United Utilities

helping life flow smoothly

United Utilities Water Limited

Annual Report and Financial Statements for the year ended 31 March 2017

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Regulatory reporting:

Regulatory reporting information for the year ended 31 March 2017 is contained in the separate Annual Performance Report, which has been prepared in accordance with regulatory reporting guidelines, and will be available separately once filed with Ofwat.

Terms used in this report:

United Utilities Water Limited's ultimate parent company is United Utilities Group PLC. 'UUG' means United Utilities Group PLC and 'United Utilities' or 'the UUG group' means United Utilities Group PLC and its subsidiary undertakings. The 'group' means United Utilities Water Limited and its subsidiary undertakings. The 'company' or 'UUW' means United Utilities Water Limited. The 'regulated business' or 'regulated activities' means the licensed water and wastewater activities undertaken by United Utilities Water Limited in the North West of England.

Cautionary statement:

This report contains certain forward-looking statements with respect to the operations, performance and financial condition of the group. By their nature, these statements involve uncertainty since future events and circumstances can cause results and developments to differ materially from those anticipated. The forward-looking statements reflect knowledge and information available at the date of preparation of this annual report and the company undertakes no obligation to update these forward-looking statements. Nothing in this annual report should be construed as a profit forecast.

Strategic report

Chairman and Chief Executive Officer's review


Dr John McAdam, Chairman and Steve Mogford, Chief Executive Officer

Overview

We have continued to improve performance for stakeholders during the year as we aim to deliver further value. Our performance in the early part of this regulatory period puts us in an industry leading position. The acceleration of our capital investment programme is delivering the benefits of operational efficiencies early and this is being reflected in our Outcome Delivery Incentive (ODI) performance where we have achieved another positive net outcome for the year. Our overall performance against our regulatory contract gives us confidence to invest an additional £100 million in projects to improve resilience over the next three years for the benefit of customers. Our Systems Thinking approach is unparalleled in the sector and on track to deliver £100 million of savings across the 2015-20 regulatory period, underpinning our business plan. In addition, we have seen a step change in customer service, delivering our best ever customer satisfaction scores.

Customer focus

The business has undergone a key cultural shift in recent years so that customer service sits at the core of everything we do. Having significantly improved customers' experience of our services over the last regulatory period, in which we became one of the most improved companies under our regulator Ofwat's Service Incentive Mechanism (SIM), we were determined to re-energise our approach to deliver an even better customer experience.

Our new customer service team was formed at the beginning of this year and set about benchmarking our performance both in and outside the sector. From this we identified a range of opportunities to improve customer satisfaction and reach out to customers struggling to pay.

Over the year, we have seen sustained improvement of our customer satisfaction scores under Ofwat's new SIM measure for this regulatory period, ending the year as one of the leading companies in our peer group. We are particularly pleased to have introduced a number of innovations that set new benchmarks for the sector.

One of our most successful innovations, Priority Services, was launched during the year. It provides dedicated support for those customers who are experiencing short or long-term personal challenges in their lives, such as physical or mental health difficulties, as well as those struggling financially.

Priority Services encompasses the wide range of initiatives we already have in place to help customers return to regular payment and adds tailored assistance to those customers with more specialised needs. We were delighted to see, over the course of the year, how well it has been received by customers, with 30,000 customers now registered.

Notwithstanding our benchmark debt management processes and wide range of schemes to help customers struggling to pay, as our region suffers from high levels of income deprivation, bad debt and cash collection will remain a principal challenge for us. Our new team has made further inroads in this area, reducing household bad debt to 2.5 per cent in 2016/17 from 3.0 per cent in the previous year.

One new innovation contributing to this success is a targeted campaign, which we call Town Action Planning, where we visit customers in areas where deprivation is particularly high. The scheme is proving particularly successful in engaging with hard to reach customers, helping them understand our various support schemes and payment options to find the arrangement

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most suited to their circumstances. In addition, we have been able to identify customers eligible for Priority Services who would otherwise have been unknown to us.

We recently introduced our new customer website, with a very different look and feel, developed following extensive research, which aims to deliver improved accessibility and ease of use. Mobile-enabled, the website reflects customers' increasing use of devices to access day-to-day online services, and offers web chat services across extended hours. This is the first phase of our digital transformation, aimed at helping customers' lives flow a little more smoothly.

Financial performance

Revenue was slightly lower than last year, reflecting the accounting impact of the disposal of the group's non-household retail business to its immediate parent as the UUG group prepared itself for the opening of competition in the non-household retail market on 1 April 2017, partly offset by our allowed regulatory revenue changes.

Operating profit was £606.8 million, up £31.5 million, mainly as a result of reduced profit last year which was principally due to costs associated with our water quality incident in Lancashire.

Profit before tax was £409.5million, up £60.7 million on the previous year, reflecting the increase in operating profit and fair value gains on our debt and derivative instruments this year, versus fair value losses last year.

We have a robust capital structure and aim to maintain, as a minimum, the company's existing credit ratings of A3 with Moody's and BBB+ with Standard & Poor's. This helps us retain efficient access to the debt capital markets throughout the economic cycle, and we have debt locked in at attractive rates versus Ofwat's cost of debt for the 2015-20 period.

Our pension scheme asset-liability matching approach has proven its effectiveness, providing us with stability in a time of turbulent market conditions this year. Our pensions position remains strong and we had an IAS 19 surplus of £195 million at the 2016/17 financial year end.

Operational performance

We began this 2015-2020 regulatory period with ODIs, set by Ofwat, reflecting an increasingly challenging set of performance targets. The ODIs are skewed heavily towards penalty, so we took the decision in the first year of the period to accelerate our capital investment programme to deliver operational performance improvements as soon as possible with the aim of mitigating the downside risks represented by the ODIs.

This acceleration has continued in year two, with a further £804 million invested, similar to last year, so that at the end of this year we had invested around £1.6 billion of our total c£3.6 billion capital programme for the five years. This programme is providing for infrastructure renewals in addition to delivering enhanced environmental performance, climate change resilience initiatives and customer service improvements.

We are delighted that this strategy is paying off with another year in which we delivered a small ODI reward of £6.7 million, improving again from the first year of the period. This reflects a considerable achievement by our operational teams to maintain sector leading performance across our asset base as new capability is progressively delivered through accelerated investment, particularly in our wastewater business.

It is important that we invest effectively, particularly where we are accelerating spend, and we use our Time, Cost and Quality index (TCQi) to measure performance in this area. Our capital team continues to deliver effectively with TCQi again scoring high at c93 per cent for the year.

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Systems thinking

Our integrated approach to delivery of services to customers, Systems Thinking, continues to progressively improve our operational capability across the business. For instance, our new telemetry backbone provides enhanced and more reliable communications, between our assets and our integrated control centre, with the potential to share more information between the two as our capabilities grow.

In addition, our real-time production capability for both water production and sludge processing is delivering efficiency benefits and flexibility during planned shutdowns and incidents, significantly improving system resilience during difficult periods. We rolled out our new field scheduling system during this year in pilot areas and we are now embracing that learning before rolling out this capability across our estate.

Performance against our regulatory contract

Having successfully locked in a low cost of debt, we feel we are in a strong position to deliver our target for the 2015-20 period of beating Ofwat's industry allowed cost of debt. We are making good progress in implementing a range of initiatives to deliver over £400 million of savings, and remain confident of meeting our totex allowance.

We are pleased to see continued strong performance in the areas of private sewers and pollution incidents, as well as good performance against our leakage targets. Following a good performance on our ODIs in 2015/16, the £6.7 million achieved this year brings our cumulative total to £9.2 million, which helps to limit our downside risk for the regulatory period. Whilst a number of our ODI measures are still susceptible to one-off events and, on the whole, they get tougher each year, our performance so far gives us the confidence to narrow our cumulative target range to between a £30 million net reward and a £50 million net penalty, across the five-year period.

As part of our responsible approach to resilience, and based on outperformance we have earned to date, we aim to make around £100 million available for additional investment across this regulatory period to deliver significant resilience benefits. The first £20 million will be made available in the next financial year, with the remaining investment phased over the rest of this regulatory period.

Long-term planning

In order to maintain a reliable, high quality water service for our customers, we have to look a long way ahead and anticipate those changes and core issues that are likely to impact on our activities. Our long-term strategy helps us define what we need to deliver over the shorter term, which in turn helps to create value. In the next 25 years, we will face many challenges and opportunities including climate change and its implications for water resources and flooding, the emergence of a more open, competitive UK water market, more rigorous environmental regulations and the ever-present need to combine affordable bills with a modern, responsive water and wastewater service.

By anticipating these changes we can ensure we continue to deliver what customers want at a fair price and in a responsible way. Our 25-year Water Resource Management Plan sets out the investment needed to ensure we have sufficient water to continue supplying our customers, taking into account the potential impact of climate change.

An example of a large project we are currently undertaking, to address future supply and demand issues for customers, is our 100 kilometre Thirlmere pipeline project, which will extend our integrated network to encompass West Cumbria. This will provide a secure, long-term supply for the area and ease pressure on environmentally sensitive local water resources. The pipeline will cross some of the most special areas of the Lake District National Park and, as a

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result, we have developed a solution which respects this sensitivity whilst delivering the lowest whole-life cost. The project demands the highest levels of stakeholder engagement and consultation to secure support, and we have been engaging with local communities on the proposed route since 2013. We were particularly pleased last autumn to receive the third and final planning approval for this project.

Water 2020

Ofwat is progressing a number of options for the next price review, which spans the period 2020-25, including competition in water resources and bio-processing (or sludge), along with the progressive transition from RPI to CPI inflation. We have continued to engage proactively and constructively with the regulators, and the industry, over the last year and have submitted comprehensive responses to Ofwat's various consultation papers.

In water resources, competition will apply to new resources only and our long-term water resources management plan indicates that our region is unlikely to need any new resources for many years. We will continue to engage strongly in regulatory developments, with customers and shareholders at the forefront of our thinking.

Our employees

Our people are fundamental to the improvements we have delivered in operational performance and customer service. We are proud of their commitment and dedication. Employee engagement remains at high levels, demonstrating that our employees have a strong capability to adapt and we would like to thank them for their critical contribution to the company's performance.

We have been successful in attracting and retaining people, having regenerated our graduate and apprentice schemes in 2010 and continuing to expand them over seven years to help provide an optimal balance of skills and experience within the group.

In the first year of our apprentice scheme in 2010 we took on six apprentices, and have built this intake to 54 apprentices in 2016, taking our total programme to 119 apprentices currently employed. We are accredited by four awarding bodies and named as one of the top 100 apprenticeship employers.

We have 64 people currently on our graduate scheme, across a range of different disciplines, including finance, engineering, commercial and project management. We encourage diversity among the new generation we are bringing into this industry and c40 per cent of our current graduates are female.

We are committed to helping local schools and have 47 trained Science, Technology, Engineering and Mathematics (STEM) ambassadors. We frequently attend careers events across our region and have good links with local universities. In March 2017, we formally launched a partnership with Teach First, a charity which strives to end educational inequality by placing and training graduates to teach in low income communities. This partnership will help with our desire to be more active with school children in communities that are hard to reach within our region, by helping them to improve their employability skills, raising awareness of future career opportunities and offering our employees development opportunities in coaching and mentoring Teach First teachers and students.

Despite continuing with a sustained focus on health, safety and wellbeing, our employee accident frequency rate for 2016/17 has increased to 0.196 accidents per 100,000 hours, compared with a rate of 0.104 in 2015/16. However, as part of our health and safety improvement programme, we have implemented several initiatives and over the same period we have been awarded the workplace wellbeing charter and retained RoSPA gold status. We recognise that we still have more to do, so health and safety will continue to be a significant area of focus for us.

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Strong corporate responsibility credentials

We operate in a manner that aims to deliver the highest levels of corporate governance and our board continues to provide sound and prudent governance, consistent with the principles of the UK Corporate Governance Code.

In the summer of 2016, we were pleased to, once again, attain Industry Leading company status, as measured through the Environment Agency's (EA) annual assessment. In particular, we delivered another strong performance in the area of pollution, and were one of only two companies to attain a Green rating for serious pollution incidents.

We have consistently met, or outperformed, our regulatory leakage targets and our performance to date keeps us on track to meet our 2015-20 targets, as set by Ofwat. We are committed to reducing our carbon footprint and increasing our generation of renewable energy. We have reduced our carbon footprint by 22 per cent over the last 10 years and progress in 2016/17 has been encouraging, with a high proportion of our waste used in regeneration projects and less than 6 per cent sent to landfill in 2016/17.

The strong corporate responsibility and environmental credentials of the UUG group were recognised this year when we retained World Class rating in the Dow Jones Sustainability Index for the ninth consecutive year, an achievement we are particularly proud of in light of the ever-evolving standards. This recognition is due primarily to the contribution of United Utilities Water Limited.

Outlook

We are encouraged by our continued strong operational and environmental performance, as well as our improvements in customer satisfaction. We have plans to improve further, supported by our Systems Thinking approach to operating the business, and the acceleration of our capital investment programme. Overall, we are encouraged by our progress in the early part of this regulatory period and are confident that we can deliver our targets for our customers and the environment.

Dr John McAdam
Chairman

Steve Mogford
Chief Executive Officer

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What we do

Where we operate

From Crewe to Carlisle, our offices and water and wastewater treatment works span the North West of England.

We gather our water from a range of different sources, but predominantly from our reservoirs in the Pennines and the Lake District. We extract water from Lake Vyrnwy in Wales for customers in Merseyside and Cheshire, while the rest is taken from the River Dee, boreholes and streams.

Of the 1,700 million litres we supply every day, well over half is from Cumbria and Wales. The two biggest reservoirs are Thirlmere and Haweswater in Cumbria. Haweswater holds more than 84,800 million litres of water – equivalent to around 33,900 Olympic swimming pools.

We own and manage over 56,000 hectares of land, making us the largest corporate landowner in England.

Much of this is catchment land (the areas immediately surrounding our reservoirs). We recognise that quality control starts right at the point of collection, so we keep our catchment land as clean and sustainable as we can. This helps with the water quality for our customers and makes a huge difference to the environment.

We help to protect over 400km of coastline and around 7,000km of rivers flowing across our region.

Our water cycle

The collection, treatment, use and return of water to the environment is naturally a cyclical process.

We collect water from the environment, which we clean and store before distributing it to our customers for their use.

We then collect it as wastewater and treat it before returning clean water back to the environment.

Our industry and market

Every day, over 50 million household and non-household customers in England and Wales receive water and wastewater services. These customers are served by 10 licensed companies which are split regionally based on river catchment areas.

United Utilities Water Limited holds licences to provide water and wastewater services to a population of approximately 7 million people in the North West of England.

We provide services to approximately 3 million households, and this generates around two-thirds of our total revenue. We also serve approximately 200,000 businesses, ranging in size from large manufacturing companies to small shops.

We, along with the other nine water and wastewater companies, comprise the vast majority of the total water and wastewater sector. We are the second largest of the 10 licensed water and wastewater companies, based on the size of our asset base, as measured by Regulatory Capital Value (RCV).

The remainder is made up of licensed companies which provide water-only services and tend to be smaller in size.

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As each company in the water sector operates as a regional monopoly for the majority of its services, they are subject to regulation in terms of both price and performance.

The privatisation of the industry, 28 years ago, has been widely perceived as a success, making a significant contribution to public health as a result of over £100 billion investment in maintaining and improving assets and services since 1989.

It has led to improvements in the quality of services, higher environmental standards, and superior quality drinking water, at lower estimated costs to customers, than if the water sector was still owned by the UK Government.

In order to protect the interests of customers and the environment, at privatisation, three separate bodies were set up to regulate the activities of water and wastewater companies under the areas of economic, drinking water quality, and environmental regulation. This has evolved to fit with the tightening of laws and regulations over time.

How we create value

Our vision

Our vision is to be the best UK water and wastewater company, providing great service to our customers.

Our core values

Our three core values provide the cultural framework within which we are working towards achieving our vision, and we encourage our employees to live these values in everything they do in their daily work.

- **Customer focus** – everything that we do will be about our customers, not us
- **Integrity** – we will make promises knowingly and keep them
- **Innovation** – we will innovate to make our services better, safer, faster and cheaper for our customers

Through our core values, we are embedding a customer service orientated culture, recognising the importance of maintaining a relationship built on trust and confidence, and continually striving to improve the customer experience.

Our business principles

We strongly believe that only by talking and listening to our customers and stakeholders can we act more responsibly and improve the way we do things.

With this in mind, we developed a set of business principles through conversations with our customers and stakeholders that demonstrate our commitment to delivering our services in an environmentally sustainable, economically beneficial and socially responsible manner.

These business principles cover five key themes:

- Providing great service to customers
- Working to protect and enhance the environment
- Actively supporting local communities
- Supporting our employees to achieve their full potential in a safe workplace
- Delivering good value to stakeholders and managing our supply chain fairly

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Our business model

Key resources

Natural resources
- Collect water for treatment
- Maintain sustainable catchment land, protecting the natural environment
- Process waste to generate renewable energy

People
- Develop and motivate our diverse workforce
- Management incentives based on performance
- Working with suppliers who share our values

Assets
- Significant capital investment programme
- Efficient maintenance of long-term fixed assets
- Innovative solutions and Systems Thinking approach

Financing
- Robust capital structure
- Long-term debt locked in at good relative value
- Proactive engagement with equity and credit investors and access to range of markets

The best service to customers

Outcomes
- Provide great water
- Dispose of wastewater
- Deliver a service customers can rely on

At the lowest sustainable cost

Outcomes
- Value for money
- Improved efficiency

In a responsible manner

Outcomes
- Protect and enhance the environment
- Support local communities
- Support employees in a safe workplace

Provide an appropriate risk and return for investors

How we measure our performance – operational KPIs

- Wholesale ODI composite
- SIM – qualitative
- SIM – quantitative

- Totex outperformance
- Financing outperformance
- Household retail cost to serve

- Leakage
- EA performance assessment
- Dow Jones Sustainability Index

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Our strategy

Our strategy is to create sustainable value by delivering:

- The best service to customers
- At the lowest sustainable cost
- In a responsible manner

These three strategic themes are used as a framework for us to measure each aspect of our performance, and each of our operational KPIs is closely linked to one of these strategic themes, although it is indicative of the interconnectivity of our business that these may often link broadly to more than one of these strategic themes.

With our core values and business principles in mind, to demonstrate how we will deliver our strategy with a focus on what our customers and stakeholders want, we have broken down our three strategic themes into eight key outcomes, as set out in our business model diagram above.

Our competitive advantage

How we offer value

The following are key features that we believe offer value to our stakeholders, alongside the specific differentiating factors described below:

- Clarity on allowed returns through to 2020, with a track record of regulatory outperformance
- Wholesale revenue and asset base linked to RPI inflation to at least 2020
- Robust capital structure: stable A3 credit rating
- Planning for the long-term, protecting and delivering essential services
- Significant improvements in customer service and operational performance, with more to come
- Customer and environmental benefits delivered through substantial capital investment, driving long-term RCV growth
- Deeply integrated with the environment, with external recognition for our responsible business credentials

How we differentiate ourselves from our competitors within the water industry

Systems thinking approach to how we operate improves efficiency and resilience

We have adopted an innovative systems-based approach to our regional water system and wastewater drainage areas which we call Systems Thinking.

By thinking of our entire network as a system, and using our integrated control centre, we are able to optimise cost and service performance, as well as encourage a proactive, rather than reactive, culture.

This helps us to:

- improve the reliability of our assets to reduce unplanned service interruptions;
- improve our use of data, at local asset level and centrally, to optimise performance; and
- allocate resources to production teams with full accountability for asset and system performance.

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This approach was built into our business plan in order to help us deliver both operational improvements and cost savings across the regulatory period.

As a result of this Systems Thinking approach, we are improving the resilience of our assets and network. This enables us to continue to provide a reliable service to our customers long into the future.

Prudent financial risk management delivers long-term predictability

Our clearly articulated financial risk management policies, covering a variety of market risks, help us reduce our exposure to the economic and regulatory environment therefore providing more predictable returns to investors.

Our policy on inflation hedging is to match the debt portion of our RCV, offset by the effect of our pension scheme liabilities, with index-linked debt. This provides equity shareholders with a reliable one-to-one exposure to RPI movements, controlling the risks of unexpected movements in inflation.

Interest rate exposure on our remaining nominal debt is managed by fixing the underlying interest cost out to 10 years, on a reducing balance basis, and is supplemented by substantively fixing interest rates for each forthcoming regulatory period at the time of the price control determination. This enables us to manage uncertainty in the approach to setting the cost of debt at each price review, and our approach to debt financing enables us to consistently lock in long-term debt at good relative value.

We adopt an asset-liability matching policy for our defined benefit pension schemes by investing in assets such as fixed income swaps, corporate bonds and gilts which perform in line with the liabilities so as to hedge against changes in swap and gilt yields. This therefore reduces the volatility of the required funding level.

The pension schemes also hedge inflation exposure, partly through RPI swaps and partly through an inflation funding mechanism, whereby company contributions are flexed for movements in RPI, providing a natural hedge against any inflationary uplift on the RCV.

How we engage with our stakeholders

Delivering water and wastewater services to 7 million people in the North West brings us into contact with a wide variety of stakeholders. Ensuring we build strong, constructive relationships with them is vital for the success of our business.

We approach stakeholder engagement in an inclusive way, taking time to understand which stakeholders are interested in which topics, holding genuine, two-way conversations with them and, through continuous engagement, working hard to understand any concerns or issues from their perspective to ensure a suitable response from the company.

Interactions with our stakeholders take many forms, from formal meetings to day-to-day contacts, and focus on a range of topics from the future direction of the sector through to everyday operational matters.

Customers – through continuous focus on improving service, we can help to build their trust and confidence in our service delivery.

Suppliers – by maintaining a good relationship and working towards the same goals, we can deliver projects on time, to budget and to the required quality.

Regulators – to help shape the policy and regulatory framework within which we operate.

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Third Sector and NGOs – through engagement with groups representing economic, environmental, social and governance interests, we can better understand their issues and seek solutions to what are shared problems.

Politicians – by maintaining good lines of communications with North West MPs and their local offices, we can help resolve water-related constituency issues as well as discuss national policy topics.

Devolved authorities – by engaging with the emerging devolved arrangements, such as new metropolitan mayors, we can better understand the needs of the region we serve.

Key Resources

Natural resources

Our 'Instrument of Appointment' or Licence is essential for us to utilise the natural environment in the North West to create value for our business.

Raw water

Rainfall in the North West is greater than in other parts of the country, and therefore water supply is not as constrained. Nonetheless, it is in everyone's interest to make the most of this precious resource. We continuously encourage our customers to use water more efficiently and have increased the number of households fitted with meters. Our water-saving initiatives can save our customers money on their bills as well as preserving this vital resource. We have a regulatory annual leakage target, based on the sustainable economic level of leakage, and we have consistently met or outperformed this target.

Catchment land

We own over 56,000 hectares of land around our reservoirs. Our sustainable catchment management programme (SCAMP) has shown that we can effectively manage these catchments to protect and enhance water quality, and to provide other benefits such as an improved natural environment. Our Catchment Wise project is looking at working with others to improve the lakes, rivers and coastal waters where we return wastewater in the North West.

Bioresources

Another key resource is waste. Bioresources from wastewater can be processed to generate renewable energy, helping to save power costs and providing an ongoing opportunity to reduce carbon emissions. Our advanced digestion facility at Davyhulme is one of the largest works of its type and we now inject biogas from Davyhulme's wastewater treatment into the national gas network. We recycle waste by supplying treated bio solids to agriculture, which provides a valuable resource for farmers.

People

Our employees play a critical role in increasing long-term value generation. Fundamental to the decisions we take, and the operational performance we deliver, is a skilled, engaged and motivated team.

Wages and long-term incentives

Our employees are paid a competitive base salary along with a staff benefits offering and the opportunity to join both the employee healthcare scheme and our share incentive plan. Independent studies have shown that this enhances the quality of work, increases employee retention and reduces absenteeism, in addition to providing societal benefits. Management has

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a range of incentives which focus on performance over a number of years, rather than just the current year, to encourage the delivery of benefits over the longer term.

Human resource policies

Our policies on maternity, paternity, adoption, personal and special leave go beyond the minimum required by law. For disabled applicants, and existing employees, we are committed to fulfilling our obligations in accordance with the relevant legislation. Applicants with disabilities are given equal consideration in the application process, and disabled colleagues have equipment and working practices modified for them, as far as possible, wherever it is safe and practical to do so. We have procedures and policies in place to ensure we act in accordance with the Universal Declaration of Human Rights.

Diverse workforce

We value diversity, providing equality of opportunity and recruiting and promoting employees on the basis of merit, which we believe provides the benefit of a more comprehensive and balanced skills-set. Despite being a highly engineering-based organisation, women are represented at all levels of the company.

	Male **2017**	Female **2017**
Group board	7 (78%)	2 (22%)
Senior managers		
- Executive team*	3 (50%)	3 (50%)
- Other senior managers	40 (85%)	7 (15%)
Wider employees	3,404 (63%)	1,973 (37%)

*Figures exclude CEO, CFO and wholesale managing director, who are included in group board figures

Health and safety

The health and safety of our employees is fundamental, both for their welfare and to the reputation and performance of our company. This continues to be a significant area of focus as we strive for continuous improvement. We have implemented a number of initiatives over recent years to improve health and safety conditions for our employees, and have been awarded the workplace wellbeing charter.

Supply chain relationships

Our suppliers and contractors provide us with essential services which we rely on to deliver our strategy, and we work with those whose business principles, conduct and standards align with our own. Our key suppliers have committed to our Sustainable Supply Chain Charter, further supporting the delivery of these benefits. Our suppliers are contributing significantly towards the c£9 billion forecast contribution we are making to the regional economy over the 2015-20 period.

Employee training and development

We place a strong emphasis on providing comprehensive training and development opportunities for our employees, which helps to improve our internal skills-base as well as create a more engaged workforce.

We strive to enhance our understanding of best business practices in other companies and sectors around the world and, by bringing this learning back to our business, we have increased our organisational knowledge and capability. This has been integral to developing our Systems Thinking approach to operating our business.

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Our award-winning apprentice scheme, coupled with our graduate recruitment programme, is helping to ensure we can continue to attract and train a high calibre of engineers, in a profession which has seen declining numbers in the UK in recent years.

Assets

Our fixed assets (including all our reservoirs, treatment works and pipes) have a gross replacement cost of around £90 billion which is the estimated amount it would cost for another company to build similar assets and networks. However, it is not the replacement cost of our assets upon which we are allowed to earn a return through our revenues. We earn a return on our regulatory capital value (RCV), a regulatory measure of the value of our capital base, which is currently just over £10 billion, so it is this asset value which is more important economically.

Long-term solutions

Many of our assets are long-term in nature, for example our impounding reservoirs have a useful economic life of around 200 years. By carefully reviewing our potential capital projects, and considering the most efficient long-term solutions, we can save future operating costs, help to reduce future customer bills, and work towards being able to operate in a more sustainable manner. It is important that we have the right systems and procedures in place in order to monitor and control the assets efficiently and effectively within our network. Embracing innovation in our asset configuration and work processes can help to make our future service better, faster and cheaper.

Investing in the region

Since privatisation in 1989, total capital investment of over £15 billion has provided substantial benefits to our customers and our region’s environment. It has also contributed to the North West's economy through job creation, both within our company and also in our supply chain. Disciplined investment, along with RPI inflation, also grows our RCV, increasing future revenues.

2015-20 investment programme

We expect to invest around £3.6 billion across 2015-20 and to continue with a substantial investment programme, for the foreseeable future, in order to meet more stringent environmental standards and to maintain and improve the current standards of our assets and services. When deciding on our investment strategy we have to be mindful of the impact on our customers’ bills and this is why, for example, we are spreading some of the environmental spend, required by European legislation, over the next 15 years.

Financing

Capital structure

We aim to maintain a robust and responsible capital structure, balancing both equity and debt, to achieve a strong investment grade credit rating. Issuing new debt is particularly important as our capital investment is largely financed through a mix of debt and cash generated from our operations. We maintain access to a broad range of sources of finance, in a number of markets, across which we seek best relative value when issuing new debt.

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Controlling our finance costs

Locking in long-term debt at good relative value can help keep our finance costs low and give us the potential to outperform the industry-allowed cost of debt. Sustained low-cost finance across the industry benefits customer bills. The average life of our term debt is around 20 years. Our prudent financial risk management policies, covering credit, liquidity, interest rate, inflation and currency risk, help reduce the group's exposure to changes in the economic and regulatory environment.

External environment

Natural environment

Whether it is treating and delivering drinking water for our customers, or returning treated wastewater to rivers and the sea, the natural environment is fundamental to our business. We continue to invest in the protection and, where appropriate, enhancement of the natural environment of the North West. This in turn brings economic benefits such as underpinning the region's tourist industry.

Preparing for climate change

We plan far into the future to ensure we are prepared for the changing natural environment, most notably the risks and opportunities presented by climate change. With severe dry periods becoming increasingly common, we must ensure we continue to have resilient water resources and an infrastructure capable of moving water efficiently around the region. At other times, we must tackle flooding incidents caused by the intensive bursts of rainfall which are becoming more frequent due to changing weather patterns. The potential effect of climate change on our future water resources is included in our 25-year Water Resource Management Plan.

Preparing for a changing population

Additionally, we must ensure we are able to meet increased demand on our sewerage network as the regional population is expected to increase. A phased, long-term approach ensures that the necessary work can be delivered without placing too much pressure on customer bills.

Returning water safely to nature

We have a responsibility to return water to the environment safely. Spills from our network can lead to pollution which, depending on their severity, can damage the natural environment and potentially lead to loss of reputation and financial penalties. We have had one of our best years in relation to serious pollution incidents, and it remains an important area of focus. The Environment Agency assesses water companies' performance across a basket of measures, including pollution, and its overall assessment is included as one of our KPIs. All of the pollution sub-measures are reported within our Corporate Responsibility pages on our website at: *http://corporate.unitedutilities.com/cr-environment.aspx.*

Reducing our environmental impact

We can make an important contribution to protecting and enhancing the natural environment by using fewer natural resources. We have been driving down our carbon footprint over the last decade (22 per cent fall in CO_2 emissions since 2005/06) and have plans to reduce it further. Less than 6 per cent of our waste goes to landfill and our use of recycled products is increasing. The UUG group plans to substantially increase its renewable energy production from 2015 to 2020 with the main contributor being solar opportunities. United Utilities Water Limited will benefit directly from this through an increasing amount of energy used coming from renewable sources. This will provide environmental benefits and energy cost savings.

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Political and regulatory environment

Over a long time frame the political and regulatory environment can change significantly. In the 28 years since the UK water industry was privatised, we have seen substantial tightening of laws and regulations. While to some extent changes to the regulatory environment are outside of our direct control, maintaining good relationships is important to enable positive participation in regulatory discussions. By positively engaging, and using our industry knowledge, we can help influence future policy with the aim of achieving the best outcome for our customers, shareholders and other stakeholders.

Economic regulation

The water industry currently operates within five-year planning cycles known as Asset Management Plan (AMP) periods. Prior to the start of each five-year period, companies submit their business plans which include their projected expenditure to enhance and maintain their assets. Following review of these plans, Ofwat sets the prices each company can charge their customers across the period. This report covers the second year of the 2015-20 (AMP6) period.

Ofwat introduced a number of important changes for the 2015-20 period, with the aim of evolving the sector in order to meet future challenges and placing greater focus on customers' needs.

Moving away from one single price control, there are now four separate price controls:

- wholesale water – covering the physical supply of water;
- wholesale wastewater – covering the removal and treatment of wastewater;
- domestic retail – covering customer-facing activities (principally customer contact, billing, meter reading and cash collection) for household customers; and
- non-household retail – covering customer-facing activities for business customers.

Separate retail price controls should provide retail businesses with greater incentives and focus on delivering a more efficient service to non-household customers, as competition expands, and to household customers under an industry average cost to serve approach.

The way companies' operating and capital costs are assessed has been modified to encourage them to utilise the most efficient, sustainable solutions under a totex model that looks at capex and opex together and treats them equivalently. Where companies out/underperform their totex allowance, this gain/pain is shared between investors and customers, ensuring both receive the impact.

In a move to a more outcomes-based approach, there was greater emphasis placed on customer engagement to set the outcomes. Companies' performance is now measured through a range of outcome delivery incentives (ODIs) covering a wide range of measures assessing operational and environmental performance, with associated rewards or penalties.

Ofwat's service incentive mechanism (SIM) assessment is continuing to be used as a measure of customer satisfaction. This will reward companies who perform well on customer service, or penalise companies who perform badly, relative to other water companies.

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Each year all water companies are required to publish an annual performance report, the first of which was published in July 2016 and can be found on our website, where our report for this financial year will also be made available: *corporate.unitedutilities.com/annualperformancereport.*

Ofwat (the Water Services Regulation Authority) is the economic regulator of the water and sewerage sectors in England and Wales, responsible for ensuring the companies provide customers with good-quality, efficient service at a fair price. Read more online at *www.ofwat.gov.uk.*

Market reform

From 1 April 2017, the 2014 Water Act opened retail competition to all non-household customers, including sewerage as well as water services. During the year the company disposed of its non-household retail business to its immediate parent as part of a wider disposal in which the UUG group ultimately disposed of the business to Water Plus, a joint venture established during the year between United Utilities PLC and Severn Trent PLC.

Following a request from Government, Ofwat assessed the potential costs and benefits of extending retail competition to household customers, and recently reported back to Government.

The Water Act paves the way for the future introduction of competition for certain parts of the wholesale, or upstream, business. Ofwat proposed, in its Water 2020 consultation document in 2015, to open up competition in the areas of water resources and sludge treatment from 2020.

We are fully engaged with regards to market reform, being always mindful of the potential impact on our customers and the value implications for our shareholders.

Environmental and quality regulation

The water and wastewater industry in the UK is subject to substantial domestic and European Union regulation, placing significant statutory obligations on water and wastewater companies with regards to, among other factors, the quality of drinking water supplied, wastewater treatment and the effects of their activities on the natural environment.

Defra is the UK Government department responsible for water policy and regulations in England and Wales; it sets drinking water quality and environmental standards (many based on European law) which water companies must meet. Read more at *www.gov.uk/defra*

The Environment Agency controls how much water can be drawn from the environment and the quality of water returned to rivers and the sea. The EA produces an assessment of water and wastewater companies' annual performance, and we include this as one of our KPIs, see page 30. Read more at *www.gov.uk/government/organisations/environment-agency*

The Drinking Water Inspectorate is responsible for ensuring compliance with the drinking water quality regulations. Read *more at www.dwi.gov.uk*

Natural England is responsible for the protection of designated sites for nature conservation, for example Sites of Special Scientific Interest. Companies are required to manage these sites and to protect and enhance biodiversity. Read more at *www.naturalengland.org.uk*

The Consumer Council for Water (CCW) represents customers' interests relating to price, service and value for money. It investigates customer complaints. Customers who remain dissatisfied can refer their complaint to be adjudicated by an independent service, WATRS (see below). Read more at *www.ccwater.org.uk*

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WATRS is an independent service designed to adjudicate disputes that have not been resolved through the water company's customer service teams or by referring the matter to the Consumer Council for Water. Read more at *www.watrs.org*

Competitive environment

The other water companies in England and Wales are naturally our main competitors and we benchmark our performance on a comparative basis. Away from the water sector, in line with our vision to be the best UK water and wastewater company, we benchmark our customer service performance against other leading service providers in our region.

Value creation

We create value for our stakeholders principally by agreeing and then delivering, or outperforming, our regulatory contract. The way we use our key resources, manage our internal environment and interact with our ever-evolving external environment, influenced by our long-term strategic approach, helps to achieve value creation. This facilitates the delivery of outcomes for our customers, employees, the environment and communities.

Performance measurement

Our key performance indicators for 2015-20 measure our progress against some of the most important value drivers for the business, feeding through from our strategic themes to deliver the best service to customers, at the lowest sustainable cost, in a responsible manner.

Decision-making

Systems Thinking lies at the heart of our day-to-day decision-making, from approving our capital expenditure programmes to agreeing our supply-chain partners. Whilst the financial impact is a key driver in decision-making, this is always set in the context of the impact on customers, shareholders, the environment, employees, communities and other stakeholders. For many years, we have included corporate responsibility factors as strategic considerations, supported by our corporate responsibility committee which is chaired by one of our non-executive directors.

Economic environment

Changes in the economy, such as inflation, interest rates or unemployment levels, can influence our ability to create value. While they are outside of our direct control, we can mitigate some of the potential adverse impacts associated with market movements, such as on inflation and interest rates, through our hedging strategies.

Regional deprivation

In recent years, unemployment in the North West has generally been higher than the national average. However, over the last year this unemployment rate has improved faster than, and is now broadly in line with, the national average. A report from the Department for Communities and Local Government, published during 2015/16, reaffirmed that the North West has the most deprived regions in England, with three of the top five local authority districts with the highest proportion of 'highly deprived' neighbourhoods (categorised as the most deprived 10 per cent). Even as the North West's economy recovers, it is unlikely to have a significant impact on deprivation, which is the principal driver of our higher than average costs to serve for our household customers. This is currently recognised by Ofwat through a special allowance for deprivation of £20 million per annum over the 2015-20 period.

Bad debt remains a risk to which we are exposed, particularly with the continuing tightening of real disposable incomes and the impact of recent welfare reforms likely to intensify. Whilst our debt management processes have been externally benchmarked as efficient and effective, we

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continue to refine and enhance them whilst also helping customers back into making regular payments through the use of manageable payment plans.

Market rate movements

Interest rates have remained below the long-term trend and we have benefited from this as we drew down, or raised, over £600 million of new debt in 2016/17. Comparatively low interest rates have also been beneficial to our future cost of debt as we continue with our interest rate hedging strategy.

RPI inflation has risen since the UK voted to leave the European Union, increasing to 3.1 per cent at March 2017, following on from lower inflation over the last couple of years. However, RPI inflation remains on the low side versus levels seen in the last 10 years. The prices we charge our customers (and therefore revenues), as well as our asset base, are linked to RPI inflation, so lower RPI has meant slightly lower growth on these measures.

However, we have a large quantity of index-linked debt which means our finance costs decrease as inflation falls, providing a partial economic offset to revenue (although this is not a perfect hedge as changes to revenue and index-linked finance costs are based on differing lagged measures of inflation). Our pension liabilities are linked to inflation, which provides an additional economic offset against our asset base. Overall, we are currently more inflation-hedged than the other listed water and wastewater companies so we are better protected in a low inflation environment.

Economic contribution

United Utilities' total forecast contribution to the regional economy, over 2015-20, is estimated at £9 billion. Direct economic contributions from our activities include the purchase of goods and services and providing extensive employment. There is also an indirect economic contribution, for example, when our suppliers make purchases from their suppliers and when people, whose jobs are supported by United Utilities, spend their personal incomes.

Social environment

We see some significant societal trends that we plan to address in our long-term strategy.

Population changes

We anticipate an increase in the North West's population of around 600,000 by 2040 (more than the population of a large city such as Liverpool). We are planning to ensure our services, and supporting infrastructure, meet the needs of this growing population, which will include a higher proportion of older people. The North West remains the most socially and economically deprived region in England and so we can anticipate continued hardship for a number of communities and difficulties for some customers in paying their bills. We will remain committed to supporting these customers through a suite of payment assistance schemes and by looking at new ways to help, like the introduction of our social tariff in 2015, supporting older customers. We are also adapting to the increasing use of social media and digital technology by our stakeholders.

Investing in local communities

The communities in which we operate are of great importance to our business – they are where our customers and employees live and work. We continue to invest in our local communities both financially and through employee volunteering. We recognise the effect that our operations can have on the community and invest in programmes that support affected areas or help tackle current social issues.

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Technological environment

Advances in technology can be used to help deliver improvements in the quality or cost of our service. Embracing innovation, using modern technology or techniques, is at the heart of how we do business. Our Systems Thinking approach across the wholesale business is a key example of this.

Energy generation

We have been utilising technology within our energy self-generation. For example, our Davyhulme sludge recycling centre employs a ground-breaking configuration of thermal hydrolysis to maximise energy generation from sludge and won an Annual Institute of Chemical Engineers award for innovation in 2013/14. Then in 2015/16 we built Europe's largest floating solar array system on our reservoir in Godley, Greater Manchester.

Technological risks

Technological advances give rise to greater risks as well as presenting opportunities. Cyber-crime has been on the increase in recent years and, as the holder of customer information, is a threat we take very seriously.

Changing customer behaviours

We must be mindful of our customers' ever increasing use of technology. We have recognised the increasing power of social media as communication channels for customers, in doing business with us, and we recently invested in a new digital external communications capability and a number of website improvements.

Internal environment

Governance

Good governance lies at the heart of all successful organisations and leads to better management decisions as well as helping to avoid exposure to potential risks.

We strive to operate in a manner that reflects the highest standards of corporate governance. Our company structure and governance standards are designed to ensure that our board continues to observe sound and prudent governance in compliance with the principles of the UK Corporate Governance Code.

Prudent risk management

As would be expected of the provider of an essential service, we adopt a prudent approach to managing risks to our business. That being said, accepting some level of risk is a normal consequence for a commercial organisation.

Given the complex legal and regulatory environment within which we operate, we are exposed to a range of risks. Risks can be in the form of possible non-compliance with existing laws or regulations, or failure to meet the terms of our current 2015-20 regulatory contract, and we face risks in relation to potential future changes in legislation or regulation, as well as from environmental impacts such as climate change.

An important risk to our business is ensuring that we get the constituent elements of our five-yearly business plans correct to ensure our financeability, and that they are agreed by Ofwat as we are bound by these plans for the following five year period with limited opportunity to change them.

See pages 39 to 44 for more details on what we consider to be our principal risks and uncertainties.

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Identifying and then being able to act upon potential opportunities can be a key determinant for adding value. Every quarter, senior management across each main area of the group routinely undertakes business reviews, including the identification and evaluation of potential opportunities.

We are committed to delivering our services in a responsible way and our approach to responsible business practice is outlined in our Business Principles document available on our website *at http://corporate.unitedutilities.com/united-utilities-business-principles.aspx*

Values and culture

Our culture is embodied in our three core values of customer focus, integrity and innovation, and we operate under these three core values at all levels of our business.

These core values are interrelated, as innovating to improve our services and acting with integrity in the way we carry out our activities all help us to continually improve customer service.

Customer focus

Everything we do will be about our customers, not us.

Over recent years, we have instilled a more customer-centric approach right across our organisation, and this evolving culture has been a key driver in the major improvements in customer service we have been able to deliver.

Putting customers right at the heart of what we do has also helped deliver benefits for shareholders and wider stakeholders.

Integrity

We will make promises knowingly and keep them.

Acting with integrity, both at board level and as a company, underpins our approach to responsible business and building trust. We actively encourage our employees to express their opinions and ideas through various engagement and social channels, such as our annual 'Your Opinion Survey', through news articles on our intranet, and on our social media collaboration tool Yammer.

Innovation

We will innovate to make our services better, safer, faster and cheaper for our customers.

Innovation is a critical enabler in creating value, helping us to be ahead of our competitors, and we welcome ideas on how we can innovate across all levels of our business.

Our employees are given the opportunity to develop and present their ideas to senior management, facilitating and encouraging an innovative environment.

Utilising innovation from our suppliers is part of our supply chain approach, which provides another avenue to benefit from new ideas and technologies.

Planning cycles

We have structured our business in line with Ofwat's four distinct price control areas:

- Wholesale water;
- Wholesale wastewater;
- Household retail; and

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- Non-household retail.

The non-household retail area is now subsumed within a joint venture between United Utilities PLC and Severn Trent PLC, Water Plus. It is not part of our consolidated group, therefore it does not form part of our business model.

The three business areas within our business model (wholesale water, wholesale wastewater, and household retail) undertake both long-term and shorter-term planning to identify how they can best deliver their outcomes. We adopt an integrated approach, which considers a whole range of stakeholders including customers, the environment, our employees and local communities. These plans take into account the internal and external factors described on pages 16 to 22. Underpinning our approach to planning, we undertake a cycle of continuous assessment using KPIs, and other performance measures, which helps us formulate our future improvement plans for our various stakeholders.

Wholesale business areas

All of the group's RCV, of just over £10 billion, sits within the wholesale water and wholesale wastewater business areas, and we are allowed to earn an annual return on this asset base on the basis of an industry-allowed cost of debt and equity set by Ofwat. Allowed costs for both of these wholesale price controls are determined by Ofwat using its totex cost assessment models. Our cost performance against our allowed cost of debt and totex will determine how much outperformance or underperformance we generate.

Retail business areas

Allowed costs within the household retail price control are determined using a water industry average cost to serve approach, rewarding companies who are able to achieve costs below the industry average. The opening of full competition in the non-household retail price control from 1 April 2017 provides a strong incentive for water companies to deliver efficiencies and service improvements in that area.

Planning – 25 years+

We provide an essential service and in order to maintain a reliable, high quality water service for our customers, we have to look a long way ahead, to anticipate and plan for the changes and core issues that are likely to impact on our activities. Our long-term strategy then helps us to define what we need to deliver over the shorter term, which in turn helps to create value.

Over the next 25 years, we will face many challenges and opportunities including:

- climate change and implications for water resources and flooding;
- the emergence of a more open, competitive UK water market;
- more rigorous environmental regulations;
- population growth;
- the implications of the UK's exit from the European Union; and
- combining affordable bills with a modern, responsive service.

By anticipating and planning ahead, we can ensure that we continue to deliver what customers want at a fair price and in a responsible way, in line with our three strategic themes.

Our Strategic Direction Statement, 'Playing our part to support the North West', sets out our long-term strategy for the next 25 years, examining the challenges ahead and how we will focus our resources and talents in order to meet them.

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We consulted with thousands of customers and other stakeholders to ensure their expectations are reflected in our plans.

Our 25-year Water Resource Management Plan sets out the investment needed to ensure we have sufficient water to continue supplying our customers, taking into account the potential impact of climate change.

Some of the key ways we create value over the long-term are by:

- investing in our people to ensure a committed, capable and motivated workforce delivering high performance;
- close collaboration with suppliers and disciplined investment, based on a sustainable whole-life cost modelling;
- efficiently implementing robust and appropriate financing;
- embracing innovation to make our future services better, faster or cheaper;
- long-term planning and management of water resources – 25-year Water Resource Management Plan;
- responding to climate change; and
- sustainable catchment management.

Read more online at *corporate.unitedutilities.com/future*

Planning – 5 years

Each five-year regulatory period is designed to help us achieve our long-term vision.

By submitting a robust, balanced plan to Ofwat, prior to the start of each five-year regulatory period, we can help ensure we receive a regulatory contract that allows for the best overall outcomes for our customers, shareholders and the environment.

Once each five-year regulatory contract is set, we create value principally by delivering, or outperforming, that contract by providing the best service to customers, at the lowest sustainable cost, in a responsible manner.

Our five-year plan for 2010-15 focused on improving customer satisfaction, meeting our statutory obligations and delivering shareholder value. We delivered on each of these, providing us with a strong platform to deliver further in 2015-20.

For the current 2015-20 regulatory period, some of the key ways in which we are aiming to create value are:

Improve customer service – improving efficiency and reducing costs, as well as improving our SIM performance to increase rewards / reduce penalties from Ofwat.

Enhance our debt collection activities – reducing retail costs, whilst providing the best support for customers struggling to pay.

Minimise total costs on a sustainable basis – for example, power, materials and property rates, which will help us to meet or outperform our allowed totex costs.

Raise low-cost finance – helping us to outperform our allowed finance costs, which is our main area of outperformance potential in this period.

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Deliver our operational and regulatory commitments – helping to ensure we achieve high levels of customer service and meet environmental standards as well as improving our ODI performance to increase rewards / reduce penalties from Ofwat, in areas such as reliably delivered high-quality water, and reducing pollution and sewer flooding incidents.

Implement our hedging strategies – fixing medium-term interest rates and power costs helps us to meet our allowance by reducing the volatility of these costs.

Increase our use of renewable energy from waste – protecting us from rising energy costs and reducing our carbon footprint.

Maintain a robust supply/demand balance – providing water resource and customer supply benefits, as well as avoiding any penalties or unfunded expenditure requirements from our regulators.

Supporting this value generation, each of our business areas has plans over 2015-20 to deliver as follows:

Wholesale water

- Maintain existing high levels of reliability in the delivery of day-to-day water services, making better use of technology to monitor remotely and control more of our source-to-tap assets.
- Maintain existing high levels of water quality as measured at customers' taps and our water treatment works.
- Reduce the number of contacts from customers regarding water quality.
- Maintain leakage at or below the sustainable economic level.
- Limit the impact on customers of increases in operating costs, such as chemicals and rates, by making cost savings elsewhere through continuous improvement in the efficiency of our operations.
- Commence work to link 150,000 customers in West Cumbria to Thirlmere reservoir to ensure a long-term, reliable supply of drinking water and to support the sensitive ecology in that area.

Wholesale wastewater

- Build on the customer satisfaction improvements we have already delivered. Continue to improve the way we operate, making better use of technology, automation and control to drive better customer service at reduced cost.
- Reduce the number of our customers' properties exposed to sewer flooding by over 40 per cent, seeking opportunities to work in partnership with others to deliver schemes cost-effectively and promote the use of more sustainable drainage systems.
- Improve the region's bathing waters to meet tougher regulatory standards, and work with other organisations to support them in delivering improvements to our region's beaches.
- Improve water quality in the North West's rivers and lakes through investment in our treatment works and at overflows, reducing pollution. We are engaging with stakeholders to explore innovative catchment management techniques to control diffuse pollution in our catchments.
- Increase our production of renewable energy from waste to help protect customers from rising energy costs and reduce our carbon footprint.

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- Constrain costs associated with taking responsibility for all private sewers and private pumping stations across the region, through improvements to our operating model and efficient delivery of our programme.

Household retail

- Continue to improve the customer experience by being more proactive with customers, anticipating problems before they materialise and improving our communication channels so that we are easier to do business with.
- Reduce further the number of customer complaints and resolve them whenever we can, avoiding the need for complaints to be referred to the Consumer Council for Water.
- Reduce the debt burden on the company and its customers by engaging with those who are struggling to pay, helping them return to sustained payment behaviour. We are extending our options for assistance to hard-pressed customers, including the social tariff, and we remain committed to contributing to the United Utilities Trust Fund, which has proven effective in helping customers in difficulty return to regular payment.
- Reduce the cost to serve our customers through systems and process improvements. This is particularly important under the new price control methodology which uses an industry average retail cost to serve to determine part of customer bills.

Planning – 1 year

Each financial year, we develop a business plan which is approved by the board. This sets our annual targets which are designed to help deliver further improvements and move us towards achievement of our five-year goals.

Our business plan covers a broad range of measures across the three strategic themes: The best service to customers, at the lowest sustainable cost, in a responsible manner.

Performance monitoring

Senior management has quarterly business review meetings with the executive directors to monitor and assess our performance against these measures, helping to ensure that we are on track to deliver our targets.

Performance measurement

At the end of every financial year, our performance is assessed against these measures and this determines employees' annual bonuses right through the organisation. As well as annual targets, our directors are assessed against three-year performance, covering total shareholder return, sustainable dividends and customer service, through long-term incentive plans.

Details of the 2016/17 annual bonus and vested long-term incentive plans for our executive directors are shown on pages 62 to 65 respectively within the remuneration report.

Systems Thinking

Underpinning the improvements in our operational performance is our drive toward Systems Thinking. This means thinking of our entire network of assets as one big system, and managing it as such.

In this regulatory period, we are investing in our new wholesale operating model and are progressing the roll-out of this unique capability. Our production line model is well established, and we opened our Integrated Control Centre (ICC) in April 2015. This has increasingly become

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a central hub for planning and control of our operations and proved to be a tremendous asset during our handling of the major incidents we had to address last year.

Our new telemetry backbone has been successfully installed across our estate with only a small number of sites to complete. This provides the ‘data highway’ between our sites and the ICC, enabling enhanced monitoring and intervention.

We have full regional production planning up and running for both water production and sludge processing, supported by more enhanced decision-making systems capability at site level.

We are in the final stages of testing of our new maintenance system, providing more effective tasking of field engineering, and we have improved asset availability.

We are using more sensors in our network and better analysing other data, such as weather forecasting, to help reduce costs, improve operational performance and, importantly, prevent issues before they impact the customer.

This is all supported by our digital strategy, in which we have already seen our IT systems overhauled, and for which data and its exploitation becomes central to our thinking. Our Systems Thinking approach is expected to deliver benefits of over £100 million across the 2015-20 regulatory period, which were already built into our business plan assumptions.

How we measure our performance

Strategic themes and outcomes

By delivering our strategy to create sustainable value in both the long and short-term, we aim to deliver the following key outcomes for our stakeholders, in line with our strategic themes:

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The best service to customers	At the lowest sustainable cost	In a responsible manner
Provide great water ▪ Drinking water is safe and clean ▪ Customers have a reliable supply of water now and in the future **Dispose of wastewater** ▪ Wastewater is removed and treated without customers ever noticing ▪ The risk of sewer flooding for homes and businesses is reduced **Deliver a service customers can rely on** ▪ Customers are highly satisfied with our service ▪ Customers find it easy to do business with us	**Value for money** ▪ Customer bills are fair ▪ We support customers who are struggling to pay ▪ The North West's economy is supported by our activities and investment **Improved efficiency** ▪ Our services are provided in an increasingly efficient way ▪ Efficiencies are delivered in a sustainable way taking a long-term view	**Protect and enhance the environment** ▪ The natural environment is protected and improved in the way we deliver our services ▪ The North West's bathing and shellfish waters are cleaner through our work ▪ Our services and assets are fit for a changing climate **Support local communities** ▪ We invest in community partnerships for mutual benefit ▪ Our employees make a positive contribution to local communities **Support employees in a safe workplace** ▪ Provide safe, secure working conditions ▪ Provide competitive rewards to attract and retain employees ▪ We invest in the learning and development of our employees

Our key performance indicators (KPIs)

To help measure our progress on how well we are adding value for our stakeholders and delivering the outcomes described above, we focus on a range of financial and operational KPIs, as defined on the next page. These KPIs are set for the five-year planning period and encompass the important areas of customer service and environmental performance, as well as financial indicators, taking into consideration the interests of all our stakeholders. Strong performance across these KPIs would indicate that our strategy is delivering on our targeted outcomes, helping us on our path to reaching our long-term strategic goals.

Our financial KPIs are the same as for the previous year, and our operational KPIs are the same as for the previous year, with the exception of the KPI relating to the non-household retail part of the business. As this is now under the UUG group's joint venture, the non-household price

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control is no longer within our consolidated group and we no longer include this as one of our KPIs.

Our executive bonuses and long-term incentives are closely aligned to our financial and operational performance KPIs, as highlighted in the remuneration report on pages 62 to 65.

Operational KPIs

These operational KPIs feed through from our three strategic themes to deliver the best service to customers, at the lowest sustainable cost, in a responsible manner.

Company objective/KPI	Definition	Target	Performance
Best service to customers			
Wholesale outcome delivery incentive (ODI) composite	Net reward/(penalty) accrued across United Utilities' 19 wholesale financial ODIs	Range of +£30m to -£70m over 2015–20	**2016/17: £6.7 million net reward** 2015/16: £2.5 million net reward ODIs only introduced in 2015/16
Service incentive mechanism – qualitative	Ofwat-derived index based on quarterly customer satisfaction surveys, measuring the absolute and relative performance of the 18 water companies. Each company receives a score in the range of zero to five, with five being the highest attainable score	To move towards the upper quartile in the medium-term	**2016/17: 4.42** 2015/16: 4.27 2014/15 4.24
Service incentive mechanism – quantitative	Ofwat-derived composite index based on the number of customer contacts, assessed by type, measuring the absolute and relative performance of the 18 water companies. Each company receives a SIM point total, where the lowest score represents the best performance	To move towards the upper quartile in the medium-term	**2016/17: 77** 2015/16: 95 2014/15: 99
Lowest sustainable cost			
Totex outperformance	Progress to date on delivering our promises to customers within the cumulative 2015-20 wholesale totex final determination allowance	To meet Ofwat's final determination totex allowance	**2015–20: On track to meet the final determination allowance** Totex new measure for 2015-20 period hence no prior years' comparators

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Financing outperformance	Progress to date on financing expenditure outperformance secured versus Ofwat's industry allowed cost of debt of 2.59 per cent real over the 2015–20 period	To beat Ofwat's industry allowed cost of debt	**2015–20: On track to beat Ofwat allowance** 2010–15: Exceeded £300m target
Household retail cost to serve	Cost to serve in our household retail business compared with Ofwat's revenue allowance	To minimise costs compared with Ofwat's revenue allowance	**2016/17: £14m outperformance** 2015/16: £10m outperformance Domestic retail allowance first introduced by Ofwat for 2015-20 period hence no prior years' comparators
In a responsible manner			
Leakage – average annual leakage	Average annual water leakage from our network quantified in megalitres per day	To meet our regulatory leakage target, as set by Ofwat	**2016/17: 441Ml/d – Met target** 2015/16: 463Ml/d - Met target 2014/15: 454Ml/d – Met target 2013/14: 452Ml/d – Met target 2012/13: 457Ml/d – Met target 2011/12: 453Ml/d – Met target
Environment Agency performance assessment	Composite assessment produced by the Environment Agency, measuring the absolute and relative performance of the 10 water and wastewater companies across a broad range of areas, including pollution.	To be a first quartile performer on a consistent basis	**2015/16: Joint 2nd** 2014/15: 2nd 2013/14: 2nd 2012/13: 2nd 2011/12: 3rd 2010/11: 7th 2015/16 is the latest available assessment
Dow Jones Sustainability Index rating	Independent rating awarded using sustainability metrics covering economic, environmental, social and governance performance	To retain 'World Class' rating each year	**2016/17: 'World Class'** 2015/16: 'World Class' 2014/15: 'World Class' 2013/14: 'World Class' 2012/13: 'World Class' 2011/12: 'World Class'

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Our performance in 2016/17

Operational performance

The best service to customers

Customer service – sitting at the core of everything we do, our strong focus on customer service has helped us deliver substantial improvements in recent years, becoming the most improved company in the 2010-15 period with a reduction of around 75 per cent in the overall number of customer complaints.

This year we re-energised our approach and have seen another upturn in customer satisfaction. In 2016/17 we delivered our best ever scores under Ofwat's qualitative Service Incentive Mechanism (SIM) measure, placing us above the industry average for the full year, and ending the year as a leading company in the sector. Customer complaints in 2016/17 were considerably lower than last year with a 27 per cent year-on-year reduction and a 55 per cent reduction in the circumstance where an issue is not resolved at first contact.

We introduced a number of innovations over the year, setting new benchmarks for the sector. One of the most successful, Priority Services, provides more targeted support for customers experiencing short or long-term personal or financial difficulties in their lives, with tailored assistance for customers. Since its launch in May 2016, we have seen more than 11,000 customers register for this service, supplementing the wide range of initiatives we already offer customers struggling to pay, in order to help them return to regular payment.

Our new customer website was designed to improve accessibility and ease of use following extensive research and customer engagement, includes web chat services across extended hours, and is mobile-enabled to accommodate customers' increasing use of mobile devices to access day-to-day online services. Additionally, we have recently launched the first fully interactive and real-time customer app in the sector.

Improving customer service will continue to be a key area of focus, and our new management team has identified a range of opportunities to deliver further benefits for our customers.

Leading North West service provider – we are consistently ranked third out of ten leading organisations in the North West, through an independent brand tracker survey which is undertaken quarterly. This covers key attributes such as reputation, trustworthiness and customer service. We are behind only Marks & Spencer and John Lewis, and ahead of seven other major organisations covering utilities, telecoms, media and banking services.

Robust water supply – our customers benefit from our robust water supply and demand balance, along with high levels of water supply reliability. Our overall water quality continues to be good, and although our water quality service index has slightly deteriorated from a very good performance in the prior year, it remains above our historical average and we have plans in place to deliver improved performance going forwards. We have consistently delivered a reliable water service, although we experienced some water no-supply incidents in 2016/17. Whilst this is disappointing, our Systems Thinking approach is helping us to respond to these events and avoid them in future.

Reducing sewer flooding – we have continued to invest heavily in schemes designed to reduce the risk of flooding of our customers' homes, including incidence-based targeting on areas more likely to experience flooding and defect identification through CCTV sewer surveys. Our plan for the 2015-20 period includes a target of reducing sewer flooding incidents by over 40 per cent, in line with customers' affordability preferences, and we have made a good start. Our wastewater network will continue to benefit from significant investment going forward, as we aim to help mitigate changing weather patterns likely to result from climate change.

Strategic report

Key performance indicators:

Outcome delivery incentives (ODIs) – we have 19 wholesale financial ODIs and, as outlined last year, the risk is skewed to the downside with 10 attracting a penalty only.

Whilst a number of our ODI measures are susceptible to one-off events and, on the whole, our ODI targets get tougher each year, our performance in the first two years of this regulatory period has now delivered a cumulative net reward of £9.2 million, exceeding our initial expectations. This gives us confidence to narrow our target range for the cumulative net ODI outcome over the 2015-20 period to between plus £30 million and minus £50 million.

In 2016/17 we have achieved another net reward of £6.7 million, exceeding our initial expectations and demonstrating the effectiveness of our planned acceleration of capital expenditure in this regulatory period, alongside our Systems Thinking and innovative approach to the way we operate.

We were particularly pleased this year with the significant improvements made against our leakage targets and have continued to perform well against private sewers and pollution incidents. Our sewer flooding ODI remains challenging as the target becomes increasingly tougher as we progress through this regulatory period. This meant that we received a small penalty this year despite having improved our overall performance compared with the prior year. Our main areas of reward came through our good performance in the areas of leakage, private sewers and pollution, with our main penalty being on reliable water service and water quality service.

Service incentive mechanism (SIM) – last year we stated our target was to move towards the upper quartile in the medium-term, and we are particularly pleased with the progress we have made this year, which saw us ending the year as a leading company in our peer group.

Qualitative: Ofwat has undertaken the four surveys for 2016/17 and United Utilities has improved its score to 4.42 points, compared with 4.27 points in 2015/16, putting us in joint 6th position for the year out of the 18 water companies, and joint 3rd position out of the 10 companies providing both water and wastewater services. We ended the year with our highest ever score of 4.56 in wave 4, which placed us in equal 3rd position in this wave, and 2nd position out of those providing both water and wastewater services. In particular, customers scored us highly for our billing and wastewater services.

Quantitative: the quantitative assessment measures customer contacts, and performance is assessed on both an absolute and relative basis. Whilst relative performance can only be assessed in full following the end of each full financial year when the other companies publish their respective results, on absolute performance for 2016/17, our score of 77 points represents a marked improvement on our 2015/16 score of 95 points, and of the 13 companies who share data on quantitative scores for the full year, this placed us in 4th position out of the 13 and 1st of the 8 water and wastewater companies in this data share.

At the lowest sustainable cost

Power and chemicals – our asset optimisation programme continues to provide the benefits of increased and more effective use of operational site management to optimise power and chemical use and the development of more combined heat and power assets to generate renewable energy. In addition to the electricity we generate from bioresources, we are developing other renewable energy facilities. This is primarily in the area of solar, where we have invested £45 million in the first two years of the 2015-20 period, contributing towards our expected investment of over £100 million across the five-year period. We have also substantially locked in our power commodity costs across 2015-20, providing greater cost certainty for the regulatory period.

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Proactive network management – through our Systems Thinking approach we are more proactive in the management of our assets and networks. We aim to improve our predictive modelling and forecasting through better use of sensors in our network and better analysis of other data, such as weather forecasting, to enable us to address more asset and network problems before they affect customers, thereby reducing the level of reactive work and improving our performance and efficiency.

Debt collection – our region suffers from high levels of income deprivation and we offer wide-ranging schemes to help customers struggling to pay, including our trust fund into which we paid a £5 million contribution in 2016/17. Notwithstanding our industry-leading debt management processes, deprivation remains the principal driver of our higher than average bad debt and cost to serve and we expect this to continue to be a challenging area for us.

Reflecting our ongoing focus on bad debt through our new customer facing management team and the penetration of our affordability schemes, our household bad debt expense has reduced to 2.5 per cent of regulated revenue from 3.0 per cent last year.

Pensions – United Utilities has taken progressive steps to de-risk its pension provision. The group had an IFRS retirement benefit surplus of £195 million as at 31 March 2017, compared with a surplus of £227 million as at 31 March 2016. Further details of the group’s pension provision are provided in the pensions section on page 38. Ongoing formal consultations continue regarding proposed changes to the group’s pension schemes.

Capital delivery and regulatory commitments – we are strongly focused on delivering our commitments efficiently and on time, and have a robust commercial capital delivery framework in place. Across the 2015-20 regulatory period, we are working with a single engineering partner and four design and construction partners to deliver our regulatory capital investment programme of c£3.6 billion. We are involving our partners much earlier in project definition and packaging projects by type, geography and timing in order to deliver efficiencies. Projects are allocated on an incentive or competitive basis leading to our partners presenting a range of solutions, innovations and pricing.

We have continued the planned acceleration of our 2015-20 investment programme in order to improve services for customers and deliver early operational and environmental benefits. Regulatory capital investment in 2016/17, including £148 million of infrastructure renewals expenditure, was £804 million, in line with our expectations. This, combined with £799 million invested in 2015/16, brings our total spend to around £1.6 billion of our planned £3.6 billion capital investment across the 2015-20 period.

We are also driving more effective and efficient delivery of our capital programme and applying a tougher measurement mechanism to our Time: Cost: Quality index (TCQi) score for this regulatory period. Despite this tougher approach, our TCQi score remains high at 93 per cent which represents a very good performance, improving from what was already a good performance at 90 per cent in 2015/16.

Financing outperformance – the low cost of debt we have already locked-in places United Utilities in a strong position to deliver our target for the 2015-20 period of minimising our cost of debt compared to Ofwat’s industry allowed cost.

Total expenditure (totex) performance – although our totex allowance for the 2015-2020 period is challenging, we are implementing a range of initiatives and are confident of meeting our target of delivering our promises to customers within the cumulative 2015-20 wholesale totex final determination allowance. Progress in the first two years has been good and we remain on track to meet the five-year target.

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Key performance indicators:

Domestic retail cost to serve – overall, it will be very challenging to meet the regulatory assumptions for domestic retail costs. This is primarily due to Ofwat's price review methodology at PR14 which made no allowance for inflation in the domestic retail business and, in our view, made insufficient allowance for dual service (water and wastewater) companies. The regulatory assumptions for domestic retail costs become progressively tougher as we move through the 2015-20 period. Our target is to minimise our costs compared with Ofwat's revenue allowance and, despite the challenging target, we have delivered a good performance in 2016/17, outperforming this year's revenue allowance by around £14 million.

In a responsible manner

Acting responsibly is fundamental to the manner in which we undertake our business, and the group has for many years included corporate responsibility factors in its strategic decision making. Our environmental and sustainability performance across a broad front has received external recognition. Earlier in the 2016/17 financial year, United Utilities retained its World Class rating in the Dow Jones Sustainability Index for the ninth consecutive year, again achieving industry leading performance status in the multi-utility/water sector. Retaining 'World Class' status for this length of time is a significant achievement, particularly as the assessment standards continue to increase and evolve.

Leakage – we have a strong, year round, operational focus on leakage, alongside our network resilience improvements and the implementation of a range of initiatives, such as active pressure management. This delivered a particularly good performance against our leakage targets in 2016/17, delivering our largest ODI reward in this area.

Environmental performance – this is a high priority for United Utilities and we were encouraged to have been awarded Industry Leading Company status in the Environment Agency's latest performance metrics, as described in the KPIs section below.

Carbon footprint – we are committed to reducing our carbon footprint and increasing our generation of renewable energy. Our carbon footprint has reduced by 22 per cent over the last 10 years. Our renewable energy production in 2016/17 was 149 GWh, representing 18 per cent of our electricity consumption in the year. This represents good progress over the last few years, up from 13 per cent in 2012/13, and we are implementing plans to significantly increase self-generation over the next few years.

Employees – we continue to work hard to engage all of our employees in the transformation of the group's performance. Employee engagement was high at 89 per cent this year, broadly in line with last year on a normalised basis as we amended the question structure slightly. We remain focused on maintaining high levels of employee engagement.

We have been successful in attracting and retaining people and have continued to expand our apprentice and graduate programmes for 2016/17. We now have a total of 64 graduates and 119 apprentices across the business. Our investment in recruiting graduates and apprentices is already benefiting the company, with 122 of them now having secured permanent roles across our business.

Over the last year, we have continued our sustained focus on health, safety and wellbeing. In this period we retained our Gold award status with the Royal Society for the Prevention of Accidents as well as the top place ranking on the Dow Jones Sustainability Index. Following a four-day audit, we were also awarded the UK Workplace Wellbeing Charter. Our contractor accident frequency rate is at its lowest ever at 0.087 accidents per 100,000 hours. For the same period, our employee accident frequency rate has increased to 0.196 accidents per 100,000 hours, compared with a rate of 0.104 in 2015/16. We recognise that we still have more to do, and health and safety will continue to be a significant area of focus as we strive for continuous improvement.

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Key performance indicators:

Communities – we continue to support partnerships, both financially and in terms of employee time through volunteering, with other organisations across the North West. Our Catchment Wise programme helps to tackle water quality issues in lakes, rivers and coastal waters across the North West, and our Beachcare employee volunteering scheme helps to keep our region's beaches tidy. We continue to support local communities, through contributions and schemes such as providing debt advisory services and our Community Fund, offering grants to local groups impacted by our capital investment programme.

Leakage – although leakage is included within our outcome delivery incentives, we intend to continue publishing our leakage position separately, with it being an important measure from a corporate responsibility perspective. We delivered an excellent performance in 2016/17 and have again met our regulatory leakage target of 463 megalitres per day.

Environmental performance – on the Environment Agency's latest annual assessment, published in July 2016, we were awarded Industry Leading Company status across the range of operational metrics. This indicates we were in second position amongst the ten water and sewerage companies and aligns with our medium-term goal of being a first quartile company on a consistent basis.

Corporate responsibility – United Utilities has a strong focus on operating in a responsible manner and is the only UK water company to have a World Class rating as measured by the Dow Jones Sustainability Index. In 2016/17, United Utilities retained its World Class rating for the ninth consecutive year.

Financial performance

Financial KPIs	2017	2016
Revenue	£1,680.3m	£1,691.7m
Operating profit	£606.8m	£575.3m
Profit before tax	£409.5 m	£348.8 m
RCV gearing	65%	64%
Interest cover	3.0	2.7

Revenue

The group has delivered a good set of financial results for the year ended 31 March 2017. Revenue was down £11.4 million at £1,680.3 million, reflecting the impact of the disposal of the group's non-household retail business to the group's immediate parent on 26 May 2016, partly offset by our allowed regulatory revenue changes.

With regard to Ofwat's revenue correction mechanism, relating to the 2014/15 financial year, we have £9.5 million to return to customers. As we have previously indicated, we propose to return the £9.5 million to customers through revenue reductions of c£3 million in 2017/18, c£3 million in 2018/19 and c£3 million in 2019/20 to help aid a smoother bill profile.

Separately, consistent with Ofwat's annual wholesale revenue forecasting incentive mechanism (WRFIM), we will also be reducing 2017/18 revenue by £7 million as actual volumes in 2015/16 were higher than our assumptions increasing revenue by 0.4 per cent.

Operating profit

Reported operating profit increased by £31.5 million, to £606.8 million. This is largely due to a higher operating costs in the prior year due to the Lancashire water quality incident, allowed regulatory revenue changes, a reduction in infrastructure renewals expenditure, an improvement in our bad debt charges and a small reduction in the remaining cost base, partly offset by the

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accounting impact of the disposal of the group's non-household retail business to its immediate parent during the year.

Investment income and finance expense

Reported net finance expense of £197.3 million was significantly lower than the £226.5 million expense in 2015/16. This £29.2 million decrease principally reflects a change in the fair value gains and losses on debt and derivative instruments, from a £41.0 million loss in 2015/16 to a £5.2 million gain in 2016/17. The fair value gain in the current year is due to the net receipts on swaps and debt under fair value option and gains on our electricity swap portfolio due to an increase in the market price of electricity. Losses in the prior year were largely due to a decrease in medium-term interest rates, which impact our derivatives hedging interest rates. The group uses these swaps to fix interest rates on a substantial proportion of its debt to better match the financing cash flows allowed by Ofwat at each price review. The group has fixed the substantial majority of its non index-linked debt for the 2015-20 regulatory period. These fair value movements were offset by increased finance expenses as a result of higher RPI inflation on index-linked debt, particularly on the portion of index-linked debt with a three-month lag.

Profit before tax

Profit before tax was £409.5 million, £60.7 million higher than last year, reflecting the increased operating profit and reduction in net finance expense.

Tax

Consistent with our wider business objectives, we are committed to acting in a responsible manner in relation to our tax affairs. Full details of our tax policies and objectives are set out on page 66.

In 2016/17, we paid corporation tax of £42.4 million compared with £26.4 million for 2015/16. The amount for 2016/17 was broadly half of the expected liability as in 2015/16 the company's cash tax position was adjusted to align with the external quarterly payment regime to HMRC, whereby half of the total liability is paid in year with the balance paid in the following year.

The total tax charge for 2016/17 is £21.7 million as compared to a total credit of £38.7 million for 2015/16, the main difference being the current year deferred tax credit of £57.8m, compared to £111.9 million in 2015/16, relating to the enacted reduction in the headline rate of corporation tax to 17 per cent from 1 April 2020.

In addition to corporation tax, the group pays and bears further annual economic contributions, typically of around £140 million per annum, in the form of business rates, employer's national insurance contributions, environmental taxes and other regulatory service fees such as water abstraction charges.

Cash flow

Net cash generated from operating activities for the year ended 31 March 2017 was £807.6 million, compared with £694.6 million in the previous year. This increase mainly reflects a switch between cash generated from operating activities and cash used in investing activities largely due to the accounting treatment the disposal of the group's non-household retail business during the year and the subsequent borrowings provided to Water Plus by the company. The group's net capital expenditure was £678.1 million, principally in the regulated water and wastewater investment programmes. This excludes infrastructure renewals expenditure which is treated as an operating cost under IFRS.

Net debt including derivatives at 31 March 2017 was £6,856.8 million, compared with £6,582.7 million at 31 March 2016. This increase reflects accelerated regulatory capital expenditure,

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payments of dividends, interest and tax, the inflationary uplift on index-linked debt and loans to joint ventures, partly offset by operating cash flows.

Fair value of debt

The group's gross borrowings at 31 March 2017 had a carrying value of £7,464.2 million. The fair value of these borrowings was £8,678.7 million. This £1,214.5 million difference principally reflects the significant fall in real interest rates, compared with the rates at the time we raised a portion of the group's index-linked debt. This difference has increased from £490.9 million at 31 March 2016 due primarily to a decrease in credit spreads.

Debt financing and interest rate management

Gearing, measured as group net debt divided by shadow (adjusted for actual spend) regulatory capital value, was 65 per cent at 31 March 2017, an increase of 1 per cent compared with the position at 31 March 2016, remaining within Ofwat's 55 per cent to 65 per cent assumed gearing range.

UUW has long-term credit ratings of A3/BBB+ from Moody's Investors Service (Moody's) and Standard & Poor's (S&P) Ratings Services respectively. The split rating reflects differing methodologies used by the credit rating agencies. Moody's has the group's ratings on a stable outlook, whereas S&P has the group's ratings on a positive outlook.

The UUG group has access to the international debt capital markets through its €7 billion euro medium-term note programme (EMTN). The EMTN programme does not represent a funding commitment, with funding dependent on the successful issue of the notes.

Cash and short-term deposits at 31 March 2017 amounted to £196.9 million. Over 2015-20 we have financing requirements totalling around £2.5 billion to cover refinancing and incremental debt, supporting our five year investment programme, and we have now raised over £1.7 billion of this requirement.

In April 2016, UUW signed a £250 million index-linked term loan facility with the EIB to support the delivery of UUW's AMP6 investment programme. As at 31 March 2017, £75 million had been drawn down.

This is an amortising facility with an average loan life of 10 years and a final maturity of 18 years from draw down and is the first tranche of an anticipated £500 million funding package for AMP6 from the EIB, with the second tranche expected to be made available for signature later in the AMP.

In June 2016, UUW's financing subsidiary, United Utilities Water Finance PLC (UUWF), raised c£76 million of term funding, via the issue of €30 million and HKD600 million private placement notes, both with a 15-year maturity, off our EMTN programme. In September 2016, UUWF raised c£53 million of term funding, via the issue of 12-year and 20-year private placement notes, in RPI-linked form, off the group's EMTN programme, at the group's best ever real interest rates. In the second half of 2016/17, UUWF raised a further c£172 million, via the issue of 15-year and 20-year private placement notes, in index-linked form, off our EMTN programme. In response to Ofwat's decision to transition away from RPI inflation linkage, £100 million of this index-linked funding was CPI-linked, these being the first ever CPI-linked notes issued by a UK utility.

In addition, since September 2016, UUW has agreed £80 million of new or replacement 5-year committed bank facilities and extended a further £75 million for an initial term of 5-years. The group has headroom to cover its financing needs into 2019.

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Long-term borrowings are structured or hedged to match assets and earnings, which are largely in sterling, indexed to UK retail price inflation and subject to regulatory price reviews every five years.

Long-term sterling inflation index-linked debt provides a natural hedge to assets and earnings. At 31 March 2017, approximately 55 per cent of the group's net debt was in index-linked form, representing around 34 per cent of UUW's regulatory capital value, with an average real interest rate of 1.3 per cent. The long-term nature of this funding also provides a good match to the company's long-life infrastructure assets and is a key contributor to the group's average term debt maturity profile, which is around 20 years.

Where nominal debt is raised in a currency other than sterling and/or with a fixed interest rate, the debt is generally swapped to create a floating rate sterling liability for the term of the debt. To manage exposure to medium-term interest rates, the group fixes underlying interest costs on nominal debt out to ten years on a reducing balance basis. This is supplemented by fixing substantially all remaining floating rate exposure across the forthcoming regulatory period around the time of the price control determination.

In line with this, the group has fixed interest costs for substantially all of its floating rate exposure over the 2015-20 period, locking in an average annual interest rate of around 3.6 per cent (inclusive of credit spreads).

Liquidity

Short-term liquidity requirements are met from the group's normal operating cash flow and its short-term bank deposits and supported by committed but undrawn credit facilities. The UUG group's €7 billion EMTN programme provides further support.

Available headroom at 31 March 2017 was £474.7 million based on cash, short-term deposits, committed bank facilities and the undrawn portion of the signed EIB term loan facilities, net of short-term debt as well as committed facilities and term debt falling due within 12 months.

The group believes that it operates a prudent approach to managing banking counterparty risk. Counterparty risk, in relation to both cash deposits and derivatives, is controlled through the use of counterparty credit limits. United Utilities' cash is held in the form of short-term money market deposits with prime commercial banks.

The group operates a bilateral, rather than a syndicated, approach to its core relationship banking facilities. This approach spreads maturities more evenly over a longer time period, thereby reducing refinancing risk and providing the benefit of several renewal points rather than a large single refinancing requirement.

Pensions

As at 31 March 2017, the group had an IAS 19 net pension surplus of £194.5million, compared with a net pension surplus of £226.9 million at 31 March 2016. This £32.4 million reduction mainly reflects the impact of a decrease in credit spreads. In contrast, the scheme specific funding basis does not suffer from volatility due to inflation and credit spread movements as it uses a fixed inflation assumption via a blend of the inflation market hedge and the inflation funding mechanism and a prudent, fixed credit spread assumption. Therefore, the recent inflation and credit spread movements have not had a material impact on the deficit calculated on a scheme specific funding basis or the level of deficit repair contributions.

Further detail on pensions is provided in note 14 ('Retirement benefit surplus') of these consolidated financial statements.

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How we manage risk

Principal risks and uncertainties

Our risk management approach supports our focus on customer service, resilience, reputation and shareholder value.

Our strategy is to create sustainable value by delivering the best service to customers, at the lowest sustainable cost and in a responsible manner. In doing this, the group is exposed to a range of internal and external risks of varying types which can impact upon us and the delivery of our objectives and operations. To understand and manage these risks, we maintain a risk management framework which includes:

- an enterprise-wide approach to risk management;
- a well-established governance and reporting structure;
- a risk assessment and management process which is aligned to ISO 31000:2009; and
- a suite of tools, guidance material and training packages to support consistency of approach.

Business areas and functions are responsible for the identification, analysis, evaluation and management of risk relative to their business environment including new and emerging circumstances. All event types (including regulatory, legal, core operations, service and hazard) are considered for their likelihood of occurrence and both the financial and reputational impact should that event occur. Each assessment takes into account a gross position (assuming no controls or that all controls fail), a current position benefitting from an analysis of the type and effectiveness of existing controls and a targeted position where further mitigation may be required if the current position is evaluated as not meeting our objectives or obligations.

The nature and extent of the risk profile culminating from this structured approach is reported to the group board twice a year, illustrating individual event based risks that underpin ten inherent risk categories that are regarded as the principal risks (see pages 41 to 44). From this initial overview, the report then focuses on two categories of risk: i) the most significant group wide business risks and ii) wholesale operational risks. These are represented by the ten highest ranked risks (based on likelihood x 'full life' financial impact) for each of the two categories and a further five risks with potentially very high impact severity in their current state (net of control effectiveness) with reputational impact noted for awareness and management. The report also highlights risks that fall outside these categories but are included due to potential reputational impact or because they are notable new/emerging circumstances.

This approach is in line with the principles of the UK Corporate Governance Code and involves reporting to the group board for each full and half year statutory accounting period allowing the board to:

- determine the nature and extent of the principal risks it is willing to take in achieving its strategic objectives;
- oversee the management of those risks and provide challenge to executive management where appropriate;
- express an informed opinion on the long-term viability of the company (see page 54); and
- monitor risk management and internal control systems and review their effectiveness.

Our risk profile currently consists of around 120 event-based risks. By their nature, these will include all combinations of high to low likelihood and high to low impact. Heat maps are typically

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used in various managerial and group reports either as a method to collectively evaluate the extent of multiple risks within a certain profile or to evaluate the effectiveness of mitigation for a single risk relative to the initial gross position.

Key features and developments

Our risk profile shows that, for each set of the ten highest ranked risks (one set for each of group wide business risks and wholesale operational risks), the majority fall into the principal risk areas ‘Political and regulatory’, ‘Water service’ and ‘Wastewater service’. Operationally, the dominance of the penalty element of the outcome delivery incentive mechanism and the effect following changes to the Environmental Sentencing Guidelines are key features of this exposure. Reputationally, our core operations/service provision (notably water service) and health safety and environmental risks have the highest focus for monitoring and reviewing control effectiveness based on the potential impact should the risk event occur.

We aim for continuous improvement in both our governance and approach to managing risk. Changes this year include the introduction of a core risk team and additional sign-off processes relating to operational risk. We have also developed a programme focused on long term resilience of assets, overseen by the newly formed wholesale resilience board. Associated with this is a focus on asset health and operational hazard risk assessment in advance of and beyond the 2015-20 regulatory period. This should ensure that we fully understand the long-term risk profile of our asset base and improve our capability to deliver the most cost-effective and proportionate risk management response. Other developments include an ongoing transformation programme (with the Drinking Water Inspectorate) to address some areas of concern arising from the Lancashire incident in 2015, system optimisation in wastewater services through a remote monitoring and control transformation project and in domestic retail a customer service improvement plan underpinned by a clear strategy, improved complaints handling, accurate data and cultural change.

The introduction of non-household retail competition required significant preparation. Ensuring we continue to operate compliantly and in accordance with ‘level playing field’ requirements remains a key area of focus.

Whilst our operations are in the UK, the potential effects of 'Brexit' have been considered, assessed and reported to the group board. Like many companies, a key issue is the level of uncertainty that exists. Our assessment included sources of funds, costs of goods and services, our ability to collect cash in the event of an economic downturn and the effect of any potential inflationary shift over current predictions. This area remains under review.

Looking further ahead, the expected introduction of competition in relation to certain wholesale activities and the possible introduction of competition in the provision of household retail activities at some future date all place risk on the group.

It is also important to acknowledge other potential significant change in environment and societal conditions. Climate change is expected to be one of the sector’s biggest challenges having significant and permanent implications on the water cycle and the long-term sustainability of water and wastewater services including water abstraction, supply and treatment capability, drainage and sewer capacity and wastewater treatment and discharge efficiency and effectiveness.

Material litigation

There continues to be one ongoing piece of material litigation worthy of note, as outlined below. However, based on the facts currently known to us and the provisions in our statement of financial position, our directors remain of the opinion that the likelihood of these having a material adverse impact on the group’s financial position is remote.

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- In March 2010, Manchester Ship Canal Company (MSCC) issued proceedings seeking, amongst other relief, damages alleging trespass against United Utilities Water Limited (UUW) in respect of discharges of water and treated effluent into the canal. Whilst the matter has not reached a final conclusion, the Supreme Court has found substantively in UUW's favour on a significant element of the claim and the High Court has upheld UUW's position on the remainder of the proceedings. MSCC have now instigated further heads of claim against UUW in order that they may continue to challenge UUW's rights to discharge water and treated effluent into the canal.

Principal risks

The principal risks (aggregated clusters of event-based risks), which have been set out in the table below reflect the categories of risks that define business activity or contributing factors where value can be lost or gained and could have a material impact on the business model, future performance, solvency or liquidity of the group. In each case the magnitude of the potential effect is highlighted together with the extent of management/mitigation. To ensure relevance with the current environment, issues or areas of uncertainty are also illustrated.

Risk description	Main business objective	Potential impact	Current key risks, issues or areas of uncertainty include:	Risk exposure	Management and mitigation
Political and regulatory risk Potential change in the political and regulatory environment and/or frameworks	Lowest sustainable cost	Changes to regulation and the regulatory regime (either through political or regulatory events, for example following Brexit) may increase costs of administration, reduce income and margin and lead to greater variability of returns.	▪ Market reform including non-household and upstream competition and, further ahead, the potential for the introduction of household competition ▪ A possible change from using the Retail Prices Index to the Consumer Prices Index for regulatory indexation ▪ Brexit	Increasing	We engage in relevant government and regulatory consultations which may affect policy and regulation in the sectors where we operate. We also consult with customers to understand their requirements and proactively consider all the opportunities and threats associated with any potential change, exploiting opportunities and mitigating risks where appropriate.
Compliance risk The potential failure to meet all legal and regulatory obligations and responsibilities	Responsible manner	Reputational, brand and general damage arising from non-compliance with existing or future laws/regulations (principally relating to the regulated business, but also including non-regulated activity/commitment) can result in additional workload, financial penalties, additional capital/operating expenditure (from enforcement orders or legal defence) and compensation following litigation. In more remote but extreme circumstances, penalties of up to 10 per cent of relevant turnover and ultimately revocation of our licence or the appointment of a special administrator are possible.	▪ Competition law and regulatory compliance whilst preparing for and operating within a changing competitive market ▪ Level playing field requirements in relation to non-household retail ▪ Current material litigation ▪ New higher fine levels for environmental offences	Stable	Legislative and regulatory developments are continually monitored. Risk-based training of employees is undertaken and we participate in consultations to influence legislative and regulatory developments. Funding for any material additional compliance costs in the regulated business is sought as part of the price determination process. The group also robustly defends litigation where appropriate and seeks to minimise its exposure by establishing provisions and seeking recovery wherever possible.

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Water service risk Potential failure of water operational processes or assets	Best Service to Customers	Operational performance problems or service or asset failures can lead to a failure to provide a secure supply of clean, safe drinking water or an inability to remove, treat and return water to the environment. This can cause public health, community and environmental impacts, additional operating or capital expenditure and/or increased regulatory scrutiny and regulatory penalties. In more extreme situations the group could also be fined for breaches of statutory obligations, be subject to enforcement action, be held liable to third parties and sustain reputational damage.	▪ Water Quality ▪ Interruption to supply ▪ Structural integrity of major assets ▪ Pollution ▪ Population growth ▪ Climate change ▪ Meeting infrastructure investment requirements ▪ Expected change to the abstraction licensing regime	Stable	Mitigation is provided through core business processes, including forecasting, quality assurance procedures, risk assessments and rigorous sampling/testing regimes. Ongoing system and network integration improves service provision and measures of success have been developed to monitor performance. Following the Lancashire water quality incident in 2015 we are further enhancing our approach to operational risk and resilience.
Wastewater service risk Potential failure of wastewater operational processes or assets	Best Service to Customers			Increasing	
Retail and commercial risk Potential inability to provide good and fair service to domestic customers and third party retailers	Lowest sustainable cost	Poor service to customers can result in financial penalties and an impact on regulatory reputation. The opening of the market for retail services to all non-household customers in England in April 2017 has generated both opportunities and risk for the group and its associated business retail function in respect of income, margin and debt. Breaches of legal and regulatory requirements could lead to fines, penalties and reputational damage. Uncertainty remains in respect of potential upstream reform from 2020.	▪ Socio-economic deprivation in the North West ▪ Welfare reform and the impact on domestic bad debt ▪ Competition in the water and wastewater market and competitor positioning ▪ Market Reform and the ability to treat other participants equally operations	Stable	For domestic retail there is a transformation plan in place covering a wide range of initiatives and activities to improve customer service, with a number of controls in place to monitor achievement against the plan. Within our wholesale department processes, systems, data and organisational capacity and capability to deal with market participants and the central market operator have been delivered. The new market requirements will require all market participants to treat other participants equally (on a 'level playing field') whilst maintaining compliance with existing regulations.
Financial risk Potential inability to appropriately finance the business	Lowest sustainable cost	The failure of financial counterparties could result in additional financing cost, an adverse impact on the income statement and potential reputational damage. Variability in inflation (as measured by the UK Retail Prices Index) and changes in interest rates, funding costs and other market risks could adversely impact the economic return on the Regulatory Capital Value. Increased pension scheme deficit could lead to a requirement for the group to make additional contributions. In extreme but remote cases adverse market conditions could	▪ Stability of financial institutions and the world economy ▪ Economic uncertainty ▪ Inflation/deflation ▪ Financial market conditions, interest rates and funding costs	Stable	Refinancing is long-term with staggered maturity dates to minimise the effect of short-term downturns. Counterparty credit, exposure and settlement limits exist to reduce any potential future impacts. These are based on a number of factors, including the credit rating and the size of the asset base of the individual counterparty. The group also employs hedging strategies to stabilise market fluctuation for inflation, interest rates and commodities (notably energy prices). Sensitivity analysis is carried out as part of the business planning process, influencing the various financial limits employed. Continuous monitoring of the markets takes

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		affect our access to debt capital markets and subsequently available liquidity and credit ratings.			place including movements in credit default swap prices and movements in equity levels.
Programme delivery risk Potential ineffective delivery of capital, operational and change programmes/processes	Lowest Sustainable Cost	Failure to deliver capital or change programmes against relevant time, cost or quality measures could result in a failure to secure competitive advantage or operating performance efficiency and cost benefits. There is also the risk of increased delivery costs or a failure to meet our obligations and customer outcomes which, depending on the nature and extent of failure, could result in an impact at future price reviews, failure of legal or regulatory obligations and subsequent penalties. This could lead to negative reputational impact with customers and regulators.	▪ Security of supply ▪ Delivery of solutions ▪ Quality and innovation ▪ New contract delivery partnerships for the 2015-2020 period with a new approach to construction and design	Decreasing	We have a developed and clear view of our investment priorities which are built into our programmes, projects and integrated business and asset plans. We have created better alignment and integration between our capital delivery partners and engineering service provider including alignment with our operating model. Our programme and project management capabilities are well established with strong governance and embedded processes to support delivery, manage risks and achieve business benefits. We utilise a time, cost and quality index (TCQi) as a key performance indicator and enhance our performance through a dedicated programme change office to deliver change in a structured and consistent way. Supply chain management is utilised to deliver end-to-end contract management which includes contract strategy and tendering, category management, security of supply, price and price volatility and financial and operational service level performance.
Resource risk The potential inability to provide appropriate resource (human, system, technological or physical) required to support business activity	Responsible manner	The capacity or capability associated with human, technological and physical resource (including information, operational technology, skill sets, systems and telecommunications) can lead to poor efficiency and effectiveness of business activity, the inability to make appropriate decisions and ultimately meet targets. This can also affect the ability to recruit and retain knowledge/expertise or to recover effectively following an incident. In remote but extreme circumstances there is also the potential for higher levels of regulatory scrutiny, financial penalties, reputational damage and missed commercial opportunities.	▪ Delivering required employee engagement ▪ Personal development and talent management ▪ Technological innovation ▪ Asset management	Stable	Developing our people with the right skills and knowledge, combined with delivering effective technology are important enablers to support the business to meet its objectives. Employees are kept informed regarding business strategy and progress through various communication channels. Training and personal development programmes exist for all employees in addition to talent management programmes and apprentice and graduate schemes. We focus on change programmes and innovative ways of working to deliver better, faster and more cost-effective operations.
Security risk The potential inability to protect people,	Best service to customers	Our resources, assets and infrastructure are exposed to various threats (malicious or accidental) which could impact the provision of vital services and/or harm	▪ Ownership and operation of National Infrastructure and Critical National Infrastructure	Stable	Physical and technological security measures combined with strong governance and inspection regimes aim to protect infrastructure, assets and operational capability.

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information, infrastructure and non-infrastructure from malicious or accidental activity		people or commercial businesses. In addition commercial or sensitive information could be lost.	▪ Cybercrime ▪ Terrorism		Recent initiatives include awareness training across the business relating to seven key areas of security and the implementation of a security governance model to oversee all aspects of security and security strategy. Ongoing system and network integration improves operational resilience and we maintain robust incident response, business continuity and disaster recovery procedures. We also maintain insurance cover for loss and liability and the licence of the regulated business also contains a 'shipwreck' clause that, if applicable, may offer a degree of recourse to Ofwat/customers in the event of a catastrophic incident.
Health, safety and environmental Potential for operational or natural hazards to affect employees, contractors, the public or the environment	Responsible Manner	Working with and around water, sewage, construction and excavation sites, plant and equipment exposes people and the environment to man-made and naturally occurring hazards. This could result in harm to people, wildlife and natural habitats and lead to increased work down-time and additional operational costs, for example environmental clean-up. Depending on the circumstances, the group could be fined heavily for breaches of statutory obligations, be held liable to compensate third parties and sustain severe reputational damage.	▪ Extreme weather conditions ▪ Excavation, tunnelling and construction work ▪ Working with substances hazardous to human health ▪ Working with water and wastewater ▪ Driving and vehicle movement	Stable	We have developed a strong health, safety and environmental culture where 'nothing we do at United Utilities is worth getting hurt for'. This is supported by strong governance and management systems which include policies and procedures which are certified to OHSAS 18001 and ISO 14001.

The strategic report was approved by the board on 09 June 2017 and signed on its behalf by:

Russ Houlden
Chief Financial Office

Corporate governance report

Introduction from Dr John McAdam, Chairman:

At United Utilities we aspire to the highest standards of board leadership, transparency and governance.

Our year

We have seen strong performance contributing towards achieving our strategic targets during 2016/17 as demonstrated by progress in meeting our customer, environmental and financial targets. The annual investment of around £800 million in building water and wastewater assets has been completed according to our plan.

Our approach

As individual directors we are cognisant of our statutory duties. Our role as the board is to set the strategy of the group and ensure that management operates the business in accordance with the strategy in order to safeguard both its long-term success and our customers' interests and to create shareholder value. As a board we have a strong sense of common purpose: our intention is to hand over the business to our successors in a better and more sustainable position for the future. Information on our vision and strategy and the way in which we create value is included in the strategic report on pages 2 to 44.

Our people

Having the same directors on both the UUG and UUW boards (with the addition of Steven Fraser, managing director of UUW's Wholesale business, on the UUW board) reflects our vision, which is to be the best UK water and wastewater company, providing great service to our customers. We comply with Ofwat's published principles on board leadership, transparency and governance; a copy of our code can be found on our website at *corporate.unitedutilities.com/corporate-governance.*

You may recall that we reported in our 2016 annual report that Catherine Bell, after nine years' service, was stepping down at the UUG annual general meeting in July 2016, and that Alison Goligher would join the board as an independent non-executive director with effect from 1 August 2016. We recently announced that Paulette Rowe would be appointed as an independent non-executive director joining the board on 1 July 2017, see page 61 for Paulette's biography.

We have maintained our target of at least 25 per cent of our board comprising women. In terms of diversity of experience, skills and personal attributes, I believe we have great diversity around our board. The directors have many years of experience gained across a variety of industries and regulated businesses. Good board dynamics are vital to the proper interaction and working of a board of directors. Board directors need to work together effectively for the good of the company and, in short, they need to get on with each other; clashes of personality are to be avoided as they do not facilitate constructive debate and challenge or effective communication. I believe we have individuals who will apply their skills and experience to the benefit of our business and speak up if they disagree but, equally, listen to the views of others.

Although there are time constraints for non-executive directors who also have an executive role, these individuals bring valuable current market experience to our board table. Similarly, we encourage our executive directors to serve as non-executive directors elsewhere to help broaden their experience, although this is normally limited to one other directorship in a company which does not conflict with United Utilities' business.

At the time this report was approved, 38 per cent of our executive team was made up of women. We are keen to develop our female senior managers so that, over time, they can be considered for executive board appointments or as potential candidates for non-executive directorships in other companies. Our current talent programme at a senior level is well embedded and we believe a non-executive appointment provides an excellent opportunity for both personal and career development and it is a way of gaining valuable experience that may be applied at United

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Utilities so long as no conflicts of interest occur. Our graduate and apprentice programmes are thriving and we are focusing more effectively on middle/junior management succession.

Our values and culture

Our aim is to act as a responsible business, and our business principles can be found on our website at corporate.unitedutilities.com/documents/Our_Business_Principles.pdf.

Our core values of acting with integrity and focusing on our customers provide both the framework for our business culture and the way in which our employees go about their daily work. 'Acting responsibly' has been part of the United Utilities ethos for a number of years. One of the key responsibilities of the board is to appoint the chief executive. Steve Mogford is a passionate supporter of the company's agenda to act as a responsible business.

Our approach to risk

Our approach toward risk is very much aligned with our culture. We are an organisation that provides a vital service to its customers and we recognise the responsibilities of this, and our intention is to act responsibly towards our stakeholders, in particular our customers, in the provision of our services to them. As a board, on behalf of our business we must take long-term decisions in order that our successors are able to operate the business efficiently for customers in the future and we need to build our assets to meet future demand and circumstances. We are a commercial organisation operating within a regulated framework and accepting some level of risk is a normal consequence of doing business. It is the board and the executive team's role to understand the risks associated with each activity of the business and ensure that actions are taken to mitigate these risks.

Dr John McAdam

Chairman

Corporate governance report

Code principle: Leadership

The UK Corporate Governance Code

UUW, as required by its licence, has 'had regard to' the UK Corporate Governance Code ('the Code', the current version of which was published by the Financial Reporting Council in 2014, a copy of which can be found at *https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf*), since 2008. The company, in agreement with Ofwat, operates a structure that allows directors to be members of the boards of both the company and its ultimate holding company, UUG, in order to increase the efficiency and effectiveness of the corporate governance structure. These arrangements have been in place since March 2011 and were in place throughout the year ended 31 March 2017. The only exception is Steven Fraser, managing director of the company's wholesale business, who is a director of UUW only. As a board member he provides the UUW board with additional insight into the operational challenges faced by the company.

The boards of both UUG and UUW fully support Ofwat's drive for the highest standards of board leadership, transparency and governance in the industry, and are fully cognisant of the long-term nature of the industry and the stewardship of water and wastewater assets for future generations of customers. We are satisfied that current practices and the application of the Code at both holding company and regulated company levels are entirely consistent with the Ofwat principles (see pages 48 to 49). A copy of our code can be found on our website at corporate.unitedutilities.com/corporate-governance

As a listed company and the ultimate holding company of UUW, UUG complies with the Code, and did so fully for the year ended 31 March 2017. The UUW board also complies with the Code or explains any deviations from it, primarily that UUW does not duplicate the board committees already operating at the UUG level (details can be found on page 55), as UUW represents 98 per cent of UUG group revenues. The activities of the principal UUG board committees as required by the Code (whose members are made up entirely of independent non-executive directors), are necessarily targeted towards UUW related matters, thus ensuring that the interests of UUW and its customers are safeguarded. An explanation of how the UUG board committees complied during the year ended 31 March 2017 with the provisions of the Code can be found on pages 52 to 109 of the UUG 2017 annual report.

Board meetings of UUG and UUW are, although normally held on the same day, kept entirely separate, thus ensuring that the board of each company takes decisions relating to and in the context of the entity in question. Any decisions of a regulatory nature are the responsibility of the UUW board.

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Compliance with Ofwat's regulated company principles on board leadership, transparency and governance

Ofwat Regulated Company Principles	Our response
Transparency – reporting must meet or exceed the standards set out in the Disclosure and Transparency Rules of the UK Listing Authority	This corporate governance report, incorporated by reference into the Directors' Report, meets the requirements of the Disclosure and Transparency Rules of the UK Listing Authority. Our Remuneration Report is included on pages 62 to 65.
The regulated company must act as if it is a separate public listed company An effective Board is fully focused on the regulated company's obligations	UUW represents 98 per cent of UUG revenues. The UUW Board (whose directors' biographies can be found on pages 57 to 61, and which includes a strong independent representation with a diverse range of backgrounds and experience) is fully focused on meeting the company's regulated obligations and activities as an appointee in accordance with its Licence as a provider of water and wastewater services*. The UUW board is responsible for the decisions it takes, is advised by the director of regulation and company secretary, and can seek independent advice on any matter it sees fit.
There must be significant independent representation on the Board Independent non-executive directors are essential to securing strong Board leadership and governance In line with best practice, boards should have the appropriate balance of skills, experience, independence and knowledge of the company	Directors' biographies can be found on pages 57 to 61. Six out of the ten directors fulfil the independence criteria of the UK Corporate Governance Code with which a listed company is required to comply (or explain its reasons for not complying) and the Chairman, on appointment as Chair of the UUG Board, fulfilled the Code's independence criteria. Information on succession planning and the appointment process for directors can be found in the UUG annual report in the report of the Nomination committee on pages 66 to 70. The outcome of the annual board evaluation can be found on pages 62 to 64 of the 2017 UUG annual report. All directors have attended all scheduled board meetings during the year.
The Chair must be independent of management and investors	The biography of the Chairman can be found on page 57. In Dr McAdam the board has an experienced leader. He shares with the group his experience of other governance practices gained throughout his career and is an effective chair of board meetings who is meticulous in his preparation and planning of all aspects ahead of meetings. Dr McAdam has not declared any interests which conflict with the business of UUW, nor UUG. The role of Chairman and CEO are separate.

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Board committees, including but not limited to audit and remuneration committees, will operate at the regulated company level There should be a majority of independent members on the audit and remuneration committees	As agreed with Ofwat in 2010, UUW does not duplicate board committees already in operation at the UUG level. This is because UUW represents in excess of 98 per cent of the UUG group's revenues. Therefore the activities of the principal UUG board committees as required by the Code (whose members are made up entirely of independent non-executive directors) and who are also independent non-executive directors of UUW, are necessarily targeted towards UUW matters, thus ensuring that the interests of UUW and its customers are safeguarded. Details of attendance at the UUG committee meetings can be found on page 62 of the 2017 UUG annual report.
The group structure must be explained in a way that is clear and simple to understand.	The group structure is shown on page 56.

*United Utilities Water Limited is regulated under the Water Industry Act 1991, the Water Act 2003, the Water Act 2014 and its Conditions of Appointment ('Licence').

The board of directors

The biographical details of our directors are given on pages 57 to 61 and the details of the directors who served during the year and their attendance at scheduled board meetings during 2016/17 are set out in the table below (figures shown in brackets show the maximum number of meetings which the directors could have attended). There were also a number of ad hoc board meetings held by means of telephone conferencing facilities as the need arose.

All the non-executive directors are independent in accordance with the Code, and the Chairman met the Code's independence criteria at the time of his appointment as Chair of the UUG board. Board succession is kept continually under review. The company was therefore compliant with the Ofwat licence obligation for there to be three independent non-executive directors serving on the board.

		Attendance at board meetings
Dr John McAdam	Chairman	8(8)
Steve Mogford	CEO	8(8)
Russ Houlden	CFO	8(8)
Steven Fraser	Managing director wholesale	8(8)
Dr Catherine Bell*	Independent non-executive director	4(4)
Stephen Carter	Independent non-executive director	8(8)
Mark Clare	Independent non-executive director	8(8)
Alison Goligher	Independent non-executive director	3(3)
Brian May	Independent non-executive director	8(8)
Sara Weller	Independent non-executive director	8(8)

*Dr Catherine Bell stepped down from the board on the 22 July 2016.

Excludes Paulette Rowe who will not be appointed until 1 July 2017.

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Overview of the board's responsibilities

The board members are fully aware of their responsibilities, both individually and collectively, to promote the long-term success of the company and of the company's responsibilities as the regulated licence holder. The board is responsible for ensuring that the company is managed in accordance with its licensed responsibilities and delivering good customer service whilst having regard to other stakeholder interests. Consideration of the long-term interests of shareholders and bondholders, together with those of the wider interests of stakeholders represented by customers, employees, suppliers, the community, the environment and regulators are factored into the company's management processes.

The board is responsible for the assessment and management of the key issues and risks impacting the business. Accordingly, the board sets the company's overall direction, reviews management performance and reviews the company's approach to business planning, risk management and development of policies including health and safety.

The board has delegated specific responsibilities to the UUW capital investment committee to consider and approve expenditure and investment proposals within limits determined by the board and the internal control manual. The committee's members are the chief executive officer, the chief financial officer, and the managing director wholesale together with other members of the senior management team. Any projects in excess of £50 million are approved by the UUW board.

Additionally, the UUG board has oversight of any project in excess of £50 million and any project which materially increases the group's risk profile. The UUG board has a schedule of matters reserved for its own decision, a copy of which can be found on the United Utilities website at corporate.unitedutilities.com/corporate-governance . There are no specific matters relating to the operation of the regulated activities of UUW that are included therein.

The UUW board delegates certain treasury matters to the chief financial officer and/or treasurer. However, any decisions taken are reported to the UUW board, which has ultimate oversight and control.

UUW board activity in 2016/17

Customer

- Received and discussed regular updates and progress with the Lancashire water quality action plan
- Considered and approved the Charges Submission for 2017/18
- Reviewed updates on the service incentive mechanism, social tariffs, help to pay scheme and the customer experience programme including the introduction of 'Priority Services' customer initiative
- Reviewed and discussed developments in cyber crime and the activities undertaken to enhance the effectiveness of the security controls used in the business and work with various government agencies and a number of other water companies to define cyber security guiding principles for use across the industry

Business as usual

- Received updates on the Security and Emergency Measures Directive
- Approved a number of projects that were above delegated limits and which required the board's approval including the Anchorsholme outfall extension and Morecambe WwTW catchment strategy
- Received an update on energy usage, energy saving and other 'green' initiatives at the Lingley Mere site

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- Received an update on the water investment programme as part of the delivery of the water transformation programme
- Reviewed progress with the implementation of the IT strategy focusing on competition, customer expectations and technological advancements
- Received regular updates on business readiness for the market opening to competition for business customers, public sector, charitable and not-for-profit customers in April 2017 and noted associated changes to the UUW Instrument of Appointment in relation to the Wholesale business
- Approved the company's exit from the non-household retail market following the joint venture with Severn Trent which combined the two companies' non-household water and wastewater retail operations
- Received and discussed the review of long-term resilience project for the Haweswater Aqueduct
- Received an annual briefing on dam and reservoir safety and a reservoir engineers' update
- Reviewed monthly updates on health and safety performance and the annual health and safety report

Regulatory

- Considered and discussed the independent assurance supporting the 2016 annual performance report including the risk and compliance statement (a requirement of Ofwat) which was approved for publication
- Received quarterly updates and the annual report on UUW's DWI water quality performance
- Received updates on the Environment Agency's performance assessment
- Received a presentation and held a discussion with representatives of YourVoice, whose role was to monitor the company's commitments to customers and stakeholders in the 2015-20 period and challenge the company in preparing its business plan for Water 2020
- Received regular updates on information made available from Ofwat in relation to the business plan for Water 2020

Governance

- Granted Powers of Attorney to senior managers to authorise treasury and property related matters
- Reviewed and updated the company's governance Code and consistency with the Ofwat Governance Principles
- Approved the appointment of both Alison Goligher and Paulette Rowe as independent non-executive director with effect from 1 August 2016 and 1 July 2017 respectively and noted Dr Catherine Bell having stepped down from the board with effect from 22 July 2016
- Reviewed the approach, background work and progress of work to identify areas where there is any risk of modern slavery occurring in the supply chain contributing to the development of and approval of the slavery and human trafficking statement

Financial

- Reviewed and approved UUW's proposed treasury activities for 2016/17 including the first issue of consumer price index-linked debt
- Approved UUW's dividends

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- Approved the UUW annual report and financial statements
- Received regular updates on cash collection, SIM scores and ODI performance

Conflicts of interest

Since 1 October 2008, all directors have been under a statutory duty to avoid any situation in which they have, or can have, a direct or indirect interest which conflicts or possibly may conflict with the interests of the company. As is permitted, the company's articles of association contain provisions which permit the unconflicted directors to authorise conflict situations and procedures have been put in place for the disclosure of any conflicts by the directors to the board and for the consideration and, if appropriate, authorisation of such conflicts. The procedures permit any authorisation to be subject to any terms and/or conditions that the unconflicted directors think fit. All directors are asked on an annual basis if their other commitments and interests have changed and a brief report to the board is prepared. In any case, all the directors are required to notify the Chairman and/or company secretary if they believe a conflict situation might arise. Any potential issue of conflict relating to prospective directors would be addressed by the board.

The directors are at all times fully mindful of the fact that they hold a directorship in both UUW and UUG (with the exception of Steven Fraser). Steve Mogford and Russ Houlden have each declared their directorship of Water Plus Limited as being a potential conflict of interest with the company. UUW and Water Plus Limited are, and operate as, distinct legal entities.

Reappointment of directors

Non-executive directors are reappointed annually reflecting their reappointment at the UUG AGM, if appropriate. Their appointment or removal would also be subject to provisions contained within the company's articles of association. Any term beyond six years for a non-executive director would be subject to particularly rigorous review, and will take into account the need for progressive refreshing of the board. A separate nomination committee is not felt to be necessary, as the succession planning needs of the board are dealt with by the UUG nomination committee as the interests of the two boards are aligned and given that UUW represents 98 per cent of the UUG group's revenues.

Information, support and advice

Board papers are generally distributed electronically five days in advance of scheduled board meetings to enable directors to obtain a thorough understanding of the matters to be discussed, and seek clarification, if required. All directors have access to the advice and services of the company secretary and his team, who are responsible to the board for ensuring that board procedures are complied with. The appointment and removal of the company secretary are matters reserved to the UUG board. The board has access, through the company secretary, to independent professional advice at the company's expense where they judge it necessary to discharge their responsibilities as directors. The company also maintains an appropriate level of directors' and officers' insurance.

Code principle: Effectiveness

Induction and training

An induction programme is devised for each new non-executive director. It would include one-to-one meetings with the Chairman and each of the existing non-executive directors. They will have one-to-one meetings with the CEO, CFO, managing director of the wholesale business and the company secretary along with other members of the executive team. They will also meet members of the operational teams and visit some of the key operational sites and capital projects to ensure they get a first-hand understanding of the water and wastewater business. New directors receive a briefing on the key duties of being a director of a regulated water company, including the role of the regulated company's holding company, and they will also meet with the director of regulation and representatives of Ofwat. (Details of Alison Goligher's induction can be found on page 70 of the UUG 2017 annual report).

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Board evaluation

Our board evaluation was again conducted internally this year; our last external evaluation was conducted by Lintstock consultants in 2015. The internal evaluation process was facilitated by the company secretary and his team. Given that there is a high degree of overlap (and common board membership) between the UUW and UUG boards, the board evaluation posed questions that were relevant to both boards. (For further details see page 62 of the UUG 2017 annual report).

Code principle: Accountability

Board's approach to risk management and internal control

The board is responsible for determining the nature and extent of the risks that it is willing to take to achieve its strategic objectives. The board is also responsible for ensuring that the company's risk management and internal control systems are effectively managed across the business and that they receive an appropriate level of scrutiny and board time. The group's risks predominantly reflect those of all regulated water and wastewater companies. These generally relate to the failing of regulatory performance targets or failing to fulfil our obligations in any five-year planning cycle, potentially leading to the imposition of fines and penalties in addition to reputational damage.

During the year, the board reviewed the effectiveness of the risk management systems, including financial, operational and compliance controls and the progress made to address the key recommendations of the investigation undertaken by Mark Clare, senior independent director, relating to the Lancashire water quality incident in 2015. This investigation identified that the risk management framework was robust whilst identifying a number of improvement opportunities, namely: better coordination of drinking water safety plans within wholesale; improved application by business units of the risk management process; further embedding existing risk management processes within wholesale; and improving system integration. All the actions have either been completed or were on target to be completed by their forecast completion date.

The UUG board, following the review by the UUG audit committee, concluded that it was appropriate to adopt the going concern basis of accounting (see page 131 of the UUG 2017 annual report). Similarly, in accordance with the principles of the Code, the UUG board concluded, following the recommendation from the UUG audit committee, that it was appropriate to provide the long-term viability statement for UUG (as set out on page 73 of the UUG 2017 annual report).

Assurance supporting these statements was provided by the review of: the group's key financial measures and contingent liabilities; the key credit financial ratios; the group's liquidity and ongoing ability to meet its financial covenants.

As part of the assurance process, the board also took into account the principal risks and uncertainties facing the company, and the actions taken to mitigate those risks. These principal risks and uncertainties are detailed on pages 48 to 49 of the UUG 2017 annual report, as are the risk management processes and structures used to monitor and manage them. Biannually, the UUG board receives a report detailing management's assessment of the most significant risks facing the company. The report gives an indication of the level of exposure, subject to the mitigating controls in place, for the risk profile of the group. This now provides the board with information in two categories – group wide business risks and wholesale operational risks. The UUG board also receives information during the year from the UUG treasury committee (to which the board has delegated matters of a treasury nature – see the structure diagram on page 59 of the UUG 2017 annual report) including such matters as liquidity policy, the group's capital funding requirements and interest rate management.

Accordingly, given that UUW represents 98 per cent of the UUG group's revenues, the UUW board similarly concluded that it was appropriate to adopt the going concern basis of accounting (see page 81) and provide a long-term viability statement as set out below.

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Long term viability statement

The directors have assessed the viability of the group, taking account of the group's current position, the potential impact of the principal risks facing the business in severe but reasonable scenarios, and the effectiveness of any mitigating actions. Based on this assessment, the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the five-year period to March 2022.

The long-term planning detailed on pages 22 to 26 assesses the group's prospects and establishes its strategy over a long-term time horizon, providing a framework for the group's strategic planning process. The viability statement has been based on the group's strategic planning process which is aligned to the price control period, the group's liquidity position providing headroom to cover its projected financing needs through until mid-2018 and the group's robust capital solvency position with a debt to RCV ratio of around 65 per cent, providing headroom within which to increase medium-term liquidity if required.

The group has a proven track record of being able to raise new forms of finance in most market conditions, and expects to continue to do so into the future. In addition, the board has considered the protections which exist from the regulatory and economic environment within which it operates. From an economic perspective, given the nature of water and wastewater services, threats to the group's viability from risks such as reduced market share, substitution of services and reduced demand are low compared to those faced by many other industries. From a regulatory perspective the group benefits from a rolling 25-year licence which, coupled with the price control set by Ofwat, provides a high degree of certainty of cash flows during the current price control period (which runs to March 2020), while between price control periods there exists additional protection afforded by Ofwat's primary legal duty to ensure that water and wastewater companies are able to finance their functions. For these reasons the board considers it appropriate to provide a medium-term viability statement of five years.

The directors have assessed the group's viability considering the principal risks as set out on pages 41 to 44, and its ability to absorb a number of severe but reasonable scenarios. These include political and regulatory risks, as well as the potential for a restriction to the availability of financing resulting from a global capital markets crisis. The viability assessment has considered the potential impacts of these risks on the group's business model, future performance, solvency and liquidity over the period. As well as the protections which exist from the regulatory environment within which it operates, a number of mitigating actions are available in the extreme scenarios considered, including the raising of new finance, capital programme deferral, the close out of derivative asset positions and the restriction of dividend payments. These actions provide the group with significant scope to improve its liquidity and capital position to further absorb such threats.

The directors also considered it appropriate to prepare the financial statements on the going concern basis, as explained in the basis of preparation paragraph on page 81.

Significant issues considered in relation to the financial statements

With regard to the UUW financial statements the UUG audit committee and the UUW board reviewed a number of principal areas of judgement. These are disclosed on page 79 of the UUG 2017 annual report.

External auditor

KPMG are appointed as statutory auditor to all wholly owned companies in the United Utilities group. The company adheres to the UUG policy on non-audit services provided by the external auditor and in relation to auditor independence (see page 77 of the UUG 2017 annual report). The company's licence requires the preparation of audited regulatory accounts, therefore there are many advantages and efficiencies if KPMG also audits the regulatory accounts. Information on the assessment of the effectiveness of the external audit process can be found on page 76 of the UUG 2017 annual report.

Corporate governance report

The UUG group last tendered its statutory audit in March 2011 when Deloitte were replaced by KPMG. The appointment of statutory auditor is a role delegated to the UUG audit committee, as is the responsibility for agreeing the audit fee and the appointment of the audit engagement partner. An explanation is included on page 78 of the UUG 2017 annual report of the audit committee's current intention that a competitive tender would next be conducted most probably during 2020, for the statutory audit services for the financial year ended 31 March 2022.

Licence obligations

The board receives reports about the performance of the company, and during the year approved the 2016 Annual Performance Report and the associated Risk and Compliance Statement (the 'Statement'). The Statement sets out how the board pays particular regard to, and awareness of and how, it meets the obligations of its Licence.

Code principle: Remuneration

Directors' remuneration

The details of directors' remuneration can be found on pages 62 to 65. Further information on the group's approach to executive remuneration can be found in the Remuneration report within the UUG 2017 annual report.

Departures from the Code

<u>Section C of the Code – Code principle Accountability</u>

UUG has an audit committee and the UUG group has a well-resourced internal audit function (see page 80 of the UUG 2017 annual report) in place to which the UUW board has access and which reports to the UUW board on matters such as the company's regulatory returns to Ofwat. As the work of the audit committee is largely undertaken on behalf of the company, the UUW board concluded that having a separate audit committee for UUW was not necessary. Membership of the audit committee consists entirely of independent non-executive directors who are also members of the UUW board. The report of the UUG audit committee can be found on pages 74 to 81 of the UUG 2017 annual report.

<u>Section D of the Code – Code principle Remuneration</u>

As UUG has a remuneration committee and because many aspects of executive directors' remuneration (in particular, employee share plans) operate at a UUG group level, the company remunerates its executive directors and senior management subject to the confines of UUG's remuneration policy. (For further details please see the remuneration report within the UUG 2017 annual report). In accordance with their letters of appointment the non-executive directors do not receive any remuneration from the company for their services to the UUW board. Membership of the UUG remuneration committee consists entirely of independent non-executive directors, who are also members of the UUW board.

<u>Section E of the Code – Code principle Relations with shareholders</u>

As a wholly owned subsidiary of UUG, this provision is not relevant to the company. UUG complies fully with this provision and makes a full disclosure in its annual report.

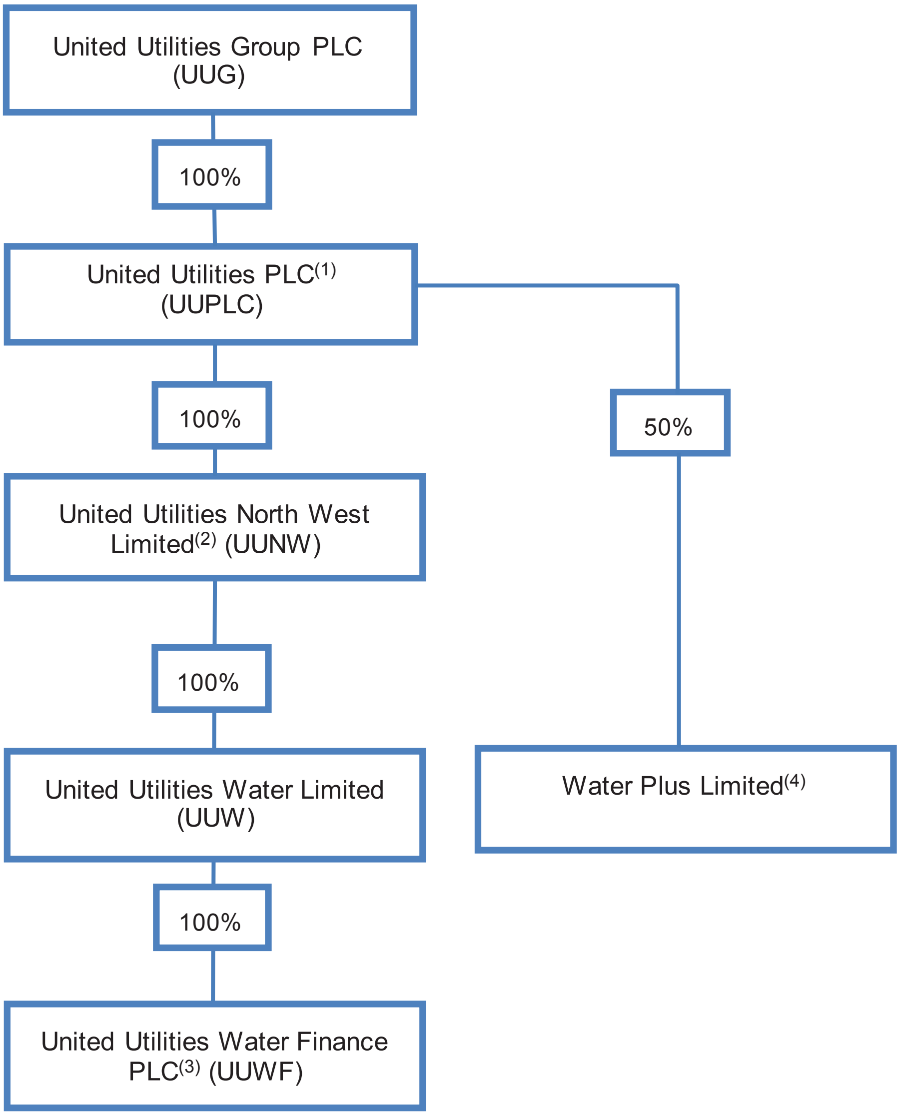
United Utilities group structure

As a group, United Utilities has a simple corporate structure. UUG has a primary listing on the London Stock Exchange with a stock code of 'UU'; it has around 90,000 registered shareholders. Below UUG, there are two intermediate holding companies, one is United Utilities PLC (UUPLC)[(1)] (which is also the holding company for a number of non-regulated and legacy/dormant companies) and United Utilities North West Limited (UUNW)[(2)]. The regulated company UUW is a direct subsidiary of UUNW which in turn is a direct subsidiary of UUPLC. Neither UUPLC nor UUNW are operational entities.

Corporate governance report

All companies are registered in England and Wales and copies of their accounts are available at Companies House.

United Utilities group structure chart



(1)United Utilities PLC – was the listed ultimate holding company prior to July 2008, when the United Utilities group of companies underwent a scheme of arrangement as part of the return of value to shareholders from the proceeds of the sale of the electricity distribution business. This company is used from time to time to raise debt financing.

(2)United Utilities North West Limited – previously held the electricity distribution business prior to its disposal in 2007 and is retained for legal purposes.

(3)United Utilities Water Finance PLC is used to raise debt finance in support of UUW.

(4)Water Plus Limited – 50 per cent joint venture with Severn Trent serving customers in the non-household (business) water and wastewater retail market.

Corporate governance report

Biographical details of the board of directors

Dr John McAdam

Chairman

Responsibilities: Responsible for the leadership of the board, setting its agenda and ensuring its effectiveness on all aspects of its role.

Qualifications: BSc (Hons) Chemical Physics, Diploma Advanced Studies in Science, PhD.

Appointment to the board: March 2011.

Skills and experience: With over 18 years' service as a board director in a wide range of companies, and as a current non-executive director serving on a number of other boards and across different sectors, John has a wealth of past and current experience on which to draw in his role as Chairman and leader of the board.

Career experience: Appointed to the board of ICI plc in 1999 and became chief executive in 2003, a position held until ICI's takeover by Akzo Nobel. He stepped down from the role of senior independent director at J Sainsbury plc in July 2016 and as a non-executive director of Rolls-Royce Holdings plc in May 2017.

Current directorships/business interests: Chairman of Rentokil Initial plc and senior independent director of Electra Private Equity PLC. He is also Chairman of United Utilities Group PLC.

Independence: John met the Code's independence criteria at the time of his initial appointment as Chairman of UUG.

Steve Mogford

Chief Executive Officer (CEO)

Responsibilities: To manage the company's business and to implement the strategy and policies approved by the board.

Qualifications: BSc (Hons) Astrophysics/Maths/Physics.

Appointment to the board: March 2011.

Skills and experience: Previously chief executive of SELEX Galileo, the defence electronics company owned by Italian aerospace and defence organisation Finmeccanica, and chief operating officer at BAE Systems PLC and a member of its PLC board, he spent his earlier career with British Aerospace PLC. He stepped down from the board at Carillion PLC in December 2015 where he had served as the senior independent director until September 2015.

Current directorships/business interests: Appointed as senior independent director of G4S PLC in May 2016. He is also Chief Executive Officer of United Utilities Group PLC.

Corporate governance report

Russ Houlden

Chief Financial Officer (CFO)

Responsibilities: To manage the company's financial affairs and to contribute to the management of the group's business and to the implementation of the strategy and policies approved by the board.

Qualifications: BSc (Hons) Management Sciences, Fellow of the Chartered Institute of Management Accountants, Chartered Global Management Accountant and a Fellow of the Association of Corporate Treasurers.

Appointment to the board: October 2010.

Skills and experience: Russ's skills and experience in accounting, treasury, tax, M&A and investor relations in other commercial and regulated companies, along with his extensive experience of driving performance improvement and managing large capital investment programmes, provides the group with valuable expertise in pursuing its strategy to drive for improvements in customer service and in providing our services at the lowest sustainable cost.

Career experience: Chief financial officer at Telecom New Zealand. Previously finance director of Lovells, BT Wholesale, BT Networks and Information Services, ICI Polyurethanes and ICI Japan.

Current directorships/business interests: Member of the supervisory board and chairman of the audit committee of Orange Polska SA, the largest listed telecommunications company in Poland. He is a member of the main committee and chairman of the financial reporting committee of the 100 Group. He is also chief financial officer of United Utilities Group PLC.

Mark Clare

Senior independent non-executive director

Responsibilities: Is responsible, in addition to his role as an independent non-executive director, for discussing any concerns with shareholders that cannot be resolved through the normal channels of communication with the Chairman or Chief Executive Officer.

Qualifications: Chartered Management Accountant (FCMA).

Appointment to the board: November 2013.

Skills and experience: In his roles at British Gas and BAA, Mark has a strong background operating within regulated environments. His extensive knowledge of customer-facing businesses is particularly valuable for United Utilities with the implementation of greater competition in the industry and in pursuit of its strategy to improve customer service.

Career experience: Mark retired from his position as chief executive at Barratt Developments plc in July 2015, a role he had held for nine years. He is a former trustee of the Building Research Establishment and the UK Green Building Council. Prior to joining Barratt, he was an executive director of Centrica plc and held a number of senior roles within both Centrica plc and British Gas. Mark was also a non-executive director of BAA plc, the airports operator.

Current directorships/business interests: He was appointed non-executive chairman of Grainger plc in February 2017 and as the senior independent director of Ladbrokes Coral PLC in September 2016. He is also a non-executive director of Premier Marinas Holdings Limited. He is also an independent non-executive director of United Utilities Group PLC.

Corporate governance report

Stephen Carter

Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board and to lead the board's agenda on acting responsibly as a business.

Qualifications: Bachelor of Law.

Appointment to the board: September 2014.

Skills and experience: As the chief executive officer of a FTSE listed company, Stephen brings current operational experience to the board. His public sector experience provides additional insights to the board regarding regulation and government relations, and his experience in the media and technology industries provides additional perspective for the board's discussions.

Career experience: Group chief executive at Informa plc, having previously served on the board of the Informa Group as a non-executive director and member of the audit committee. Previous executive roles include president/managing director, Europe, Middle East and Africa, and a member of the executive management board at Alcatel Lucent Inc. Stephen has also held a number of public service roles, serving a term as the founding chief executive of Ofcom. He was formerly chairman of the board at Ashridge Business School. He is a Life Peer.

Current directorships/business interests: Group chief executive at Informa plc and a non-executive director of the Department for Business, Energy and Industrial Strategy. He is also an independent non-executive director of United Utilities Group PLC.

Alison Goligher

Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board.

Qualifications: BSc (Hons) Mathematical Physics, MEng Petroleum Engineering

Appointment to the board: August 2016.

Skills and experience: Alison has strong technical and capital project management skills, having been involved in large projects and the production side of Royal Dutch Shell's business. This experience of engineering and industrial sectors provides the board with additional insight into delivering United Utilities' capital investment programme.

Career experience: From 2006 to 2015, Alison worked for Royal Dutch Shell, with her most recent executive role as Executive Vice President Upstream International Unconventionals. Prior to that she spent 17 years with Schlumberger, an international supplier of technology, integrated project management and information solutions to the oil and gas industry.

Current directorships/business interests: She is a non-executive director of Meggitt PLC and was appointed as part-time executive chair of Silixa Ltd in August 2016. She is also an independent non-executive director of United Utilities Group PLC.

Corporate governance report

Steve Fraser

Managing director, UUW Wholesale

Responsibilities: To develop the strategy for, and to manage, the wholesale business in the UK and the UUG group's interests overseas.

Qualifications: BA (Hons) Management Studies, MSC Engineering Management, AMP Harvard University

Appointment to the board: April 2013 (had previously served as a director between July 2009 and March 2011).

Current Directorships: Non-Executive Director and Chairman of the Remuneration Committee of Tallinna Vesi plc

Career Experience: Steve has a wide range of project and contract management experience within the infrastructure sector. Prior to joining United Utilities he was Operations Director of Bethell plc, the power and construction group and subsequently Managing Director of Energy and Contracting Services, a global utilities outsourcing business.

Skills and Experience: Steve brings a strong commercial acumen and operations focus to the wider business. He has a proven track record in managing business turn arounds and extensive change management skills. Steve has broad experience across all forms of utilities construction, programme and operations management. He has worked in partnership with infrastructure investors throughout his career on both acquisition and sales of different infrastructure focused businesses to create shareholder value.

Brian May

Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board and to lead the UUG audit committee.

Qualifications: BSc (Hons) Actuarial Science, Chartered Accountant FCA.

Appointment to the board: September 2012.

Skills and experience: Brian joined Bunzl plc in 1993 as head of internal audit before becoming group treasurer, then finance director (Europe and Australasia), and is currently finance director. Brian's background and the various finance roles that he has held are major assets to the board in chairing both the audit and the treasury committees.

Career experience: Brian has been finance director at Bunzl plc since 2006 and prior to that held a number of senior finance roles within the company. Prior to joining Bunzl, Brian qualified as a chartered accountant with KPMG.

Current directorships/business interests: Finance director at Bunzl plc. He is also an independent non-executive director of United Utilities Group PLC.

Corporate governance report

Paulette Rowe

Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board.

Qualifications: MSc Mechanical Engineering and Management, MBA.

Appointment to the board: September 2012.

Skills and experience: Paulette has spent most of her career in the regulated finance industry which will provide the board with additional perspective and first hand regulatory experience. Her experience of technology driven transformation will contribute to United Utilities' customer experience programme and Systems Thinking approach.

Career experience: Paulette is managing director, Global Payments Acceptance at Barclaycard. Prior to joining Barclays, she was strategy director at NBNK Investments plc and before which she was commercial and marketing director at Tesco Personal Finance. She spent seven years at the Royal Bank of Scotland, where her roles included chief executive European Consumer Finance and managing director, NatWest Retail Banking. She has served on the board of the Prince's Youth Business Trust and as a trustee for Community Service Volunteers.

Current directorships/business interests: She is non-executive chair of the Mayor's Fund for London. She is also an independent non-executive director of United Utilities Group PLC.

Sara Weller

Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board and to lead the board's activities concerning directors' remuneration.

Qualifications: MA Chemistry.

Appointment to the board: March 2012.

Skills and experience: Sara's experience of customer-facing businesses, together with her knowledge of operating within a regulated environment, provides the board with valuable perspective as the company responds to the increased competition in the sector and improves its service to customers.

Career experience: Sara has wide-ranging business experience, having worked for Mars, Abbey National and J Sainsbury plc and latterly as managing director of Argos from 2004 to 2011. She served as the senior independent director at Mitchells and Butlers plc from 2003 to 2006 and also chaired its remuneration committee from 2003 to 2010. She was the former lead non-executive director for the Department for Communities and Local Government.

Current directorships/business interests: Non-executive director of Lloyds Banking Group plc. Sara is chair of the Planning Inspectorate (an executive agency of the Department of Communities and Local Government), lead non-executive director for the Department of Work and Pensions, a board member at the Higher Education Funding Council for England and a council member at Cambridge University. She is also an independent non-executive director of United Utilities Water Limited.

Corporate governance report

Directors' remuneration report

This note should be read in conjunction with note 2 to the financial statements, which provides information in respect of the total directors' remuneration.

With the exception of Steve Fraser, all directors of United Utilities Water Limited (UUW) are also directors of United Utilities Group PLC (UUG). Further remuneration details including the policy can be found in the annual report and Accounts of UUG. The remuneration policy for Steve Fraser is generally in line with UUG policy unless stated otherwise in this report.

For the purposes of this disclosure, the company's directors can be split into two categories:

- executive directors of UUW; and
- non-executive directors of UUW.

Non-executive directors
As outlined in the annual report and accounts of United Utilities Group PLC, the non-executive Chairman and non-executive directors do not participate in the company's incentive arrangements (i.e. annual bonus or share schemes) and were paid no remuneration linked to water service standards.

Executive directors' remuneration 2016/17

	Base Salary £'000	Benefits £'000	Bonus [1] £'000	Long-term incentives [2] £'000	Cash allowance in lieu of pension £'000	Total £'000
Steve Mogford	721	28	785	617	159	2,310
Russ Houlden	455	26	492	390	100	1,463
Steve Fraser	318	17	246	146	70	797

Note:

[1]For Steve Mogford and Russ Houlden, 50 per cent of bonus was deferred into shares for three years under the Deferred Bonus Plan (DBP). For Steve Fraser 40 per cent of bonus was deferred under the DBP.

[2]See pages 64 to 65 for further detail on the long-term incentives.

A recharge of £317,000 during the year ended 31 March 2017 (2016: £299,000) was charged to other companies in the United Utilities group in relation to the provision of executive director services (£273,000) and non-executive director services (£44,000).

Corporate governance report

Directors' remuneration report (continued)

2016/17 annual bonus

During 2015/16 the Committee reviewed the annual bonus measures to ensure that they were aligned to the delivery of the business strategy for regulatory period 2015-20. The 2016/17 bonus measures and outcome is shown in the table below:

Measure	Steve Mogford		Russ Houlden		Steve Fraser	
	Max. %	Actual %	Max. %	Actual %	Max. %	Actual %
Underlying operating profit	30.0	24.4	30.0	24.4	20.0	16.4
Customer service in year						
Service Incentive Mechanism – Qualitative	12.0	12.0	12.0	12.0	12.0	12.0
Service Incentive Mechanism – Quantitative	4.0	4.0	4.0	4.0	4.0	4.0
Maintaining and enhancing services for customers						
Wholesale outcome delivery incentive composite	20.0	16.7	20.0	16.7	20.0	16.7
Time, cost and quality of capital programme (TCQi)	20.0	13.6	20.0	13.6	20.0	13.6
Corporate responsibility						
Dow Jones Sustainability Index rating	4.0	4.0	4.0	4.0	4.0	4.0
Personal objectives	10.0	9.0	10.0	8.5	20.0	19.0
Total as % bonus maximum	**100.0**	**83.7**	**100.0**	**83.2**	**100.0**	**85.7**
Total as % base salary	**130.0**	**108.8**	**130.0**	**108.2**	**90.0**	**77.1**
Total £'000		**785**		**492**		**246**

For all of these bonus measures there was a threshold level of performance which triggered a partial payment of bonus with a sliding scale providing for achievement of up to 100 per cent of the relevant element of bonus.

Corporate governance report

Directors' remuneration report (continued)

Long-term incentives

Details of UUG shares previously granted to UUW executive directors which vested in 2016/17, or whose performance period ended in 2016/17, are as follows:

Director	Number of shares vesting	Value of shares vesting £'000
	2014 LTP[(1)]	**2014 LTP**[(2)]
Steve Mogford	65,296	617
Russ Houlden	41,216	390
Steve Fraser	15,464	146

Note:

(1) The 2014 Long Term Plan (LTP) awards were granted in July 2014. The performance period started on 1 April 2014 and ended on 31 March 2017. The final outcome for the customer service excellence measure (which forms 33% of the award) will not be known until Ofwat publishes the combined service incentive mechanism (SIM) score for the company and its comparator water companies (expected to be published in late summer 2017). The number and value of the vested 2014 LTP awards in the table above is therefore estimated. Awards granted to Steve Fraser are expected to vest once the combined SIM scores are published. Awards granted to Steve Mogford and Russ Houlden will normally vest in April 2019, following an additional two year holding period. The awards accrue dividend equivalents.

(2) The value of the 2014 LTP awards has been calculated by multiplying the number of shares vesting by the average share price over the three month period 1 January 2017 to 31 March 2017 (946 pence per share).

The performance measures, and estimated achievement against those measures, are summarised below:

Performance measure	Weighting	Estimated achievement
Total Shareholder Return (TSR) over the performance period, relative to the median TSR of FTSE 100 companies (excluding financial services, oil and gas and mining companies)	**33.3%**	**33.3% out of 33.3%**
Sustainable dividends. Dividend growth in each year of the performance period, with an underlying dividend cover underpin	33.3%	8.3% out of 33.3%
Customer service excellence. Ranking for the year ended 31 March 2017 versus 17 other water companies using Ofwat's SIM combined score	33.3%	17.5% out of 33.3%
Total vesting		**59.1%**

Corporate governance report

Directors' remuneration report (continued)

Directors' remuneration 2017/18

In addition to the normal annual salary and fee review, there will be some changes to the 2017/18 bonus scheme and long term incentives granted in 2017.

The bonus will operate in a broadly similar way with the exception that the Dow Jones measure (currently representing a maximum of 4 per cent of executive director's bonuses) will be removed from the bonus scorecard and the weighting redistributed to the outcome delivery incentive (ODI) measure.

In line with the revised remuneration policy, recovery and withholding provisions for the annual bonus scheme and long term incentives will be made more robust on an ongoing basis. For the long term incentives granted in 2017 there will also be some changes made to the customer service measure to ensure we are measuring performance appropriately.

United Utilities Group PLC incentive arrangements will continue to reflect the importance of achieving service standards and performance will again be assessed against a number of key measures including ODIs and Service Incentive Mechanism (SIM) scores, which will be used by Ofwat to assess standards of company performance over the regulatory period 2015-20.

Corporate governance report

Tax policies and objectives

Consistent with our wider business objectives we are committed to acting in a responsible manner in relation to our tax affairs.

Our tax policies and objectives, which are approved by the board on an annual basis, ensure that we:

- only engage in reasonable tax planning aligned with our commercial activities and we always comply with what we believe to be both the letter and the spirit of the law;
- do not engage in aggressive or abusive tax avoidance;
- are committed to an open, transparent and professional relationship with HMRC based on mutual trust and collaborative working; and
- maintain a robust governance and risk management framework to ensure that these policies and objectives are applied at all levels.

In line with the above, we expect to fully adhere to the new HMRC framework for co-operative compliance.

Under the regulatory framework the group operates within, the majority of any benefit from reduced tax payments will typically not be retained by the group but will pass to customers via reduced bills.

In any given year, the group's effective cash tax rate on underlying profits may fluctuate from the standard UK rate due to the available tax deductions on capital investment and pension contributions. These deductions are achieved as a result of utilising tax incentives, which have been explicitly put in place by successive governments precisely to encourage such investment. This reflects responsible corporate behaviour in relation to tax.

Consistent with the group's general risk management framework, any tax risks are assessed for the likelihood of occurrence and the negative financial or reputational impact on the group and its objectives, should the event occur. In any given period, the key tax risk is likely to be the introduction of unexpected legislative or tax practice changes which lead to increased cash outflow which has not been reflected in the current regulatory settlement. The group is committed to actively engaging with relevant authorities in order to manage any such risk.

The group operates solely in the UK, its customers are solely based here, and all of the group's profits are taxable in the UK.

In addition to corporation tax, the group pays and bears significant further annual economic contributions, totalling around £140 million per annum, in the form of business rates, employer's national insurance contributions, environmental taxes and other regulatory service fees, such as water abstraction charges.

We expect the above details, which apply for both financial years ending 31 March 2017 and 31 March 2018, to fully comply with the new legislative requirements for "Publication of Group Tax Strategies" for UK groups.

Directors' report

The directors present their management report and the audited financial statements for the year ended 31 March 2017.

Profit and dividends

The results for the year, set out in the consolidated income statement on page 76 show that profit for the year after tax was £387.8 million (2015: £387.5 million).

The directors have not recommended a final ordinary dividend (2016: £nil). Interim ordinary dividends of £229.7 million have been declared and paid during the year (2016: £186.1 million), in addition to an £18.4 million dividend in specie arising as a result of the transfer of the group's non-household retail business, representing the value of the assets transferred.

Business model

A description of the group's business model can be found within the Strategic Report earlier on within this annual report.

United Utilities Water Limited ("UUW") is a subsidiary of United Utilities North West Limited. The ultimate parent company of UUW is United Utilities Group PLC ("UUG").

Corporate governance report

The corporate governance report on pages 45 to 66 including the remuneration report is hereby incorporated into this directors' report by reference. A copy of the 2014 UK Corporate Governance Code (the Code) as published by the Financial Reporting Council can be found at *https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf.*

Political and charitable donations

The group does not support any political party and does not make what are commonly regarded as donations to any political party or other political organisations. However, the wide definition of donations in the Political Parties, Elections and Referendums Act 2000 covers activities which form part of the necessary relationship between the group and our political stakeholders. This includes promoting United Utilities' activities at the main political parties' annual conferences, and occasional stakeholder engagement in Westminster.

The group incurred expenditure of £11,298 (2016: £5,360) as part of this process. At the 2016 UUG AGM, an authority was taken to cover such expenditure. A similar resolution will be put to the UUG shareholders at the 2017 AGM to authorise such expenditure.

Research and development

The group undertakes research primarily to provide improved standards of service to customers, together with continuing improvements in business efficiency. Its intention is to strengthen its understanding of science and technology in relation to its range of wastewater and water treatment processes to ensure that treatment plants are able to meet the required current and future standards of environmental performance whilst being operated in a cost-effective and efficient manner.

The group is a member of a number of collaborative research programmes including UK Water Industry Research and Water Research Centre, both of which address common issues that face the UK water industry. The group also undertakes specific projects with these and other research and development providers, manufacturers and with universities.

Research and development incurred by the group and charged to the income statement was £2.3 million in the year ended 31 March 2017 (2016: £2.3 million).

Directors' report

Events after the balance sheet date

There were no events arising after the reporting date that require recognition or disclosure in the financial statements for the year ended 31 March 2017.

Going concern basis of accounting

The directors' considerations in preparing these financial statements on a going concern basis of accounting are set out in the corporate governance report and in the accounting policies note to the financial statements.

Directors

The directors who held office during the year and to date are given below:

Non-executive directors

Dr John McAdam
Dr Catherine Bell (stepped down 22 July 2016)
Stephen Carter
Mark Clare
Alison Goligher (appointed 1 August 2016)
Brian May
Sara Weller

Executive directors

Steve Mogford
Steve Fraser
Russ Houlden

Secretary

Simon Gardiner

At no time in the year did any director have a material interest in any contract or arrangement which was significant in relation to the group's business.

Directors' indemnities and insurance

The group has in place contractual entitlements for the directors of the company to claim indemnification by the company in respect of certain liabilities which might be incurred by them in the course of their duties as directors. These arrangements, which constitute qualifying third party indemnity provision and qualifying pension scheme indemnity provision, have been established in compliance with the relevant provisions of the Companies Act 2006 and have been in force throughout the financial year. They include provision for the group to fund the costs incurred by directors in defending certain claims against them in relation to their duties as directors of the company or its subsidiaries. The group also maintains an appropriate level of directors' and officers' liability insurance.

Employment policies

Our policies on maternity, paternity, adoption, personal and special leave go beyond the minimum required by law. For disabled applicants and existing employees, we are committed to fulfilling our obligations in accordance with the relevant legislation. Applicants with disabilities are given equal consideration in the application process. Disabled colleagues have equipment and working practices modified for them as far as is possible and wherever it is safe and practical to do so. A copy of our business principles can be found at corporate.unitedutilities.com/documents/Our_Business_Principles.pdf, which explains the way in which we do business and make it clear that our employees must seek to act with integrity and fairness and observe legal requirements. Anyone with serious concerns that the company may not be adhering to these principles is encouraged to speak up via their line manager or through

Directors' report

a confidential telephone line. Importance is placed on strengthening employees' engagement, measuring their views annually, then taking action to improve how they feel about the company and understand its direction. Employees are provided with regular information to enable them to understand the financial and economic factors affecting the company's performance. Employees are encouraged to hold shares in UUG through the all employee share incentive plan. Information on the average number of employees can be found in note 2 on page 86.

Financial instruments

The risk management objectives and policies of the group in relation to the use of financial instruments can be found in note A5 to the financial statements.

Share capital

At 31 March 2017, the issued ordinary share capital of the company was £100.0 million divided into 100,000,000 ordinary shares of £1.00 each. Details of our share capital and movements in our issued share capital are shown in note 18 to the financial statements on page 98.

All our ordinary shares have the same rights, including the rights to one vote at any of our general meetings, to an equal proportion of any dividends we declare and pay, and to an equal amount of any surplus assets which are distributed in the event of a winding-up.

Disclosure of information to the auditor

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

1. so far as he or she is aware, there is no relevant audit information of which the group's auditor is unaware; and

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

This confirmation is given, and should be interpreted, in accordance with the provisions of section 418 of the Companies Act 2006.

Auditor

Pursuant to Section 487 of the Companies Act 2006, the auditor will be deemed to be reappointed and KPMG LLP will therefore continue in office. The remuneration of the auditor will be agreed by the UUG Audit Committee.

Approved by the board and signed on its behalf by:

Russ Houlden
Chief Financial Officer

9 June 2017

Statement of directors' responsibilities in respect of the annual report and the financial statements

The directors are responsible for preparing the annual report and the group and parent company financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare group and parent company financial statements for each financial year. Under that law they have elected to prepare the group financial statements in accordance with IFRSs as adopted by the EU and applicable law and have elected to prepare the parent company financial statements on the same basis.

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 parent company and of their profit or loss for that period. In preparing each of the group and parent company financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the group and the parent company will continue in business.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the parent company's transactions and disclose with reasonable accuracy at any time the financial position of the parent company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the group and to prevent and detect fraud and other irregularities.

Under applicable law and regulations, the directors are also responsible for preparing a Strategic Report, Directors' Report, Directors' Remuneration Report and Corporate Governance Statement that complies with that law and those regulations.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Responsibility statement of the directors in respect of the annual financial report

We confirm that to the best of our knowledge:

- the financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the assets, liabilities, financial position and profit or loss of the company and the undertakings included in the consolidation taken as a whole; and
- the strategic report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

We consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the group's position and performance, business model and strategy.

Signed on behalf of the board:

Russ Houlden
Chief Financial Officer

9 June 2017

Independent auditor's report

to the members of United Utilities Water Limited only

Opinions and conclusions arising from our audit

1. Our opinion on the financial statements is unmodified

We have audited the financial statements of United Utilities Water Limited for the year ended 31 March 2017 set out on pages 76 to 129. 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 2017 and of the group's and the parent company's profit for the year then ended;
- the group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU);
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

2. Our assessment of risks of material misstatement

In arriving at our audit opinion above on the financial statements, the risks of material misstatement that had the greatest effect on our audit, in decreasing order of audit significance, were as follows. We no longer consider derivative financial instrument valuations to be a significant risk of material misstatement on the basis that the valuations performed are mechanistic in nature and, although they are cumulatively a large balance, the risk of an error within the balance is relatively low.

<table>
<tr><td colspan="2">Revenue recognition and provision for customer debts

Revenue: £1,680.3 million (2016: £1,691.7 million) Provision for customer debts: £85.3 million (2016: £94.3 million)

Refer to pages 82 and 123 (accounting policy), and page 93 (financial disclosures).</td></tr>
<tr><td>The Risk

Subjective estimation:

A proportion of the group's customers do not, or cannot, pay their bills, which results in the need for provisions to be made for non-payment of the customer balance. Due to the level of judgement and complexity of the calculation, which could lead to revenue and provision for customer debt being misstated, this is considered a key audit risk.

Significant judgement is required when recognising revenue for services that are billed that relate to properties where either the</td><td>Our Response

Our procedures included:

Accounting analysis: comparison of policy with relevant accounting standards and industry practice, including the policy of not recognising revenue where it is not probable that cash will be received. Then through observation of processes assessing whether appropriate revenue recognition policies have been applied in practice;

Control observation: testing the group's controls over revenue recognition and provision for customer debts, including</td></tr>
</table>

Independent auditor's report

to the members of United Utilities Water Limited only

occupier cannot be identified or where a past history of non-payment of bills exists and therefore there is uncertainty over the probability of these bills being settled. Further, an estimate is required of revenue for the value of water supplied to metered customers between the last meter reading and the period end.	reconciliations between sales and cash receipts systems and the general ledger; **Methodology choice**: assessing the appropriateness of the customer debt provisioning based on historical cash collections, credits, re-bills and write-off information; **Tests of details**: assessing the assumptions used to calculate the metered accrued income by considering whether inputs to the calculation have been derived appropriately and recalculating the accrued income with the support of our own modelling specialists; and **Assessing transparency:** assessing the adequacy of the group's disclosures of its revenue recognition and customer debt provisioning policies, including the estimation uncertainty involved in recording revenue and the bad debt provision.
Capital expenditure £705.6 million (2016: £633.7 million) *Refer to pages 82 and 124 to 125 (accounting policy), and pages 91 to 92 (financial disclosures).*	
The Risk **Accounting treatment:** The group has a substantial capital programme which has been agreed with the Water Services Regulation Authority (Ofwat) and therefore incurs significant annual expenditure in relation to the development and maintenance of both infrastructure and non-infrastructure assets. The determination of project costs as capital or operating expenditure is inherently judgemental as there is a need to distinguish between enhancement and maintenance works. Costs capitalised include an allocation of overhead costs, relating to the proportion of time spent by support function staff, which is also inherently judgemental.	**Our Response** **Our procedures included:** **Accounting analysis:** assessing the group's capitalisation policy for compliance with relevant accounting standards; **Control observation:** testing controls over the application of the policy in the period including assessment of project business case submissions and attending capital approval meetings to observe the judgements made and evaluating the documented conclusions; **Tests of details:** critically assessing the costs capitalised for a sample of projects against the capitalisation policy; **Tests of details:** identify and assess the impact of in year changes to capitalisation rates and for all existing projects, as once set they are typically unchanged period to period; **Historical comparisons:** critically assess the

Independent auditor's report

to the members of United Utilities Water Limited only

	proportion of overhead costs by business area which are capitalised using historical comparisons and expected changes based on corroborated enquiry and our sector knowledge; and **Assessing transparency**: assessing the adequacy of the group's disclosures of its capitalisation policy and other related disclosures.
Retirement benefit surplus £194.5 million (2016: £226.9 million) *Refer to pages 83 and 128 to 129 (accounting policy), and pages 95 to 96 (financial disclosures).*	
The Risk	**Our Response**
Subjective estimation: Significant estimates are made in valuing the group's retirement benefit obligation. Small changes in assumptions and estimates used to value the group's pension obligation would have a significant effect on the group's financial position.	**Our procedures included:** **Benchmarking assumptions**: challenging the key assumptions supporting the group's retirement benefit obligations valuation with input from our own actuarial specialists, including comparing the discount rate, inflation rate, salary, pension increase rates and life expectancy assumptions used against externally derived data; and **Assessing transparency:** assessing the group's disclosure in respect of the sensitivity of the surplus to changes in the key assumptions.

3. Our application of materiality and an overview of the scope of our audit

Materiality for the group financial statements as a whole was set at £18.5 (2016: £19.0m), determined with reference to a benchmark of profit before taxation, normalised to exclude net fair value losses on debt and derivative instruments (see Note 5). Materiality represents 4.6 per cent (2016: 4.6 per cent) of normalised profit before tax. Specific audit procedures have been performed over items excluded from the normalised profit before tax. We report to the audit committee any corrected or uncorrected identified misstatements exceeding £0.5 million (2016: £0.5 million), in addition to other identified misstatements that warrant reporting on qualitative grounds.

4. Our opinion on the other matter prescribed by the Companies Act 2006 is unmodified

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006;

Independent auditor's report

to the members of United Utilities Water Limited only

- the information given in the Strategic Report and the Directors' Report for the financial year is consistent with the financial statements; and
- the information given in the Corporate Governance Statement set out on pages 53 to 54 with respect to internal control and risk management systems in relation to financial reporting processes and about share capital structures ("the specified Corporate Governance information") is consistent with the financial statements.

Based solely on the work required to be undertaken in the course of the audit of the financial statements and from reading the Strategic Report, the Directors' Report and the Corporate Governance Statement:

- we have not identified material misstatements in the Strategic Report, the Directors' Report, or the specified Corporate Governance information;
- in our opinion, the Strategic Report and the Directors' Report have been prepared in accordance with the Companies Act 2006; and
- in our opinion, the Corporate Governance Statement has been prepared in accordance with rules 7.2.2, 7.2.3, 7.2.5, 7.2.6 and 7.2.7 of the Disclosure Rules and Transparency Rules of the Financial Conduct Authority.

5. We have nothing to report on the disclosures of principal risks

Based on the knowledge we acquired during our audit, we have nothing material to add or draw attention to in relation to:

- the directors' statement of long-term viability on page 54, concerning the principal risks, their management, and, based on that, the directors' assessment and expectations of the group's continuing in operation over the 5 years to March 2022; or
- the disclosures in note 1 of the financial statements concerning the use of the going concern basis of accounting.

6. We have nothing to report in respect of the matters on which we are required to report by exception

Under ISAs (UK and Ireland) we are required to report to you if, based on the knowledge we acquired during our audit, we have identified other information in the annual report that contains a material inconsistency with either that knowledge or the financial statements, a material misstatement of fact, or that is otherwise misleading.

In particular, we are required to report to you if:

- we have identified material inconsistencies between the knowledge we acquired during our audit and the directors' statement that they consider that the annual report and financial statements taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the group's position and performance, business model and strategy; or
- the audit committee section of the Corporate Governance Report does not appropriately address matters communicated by us to the audit committee.

Under the Companies Act 2006 we are required 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

Independent auditor's report

to the members of United Utilities Water Limited only

- the parent company financial statements and the part of the Directors' Remuneration Report to be audited 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.

Under the Listing Rules we are required to review:

- the directors' statements, set out on pages 53 and 54, in relation to going concern and longer-term viability; and
- the part of the Corporate Governance Statement on pages 45 to 66 relating to the company's compliance with the eleven provisions of the 2014 UK Corporate Governance Code specified for our review.

We have nothing to report in respect of the above responsibilities.

Scope and responsibilities

As explained more fully in the Directors' Responsibilities Statement set out on page 70, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate. This report is made solely to the company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2014a, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

William Meredith (Senior Statutory Auditor)

for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
St Peter's Square, Manchester M2 3AE
9th June 2017

Consolidated income statement

for the year ended 31 March

	Note	2017 £m	2016 £m
Revenue	1	1,680.3	1,691.7
Employee benefits expense	2	(145.9)	(140.4)
Other operating costs	3	(417.2)	(446.0)
Other income	3	4.1	3.0
Depreciation and amortisation expense	3	(363.7)	(363.7)
Infrastructure renewals expenditure		(150.8)	(169.3)
Total operating expenses		(1,073.5)	(1,116.4)
Operating profit		606.8	575.3
Investment income	4	10.7	4.4
Finance expense	5	(208.0)	(230.9)
Investment income and finance expense		(197.3)	(226.5)
Profit before tax		409.5	348.8
Current tax charge	6	(45.5)	(49.4)
Deferred tax charge	6	(34.0)	(23.8)
Deferred tax credit – change in tax rate	6	57.8	111.9
Tax	6	(21.7)	38.7
Profit after tax		387.8	387.5

All of the results shown above relate to continuing operations.

Consolidated statement of comprehensive income

for the year ended 31 March

	Note	2017 £m	2016 £m
Profit after tax		387.8	387.5
Other comprehensive income			
Remeasurement (losses)/gains on defined benefit pension schemes	14	(70.5)	124.6
Tax on items taken directly to equity	6	15.4	(20.4)
Total comprehensive income		332.7	491.7

None of the items in the table above will be prospectively reclassified to profit or loss.

Consolidated and company statement of financial position

at 31 March

Group and company

	Note	2017 £m	2016 £m
ASSETS			
Non-current assets			
Property, plant and equipment	9	10,361.0	9,997.9
Intangible assets	10	187.7	162.4
Investments	A1	0.1	0.1
Trade and other receivables	11	100.0	-
Retirement benefit surplus	14	194.5	226.9
Derivative financial instruments	A5	544.0	624.1
		11,387.3	11,011.4
Current assets			
Inventories		9.0	9.9
Trade and other receivables	11	343.2	406.2
Cash and short-term deposits	12	196.9	204.3
Derivative financial instruments	A5	76.2	-
Assets classified as available for distribution	8	-	18.3
		625.3	638.7
Total assets		12,012.6	11,650.1
LIABILITIES			
Non-current liabilities			
Trade and other payables	17	(587.9)	(529.3)
Borrowings	13	(7,079.8)	(6,589.4)
Deferred tax liabilities	15	(1,016.6)	(1,048.2)
Derivative financial instruments	A5	(235.5)	(255.8)
		(8,919.8)	(8,422.7)
Current liabilities			
Trade and other payables	17	(309.5)	(326.2)
Borrowings	13	(384.4)	(600.7)
Current tax liabilities		(15.4)	(18.6)
Provisions	16	(22.9)	(14.9)
Derivative financial instruments	A5	(14.2)	(5.2)
		(746.4)	(965.6)
Total liabilities		(9,666.2)	(9,388.3)
Total net assets		2,346.4	2,261.8
EQUITY			
Capital and reserves attributable to equity holders of the company			
Share capital	18	100.0	100.0
Retained earnings		2,246.4	2,161.8
Shareholder's equity		2,346.4	2,261.8

These financial statements for the group and United Utilities Water Limited (company number: 2366678) were approved by the board of directors and authorised for issue on 9 June 2017, and signed on its behalf by:

Russ Houlden
Chief Financial Officer

Consolidated and company statement of changes in equity

for the year ended 31 March

Group and company

	Share capital £m	Retained earnings £m	Total £m
At 1 April 2016	100.0	2,161.8	2,261.8
Profit after tax	-	387.8	387.8
Other comprehensive (expense)/income			
Remeasurement losses on defined benefit pension schemes (see note 14)	-	(70.5)	(70.5)
Tax on items taken directly to equity (see note 6)	-	15.4	15.4
Total comprehensive income	-	332.7	332.7
Dividends (see note 7)	-	(248.1)	(248.1)
At 31 March 2017	100.0	2,246.4	2,346.4

	Share capital £m	Retained earnings £m	Total £m
At 1 April 2015	100.0	1,856.2	1,956.2
Profit after tax	-	387.5	387.5
Other comprehensive income/(expense)			
Remeasurement gains on defined benefit pension schemes (see note 14)	-	124.6	124.6
Tax on items taken directly to equity (see note 6)	-	(20.4)	(20.4)
Total comprehensive income	-	491.7	491.7
Dividends (see note 7)	-	(186.1)	(186.1)
At 31 March 2016	100.0	2,161.8	2,261.8

As permitted by section 408 of the Companies Act 2006, the company has not presented its own income statement. The results of the company are the same as the group.

Consolidated and company statement of cash flows

for the year ended 31 March

Group and company

	Note	2017 £m	2016 £m
Operating activities			
Cash generated from operations	A2	1,007.1	893.3
Interest paid		(161.9)	(173.9)
Interest received and similar income		3.6	1.6
Tax paid		(42.4)	(26.4)
Tax received		1.2	-
Net cash generated from operating activities		807.6	694.6
Investing activities			
Purchase of property, plant and equipment		(658.7)	(603.2)
Purchase of intangible assets		(52.4)	(66.1)
Proceeds from sale of property, plant and equipment		4.0	1.4
Grants and contributions received	17	29.0	17.3
Loans to related parties	A7	(100.0)	-
Net cash used in investing activities		(778.1)	(650.6)
Financing activities			
Proceeds from borrowings		675.8	658.1
Repayment of borrowings		(478.6)	(498.9)
Dividends paid to equity holders of the company	7	(229.7)	(186.1)
Net cash used in financing activities		(32.5)	(26.9)
Net (decrease)/increase in cash equivalents		(3.0)	17.1
Cash and cash equivalents at beginning of the year		173.6	156.5
Cash and cash equivalents at end of the year	12	170.6	173.6

Accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below. Further detail can be found in note A8.

Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU). They have been prepared on the historical cost basis, except for the revaluation of financial instruments, accounting for the transfer of assets from customers and the revaluation of infrastructure assets to fair value on transition to IFRS.

The preparation of financial statements, in conformity with IFRS, requires management to make estimates and assumptions that affect the amounts of assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting periods presented. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results ultimately may differ from these estimates.

The financial statements have been prepared on the going concern basis as the directors have a reasonable expectation that the group has adequate resources for a period of at least 12 months from the date of the approval of the financial statements, and that there are no material uncertainties to disclose.

In assessing the appropriateness of the going concern basis of accounting, the directors have reviewed the resources available to the group, taking account of the group's financial projections, together with available cash and committed borrowing facilities as well as consideration of the group's capital adequacy, consideration of the primary legal duty of United Utilities Water Limited (UUW) economic regulator to ensure that water and wastewater companies can finance their functions, and any material uncertainties. The board has also considered the magnitude of potential impacts resulting from uncertain future events or changes in conditions, the likelihood of their occurrence and the likely effectiveness of mitigating actions that the directors would consider undertaking.

Adoption of new and revised standards

The following standards, interpretations and amendments, effective for the year ended 31 March 2017, have had no material impact on the group's financial statements:

- amendments to IAS 1 'Disclosure Initiative', in respect of improved financial statement disclosures;
- amendments to IFRS 11 'Accounting for Acquisitions of Interests in Joint Operations'; requiring business combination accounting to be applied; and
- improvements to IFRS (2014), comprising a collection of narrow-scope amendments across a number of standards.

Critical accounting judgements and key sources of estimation uncertainty

In the process of applying its accounting policies set out in note A8, the group is required to make certain estimates, judgements and assumptions that it believes are reasonable based on the information available. These judgements, estimates and assumptions affect the amounts of assets and liabilities at the date of the financial statements and the amounts of revenues and expenses recognised during the reporting periods presented. Changes to these estimates, judgements and assumptions could have a material effect on the financial statements.

On an ongoing basis, the group evaluates its estimates using historical experience, consultation with experts and other methods considered reasonable in the particular circumstances. Actual

Accounting policies

results may differ significantly from the estimates, the effect of which is recognised in the period in which the facts that give rise to the revision become known.

The following paragraphs detail the estimates and judgements the group believes to have the most significant impact on the annual results under IFRS.

Revenue recognition and allowance for doubtful receivables

Accounting judgement - the group recognises revenue generally at the time of delivery and when collection of the resulting receivable is reasonably assured. When the group considers that the criteria for revenue recognition are not met for a transaction, revenue recognition is delayed until such time as collectability is reasonably assured. Payments received in advance of revenue recognition are recorded as deferred income.

Accounting estimate - at each reporting date, the company and each of its subsidiaries evaluate the estimated recoverability of trade receivables and record allowances for doubtful receivables based on experience. Judgements associated with these allowances are based on, amongst other things, a consideration of actual collection history. The actual level of receivables collected may differ from the estimated levels of recovery, which could impact operating results positively or negatively.

Accounting estimate – the company raises bills in accordance with its entitlement to receive revenue in line with the limits established by the periodic regulatory price review processes. For water and wastewater customers with water meters, the receivable billed is dependent on the volume supplied including the sales value of an estimate of the units supplied between the date of the last meter reading and the billing date. Meters are read on a cyclical basis and the group recognises revenue for unbilled amounts based on estimated usage from the last billing through to each reporting date. The estimated usage is based on historical data, judgement and assumptions; actual results could differ from these estimates, which would result in operating revenues being adjusted in the period that the revision to the estimates is determined. For customers who do not have a meter, the receivable billed and revenue recognised is dependent on the rateable value of the property, as assessed by an independent rating officer.

Property, plant and equipment

Accounting judgement - the group recognises property, plant and equipment (PPE) on its water and wastewater infrastructure assets where such expenditure enhances or increases the capacity of the network, whereas any expenditure classed as maintenance is expensed in the period it is incurred. Determining enhancement from maintenance expenditure requires an accounting judgement, particularly when projects have both elements within them. In addition, management capitalises time and resources incurred by the group's support functions on capital programmes, which requires accounting judgements to be made in relation to the appropriate capitalisation rates.

Accounting estimate - the estimated useful economic lives of PPE are based on management's experience. When management identifies that actual useful economic lives differ materially from the estimates used to calculate depreciation, that charge is adjusted prospectively. Due to the significance of PPE investment to the group, variations between actual and estimated useful economic lives could impact operating results both positively and negatively and, as such, this is a key source of estimation uncertainty, although historically few changes to estimated useful economic lives have been required.

Accounting estimate - the group is required to evaluate the carrying values of PPE for impairment whenever circumstances indicate, in management's view, that the carrying value of such assets may not be recoverable. An impairment review requires management to make uncertain estimates concerning the cash flows, growth rates and discount rates of the cash generating units under review.

Accounting policies

Retirement benefits

Accounting estimate - the group operates two defined benefit schemes which are independent of the group's finances. Actuarial valuations of the schemes are carried out as determined by the trustees at intervals of not more than three years. The pension cost under IAS 19 'Employee Benefits' is assessed in accordance with the advice of a firm of actuaries based on the latest actuarial valuation and assumptions determined by the actuary, which are used to estimate the present value of defined benefit obligations. The assumptions are based on information supplied to the actuary by the company, supplemented by discussions between the actuary and management. The assumptions are disclosed in note A6.

Accounting estimate - profit before tax and net assets are affected by the actuarial assumptions used. The key assumptions include: discount rates, pay growth, mortality and increases to pensions in payment and deferred pensions. It should be noted that actual rates may differ from the assumptions used due to changing market and economic conditions and longer or shorter lives of participants and, as such, this represents a key source of estimation uncertainty.

Tax

Accounting judgement - assessing the outcome of uncertain tax positions requires judgements to be made regarding the application of tax law and the result of negotiations with, and enquiries from, the tax authorities.

Derivative financial instruments

Accounting estimate - the model used to fair value the group's derivative financial instruments requires management to estimate future cash flows based on applicable interest rate curves. Projected cash flows are then discounted back using discount factors which are derived from the applicable interest rate curves adjusted for management's estimate of counterparty and own credit risk, where appropriate.

Provisions and contingencies

Accounting judgements - the group is subject to a number of claims incidental to the normal conduct of its business, relating to and including commercial, contractual, employment and environmental matters, which are handled and defended in the ordinary course of business. The group routinely assesses the likelihood of any adverse judgements or outcomes to these matters as well as ranges of probable and reasonably estimated losses.

Accounting estimates - reasonable estimates are made by management after considering information including notifications, settlements, estimates performed by independent parties and legal counsel, available facts, identification of other potentially responsible parties and their ability to contribute, and prior experience. A provision is recognised when it is probable that an obligation exists for which a reliable estimate can be made after careful analysis of the individual matter. The required provision may change in the future due to new developments and as additional information becomes available. Matters that either are possible obligations or do not meet the recognition criteria for a provision are disclosed as contingent liabilities in note 20, unless the possibility of transferring economic benefits is remote.

New and revised standards not yet effective

At the date of authorisation of these financial statements, the following relevant major standards were in issue but not yet effective. The directors anticipate that the group will adopt these standards on their effective dates.

Accounting policies

IFRS 9 'Financial Instruments'

The standard is effective for periods commencing on or after 1 January 2018. Under the provisions of this standard, where the group has chosen to measure borrowings at fair value through profit or loss, the portion of the change in fair value due to changes in the group's own credit risk will be recognised in other comprehensive income rather than within profit or loss. If this standard had been adopted in the current year, a £11.9 million loss would have been recognised in other comprehensive income rather than within the income statement.

The standard also broadens the scope of what can be included within a hedge relationship, which may enable the group's regulatory swaps to be designated within cash flow hedge relationships. If the standard had been adopted in the current year, with all such swaps being designated and all hedges being fully effective, £0.8 million of fair value losses would have been recognised in other comprehensive income rather than within the income statement.

In addition, the standard requires entities to use an expected credit loss model for impairment of financial assets instead of an incurred credit loss model. This is expected to impact the way in which the group provides for bad and doubtful receivables. Work in this area is ongoing and it is not currently possible to quantify the expected impact as this will be dependent on the design of the model and the economic circumstances at the point of implementation; however, the current expectation is that it is unlikely to have a material impact on the overall level of provisions.

IFRS 15 'Revenue from Contracts with Customers'

The standard is effective for periods commencing on or after 1 January 2018. This standard introduces a new revenue recognition model and replaces IAS 18 'Revenue', IAS 11 'Construction Contracts', IFRIC 13 'Customer Loyalty Programmes', IFRIC 15 'Agreements for the Construction of Real Estate', IFRIC 18 'Transfer of Assets from Customers' and SIC-31 'Revenue – Barter Transactions Involving Advertising Services'. While the introduction of IFRS 15 is expected to have a significant impact for many companies, the directors have carefully considered the potential effects in the context of the group's revenues and have concluded that on adoption there will be no significant changes to the way in which the group's performance obligations to customers are identified or deemed to be satisfied and, therefore, no material impact on the revenues recognised in the financial statements.

IFRS 16 'Leases'

The standard is effective for periods commencing on or after 1 January 2019 but has not yet been endorsed by the EU. Under the provisions of the standard most leases, including the majority of those previously classified as operating leases, will be brought onto the statement of financial position, as both a right-of-use asset and a largely offsetting lease liability. The right-of-use asset and lease liability are both based on the present value of lease payments due over the term of the lease, with the asset being depreciated in accordance with IAS 16 'Property, Plant and Equipment' and the liability increased for the accretion of interest and reduced by lease payments.

If the standard had been adopted in the current year a depreciation charge of around £4 million in relation to the right-of-use asset and a finance expense charge of around £1 million would have been recognised in the income statement in place of the operating lease charge of £4.4 million. In addition, a right-of-use asset and largely offsetting lease liability of around £105 million would be recognised in the statement of financial position, assuming application of the modified retrospective transitional approach as permitted by the standard and current incremental costs of borrowing. The actual impact on adoption will be sensitive to the incremental costs of borrowing at the 1 April 2019 application date.

All other standards, interpretations and amendments, which are in issue but not yet effective, are not expected to have a material impact on the group's financial statements.

Notes to the financial statements

1. Revenue and segment reporting

The group's revenue arises from the provision of services within the United Kingdom.

The group has a large and diverse domestic retail customer base with no significant reliance on any single customer in this area. Following the sale of the group's non-household business on 26 May 2016 (see note 8), £402.7 million (2016: £nil) of the group's revenue from wholesale water and wastewater services during the year was derived from sales to Water Plus Group Limited (Water Plus), a joint venture formed during the year between United Utilities PLC and Severn Trent PLC, and its subsidiaries. Please see notes A5 and A7 for further details.

The group operates and is managed as one class of business, which is the provision of water and wastewater services, therefore no segmental information is required to be disclosed.

2. Directors and employees

Directors' remuneration	2017 £m	2016 £m
Fees to non-executive directors	0.7	0.6
Salaries	1.5	1.5
Benefits	0.4	0.4
Bonus	0.7	0.5
Share-based payment charge	1.8	1.1
	5.1	4.1

Included within the above are aggregate emoluments of £2.2 million (2016: £1.8 million) in respect of the highest paid director. The highest paid director exercised share options during the current year.

A recharge of £0.3 million during the year ended 31 March 2017 (2016: £0.3 million) was charged to other companies in the United Utilities group in relation to the provision of director services. No executive directors accrued benefits under defined benefit schemes, and all executive directors opted for a cash allowance in lieu of their defined contribution pension entitlement during the current and prior year.

Three directors (2016: three directors) received shares in United Utilities Group PLC in respect of qualifying services, and one director (2016: three directors) exercised nil-cost share options in United Utilities Group PLC during the year. Three directors (2016: three directors) had long-term incentive plans which vested during the year. Aggregate amounts receivable of £2.4 million (2016: £2.4 million), were recognised during the year relating to long-term incentive plans.

Remuneration of key management personnel

	2017 £m	2016 £m
Salaries and short-term employee benefits	5.5	4.9
Post-employment benefits	0.1	0.1
Share-based payment charge	2.6	1.8
	8.2	6.8

Key management personnel comprises all directors and certain senior managers who are members of the executive team.

Notes to the financial statements

2. Directors and employees (continued)

Employee benefits expense (including directors)

	2017 £m	2016 £m
Wages and salaries	219.6	212.5
Social security	21.7	19.1
Severance	7.0	(0.2)
Post-employment benefits:		
Defined benefit pension expense (see note 14)	22.8	23.3
Defined contribution pension expense (see note 14)	11.2	9.9
	34.0	33.2
Employee benefits expense before recharges	282.3	264.6
Amounts recharged to parent and fellow subsidiary companies	(3.4)	(3.7)
Amounts recharged to related parties at nil margin under transitional service agreements (see note A7)	(4.0)	-
Charged to regulatory capital schemes	(129.0)	(120.5)
Employee benefits expense	145.9	140.4

Within employee benefits expense were £9.8 million (2016: £0.7 million) of restructuring costs.

A recharge of £7.4 million during the year ended 31 March 2017 (2016: £3.7 million) was charged to other companies in the UUG group in relation to the provision of employee services.

Options over shares of the ultimate parent undertaking, United Utilities Group PLC, have been granted to employees of the company under various schemes. Details of the terms and conditions of each share option scheme are given in the 2017 UUG annual report. Included within wages and salaries is an expense of £3.3 million (2016: £2.3 million) relating to a recharge of share-based payment costs from the ultimate parent undertaking (see note A7).

Average number of employees during the year (full time equivalent including directors)

	2017 number	2016 number
Average number of employees during the year	5,098	5,054

The 2017 total employee benefits expense, before recharges, of £282.3 million (2016: £264.6 million) includes the employee costs relating to the persons employed during the year noted above in addition to costs of £16.2 million (2016: £15.4 million) in relation to services provided by employees of United Utilities PLC who support UUW. These costs have been incurred directly by UUW throughout the year but relate to employees of United Utilities PLC. The average number of employees of United Utilities PLC providing services to the company during the year was 212 (2016: 211).

Notes to the financial statements

3. Operating profit

	2017 £m	2016 £m
Other operating costs		
Hired and contracted services	98.2	105.8
Property rates	91.2	86.5
Power	70.5	65.0
Materials	67.5	67.1
Charge for bad and doubtful receivables (see note 11)	29.8	39.1
Regulatory fees	28.6	27.9
Legal and professional expenses	4.0	4.3
Operating leases payable:		
Property	3.6	4.0
Plant and equipment	0.6	0.8
Loss on disposal of property, plant and equipment	3.3	5.4
Impairment of property, plant and equipment (see note 9)	0.2	11.4
Amortisation of deferred grants and contributions (see note 17)	(6.7)	(6.9)
Compensation from insurers	(12.3)	(20.1)
Other expenses	38.7	55.7
	417.2	446.0
Other income		
Other income	(4.1)	(3.0)
	(4.1)	(3.0)
Depreciation and amortisation expense		
Depreciation of property, plant and equipment (see note 9)	335.0	332.5
Amortisation of intangible assets (see note 10)	28.7	31.2
	363.7	363.7

As a result of two significant flooding incidents caused by Storms Desmond and Eva in December 2015, there were £13.8 million (2016: £19.5 million) of expenses incurred, comprising £11.1 million (2016: £7.0 million) of operating costs, £2.5 million (2016: £1.1 million) of infrastructure renewals expenditure, and a £0.2 million (2016: £11.4 million) impairment of property, plant and equipment. Insurance compensation of £12.3 million (2016: £20.1 million) relating to the flooding incidents has been recognised and the group expects there to be further recovery of the flooding incident costs under its insurance cover in the year ending 31 March 2018, as further remedial work is undertaken.

In addition, there were £5.8 million (2016: £11.1 million) of market reform restructuring costs incurred in preparing the business for competition in the non-household retail market and £nil (2016: £24.8 million) of costs relating to a large water quality incident, largely comprising customer compensation payments included within other expenses.

Total other operating costs are stated net of £14.5 million (2016: £nil) of costs recharged to Water Plus at nil margin under transitional service agreements.

Research and development expenditure for the year ended 31 March 2017 was £2.3 million (2016: £2.3 million).

During the year, the group obtained the following services from its auditor, with a total value of £297,000 (2016: £350,000), which are broken down as follows:

	2017 £'000	Re-presented* 2016 £'000
Audit services		
Statutory audit – group and company	200	170
Statutory audit – subsidiary	16	15
	216	185

Notes to the financial statements

3. Operating profit (continued)

	2017 £'000	Re-presented* 2016 £'000
Non-audit services		
Regulatory audit services provided by the statutory auditor	53	45
Other non-audit services	28	120
	81	165

* Prior year comparatives in the above table have been re-presented to reflect the classification of services provided by the auditor that will be adopted prospectively in accordance with the group audit committee's policy in relation to this area, further details of which can be found within the corporate governance report on page 77 of the 2017 UUG annual report.

4. Investment income

	2017 £m	2016 £m
Interest receivable on short-term bank deposits held at amortised cost	0.8	1.6
Interest receivable on loans to joint ventures of the UUG group held at amortised cost (see note A7)	1.5	-
Net pension interest income (see note 14)	8.4	2.8
	10.7	4.4

5. Finance expense

	2017 £m	2016 £m
Interest payable		
Interest payable on borrowings held at amortised cost(1)	201.3	176.9
Interest payable on borrowings from parent and fellow subsidiary undertakings	2.8	3.9
Preference share dividends (see note 7)	9.1	9.1
	213.2	189.9
Fair value (gains)/losses on debt and derivative instruments(2)		
Fair value hedge relationships:		
Borrowings	26.0	55.2
Designated swaps	(35.8)	(57.6)
	(9.8)	(2.4)
Financial instruments at fair value through profit or loss		
Borrowings designated at fair value through profit or loss(3)	37.5	4.3
Associated swaps(4)	(30.1)	(23.5)
	7.4	(19.2)
Fixed interest rate swaps(4)	0.8	46.2
Electricity swaps(4)	(9.6)	14.2
Net payments on swaps and debt under fair value option	5.9	1.1
Other swaps(4)(5)	(5.0)	(3.0)
Other	5.1	4.1
	(2.8)	62.6
Net fair value (gains)/losses on debt and derivative instruments(6)	(5.2)	41.0
	208.0	230.9

Notes to the financial statements

5. Finance expense (continued)

Notes:

(1) Includes a £80.7 million (2016: £37.9 million) non-cash inflation uplift expense in relation to the group's index-linked debt.

(2) Includes foreign exchange losses of £59.1 million (2016: £48.7 million), excluding those on instruments measured at fair value through profit or loss. These losses are largely offset by fair value gains on derivatives.

(3) Includes a £11.9 million loss (2016: £15.1 million gain) on the valuation of debt reported at fair value through profit or loss due to changes in credit spread assumptions.

(4) These swap contracts are not designated within an IAS 39 hedge relationship and are, as a result, classed as 'held for trading' under the accounting standard. These derivatives form economic hedges and, as such, management intends to hold these through to maturity.

(5) Includes fair value movements in relation to other economic hedge derivatives relating to debt held at amortised cost.

(6) Includes £5.7 million expense (2016: £0.9 million) due to interest on swaps and debt under fair value option.

Interest payable is stated net of £29.2 million (2016: £21.3 million) borrowing costs capitalised in the cost of qualifying assets within property, plant and equipment and intangible assets during the year. This has been calculated by applying a capitalisation rate of 3.0 per cent (2016: 2.7 per cent) to expenditure on such assets as prescribed by IAS 23 'Borrowing Costs'.

6. Tax

	2017 £m	2016 £m
Current tax		
UK corporation tax	53.5	55.1
Adjustments in respect of prior years	(8.0)	(5.7)
Total current tax charge for the year	45.5	49.4
Deferred tax		
Current year	27.9	18.5
Adjustments in respect of prior years	6.1	5.3
	34.0	23.8
Change in tax rate	(57.8)	(111.9)
Total deferred tax credit for the year	(23.8)	(88.1)
Total tax charge/(credit) for the year	21.7	(38.7)

The deferred tax credit of £57.8 million (2016: £111.9 million) reflects the enacted reduction in the headline rate of corporation tax to 17 per cent from 1 April 2020 (2016: 20 per cent to 18 per cent from 1 April 2020). The adjustments in respect of prior years relates to agreement with the tax authorities of prior years' UK tax matters.

Notes to the financial statements

6. Tax (continued)

The table below reconciles the notional tax charge at the UK corporation tax rate to the effective tax rate for the year:

	2017 £m	2017 %	2016 £m	2016 %
Profit before tax	409.5		348.8	
Tax at the UK corporation tax rate	81.9	20.0	69.8	20.0
Adjustments in respect of prior years	(1.9)	(0.5)	(0.4)	(0.1)
Change in tax rate	(57.8)	(14.1)	(111.9)	(32.1)
Net (income)/expense not taxable/other	(0.5)	(0.1)	3.8	1.1
Total tax charge/(credit) and effective tax rate for the year	21.7	5.3	(38.7)	(11.1)

Tax on items taken directly to equity

	2017 £m	2016 £m
Current tax		
Relating to other pension movements	(7.6)	-
	(7.6)	-
Deferred tax (see note 15)		
On remeasurement (losses)/gains on defined benefit pension schemes	(12.7)	24.9
Relating to other pension movements	6.8	-
Change in tax rate	(1.9)	(4.5)
	(7.8)	20.4
Total tax (credit)/charge on items taken directly to equity	(15.4)	20.4

The deferred tax credit of £1.9 million (2016: £4.5 million) reflects the enacted reduction in the headline rate of corporation tax to 17 per cent from 1 April 2020 (2016: 20 per cent to 18 per cent from 1 April 2020).

7. Dividends

Amounts recognised as distributions to equity holders of the company in the year comprise:

	2017 £m	2016 £m
Ordinary shares		
Interim dividend for the year ended 31 March 2016 at 0.7 pence per share (2015: 119.4 pence)	0.7	119.4
Interim dividend for the year ended 31 March 2017 at 128.3 pence per share (2016: 62.2 pence)	128.3	62.2
Interim dividend for the year ended 31 March 2017 at 65.3 pence per share (2016: 4.5 pence)	65.3	4.5
Interim dividend for the year ended 31 March 2017 at 35.4 pence per share (2016: nil pence)	35.4	-
Dividend relating to the transfer of non-household retail business(see note 8)	18.4	-
	248.1	186.1

The directors have not recommended a final ordinary dividend (2016: £nil).

Notes to the financial statements

7. Dividends (continued)

The company's redeemable preference shares are included in the statement of financial position as a liability and, accordingly, dividends payable on them are included in net interest payable (see notes 5 and 13).

On 26 May 2016 the group's non-household retail business was transferred to United Utilities North West Limited, the company's immediate parent. This transfer gave rise to a dividend which represents the value of the assets transferred (see note 8).

8. Disposal of non-household retail business

On 3 May 2016, the Competition and Markets Authority approved the formation of a joint venture, Water Plus, between United Utilities PLC and Severn Trent PLC. On 1 June 2016, United Utilities PLC completed the disposal of its non-household water and wastewater retail business, principally comprising billing and customer service activities, to Water Plus. Prior to this ultimate disposal, the company transferred its non-household retail business to United Utilities North West Limited on 26 May 2016. This transfer gave rise to a dividend which represents the value of the assets transferred (see note 7). This resulted in the disposal of assets that had been classified as available for distribution.

9. Property, plant and equipment

Group and company	Land and buildings £m	Infra-structure assets £m	Operational assets £m	Fixtures, fittings, tools and equipment £m	Assets in course of construction £m	Total £m
Cost						
At 1 April 2015	305.6	4,888.0	6,260.9	490.3	878.8	12,823.6
Additions	4.5	98.0	76.1	7.4	447.7	633.7
Transfers	19.1	134.8	156.5	11.1	(321.5)	-
Disposals	(0.3)	(0.1)	(44.4)	(7.0)	-	(51.8)
At 31 March 2016	328.9	5,120.7	6,449.1	501.8	1,005.0	13,405.5
Additions	6.7	80.1	100.0	10.5	508.3	705.6
Transfers	24.3	42.2	488.9	22.5	(577.9)	-
Disposals	(3.7)	-	(47.9)	(34.4)	-	(86.0)
At 31 March 2017	356.2	5,243.0	6,990.1	500.4	935.4	14,025.1
Accumulated depreciation						
At 1 April 2015	95.6	275.2	2,438.4	299.5	-	3,108.7
Charge for the year	9.1	34.6	249.2	39.6	-	332.5
Impairment	-	-	11.4	-	-	11.4
Disposals	(0.3)	(0.1)	(39.2)	(5.4)	-	(45.0)
At 31 March 2016	104.4	309.7	2,659.8	333.7	-	3,407.6
Charge for the year	10.1	36.1	251.5	37.3	-	335.0
Impairment	-	-	0.2	-	-	0.2
Transfers	-	0.1	0.1	(0.2)	-	-
Disposals	(2.6)	-	(42.9)	(33.2)	-	(78.7)
At 31 March 2017	111.9	345.9	2,868.7	337.6	-	3,664.1
Net book value						
At 31 March 2016	224.5	4,811.0	3,789.3	168.1	1,005.0	9,997.9
At 31 March 2017	**244.3**	**4,897.1**	**4,121.4**	**162.8**	**935.4**	**10,361.0**

Notes to the financial statements

9. Property, plant and equipment (continued)

At 31 March 2017, the group and company had entered into contractual commitments for the acquisition of property, plant and equipment amounting to £335.2 million (2016: £439.0 million).

In addition to these commitments, the group and company have long-term expenditure plans which include investments to achieve improvements in performance required by regulators and to provide for future growth.

10. Intangible assets

Group and company	Total £m
Cost	
At 1 April 2015	263.9
Additions	67.0
Transfer to assets classified as held for sale	(20.6)
At 31 March 2016	310.3
Additions	54.5
Disposals	(8.2)
At 31 March 2017	356.6
Accumulated amortisation	
At 1 April 2015	119.0
Charge for the year	31.2
Transfer to assets classified as held for sale	(2.3)
At 31 March 2016	147.9
Charge for the year	28.7
Disposals	(7.7)
At 31 March 2017	168.9
Net book value at 31 March 2016	162.4
Net book value at 31 March 2017	**187.7**

The group and company's intangible assets relate mainly to computer software.

At 31 March 2017, the group and company had entered into contractual commitments for the acquisition of intangible assets amounting to £1.7 million (2016: £8.3 million).

Notes to the financial statements

11. Trade and other receivables

Group and company	2017 £m	2016 £m
Trade receivables	116.9	172.7
Amounts owed by parent and fellow subsidiary undertakings (see note A7):		
Trading balances	17.5	5.3
Floating rate loan	40.0	40.0
Amounts owed by other related parties (see note A7)	140.8	0.1
Other debtors and prepayments	63.9	71.2
Accrued income	64.1	116.9
	443.2	406.2

At 31 March 2017, the group and company had £100.0 million (2016: £nil) of trade and other receivables classified as non-current, which related to amounts owed by related parties.

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

Trade receivables do not carry interest and are stated net of allowances for doubtful receivables, an analysis of which is as follows:

Group and company	2017 £m	2016 £m
At the start of the year	94.3	100.5
Amounts charged to operating expenses (see note 3)	29.8	39.1
Trade receivables written off	(38.8)	(45.3)
At the end of the year	85.3	94.3

At each reporting date, the group and company evaluates the recoverability of trade receivables and records allowances for doubtful receivables based on experience.

At 31 March 2017 and 31 March 2016, the group and company had no trade receivables that were past due and not individually impaired.

The following table provides information regarding the ageing of net trade receivables that were past due and individually impaired:

Group and company	Aged less than one year	Aged between one year and two years	Aged greater than two years	Carrying value
	£m	£m	£m	£m
Trade receivables				
At 31 March 2017	79.9	32.0	5.0	116.9
At 31 March 2016	126.0	37.5	5.1	168.6

At 31 March 2017, the group and company had no trade receivables that were not past due (2016: £4.1 million).

Notes to the financial statements

12. Cash and cash equivalents

Group and company	2017 £m	2016 £m
Cash at bank and in hand	0.6	2.5
Short-term bank deposits	196.3	201.8
Cash and short-term deposits	196.9	204.3
Book overdrafts (included in borrowings, see note 13)	(26.3)	(30.7)
Cash and cash equivalents in the statement of cash flows	170.6	173.6

Cash and short-term deposits include cash at bank and in hand, deposits, and other short-term highly liquid investments which are readily convertible into known amounts of cash and have a maturity of three months or less. The carrying amounts of cash and cash equivalents approximate their fair value.

Book overdrafts, which result from cash management practices, represent the value of cheques issued and payments initiated that had not cleared as at the reporting date.

13. Borrowings

Group and company	2017 £m	2016 £m
Non-current liabilities		
Bonds[1]	3,976.0	3,646.3
Bank and other term borrowings	2,207.4	2,069.6
Amounts owed to intermediate parent undertaking (see note A7)	896.4	873.5
	7,079.8	6,589.4
Current liabilities		
Bonds	37.3	-
Bank and other term borrowings	126.2	364.1
Book overdrafts	26.3	30.7
130,000,000 7.0 per cent £1.00 redeemable preference shares	130.0	130.0
Amounts owed to intermediate parent undertaking (see note A7)	64.6	75.9
	384.4	600.7
	7,464.2	7,190.1

Note:

[1] For the company, bonds includes £438.7 million (2016: £126.6 million) of amounts owed to subsidiary undertakings.

The £130.0 million 7.0 per cent redeemable preference shares have been presented as amounts falling due within one year as they may be redeemed by not less than 30 days' written notice served by the group or the shareholder. Preference shareholders are not entitled to receive notice of, attend or vote at, any general meeting of the group. However, preference shareholders receive priority to other classes of shareholders on a winding up, liquidation or other return of capital to shareholders of the group. The preference shares have a latest redemption date of 1 October 2099.

For further details of the principal economic terms and conditions of outstanding borrowings see note A4.

Borrowings are unsecured and are measured at amortised cost. The carrying amounts of borrowings approximate their fair value.

Notes to the financial statements

14. Retirement benefit surplus

Defined benefit schemes

The net pension expense before tax recognised in the income statement in respect of the defined benefit schemes is summarised as follows:

Group and company	2017 £m	2016 £m
Current service cost	18.3	20.7
Curtailments/settlements	2.8	0.9
Administrative expenses	1.7	1.7
Pension expense charged to operating profit	22.8	23.3
Net pension interest income credited to investment income (see note 4)	(8.4)	(2.8)
Net pension expense charged before tax	14.4	20.5

Defined benefit pension costs excluding curtailments/settlements included within employee benefit expense were £20.0 million (2016: £22.4 million) comprising current service costs and administrative expenses.

Total post-employment benefits expense excluding curtailments/ settlements charged to operating profit of £31.2 million (2016: £32.3 million) comprise the defined benefit costs described above of £20.0 million (2016: £22.4 million) and defined contribution pension costs of £11.2 million (2016: £9.9 million) (see note 2).

The reconciliation of the opening and closing net pension surplus included in the statement of financial position is as follows:

Group and company	2017 £m	2016 £m
At the start of the year	226.9	74.8
Expense recognised in the income statement	(14.4)	(20.5)
Contributions paid	52.5	48.0
Remeasurement (losses)/gains gross of tax	(70.5)	124.6
At the end of the year	194.5	226.9

Included in the contributions paid of £52.5 million (2016: £48.0 million) were deficit repair contributions of £32.7 million (2016: £24.7 million). No inflation funding mechanism payments were made during the year (2016: £nil).

Remeasurement gains and losses are recognised directly in the statement of comprehensive income.

Notes to the financial statements

14. Retirement benefit surplus (continued)

Group and company	2017 £m	2016 £m
The return on plan assets, excluding amounts included in interest	416.8	48.2
Actuarial (losses)/gains arising from changes in financial assumptions	(538.5)	71.4
Actuarial gains/(losses) arising from changes in demographic assumptions	37.9	(34.8)
Actuarial gains arising from experience	13.3	39.8
Remeasurement (losses)/gains on defined benefit pension schemes	(70.5)	124.6

For more information in relation to the group's and company's defined benefit pension schemes see note A6.

Defined contribution schemes

During the year, the group and company made £11.2 million (2016: £9.9 million) of contributions to defined contribution schemes which are included in employee benefit expense (see note 2).

15. Deferred tax liabilities

The following are the major deferred tax liabilities and assets recognised by the group and company, and the movements thereon, during the current and prior year:

Group and company	Accelerated tax depreciation £m	Retirement benefit obligations £m	Other £m	Total £m
At 1 April 2015	1,123.8	15.7	(23.6)	1,115.9
(Credited)/charged to the income statement (see note 6)	(87.7)	4.8	(5.2)	(88.1)
Charged to equity (see note 6)	-	20.4	-	20.4
At 31 March 2016	1,036.1	40.9	(28.8)	1,048.2
(Credited)/charged to the income statement (see note 6)	(26.3)	-	2.5	(23.8)
Credited to equity (see note 6)	-	(7.8)	-	(7.8)
At 31 March 2017	1,009.8	33.1	(26.3)	1,016.6

Certain deferred tax assets and liabilities have been offset in accordance with IAS 12 'Income Taxes'.

Notes to the financial statements

16. Provisions

Group and company	Severance £m	Other £m	Total £m
At 1 April 2015	4.8	7.4	12.2
(Credited)/charged to the income statement	(0.2)	11.4	11.2
Utilised in the year	(3.7)	(4.8)	(8.5)
At 31 March 2016	0.9	14.0	14.9
Charged to the income statement	7.0	7.5	14.5
Utilised in the year	(4.2)	(2.3)	(6.5)
At 31 March 2017	3.7	19.2	22.9

The group and company had no provisions classed as non-current at 31 March 2017 or 31 March 2016.

The severance provision as at 31 March 2017 and 31 March 2016 relates to severance costs as a result of group reorganisation.

Other provisions principally relate to contractual, legal and environmental claims against the group and company and represent management's best estimate of the value of settlement, the timing of which is dependent on the resolution of the relevant legal claims.

17. Trade and other payables

Group and company	2017 £m	2016 £m
Non-current		
Deferred grants and contributions	570.7	517.4
Other creditors	17.2	11.9
	587.9	529.3
Current		
Trade payables	34.5	43.6
Amounts owed to parent undertakings (see note A7)	2.4	1.4
Amounts owed to other related parties (see note A7)	12.1	-
Other tax and social security	5.1	4.9
Deferred grants and contributions	8.5	9.0
Accruals and other creditors	207.5	224.8
Deferred income	39.4	42.5
	309.5	326.2
	897.4	855.5

Included within accruals and other creditors as at 31 March 2017 was £2.5 million (2016: £0.7 million) of accrued interest, which at the company level was owed to subsidiary undertakings.

The average credit period taken for trade purchases is 23 days (2016: 28 days).

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

Notes to the financial statements

17. Trade and other payables (continued)

Deferred grants and contributions

Group and company	2017 £m	2016 £m
At the start of the year	526.4	485.8
Cash received during the year	29.0	17.3
Transfer of assets from customers	33.5	32.8
Credited to the income statement – revenue	(3.0)	(2.6)
Credited to the income statement – other operating costs (see note 3)	(6.7)	(6.9)
	579.2	526.4

18. Share capital

Group and company	2017 £m	2016 £m
Issued, called up and fully paid		
100,000,000 (2016: 100,000,000) ordinary shares of £1.00 each	100.0	100.0
130,000,000 7 per cent cumulative redeemable preference shares of £1.00 each	130.0	130.0
	230.0	230.0
Less: 130,000,000 7 per cent cumulative redeemable preference shares of £1.00 each designated as borrowings (see note 13)	(130.0)	(130.0)
	100.0	100.0

Zero per cent preference shareholders are not entitled to receive notice of, attend or vote at, any general meeting of the group. However, preference shareholders receive priority to other classes of shareholders on a winding up, liquidation or other return of capital to shareholders of the company.

In accordance with IAS 32 'Financial Instruments: Presentation', 130,000,000 7 per cent preference shares of £1.00 each have been recognised as financial liabilities. The 7 per cent preference shares have a redemption date of 1 October 2099. For further information, see note 13.

Notes to the financial statements

19. Operating lease commitments

Group and company	Property 2017 £m	Plant and equipment 2017 £m	Property 2016 £m	Plant and equipment 2016 £m
Commitments under non-cancellable operating leases due:				
Within one year	2.8	0.6	3.0	0.7
In the second to fifth years inclusive	10.1	0.4	10.3	0.5
After five years	277.8	-	278.5	-
	290.7	1.0	291.8	1.2

In respect of the group and company's commitment to significant property leases, there are no contingent rentals payable, or restrictions on dividends, debt or further leasing imposed by these lease arrangements. Wherever possible, the group ensures that it has the benefit of security of tenure where this is required by operational and accommodation strategies. Escalation of rents is via rent reviews at agreed intervals.

20. Contingent liabilities

No performance guarantees have been entered into as at 31 March 2017 by either the group or the company (2016: none).

21. Events after the reporting period

There were no events arising after the reporting date that require recognition or disclosure in the financial statements for the year ended 31 March 2017.

22. Ultimate parent undertaking

The company's immediate parent undertaking is United Utilities North West Limited, a company incorporated in England and Wales.

The company's ultimate parent undertaking and controlling party is United Utilities Group PLC, a company incorporated in England and Wales.

The smallest group in which the results of the company are consolidated is that headed by United Utilities Water Limited.

The largest group in which the results of the company are consolidated is that headed by United Utilities Group PLC. The consolidated accounts of this group are available to the public and may be obtained from: The Company Secretary, United Utilities Group PLC, Haweswater House, Lingley Mere Business Park, Lingley Green Avenue, Great Sankey, Warrington, WA5 3LP.

Notes to the financial statements

A1 Subsidiaries and other group undertakings

Details of the company's subsidiary undertakings and significant holdings in undertakings other than subsidiary undertakings, all of which are unlisted, are set out below. The registered address for each entity is Haweswater House, Lingley Mere Business Park, Lingley Green Avenue, Great Sankey, Warrington, WA5 3LP, United Kingdom.

	Class of share capital held	Proportion of share capital owned %	Nature of business
Subsidiary undertakings			
England and Wales			
United Utilities Water Finance PLC	Ordinary	100.00	Financing company
Significant holdings in undertakings other than subsidiary undertakings			
England and Wales			
Lingley Mere Management[(1)] Company Limited	Ordinary (non-voting)	93.27	Property management

[(1)] See note A7 for further information.

The company does not hold any interests in joint ventures or associated undertakings. All other investments are held at fair value.

Notes to the financial statements

A2 Cash generated from operations

Group and company	2017 £m	2016 £m
Profit before tax	409.5	348.8
Adjustment for investment income (see note 4) and finance expense (see note 5)	197.3	226.5
Operating profit	606.8	575.3
Adjustments for:		
Depreciation of property, plant and equipment (see note 9)	335.0	332.5
Amortisation of intangible assets (see note 10)	28.7	31.2
Impairment of property, plant and equipment (see note 9)	0.2	11.4
Loss on disposal of property, plant and equipment (see note 3)	3.3	5.4
Loss on disposal of intangible assets	0.5	-
Amortisation of deferred grants and contributions (see note 17)	(6.7)	(6.9)
Other non-cash movements	(3.0)	(3.6)
Changes in working capital:		
Decrease/(increase) in inventories	0.9	(0.6)
Decrease/(increase) in trade and other receivables	61.7	(17.6)
Increase/(decrease) in trade and other payables	1.4	(11.8)
Increase in provisions (see note 16)	8.0	2.7
Pension contributions paid less pension expense charged to operating profit	(29.7)	(24.7)
Cash generated from operations	1,007.1	893.3

The group and company have received property, plant and equipment of £33.5 million (2016: £32.8 million) in exchange for the provision of future goods and services (see notes 17 and A8).

A3 Net debt

Group and company	2017 £m	2016 £m
At the start of the year	6,582.7	6,359.0
Net capital expenditure	678.1	650.6
Dividends (see note 7)	229.7	186.1
Loans to joint ventures of the UUG group	100.0	-
Interest	158.3	172.3
Inflation uplift on index-linked debt (see note 5)	80.7	37.9
Tax	41.2	26.4
Other	4.3	3.8
Fair value movements(1)	(11.1)	39.9
Cash generated from operations (see note A2)	(1,007.1)	(893.3)
At the end of the year	6,856.8	6,582.7

(1) Fair value movements includes net fair value gains on debt and derivative instruments of £5.2 million (2016: £41.0 million losses), less £5.9 million (2016: £1.1 million) of net payments on swaps and debt under fair value option (see note 5).

Net debt comprises borrowings, net of cash and short-term deposits, derivatives and a £40.0 million loan receivable from intermediate parent undertaking.

Notes to the financial statements

A4 Borrowings

Terms and debt repayment schedule

The principal economic terms and conditions of outstanding borrowings, along with fair value and carrying value were as follows:

Group and company	Currency	Year of final repayment	Fair value 2017 £m	Carrying value 2017 £m	Fair value 2016 £m	Carrying value 2016 £m
Borrowings in fair value hedge relationships			**2,041.2**	**2,022.9**	**1,845.9**	**1,918.1**
5.375% 150m bond	GBP	2018	164.3	156.8	169.6	162.5
4.25% 500m bond	EUR	2020	478.9	469.7	455.9	455.1
5.75% 375m bond	GBP	2022	455.4	429.3	449.5	434.5
1.129% 52m bond(1)	EUR	2027	43.5	43.6	38.4	41.0
5.625% 300m bond	GBP	2027	408.7	412.1	382.7	411.1
5.02% JPY 10bn dual currency loan	JPY/USD	2029	97.7	105.8	81.4	96.1
2.058% 30m bond(1)	EUR	2030	27.0	26.3	23.7	25.1
1.641% 30m bond(1)	EUR	2031	25.7	24.6	-	-
2.9% 600m bond(1)	HKD	2031	61.1	56.4	-	-
5.0% 200m bond	GBP	2035	278.9	298.3	244.7	292.7
Borrowings designated at fair value through profit or loss			**375.5**	**375.5**	**338.0**	**338.0**
6.875% 400m bond (owed to intermediate parent)	USD	2028	375.5	375.5	338.0	338.0
Borrowings measured at amortised cost			**6,262.0**	**5,065.8**	**5,497.1**	**4,934.0**
1.97% + RPI 200m EIB IL loan	GBP	2016	-	-	269.9	267.4
Short-term bank borrowings - fixed	GBP	2017	66.9	66.9	53.9	53.9
1.30% + LIBOR 5bn bond	JPY	2017	36.3	37.3	31.7	32.0
2.46% + RPI 50m EIB IL loan	GBP	2020	69.3	60.8	65.7	59.3
2.10% + RPI 50m EIB IL loan	GBP	2020	68.5	60.8	64.7	59.3
1.93% + RPI 50m EIB IL loan	GBP	2020	68.2	60.9	64.5	59.4
1.90% + RPI 50m EIB IL loan	GBP	2020	68.2	61.0	64.5	59.5
1.88% + RPI 50m EIB IL loan	GBP	2020	68.1	60.9	64.2	59.3
1.84% + RPI 50m EIB IL loan	GBP	2020	68.2	61.1	64.4	59.6
1.73% + RPI 50m EIB IL loan	GBP	2020	68.0	61.2	64.2	59.6
1.61% + RPI 50m EIB IL loan	GBP	2020	67.8	61.2	63.9	59.7
0.80% + LIBOR 100m loan	GBP	2022	102.6	100.0	98.3	100.0
0.47% + RPI 100m IL loan	GBP	2023	116.5	107.9	105.0	105.2
0.49% + RPI 100m IL loan	GBP	2025	115.6	103.8	101.1	101.2
0.013% + RPI 25m IL bond(1)	GBP	2025	28.1	25.9	24.2	25.2
0.1275% + RPI 100m IL loan	GBP	2026	112.3	102.4	96.4	100.0
0.01% + RPI 20m IL bond(1)	GBP	2028	22.0	22.3	-	-
1.29% + RPI 50m EIB (amortising) IL loan	GBP	2029	57.4	51.5	58.6	54.2
1.23% + RPI 50m EIB (amortising) IL loan	GBP	2029	55.1	49.7	54.6	52.5
1.12% + RPI 50m EIB (amortising) IL loan	GBP	2029	56.5	51.0	57.6	53.7
1.10% + RPI 50m EIB (amortising) IL loan	GBP	2029	56.3	51.0	57.4	53.7
0.75% + RPI 50m EIB (amortising) IL loan	GBP	2029	56.5	51.9	55.2	54.4
1.15% + RPI 50m EIB (amortising) IL loan	GBP	2030	57.5	51.5	56.2	54.1
1.11% + RPI 50m EIB (amortising) IL loan	GBP	2030	57.6	51.7	56.2	54.2
0.76% + RPI 50m EIB (amortising) IL loan	GBP	2030	56.4	51.7	55.0	54.3
0.178% + RPI 35m IL bond(1)	GBP	2030	40.2	36.2	33.6	35.3
0.245% + CPI 20m IL bond(1)	GBP	2031	20.2	20.0	-	-
0.01% + RPI 38m IL bond(1)	GBP	2031	42.2	41.3	-	-
3.375% + RPI 50m IL bond	GBP	2032	124.1	74.2	107.6	72.8
0.709% + LIBOR 100m EIB (amortising) loan	GBP	2032	94.9	93.8	95.6	100.0
0.691% + LIBOR 150m EIB (amortising) loan	GBP	2032	146.4	145.3	142.9	150.0

Notes to the financial statements

A4 Borrowings (continued)

	Currency	Year of final repayment	Fair value 2017 £m	Carrying value 2017 £m	Fair value 2016 £m	Carrying value 2016 £m
Borrowings measured at amortised cost (continued)						
0.573% + LIBOR 100m EIB (amortising) loan	GBP	2033	100.2	100.0	93.7	100.0
0.511% + LIBOR 150m EIB (amortising) loan	GBP	2033	149.6	150.0	140.0	150.0
0.01% + RPI 100m EIB (amortising) IL loan	GBP	2033	107.9	102.3	94.7	99.7
0.01% + RPI 75m EIB (amortising) IL loan	GBP	2034	80.9	76.7	71.1	74.7
0.01% + RPI 75m EIB (amortising) IL loan	GBP	2034	80.7	76.2	-	-
0.01% + RPI 75m EIB (amortising) IL loan	GBP	2034	80.7	76.2	-	-
1.9799% + RPI 100m IL bond	GBP	2035	212.4	138.9	171.4	136.4
0.379% + CPI 20m IL bond(1)	GBP	2036	20.9	20.0	-	-
0.01% + RPI 26.5m IL bond(1)	GBP	2036	30.3	31.0	-	-
0.01% + RPI 29m IL bond(1)	GBP	2036	32.2	31.5	-	-
1.66% + RPI 35m IL bond	GBP	2037	62.7	44.7	51.6	43.6
0.093% + CPI 60m IL bond(1)	GBP	2037	59.0	59.6	-	-
2.40% + RPI 70m IL bond	GBP	2039	132.2	87.2	113.5	85.0
1.7829% + RPI 100m IL bond	GBP	2040	207.5	137.5	172.8	135.0
1.3258% + RPI 50m IL bond	GBP	2041	95.7	68.6	78.9	67.3
1.5802% + RPI 100m IL bond	GBP	2042	202.6	137.0	166.6	134.5
1.5366% + RPI 50m IL bond	GBP	2043	102.4	68.4	82.5	67.1
1.397% + RPI 50m IL bond	GBP	2046	102.9	68.5	81.8	67.3
1.7937% + RPI 50m IL bond	GBP	2049	118.0	68.2	91.1	67.0
Commission for New Towns (amortising) loan – fixed	GBP	2053	56.1	28.4	52.5	28.7
1.847% + RPI 100m IL bond	GBP	2056	224.1	135.0	180.8	131.6
1.815% + RPI 100m IL bond	GBP	2056	221.5	134.4	179.4	131.0
1.662% + RPI 100m IL bond	GBP	2056	218.2	134.2	173.1	130.8
1.591% + RPI 25m IL bond	GBP	2056	52.5	33.4	42.4	32.6
1.5865% + RPI 50m IL bond	GBP	2056	105.8	67.0	85.6	65.3
1.556% + RPI 50m IL bond	GBP	2056	105.3	66.7	84.5	65.0
1.435% + RPI 50m IL bond	GBP	2056	102.5	66.5	82.0	64.8
1.3805% + RPI 35m IL bond	GBP	2056	71.0	46.5	56.7	45.3
1.702% + RPI 50m IL bond	GBP	2057	107.9	65.1	86.1	63.5
1.585% + RPI 100m IL bond	GBP	2057	208.6	129.1	165.1	125.9
Preference shares (owed to immediate parent undertaking)	GBP	2099	130.0	130.0	130.0	130.0
Amounts owed to intermediate parent undertaking	GBP	Various	585.5	585.5	611.4	611.4
Book overdrafts (see note 12)	GBP	2017	26.3	26.3	30.7	30.7
			8,678.7	**7,464.2**	**7,681.0**	**7,190.1**

IL Index-linked debt – this debt is adjusted for movements in the Consumer or Retail Prices Indices with reference to a base CPI or RPI established at the trade date

CPI The UK general index of consumer prices (for all items) as published by the Office for National Statistics (May 2015 = 100)

RPI The UK general index of retail prices (for all items) as published by the Office for National Statistics (Jan 1987 = 100)

EIB Borrowings that are held with the European Investment Bank

Borrowings are unsecured. Funding raised in currencies is swapped to sterling to match funding costs to income.

(1) For the company these borrowings relate to amounts owed to subsidiary undertakings on terms identical to those of the bonds held by United Utilities Water Finance PLC.

Notes to the financial statements

A5 Financial risk management

Risk management

The board (or as appropriate the UUG board) is responsible for treasury strategy and governance, which is reviewed on an annual basis.

The UUG treasury committee, a subcommittee of the UUG board, has responsibility for setting and monitoring the group's adherence to treasury policies, along with oversight in relation to the activities of the treasury function.

Treasury policies cover the key financial risks: liquidity risk, credit risk, market risk (inflation, interest rate, electricity price and currency) and capital risk. These policies are reviewed by the UUG treasury committee for approval on at least an annual basis, or following any major changes in treasury operations and/or financial market conditions.

Day-to-day responsibility for operational compliance with the treasury policies rests with the treasurer. An operational compliance report is provided monthly to the UUG treasury committee, which details the status of the group's compliance with treasury policies and highlights the level of risk against the appropriate risk limits in place.

The treasury function does not act as a profit centre and does not undertake any speculative trading activity.

Liquidity risk

The group looks to manage its liquidity risk by maintaining liquidity within a board approved duration range set with reference to overall UUG policy parameters. Liquidity is actively monitored by the treasury function and is reported monthly to the UUG treasury committee through the operational compliance report.

At 31 March 2017, the group and company had £951.5 million (2016: £854.3 million) of available liquidity, which comprised £196.9 million cash and short-term deposits (2016: £204.3 million), £579.6 million (2016: £575.0 million) of undrawn committed borrowing facilities and £175.0 million (2016: £75.0 million) of undrawn term loan facilities. Short-term deposits mature within three months.

The group and company had available committed borrowing facilities as follows:

Group and company	2017 £m	2016 £m
Expiring within one year	130.0	115.0
Expiring after one year but in less than two years [(1)]	170.0	220.0
Expiring after more than two years	315.0	240.0
Total borrowing facilities	615.0	575.0
Facilities drawn[(2)]	(35.4)	-
Undrawn borrowing facilities	579.6	575.0

Note:
[(1)] Figure includes £90.0 million (2016: £90.0 million) facility provided by intermediate parent undertaking.
[(2)] Facilities drawn are provided by the intermediate parent undertaking, expiring after one year but in less than two years.

These facilities are arranged on a bilateral rather than a syndicated basis, which spreads the maturities more evenly over a longer time period, thereby reducing the refinancing risk by providing several renewal points rather than a large single refinancing point.

Notes to the financial statements

A5 Financial Risk Management (continued)

Maturity analysis

Concentrations of risk may arise if large cash flows are concentrated within particular time periods. The maturity profile in the following table represents the forecast future contractual principal and interest cash flows in relation to the group and company's financial liabilities on an undiscounted basis. Derivative cash flows have been shown net where there is a contractual agreement to settle on a net basis; otherwise the cash flows are shown gross.

Group and company	**Total[1]**	**Adjustment[2]**	**1 year or less**	**1-2 years**	**2-3 years**	**3-4 years**	**4-5 years**	**More than 5 years**
At 31 March 2017	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Bonds	8,324.9		142.7	257.3	538.5	82.8	458.9	6,844.7
Bonds – UUWF	581.6		3.5	3.5	3.5	3.5	3.5	564.1
Bank and other term borrowings	2,925.0		182.1	110.9	117.8	663.4	111.6	1,739.2
Preference shares	130.0		130.0	-	-	-	-	-
Parent borrowings	1,099.5		90.2	444.6	71.8	71.1	20.6	401.2
Adjustment to carrying value[2]	(5,596.8)	(5,596.8)						
Borrowings	7,464.2	(5,596.8)	548.5	816.3	731.6	820.8	594.6	9,549.2
Derivatives:								
Payable	940.5		112.7	76.8	491.2	33.3	25.0	201.5
Receivable	(1,314.6)		(193.9)	(318.8)	(518.7)	(10.7)	(10.6)	(261.9)
Adjustment to carrying value[2]	3.6	3.6						
Derivatives – net assets	(370.5)	3.6	(81.2)	(242.0)	(27.5)	22.6	14.4	(60.4)

Group and company	**Total[1]**	**Adjustment[2]**	**1 year or less**	**1-2 years**	**2-3 years**	**3-4 years**	**4-5 years**	**More than 5 years**
At 31 March 2016	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Bonds	8,479.4		105.4	138.0	257.3	516.0	83.9	7,378.8
Bonds – UUWF	176.2		1.0	1.0	1.0	1.1	1.1	171.0
Bank and other term borrowings	3,075.0		432.0	89.8	107.4	109.7	656.9	1,679.2
Preference shares	130.0		130.0	-	-	-	-	-
Parent borrowings	1,117.7		100.4	72.4	407.6	69.6	69.0	398.7
Adjustment to carrying value(2)	(5,788.2)	(5,788.2)						
Borrowings	7,190.1	(5,788.2)	768.8	301.2	773.3	696.4	810.9	9,627.7
Derivatives:								
Payable	801.6		66.0	114.2	71.8	411.1	26.4	112.1
Receivable	(1,174.8)		(82.6)	(175.3)	(269.9)	(485.4)	(8.0)	(153.6)
Adjustment to carrying value(2)	10.1	10.1						
Derivatives – net assets	(363.1)	10.1	(16.6)	(61.1)	(198.1)	(74.3)	18.4	(41.5)

Notes:

[1] Forecast future cash flows are calculated, where applicable, using forward interest rates based on the interest environment at year-end and are, therefore, susceptible to changes in market conditions. For index-linked debt it has been assumed that RPI will be three per cent and CPI will be two per cent over the life of each instrument.

[2] The carrying value of debt is calculated following various methods in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' and therefore this adjustment reconciles the undiscounted forecast future cash flows to the carrying value of debt in the statement of financial position.

For the company, those bonds with United Utilities Water Finance PLC represent amounts owed to subsidiary undertakings.

Notes to the financial statements

A5 Financial Risk Management (continued)

Credit risk

Credit risk arises principally from trading (the supply of services to customers) and treasury activities (the depositing of cash and holding of derivative and foreign exchange instruments). While the opening of the non-household retail market to competition from 1 April 2017 has impacted on the profile of the group's concentration of credit risk, as discussed further below, the group and company do not believe they are exposed to any material concentrations that could have an impact on their ability to continue as a going concern or its longer-term viability.

The group manages its risk from trading through the effective management of customer relationships. Concentrations of credit risk with respect to trade receivables are limited due to the majority of the group’s customer base consisting of a large number of unrelated households. The Water Industry Act 1991 (as amended by the Water Industry Act 1999) prohibits the disconnection of a water supply and the limiting of supply with the intention of enforcing payment for certain premises including domestic dwellings.

Following the transfer of the group’s non-household business on 26 May 2016 and the non-household retail market opening to competition, credit risk in this area is now concentrated to a small number of retailers to whom the group provides wholesale water and wastewater services. Retailers are licensed and monitored by Ofwat and as part of the regulations they must demonstrate that they have adequate resources available to supply services. The group’s retail customers are on 30 day credit terms in respect of trading transactions. As at 31 March 2017, Water Plus was the group's single largest debtor, with amounts outstanding in relation to wholesale services of £40.8 million (2016: £nil), (see note A7). During the year, sales to Water Plus in relation to wholesale services were £402.7 million (2016: £nil).

Under the group’s revenue recognition policy, revenue is only recognised when collection of the resulting receivable is reasonably assured. Considering the above, the directors believe there is no further credit risk provision required in excess of the allowance for doubtful receivables (see note 11). An allowance is made by the water regulator in the price limits at each price review for a proportion of debt deemed to be irrecoverable.

The group manages its risk from treasury activities by establishing a total credit limit by counterparty, which comprises a counterparty credit limit and an additional settlement limit to cover intra-day gross settlement cash flows. In addition, potential derivative exposure limits are also established to take account of potential future exposure which may arise under derivative transactions. These limits are calculated by reference to a measure of capital and credit ratings of the individual counterparties and are subject to a maximum single counterparty limit. A control mechanism to trigger a review of specific counterparty limits, irrespective of credit rating action, is in place. This entails daily monitoring of counterparty credit default swap levels and/or share price volatility. Credit exposure is monitored daily by the group’s treasury function and is reported monthly to the treasury committee through the operational compliance report.

At 31 March 2017 and 31 March 2016, the maximum exposure to credit risk for the group and company is represented by the carrying amount of each financial asset in the statement of financial position:

Group and company	2017 £m	2016 £m
Cash and short-term deposits (see note 12)	196.9	204.3
Trade and other receivables (see note 11)	443.2	406.3
Derivative financial instruments	620.2	624.1
	1,260.3	1,234.7

The credit exposure on derivatives is disclosed gross of any collateral held. At 31 March 2017, the group and company held £66.9 million (2016: £53.9 million) as collateral in relation to derivative financial instruments (included within borrowings in note A4).

Notes to the financial statements

A5 Financial risk management (continued)

Market risk

The group and company's exposure to market risk primarily results from its financing arrangements and the economic return which it is allowed on the regulatory capital value (RCV).

The group uses a variety of financial instruments, including derivatives, in order to manage the exposure to these risks.

Inflation risk

The group earns an economic return on its RCV, comprising a real return through revenues and an inflation return as an uplift to its RCV. To the extent that nominal debt liabilities finance a proportion of the RCV, there is an asset-liability mismatch which potentially exposes the group to the risk of economic loss where actual inflation is lower than that implicitly locked-in through nominal debt.

The group's index-linked borrowings linked to RPI inflation, form an economic hedge of the group's regulatory assets, which are also linked to RPI inflation. In particular, index-linked debt delivers a cash flow benefit compared to nominal debt, as the inflation adjustment on the index-linked liabilities is a deferred cash flow until the maturity of each financial instrument, providing a better match to the inflation adjustment on the regulated assets, which is recognised as a non-cash uplift to the RCV.

In addition, the group's pension obligations also provide an economic hedge of the group's regulatory assets. The pension schemes' inflation funding mechanism (see note A6) ensures that future contributions will be flexed for movements in RPI and smoothed over a rolling five-year period, providing a natural hedge against any unexpected RCV movements caused by inflation.

Ofwat has indicated that, from April 2020, the inflation return as an uplift to RCV will still comprise an element that will be linked to RPI, however this will commence transition towards CPI. As a result, the group will identify opportunities to amend the economic hedge currently in place which can be evidenced by the issuing of £100.0 million of CPI indexed-linked debt during the year. Inflation risk is reported monthly to the UUG treasury committee in the operational compliance report.

The carrying value of index-linked debt held by the group was £3,602.3 million at 31 March 2017 (2016: £3,447.3 million).

Sensitivity analysis

The following table details the sensitivity of profit before tax to changes in the RPI and CPI on the group's index-linked borrowings. The sensitivity analysis has been based on the amount of index-linked debt held at the reporting date and, as such, is not indicative of the years then ended. In addition, it excludes the hedging aspect of the group's regulatory assets and post-retirement obligations described above.

Increase/(decrease) in profit before tax and equity

Group and company	2017 £m	2016 £m
1 per cent increase in RPI/CPI	(36.4)	(35.0)
1 per cent decrease in RPI/CPI	36.4	35.0

Notes to the financial statements

A5 Financial risk management (continued)

Inflation risk (continued)
Sensitivity analysis (continued)

The sensitivity analysis assumes a one per cent change in RPI and CPI having a corresponding one per cent impact on this position over a 12-month period. It should be noted, however, that there is a time lag by which current RPI and CPI changes impact on the income statement, and the analysis does not incorporate this factor. The portfolio of index-linked debt is calculated on either a three or eight-month lag basis. Therefore, at the reporting date the index-linked interest and principal adjustments impacting the income statement are fixed and based on the annual RPI or CPI change either three or eight months earlier.

Interest rate risk

The group's policy is to structure debt in a way that best matches its underlying assets and cash flows. The regulated business earns an economic return on its RCV, comprising a real return through revenue, determined by the real cost of capital fixed by the regulator for each five-year regulatory pricing period, and an inflation return as an uplift to its RCV.

The preferred form of debt, therefore, is sterling index-linked debt which incurs fixed interest, in real terms, and forms a natural hedge of regulatory assets and cash flows.

Where conventional long-term debt is raised in a fixed-rate form, to manage exposure to long-term interest rates, the debt is generally swapped at inception to create a floating rate liability for the term of the liability through the use of interest rate swaps. These instruments are typically designated within a fair value accounting hedge.

To manage the exposure to medium-term interest rates, the group fixes underlying interest rates on nominal debt out to ten years in advance on a reducing balance basis. This is supplemented by managing residual exposure to interest rates within the relevant regulatory price control period by fixing substantively all residual floating underlying interest rates on projected nominal debt across the immediately forthcoming regulatory period at around the time of the price control determination.

The group seeks to manage its risk by maintaining its interest rate exposure within an approved treasury policy range. Interest rate risk is reported monthly to the UUG treasury committee through the operational compliance report.

Sensitivity analysis

The following table details the sensitivity of profit before tax and equity to changes in interest rates. The sensitivity analysis has been based on the amount of net debt and the interest rate hedge positions in place at the reporting date and, as such, is not indicative of the years then ended.

Increase/(decrease) in profit before tax and equity

	2017	2016
Group and company	£m	£m
1 per cent increase in interest rate	154.2	173.8
1 per cent decrease in interest rate	(152.5)	(181.6)

The sensitivity analysis assumes that both fair value hedges and borrowings designated at fair value through profit or loss are effectively hedged and it excludes the impact on post-retirement obligations.

The exposure largely relates to fair value movements on the group's fixed interest rate swaps which manage the exposure to medium-term interest rates. Those swaps are not included in hedge relationships.

Notes to the financial statements

A5 Financial risk management (continued)

Repricing analysis

The following tables categorise the group and company's borrowings, derivatives and cash deposits on the basis of when they reprice or, if earlier, mature. The £130.0 million redeemable preference shares have been classified as more than five years according to their latest redemption date of 1 October 2099.

The repricing analysis demonstrates the group and company's exposure to floating interest rate risk.

Our largest concentration of floating interest rate risk is with index-linked instruments. This has been classified as repricing in one year or less due to the refixing of the interest charge with changes in RPI and CPI.

Group and company At 31 March 2017	Total £m	1 year or less £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m
Borrowings in fair value hedge relationships							
Fixed rate instruments	2,022.9	-	156.8	469.7	-	429.3	967.1
Effect of swaps	-	2,022.9	(156.8)	(469.7)	-	(429.3)	(967.1)
	2,022.9	2,022.9	-	-	-	-	-
Borrowings designated at fair value through profit or loss							
Fixed rate instruments	375.5	-	-	-	-	-	375.5
Effect of swaps	-	375.5	-	-	-	-	(375.5)
	375.5	375.5	-	-	-	-	-
Borrowings measured at amortised cost							
Fixed rate instruments	225.3	67.4	0.5	0.6	0.6	0.7	155.5
Floating rate instruments	1,238.2	1,238.2	-	-	-	-	-
Index-linked instruments	3,602.3	3,602.3	-	-	-	-	-
	5,065.8	4,907.9	0.5	0.6	0.6	0.7	155.5
Effect of fixed interest rate swaps	-	(3,131.3)	(50.0)	1,127.1	325.0	-	1,729.2
Total borrowings	7,464.2	4,175.0	(49.5)	1,127.7	325.6	0.7	1,884.7
Cash and short-term deposits	(196.9)	(196.9)	-	-	-	-	-
Net borrowings	7,267.3	3,978.1	(49.5)	1,127.7	325.6	0.7	1,884.7

Notes to the financial statements

A5 Financial risk management (continued)

Repricing analysis (continued)

At 31 March 2016	Total £m	1 year or less £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m
Borrowings in fair value hedge Relationships							
Fixed rate instruments	1,918.1	-	-	162.5	455.1	-	1,300.5
Effect of swaps	-	1,918.1	-	(162.5)	(455.1)	-	(1,300.5)
	1,918.1	1,918.1	-	-	-	-	-
Borrowings designated at fair value through profit or loss							
Fixed rate instruments	338.0	-	-	-	-	-	338.0
Effect of swaps	-	338.0	-	-	-	-	(338.0)
	338.0	338.0	-	-	-	-	-
Borrowings measured at amortised cost							
Fixed rate instruments	212.6	54.1	0.5	0.5	0.6	0.6	156.3
Floating rate instruments	1,274.1	1,274.1	-	-	-	-	-
Index-linked instruments	3,447.3	3,447.3	-	-	-	-	-
	4,934.0	4,775.5	0.5	0.5	0.6	0.6	156.3
Effect of fixed interest rate swaps	-	(3,006.3)	(125.0)	(50.0)	1,127.1	325.0	1,729.2
Total borrowings	7,190.1	4,025.3	(124.5)	(49.5)	1,127.7	325.6	1,885.5
Cash and short-term deposits	(204.3)	(204.3)	-	-	-	-	-
Net borrowings	6,985.8	3,821.0	(124.5)	(49.5)	1,127.7	325.6	1,885.5

Electricity price risk

The group is allowed a fixed amount of revenue by the regulator, in real terms, to cover electricity costs for each five-year regulatory pricing period. To the extent that electricity prices remain floating over this period, this exposes the group to volatility in its operating cash flows. The group's policy, therefore, is to manage this risk by fixing a proportion of electricity commodity prices in a cost-effective manner.

The group has fixed the price on a substantial proportion of its anticipated net electricity usage out to the end of the AMP in 2020, partially through entering into electricity swap contracts.

Sensitivity analysis

The following table details the sensitivity of the group's profit before tax and equity to changes in electricity prices. The sensitivity analysis has been based on the amounts of electricity swaps in place at the reporting date and, as such, is not indicative of the years then ended.

Increase/(decrease) in profit before tax and equity

Group and company	2017 £m	2016 £m
20 per cent increase in electricity commodity prices	9.8	7.7
20 per cent decrease in electricity commodity prices	(9.8)	(7.7)

Notes to the financial statements

A5 Financial risk management (continued)

Currency risk

Currency exposure principally arises in respect of funding raised in foreign currencies.

To manage exposure to currency rates, foreign currency debt is hedged into sterling through the use of cross currency swaps and these are typically designated within a fair value accounting hedge.

The group seeks to manage its risk by maintaining currency exposure within UUG board approved limits. Currency risk in relation to foreign currency denominated financial instruments is reported monthly to the UUG treasury committee through the operational compliance report.

The group and company have no material net exposure to movements in currency rates.

Capital risk management

The group's objective when managing capital is to maintain efficient access to debt capital markets throughout the economic cycle.

Assuming no significant changes to existing rating agencies' methodologies or sector risk assessments, the company aims to maintain, as a minimum, its existing credit ratings of A3 with Moody's Investors Service (Moody's) and BBB+ with Standard & Poor's Ratings Services (Standard & Poor's) for the company and debt issued by its financing subsidiary, United Utilities Water Finance PLC.

In order to maintain existing credit ratings, the group needs to manage its capital structure with reference to ratings methodology and measures used by Moody's and Standard & Poor's. The ratings methodology is normally based on a number of key ratios (such as RCV gearing, adjusted interest cover and Funds from Operations (FFO) to debt) and threshold levels as updated and published from time to time by Moody's and Standard & Poor's. The group looks to manage its risk by maintaining the relevant key financial ratios used by the credit rating agencies to determine a corporate's credit rating, within the thresholds approved by the board. Capital risk is reported monthly to the UUG treasury committee through the operational compliance report.

Further detail on the precise measures and methodologies used to assess water companies' credit ratings can be found in the methodology papers published by the rating agencies.

Notes to the financial statements

A5 Financial risk management (continued)

Fair values

The table below sets out the valuation basis of financial instruments held at fair value and financial instruments where fair value has been separately disclosed in the notes as the carrying value is not a reasonable approximation of fair value.

Group and company

At 31 March 2017	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets at fair value through profit or loss				
Derivative financial assets – fair value hedge	-	404.1	-	404.1
Derivative financial assets – held for trading[1]	-	216.1	-	216.1
Financial liabilities at fair value through profit or loss				
Derivative financial liabilities – held for trading[1][2]	-	(249.7)	-	(249.7)
Financial liabilities designated as fair value through profit or loss	-	(375.5)	-	(375.5)
Financial liabilities for which fair value has been disclosed				
Financial liabilities in fair value hedge relationships	(1,262.7)	(778.5)	-	(2,041.2)
Other financial liabilities at amortised cost	(937.9)	(5,324.1)	-	(6,262.0)
	(2,200.6)	(6,107.6)	-	(8,308.2)

At 31 March 2016	Level 1 £m	Level 2 £m	Level 3 £m	Total £m
Financial assets at fair value through profit or loss				
Derivative financial assets – fair value hedge	-	441.9	-	441.9
Derivative financial assets – held for trading[1]	-	182.2	-	182.2
Financial liabilities at fair value through profit or loss				
Derivative financial liabilities – held for trading[1][2]	-	(261.0)	-	(261.0)
Financial liabilities designated as fair value through profit or loss	-	(338.0)	-	(338.0)
Financial liabilities for which fair value has been disclosed				
Financial liabilities in fair value hedge relationships	(1,702.4)	(143.5)	-	(1,845.9)
Other financial liabilities at amortised cost	(1,309.9)	(4,187.2)	-	(5,497.1)
	(3,012.3)	(4,305.6)	-	(7,317.9)

Notes:
[1] These derivatives form economic hedges and, as such, management intends to hold these through to maturity.
[2] Derivatives forming an economic hedge of the currency exposure on borrowings included in these balances were £215.7 million (2016: £177.2 million).

Notes to the financial statements

A5 Financial risk management (continued)

Fair values (continued)

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

The group has calculated fair values using quoted prices where an active market exists, which has resulted in £2,200.6 million (2016: £3,012.3 million) of 'level 1' fair value measurements. In the absence of an appropriate quoted price, the group has applied discounted cash flow valuation models utilising market available data in line with prior years. The £811.7 million reduction (2016: £1,220.2 million) in 'level 1' fair value measurements is largely due to a decrease in the number of observable quoted bond prices in active markets at 31 March 2017.

During the year, the fair value of financial liabilities designated at fair value through profit or loss fell, resulting in a £37.5 million loss (2016: £4.3 million). Included within this was an £11.9 million loss (2016: £15.1 million gain) attributable to changes in own credit risk. The cumulative amount recognised in the income statement due to changes in credit spread was £62.2 million profit (2016: £74.1 million). The carrying amount is £173.4 million (2016: £135.9 million) higher than the amount contracted to settle on maturity.

Notes to the financial statements

A6 Retirement benefits

Defined benefit schemes

The group participates in two major funded defined benefit pension schemes in the United Kingdom – the United Utilities Pension Scheme (UUPS) and the United Utilities PLC group of the Electricity Supply Pension Scheme (ESPS), both of which are closed to new employees. The assets of these schemes are held in trust funds independent of the group's finances.

The trustees are composed of representatives of both the employer and employees. The trustees are required by law to act in the interests of all relevant beneficiaries and are responsible for the investment policy with regard to the assets plus the day-to-day administration of the benefits.

The group also operates a series of unfunded, unregistered retirement benefit schemes. The costs of these schemes are included in the total pension cost, on a basis consistent with IAS 19 'Employee Benefits' and the assumptions set out below.

Information about the pension arrangements for executive directors is contained in the directors' remuneration report.

Under the schemes, employees are entitled to annual pensions on retirement. Benefits are also payable on death and following other events such as withdrawing from active service. No other post-retirement benefits are provided to these employees.

The defined benefit obligation includes benefits for current employees, former employees and current pensioners as analysed in the table below:

Group and company	2017 £m	2016 £m
Total value of current employees benefits	853.6	763.1
Deferred members benefits	458.1	338.7
Pensioner members benefits	1,370.4	1,081.8
Total defined benefit obligation	2,682.1	2,183.6

The duration of the combined schemes is around 21 years. The schemes' duration is an indicator of the weighted-average time until benefit payments are settled, taking account of the split of the defined benefit obligation between current employees, deferred members and the current pensioners of the schemes.

Funding requirements

The latest finalised funding valuations of the schemes were carried out by independent qualified actuaries as at 31 March 2013 (UUPS) and 31 March 2016 (ESPS) and determined that the schemes were both in a deficit position on a funding basis. The basis on which scheme liabilities are valued for funding purposes differs from the basis required under IAS 19, with liabilities on a funding basis being subject to assumptions at the valuation date that are not updated between valuations. Funding deficits vary significantly from company to company, but neither the deficits, the assumptions on which they are based, the associated sensitivities, nor the risk exposures are disclosed by many companies and therefore meaningful cross-company comparisons are not possible. Conversely, scheme liabilities are valued on a consistent basis between companies under IAS 19 and are subject to assumptions and sensitivities that are required to be disclosed. Consequently, the relative economic positions of companies are only comparable on an IAS 19 basis, subject to normalisation of assumptions used between companies.

Notes to the financial statements

A6 Retirement benefits (continued)

Funding requirements (continued)

A retirement benefit surplus was recognised as an asset at both 31 March 2017 and 31 March 2016 as, under both the UUPS and ESPS scheme rules, the group has an unconditional right to a refund of the surplus assuming the full settlement of the plans' liabilities in a single event, such as a scheme wind-up.

Under UK legislation there is a requirement that pension schemes are funded prudently, and that funding plans are agreed by pension scheme trustees. The group has plans in place with the schemes' trustees to address the funding deficits by 31 December 2020 for the UUPS and 30 September 2024 for the ESPS, through a series of deficit recovery contributions. The group and trustees have agreed long-term strategies for reducing investment risk in each scheme.

For UUPS, this includes an asset-liability matching policy which aims to reduce the volatility of the funding level of the pension plan by investing in assets such as fixed income swaps and gilts which perform in line with the liabilities so as to hedge against changes in swap and gilt yields. For ESPS, a partial hedge is in place to protect against changes in swap and gilt yields. Further details of the derivatives used in reducing investment risk are disclosed in the 'Further reporting analysis' section of this appendix.

In addition, the group has had an Inflation Funding Mechanism (IFM) in place since 2010 for the UUPS, which was extended to the ESPS in 2013. Under the IFM, additional contributions may be payable annually, calculated with reference to a notional amount of liabilities and the difference between outturn inflation and a fixed inflation assumption, currently set at 3.0 per cent per annum. To the extent that outturn inflation exceeds the fixed inflation assumption, additional contributions are payable in the following year and the base on which future payments are calculated increases, resulting in the smoothing of inflation effects over future years. If outturn inflation is less than the fixed inflation assumption, no additional contributions are payable. The IFM does not have an accounting impact except to the extent that resulting cash contributions increase the level of scheme assets.

The group expects to make contributions of £50.7 million in the year ending 31 March 2018, comprising £32.1 million to the UUPS and £0.7 million to the ESPS in respect of deficit repair contributions, £17.2 million and £0.4 million in respect of regular contributions to UUPS and ESPS respectively, and £0.3 million in respect of expenses to the ESPS; no additional contributions are expected to be made under the IFM.

The schemes' funding plans are reviewed every three years. The UUPS funding valuation at 31 March 2016 is currently ongoing and the next funding valuation for the ESPS is due no later than 31 March 2019.

Impact of scheme risk management on IAS 19 disclosures

Under the prescribed IAS 19 basis, pension scheme liabilities are calculated based on current accrued benefits. Expected cash flows are projected forward allowing for RPI and the current member mortality assumptions. These projected cash flows are then discounted by a high quality corporate bond rate, which comprises an underlying interest rate and a credit spread.

The group has de-risked its pension schemes through hedging strategies applied to the underlying interest rate and the forecast RPI. The underlying interest rate has been largely hedged through external market swaps and gilts, the value of which is included in the schemes' assets, and the forecast RPI has been largely hedged through the IFM, with RPI in excess of 3.0 per cent per annum being funded through an additional schedule of deficit contributions, and through external market hedges.

As a consequence, the reported statement of financial position under IAS 19 remains volatile to changes in credit spread which have not been hedged, primarily due to the difficulties in doing so over long durations; changes in inflation, as the IFM results in changes to the IFM deficit contributions rather than a change in the schemes' assets; and, to a lesser extent, changes in

Notes to the financial statements

A6 Retirement benefits (continued)

Impact of scheme risk management on IAS 19 disclosures (continued)

mortality as management has decided, at the current time, not to hedge this exposure due to its lower volatility in the short-term and the relatively high hedging costs.

In contrast, the schemes' specific funding basis, which forms the basis for regular (non-IFM) deficit repair contributions, is unlikely to suffer from significant volatility due to credit spread or inflation. This is because a prudent, fixed credit spread assumption is applied, and inflation-linked contributions are included within the IFM.

In the year ended 31 March 2017, the discount rate has fallen by 0.85 per cent, which includes a 0.6 per cent decrease in credit spreads and a 0.25 per cent decrease in swap yields over the year. The IAS 19 remeasurement loss of £70.5 million reported in note 14 has largely resulted from the impact of the decrease in credit spreads during the year, partially offset by growth asset gains, the reduction in swap yields and the favourable impact of changes in mortality during the year.

Reporting and assumptions

The results of the latest funding valuations at 31 March 2016 for ESPS, and 31 March 2013 for UUPS, have been adjusted for IAS 19 in order to assess the position at 31 March 2017, by taking account of experience over the period, changes in market conditions, and differences in the financial and demographic assumptions. The present value of the defined benefit obligation, and the related current service costs, were measured using the projected unit credit method.

Member data used in arriving at the liability figure included within the overall IAS 19 surplus has been based on the finalised actuarial valuation as at 31 March 2016 for ESPS and the preliminary results of the actuarial valuation as at 31 March 2016 for UUPS.

Financial assumptions

The main financial and demographic assumptions used by the actuary to calculate the defined benefit surplus of UUPS and ESPS are outlined below:

	2017 % p.a.	2016 % p.a.
Discount rate	2.55	3.40
Pensionable salary growth and pension increases	3.40	3.20
Price inflation	3.40	3.20

Demographic assumptions

Mortality in retirement is assumed to be in line with the Continuous Mortality Investigation's (CMI) S2PA (2016: S1NA) year of birth tables, with scaling factor of 108 per cent for males and 102 per cent for females (2016: one-year age rating for males in the UUPS only), reflecting actual mortality experience; and CMI 2015 (2016: CMI 2014) long-term improvement factors, with a long-term annual rate of improvement of 1.75 per cent (2016: 1.75 per cent). The current life expectancies at age 60 underlying the value of the accrued liabilities for the schemes are:

	2017 years	2016 years
Retired member – male	27.0	27.1
Non-retired member – male	29.0	29.2
Retired member – female	29.8	30.7
Non-retired member – female	31.9	32.9

Notes to the financial statements

A6 Retirement benefits (continued)

Sensitivity of the key scheme assumptions

The measurement of the group's defined benefit surplus is sensitive to changes in key assumptions, which are described above. The sensitivity calculations presented below allow for the specified movement in the relevant key assumption, whilst all other assumptions are held constant. This approach does not take into account the inter-relationship between some of these assumptions or any hedging strategies adopted.

Asset volatility
If the schemes' assets underperform relative to the discount rate used to calculate the schemes' liabilities, this will create a deficit. The schemes hold some growth assets (equities, diversified growth funds and emerging market debt) which, though expected to outperform the discount rate in the long-term, create volatility in the short term. The allocation to growth assets is monitored to ensure it remains appropriate given the schemes' long term objectives.

Discount rate
An increase/decrease in the discount rate of 0.1 per cent would have resulted in a £55.5 million (2016: £42.9 million) decrease/increase in the schemes' liabilities at 31 March 2017, although as long as credit spreads remain stable this will be largely offset by an increase in the value of the schemes' bond holdings and other instruments designed to hedge this exposure. The discount rate is based on high quality corporate bond yields of a similar duration to the schemes' liabilities.

Price inflation
An increase/decrease in the inflation assumption of 0.1 per cent would have resulted in a £51.9 million (2016: £40.7 million) increase/decrease in the schemes' liabilities at 31 March 2017, as a significant proportion of the schemes' benefit obligations are linked to inflation. However, around half of the schemes' liabilities were hedged for RPI in the external market at 31 March 2017, meaning that this sensitivity is likely to be halved as a result. In addition, around half of the schemes' liabilities were hedged through the IFM, with any change in inflation out-turn resulting in a change to cash contributions provided under this mechanism. Any change in inflation out-turn results in a change to the cash contributions provided under the IFM. As assumptions for pensionable salary growth and pension increases are in line with those for price inflation, sensitivities are also in line.

Life expectancy
An increase/decrease in life expectancy of one year would have resulted in a £100.4 million (2016: £33.4 million) increase/decrease in the schemes' liabilities at 31 March 2017. The majority of the schemes' obligations are to provide benefits for the life of the member and, as such, the schemes' liabilities are sensitive to these assumptions.

Further reporting analysis

At 31 March, the fair value of the schemes' assets recognised in the statement of financial position were as follows:

Group	Schemes' assets %	2017 £m	Schemes' assets %	2016 £m
Equities	10.1	290.1	9.8	236.8
Other non-equity growth assets	4.8	138.1	9.4	226.2
Gilts	49.8	1,431.9	41.1	990.4
Bonds	39.0	1,123.1	40.5	975.8
Other	(3.7)	(106.6)	(0.8)	(18.7)
Total fair value of schemes' assets	100.0	2,876.6	100.0	2,410.5
Present value of defined benefit obligations		(2,682.1)		(2,183.6)
Net retirement benefit surplus		194.5		226.9

Notes to the financial statements

A6 Retirement benefits (continued)

Further reporting analysis (continued)

The fair values in the table overleaf are all based on quoted prices in an active market, where applicable.

The assets, in respect of UUPS, included in the table above, have been allocated to each asset class based on the return the assets are expected to achieve as UUPS has entered into a variety of derivative transactions to change the return characteristics of the physical assets held in order to reduce undesirable market and liability risks. As such, the breakdown shown separates the assets of the schemes to illustrate the underlying risk characteristics of the assets held.

Both of the schemes employ a strategy where the asset portfolio is made up of a growth element and a defensive element. Assets in the growth portfolio are shown as equities and other non-equity growth assets above, while assets held in the defensive portfolio represent the remainder of the schemes' assets.

The defensive element of the portfolio contains a proportion of assets set aside for collateral purposes linked to the derivative contracts entered into, as described above. The collateral portfolio, comprising cash and eligible securities readily convertible to cash, provides sufficient liquidity to manage the derivative transactions and is expected to achieve a return in excess of LIBOR.

The fair value derivatives included within pension scheme asset classification are analysed as follows:

Group and company	Underlying assets	Fair value of Derivatives	Combined
At 31 March 2017	£m	£m	£m
Equities	265.4	24.7	290.1
Other non-equity growth assets	138.1	-	138.1
Gilts	1,431.9	-	1,431.9
Bonds	1,131.6	(8.5)	1,123.1
Other	76.0	(182.6)	(106.6)
Total fair value of schemes' assets	3,043.0	(166.4)	2,876.6
At 31 March 2016			
Equities	235.8	1.0	236.8
Other non-equity growth assets	226.2	-	226.2
Gilts	990.4	-	990.4
Bonds	987.8	(12.0)	975.8
Other	(19.2)	0.5	(18.7)
Total fair value of schemes' assets	2,421.0	(10.5)	2,410.5

The derivative values in the tables above represent the net market value of derivatives held within each of these asset categories as follows:

- Derivatives are held within the UUPS equity portfolio to gain economic exposure equivalent to around 4.0 per cent of that scheme's assets, and comprises total return swaps on equity indices with a value of £15.1 million (2016: £0.8 million) and currency forwards with a value of £9.6 million (2016: £0.2 million);

Notes to the financial statements

A6 Retirement benefits (continued)

Further reporting analysis (continued)

- Derivatives are used within the UUPS bond portfolio to hedge non-sterling exposure back to sterling, and comprises credit default swaps with a value of £(8.5) million (2016: £0.4 million), interest rate swaps with a value of £nil (2016: £(12.8) million) and currency forwards with a value of £nil (2016: £0.4 million);

- Derivatives are used within both the UUPS and ESPS 'other' portfolios to manage liability risks, and comprises £(188.6) million (2016: £(7.4) million) in the UUPS and £6.0 million (2016: £7.9 million) in the ESPS. These are further broken down as follows:

  - The UUPS has a liability hedging strategy in place, which uses a wide range of derivatives to target a high level of interest rate and inflation hedging. The net value of £(188.6) million (2016: £(7.4) million) comprises asset swaps with a value of £(110.0) million (2016: £(207.6) million), interest rate swaps with a value of £432.2 million (2016: £523.1 million), gilt repurchase agreements with a value of £(543.0) million (2016: £(312.7) million) and RPI inflation swaps with a value of £32.2 million (2016: £(10.2) million).

  - The ESPS has a liability hedging strategy in place, implemented using pooled funds which make use of derivatives. The value of £6.0 million (2016: £7.9 million) represents the total value of these pooled funds, i.e. underlying assets plus the value of the derivatives within these funds.

The derivatives shown in the tables only cover those expressly held for the purpose of reducing certain undesirable asset and liability risks. The schemes also invest in a number of other pooled funds that make use of derivatives. No allowance is made in the figures above for any derivatives held within these, as these are not held expressly for the purpose of managing risk. The total fair value of pooled funds held within the schemes' assets was £691.8 million (2016: £986.5 million).

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

	2017 £m	2016 £m
At the start of the year	2,410.5	2,317.3
Interest income on schemes' assets	81.3	71.2
The return on plan assets, excluding amounts included in interest	416.8	48.2
Member contributions	4.9	5.5
Benefits paid	(87.7)	(78.0)
Administrative expenses	(1.7)	(1.7)
Group contributions	52.5	48.0
At the end of the year	2,876.6	2,410.5

The group's actual return on the schemes' assets was a gain of £498.1 million (2016: £119.4 million), principally due to gains on derivatives hedging the schemes' liabilities.

Notes to the financial statements

A6 Retirement benefits (continued)

Further reporting analysis (continued)

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

	2017 £m	2016 £m
At the start of the year	(2,183.6)	(2,242.5)
Interest cost on schemes' obligations	(72.9)	(68.4)
Actuarial (losses)/gains arising from changes in financial assumptions	(538.5)	71.4
Actuarial gains/(losses) arising from changes in demographic assumptions	37.9	(34.8)
Actuarial gains arising from experience	13.3	39.8
Curtailments/settlements	(2.8)	(0.9)
Member contributions	(4.9)	(5.5)
Benefits paid	87.7	78.0
Current service cost	(18.3)	(20.7)
At the end of the year	(2,682.1)	(2,183.6)

A contingent liability exists in relation to the equalisation of Guaranteed Minimum Pension (GMP), which is expected to have a widespread impact for defined benefit schemes operating in the UK. The UK Government intends to implement legislation which could result in an increase in the value of GMP for males. This would increase the defined benefit obligation of the schemes. At this stage, until the Government has further developed its proposals, it is not possible to quantify the impact of this change.

Notes to the financial statements

A7 Related party transactions

The aggregate disclosable transactions between the UUW group and company and the related parties in the wider UUG group of companies were as follows:

	Sales of goods and services		Purchase of goods and services		Recharge of costs to/(by) related parties at nil margin	
	2017	2016	2017	2016	2017	2016
Group	£m	£m	£m	£m	£m	£m
Ultimate parent undertaking	-	-	-	-	(3.3)	(2.3)
Intermediate parent undertaking	7.0	-	-	-	1.3	0.5
Fellow subsidiaries	1.4	-	2.0	0.6	3.0	4.8
Joint ventures of the UUG group	403.3	-	0.7	0.7	18.5	-
	411.7	-	2.7	1.3	19.5	3.0

Sales of services to related parties during the year mainly represent non-household wholesale charges and were on the group's normal trading terms.

Details of transactions with key management are disclosed in note 2.

In addition to the above, £1.5 million (2016: £nil) of interest income was recognised on loans to joint ventures of the UUG group.

Company

In addition to the above amounts, the company incurred interest charges of £4.8 million (2016: £1.3 million) in relation to the amounts owed to its subsidiary, United Utilities Water Finance PLC (UUWF), which represent external borrowings held by UUWF that are on-lent to the company on identical terms to those borrowings owed by UUWF to external parties (see below).

The company also incurred a management fee of £0.1 million (2016: £0.1 million) in relation to the services provided by UUWF.

The following amounts were outstanding at the reporting date:

	Amounts owed by related parties		Amounts owed to related parties	
	2017	2016	2017	2016
Group	£m	£m	£m	£m
Ultimate parent undertaking	-	-	2.2	1.1
Intermediate parent undertaking	56.6	43.4	961.2	949.7
Immediate parent undertaking	-	-	130.0	130.0
Fellow subsidiaries	0.9	1.9	-	-
Joint ventures of the UUG group	140.8	0.1	12.1	-
	198.3	45.4	1,105.5	1,080.8

At 31 March 2017, amounts owed by related parties were £198.3 million (2016: £45.4 million), comprising £58.3 million (2016: £5.4 million) of trade balances and £140.0 million (2016: £40.0 million) relating to loans.

Trade balances are unsecured and will be settled in accordance with normal credit terms. Included within these balances was £40.8 million (2016: £0.1 million) owed by Water Plus and £17.5 million (2016: £5.3 million) owed by the group's intermediate parent company and fellow subsidiaries of the UUG group.

Notes to the financial statements

A7 Related party transactions (continued)

Included within these loans receivable was £100.0 million (2016: £nil) owed by Water Plus on a £100.0 million revolving credit facility, which is guaranteed by United Utilities PLC and has a maturity date of 30 September 2019, and £40.0 million (2016: £40.0 million) owed by United Utilities PLC, which is repayable on demand. Both of these loans bear interest at LIBOR plus credit margin.

No expense or allowance has been recognised for bad and doubtful receivables in respect of the amounts owed by related parties (2016: £nil).

At 31 March 2017, amounts owed to related parties were £1,105.5 million (2016: £1,080.8 million), comprising £14.3 million (2016: £1.1 million) of trade balances, £961.0 million (2016: £949.4 million) of borrowings (see note 13) and its associated accrued interest of £0.2 million (2016: £0.3 million) owed to United Utilities PLC, and £130.0 million (2016: £130.0 million) relating to preference shares in the company held by United Utilities North West Limited (see notes 13 and 18).

Included within these trade balances were £12.1 million (2016: £nil) owed to Water Plus and £2.2 million (2016: £1.1 million) owed to United Utilities PLC.

During the year, guarantees with an aggregate limit of £24.0 million (2016: £nil) have been provided to the company by United Utilities PLC in respect of amounts owed by Water Plus in relation to wholesale charges.

Company

In addition to the amounts outstanding above, the company owed £438.7 million (2016: £126.6 million) in respect of borrowings (see note A4), and £2.5 million (2016: £0.7 million) in respect of associated accrued interest, to its subsidiary, UUWF. These amounts represent external borrowings held by UUWF, which are on-lent to the company on identical terms to those of the amounts owed to external parties. The company has guaranteed these external borrowings held by UUWF.

A8 Accounting policies

Of the accounting policies outlined below, those deemed to be the most significant for the group are those that align with the critical accounting judgements and key sources of estimation uncertainty set out on pages 81 to 84.

Basis of consolidation

The group financial statements consolidate the financial statements of the company and entities controlled by the company (its subsidiaries), and incorporate the results of its share of joint ventures using the equity method of accounting. The results of subsidiaries and joint ventures acquired or disposed of during the year are included in the consolidated income statement from the date control is obtained or until the date that control ceases, as appropriate.

Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used under the relevant local GAAP into line with those used by the group.

Subsidiaries

Subsidiaries are entities controlled by the group. Control is achieved where the group is exposed to, or has the rights to, variable returns from its involvement in an entity and has the ability to affect those returns through its power over the entity. In the parent company accounts, investments are held at cost less provision for impairment.

Notes to the financial statements

A8 Accounting Policies (continued)

Subsidiaries (continued)

On acquisition, the assets and liabilities and contingent liabilities of a subsidiary are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired is credited to the income statement in the period of acquisition. All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Revenue recognition

Revenue represents the fair value of the income receivable in the ordinary course of business for goods and services provided, exclusive of value added tax and foreign sales tax. Where relevant, this includes an estimate of the sales value of units supplied to customers between the date of the last meter reading and the period end.

The group recognises revenue generally at the time of delivery and when collection of the resulting receivable is reasonably assured. Should the group consider that the criteria for revenue recognition are not met for a transaction, revenue recognition would be delayed until such time as collectability is reasonably assured. Payments received in advance of revenue recognition are recorded as deferred income.

Operating profit

Operating profit is stated after charging operational expenses but before investment income and finance expense.

Borrowing costs and finance income

Except as noted below, all borrowing costs and finance income are recognised in the income statement on an accruals basis.

Transaction costs that are directly attributable to the acquisition or issue of a financial asset or financial liability are included in the initial fair value of that instrument.

Where borrowing costs are attributable to the acquisition, construction or production of a qualifying asset, such costs are capitalised as part of the specific asset.

Tax

The tax expense represents the sum of current tax and deferred tax.

Current tax

Current tax is based on the taxable profit for the period and is provided at amounts expected to be paid or recovered using the tax rates and laws that have been enacted or substantively enacted at each reporting date.

Taxable profit differs from the net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

Current tax is charged or credited in the income statement, except when it relates to items charged or credited to equity, in which case the tax is also dealt with in equity.

Notes to the financial statements

A8 Accounting Policies (continued)

Deferred tax

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit. Deferred tax liabilities are provided, using the liability method, on all taxable temporary differences at each reporting date. Such assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and interests in joint ventures, except where the group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is measured at the average tax rates that are expected to apply in the periods in which the temporary timing differences are expected to reverse based on tax rates and laws that have been enacted or substantively enacted at each reporting date.

The carrying amount of deferred tax assets is reviewed at each reporting date and is reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited to equity, in which case the deferred tax is also dealt with in equity.

Property, plant and equipment

Property, plant and equipment comprises water and wastewater infrastructure assets and overground assets.

The useful economic lives of these assets are primarily as follows:

• water and wastewater infrastructure assets:

-impounding reservoirs 200 years;

-mains and raw water aqueducts 30 to 300 years;

-sewers and sludge pipelines 60 to 300 years;

-sea outfalls 77 years;

• buildings 10 to 60 years;

• operational assets 5 to 80 years; and

• fixtures, fittings, tools and equipment 3 to 40 years.

Employee and other related costs incurred in implementing the capital schemes of the group are capitalised.

Water and wastewater infrastructure assets

Infrastructure assets comprise a network of water and wastewater pipes and systems. Expenditure on the infrastructure assets, including borrowing costs where applicable, relating to increases in capacity or enhancements of the network is treated as additions. Amounts incurred in maintaining the operating capability of the network in accordance with defined standards of service are expensed in the year in which the expenditure is incurred. Infrastructure assets are depreciated by writing off their cost (or deemed cost for infrastructure assets held on transition to IFRS), less the estimated residual value, evenly over their useful economic lives.

Notes to the financial statements

A8 Accounting Policies (continued)

Property, plant and equipment (continued)
Other assets

All other property, plant and equipment is stated at historical cost less accumulated depreciation.

Historical cost includes expenditure that is directly attributable to the acquisition of the items, including relevant borrowing costs, where applicable, for qualifying assets. Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the group and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the income statement during the financial period in which they are incurred.

Freehold land and assets in the course of construction are not depreciated. Other assets are depreciated by writing off their cost, less their estimated residual value, evenly over their estimated useful economic lives, based on management's judgement and experience.

Depreciation methods, residual values and useful economic lives are reassessed annually and, if necessary, changes are accounted for prospectively. The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognised in other operating costs.

Transfer of assets from customers and developers

Where the group receives from a customer or developer an item of property, plant and equipment (or cash to construct or acquire an item of property, plant and equipment) that the group must then use, either to connect the customer to the network, or to provide the customer with ongoing access to a supply of goods or services, or to do both, such items are capitalised at their fair value and included within property, plant and equipment, with a credit of the same amount to deferred grants and contributions. The assets are depreciated over their useful economic lives and the deferred contributions released to revenue over the same period (or where the receipt of property, plant and equipment is solely to connect the customer to the network, the deferred contribution is released immediately to revenue). This interpretation has been applied to transfers of assets from customers received on or after 1 July 2009.

Assets transferred from customers or developers are accounted for at fair value. If no market exists for the assets then incremental cash flows are used to arrive at fair value.

Intangible assets

Intangible assets are measured initially at cost and are amortised on a straight-line basis over their estimated useful economic lives. The carrying amount is reduced by any provision for impairment where necessary. On a business combination, as well as recording separable intangible assets already recognised in the statement of financial position of the acquired entity at their fair value, identifiable intangible assets that arise from contractual or other legal rights are also included in the acquisition statement of financial position at fair value.

Internal expenditure is capitalised as internally generated intangibles only if it meets the criteria of IAS 38 'Intangible Assets'.

Intangible assets, which relate primarily to computer software, are amortised over a period of three to ten years.

Impairment of tangible and intangible assets

Intangible assets and property, plant and equipment are reviewed for impairment at each reporting date to determine whether there is any indication that those assets may have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any. Where the asset does not generate cash flows that are independent from other assets, the group estimates the recoverable amount of the cash generating unit to which the asset belongs.

Notes to the financial statements

A8 Accounting Policies (continued)

Impairment of tangible and intangible assets (continued)

The recoverable amount is the higher of fair value less costs to sell, and value in use. Value in use represents the net present value of expected future cash flows, discounted on a pre-tax basis, using a rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (or cash generating unit) is reduced to its recoverable amount. Impairment losses in respect of non-current assets are recognised in the income statement within operating costs.

Where an impairment loss subsequently reverses, the reversal is recognised in the income statement and the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but not so as to exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

Non-current assets classified as available for distribution

Non-current assets classified as available for distribution are measured at their carrying value. Non-current assets are classified as held for sale when management is committed to distributing the asset to the company's shareholder. This condition is regarded as having been met only when the asset is available for immediate distribution in its present condition and the distribution is highly probable. Management must have taken action to initiate the completion of the distribution and the distribution should be expected to be completed within one year from the date of classification.

Financial instruments

Financial assets and financial liabilities are recognised and derecognised on the group's statement of financial position on the trade date when the group becomes/ceases to be a party to the contractual provisions of the instrument.

Cash and short-term deposits

Cash and short-term deposits include cash at bank and in hand, deposits and other short-term highly liquid investments which are readily convertible into known amounts of cash, have a maturity of three months or less from the date of acquisition and which are subject to an insignificant risk of change in value. In the consolidated statement of cash flows and related notes, cash and cash equivalents include cash and short-term deposits, net of book overdrafts.

Financial investments

Investments (other than interests in subsidiaries, joint ventures and fixed deposits) are initially measured at fair value, including transaction costs. Investments classified as available for sale in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' are measured at subsequent reporting dates at fair value. Gains and losses arising from changes in fair value are recognised directly in equity, until the security is disposed of or is determined to be impaired, at which time the cumulative gain or loss previously recognised in equity is included in the net profit or loss for the period.

Trade receivables

Trade receivables are initially measured at fair value, and are subsequently measured at amortised cost, less any impairment for irrecoverable amounts. Estimated irrecoverable amounts are based on historical experience of the receivables balance.

Trade payables

Trade payables are initially measured at fair value and are subsequently measured at amortised cost.

Notes to the financial statements

A8 Accounting Policies (continued)

Financial instruments (continued)

Financial liabilities and equity

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the group after deducting all of its liabilities.

Equity instruments

Equity instruments issued by the group are recorded at the proceeds received, net of direct issue costs.

Borrowings

The group's default treatment is that bonds and loans are initially measured at fair value being the cash proceeds received net of any direct issue costs. They are subsequently measured at amortised cost applying the effective interest method. The difference between the net cash proceeds received at inception and the principal cash flows due at maturity is accrued over the term of the borrowing.

The default treatment of measuring at amortised cost, whilst associated hedging derivatives are recognised at fair value, presents an accounting measurement mismatch that has the potential to introduce considerable volatility to both the income statement and the statement of financial position. Therefore, where feasible, the group takes advantage of the provisions under IAS 39 'Financial Instruments: Recognition and Measurement' to make fair value adjustments to its borrowing instruments to reduce this volatility and better represent the economic hedges that exist between the group's borrowings and associated derivative contracts.

Where feasible, the group designates its financial instruments within fair value hedge relationships. In order to apply fair value hedge accounting, it must be demonstrated that the hedging derivative has been, and will continue to be, a highly effective hedge of the risk being hedged within the applicable borrowing instrument.

Borrowings designated within a fair value hedge relationship

Where designated, bonds and loans are initially measured at fair value being the cash proceeds received net of any direct issue costs. They are subsequently adjusted for any change in fair value attributable to the risk being hedged at each reporting date, with the change being charged or credited to finance expense in the income statement.

Hedge accounting is discontinued prospectively when the hedging instrument is sold, terminated or exercised, or where the hedge relationship no longer qualifies for hedge accounting.

Borrowings designated at fair value through profit or loss

Designation is made where the requirements to designate within a fair value hedge cannot be met at inception despite there being significant fair value offset between the borrowing and the hedging derivative. Where designated, bonds and loans are initially measured at fair value being the cash proceeds received and are subsequently measured at fair value at each reporting date, with changes in fair value being charged or credited to finance expense in the income statement.

Derivative financial instruments

Derivative financial instruments are measured at fair value at each reporting date, with changes in fair value being charged or credited to finance expense in the income statement. The group enters into financial derivatives contracts to manage its financial exposure to changes in market rates (see note A5).

Notes to the financial statements

A8 Accounting Policies (continued)

Financial instruments (continued)

Derivatives and borrowings – valuation

Where an active market exists, designated borrowings and derivatives recorded at fair value are valued using quoted market prices. Otherwise, they are valued using a net present value valuation model. The model uses applicable interest rate curve data at each reporting date to determine any floating cash flows. Projected future cash flows associated with each financial instrument are discounted to the reporting date using discount factors derived from the applicable interest curves adjusted for counterparty credit risk where appropriate. Discounted foreign currency cash flows are converted into sterling at the spot exchange rate at each reporting date. Assumptions are made with regard to credit spreads based on indicative pricing data.

The valuation of debt designated in a fair value hedge relationship is calculated based on the risk being hedged as prescribed by IAS 39 'Financial Instruments: Recognition and Measurement'. The group's policy is to hedge its exposure to changes in the applicable underlying interest rate and it is this portion of the cash flows that is included in the valuation model (excluding any applicable company credit risk spread).

The valuation of debt designated at fair value through the profit or loss incorporates an assumed credit risk spread in the applicable discount factor. Credit spreads are determined based on indicative pricing data.

Inventories

Inventories are stated at the lower of cost and net realisable value. For properties held for resale, cost includes the cost of acquiring and developing the sites, including borrowing costs where applicable.

Net realisable value represents the estimated selling price less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

Employee benefits

Retirement benefit obligations

The group operates two defined benefit pension schemes, which are independent of the group's finances, for its employees. Actuarial valuations to determine the funding of the schemes, along with future contribution rates, are carried out by the pension scheme actuary as directed by the trustees at intervals of not more than three years. In any intervening years, the trustees review the continuing appropriateness of the funding and contribution rates.

From a financial reporting perspective and in accordance with IAS 19, defined benefit assets are measured at fair value while liabilities are measured at present value, using the projected unit credit method. The difference between the two amounts is recognised as a surplus or obligation in the statement of financial position. Where this difference results in a defined benefit surplus this is recognised in accordance with IFRIC 14 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction' on the basis that the group has an unconditional right to a refund of any surplus that may exist following the full settlement of plan liabilities in a single event.

The cost of providing pension benefits to employees relating to the current year's service (including curtailment gains and losses) is included within employee benefits expense, while the interest on the schemes' assets and liabilities is included within investment income and finance expense respectively. Remeasurement gains/losses on scheme assets and liabilities are presented in other comprehensive income.

Notes to the financial statements

A8 Accounting Policies (continued)

Employee benefits (continued)

Retirement benefit obligations (continued)

In addition, the group also operates a defined contribution pension section within the United Utilities Pension Scheme. Payments are charged as employee costs as they fall due. The group has no further payment obligations once the contributions have been paid.

Provisions

Provisions are recognised when the group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and the amount can be reliably estimated. Expenditure that relates to an existing condition caused by past operations that does not contribute to current or future earnings is expensed.

Foreign currency translation

Transactions and balances

Transactions in foreign currencies are recorded at the exchange rates applicable on the dates of the transactions. At each reporting date, monetary assets and liabilities denominated in foreign currencies are translated into sterling at the relevant rates of exchange applicable on that date. Gains and losses arising on retranslation are included in net profit or loss for the period.

In order to hedge its exposure to certain foreign exchange risks, the group enters into derivative instruments (see note A5).

Grants and contributions

Grants and contributions receivable in respect of property, plant and equipment arise from a number of sources including contributions from developers towards the expansion of the water and wastewater network and connection of properties to the network. These grants and contributions are treated as deferred income, which is credited to the income statement over the estimated useful economic lives of the related assets.

Leases

Leases are classified according to the substance of the transaction. Operating leases are leases that do not transfer substantially all the risks and rewards of ownership to the lessee.

Operating lease rentals are charged to the income statement on a straight-line basis over the period of the lease.