Plan (AAPMP), which is treated as a defined benefit scheme and is not open to new entrants.

The AAUK scheme is governed by a corporate trustee whose board is currently composed of member-nominated and company-nominated directors. The AAI scheme is governed by a corporate trustee whose board is currently composed of company-nominated directors of which some are also members of the scheme. For both pension schemes the company-nominated directors include an independent director whom the trustee board directors have nominated as Chairman. The Trustee of each scheme is responsible for paying members' benefits and for investing scheme assets, which are legally separate from the Group.

The AAUK and AAI schemes are subject to full actuarial valuations every three years using assumptions agreed between the Trustee of each scheme and the Group. The purpose of this valuation is to design a funding plan to ensure that the pension scheme has sufficient assets available to meet the future payment of benefits to scheme members.

The valuation of liabilities for funding purposes differs to the valuation for accounting purposes, mainly due to the different assumptions used and changes in market conditions between different valuation dates. For funding valuation purposes the assumptions used to value the liabilities are agreed between the Trustee and Group with the discount rate, for example, being based on a bond yield plus a margin based on the assumed rate of return on scheme assets. For accounting valuation purposes the assumptions used to value the liabilities are determined in accordance with IAS19 with the discount rate, for example, being based on high quality (AA rated) corporate bonds.

The valuations have been based on a full assessment of the liabilities of the schemes which have been updated where appropriate to 31 July 2018 by independent qualified actuaries.

Notes to the financial statements (continued)

16 Defined benefit pension scheme liabilities (continued)

The amounts recognised in the balance sheet are as follows:

	As at 31 July 2018			
	AAUK £m	AAI £m	AAPMP £m	Total £m
Present value of the defined benefit obligation in respect of pension and healthcare plans	(2,363)	(48)	(43)	(2,454)
Fair value of plan assets	2,323	45	-	2,368
Deficit	(40)	(3)	(43)	(86)

	As at 31 July 2017			
	AAUK £m	AAI £m	AAPMP £m	Total £m
Present value of the defined benefit obligation in respect of pension and healthcare plans	(2,515)	(53)	(60)	(2,628)
Fair value of plan assets	2,220	44	-	2,264
Deficit	(295)	(9)	(60)	(364)

	As at 31 January 2018			
	AAUK £m	AAI £m	AAPMP £m	Total £m
Present value of the defined benefit obligation in respect of pension plans	(2,491)	(50)	(45)	(2,586)
Fair value of plan assets	2,303	43	-	2,346
Deficit	(188)	(7)	(45)	(240)

The decrease in the deficit is due to increasing discount rates, falling long-term inflationary expectations, changes in the demographic assumptions (reflecting the latest outlook for mortality rates), and Group contributions paid into the schemes.

In June 2017 the Group completed the AAUK scheme triennial valuation as at 31 March 2016 agreeing a funding deficit of £366m with the pension trustees. The Group has committed to paying an additional £8m per annum from July 2017 to March 2019, £11m per annum from April 2019 to March 2021, uplifted in line with RPI from 1 April 2020 and £13m per annum from April 2021 to June 2026 uplifted in line with RPI from 1 April 2022 annually. In November 2013 the Group implemented an asset backed funding scheme which remains in place. The asset backed funding scheme provides a long-term deficit reduction plan where the Group makes an annual deficit reduction contribution of £13m increasing annually with inflation, until October 2038, secured on the Group's brands. The next triennial valuation of the AAUK scheme will take place as at 31 March 2019.

Using an inflation assumption of 3.0% and a discount rate assumption of 2.6%, the present value of the future deficit reduction contributions has been calculated. Based on these assumptions, the Group expects the present value of deficit reduction contributions to exceed the IAS 19 deficit. The Group notes that, in the event that a surplus emerges, it would have an unconditional right to a refund of the surplus assuming the gradual settlement of AAUK scheme liabilities over time until all members have left the scheme.

During the prior year the Group recognised a one-off past service credit of £34m as a result of the benefit changes described above. A £12m gain from closure of the Final Salary sections of the AAUK scheme, due to the assumed deferred pension revaluation being lower than the assumed pensionable earnings increases, and a £22m gain from the change in indexation in the CARE section from RPI-based to CPI-based, which is expected to be lower in the long term.

In the period since the balance sheet date, the AAUK scheme has purchased a bulk annuity policy which insures all the benefits payable under the scheme in respect of 2,510 pensioner and dependant members. Please see note 19 for further details on this.

Notes to the financial statements (continued)

16 Defined benefit pension scheme liabilities (continued)

The last triennial valuation for the AAI scheme was as at 31 December 2016, the result of which was an increase in the Going Concern deficit with the contribution level remaining the same. The Group made deficit reduction contributions of c. £2m in the year ended 31 January 2018 and will continue to make annual deficit reduction contributions, increasing with inflation, until December 2023 or until an alternative agreement is signed with the trustees. The next triennial valuation of the AAI scheme will take place as at 31 December 2019.

In total, the Group is currently committed to pay c. £22m in on going employer contributions and c. £24m in deficit reduction employer contributions to its defined benefit plans (AAUK and AAI) in the year ending 31 January 2019.

In November 2017 the Group completed a full accounting valuation of the AAPMP with a valuation date of 31 January 2017. This updated the previous full accounting valuation of the AAPMP that was performed as at 31 January 2013 and was projected forward to relevant reporting dates.

The 31 January 2017 full accounting valuation of the AAPMP revealed a reduction in reported deficit as a result of the actual level of medical premium inflation experienced being lower than that assumed over the period between full valuations and the impact of the latest longevity expectations.

Fair value of plan assets

The table below shows the AAUK plan assets split between those that have a quoted market price and those that are unquoted. Of the AAI scheme, 30.2% (2017: 33.5%) of assets do not have a quoted market price.

The fair value of the AAUK plan assets and the return on those assets were as follows:

	As at 31 July 2018		As at 31 July 2017	
	Assets with a quoted market price £m	Assets without a quoted market price £m	Assets with a quoted market price £m	Assets without a quoted market price £m
Equities	183	364	180	300
Bonds	838	215	825	200
Property	85	186	84	179
Hedge funds	23	396	-	426
Cash/current assets	31	2	24	2
Total plan assets	1,160	1,163	1,113	1,107

Notes to the financial statements (continued)

16 Defined benefit pension scheme liabilities (continued)

Pension plan assumptions

The principal actuarial assumptions were as follows:

%	AAUK and AAPMP			AAI		
	July 2018 %	July 2017 %	January 2018 %	July 2018 %	July 2017 %	January 2018 %
Pensioner discount rate	2.6	2.4	2.5	1.6	1.6	1.6
Non pensioner discount rate	2.8	2.6	2.6	2.6	2.5	2.3
Pensioner RPI	3.2	3.2	3.3	-	-	-
Non pensioner RPI	3.2	3.2	3.3	-	-	-
Pensioner CPI	2.1	2.1	2.2	1.6	1.5	1.6
Non pensioner CPI	2.1	2.1	2.2	1.6	1.5	1.6
Rate of increase of pensions in payment (final salary sections) - pensioner	3.0	3.0	3.1	-	-	-
Rate of increase of pensions in payment (final salary sections) - non pensioner	3.0	3.0	3.1	-	-	-
Rate of increase of pensions in payment (CARE section) - pensioner	1.7	1.5	1.7	-	-	-
Rate of increase of pensions in payment (CARE section) - non pensioner	1.7	1.5	1.7	-	-	-
Pensioner increase for deferred benefits	2.1	2.1	2.2	1.6	1.5	1.6
Medical premium inflation rate	7.2	7.2	7.3	-	-	-

Mortality assumptions are set using standard tables based on scheme specific experience where available and an allowance for future improvements. For 2018, the assumptions used were in line with the SAPS (S2) series mortality tables (2017 – SAPS (S2) series) with future improvements in line with the CMI_2017 model with a 1.25% long-term rate of improvement (2017 – CMI_2015 model with a 1.5% long-term rate of improvement). The AAI scheme mortality assumptions are set using standard tables with scheme specific adjustments.

The AA schemes' overall assumptions are that an active male retiring in normal health currently aged 60 will live on average for a further 27 years and an active female retiring in normal health currently aged 60 will live on average for a further 29 years.

Notes to the financial statements (continued)

17 Fair values

Financial instruments held at fair value are valued using quoted market prices or other valuation techniques.

The fair values are periodically reviewed by the Group Treasury function. The following tables provide the quantitative fair value hierarchy of the Group's interest rate swaps and loan notes. The carrying values of all other financial assets and liabilities (including the Senior Term Facility) approximate to their fair values:

At 31 July 2018:

	Carrying value £m	Fair value measurement using		
		Quoted prices in active markets (Level 1) £m	Significant observable inputs (Level 2) £m	Significant unobservable inputs (Level 3) £m
Financial assets measured at fair value				
Interest rate swaps (note 15)	1	-	1	-
Fuel hedge (note 15)	1	-	1	-
Financial liabilities measured at fair value				
Interest rate swaps (note 15)	-	-	-	-
Liabilities for which fair values are disclosed				
Loan notes (note 14)	2,718	2,749		

At 31 July 2017:

	Carrying value £m	Fair value measurement using		
		Quoted prices in active markets (Level 1) £m	Significant observable inputs (Level 2) £m	Significant unobservable inputs (Level 3) £m
Financial liabilities measured at fair value				
Interest rate swaps (note 15)	17	-	17	-
Liabilities for which fair values are disclosed				
Loan notes (note 14)	2,473	2,714	-	-

Valuation techniques include net present value and discounted cash flow models, and comparison to similar instruments for which market observable prices exist. Assumptions and market observable inputs used in valuation techniques include interest rates.

The objective of using valuation techniques is to arrive at a fair value that reflects the price of the financial instrument at each period end at which the asset or liability would have been exchanged by market participants acting at arm's length.

Observable inputs are those that have been seen either from counterparties or from market pricing sources and are publicly available. The use of these depends upon the liquidity of the relevant market. When measuring the fair value of an asset or a liability, the Group uses observable inputs as much as possible. Fair values are categorised into different levels in a fair value hierarchy based on the inputs used in the valuation as follows:

Level 1 - Quoted market prices in an actively traded market for identical assets or liabilities. These are the most reliable.

Notes to the financial statements (continued)

17 Fair values (continued)

Level 2 - Inputs other than quoted prices included in Level 1 that are observable for the assets or liabilities. These include valuation models used to calculate the present value of expected future cash flows and may be employed either when no active market exists or when there are quoted prices available for similar instruments in active markets. The models incorporate various inputs including interest rate curves and forward rate curves of the underlying instrument.

Level 3 - Inputs for assets or liabilities that are not based on observable market data.

If the inputs used to measure the fair values of an asset or a liability might be categorised in different levels of the fair value hierarchy, then the fair value measurement is categorised in its entirety in the same level as the lowest input that is significant to the entire measurement.

18 Related parties

The following table provides the total value of transactions that have been entered into with associates during each financial year:

Transactions with associates:

Associate	Nature of transaction	July 2018 £m	July 2017 £m	January 2018 £m
ARC Europe SA	Registration fees incurred	1	1	4

19 Post Balance Sheet Events

Pension buy-in

In the period since the balance sheet date, the Trustee of the AA UK Pension Scheme has purchased a bulk annuity policy from Canada Life which insures all the benefits payable under the scheme in respect of 2,510 pensioner and dependant members. The Trustee has invested in such a policy as the Scheme will see all financial and demographic risks exactly matched for the covered members.

The annuity policy has been purchased in the name of the Trustee and therefore remains an asset of the AA UK Pension Scheme. Under IAS 19, this policy is considered to be a qualifying insurance policy which exactly matches the amount and timing of certain benefits payable under the scheme. The fair value of the insurance policy is therefore deemed to be the present value of the related defined benefit obligations.

At 23 August 2018, the date of the risk transfer to Canada Life, the defined benefit obligation for the covered population was c.£47m less than the premium of c.£351m paid for the policy. This difference between premium paid and fair value of the insurance policy will be recognised on balance sheet at the 31 January 2019 year-end through other comprehensive income ("OCI") as an asset loss. It should be noted that this is separate to the measure of the funding deficit (used to set cash contributions to the Scheme) which we expect will be reduced as a result of this policy given the prudent nature of the funding measure.

There will be a final adjustment premium paid once a data cleanse has taken place to take account of differences between the data used for quotation purposes and the finalised data, which will be concluded within 24 months of the risk transfer date. Any further premiums, or refunds where relevant, will be recognised through OCI.