United Utilities Group PLC
27 June 2014

UNITED UTILITIES 2015-20 BUSINESS PLAN REVISIONS

As scheduled, United Utilities Water PLC (UUW) has submitted to Ofwat revisions to its business plan covering the 2015-20 period. The initial business plan was submitted on 2 December 2013 and the revisions to the plan follow extensive discussions with Ofwat, our Customer Challenge Group and our other stakeholders. Ofwat is expected to publish draft determinations on 29 August 2014.

Overview

- Average household bills fall by a further 0.6% to 2.3% in real terms over 2015-20 period
- Total expenditure of £6.6bn, including capex of £3.75bn, similar to initial plan
- Comprehensive further evidence provided to support company specific adjustments
- Proposed exclusions from totex modelling: c£960m wastewater and c£215m water
- Retail household cost to serve adjustment of £19m p.a. due to high levels of deprivation
- Plan based on Ofwat's weighted average cost of capital guidance
- Outcome delivery incentives now include rewards as well as penalties
- Revenue adjustments of c£130m relating to the 2010-15 period

Balanced plan

Our business plan for the next five-year period means that customers would benefit from below inflation growth in average household bills for the decade to 2020. Our plan reflects the views of customers on service and affordability, it delivers a paced investment programme to meet our environmental obligations and it provides an appropriate return for investors.

Customer bills

Extensive stakeholder engagement has highlighted that the principal concern for customers is affordability. Customers are generally satisfied with the current high levels of water and wastewater services being provided and are only prepared to pay for specific targeted areas of improvement, with 86% of household customers supportive of bill rises no higher than inflation. This has been a key driver in the formulation of our plan.

Following Ofwat's risk and reward guidance, we are now proposing an average real terms bill decrease of 2.3% for household customers across the five-year period (excluding the impact of the previously announced special customer discount, which is being applied to 2014/15 bills). This compares with an average real terms bill decrease of 1.7% in our initial plan, reflecting the combined changes of a lower cost of capital, revised 'pay as you go' ratios and expenditure revisions.

Real change proposed in average household bills

	2015/16	2016/17	2017/18	2018/19	2019/20
Annual change	-0.5%	-0.6%	-0.6%	-0.4%	-0.2%
Cumulative change	-0.5%	-1.1%	-1.7%	-2.1%	-2.3%

For non-household customers, we are now proposing an average real terms bill decrease of 0.9% in 2015/16, with a total real terms increase of 2.5% by 2019/20 which is similar to our initial plan. We tested our initial proposal with non-household customers and 76% were supportive and our business retail team continue to engage with customers to help them reduce their overall spend.

Real change proposed in average non-household bills

	2015/16	2016/17	2017/18	2018/19	2019/20
Annual change	-0.9%	+0.5%	+1.3%	+1.1%	+0.3%
Cumulative change	-0.9%	-0.4%	+0.9%	+2.1%	+2.5%

Total expenditure

Our plan includes total expenditure of £6.6 billion (2012/13 prices), which overall is similar to the initial plan. Wastewater and water total expenditure (totex) has reduced by around £150 million and £70 million respectively, relating to efficiencies and scope reductions, but has been broadly offset by the acceleration of spend relating to the water service and a revised cost profile relating to the retail service. The proposed total expenditure of £6.6 billion comprises capital investment (capex), including infrastructure renewals expenditure of £3.75 billion and operating expenditure (opex) of £2.85 billion.

This mix of opex and capex has been derived from the optimal cost assessment over the life of our assets. We have set the wholesale business 'pay as you go' (PAYG) ratio at 54% (the PAYG ratio is the proportion of wholesale total expenditure recovered directly through wholesale revenues). This would result in real growth in the regulatory capital value of around £600 million over the 2015-20 period (based on an assumed regulatory capital value at 1 April 2015 of over £9.6 billion, in 2012/13 year-end prices).

The PAYG ratio for the wastewater service is 47%, reflecting the significant enhancement requirements in this area, largely driven by new environmental obligations, whereas the PAYG ratio for the water service is 63%, reflecting the lower level of quality improvement requirements and therefore a greater proportion of maintenance activity.

Operating expenditure

Total operating expenditure in the plan is £2.85 billion, which is similar to our initial plan. This is split £1.08 billion opex for the water service, £1.12 billion opex for the wastewater service and £0.65 billion of operating expenditure for the retail service.

Our plan includes initiatives designed to save around £60 million per annum of opex by 2019/20, relative to 2012/13, which is similar to our initial plan. This will largely offset the unavoidable cost increases in areas such as rates and power, alongside the addition of private pumping stations and enhancement programme costs.

Capital expenditure

Our proposed £3.75 billion capital investment programme (net of grants and contributions) comprises £1.39 billion for the water service, £2.3 billion for the wastewater service and £0.06 billion for the retail service. Overall, our total capex requirements are similar to our initial plan.

Investment to meet tighter regulatory quality standards, enhance service to customers and maintain the supply/demand balance is forecast at £1.47 billion, with the remainder relating to maintenance. We have kept capex constrained at £3.75 billion by meeting new environmental obligations via a phased approach, supported by the Environment Agency and the Drinking Water Inspectorate.

Company specific adjustments

Deprivation – reflecting the impact of the extreme levels of deprivation in the North West on our costs, we are seeking an adjustment to the household retail average cost to serve of around £19 million per annum. We had already provided robust evidence to Ofwat in support of this approach and have added to this evidence base since the submission of our initial plan in December.

Water: Thirlmere totex exclusion – this proposed exclusion from Ofwat's totex modelling methodology relates to investment required to comply with the Habitats Directive requirement to revoke our Ennerdale abstraction licence in the Lake District. The River Ehen, downstream of Ennerdale Water, contains a declining population of the internationally endangered freshwater mussel. Revocation of the licence will cause a loss of water resources and customers would be at risk of loss of supply in the West Cumbria area.

Our preferred plan to address this deficit is to build a pipeline from our Thirlmere reservoir, with a new water treatment works near Keswick. There is no modelled spend in Ofwat's totex model for this type of investment. Since our initial business plan submission, we have reviewed the project timescales to meet the statutory obligations and have brought forward £165 million of investment which was originally planned for the 2020-25 period. This has increased our proposed spend on this initiative for the 2015-20 period to £215 million, which we have asked for Ofwat to exclude from its totex methodology.

Ofwat published its 'risk-based review initial thresholds' in March 2014 and this indicated a totex gap in respect of UUW's water service of around £70 million. Our water totex submission is now £2.48 billion, increasing this gap to around £170 million. However, we have asked for £215 million, of our £2.48 billion submission, to be assessed separately.

Wastewater totex exclusions – The North West is the only region in the UK with both large areas of high population density and high rainfall levels and these factors are significant drivers of wastewater costs. Our region has a very large industrial base and we treat the highest volume of trade effluent of any region. We also have the legacy of industrial pollution inherent in the North West, along with high phosphorus levels and have the largest volume of wastewater that is required to be treated to the highest standards. Our region has low dilution capacity of rivers and one third of the poorest quality rivers in England and Wales, together with two thirds of all of the failing bathing waters in England and Wales. This will be exacerbated by the Bathing Water Directive, which will increase the required standards from 2015. In addition, the North West contains an abundance of internationally and nationally designated sites of environmental importance that need to be protected and often improved, with our region containing England's largest area of 'Sites of Special Scientific Interest'. Overall, the North West has significant regional differences which have a material impact on the cost of providing wastewater services.

We have worked hard with the Environment Agency to constrain and balance our expenditure programme. Nonetheless, similar to previous regulatory periods, our wastewater spend includes a significant environmental programme. In light of our regional differences and a lack of relevant comparable costs across the industry, we believe it is necessary to assess several elements of this programme outside of Ofwat's totex modelling methodology. This reflects our view that it would be very difficult to capture all of the explanatory factors relating to certain projects solely through a top-down modelling approach, especially with regard to complex programmes that deliver multiple outcomes and/or which are driven by requirements across multiple regulatory periods.

Ofwat's 'risk-based review initial thresholds' indicated a totex gap in respect of UUW's wastewater service of £1.13 billion. After applying around £150 million of scope and efficiency reductions to the December plan, we now propose that around £960 million be excluded from Ofwat's totex modelling methodology and assessed separately (as outlined in the following bullets). We have provided Ofwat with extensive additional evidence and information to support these model exclusions.

Whilst our assessment of Ofwat's modelled approach is that there are multiple factors which give rise to this difference, key drivers can be broadly categorised as follows:

- c£370 million reflecting regional circumstances not reflected in Ofwat's models, impacting schemes such as those relating to bathing waters and biodiversity;

- c£330 million in respect of items where requirements are not modelled, or only partly included, in Ofwat's 'risk-based review initial thresholds'. This includes schemes driven by the future National Environment Programme, including areas such as those relating to the Water Framework Directive; and

- c£260 million relating to specific large integrated schemes driven by requirements across multiple regulatory periods. This includes a major project at our Davyhulme wastewater treatment works serving the population of much of Greater Manchester.

Although these key drivers substantially reflect our proposed model exclusions, we have also raised a number of other matters relating to the application of the models, company efficiency and the cost exclusions. These could affect Ofwat's assessment of the wastewater plan and inform its judgement in setting the wastewater totex baseline.

More information relating to our wastewater totex company specific adjustments is provided in a presentation pack, which can be accessed via the following website link:
http://corporate.unitedutilities.com/investors.aspx

Return on capital

Our revised plan is based on the weighted average cost of capital (WACC) provided by Ofwat in its risk and reward guidance, which was published in January 2014. This is a real, vanilla WACC of 3.7% for our wholesale business, plus retail margin. Our initial business plan proposed 4.1%, plus retail margin.

Outcome delivery incentives (ODIs)

Our initial plan included a range of ODIs where financial incentives were exclusively penalty-based. Following the publication of Ofwat's revised risk and reward guidance, we have reviewed our approach and undertaken further engagement with customers to better understand their preferences. As a result, we have revised our ODI package so that it is more symmetric, having both rewards as well as penalties, and now has better alignment of financial returns to the value delivered to customers. Following further engagement with the North West Customer Challenge Group we have submitted a total of 17 ODIs as part of our revised plan.

Eight ODIs relate to the water service and cover performance in areas such as reliability of supply, water quality, leakage and river quality improvements. The total reward incentive is around £100 million, with a total penalty risk of around £190 million, based on potential outcomes covering 80% of the probability range.

The other nine ODIs relate to the wastewater service and cover performance in areas such as sewer flooding, bathing waters, private sewers and sludge disposal. The total reward incentive is around £100 million, with a total penalty risk of around £190 million, based on potential outcomes covering 80% of the probability range.

Recognising customers' preference for bill predictability and stability, we propose to make any performance adjustments relating to our ODIs at the end of the 2015-20 regulatory period.

Adjustments relating to the 2010-15 period

We have enhanced our supporting evidence and made a number of adjustment claims in line with Ofwat's methodology. These include areas such as the revenue correction mechanism, opex incentive allowance, the capital expenditure incentive scheme and the service incentive mechanism. Overall, these adjustments amount to a revenue uplift of around £130 million across the 2015-20 period.

Next steps

Ofwat is expected to publish draft determinations on 29 August 2014, when it will provide its view of our revised plan. Final determinations are due on 12 December 2014.

Investor and analyst conference call

A conference call for investors and analysts starts at 11.00am this morning, hosted by our Chief Executive, Steve Mogford, and our Chief Financial Officer, Russ Houlden. The call can be accessed by dialling: +44 (0) 20 3139 4830, access code 19262851#. A recording of the call will be available for 30 days following 27 June 2014 on +44 (0) 20 3426 2807, access code 649069#.

United Utilities' contacts

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This announcement will be available on the day at: http://corporate.unitedutilities.com/investors.aspx

Appendix – Expenditure Summary

2015-20 five-year totals **£m (presented in 2012/13 prices)**	**Business Plan 27 June 2014**	**Initial Business Plan 2 December 2013**	**Difference**
Totex			
Water	2,478	2,379	+99
Wastewater	3,414	3,566	-152
Retail	707	665	+42
Total	**6,599**	**6,609**	**-10**
Opex			
Water	1,084	1,118	-34
Wastewater	1,116	1,129	-13
Retail	648	606	+42
Total	**2,848**	**2,853**	**-4**
Capex			
Water	1,394	1,260	+133
Wastewater	2,298	2,437	-139
Retail	59	59	0
Total	**3,750**	**3,756**	**-6**
Water capex			
Infrastructure renewals expenditure	380	386	-6
Maintenance	603	621	-18
Quality, enhancement, supply & demand	411	253	+158
Total	**1,394**	**1,260**	**133**
Wastewater capex			
Infrastructure renewals expenditure	340	355	-16
Maintenance	898	887	+11
Quality, enhancement, supply & demand	1,060	1,194	-134
Total	**2,298**	**2,437**	**-139**