# United Utilities Water Limited

## Annual Report and Financial Statements for the year ended 31 March 2018

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## Directors, advisers and other information

### Non-executive directors

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### Regulatory reporting:

Regulatory reporting information for the year ended 31 March 2018 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

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

### Overview

Our strategy has, for many years now, focused on putting customers first in everything we do.

The improvement in customer satisfaction that we have delivered as a result of this positions us as a leader in the sector, recognised across a range of metrics, and our approach to vulnerability and affordability is setting new benchmarks for the industry.

Our industry faces many challenges, ranging from recent increased political scrutiny and preparations for the next regulatory review, to planning for long-term resilience needs to cope with a changing climate and growing population.

We are using advanced technology and innovations from around the world and across different sectors to accelerate our implementation of Systems Thinking. This is delivering sustainable improvements in service, resilience and efficiency, and is contributing to outperformance in the current regulatory period.

We are sharing our anticipated net outperformance with customers by investing in projects that were not part of our original regulatory settlement for this regulatory period but that will help deliver long-term resilience for the benefit of customers and the environment, and ease the burden of future customer bills to help improve affordability.

### Customer focus

Our customers are benefiting from sustained improvements in service, efficiency and greater resilience, and this is demonstrated by the continuous improvements we have made in our customer satisfaction scores.

This year, we achieved our best ever scores against Ofwat's qualitative Service Incentive Mechanism (SIM), and we were delighted to be positioned first in the industry in the final wave of the year, and to be in an upper quartile position for the year overall.

Our best practice in customer satisfaction has received external recognition through several awards, many of which look beyond the water sector. We achieved an upper quartile performance in the UK Customer Satisfaction Index, which covers all industries, and we are one of the leading companies for the Consumer Council for Water's assessment of household complaint numbers.

The North West suffers from high levels of extreme deprivation. Helping vulnerable customers is a high priority for us. We are supporting more than 50,000 customers through our Priority Services scheme, which 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.

We have far surpassed our target for the number of customers we would help through our financial assistance schemes in this regulatory period. In January, we hosted the first ever North West Affordability summit, engaging with many of our stakeholders including customers and building on our already leading position on affordability and vulnerability.

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Notwithstanding our benchmark debt management processes and wide range of schemes to help customers struggling to pay, the high levels of income deprivation in our region mean that bad debt and cash collection will remain a principal challenge for us.

We have made significant inroads in this area, reducing household bad debt even further to 2.3 per cent in 2017/18, from 2.5 per cent in 2016/17.

## Financial performance

Revenue was £36.3 million higher than last year, at £1,716.6 million, reflecting our allowed regulatory revenue changes, partly offset by regulatory adjustments including Ofwat's revenue correction mechanism and Ofwat's annual wholesale revenue forecasting incentive mechanism (WRFIM).

Reported operating profit was up £27.4 million, at £634.2 million, reflecting our allowed regulatory revenue changes and lower total costs partly offset by an increase in depreciation and amortisation and reduced profits in the prior year due to costs associated with preparing the business for open competition in the non-household retail sector and other restructuring costs.

Reported profit before tax was up £6.7 million, at £416.2 million, reflecting the increased operating profit partly offset by the increase in net finance expense.

We have a robust capital structure, and aim to maintain targeted minimum 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 a low cost of debt already locked-in that places us in a strong position to substantially outperform our industry allowed cost of debt for the 2015–20 regulatory period.

Our pension scheme asset-liability matching approach continues to prove its effectiveness, providing us with stability in times of turbulent market conditions. We had an IAS 19 surplus of £264.1 million at 31 March 2018.

## Creating value for our community

We are a highly visible service provider in the North West and do our best to be a good neighbour and add value by investing in the communities where we live and operate.

We have a long-standing partnership that helps to regenerate neighbourhoods impacted by our work, for example our work to improve our mains and sewers. As part of this initiative, we have supported a range of local environmental projects around our Davyhulme wastewater treatment works in Greater Manchester, including the creation of a community orchard.

We work with schools across our region, with workshops encouraging a focus on the importance of saving water, not flushing the wrong things down the toilet, practical tips for the home and garden, and protecting and enhancing our beaches and bathing waters.

Our employees love getting involved in local communities through volunteering, fundraising, and charitable giving. We support and encourage this, offering paid volunteering leave, matching charitable fundraising efforts, and through our payroll giving scheme.

Whether it's walking the hills, spotting wildlife, swimming or sailing, locals and tourists would agree that the North West is a nature lover's delight. We work to continually maintain and enhance the environment in our region, and we encourage the public to access our land and regional bathing waters for relaxation and recreation, and to enjoy them safely.

# Strategic report

## Operational performance

Innovation and our Systems Thinking approach are radically changing the way we operate.

We have driven efficiency into the delivery of our 2015–20 investment programme through changing our delivery model, and are creating value through greater use of innovation and advanced technology alongside our substantial capital investment programme.

As well as customer service, operational and environmental benefits, this strategy has optimised performance under our outcome delivery incentives (ODIs) and delivered efficiency savings, contributing to regulatory outperformance beyond the significant savings that were already included in our business plan.

We are particularly proud that we have delivered these efficiencies whilst maintaining highly effective capital delivery, as reflected in our Time: Cost: Quality index (TCQi) score which remains high at over 90 per cent.

Total net regulatory capital expenditure in the year, including £147 million of infrastructure renewals expenditure, was £816 million. This brings our cumulative net regulatory capital expenditure for the first three years of this five year period to around £2.4 billion, reflecting the planned acceleration that we have implemented in order to optimise our operational performance and reap the benefits of enhancements earlier in the regulatory period.

## Performance against our regulatory contract

The low cost of debt we have already locked-in places us in a strong position to substantially outperform compared with the allowed cost of debt under industry price limits.

We are also confident in delivering outperformance of £100 million compared with our totex allowance for the 2015–20 regulatory period. This is in addition to £400 million of savings that we had already committed to deliver over the period to meet our final determination.

Our ODIs get increasingly challenging as we progress through this regulatory period, and we received a net £7.0 million penalty for 2017/18. Our wastewater ODI performance remains strong, but we recognise that against our water measures there are still areas in which we can improve and we are committed to achieving this. Our water metrics over the first three years of this regulatory period have been impacted by a number of big bursts on our network. We have been successful in minimising the impact of these events on customers, and we are working hard to improve performance in this area.

Our cumulative net ODI performance for the first three years of the period remains positive at a net £2.2 million reward, and we are on track to deliver a good performance against one of our ODIs that will only impact the final year of this regulatory period, 2019/20, in relation to our West Cumbria pipeline project.

Our performance in the first three years of this regulatory period exceeds our initial expectations and we now expect, in the absence of any unforeseen events over the remainder of the 2015–20 period, to end the period with a cumulative net reward on ODIs.

We are sharing our anticipated net outperformance by reinvesting to improve resilience for the benefit of customers. We have increased the additional investment that we are making available in this regulatory period from £100 million to £250 million. This is in line with the approach we took in the 2010–15 regulatory period. This takes our total 2015–20 net regulatory capital expenditure programme to around £3.8 billion.

# Strategic report

## Preparing for the long term

We are advanced in our plans for PR19, informed by extensive engagement with customers regarding their needs and priorities. We are on track to submit our PR19 business plan in September 2018 and we are confident that it will deliver against Ofwat's four key themes – great customer service, affordable bills, innovation and resilience. These are not new for us in the way that we run our business and have been areas of focus for some time. Indeed, in many of these areas we are a leader in the industry and already have plans in place to build on this in the 2020–25 regulatory period and beyond.

We have recently finished consulting with customers and other stakeholders on our new 25-year Water Resources Management Plan, balancing investment with affordability in our long-term planning for the 2020–45 period.

## 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 July 2017, we were delighted to retain Industry Leading Company status, as measured through the Environment Agency's annual assessment. We achieved frontier performance for the sector with the lowest number of pollution incidents, alongside our best-in-sector level of self-reporting.

Our drinking water quality has improved again and is the best it has ever been, and we are leading the industry in our approach to resilience.

We retained our World Class rating in the Dow Jones Sustainability Index for the tenth consecutive year, a very good achievement in light of the ever-evolving standards.

We have consistently met, or outperformed, our regulatory leakage targets and our performance to date keeps us on track to meet our 2015–20 regulatory targets.

By 2020, we aim to reduce our carbon footprint by 50 per cent compared with a 2005/06 baseline and we are on track to do so. Our carbon footprint has reduced by one-third since 2005/06, helped by a 4 per cent reduction in electricity use. This illustrates good progress in our energy strategy to use less and generate more renewable energy.

## Our employees

The commitment and dedication of our people is critical to the sustained improvements we have delivered in operational performance and customer service.

Employee engagement of 79 per cent this year, as measured through our annual Employee Voice survey, is higher than the UK norm. We are immensely grateful for the contribution our people make 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 to help provide an optimal balance of skills and experience within the business.

In the first year of our apprentice scheme in 2010 we took on six apprentices, and have built this intake to 42 in 2017, taking our total programme to 118 currently employed. We are accredited by four awarding bodies and named as one of the top 100 apprenticeship employers.

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We have 55 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 40 per cent of our current graduates are female.

We are committed to helping local schools and have trained Science, Technology, Engineering and Mathematics (STEM) ambassadors. We frequently attend careers events across our region and have good links with local universities.

Last year we launched a partnership with Teach First, a charity that strives to end educational inequality by placing and training graduates to teach in low income communities. This helps with our desire to be more active with schoolchildren in communities that are hard to reach within our region, helping them to improve their employability skills, raising awareness of future career opportunities, and offering our employees development opportunities in coaching and mentoring.

We work with our supply chain partners to give young people not in education, employment or training (NEETs) the chance to realise their potential, and gain hands on experience and basic skills training in a real workplace environment, bringing social and economic benefit to the region.

Our employee accident frequency rate for 2017/18 was 0.101 accidents per 100,000 hours, compared with a rate of 0.196 in 2016/17. Our contractor accident frequency rate in 2017/18 was 0.092 compared to 0.087 in 2016/17. As part of our health and safety improvement programme, we continue to make improvements to our corporate health, safety and wellbeing management system and through local initiatives. For example, in the last 12 months we have deployed around 600 devices to high-risk lone workers to increase their level of personal protection.

We have been awarded the workplace wellbeing charter, continue to retain Occupational Health and Safety Assessment Series (OHSAS) 18001 accreditation, and have achieved the Gold Health and Safety Award from the Royal Society for the Prevention of Accidents (RoSPA) for the sixth consecutive year.

We aim to ensure that all our colleagues go home safe and well and we firmly believe that nothing we do is worth getting hurt for.

## Outlook

Systems Thinking and the implementation of innovative technology has put us in a strong position as we look ahead to the next regulatory review.

Our leading operational performance is supported by a robust financing position. We are outperforming the regulatory contract for the 2015–20 period, allowing us to fund additional investment for the benefit of customers, and we have plans in place to improve yet further, giving us confidence heading into the 2020–25 regulatory period and beyond.

We have achieved industry-leading environmental and water quality performance scores, and we are making a substantial contribution to the North West. Our £3.8 billion investment programme is helping to enhance the environment that provides a home for wildlife, areas for recreation for our community, and a major pull for tourism in our region.

Our work supports thousands of jobs, both directly and indirectly through our supply chain, which helps underpin the success of the North West economy through employment and training opportunities.

# Strategic report

We are planning and preparing for the next price review and for long-term challenges through our new 25-year Water Resources Management Plan. Through this, we will ensure that we remain resilient in the face of increasingly extreme weather and prepare to support a growing population in the North West.

Last, but by no means least, we want to give a big thank you to our employees, customers and wider stakeholders for their continued support.

**Dr John McAdam**
Chairman

**Steve Mogford**
Chief Executive Officer

# Strategic report

## What we do

### Where we operate

We operate in the North West, for the North West. We provide water and wastewater services to millions of customers, and we invest in our region, supporting the economy and the environment.

We supply 1.7 billion litres a day of clean, treated water to our customers. We gather water for treatment from reservoirs, lakes, boreholes and streams. Our biggest reservoirs are Haweswater and Thirlmere in Cumbria, with Haweswater holding more than 84 billion litres of water when full, and supplying about a quarter of the North West's water supply.

We serve 3 million households and 200,000 business customers (from small shops to large manufacturing companies) served across the North West. We are also one of the largest employers in the North West, with more than 5,000 employees, and 10,000 people engaged through our supply chain, meaning that we support – directly or indirectly – one in every 150 jobs in the region.

Over 56,000 hectares and much of the land we own and manage is catchment land (the areas immediately surrounding our reservoirs). We believe that quality control starts right from the point of collection, so we manage our catchment land so that it is as clean and sustainable as possible. Much of our land is also open to the public, for the enjoyment of our communities in the North West and tourists visiting the area.

Over 400km of coastline and around 7,000km of rivers flowing across our region. Over 30 of our beaches are designated for swimming and paddling, including Blackpool South that achieved its first blue flag status in 2016. We are required to meet increasingly stringent regulation standards for bathing water quality to keep our beaches and waters up to scratch.

£3.8 billion investment through our planned capital programme across the current 2015–20 regulatory period is delivering substantial investment and improvements across the North West, and this includes £250 million of additional spend on resilience projects, above and beyond the scope of our regulatory contract, which we have committed to fund from our anticipated net outperformance.

### Our water cycle

**We collect water -** We collect water and store it in our 166 reservoirs

**We treat water -** We treat water in our 88 water treatment works and then protect it in covered reservoirs

**We distribute water -** We distribute 1.7 billion litres of water a day to customers' taps using over 42,000km of water pipes

**Customers use the water -** Customers enjoy a clean, reliable supply of water 24 hours a day

**We remove wastewater -** We collect wastewater and transport it using over 77,000km of wastewater pipes to be cleaned

**We create energy from bioresources -** We treat over 180,000 tonnes of sewage sludge a year in our 37 facilities to generate clean, renewable energy

**We treat wastewater -** We treat wastewater in our 568 wastewater treatment works to meet stringent environmental standards

**We return clean water -** We return clean water safely to the environment, allowing the sustainable cycle to begin again

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## Our purpose and strategy

Our purpose is to provide great service to our customers and communities in the North West, creating long-term value for all of our stakeholders.

### Our vision

Our vision is to be the best UK water and wastewater company.

### Our strategy

We will realise our vision by delivering:

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

We use these three strategic themes as a framework to measure each aspect of our performance with each of our operational key performance indicators and risks closely linked to one of them or, often, to more than one, such is the interconnectivity of our business.

### Our core values

Our 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 we do is about our customers, not us. We put customers at the heart of everything we do so that we can give them our best service.

This means not only supplying the seven million people and 200,000 businesses in our region with clean water and treating their wastewater every day, but also improving our customer contacts, keeping bills down, and giving extra help to those vulnerable customers who need it most.

Customer focus means putting customers first now, and also building a resilient and sustainable network to prepare for future generations.

**Innovation**

The world doesn't stand still and neither do we. We will continue to innovate to make our services better, safer, faster and cheaper. We're always searching for new and better ways of working, adapting our service to suit the needs of our region's diverse population.

Only by making the best use of new processes and technologies can we ensure we are prepared for a growing population and extreme weather, to ensure we continue to deliver the lowest sustainable cost in an ever changing world.

One example of innovation that spans our entire business is our Systems Thinking operational approach.

**Integrity**

We make promises knowingly and keep them.

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We behave responsibly towards all of our stakeholders, including our customers; the communities we operate in; our employees; our suppliers; and the environment.

## 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;
- Planning for the long term, protecting and delivering essential services;
- Significant improvements in customer service and operational performance, with more to come;
- Sustainable dividend policy, targeting a growth rate of at least RPI inflation per annum to at least 2020;
- Robust capital structure with a stable A3 credit rating;
- Customer and environmental benefits delivered through substantial capital investment, driving long-term RCV growth; and
- Deeply integrates with the environment, with external recognition for our responsible business approach.

### 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. This enables us to build a better understanding by examining the linkages and interactions between each of the components in our system. Rather than operating each treatment works in isolation, our field engineers are linked via our Integrated Control Centre (ICC), the data hub where we plan, monitor and control our water and wastewater infrastructure. It's one integrated system across the North West, and we can process enormous amounts of data received in real time from the telemetry backbone across our network, as well as factoring in other source data such as weather forecasts.

By operating our network in this way we are able to optimise cost and service performance, as well as moving away from a reactive mind-set to address problems proactively, before they actually affect customers. This helps us to improve the reliability of our assets in order to reduce unplanned service interruptions. It also helps us to 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.

This approach was built into our business plan in order to help us deliver both operational improvements and cost savings across the 2015–20 regulatory period, and is part of our long-term strategy to continue delivering operational benefits in future regulatory periods. As a result of this Systems Thinking approach, we are improving the resilience of our assets and network. This enables us to keep providing a reliable service to customers long into the future.

**Prudent financial risk management delivers long-term predictability and resilience to financial shocks**

Effective financial risk management delivers long-term predictability and resilience to financial shocks. Our clearly articulated policies, covering a variety of market risks, help us reduce our exposure to the economic and regulatory environment, providing more predictable returns to

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investors. They underpin our target to maintain debt to regulatory capital gearing (RCV) within a range of 55 to 65 per cent, supporting a solid A3 rating with Moody's and efficient access to the debt capital markets across the economic cycle.

Inflation exposure is managed by having around 50 per cent of our debt in index-linked form, which offers good value relative to nominal debt and acts as a partial hedge of the impact of inflation on our RCV and revenues. Most of our index-linked debt is RPI-linked, reflecting the regulatory model to March 2020, but thereafter the regulatory model will transition towards CPIH. In the absence of a CPIH debt capital market we will, subject to cost and availability, gradually transition towards a greater proportion of CPI-linked debt, being the best available proxy for CPIH.

Interest rate exposure on our remaining nominal debt is managed by fixing the underlying interest cost out to ten years, on a reducing balance basis. We have previously supplemented this by substantively fixing interest rates for each forthcoming regulatory period at the time of the price control determination, but this is no longer necessary as Ofwat is using debt indexation on the assumed portion of new debt from 2020. Our approach to interest rate management enables us to manage uncertainty in the approach to setting the cost of debt at each price review and our approach to debt financing, with a continuous assessment of various funding opportunities, 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 corporate bonds and gilts along with the use of interest rate swaps, 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 schemes have also hedged inflation exposure, partly through RPI swaps and partly through an inflation funding mechanism, whereby company contributions are flexed for movements in RPI inflation, providing a natural hedge against any inflationary uplift on the RCV. It is anticipated that further progressive de-risking measures will continue to be implemented in relation to the pension schemes as part of a long-term 'self-sufficiency' strategy.

## Our marketplace

### Our industry and market

Every day, over 50 million household and non-household customers receive water and wastewater services in England and Wales. There are ten licensed water and wastewater companies, which are split regionally based on river catchment areas, and these make up around 95 per cent of the industry, with the remainder being made up of licensed companies which provide water-only services and tend to be smaller in size.

United Utilities Water Limited (UUW) is the second largest based on the size of our asset base, as measured by Regulatory Capital Value (RCV). We are licensed to provide water and wastewater services to a population of approximately seven million people in the North West, and we provide services to approximately three million households, which generates around two-thirds of our total revenue, and approximately 200,000 businesses, ranging in size from large manufacturing companies to small shops.

The privatisation of the industry has delivered a significant contribution to improvements in public health as a result of over £130 billion that has been invested in maintaining and improving assets and services since 1989. It has led to improvements in the quality of services, significantly higher environmental standards, and superior quality drinking water, all at a fair cost to customers that has been estimated to be lower than would be the case if the water sector was still owned by the UK Government, with prices that have declined in real terms over the current and last regulatory periods.

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The advancement of technology and innovation makes way for even more improvements in the future, as investment continues to be made in improving the service we provide for the long term.

## Our competitive environment

The other water companies in England and Wales are naturally our main competitors, and we benchmark our performance on a comparative basis with these peers.

In line with our vision to be the best UK water and wastewater company, we also benchmark our customer service performance against other leading service providers in our region.

## Our political and regulatory environment

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

At privatisation, in order to protect the interests of both customers and the environment, 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 since evolved further to fit with the substantial tightening of laws and regulations that we have seen since privatisation.

Over a long time frame the political and regulatory environment can change significantly. While to some extent these changes are outside of our direct control, we believe in the importance of maintaining good relationships. This enables us to engage positively in regulatory discussions, offering our industry knowledge in order to help influence future policy with the aim of achieving the best outcome for customers, and other stakeholders.

## Environmental and quality regulation

The water and wastewater industry in the UK is subject to substantial domestic and European Union (EU) regulation, placing significant statutory obligations on companies relating to, amongst other factors, the quality of drinking water supplied, wastewater treatment, and the impact of our activities on the 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.

The **Environment Agency (EA)** 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 operational KPIs, see pages 42 and 43.

The **Drinking Water Inspectorate (DWI)** is responsible for ensuring compliance with the drinking water quality regulations.

**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.

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).

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The **Water Redress Scheme (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.

## Economic regulation

The Water Services Regulation Authority (Ofwat) 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.

The water industry plans and operates within five-year regulatory periods known as Asset Management Plan (AMP) periods.

Prior to the start of each regulatory period, Ofwat consults with stakeholders, including companies and sets out its price review methodology, which gives the framework for the forthcoming five-year regulatory period.

As part of the price review process, companies submit their business plans to Ofwat with a projection of the expenditure needed to enhance and maintain their assets over the period, in line with customer priorities, statutory requirements and the regulatory framework. Ofwat scrutinises and challenges these business plans, and ultimately sets the five-year price, service and incentive package – this is the regulatory contract that company performance is measured against over the regulatory period.

Each year all water companies are required to publish an annual performance report (APR). Our APRs from the beginning of this regulatory period can be found on our website, where our report for this financial year will also be made available: (*unitedutilities.com/corporate)* This report covers the third year of the 2015–20 regulatory period (AMP6).

While we are working to perform within the current regulatory period, the industry and its stakeholders, including government and regulators, are constantly looking ahead and planning for the future. The 2014 Water Act paved the way for the extension of competition into certain parts of the wholesale business. The retail market was opened to competition for all non-household customers from 1 April 2017 and Ofwat proposed, in its Water 2020 consultation document in 2015, to open up the areas of water resources and bioresources treatment to future competition.

In December 2017, Ofwat published its final methodology for the price review (PR19) for the 'AMP7' regulatory period, which runs from April 2020 to March 2025. This methodology forms part of Water 2020, which is Ofwat's overall vision for the water sector in England and Wales.

Ofwat has outlined four key themes in its final methodology for the 2020–25 regulatory period:

- Great customer service;
- Affordable bills;
- Resilience in the round; and
- Innovation.

These are not new for us in the way that we run our business and have been areas of focus for us for some time. We have been actively engaged in the development of Ofwat's approach to PR19, contributing across the full range of working groups and providing detailed proposals in key areas. We have been carrying out extensive customer research and engagement with stakeholders to determine our plans for AMP7. We will be submitting our business plan in September 2018.

Ofwat is introducing a number of changes for the 2020–25 regulatory period.

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## Price controls

**2015–20 regulatory period (AMP6)**

Ofwat moved away from one single price control and introduced four separate price controls:

- Wholesale water – the physical supply of water
- Wholesale wastewater – the removal and treatment of wastewater
- Household retail – customer-facing activities (principally customer contact, billing, meter reading and cash collection) for households
- Non-household retail – customer-facing activities for business (now covered by UUPLC's joint venture Water Plus)

Separate retail price controls were introduced to encourage a more efficient service and to promote competition in non-household retail.

**2020–25 regulatory period (AMP7)**

Ofwat's methodology for AMP7 sets out six separate binding controls:

- Water resources – the resources from which water is sourced
- Water network plus – water treatment and distribution
- Wastewater network plus – wastewater collection and treatment
- Bioresources – the treatment and sale of energy and nutrient-rich bioresources from recycled organic waste
- Residential retail (the equivalent of household retail)
- Business retail (the equivalent of non-household retail)

This further separation is intended to promote future competition in water resources and bioresources. As we have transferred our non-household (business) retail business to UUPLC's joint venture, Water Plus, we will not be covered by the business retail price control.

## Operating and capital costs (totex)

**2015–20 regulatory period (AMP6)**

In order to encourage companies to utilise the most efficient sustainable solutions, Ofwat changed the way companies' operating and capital costs are assessed for AMP6, from separate capex and opex to a combined totex model that treats them both equally.

Ofwat developed wholesale cost assessment totex models as part of the last price review process, which were used to set the allowed costs for companies in AMP6.

Where companies outperform or underperform their totex allowance, this gain or pain is shared between investors and customers, ensuring both receive a share of the impact. We include our performance against our allowed totex expenditure as one of our operational KPIs.

**2020–25 regulatory period (AMP7)**

Ofwat is developing new cost assessment totex models for AMP7, and we have taken a constructive approach in sharing cost driver analysis from third party experts with Ofwat and our peers in the industry through working groups and other available consultation channels.

Ofwat has introduced a new mechanism for AMP7 that uses cost sharing rates to incentivise companies to submit efficient business plans. Each company will have one cost sharing rate for outperformance and another rate for underperformance, with the rates determined by the ratio of

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a company's business plan totex to Ofwat's view of efficient totex as determined by its cost assessment models. Business plans that are deemed efficient versus the models used by Ofwat will get more favourable cost sharing rates, and vice versa.

## Performance commitments and incentives

**2015–20 regulatory period (AMP6)**

In a move to a more outcomes-based approach, there was greater emphasis placed on customer engagement to set outcomes for AMP6. Companies' performance is measured through performance commitments covering a wide range of measures assessing operational and environmental performance, with associated rewards or penalties (outcome delivery incentives, or ODIs). We include our performance against our ODIs in our operational KPIs.

Following their introduction in AMP6 there was a wide variety of approaches towards definition, measurement, targets, rewards and penalty payments associated with performance commitment measurements and outcome delivery incentives. There is a cap of +/- 2 per cent of the return on regulated equity in place in AMP6. In part, this reflected a recognition that this was the first period in which these new performance incentives had been applied.

**2020–25 regulatory period (AMP7)**

Ofwat has set out a clear intention to introduce more powerful ODIs in AMP7, with a drive for companies' returns to be more heavily dependent on their operational performance against stretching targets. It intends to achieve this by removing the cap that is currently in place and also through enhanced outperformance payment rates for significant outperformance and higher underperformance penalty rates for very poor performance.

Alongside the increased scope for outperformance and underperformance payments, company performance commitments and outcome delivery incentives are likely to be subject to significant revision in AMP7, including a set of 14 common performance commitments across the industry, with three of these having common upper quartile performance targets.

## Customer satisfaction

**2015–20 regulatory period (AMP6)**

Ofwat's Service Incentive Mechanism (SIM) assessment is used as a measure of customer satisfaction that rewards companies that perform particularly well on customer service relative to other water companies, and penalises companies that perform particularly poorly.

SIM is split into two components – quantitative SIM is based on the number of customer contacts, and qualitative SIM is based on the satisfaction of customers with the outcomes of those contacts. We include both of these SIM assessments as operational KPIs.

**2020–25 regulatory period (AMP7)**

A new customer service metric, C-MeX, will replace SIM in AMP7, and will be piloted from 2018/19. This will be based on two customer surveys, one from customers that have contacted the company, which should be similar to the qualitative SIM in the current period, and one from customers that have not contacted the company. The proposed incentive range will be higher than is currently available for SIM, demonstrating a greater emphasis on customer satisfaction and customer sentiment in AMP7.

In addition, Ofwat plans to introduce a new developer service measure, D-MeX, which will also be piloted from 2018/19.

# Strategic report

## Household retail

### 2015–20 regulatory period (AMP6)

Allowed costs within the household retail price control are determined using a water industry average cost to serve approach in AMP6, rewarding companies that are able to achieve costs below the industry average.

Our household retail revenue allowance includes the assumed average cost to serve plus a margin that is intended to cover retail costs not covered through the average cost to serve, such as financing of new retail assets and the retailer's working capital.

We include our performance against our household retail revenue allowance as one of our operational KPIs.

### 2020–25 regulatory period (AMP7)

Ofwat intends to replace its previous average cost to serve approach with a cost assessment based on econometric models of household retail costs in AMP7. These costs will be benchmarked to an efficient baseline.

We support the decision to use econometric models. This more sophisticated approach has the potential to directly reflect key industry cost drivers such as dual and single billing, meter penetration and the impact of extreme deprivation when estimating of efficient levels for retail cost allowances.

## Financing

### 2015–20 regulatory period (AMP6)

Ofwat estimated a weighted average cost of capital for AMP6 (3.74 per cent, in real terms, based on RPI inflation) in order to provide debt and equity investors with a return that was considered to be commensurate with the level of risk that underpinned their investment.

In setting the cost of capital Ofwat used a notional capital structure with 62.5 per cent gearing, calculated as net debt as a percentage of regulatory capital value.

We include our performance against Ofwat's industry allowed cost of debt as one of our operational KPIs.

### 2020–25 regulatory period (AMP7)

Ofwat has been clear that the estimated weighted average cost of capital will be lower in AMP7, recognising that requirements for overall returns are lower now than they have been historically, and reflecting its intention that a higher proportion of companies' returns should come from operational outperformance.

In setting the cost of capital Ofwat is using a notional capital structure with 60 per cent gearing – this is the mid-point of our target range of 55 to 65 per cent. Ofwat will apply debt indexation to new debt in order to reduce the risk of forecast errors, and has confirmed that CPIH will be adopted for the indexation of future price controls.

Ofwat has set an indicative figure for its estimate of the cost of capital of 3.4 per cent in real terms (using CPIH as the price index), which is equivalent to 2.4 per cent if RPI had been used as the price index, as in earlier price reviews.

# Strategic report

## Our way of creating value

We create value by delivering the services that customers want, at a price they can afford, now and in the future, through innovation and efficient operational performance, effective risk management and efficient financing. Through the work that we do and the investment that we make, we also create value for wider stakeholders, including the environment and communities in the North West.

We use short, medium and long-term planning horizons to focus our activities and investment on the creation of sustainable value, under our strategy of delivering the best service to customers, at the lowest sustainable cost, in a responsible manner.

Our 25-year planning horizon seeks to ensure we are investing in our people, collaborating with suppliers, innovating to make our services better and more efficient, maintaining a robust capital structure, and preparing to ensure a resilient service in the face of future challenges.

This long-term planning helps us to focus the business plans that we submit to Ofwat, which set out how we intend to create value for each five-year regulatory period, whilst setting ourselves up in a sustainable way to continue creating value in future years. We monitor progress against these five-year plans as well as each individual financial year.

### Delivering our regulatory contract

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 regulatory contract is set, we create value in line with our business plan by delivering that contract. In order to drive better and more efficient operational performance, there are a number of areas in which companies have the opportunity to outperform in each regulatory period, and in doing so we are able to create further value for customers and wider stakeholders.

During the 2015–20 regulatory period, there are five main areas in which Ofwat has given incentives for companies to outperform.

#### Totex

We can create value by delivering the agreed outcomes for customers within or below the total expenditure (totex) allowance. This requires us to innovate and create operational efficiencies to minimise our expenditure.

#### ODIs

We can create value by delivering a level of operational service that meets or exceeds the targets set in our wholesale outcome delivery incentives. These targets stretch us to continually improve our service to customers and our environmental performance.

#### Customer satisfaction

We can create value by delivering a great level of customer service that is favourable relative to the other water companies. This is measured through Ofwat's quarterly service incentive mechanism (SIM) surveys during the current regulatory period.

#### Financing

We can create value by raising debt finance at a cost that meets or beats the industry allowed cost of debt.

# Strategic report

### Household retail

We can create value by minimising the costs to serve our customers relative to the allowed revenue for household retail activities.

We include our performance against each of the above areas in our operational KPIs, including our targets for the 2015–20 regulatory period.

## Risk management

The risk-return trade-off means that the level of return to be earned from an investment should increase as the level of risk increases, therefore value is created through the effective management of risk. We adopt a prudent approach to risk management.

Our Systems Thinking approach and telemetry backbone improves our ability to manage operational risks, as we are able to recognise the normal ‘signature’ of our network and generate real-time alerts of potential issues, which we can then manage before there is any impact on service delivery, by undertaking proactive repairs and/or redirecting supply from elsewhere in our network where we have built in additional capacity.

Our financial risk management policies help us reduce our exposure to the economic and regulatory environment, thereby providing more predictable returns to investors. These cover a variety of market risks including inflation hedging, interest rate exposure, and an asset-liability matching policy for our defined benefit pension schemes.

Systems Thinking and prudent financial risk management are competitive advantages for us, as we set out on pages 11 and 12.

We also engage in reasonable tax planning, which fully complies with the letter and spirit of the law. We benefit from allowable tax deductions on our substantial capital investment programme, whilst continuing to pay corporate tax at the full headline rate. We maintain an open, transparent and collaborative relationship with HMRC, and maintain a robust governance and tax risk management framework.

## Stakeholders

We value the importance of building and maintaining constructive relationships with all of our stakeholder groups in order to ensure we are considering their interests in our strategic decisions and to influence and inform as much as we are able to do so.

We create value for a number of stakeholder groups through the essential service we provide to customers and support to those in vulnerable situations, the contribution we make to the economy and our communities across the North West, and the natural environment that we maintain and enhance.

One area from which value is derived is market sentiment. This encompasses any developments in the regulatory environment, political and media focus, and any speculation there may be on potential merger and acquisition (M&A) activity in the sector.

This sentiment has many elements that impact the industry as a whole and are largely outside of management control, however we seek to influence elements where possible.

# Strategic report

## Our business model

**We consult and plan for short, medium and long-term horizons**

We provide essential water and wastewater services to millions of customers every day, and our work places us at the heart of the communities in the North West of England.

We are reliant on a variety of key resources, and the way that we manage these is influenced by a broad range of external drivers and relationships with a number of stakeholders.

Managing these relationships and consulting with customers and stakeholders forms an integral part of our long-term planning process.

We agree outcomes that we will deliver for customers during each five-year regulatory period and for the long-term, and the work we do delivers a range of long-term benefits and value for many different stakeholder groups. This value creation feeds back into the continuous cycle of what we do.

### Our key resources

- Natural resources
- People
- Assets
- Financing

### Our external drivers and relationships

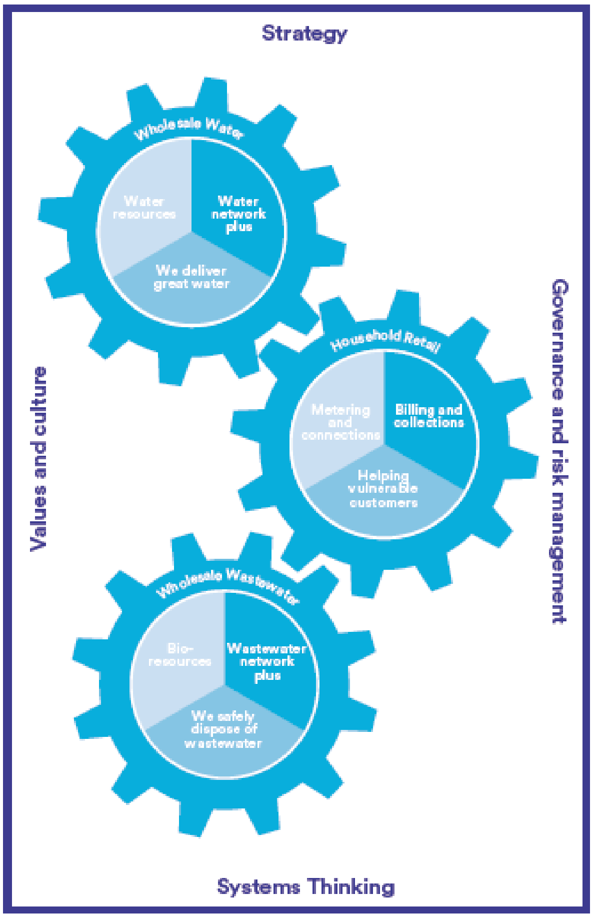
- Stakeholders
- Natural environment
- Economic environment
- Technology and innovation
- Regulatory environment
- Political environment

We have plans in place that set out what we are working to deliver within this five-year period within each of the price controls areas set by Ofwat, which for this regulatory period are wholesale water, wholesale wastewater and household retail, with non-household retail sitting within our joint venture, Water Plus.

What differentiates us from our peers is our Systems Thinking approach – we operate our entire network as one integrated system rather than as individual assets.

Our strategy, governance and risk management, values and culture also underpin everything that we do.

### Our internal drivers




**We review and measure our progress**

# Strategic report

## Our business model

**We deliver the outcomes set out in our regulatory contract**

We review progress towards the outcomes we have promised to deliver for customers in this regulatory period.

We measure our performance against operational KPIs as well as financial measures.

These outcomes and KPIs fit within the framework of our three strategic themes.

### Our outcomes and KPIs

#### The best service to customers

**Outcomes**

- Provide great water;
- Dispose of wastewater; and
- Deliver a service customers can rely on.

**KPIs**

- Wholesale ODI composite;
- SIM – qualitative; and
- SIM – quantitative.

#### At the lowest sustainable cost

**Outcomes**

- Value for money; and
- Improved efficiency.

**KPIs**

- Totex outperformance;
- Financing outperformance; and
- Household retail cost to serve.

#### In a responsible manner

**Outcomes**

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

**KPIs**

- Leakage;
- EA performance assessment; and
- Dow Jones Sustainability Index.

**We create value for a range of stakeholders**

The work we do delivers a wide range of benefits to a variety of stakeholder groups, creating long-term sustainable value for our shareholders, customers, people, the environment, and communities in our region. Responsible business runs through everything we do, as encapsulated by our business principles. Read more at unitedutilities.com/corporate/responsibility/our-approach




# Strategic report

## Our key resources

### Natural resources

- We rely on natural sources of raw water that we collect for treatment, and we return wastewater safely and cleanly to the environment.
- We maintain large areas of catchment land in a sustainable way.
- We process bioresources from wastewater to generate renewable energy, which helps to reduce our carbon footprint, the amount of waste that goes to landfill, and our energy costs.

### Assets

- Our significant capital investment programme grows our business whilst building resilience and maintaining sustainable long-term assets.
- We manage our assets as one integrated network through our innovative Systems Thinking approach and using our Integrated Control Centre.
- We continually innovate to find more efficient ways of building and maintaining our assets.

### People

- We develop, train and motivate our diverse skilled workforce.
- We have management incentives based on performance and a long-term incentive plan.
- We build effective relationships and work with suppliers who share our values.

### Financing

- We maintain a robust capital structure with an appropriate gearing level.
- We are prudent in our approach to risk management and we have long-term debt locked-in at good relative value.
- We proactively engage with equity and credit investors, and maintain access to a range of markets.

## Our external drivers and relationships

### Stakeholders

- It is the nature of our business, being such a vital part of our customers' lives and managing huge areas of land where people live and visit, that we have an impact on a large variety of stakeholders.
- We build relationships and consult with these stakeholders in developing and executing our plans for running our business.

### Natural environment

- The natural environment is constantly changing, and we must adapt and prepare for future impacts such as climate change and population growth, as our business is very long-term by its nature.
- Our use and return of water to the environment is a continuous cycle, and returning water cleanly and safely, as well as managing our catchment land effectively, allows this cycle to begin again from the best starting point.
- We are committed to reducing our environmental impact in order to protect and enhance the natural environment that we live and operate in.

### Economic environment

- We operate in an area of high regional deprivation in the North West, and so helping vulnerable customers is particularly important for us.

# Strategic report

- We are impacted by market rate movements, such as interest rates and inflation, and seek to manage these prudently to reduce risk as far as practicable.
- We are one of the largest employers in the North West and make a huge contribution to the North West economy.

### Technology and innovation

- New technologies present opportunities for us to continue improving quality and efficiency in our business.
- New ideas can come from many sources, which is why we encourage it across our business at all levels, from our annual CEO Challenge and our dedicated innovation team to our new Innovation Lab.
- We constantly seek ways to make our services better, faster, cheaper and safer.

### Regulatory environment

- We place great value on our relationships with our economic, environmental and quality regulators, engaging actively and influencing where we are able to.
- It is also part of our sustainable approach to our business that we are constantly adapting to prepare for upcoming market reform, and actively engaging in any discussions about potential future reforms.

### Political environment

- As well as our regulators, we engage with North West MPs through regular meetings, an annual drop-in session with our senior directors, and party conferences.
- We engage in relation to areas such as our local investment schemes, our economic contribution to the North West, and key policy issues affecting the water industry.

## We create value for a range of stakeholders

The work we do delivers a wide range of benefits to a variety of stakeholder groups, creating long-term sustainable value for our shareholders, customers, people, the environment, and communities in our region. Responsible business runs through everything we do, as encapsulated by our business principles.

Read more at *unitedutilities.com/corporate/responsibility/our-approach.*

### For our customers

- We focus on innovation and efficiency to provide a great service and bills have declined in real terms since 2010.
- We support over 100,000 vulnerable customers through a wide range of assistance schemes, including our sector leading Priority Services scheme, in our region that struggles with high levels of extreme deprivation.

### For our people

- We focus on attracting, developing and retaining a diverse workforce, and ensuring that we look after their health, safety and well-being.
- We have more than 5,000 employees, and 10,000 people are engaged through our supply chain, meaning that we support, directly or indirectly, one in every 150 jobs in the region.

### For the environment

- We are rated Industry Leading by the Environment Agency, and we strive to reduce our environmental impact and invest in innovative technology to tackle environmental challenges for future generations.

# Strategic report

- Maintaining and enhancing our reservoirs, catchment land and bathing waters provides a home for wildlife, areas for recreation, and a major pull for tourism.

**For the community**

- We invest in the North West's infrastructure and generate jobs, skills and income through our supply chain that supports the economy in our region.
- We build partnerships to develop employability skills and help people back to work. We also work with teachers and children to build awareness among the next generation.
- We actively encourage employee volunteering programmes to help create better places, stronger communities, and accomplish more to address local issues together.

## Key resources

### Natural resources

#### How our natural resources help us to create value

We hold abstraction licences that permit us to utilise the natural environment in the North West to create value for our business. Raw water is collected from our catchment land and stored in our reservoirs, or is taken directly from rivers and boreholes. This key resource is essential in order for us to continue providing water to our customers' taps once we have treated it.

We own over 56,000 hectares of land, much of which is catchment land around our reservoirs. As well as providing a source for raw water collection, the way we manage this land helps to protect and improve the natural environment in the North West, enhancing recreational value for the community and providing economic benefits such as underpinning the region's tourist industry.

Another value-generator can be found in the waste that we collect. Bioresources from wastewater can be processed to generate renewable energy. Our advanced digestion facility at our Davyhulme wastewater treatment works is one of the largest of its type, and we inject biogas from Davyhulme's wastewater treatment into the national gas network. We recycle waste by supplying treated biosolids to agriculture, providing a valuable resource for farmers as high quality fertiliser.

We have a responsibility to return water to the environment safely after extensive cleaning processes. Spills from our network can lead to pollution which, depending on the severity, can damage the natural environment and potentially lead to loss of reputation and/or financial penalties.

**The best service to customers**

Providing the best service to customers goes beyond the provision of water and wastewater services and looks at ways we can add further value. We help customers to save money on their bills through our water-saving initiatives, efforts to reduce leakage, and 'what not to flush' campaigns to prevent blockages.

**At the lowest sustainable cost**

The generation of renewable energy from bioresources helps to save power costs, and we seek to use the lowest cost sources where practicable and innovate to find the most cost-effective methods to treat water and wastewater.

Preparing our network to cope with the extreme weather and potential effects of a changing climate we are both experiencing and predicting for the future can save repair and recovery costs as well as ensuring a more resilient service for our customers.

# Strategic report

**In a responsible manner**

We continue to invest in the protection and, where appropriate, enhancement of the natural environment of the North West.

Much of our catchment land is open to the public for use and enjoyment by our communities and the tourists that visit our region.

We consider the natural environment in the management, operation and maintenance of our sites, helping to support rare species and habitats. Wildlife is not only protected, but frequently improved, as a result of our interventions.

Our Sustainable Catchment Management Programme (SCaMP) has shown that we can manage our catchment land to protect and enhance water quality and to provide other benefits for the North West, such as an improving biodiversity.

Our approach to integrated catchments looks at working with others to improve the lakes, rivers and coastal waters where we return treated wastewater in the North West.

Rainfall in our region is greater than in other parts of the country, and therefore short, medium and long-term water supply is not as constrained. Nonetheless, it is in everyone’s interest to make the most of this precious resource. Reducing demand for water is important, and our efforts to encourage and support water efficiency are increasing. We encourage customers to save water, and are working with external partners to integrate our messaging further afield, as well as working to reduce leakage.

The use of bioresources provides an ongoing opportunity to reduce carbon emissions, helping in the global fight against climate change as well as saving money that can be used to add further value by investing in improving the resilience of our assets and/or by reducing bills for customers.

We can make an important contribution to protecting and enhancing the natural environment by using fewer natural resources and reducing our greenhouse gas emissions.

While providing water and wastewater services to the North West, we produce waste materials such as sludges, excavated materials and general office waste, which we are committed to managing in a sustainable way, with less than five per cent of our waste going to landfill.

We are looking at ways to lessen our use of raw materials to reduce our impact on the environment and make us more efficient, and we use recycled products where practicable.

### How we manage our natural resources

Our ISO accredited environment management system covers the whole business and our environmental policy is available on our website at: *unitedutilities.com/corporate/responsibility/environment*

This policy details our commitments to:

- Manage water resources sustainably and promote water efficiency;
- Improve the North West’s bathing waters through our work and that of others;
- Act to prevent pollution from our operations and inform our customers on the responsible disposal of waste to our sewers;
- Protect and enhance the natural environment and the services it provides;
- Manage our use of natural resources, reduce waste and put it to valuable uses;
- Consider the impacts of climate change on the services we deliver and adapt our business accordingly;

# Strategic report

- Reduce our greenhouse gas emissions and generate more renewable energy;
- Aim to observe legal and regulatory requirements and appropriate industry codes of practice; and
- Integrate environmentally responsible behaviour into our operations.

Our regulatory framework shapes the way that we manage natural resources as we are governed by environmental regulators.

Protecting and enhancing the environment is one of the promises and key outcomes that we committed to deliver as part of our business plan for the current regulatory period, and features as one of our Business Principles, which can be accessed online at: *unitedutilities.com/corporate/about-us/governance/business-principles.*

We continuously encourage our customers to use water more efficiently and have increased the number of households fitted with meters.

In terms of managing water supply and demand, we already have an integrated supply zone covering the majority of the North West. Generally, this system is proficient in managing demand, but there are extremities that require further improvements to deal with future challenges. Where there is any potential shortfall, we bring more supplies online to meet demand.

We have a regulatory annual leakage target, based on the sustainable economic level of leakage, which is one of our operational KPIs (see pages 42 and 43), and we have consistently met or outperformed this target.

As a major owner of woodland we manage our trees in a sustainable way to protect water quality, conservation, access, recreation and timber, and we have been Forest Stewardship Council® (FSC®) certified since 2003.

The sustainable management of surface water is vital in adapting to the predicted increase in more intense rainfall across the region, which is the key risk to our wastewater service.

We are one of many organisations with a role to play in boosting the quality of bathing water on the North West coast. With strict bathing water standards, we continue to work with partners to improve the quality of rivers and coastal waters, and we give the public real-time information on bathing water quality.

The Environment Agency assesses water companies' performance across a basket of measures, such as regulatory compliance, pollution incidents and improvement plans, and its overall assessment is included as one of our operational KPIs (see pages 42 and 43).

Our environmental performance is reported within our corporate responsibility pages on our website at: *unitedutilities.com/corporate/responsibility/environment/environment-performance*

### Impact of the external environment

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.

Climate change is the long-term change in average weather conditions, including temperature, rainfall and wind. It is predicted that our climate will change dramatically and for the North West, this will result in higher daily temperatures in both winter and summer, and a shift in our rainfall from summer to winter.

This will mean there is likely to be:

- More frequent and/or higher magnitude drought events in summer;
- More rainfall in the winter; and

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- More occurrences of heavy rainfall.

Climate change has been the subject of strategic concern to us for over two decades. As a water and wastewater utility provider, we have first-hand experience of the impacts of extreme weather events on our operations and our customers, and we recognise our part to play in mitigating 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.

Our response to climate change can be split into two areas:

- Adaptation – making sure our services are resilient to a changing climate.

The potential effect of climate change on our future water resources is included in our 25-year Water Resources Management Plan, and we have published two adaptation reports, in 2011 and 2015, outlining our holistic, integrated and partnership approach to a range of short, medium and long-term challenges including climate change.

- Mitigation – reducing the carbon emissions associated with our services, especially through our energy strategy.

The key factor in climate change is an increase in greenhouse gases. There is global scientific agreement that as a result of human activity the amount of greenhouse gases in the atmosphere is increasing and affecting the global climate. Therefore minimising the greenhouse gases emitted as a result of our operations will mitigate climate change.

We have been driving down our carbon footprint over the last decade (a reduction of one-third since 2005/06) and have plans to reduce it further.

More information on our approach to all of these impacts and our environmental performance can be found on our website at: *unitedutilities.com/corporate/responsibility/environment/environment-performance.*

For information on principal risks and uncertainties in this area, see pages 54 to 57 ‘Health safety and environmental risk’, ‘Water service risk’ and ‘Wastewater service risk’.

## People

### How our people help us to create value

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.

Our suppliers and contractors provide us with essential services that we rely on to deliver our strategy. Our suppliers are contributing significantly towards the around £9 billion forecast contribution we are making to the regional economy over the 2015–20 period.

**The best service to customers**

Our people, both our employees and our supply chain, act as the face of our business for our customers, and therefore are a crucial part of delivering the best service to customers across our entire business.

**At the lowest sustainable cost**

Independent studies have shown that competitive wages, benefits and long-term incentives enhance the quality of work, increase employee retention and reduce absenteeism, as well as

# Strategic report

providing societal benefits, which helps to ensure efficient costs in relation to salaries and training. Comprehensive training and development opportunities for our employees help to improve our internal skills-base and therefore quality of work at an efficient cost, as well as creating a more engaged workforce.

**In a responsible manner**

We are supporting thousands of jobs in the North West, we have been named as one of the top 100 apprenticeship employers and have a growing graduate programme, helping to secure a legacy for the future in our region.

We work with our supply chain partners to give young people not in education, employment or training (NEETs) the chance to gain hands on experience and basic skills training in a real workplace environment, bringing social economic benefit to the region.

We are committed to promoting a safe, happy and diverse workforce and we maintain a comprehensive suite of policies, from ‘Agency worker’ to ‘Working time’ which are available to all employees on our intranet.

## How we manage our people

Our employees are paid a competitive base salary along with a benefits offering and the opportunity to join both the employee healthcare scheme and our share incentive plan. We measure employee engagement each year through our Employee Voice survey and achieved 79 per cent in the latest survey, which is higher than the UK norm. Management has 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.

We place a strong emphasis on providing comprehensive training and development opportunities for our employees. 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.

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.

We value diversity, providing equal opportunity and recruiting and promoting employees on the basis of merit, which we believe drives a more comprehensive and balanced skills-set. Despite being a highly engineering-based organisation, women are represented at all levels of our company. Over a third of our combined board and executive team is female. See chart below.

| | Male<br>**2018** | Female<br>**2018** |
|---|---|---|
| Group board | 7 (70%) | 3 (30%) |
| Senior managers | | |
| - Executive team* | 2 (50%) | 2 (50%) |
| - Other senior managers | 37 (84%) | 7 (16%) |
| Wider employees | 3,416 (64%) | 1,914 (36%) |

*Figures exclude CEO, CFO and COO, who are included in group board figures

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Over the last few years, we have been striving to improve diversity at all levels and across all types of roles within our business, including establishing our Gender Equality Network in 2015 to provide role models, mentoring and opportunities, and targeting diverse shortlists and attraction campaigns for our apprentice and graduate schemes.

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, where it is safe and practical to do so.

Our Human Rights policy demonstrates our commitment to protecting the human rights of our employees and supply chain. We convened a cross-company working group to draft the policy statement, and identify and assess human rights risks and potential impacts on our employees, customers, suppliers and communities. This group identified our salient human rights issues as access to clean water, data protection and privacy, health and safety, and modern slavery.

We work with suppliers and contractors whose business principles, conduct and standards align with our own. Our key suppliers have committed to our Sustainable Supply Chain Charter. We support the appointment of a small business commissioner to investigate companies who do not treat suppliers fairly, are a signatory to the Prompt Payment Code, and will fully comply with rules on reporting payments to suppliers.

### Impact of the external environment

The availability of skilled engineers is dependent on economic and social conditions and preferences. 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.

For information on principal risks and uncertainties in this area, see pages 54 to 57 'Health safety and environmental risk' and 'Resource risk'. To date, we have not identified any human rights abuses within our own operations nor our supply chain and so no remediation actions have been required. We have mapped our human rights risks against our corporate risk register and manage them within this framework. Our supply chain modern slavery risk management plan is detailed in our Slavery and Human Trafficking Statement.

Read more online at: *unitedutilities.com/corporate/responsibility/our-approach/human-rights*

## Assets

### How our assets help us to create value

Many of our assets are long-term in nature, for example our impounding reservoirs have a useful economic life of around 200 years. We earn a return, received through revenues, based on a regulatory measure of the value of our capital asset base, Regulatory Capital Value (RCV). This mechanism allows us to share the cost of building these long-term assets between the generations that will benefit from the use of those assets.

Our RCV is currently just over £11 billion, however the gross replacement cost of our fixed assets (including all our reservoirs, treatment works and pipes), i.e. the estimated amount it would cost for another company to build similar assets and networks, is around £90 billion. We expect to invest around £3.8 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.

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We manage our assets in a holistic way that seeks to minimise whole life costs, which helps us to deliver efficient totex against our regulatory allowance.

**The best service to customers**

Since privatisation in 1989, total capital investment of over £15 billion has provided substantial benefits to our customers, including reduced supply interruptions and improved water quality.

**At the lowest sustainable cost**

By carefully reviewing our potential capital projects, and considering the most efficient long-term solutions in terms of the lowest whole-life cost, we can save future operating costs, help to reduce future customer bills, and work towards being able to operate in a more sustainable manner. Disciplined investment, along with RPI inflation, also grows our RCV, increasing future revenues.

**In a responsible manner**

Effective capital investment helps us to meet increasingly stringent environmental standards, which helps to improve the region's environment and protect indigenous wildlife, as well as contributing to the North West's economy through job creation, both within our company and through our supply chain.

## How we manage our assets

When deciding on our investment strategy we need 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.

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.

We are committed to managing and operating our water, wastewater and energy assets to ensure we continue to provide a water and wastewater service that helps life flow smoothly for our customers, regulators and other stakeholders.

We have an asset management policy that is available to all employees on our intranet that details how we will operate, maintain and invest in our assets with the aim of delivering our customer promises and their associated outcomes, as agreed at the price review for the current regulatory period.

## Impact of the external environment

We anticipate an increase in the North West's population of around 900,000 by 2045 (more than the population of a large city such as Liverpool).

We are planning to ensure that our services and supporting infrastructure are able to meet the needs of this growing population, which is also expected to include a higher proportion of older people. We must ensure we are able to meet increased demand on both our water and wastewater networks as the regional population is expected to increase.

We must build increased resilience into all of our assets in order to cope with the anticipated impacts of a changing climate. Our assets must be prepared to meet the changing and increasingly challenging environmental constraints that we have to comply with in regard to areas such as water abstraction, increasingly stringent wastewater treatment levels, and improvements to flood defences as a result of increasing extreme weather conditions.

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There is need for a careful balance between preparing for future challenges and maintaining affordable bills by phasing the work and cost. We must strike a balance between the various interests of customers and our many regulators, as well as political and societal interest.

A phased, long-term approach to address all of these concerns ensures that the necessary work can be delivered without placing too much pressure on customer bills.

Technology and innovation presents an opportunity, for example the new wastewater treatment process, Nereda, has transformed this area, our use of robots in managing the water network has driven greater efficiency and improved customer service, and we are using drones to inspect assets with restricted access to improve health and safety as well as reduce time and costs.

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.

Advances in technology can be used to help deliver improvements in the quality and/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 to operating our network is a key example of this.

Technological advances can 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.

For information on principal risks and uncertainties in this area, see pages 54 to 57 ‘Security risk’, ‘Water service risk’, ‘Wastewater service risk’, ‘Compliance risk’, and ‘Supply chain and programme delivery’.

## Financing

### How our financing helps us to create value

We aim to maintain a robust and sustainable capital structure, balancing both equity and debt, to achieve a strong investment grade credit rating, thus enabling efficient access to the debt capital markets across the economic cycle.

We adopt a prudent approach to managing financial risks, which helps to ensure financial resilience in the long term. We have a long track record of aligning our financial risk management with the regulatory model through inflation and interest rate management policies, which helps us manage uncertainty in volatile market conditions and when faced with changes in Ofwat’s approach to setting the cost of debt at each price review.

**The best service to customers**

Customers benefit from reductions to bills and lower finance costs contribute to our ability to deliver this.

Customers also appreciate receiving the benefit of service improvements earlier rather than later, and the ability to efficiently finance our business helps enable us to deliver this.

**At the lowest sustainable cost**

Locking in long-term debt and swaps at good relative value can help keep our finance costs low and provides the potential to outperform the industry-allowed cost of debt.

The long-term average life of our debt portfolio, our strong and stable investment grade credit rating, robust hedging policies, and maintaining access to a broad range of sources of finance, all help to ensure that our ability to efficiently finance our business is sustainable, and to reduce

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our exposure to the risk of fluctuating market conditions and changes in the regulatory environment.

**In a responsible manner**

We have open and transparent reporting around all of our equity and debt financing arrangements.

We do not utilise offshore financing vehicles, and we maintain an appropriate level of gearing, measured as net debt to regulatory capital value (RCV), broadly in line with regulatory assumptions, which supports a robust and sustainable capital structure.

### How we manage our financing

We have proactive programmes of engagement with equity and credit investors, which allows us to hear their views, which we then consider in our strategic planning, and also to update them on developments in our business.

As part of our planning process, we review key credit ratios to ensure these meet required thresholds in order to satisfy the board's ratings targets. Performance against business plan credit ratios is regularly monitored, and we maintain close contact with the credit rating agencies to understand the methodology and any changes. Gearing is maintained within our target range of 55 per cent to 65 per cent, which broadly mirrors regulatory assumptions.

Issuing new debt is 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 and diverse range of sources of finance, in a number of markets, across which we seek best relative value when issuing new debt. We manage relationships with a diverse range of banks, and we refresh our European Medium Term Note (EMTN) Programme annually to allow for efficient issuing of debt under pre-agreed contractual terms.

We aim to avoid a concentration of refinancing in any one year, and tend to fund long-term where possible, with the average life of our term debt being just under 20 years. We regularly review liquidity forecasts against our policy of having available resources to cover the next 15–24 months of projected cash flows. This helps ensure forward funding requirements are met.

We have clearly articulated financial risk management policies, covering credit, liquidity, interest rate, and currency risk, and we responded proactively to Ofwat's intention to transition from RPI to CPIH inflation and to index the portion of new debt in calculating the cost of debt in the next regulatory period.

We have conducted an extensive review of our inflation and interest rate hedging policies and amended these to align with the new regulatory model and continue to maintain the most appropriate financial risk management. We will no longer substantively fix all of our nominal debt at the start of each regulatory period, but maintain a rolling ten-year fixing profile on nominal debt to mirror Ofwat's assumed 70 per cent embedded and 30 per cent new debt split (with debt indexation on the new debt portion). We aim to retain around half of our net debt in index-linked form (where it is economic to do so), by issuing index-linked debt and/or swapping a portion of nominal debt. This is expected to remain mostly in RPI-linked form until CPI / CPIH debt and swaps become available in sufficient size at an economic cost.

We are the sector leader in CPI inflation linked financing, having issued the first ever CPI-linked notes by a UK utility and have continued to build the CPI-linkage in our debt portfolio where good relative value opportunities can be found.

### Impact of the external environment

Changes in economic conditions and financial markets, such as inflation and interest rates, can influence our ability to create value through financing. While these are outside of our direct control, we can mitigate some of the potential adverse impacts associated with market

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movements, such as on inflation and interest rates, through our financial hedging strategies. In this way we can create value by reducing the risks to which we are exposed.

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 2017/18. Comparatively low interest rates have been beneficial to our future cost of debt as we continue with our nominal interest rate hedging strategy.

RPI inflation has continued to rise during 2017/18, briefly reaching levels as high as 4.1 per cent, but returning to 3.3 per cent at March 2018, compared with 3.1 per cent at March 2017. However, it has been lower over recent years than levels it has reached in the last 10 years. The prices we charge our customers (which drive our revenue) and our regulatory capital value (RCV) are linked to RPI inflation for the current regulatory period, therefore lower RPI over recent years has meant slightly lower growth on these measures. However, as a result of our large quantity of index-linked debt, our finance costs decrease as inflation falls, providing a partial economic offset to revenue.

Our pension liabilities are linked to RPI inflation, and have been hedged by a combination of a market hedge and the inflation funding mechanism (IFM), whereby company contributions are flexed for movements in RPI. We expect the schemes to increase the market hedge for inflation in line with a progressive de-risking strategy, with a corresponding reduction in the IFM.

Market sentiment can also have an impact on our financing. While much of this can be outside of our direct control, there are ways in which we are able to help inform and influence public opinion.

For information on principal risks and uncertainties in this area, see pages 54 to 57 ‘Financial risk’.

## Internal environment

### Governance

Good governance lies at the heart of all successful organisations. We firmly believe that it leads to better management decisions as well as helping to avoid exposure to potential risks and improving corporate resilience.

We strive to operate in a manner that reflects the highest standards of corporate governance, accountability and transparency. 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.

We have an anti-bribery policy that all our employees must follow, and processes in place to monitor compliance with the policy. This policy is available to view online at *unitedutilities.com/corporate/about-us/governance*

We also operate an independently provided, confidential reporting telephone helpline and web portal for employees to raise matters of concern in relation to fraud, dishonesty, corruption, theft, security and bribery, and all claims are fully investigated.

Our employees and representatives of our suppliers must also comply with our sustainable supply chain charter, which explains that we will not tolerate corruption, bribery and anti-competitive actions and we expect our suppliers to comply with applicable laws and regulations and in particular never to offer or accept any undue payment or other consideration, directly or indirectly, for the purposes of inducing any person or entity to act contrary to their prescribed duties.

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## Prudent risk management

As you would expect 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 being run in a cost-effective way.

Given the complex legal and regulatory environment within which we operate, we are exposed to a range of risks.

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, as well as the outcomes we will deliver for customers, and that we provide sufficient information to Ofwat to ensure we receive a final determination that covers these, as we are bound by these plans for the following five-year period with limited opportunity to change them. Failure to meet the terms of our current 2015–20 regulatory contract is a risk.

We face risks in relation to potential future changes in legislation or regulation. This includes the anticipated changes for the 2020–25 regulatory period, as outlined on pages 13 to 14, and increased political scrutiny with discussion of the potential Renationalisation of the water industry, as well as potential changes further into the future.

We also face risks such as possible non-compliance with existing laws or regulations, and from environmental impacts such as climate change.

See pages 54 to 57 for more details on what we consider to be our principal risks and uncertainties.

## Values and culture

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, which is available on our website at: *unitedutilities.com/corporate/about-us/governance/business-principles.*

Our culture is embodied in our three core values of customer focus, integrity and innovation, and we operate with these at all levels of our business. These core values are interrelated – innovating to improve our services and acting with integrity in the way we conduct our activities helps us to continually improve customer service.

## Customer focus

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

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

## Integrity

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 ‘Employee Voice’ survey, through news articles on our intranet, and on our social media collaboration tool ‘Yammer’.

## Innovation

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 and from wider industries across the world.

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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.

## Our stakeholder engagement

### Why stakeholder engagement matters

Delivering water and wastewater services underpins our region's economy, society and environment and this creates a deep connection between the company and the society we serve. We do not operate in isolation and we cannot alone determine what the region needs from its water supplier.

It is essential that we engage with stakeholders across the North West to ensure our service delivery is prioritised to meet those needs and that we serve customers in a reliable and sustainable way. We depend on the perspectives that stakeholders can bring to our decision-making, but this can only be achieved if we build strong, constructive relationships with a broad range of stakeholders representing different interests.

There is considerable stakeholder interest in corporate governance and business conduct, and how actions taken by companies need to build trust. It is important that our approach to stakeholder engagement is subject to robust governance so that the relationships we develop are taken into account in our decision making. This makes an important contribution to building trust. The UUG board's corporate responsibility committee meets four times a year and an update on stakeholder engagement is one of its standing agenda items. The chair of the independent customer challenge group, YourVoice, attends board meetings to provide an external perspective.

### Who are our principal stakeholders?

**Customers** – Through relentless focus on improving service at an efficient cost, we can help to build their trust and confidence in our service delivery. Providing clean drinking water remains one of our most significant contributions to public health, and customers expect us to provide reliable water and wastewater services they can depend upon. They also want us to support customers in vulnerable circumstances.

**Community** – Our work puts us right at the heart of the communities in which we operate. With the highest proportion of the UK's most socially and economically deprived areas in the North West, working with community stakeholders is critical if we are to make a meaningful contribution to tackling water poverty. Other organisations play an important role in tackling the water challenges we face of too much water, too little water, and water of the right quality.

**Suppliers** – Supporting jobs through our supply chain stimulates the development of skills and employment the North West economy needs. By maintaining good relationships with suppliers we can continue to improve our delivery of projects to time and good quality at efficient costs. Working with responsible suppliers means we can achieve more and succeed together. Key for our suppliers is fair and prompt payment terms.

**Employees** – By developing our people we can continue to improve our service to customers, and by demonstrating that we are a dynamic, innovative organisation we can attract the talent our future workforce needs. Increasing the diversity of our employees ensures we have access to a broad set of views that are fit for our modern society. Looking after the health, safety and wellbeing of our employees is paramount.

**Regulators** – We engage actively to help shape the policy and regulatory framework within which we operate, covering customer, economic and environmental factors. These priorities require balancing and need to be looked at over a long-term horizon. Maintaining relationships is

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key to assist with this. There are also changes in the priorities and aims of our regulators over time, and actively engaging in discussions around future policy is important for us to provide the company perspective.

**Political** – Engagement with national and local government, as well as elected representatives and devolved administrations, on topics of public interest helps us to understand their issues and seek solutions to shared environmental, social, economic and governance issues.

**Media** – It is through the media, and increasingly its social media platforms, that many stakeholders receive their information about us and our activities. Given the essential nature of our services, it is important that coverage is fair, balanced and accurate, requiring effective two-way dialogue.

### How we engage with stakeholders

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.

In some cases, our engagement focuses on future requirements so that our investment in infrastructure enables the North West economy to grow. Other times, we have to be more reactive, supporting our stakeholders when issues arise such as extreme weather events. Our approach goes beyond simple engagement, as it is important to understand what issues our stakeholders consider to be material and the wider benefit that addressing these issues brings.

To understand which issues are of material concern to stakeholders, and which are most material to our company strategy, we regularly compile a materiality matrix. This is informed by extensive stakeholder consultation and customer research, which we carry out on a rolling programme to validate our business planning, and by business representatives sitting on our corporate responsibility panel.

There are a number of ways in which we engage with stakeholders. For example, our panel of customer representatives, YourVoice, typically meets quarterly to ensure that customers are at the heart of the company’s business planning engagement.

We arrange regular meetings with stakeholders from across the region to cover a variety of topics, such as workshops to discuss priorities for our draft business plan. Some of our employees also have formal roles on bodies set up by our stakeholders, providing the opportunity to give the company’s perspective on topics ranging from land management to infrastructure development.

We act on the findings of our annual opinion surveys to ensure that employees are engaged and committed to deliver the company’s goals and objectives.

### Stakeholder engagement activities

As part of our continuous programme of communicating with our stakeholders, we held a series of workshops in 2017/18 where 200 representatives from local authorities, tourism bodies, environmental regulators, public health representatives, national and local non-governmental organisations and the business community came together to discuss their priorities for our services.

Our ‘you care more than you think’ campaign using #nwmatters encouraged feedback on our draft 2020–25 business plan by encouraging people in the North West to think about what water really means to their lives. The campaign reached over 1.5 million people, with 25,000 engagements from social media users and over 4,000 face-to-face interactions at nine roadshows. This insight is influencing what we do, the services we deliver, and shaping what we propose for our future plans.

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Our first ever affordability summit brought together the region's stakeholders to identify ways to help customers in vulnerable circumstances. Five key action areas emerged, where we are co-creating and co-delivering projects to find shared solutions to shared problems.

We actively involved customers in the design process for a new bill for metered customers, learning what aspects of the existing bill were not working effectively, then testing the new design with them.

Engagement with environmental stakeholders in Cumbria has shaped the solution we are installing to improve water quality in the River Petteril. Working with partners, we are implementing a range of solutions that will bring wider benefits than just water quality, at a lower overall cost.

## Our planning cycles

### Our approach to planning

The three business areas within our business model – wholesale water, wholesale wastewater, and household retail – are structured in line with Ofwat's distinct price controls for the current regulatory period.

The fourth price control, non-household retail, is regulated within the 50:50 joint venture between UUPLC and Severn Trent, Water Plus. While we can influence it, we cannot control this joint venture and it is not part of our consolidated group, therefore it does not form part of our group's business model.

Each business area undertakes both long, medium and short-term planning to identify how they can best deliver their outcomes now and in the future.

We have planning cycles that cover:

**25+ years** – reflecting the long-term nature of our business, which provides an essential service to customers, and helping us to define what we need to deliver in each five-year regulatory period to ensure long-term resilience;

**5 years** – reflecting the regulatory review periods within which our revenue allowances are set, and helping us move towards achievement of our long-term goals; and

**1 year** – reflecting the annual targets we set to help move us towards achievement of our five-year goals.

Our plans take into account the internal and external drivers and relationships described in our business model, and we adopt an integrated approach that consults with and considers the interests of a whole range of stakeholders.

Underpinning our approach to planning, we continuously assess our performance using key performance indicators (KPIs) and other performance measures, which help us to formulate our future improvement plans for our various stakeholders.

### Planning – 25+ years

In order to maintain a reliable, high quality water service for our customers into the future, 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.

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

- Climate change and its implications for water resources and flooding;

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- A more open, competitive UK water market;
- More rigorous environmental regulations;
- Population growth;
- Developments in technology;
- The UK's exit from the European Union; and
- Combining affordable bills with a modern, responsive service.

By anticipating and planning ahead for these, we can ensure that we continue to deliver **the best service to customers, at the lowest sustainable cost, in a responsible manner**.

Our strategy for the future is set out on our web pages where we examine the challenges ahead and how we will focus our resources and talents in order to meet them. Our current 25-year Water Resources Management Plan (WRMP) was published in 2015 covering the 2015–40 period.

We have recently finished consulting with customers and stakeholders to ensure their interests are reflected in our new 25-year WRMP, which covers the 2020–45 period and will be submitted to Defra in August 2018.

These long-term plans set 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 are aiming to 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 sustainable whole-life cost modelling;
- Efficiently implementing a robust and appropriate mix of debt and equity financing;
- Embracing innovation and our Systems Thinking approach to make our future services better, faster, safer and cheaper;
- Long-term planning and management of water resources (25-year WRMP);
- Responding to the many challenges and opportunities we face, including climate change and population growth; and
- Sustainable catchment management.

### Planning – 5 years

Each five-year regulatory contract is designed with our strategic themes in mind and aims to help us to work towards our long-term plans and ultimately to achieve our long-term vision. We submit a robust, balanced plan to Ofwat in order to agree a regulatory contract that allows for the best overall outcomes for our customers, shareholders and the environment.

Once each 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 the 2010–15 regulatory period focused on improving customer satisfaction and meeting our statutory obligations.

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We delivered on each of these, which provided us with a strong platform to deliver further in the current 2015–20 regulatory period.

Some of the key ways we are aiming to create value over the 2015–20 regulatory period are:

- Improving our customer service further – improving efficiency while reducing costs, improving our SIM performance to increase rewards/reduce penalties from Ofwat;
- Enhancing our debt collection activities – reducing retail costs, whilst providing the best support for customers struggling to pay;
- Minimising 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;
- Raising low-cost finance – helping us to outperform our allowed finance costs, which is our most significant area of potential outperformance in this regulatory period;
- Delivering 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 reliable water delivery and reducing pollution and sewer flooding incidents;
- Implementing our hedging strategies to fix medium-term interest rates and power costs – helping us to meet our allowance by reducing the volatility of these costs;
- Increasing our production of renewable energy from waste – helping to protect us from rising energy costs and reducing our carbon footprint; and
- Maintaining a robust supply/demand balance – providing water resource and customer supply benefits, and avoiding penalties/unfunded expenditure requirements.

**Wholesale water**

- Maintain existing high levels of reliability in the delivery of day-to-day water services, making better use of technology for remote monitoring and control of 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 customer contacts 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 our operational efficiency; and
- 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**

- Continue to improve the way we operate, making better use of technology, automation and control to drive better customer service at reduced cost, and build on customer satisfaction improvements already delivered;
- Reduce the number of our customers' properties exposed to sewer flooding, working in partnerships to deliver schemes cost-effectively and promote the use of more sustainable drainage systems;

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- Improve 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, and engage with others to explore innovative catchment management techniques to control diffuse pollution in our catchments;
- Increase production of renewable energy from waste to protect customers from rising energy costs and reduce our carbon footprint; and
- Constrain the costs of 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, anticipating problems before they materialise and improving our communication channels;
- Reduce the number of customer complaints further, 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, 'Restart', which has proven effective in helping customers in difficulty return to regular payment; and
- Reduce the cost to serve our customers through systems and process improvements. This is particularly important under the current price control methodology which uses an industry average retail cost to serve to determine part of customer bills.

**Adapting our plans to meet our customers' evolving needs**

The North West remains the most socially and economically deprived region in England, which is the principal driver of our higher than average cost to serve for household customers. This is currently recognised by Ofwat through an additional cost allowance for deprivation of £20 million per annum over the 2015–20 regulatory period.

A report from the Department for Communities and Local Government in 2015/16 reaffirmed that the North West has the most deprived regions in England, containing three of the top five local authority districts with the highest proportion of 'highly deprived' neighbourhoods (categorised as the most deprived ten per cent).

Bad debt remains a risk, particularly with the continuing tightening of real disposable incomes and the impact of welfare reforms likely to intensify. Our debt management processes have been externally benchmarked as efficient and effective. We continue to refine and enhance them, whilst also helping customers back into making regular payments through the use of manageable payment plans.

We 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 elderly customers.

We are also adapting to the increasing use of social media and digital technology. We have recognised the increasing power of social media as communication channels for customers in

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doing business with us, and have invested in a new digital external communications capability and a number of website improvements that were built through consultation with our customers.

### Planning – 1 year

Before the start of each financial year, we develop a business plan for that year, which is approved by the board.

This sets our annual targets, which are designed to help deliver further improvements in service delivery and efficiency, and to help move us towards achievement of our five-year goals.

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

Our one-year targets help us to measure progress towards our five-year goals, which in turn help us work towards our long-term plans and, ultimately, our vision to be the best UK water and wastewater company.

This top-down approach helps us to ensure the long-term resilience and sustainability of our business through short and medium-term goals that we can monitor and measure our progress against.

**Performance monitoring**

The executive directors hold quarterly business review meetings with senior managers 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 2017/18 annual bonus and vested long-term incentive plans for our executive directors are shown on pages 76 to 79 within the remuneration report.

## How we measure our performance

### Our key performance indicators (KPIs)

To help measure progress on how well we are delivering the outcomes described in our business model and adding value for all our stakeholders, we focus on a range of financial and operational KPIs, encompassing the important areas of customer service and environmental performance, as well as financial indicators. We set KPIs for the five-year regulatory period, and they remain the same as last year. 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 76 to 79.

### 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.

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| 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. | End the 2015-20 regulatory period with a cumulative net ODI reward. | **2017/18: £7.0 million net penalty (cumulative £2.2 million net reward)**<br>2016/17: £6.7 million net reward (cumulative £9.2 million net reward)<br>2015/16: £2.5 million net reward |
| **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. | **2017/18: 4.49**<br>2016/17: 4.42<br>2015/16: 4.27<br>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. | **2017/18: 71**<br>2016/17: 77<br>2015/16: 95<br>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 outperform Ofwat's final determination totex allowance by £100 million over the 2015-20 regulatory period. | **2015–20: Confident of outperforming the final determination allowance by £100 million over the 2015–20 regulatory period**<br>Totex new measure for 2015-20 period hence no prior years' comparators |
| **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**<br>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 | **2017/18: £9m outperformance**<br>2016/17: £14m |

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| | | | |
|---|---|---|---|
| | | revenue allowance. | outperformance<br>2015/16: £10m outperformance |
| 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. | **2017/18: Met target**<br>2016/17: Met target<br>2015/16: Met target<br>2014/15: Met target<br>2013/14: 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 (i.e. at least 4th) on a consistent basis. | **2016/17: Joint 1st**<br>2015/16: Joint 2nd<br>2014/15: 2nd<br>2013/14: 2nd<br>2012/13: 2nd<br>2016/17 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. | **2017/18: 'World Class'**<br>2016/17: 'World Class'<br>2015/16: 'World Class'<br>2014/15: 'World Class'<br>2013/14: 'World Class' |

## Our performance in 2017/18

### 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 regulatory period with a reduction of around 75 per cent in the overall number of customer complaints.

This year, we have seen another step change in our customer satisfaction performance. We achieved our highest ever scores against Ofwat's qualitative Service Incentive Mechanism (SIM) measure, finishing first in the final survey of the year and third for the year overall. This performance is mirrored in the number of complaints that we receive. These have reduced by over 34 per cent in two years and the number of repeat complaints have reduced by 63 per cent over the same period.

We have added to our already leading position on affordability and vulnerability. We are now supporting more than 50,000 customers in need of help through our Priority Services scheme, providing more targeted support for customers experiencing short or long-term personal or financial difficulties in their lives, with tailored assistance. In January we hosted the first ever North West Affordability summit, engaging with customers and key stakeholders with an interest in this topic.

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We have an industry leading digital capability informed by customers with more than 750,000 customers now registered for our online customer portal, My Account, and we have launched the sector's first truly integrated mobile app allowing customers to complete a variety of interactions with us using their preferred channel.

Improving customer service will continue to be a key area of focus, and we have identified a range of opportunities to deliver further benefits for 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 compared with the prior year, it remains above our historical average and we have plans in place to deliver improved performance going forward. We have consistently delivered a reliable water service, although we have experienced some water no-supply incidents in the 2015–20 regulatory period. 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, projects and programmes of work 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 and other innovative technologies. Our plan for the 2015–20 regulatory period includes a target of reducing sewer flooding incidents by over 40 per cent, in line with customers' affordability preferences, and we are making good progress. We have achieved our best ever five-year performance on our repeat flooding and internal operational flooding measures. Our wastewater network will continue to benefit from significant investment going forward and we will continue to seek to work in collaboration with other external lead flood authorities and associated partners to address the widespread flooding events that hit our region, as we aim to help mitigate changing weather patterns likely to result from climate change.

## Key performance indicators:

**Outcome delivery incentives (ODIs)** – we have 19 wholesale financial ODIs and as was supported by customers, the risk is skewed to the downside with only ten providing the potential to earn a reward in the 2015–20 regulatory period.

Our performance for 2017/18 has resulted in a £7.0 million net penalty. Overall, performance was again good against our wastewater measures but we recognise that there are still areas in which we can improve against our water measures, and we are committed to achieving this.

We are pleased with our cumulative performance over the first three years of the current regulatory period resulting in a net reward of £2.2 million, exceeding our initial expectations. 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 strong performance to date coupled with continued targeted investment alongside our Systems Thinking and innovative approach to the way we operate, gives us confidence that we will achieve a cumulative net ODI outcome over the 2015–20 regulatory period in positive reward territory.

Our main areas of reward to date have come through our performance in the areas of private sewers, pollution and leakage, with our main penalty being on reliable water service and water quality service.

# Strategic report

**Service incentive mechanism (SIM)** – we have previously 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, ending the year as a leading company in our peer group.

Qualitative: Ofwat has undertaken the four surveys for 2017/18 and United Utilities has improved its score to 4.49 points, compared with 4.42 points in 2016/17, putting us in third position for the year out of the 18 water companies, and also third position out of the 10 companies providing both water and wastewater services. We ended the year with our highest ever score of 4.61 in wave 4, which placed us in first position in this wave for the sector overall. 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 financial year when the other companies publish their respective results, on absolute performance for 2017/18, our score of 71 points represents a marked improvement on our 2016/17 score of 77 points. For the first nine months of the year, of the companies that share data on quantitative SIM, we were first of the seven water and wastewater companies and fourth of the 11 water companies.

## 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 utilising other renewable energy facilities generated by other UUG group companies. We have also substantially locked-in our power commodity costs across 2015–20, providing greater cost certainty for the regulatory period.

**Proactive network management –** through our Systems Thinking approach we are more proactive in the management of our assets and networks. We have improved our predictive modelling and forecasting through better use of sensors in our network and better analysis of other data, such as weather forecasting, enabling us to address more asset and network problems before they affect customers. This reduces the level of reactive work and improves 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. We now have over 100,000 customers on affordability schemes, almost double the commitment we made at the start of AMP6. 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 initiatives such as our affordability schemes, our household bad debt expense has reduced to 2.3 per cent of regulated revenue from 2.5 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 £264.1 million as at 31 March 2018, compared with a surplus of £194.5 million as at 31 March 2017. Further details of the group's pension provision are provided in the pensions section on pages 113 to 114.

From 1 April 2018, the majority of active members in the defined benefit sections of the group's pension schemes transitioned to a hybrid section incorporating both defined benefit and defined contribution elements. The changes have had no impact on the financial statements for the year ended 31 March 2018 as they have only taken effect for pensionable service from 1 April 2018.

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**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 around £3.8 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 accelerated our 2015–20 investment programme in order to improve services for customers and deliver early operational and environmental benefits. Regulatory capital investment in 2017/18, including £147 million of infrastructure renewals expenditure, was £816 million, including additional investment that we have committed to, sharing our overall regulatory outperformance with customers. This, combined with £1.6 billion invested in the first two years of the regulatory period, brings our total spend to around £2.4 billion of our planned £3.8 billion capital investment across the 2015–20 regulatory 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, representing very good performance.

### Key performance indicators:

**Total expenditure (totex) performance** – our totex allowance for the 2015–2020 regulatory period represented a significant challenge compared with the costs we originally submitted as part of our business plan. We have not only closed the gap to our allowance but we are now also confident of outperforming that allowance by £100 million. This has been achieved through a combination of driving efficiency into our capital programme and also through Systems Thinking.

**Financing outperformance** – the low cost of debt we have already locked-in places United Utilities in a strong position to deliver significant outperformance for the 2015–20 regulatory period compared with the industry allowed cost.

**Household retail cost to serve** – we continue to deliver against a challenging benchmark set for AMP6. Our target is to minimise our costs compared with our revenue allowance and we have delivered a good performance in 2017/18, outperforming this year's revenue allowance by around £9 million. By 2020, we are forecasting a cost to serve in line with the regulatory cost allowance and we are hopeful that our cost plans will move us towards upper quartile performance in AMP7.

## In a responsible manner

Behaving 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, social and governance performance across a broad front has received external recognition. Earlier in the 2017/18 financial year, United Utilities retained a World Class rating in the Dow Jones Sustainability Index for the tenth 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 continued our strong operational focus on leakage, alongside our network resilience improvements and a range of initiatives such as active pressure management, satellite technology and the UK's first leakage sniffer dog specially trained to pinpoint the exact

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location of leaks. This has delivered good performance against our leakage targets in 2017/18. Encouraging our customers to save water through water efficiency programmes not only enables them to help preserve this precious resource but can also save money on their water bill.

**Environmental performance** – this is a high priority for United Utilities and we were delighted to have retained our Industry Leading Company status in the Environment Agency's latest performance metrics, as described in the KPIs section below. This is a result of our approach to managing our assets in an integrated way and has resulted in reduced environmental incidents. We still don't always get it right and this year we delivered the obligations under our first enforcement undertakings, investing in catchment schemes rather than accepting formal prosecutions.

**Carbon footprint** – by 2020, we aim to reduce our carbon footprint by 50 per cent compared with a 2005/06 baseline and we are on track to do so. This year our carbon footprint has reduced to 391,640 tonnes of carbon dioxide equivalent, a reduction of one-third since 2005/06, helped by a 4 per cent reduction in electricity use. In addition, we generated more renewable energy than ever before, at 167 gigawatt hours, up 12 per cent on the previous year. This illustrates good progress in the company's energy strategy to use less and generate more renewable energy.

**Employees** – we continue to work hard to engage all of our employees in the transformation of the group's performance. Employee engagement was at 79 per cent this year, higher than the UK norm. 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 2017/18. We now have a total of 55 graduates and 118 apprentices across the business. Our investment in recruiting graduates and apprentices is already benefiting the company with 153 employees securing permanent roles across our business, having previously been on either the graduate or apprentice scheme.

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 and our status under the UK workplace wellbeing charter. Our employee accident frequency rate for 2017/18 reduced to 0.101 accidents per 100,000 hours, compared with a rate of 0.196 in 2016/17. For the same period, our contractor accident frequency rate increased slightly to 0.092 per 100,000 hours, compared with a rate of 0.087 in 2016/17. We recognise that there is always more to do, and health, safety and wellbeing will continue to be a significant area of focus as we strive for continuous improvement.

**Communities** – we continue to support partnerships, both financially and in terms of employee time through volunteering, with other organisations across the North West. Our approach to integrated catchments helps to tackle water quality issues in lakes, rivers and coastal waters across the North West, and our LoveMyBeach contribution includes employees volunteering to help 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 work with Youth Focus North West engages the region's young people, and our future customers, with our business planning process.

### Key performance indicators:

**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. In 2017/18 we 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 2017, we were awarded Industry Leading Company status across the range of

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operational metrics for the second year running and were one of only two companies to achieve this status. This 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 2017/18, United Utilities retained its World Class rating for the tenth consecutive year.

## Financial performance

| **Financial KPIs** | Year ended 31 March 2018 | Year ended 31 March 2017 |
|---|---|---|
| Revenue | £1,716.6m | £1,680.3m |
| Operating profit | £634.2m | £606.8m |
| Profit before tax | £416.2m | £409.5m |
| RCV gearing | 64% | 64%* |
| Interest cover | 2.9 | 3.0 |

*The 2017 gearing percentage has been updated to reflect a change in calculation methodology by incorporating shadow RCV, being the Ofwat determined RCV adjusted for actual spend and presented in outturn prices.

### Revenue

The group has delivered a strong set of financial results for the year ended 31 March 2018. Revenue was up £36.3 million at £1,716.6 million, reflecting our allowed regulatory revenue changes, partly offset by the impact of UUPLC's Water Plus JV, which completed on the 1 June 2016 and the below regulatory adjustments.

With regard to Ofwat's revenue correction mechanism, relating to the 2014/15 financial year, we have around £9 million to return to customers. As we have previously indicated, we have begun to return this to customers with a revenue reduction of around £3 million in 2017/18, with further revenue reductions proposed of around £3 million in both of 2018/19 and 2019/20. This approach has been adopted to help aid a smoother bill profile.

Separately, consistent with Ofwat's annual wholesale revenue forecasting incentive mechanism (WRFIM), revenue has also been reduced in 2017/18 by £10 million as actual volumes in 2015/16 were higher than our original assumptions. We will further be reducing revenues in 2018/19 by £4 million as actual volumes in 2016/17 were also higher than our original assumptions.

### Operating profit

Reported operating profit increased by £27.4 million, to £634.2 million. This reflects our allowed regulatory revenue changes and lower total costs partly offset by an increase in depreciation and amortisation and reduced profits in the prior year due to costs associated with preparing the business for open competition in the non-household retail sector and other restructuring costs.

### Investment income and finance expense

Reported net finance expense of £218.0 million was higher than the £197.3 million expense in 2016/17. This £20.7 million increase principally reflects the increased indexation charge in the year of £57.1 million which has been partly offset by an increase in the fair value gains on debt and derivative instruments, from a £5.2 million gain in 2016/17 to £27.2 million in 2017/18.

The group has fixed the substantial majority of its non index-linked debt for the 2015-20 regulatory period.

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## Profit before tax

Profit before tax was £416.2 million, £6.7 million higher than last year, reflecting the increased operating profit partly offset by the increase in net finance expense.

## Tax

In addition to corporation tax, the group pays significant other contributions to the public finances on its own behalf as well as collecting and paying over further amounts for its 5,000 strong workforce. Full details of our tax policies and objectives are set out on page 80.

In 2017/18, we paid corporation tax of £35.5 million compared with £42.4 million for 2016/17. The total tax charge for 2017/18 is £77.0 million as compared to a total charge of £21.7 million for 2016/17, the main difference being the prior year deferred tax credit of £57.8m relating to changes in the Government's future planned tax rate.

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 2018 was £822.7 million, compared with £807.6 million in the previous year. This increase mainly reflects lower interest and corporation tax paid. The group's net capital expenditure was £701.6 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 and a £40.0 million loan receivable from intermediate parent undertaking was £7,165.0 million at 31 March 2018, compared with £6,856.8 million at 31 March 2017. This increase reflects accelerated regulatory capital expenditure, payments of dividends, interest and tax, the inflationary uplift on index-linked debt, partly offset by loans to joint ventures provided in the prior year.

## Fair value of debt

The group's gross borrowings at 31 March 2018 had a carrying value of £8,119.9 million. The fair value of these borrowings was £9,254.3 million. This £1,134.4 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 decreased from £1,214.5 million at 31 March 2017 due primarily to an increase 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 64 per cent at both 31 March 2018 and 31 March 2017, remaining within Ofwat's 55 per cent to 65 per cent assumed gearing range.

UUW has long-term credit ratings of A3/A- from Moody's Investors Service (Moody's) and Standard & Poor's (S&P) Ratings Services respectively. Both Moody's and S&P have the group's ratings on a stable 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.

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Cash and short-term deposits at 31 March 2018 amounted to £499.6 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 £2.2 billion of this requirement.

In April 2016, UUW signed a £250 million index-linked term loan facility with the European Investment Bank (EIB) to support the delivery of UUW's AMP6 investment programme. In October 2017 the final £75 million was drawn down such that as at 31 March 2018, the full £250 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.

In December 2017, UUW's financing subsidiary, United Utilities Water Finance PLC (UUWF), raised around £23 million of term funding, via the issue of €26 million private placement notes, with a 15-year maturity, off our EMTN programme. In January 2018, UUWF raised around £27 million of term funding, via the issue of €30 million private placement notes, with a 15-year maturity, off our EMTN programme. In February 2018, UUWF raised around £68 million of term funding, via the issue of HKD739 million private placement notes, with an 8-year maturity, off our EMTN programme. Also in February 2018, UUWF issued £300 million fixed rate notes in the public bond market, with a 7-year maturity. This was the group's first public bond issue since 2009 and was well received by the market with good investor participation generating an order book in excess of £600 million. Notwithstanding a degree of market volatility at the time of issuance, we were pleased to price the bond at a very satisfactory level.

We remain the sector leader in CPI based financing having previously raised £165 million, in response to Ofwat's decision to transition away from RPI inflation linkage.

In addition, since September 2017, the group has renewed £80 million of committed bank facilities.

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 2018, approximately 52 per cent of the group's net debt was in index-linked form, representing around 33 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 just under 20 years.

Recognising Ofwat's intention to transition to the use of CPIH as part of its PR19 methodology, the group has undertaken a review of its inflation hedging policy. This review involved a balanced assessment across a range of factors including maintaining an appropriate economic hedge of the RCV and associated cash flows, the availability and costs of hedging instruments, the impact of different hedging strategies on key financial indicators including income statement metrics, along with a consideration of broader sector positioning. Taking account of these factors, along with the intention of the group's defined benefits pension schemes to implement further de-risking by increasing their hedges of RPI inflation with a corresponding reduction/removal of the pension Inflation Funding Mechanism, has resulted in a revised inflation hedging policy whereby the group intends to maintain around half of net debt in index-linked form.

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. Historically, this has been supplemented by fixing substantially all remaining floating rate exposure across the forthcoming

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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 regulatory period, locking in an average annual interest rate of around 3.2 per cent nominal (inclusive of credit spreads).

Recognising Ofwat's intention to apply debt indexation for new debt raised during the 2020–25 regulatory period, we will retain the hedge to fix underlying interest costs on nominal debt out to ten years on a reducing balance basis, but we will no longer supplement this with the additional 'top up' hedge at the start of each new regulatory period.

### 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 2018 was £118.0 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 2018, the group had an IAS 19 net pension surplus of £264.1 million, compared with a net pension surplus of £194.5 million at 31 March 2017. This £69.6 million increase mainly reflects the impact of a decrease in credit spreads and the favourable impact of updating mortality assumptions. 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, any 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.

## How we manage risk

## Principal risks and uncertainties

We continue to focus on creating sustainable value by delivering a high quality customer service, at the lowest sustainable cost, while acting in a responsible manner at every level within our organisation. In our day-to-day operations we encounter a wide variety of risks which can challenge the quality, cost-effectiveness and timescales for the delivery of our aims and ambitions. We identify and plan for mitigation of these risks under our established risk management framework which includes:

- an enterprise-wide approach to risk management;

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- oversight and control of risk through a well-established governance and reporting structure;
- a risk assessment and management process which is aligned to ISO 31000:2009; and
- training materials, accessible policies and guidance to help our people to identify and manage risk in a consistent manner.

Business areas and functions are responsible for the identification, analysis, evaluation and our individual business areas and functions take responsibility for identifying, quantifying, communicating and controlling the risks relevant to their own business activities. We also use a forward looking approach to take into account new and emerging areas of concern and the long-term impact of risk. The identified risks cover a very wide range of potential events including regulatory, legal, core operations, service and hazard risks. They are reviewed and scored for likelihood as well as for financial and reputational impact should the identified event occur. Initially we use the gross position when assessing risk, i.e. we assume that any controls over the risk are absent or have failed. We then assess the current position of the risk including considering existing controls and their effectiveness. This is then followed by a targeted risk position which introduces further mitigating controls where the current state does not fully align with objectives and/or obligations.

Our governance and reporting process includes twice-yearly reports to our group board on the character of the group's risk profile, informed by the above risk identification and assessment approach. Individual event-based risks are identified and then categorised within ten inherent risk areas known as principal risks. We also build on this overview in the board report, highlighting two key categories of risk: i) the most significant group-wide business risks; and ii) wholesale operational risks. These are represented by the 10 highest ranked risks (based on the scores awarded for likelihood x 'full life' financial impact) for each of the two categories plus a further five risks with potentially very high impact severity in their current state (net of control effectiveness). In addition, the report also identifies risks that could create potentially significant reputational impacts or are associated with potentially significant emerging topics but have not already been covered by the other reported categories.

Our approach aligns with the UK Corporate Governance Code and includes reports to UUG group board for every full and half year statutory accounting period so that the board is in a position 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 pages 67 and 68); and
- monitor risk management and internal control systems and review their effectiveness.

## Key developments

Key developments in the last 12 months include a maturing of and increased formalisation of our risk appetite framework. Our framework supports our assessment of the extent of risk we are willing to take based on obligations, stakeholders' requirements and the company's capacity and capability to manage risk. By doing this we aim to influence the target position for individual risks underpinning the principal risks through improved consistency. This approach also enables better benchmarking of individual risks against the appetite limits and boundaries. We have also sought to make an incremental governance improvement in our sign-off processes for all risks and also in relation to the wholesale risk and resilience board and the core risk team meetings which focus on long-term resilience. Associated with this is a focus on asset health and

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operational hazard risk assessment in advance of and beyond PR19. This supports our understanding of the long-term risk profile of our asset base and improves our capability to deliver the most cost-effective and proportionate risk management response as a result.

## Profile features

Our risk profile currently consists of around 200 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 used in various managerial and group reports either as a method to 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.

Political and regulatory risk and uncertainty feature prominently within the profile, notably with the outcome of PR19 which is expected to be even tougher than previous price reviews. The possibility of 'Renationalisation' is a key area of uncertainty as is the opening up to competition of wholesale operations (including the current focus on possible competition in bioresources and water abstraction) and the potential for competition covering domestic retail activities.

Our operations continue to be UK-based, but the potential impacts of 'Brexit' remain under review and have been reported to the group board. In common with other UK companies, a significant issue is the uncertainty surrounding the effects of the Brexit deal that the UK Government ultimately delivers. Our review has considered the availability of European funding, the price of goods and services, exchange rate impacts, possible impacts on our ability to collect cash were there to be an economic downturn and the effect of any potential inflationary shift outside current predicted parameters. We continue to keep this area under review.

Following the launch of non-household retail competition in April 2017, we have continued to monitor our operations within the market to review compliance risks and ensure that we continue to operate in a manner that complements and promotes the 'level playing field'.

From an operational risk perspective, the dominance of the penalty element of Ofwat's outcome delivery incentive mechanism and the effect following changes to the Environmental Sentencing Guidelines are key features of evolving 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 continue to adapt to and plan for climate change and its significant and permanent impacts on the water cycle, our operations and the broader operating environment. This includes consideration of the long-term viability of water and wastewater services such as water abstraction, drinking water supply and treatment capability, drainage and sewer capacity, wastewater treatment and its discharge efficiency and effectiveness. The recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) support and reinforce the need to consider climate-related risks and uncertainties. These continue to be factored into risk management and the likely effects of future changes are a critical consideration in our long and medium-term risk, operational and financial planning. Our water service and wastewater service risks summarised below also reflect current key risks including the potential for extreme weather and climate change.

## 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 this having a material adverse impact on the group's financial position is remote.

In March 2010, Manchester Ship Canal Company (MSCC) issued proceedings seeking, amongst other relief, damages alleging trespass against United Utilities Water Limited (UUW) in

# Strategic report

respect of UUW's discharges of water and treated effluent into the canal. While 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 (combinations of event-based risks), which have been set out 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 nature and the extent of exposure 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 | Principal/significant impacts | Risk exposure | Management and mitigation | Current key risks, issues and uncertainties: |
|---|---|---|---|---|---|
| **Political and regulatory risk**<br>Potential change in the political and regulatory environment and/or frameworks | Lowest sustainable cost | ▪ A potential increase in costs of administration, reduced income, margin and greater variability of returns<br>▪ A potential loss of confidence of equity investors and challenging debt market conditions creating funding pressures given the need to raise finance and refinance debt on an on-going basis<br>▪ The possibility on a potential Renationalisation that the business is acquired below fair value | Increased | 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. We keep customers and the public informed. We also provide information to the government, regulators, customers and the public as appropriate to help them to make informed decisions. | ▪ Potential Renationalisation of the water sector<br>▪ Market reform including non-household and upstream competition and, further ahead, the potential for the introduction of household competition<br>▪ A possible change from using the Retail Prices Index to the Consumer Prices Index for regulatory indexation<br>▪ Brexit |
| **Compliance risk**<br>A failure to provide a secure supply of clean, safe drinking water and the potential for negative impact on public confidence in water supply | Responsible manner | ▪ The potential to receive penalties of up to ten per cent of relevant turnover and ultimately revocation of our licence or the appointment of a special administrator | 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. Allowance 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. | ▪ Competition law and regulatory compliance while preparing for and operating within a changing competitive market<br>▪ Level playing field requirements in relation to the non-household retail market<br>▪ Current material litigation<br>▪ Higher fine levels for environmental offences<br>▪ Introduction of material pieces of legislation e.g. the General Data Protection Regulation |

# Strategic report

| | | | | | |
|---|---|---|---|---|---|
| **Water service risk**<br>A failure to provide a secure supply of clean, safe drinking water and the potential for negative impact on public confidence in water supply | Best Service to Customers | ▪ The potential for public health issues associated with poor water quality<br>▪ The potential for supply interruptions that could affect large populations within the region for long durations<br>▪ The potential for serious pollution (including sewer flooding) leading to disruption to the public, businesses and the environment (wildlife, fish and natural habitats) resulting in fines and reputational damage | Increased | Mitigation is provided through core business processes, including centralised planning and control, quality assurance procedures, risk assessments and rigorous sampling/testing regimes. Optimisation of operational and maintenance tasks together with targeted capital interventions help to ensure services to customers are maintained. Our 25-year Water Resources Management Plan defines our strategy to achieve a long-term, best-value and sustainable plan for water supplies in the North West including consideration of over 20 different climate change scenarios including a 2°C or lower global warming scenario (assessing systems resilience). We continue to develop innovative solutions and invest in resilience to further support the delivery of water and wastewater services in the long-term. | ▪ Population growth<br>▪ Extreme weather and climate change<br>▪ Meeting infrastructure investment requirements<br>▪ Expected change to the abstraction licensing regime Population growth<br>▪ Catchment management<br>▪ Raw water quality<br>▪ Drinking water safety and security<br>▪ Critical asset failure<br>▪ Drought |
| **Wastewater service risk**<br>A failure to remove and treat wastewater | Best Service to Customers | | Stable | | |
| **Retail and commercial risk**<br>Failing to provide good and fair service to domestic customers and third party retailers | Lowest sustainable cost | ▪ The potential for significant regulatory penalties and long-term reputational damage associated with poor customer satisfaction<br>▪ The potential for a significant increase in the bad debt charge, reducing profitability | Decreased | For domestic retail there are a wide range of initiatives and activities focused on improving customer satisfaction, including proactive incident communication, complaints handling and use of appropriate tariffs. Bad debt risk is managed through the adoption of best practice collection techniques, segmentation of customers based on their credit risk profile and the use of data sharing to better understand customers' circumstances to determine the most appropriate collection and support activities. Our wholesale business maintains processes, systems, data and organisational capacity and capability to deal fairly with market participants and the central market operator in the Business Retail market in order to generate and collect revenue. | ▪ Socio-economic deprivation in the North West<br>▪ Welfare reform and the impact on domestic bad debt<br>▪ Competition in the water and wastewater market and competitor positioning<br>▪ Brexit<br>▪ Non-household retail competition and the ability to treat other participants equally |
| **Financial risk**<br>Potential inability to finance the business appropriately | Lowest sustainable cost | ▪ The potential for worse credit ratings, associated funding costs or reduced access to debt capital markets leading to lower liquidity and adversely impacting the economic return on the regulatory capital value (RCV)<br>▪ The potential for a worsening of the pension scheme funding position leading to a requirement for the group to make additional | Decreased | 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 manage the impact of market fluctuations for inflation, interest rates and energy prices. Sensitivity analysis is carried out as part of the business planning process, influencing the various financial limits employed. Continuous | ▪ Stability of financial institutions and the world economy<br>▪ Economic uncertainty<br>▪ Inflation/deflation<br>▪ Financial market conditions, interest rates and funding costs<br>▪ Brexit |

# Strategic report

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| | | contributions | | monitoring of the markets takes place including movements in credit default swap prices and movements in equity levels. | |
| **Supply chain and programme delivery risk**<br><br>Potential ineffective delivery of capital, operational and change programmes/ processes | Lowest Sustainable Cost | ▪ Potential failure to meet our obligations and customer outcomes resulting in an impact at future price reviews, negative reputational impact with customers and regulators | Stable | Supply chain management is utilised to deliver an end-to-end contract management service, including contract strategy, tendering and category management, which provides a risk-based approach and relationship management programmes for suppliers. We prioritise our investment programmes, projects and integrated business and asset plans. We have created better alignment and integration between our capital delivery partners and engineering service providers 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. | ▪ Security of supply<br><br>▪ Delivery of solutions<br><br>▪ Technical quality and innovation<br><br>▪ Brexit |
| **Resources risk**<br><br>Failing to provide appropriate resources (human, technological or physical resource) required to support business activity | Responsible manner | ▪ The potential inability to recruit and retain knowledge/expertise<br><br>▪ The potential inability to respond and recover due to ineffective non-resilient business activity | Stable | Developing our people to have the right skills and knowledge, combined with delivering effective technology 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. | ▪ Delivering required employee engagement<br><br>▪ Personal development and talent management<br><br>▪ Technological innovation<br><br>▪ Asset management |
| **Security risk**<br><br>Potential for malicious activity (physical or technological) against people, assets or operations | Best service to customers | ▪ The potential for loss of data / information and the consequent effect on service provision<br><br>▪ The potential for catastrophic damage to UU property, infrastructure and non-infrastructure and the consequent effect on service provision | Increasing | Physical and technological security measures and awareness training combined with strong governance and inspection regimes which aim to protect infrastructure, assets and operational capability. Externally, we work closely with our industry peers, the Centre for the Protection of National Infrastructure (CPNI), the National Cyber Security Centre (NCSC) and Defra to shape the sector approach to security, particularly cyber security, and to understand how we can best deliver the appropriate levels of protection to our business. 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 | ▪ Cybercrime<br><br>▪ Terrorism<br><br>▪ Fraud<br><br>▪ Ownership of Critical National Infrastructure and National Infrastructure |

# Strategic report

| | | | | | |
|---|---|---|---|---|---|
| | | | | and liability and our licence 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**<br><br>Potential harm to people (employees, contractors or the public) and the environment | Responsible Manner | ▪ The potential for serious injury or loss of life in remote, extreme circumstances<br><br>▪ The potential for catastrophic damage to private, public or commercial property / infrastructure including the consequent effect on water and wastewater service provision<br><br>▪ The potential for serious impact to wildlife, fish or natural habitats resulting in significant fines and reputational damage | Stable | We have developed a strong health and safety culture where 'nothing we do at United Utilities is worth getting hurt for', supported by strong governance and management systems certified to OHSAS 18001. We actively seek to improve health, safety and wellbeing across the group through targeted improvements and benchmarking against our peers. Also certified to ISO 14001, we seek to protect and improve the environment through the responsible delivery of our services. This includes helping to support rare species and habitats through targeted engagement and activity and commitment to reducing our carbon emissions by designing out waste from our operations, generating our own energy and looking at ways to reduce our use of raw materials. We also recognise the impact the environment can have on our service provision with extreme weather and climate change being integrated into our risk, planning and decision-making processes. | ▪ Impounding reservoirs containing significant volumes of water<br><br>▪ Other critical asset failure<br><br>▪ Process safety<br><br>▪ Excavation, tunnelling and construction work<br><br>▪ Working with chemicals<br><br>▪ Fluvial and coastal flooding |

The strategic report was approved by the board on 12 June 2018 and signed on its behalf by:

**Russ Houlden**

Chief Financial Officer

# 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 2017/18. We were proud of our employees in achieving our best ever overall score during the year under Ofwat's customer service index, known as the Service Incentive Mechanism (SIM), where we were placed in an upper quartile position of the 18 water and wastewater companies. SIM, along with other key performance indicators (see pages 42 and 43), is regularly reviewed at board meetings. This has been a fantastic milestone to achieve as part of our strategic journey.

During the year, we have also had our challenges, including prosecutions for operational incidents most notably relating to the 2015 Lancashire water quality incident at Franklaw water treatment works incurring a fine of £300,000. Access to our more remote assets during the severe weather in February 2018 proved difficult and we worked hard to minimise freeze-thaw issues disrupting customers' supplies. Similarly, during the industrial action in relation to the changes to the defined benefit pension scheme, colleagues not on strike worked hard to ensure our services to customers were not affected.

### Our approach

As individual directors we are cognisant of our statutory duty to act in the way he/she considers, in good faith, would most likely be to promote the success of the company for the benefit of its members as a whole, as set out in s172 of the Companies Act 2006. Our role as the board is to set the strategy of the group and ensure that management operates the business in accordance with this strategy. Details of the strategy are set out in the strategic report (see page 9). We believe this approach will promote the group's long-term success and our customers' interests as well as have regard to our other stakeholders. The board's intention is to hand over the business to our successors in a better and more sustainable position for the future. Within our region, our activities often have multiple touch points on individuals' lives. United Utilities is a monopoly supplier of water and wastewater services to domestic households. Many of our customers are also UUG shareholders either directly or indirectly holding shares through pension scheme investments. Indeed, many of our employees are also both customers, shareholders and future pensioners and have an interest in the group's long-term success. As directors we are mindful of our duties to exercise independent judgement and reasonable care, skill and diligence and there are times when difficult decisions must be taken. Last year, the board considered proposals in relation to the United Utilities defined benefit pension scheme and the related discussions with the trade unions. We listened to our employees and their representatives and were able to respond to some of their requests and address some of the aspects of the pension scheme that employees valued the most nothwithstanding the decision taken to proceed with changes to the defined benefit pension scheme with effect from 1 April 2018. This was one of those difficult decisions, where we had to act in the way we considered was most likely to promote the success of the company in the long term. I am pleased to say that these issues have now been resolved.

### Our people

Having the same directors on both the UUG and UUW boards reflects our vision, which is to be the best UK water and wastewater company. 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 *unitedutilities.com/corporate-governance.*

As reported in last year's report, Paulette Rowe was appointed as an independent non-executive director on 1 July 2017. In addition to her experience of the regulated financial services industry, Paulette has long had an interest and involvement in the charitable sector, which brings a wider perspective to board discussions.

# Corporate governance report

Furthermore, we are pleased to appoint Steve Fraser as our chief operating officer. Steve has been with the business in various operational roles since 2005. Most recently his role was managing director of our wholesale business and his appointment to the board reflects the value we place on his experience and in-depth knowledge of our business as we face the challenges of the next five-year asset management period.

Biographies of the board members can be found on pages 71 to 75.

With three out of ten directors on the board being women we have maintained our gender target of at least 25 per cent of our board comprising women, and the board aspires to achieve 33 per cent by 2020. With regards to diversity more generally, I am satisfied that we have an appropriately diverse board in terms of experience, skills and personal attributes and in terms of age and ethnicity amongst our board members. The directors have many years of experience gained across a variety of industries and regulated businesses, and so are familiar with the particular challenges of a regulated operating environment. Although there are time constraints for non-executive directors who also have an executive role, these individuals bring valuable current market experience and thinking to the 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 in an industry which does not conflict with United Utilities' business.

Twenty-seven per cent of our executive team is 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 for senior managers provides an excellent opportunity for both personal and career development. It is a way of gaining valuable experience that may be applied at United 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. Historically, our industry has been male dominated, but we have measures in place to increase diversity in broad terms, including gender amongst our employees.

## Our values and culture

Our aim is to behave as a responsible business, and our business principles can be found on our website. Our core values of acting with integrity and focusing on our customers provides both the framework for our business culture and the way in which our employees go about their daily work. Behaving responsibly has been part of the United Utilities ethos for a number of years.

## 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, we must take long-term decisions to ensure our successors are able to operate the business efficiently for customers, 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's 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' since 2008. The current version of which was published by the Financial Reporting Council in 2016, a copy of which can be found at *https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf*. 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 2018.

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 61 to 62). A copy of our code on board leadership, transparency and governance 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 main and subsidiary principles and provisions of the Code, and did so fully for the year ended 31 March 2018. 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, 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 2018 with the provisions of the Code can be found on pages 60 to 115 of the UUG 2018 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.

# Corporate governance report

## 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 Guidance 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 Guidance and Transparency Rules of the UK Listing Authority. Our Remuneration Report is included on pages 76 to 79. |
| The regulated company must act as if it is a separate public listed company<br><br>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 71 to 75, 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 strategy and regulation and the company secretary, and can seek independent advice on any matter it sees fit. |
| There must be significant independent representation on the Board<br><br>Independent non-executive directors are essential to securing strong Board leadership and governance<br><br>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 71 to 75. 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 2018 UUG annual report in the report of the Nomination committee on pages 74 to 81. The outcome of the annual board evaluation can be found on pages 70 to 72 of the 2018 UUG annual report. |
| The Chair must be independent of management and investors | The biography of the Chairman can be found on page 71. 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 of board meetings.<br><br>Dr McAdam has not declared any interests which conflict with the business of UUW, nor UUG. The role of Chairman and CEO are separate. |
| Board committees, including but not limited to | As agreed with Ofwat in 2010, UUW does not |

# Corporate governance report

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|---|---|
| audit and remuneration committees, will operate at the regulated company level<br><br>There should be a majority of independent members on the audit and remuneration committees | 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 70 of the 2018 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 70. |

*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 71 to 75 and the details of the directors who served during the year and their attendance at scheduled board meetings during 2017/18 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) |
| Steve Fraser | COO | 8(8) |
| Stephen Carter(1) | Independent non-executive director | 7(8) |
| Mark Clare | Independent non-executive director | 8(8) |
| Alison Goligher | Independent non-executive director | 8(8) |
| Brian May | Independent non-executive director | 8(8) |
| Paulette Rowe(2) | Independent non-executive director | 5(5) |
| Sara Weller | Independent non-executive director | 8(8) |

(1) Stephen Carter was unable to attend a meeting of the board due to a conflicting commitment.

(2) Paulette Rowe was appointed on 1 July 2017.

# Corporate governance report

## 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 chief operating officer 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 £150 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 *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 2017/18

**Customer**

- Reviewed the progress with the implementation of the lessons learnt and recommendations of the internal investigation undertaken by Mark Clare, independent non-executive director, in relation to the August 2015 Lancashire water quality incident and the outcome of the subsequent prosecution by the DWI in September 2017;
- Considered and approved the publication and submission to Ofwat of 2018/19 Charges for wholesale water, wholesale wastewater and household and new connections services;
- 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 and plans for more proactive customer communications; and
- 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 capital works at Blackburn and Darwen WwTW and an update on the West Cumbria supply project;

# Corporate governance report

- Received an update on energy usage, energy saving and energy generation at sites and treatment works;
- 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 and an update on the progress of developing and implementating an improved health and safety culture within the business 'home safe and well'; and
- Discussed the results of the annual employee voice and engagement survey and a general employee and people update.

**Regulatory**

- Considered and discussed the independent assurance supporting the 2017 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 regular updates on the company's preparedness and plans for the 2020-25 regulatory period and the preparation of the company's business plan due for submission to Ofwat in September 2018;
- Reviewed and approved the submission of the draft 2019 Water Resource Management Plan to Defra;
- Reviewed and approved the proposed approach to splitting the water resources RCV for submission to Ofwat; and
- Reviewed and approved the proposed approach to splitting the bioresources RCV for submission to Ofwat.

**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 Paulette Rowe as an independent non-executive director with effect from 1 July 2017; and
- 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 2017/18;
- Approved UUW's dividends;
- Approved the UUW annual report and financial statements;

# Corporate governance report

- Reviewed discussed and approved proposals in relation to pensions in general and specifically the United Utilities defined benefit pension scheme and related discussions with trade unions;
- Received regular updates on cash collection, SIM scores and ODI performance; and
- Reviewed the potential effects of changes to inflation on the water sector and proposals from Ofwat to transition from the Retail Prices Index (RPI) to the Consumer Prices Index including owner occupiers' housing costs (CPIH) as the primary means of indexation in the next asset management period.

### 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. 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 Group 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 UUW 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, COO 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

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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 Paulette Rowe's induction can be found on page 77 of the UUG 2018 annual report).

### Board evaluation

2017/18 being the third year since the previous external evaluation, this year's evaluation was conducted by Lintstock Consultants (Lintstock).  In other years the evaluation is an internal one conducted by the company secretary and his team. Lintstock have no other connection with the company other than facilitating external evaluations in 2012 and 2015. 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 70 of the UUG 2018 annual report).

## Code principle: Accountability

### Board's approach to risk management and internal control

The board discharges its responsibility for determining the nature and extent of the risks that it is willing to take to achieve its strategic objectives through the risk appetite framework. Sitting alongside the risk management framework, risk appetite captures on an annual basis the board's desire to take and manage risk relative to the company's obligations, stakeholder interests and the capacity and capability of our key resources.

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/company's risks predominately 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.

All the actions relating to the improvements to the risk management framework that were identified by the investigation undertaken by Mark Clare, independent non-executive director, following the Lancashire water quality incident in 2015 have been completed. A series of briefing sessions were held with other industry executives and stakeholders to share lessons learnt from the Lancashire water quality incident of 2015.

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 140 of the UUG 2018 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 81 of the UUG 2018 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 56 to 57 of the UUG 2018 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 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 67 of the UUG 2018 annual report) including such matters as liquidity policy, the group's capital

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funding requirements and interest rate management. Furthermore, the board believes that under the current regulatory and statutory framework a period of five years to assess the group's long-term viability is appropriate, amongst other things, because of the underlying protection provided by Ofwat's primary legal duty to ensure that water and wastewater companies are able to finance their functions.

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 95) and provide a long-term viability statement as set out below.

**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. This assessment has been performed in the context of the group's prospects as considered over the longer term. Based on this viability 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 2023.

This viability statement is based on the fundamental assumption that the current regulatory and statutory framework does not substantively change, for example a change which facilitated the compulsory purchase of the shares or assets of either UUW or its ultimate parent undertaking for the Renationalisation of the water sector, throughout the viability assessment period.

The long-term planning detailed on pages 37 and 38 assesses the group's prospects and establishes its strategy over a 25-year time horizon consistent with its rolling 25-year licence and its published long-term strategy. This provides a framework for the group's strategic planning process, and is key to achieving the group's aim of providing the best service to customers at the lowest sustainable cost and in a responsible manner over the longer term, underpinning our business model set out on pages 20 and 21. In order to achieve this aim and promote the long-term sustainability and resilience of the business, due consideration is given to the management of risks that could impact on the business model, future performance, solvency and liquidity of the group. An overview of our risk management approach that supports the group's long-term planning and prospects, together with the principal risks and uncertainties facing the business, can be found on pages 54 to 57.

The viability statement for the five-year period to March 2023 has been assessed based upon the group's medium-term business planning process, which sits within the overarching strategic planning process and considers:

- The group's current liquidity position – which provides headroom to cover projected financing needs through until mid-2019;
- The group's robust capital solvency position – with a debt to regulatory capital value (RCV) ratio of around 65 per cent, providing considerable headroom supporting access to medium-term liquidity as required; and
- The current regulatory framework within which the group operates – which provides a high degree of certainty over cashflows in the short to medium term and broader regulatory protections in the longer term.

The analysis underpinning this assessment has been through a robust internal review process, which has included scrutiny and challenge from the audit committee, and has been reviewed by the group's external auditors, KPMG, as part of their normal audit procedures.

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 market structure of water and wastewater services, threats to the group's viability from risks such as reduced market share,

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substitution of services and reduced demand are low compared to those faced by many other industries.

From a regulatory perspective the group currently benefits from a rolling 25-year licence and a regulatory regime in which regulators – including the economic regulator, Ofwat – are required to have regard to the principles of best regulatory practice. These include that regulation should be carried out in a way which is transparent, accountable, proportionate, consistent and targeted. Ofwat's primary duties provide that it should protect consumers' interests, by promoting effective competition wherever appropriate, secure that the company properly carries out its statutory functions, secure that the company can finance the proper carrying out of these functions – in particular through securing reasonable returns on capital, and secure that water and wastewater supply systems have long-term resilience and that the company takes steps to meet long-term demands for water supplies and wastewater services.

The business planning process is closely aligned with these principles, and, coupled with the group's robust management of risks, gives confidence that current and future regulatory price controls will provide certainty around cash flows that will support the continuing viability and prospects of the group. 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 in the context of its expected performance and past ability to deliver for customers, considering the principal risks as set out on pages 54 to 57 and its ability to absorb a number of severe but reasonable scenarios including those arising from operational and environmental risks, political and regulatory risks, the risk of critical asset failure and 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 based on a number of stress-tested and sensitised scenarios in which the group is assumed to face a series of the top risks in terms of the most severe impact and likelihood of occurrence over the course of the viability assessment period. As well as the protections which exist from the regulatory environment within which the group operates, a number of mitigating actions are available in the kind of severe scenarios considered, including the raising of new finance, capital programme deferral, the close-out of derivative asset positions, the restriction of dividend payments and access to additional equity. 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 96.

### 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 87 of the UUG 2018 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 85 of the UUG 2018 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 85 of the UUG 2018 annual report.

The UUG group last undertook a formal tender process for its statutory audit service 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 86 of the UUG 2018 annual report of the audit committee's current intention that a competitive tender

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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 2017 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 76 to 79. Further information on the group's approach to executive remuneration can be found in the remuneration report within the UUG 2018 annual report.

### Departures from the Code

Section C of the Code – Code principle Accountability

UUG has an audit committee and the UUG group has a well-resourced internal audit function (see page 88 of the UUG 2018 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 82 to 89 of the UUG 2018 annual report.

Section D of the Code – Code principle Remuneration

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 on UUG's remuneration policy 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.

Section E of the Code – Code principle Relations with shareholders

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 70,000 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.

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

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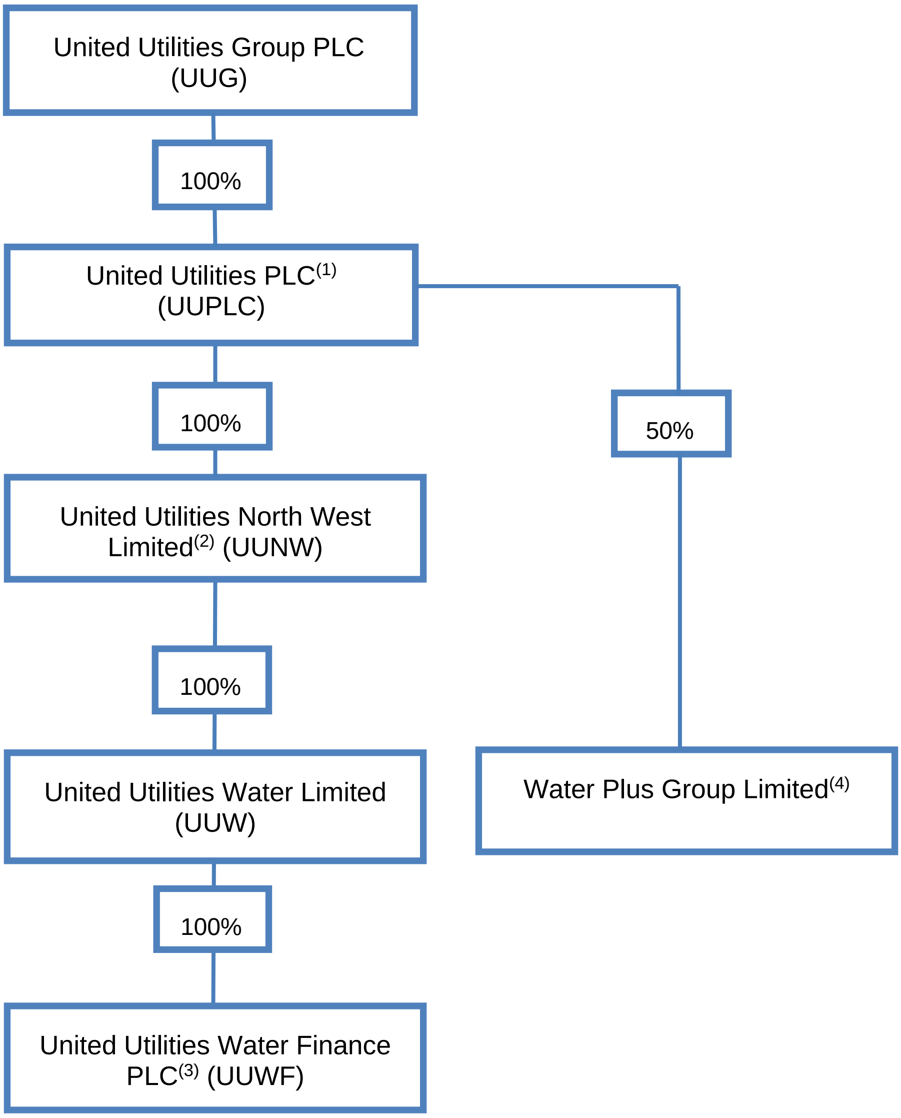
United Utilities group structure chart




(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 Group 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 19 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 previously held roles as: senior independent director at J Sainsbury plc; non-executive director of Rolls-Royce Holdings plc until May 2017; and senior independent director at Electra Private Equity PLC until 1 March 2018.

**Current directorships/business interests:** Chairman of Rentokil Initial plc and was appointed as non-executive and senior independent director of Cobham plc on 1 August 2017. He is also Chairman of United Utilities Group PLC.

**Independence:** John met the 2016 UK Corporate Governance Code's independence criteria on 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:** Steve's experience of the highly competitive defence market and complex design, manufacturing and support programmes has driven forwards the board's strategy of improving customer service and operational performance at United Utilities, and his perspective of the construction and infrastructure sector provides valuable experience and insight to support United Utilities' capital investment programme.

**Career 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.

**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.

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## 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:** He previously held roles as chief financial officer at Telecom New Zealand and 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.

## Steve Fraser

Chief Operating Officer (COO)

**Responsibilities:** To develop the strategy for, and to manage, the group's operations.

**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).

**Skills and Experience:** Steve brings a strong commercial acumen and operations focus to the wider business. He has a proven track record in managing networks and using his change management skills and broad experience across all aspects of utilities construction, programme and operations management.

**Career Experience:** Steve has a wide range of project and contract management experience within the infrastructure sector. Prior to joining United Utilities in 2005, he was Operations Director of Bethell plc, the power and construction group.

**Current Directorships:** He is also chief operating officer of United Utilities Group PLC.

# Corporate governance report

## Mark Clare

Independent non-executive director

**Responsibilities:** 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:** Through his previous 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 our 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, and Ladbrokes Coral PLC.

**Current directorships/business interests:** He was appointed non-executive chairman of Grainger plc in February 2017. 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.

## 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. Stephen’s previous public sector roles underpin his knowledge of the utilities sector.

**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 sector/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.

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## 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:** Alison is a non-executive director of Meggitt PLC, was appointed as part-time executive chair of Silixa Ltd in August 2016, and sits on the board of Edinburgh Business School. She is also an independent non-executive director of United Utilities Group PLC.

## 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 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. Brian has been chair of the audit committee for nearly five years and has considerable knowledge of the company and the specifics of the utilities sector.

**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.

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## 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:** Mechanical Engineering and Management, MBA.

**Appointment to the board:** July 2017.

**Skills and experience**: Paulette has spent most of her career in the regulated finance industry providing 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 its Systems Thinking approach. Paulette's experience of operating a commercial organisation within a regulated framework is directly relevant to the utilities sector.

**Career experience:** Paulette is managing director, Barclaycard Payments Solutions at Barclays Bank. 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 is a former trustee and chair of childrens' charity The Mayor's Fund for London.

**Current directorships/business interests:** From 9 July 2018 Paulette will take up a new appointment on the EMEA Executive of Facebook Inc. 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 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. Previously, she was the lead non-executive director for the Department for Communities and Local Government and chair of the Planning Inspectorate (an executive agency of the Department of Communities and Local Government).

**Current directorships/business interests:** Sara is a non-executive director of Lloyds Banking Group plc; the 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 Group PLC.

# 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.

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.

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 2017/18 (audited information)**

| | Base Salary £’000 | Benefits £’000 | Bonus [1] £’000 | Long-term incentives [2] £’000 | Cash allowance in lieu of pension £’000 | Total £’000 |
|---|---|---|---|---|---|---|
| Steve Mogford | 737 | 29 | 718 | 429 | 162 | 2,075 |
| Russ Houlden | 466 | 25 | 450 | 271 | 102 | 1,314 |
| Steve Fraser | 384 | 20 | 351 | 102 | 85 | 942 |

Note:

[1] 50 per cent of each of the executive director’s bonus was deferred into shares for three years under the Deferred Bonus Plan (DBP), except for the part of Steve Fraser’s bonus that was earned in respect of the period 1 April 2017 to 31 July 2017, of which 40 per cent of bonus was deferred under the DBP.

[2] See page 78 for further detail on the long-term incentives.

A recharge of £354,000 during the year ended 31 March 2018 (2017: £317,000) was charged to other companies in the United Utilities group in relation to the provision of executive director services (£305,000) and non-executive director services (£49,000).

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## Directors' remuneration report (continued)

**2017/18 annual bonus (audited information)**

| Measure | Steve Mogford | | Russ Houlden | | Steve Fraser (1 April 2017 to 31 July 2017) | | Steve Fraser (1 August 2017 to 31 March 2018) | |
|---|---|---|---|---|---|---|---|---|
| | Max. % | Actual % | Max. % | Actual % | Max. % | Actual % | Max % | Actual % |
| Underlying operating profit | 30.0 | 24.3 | 30.0 | 24.3 | 20.0 | 17.5 | 30.0 | 26.2 |
| **Customer service in year** | | | | | | | | |
| Service Incentive Mechanism – Qualitative | 12.0 | 12.0 | 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 | 4.0 | 4.0 |
| **Maintaining and enhancing services for customers** | | | | | | | | |
| Wholesale outcome delivery incentive composite | 24.0 | 11.8 | 24.0 | 11.8 | 24.0 | 11.8 | 24.0 | 11.8 |
| Time, cost and quality of capital programme (TCQi) | 20.0 | 13.8 | 20.0 | 13.8 | 20.0 | 13.8 | 20.0 | 13.8 |
| Personal objectives | 10.0 | 9.0 | 10.0 | 8.5 | 20.0 | 18.0 | 10.0 | 9.0 |
| **Total as % bonus maximum** | **100.0** | **74.9** | **100.0** | **74.4** | **100.0** | **77.1** | **100.0** | **76.8** |
| | | | | | | | | |
| **Total as % base salary** | **130.0** | **97.3** | **130.0** | **96.7** | **90.0** | **69.3** | **130.0** | **99.8** |
| **Total £'000** | | **718** | | **450** | | **74** | | **277** |
| **Total £'000** | | | | | **351** | | | |

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 (audited information)**

Details of UUG shares previously granted to UUW executive directors which vested in 2017/18, or whose performance period ended in 2017/18, are as follows:

| Director | Number of shares vesting | Value of shares vesting £'000 |
|---|---|---|
| | 2015 LTP[(1)] | 2015 LTP[(2)] |
| Steve Mogford | 59,998 | 429 |
| Russ Houlden | 37,878 | 271 |
| Steve Fraser | 14,210 | 102 |

Note:

[(1)] The 2015 Long Term Plan (LTP) awards were granted in July 2015. The performance period started on 1 April 2015 and ended on 31 March 2018. 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 2018). The number and value of the vested 2015 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 2020, following an additional two year holding period. The awards accrue dividend equivalents.

[(2)] The value of the 2015 LTP awards has been calculated by multiplying the number of shares vesting by the average share price over the three month period 1 January 2018 to 31 March 2018 (715.8 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% | 0.0% out of 33.3% |
| **Sustainable dividends.** Dividend growth in each year of the performance period, with an underlying dividend cover underpin | 33.3% | 33.3% out of 33.3% |
| **Customer service excellence.** Ranking for the year ended 31 March 2018 versus 17 other water companies using Ofwat's SIM combined score | 33.3% | 22.1% out of 33.3% |
| **Total vesting** | | **55.4%** |

# Corporate governance report

## Directors' remuneration report (continued)

**Directors' remuneration 2018/19**

Directors' remuneration is expected to operate in a broadly similar way for 2018/19 as for 2017/18.

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.

For the long-term incentives granted in 2018 the performance targets for the total shareholder return and customer service measure are expected to be as for the 2017 LTP award, but the committee retains the discretion to adjust the customer service measure and targets once Ofwat's approach to assessing customer service for the regulatory period 2020-25 is agreed. The targets for the sustainable dividends measure will reflect the fact that the performance period starting in 2018 will cross two regulatory periods.

# Corporate governance report

## Tax policies and objectives

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 HMRC framework for co-operative compliance.

Our Chief Financial Officer ("CFO") has responsibility for tax governance with oversight from the board. The CFO is supported by a specialist team of tax professionals with many years of tax experience within the water sector and led by the Head of Tax. The Head of Tax has day-to-day responsibility for managing the group's tax affairs and engages regularly with key stakeholders from around the group in ensuring that tax risk is proactively managed. Where appropriate, he will also engage with both external advisers and HMRC to provide additional required certainty with the aim of ensuring that any residual risk is typically low. All significant tax issues are reported to the board regularly.

Consistent with the group's general risk management framework, all 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 actively manage any such risk.

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 taxation.

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; reducing their bills. For 2017/18, the impact of tax deductions on capital investment alone reduced average household bills by around £20.

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

Every year, the group pays significant contributions to the public finances on its own behalf as well as collecting and paying over further amounts for its 5,000 strong workforce. Details of the total payments for 2018 can be found in page 116 of the UUG 2018 annual report.

We expect the above details, which apply for the year ended 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 2018.

## Profit and dividends

The results for the year, set out in the consolidated income statement on page 91 how that profit for the year after tax was £339.2 million (2017: £387.8 million).

The directors have not recommended a final ordinary dividend (2017: £nil). Interim ordinary dividends of £316.7 million have been declared and paid during the year (2017: £229.7 million). In the prior year an additional £18.4 million dividend in specie arose 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 58 to 80 including the remuneration report is hereby incorporated into this directors' report by reference. The current version of which was published by the Financial Reporting Council in 2016, a copy of which can be found at *https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.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 £21,662 (2017: £11,298) as part of this process. At the 2017 UUG AGM, an authority was taken to cover such expenditure. A similar resolution will be put to the UUG shareholders at the 2018 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 £1.2 million in the year ended 31 March 2018 (2017: £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 2018.

## 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
Stephen Carter
Mark Clare
Alison Goligher
Brian May
Paulette Rowe (appointed 1 July 2017)
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 *unitedutilities.com/corporate/about-us/governance/business-principles,* 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

# Directors' report

through 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 104.

## 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 2018, 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 116.

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

12 June 2018

# 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 are required to prepare the Group financial statements in accordance with International Financial Reporting Standards (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, relevant and reliable;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- assess the Group and parent Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the Group or the parent Company or to cease operations, or have no realistic alternative but to do so.

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 are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and 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, and Corporate Governance Statement that complies with that law and those regulations.

**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.

Signed on behalf of the board:

**Russ Houlden**
Chief Financial Officer

12 June 2018

# Independent auditor's report

**to the members of United Utilities Water Limited**

## 1. Our opinion is unmodified

We have audited the financial statements of United Utilities Water Limited ("the Company") for the year ended 31 March 2018 which comprise the Consolidated income statement, the Consolidated statement of comprehensive income, the Consolidated and company statement of financial position, the Consolidated and company statement of changes in equity, the Consolidated and company statement of cashflows, and the related notes, including the accounting policies on pages 96 to 102 and 142 to 149.

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 2018 and of the Group'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.

**Basis for opinion**

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion. Our audit opinion is consistent with our report to the audit committee.

We were appointed as auditor by the directors on 9 October 2017. The period of total uninterrupted engagement is for the seven financial years ended 31 March 2018. We have fulfilled our ethical responsibilities under, and we remain independent of the Group in accordance with, UK ethical requirements including the FRC Ethical Standard as applied to listed public interest entities. No non-audit services prohibited by that standard were provided.

## 2. Key audit matters: our assessment of risks of material misstatement

Key audit matters are those matters that, in our professional judgment, were of most significance in the audit of the financial statements and include the most significant assessed risks of material misstatement (whether or not due to fraud) identified by us, including those which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team. We summarise below the key audit matters, in decreasing order of audit significance, in arriving at our audit opinion above, together with our key audit procedures to address those matters and, as required for public interest entities, our results from those procedures. These matters were addressed, and our results are based on procedures undertaken, in the context of, and solely for the purpose of, our audit of the financial statements as a whole, and in forming our opinion thereon, and consequently are incidental to that opinion, and we do not provide a separate opinion on these matters.

***Risk relevant to Parent Company and the Group***

**Revenue recognition and provision for household customer debt**
Revenue not recognised: £20.3 million (2017: £28.3 million)
Provision for customer debts: £63.2 million (2017: £85.4 million)

# Independent auditor's report
## to the members of United Utilities Water Limited

<table>
<tr><td colspan="2">Refer to pages 97 and 142 (accounting policy), and page 111 (financial disclosures).</td></tr>
<tr><td>The Risk<br><br>Subjective estimation:<br><br>Household revenue recognition and provision for household customer debts are key areas of judgement, particularly in relation to:<br>- identifying properties where there is little prospect cash will be received for revenue that has been billed due to either the occupier not being able to be identified or a past history of non-payment of bills relating to that property; and<br>- assessing the recoverability of trade debtors.</td><td>Our Response<br><br>Our procedures included:<br><br>Accounting analysis – Assessing whether appropriate revenue recognition policies are applied through comparison with relevant accounting standards including the policy of not recognising revenue where it is not probable that cash will be received;<br><br>Control observation – Testing the group's controls over revenue recognition and provision for customer debts, including reconciliations between sales and cash receipts systems and the general ledger;<br><br>Methodology choice – Assessing the appropriateness of the customer debt provisioning policy based on historical cash collections, credits, re-bills and write-off information; and<br><br>Assessing transparency – Assessing the adequacy of the group's disclosures of its revenue recognition and customer debt provisioning policies, including the judgement involved in recording revenue and estimation uncertainty of the bad debt provision.<br><br>Our results:<br>- In respect of the recognition of revenue only where it is probable that economic benefits/cash will be received, we found the amount of revenue recognised to be appropriate; and<br>- From the evidence obtained, we considered the level of bad debt provisioning to be acceptable.</td></tr>
<tr><td colspan="2"><u>Risk relevant to Parent Company and the Group</u><br><br>Capital expenditure<br>£732.6 million (2017: £705.6 million)<br>Refer to pages 97 to 98 and 144 to 145 (accounting policy), and pages 109 to 110 (financial disclosures).</td></tr>
<tr><td>The Risk<br><br>Subjective classification:<br><br>The group has a substantial capital programme which has been agreed with the Water Services Regulation Authority (Ofwat)</td><td>Our Response<br><br>Our procedures included:<br><br>Accounting analysis – Assessing the group's capitalisation policy for compliance with relevant accounting standards;</td></tr>
</table>

# Independent auditor's report

## to the members of United Utilities Water Limited

<table>
<tr><td>and therefore incurs significant annual expenditure in relation to the development and maintenance of both infrastructure and non-infrastructure assets.<br><br>The determination of in year project costs as capital or operating expenditure is inherently judgemental. Costs capitalised include an allocation of overhead costs, relating to the proportion of time spent by support function staff, which is also inherently judgemental.</td><td>Control observation – Testing controls over the application of the policy in the period including review of project business case submissions, and attending a sample of capital approval meetings to observe the judgements made and evaluating the documented conclusions;<br><br>Tests of details – Critically assessing the costs capitalised for a sample of projects against the capitalisation policy;<br><br>Tests of details – Identify and assess the impact of changing capitalisation rates for all existing projects;<br><br>Historical comparisons – Critically assess the proportion of overhead costs by business area which are capitalised using historical comparisons and expected changes based upon corroborated enquiry and our sector knowledge; and<br><br>Assessing transparency – Assessing the adequacy of the group's disclosures of its capitalisation policy and other related disclosures.<br><br>Our results:<br><br>We found the group's treatment of expenditure as capital or operating to be acceptable.</td></tr>
<tr><td colspan="2"><u>Risk relevant to Parent Company and the Group</u><br><br>Retirement benefit obligation valuation<br>£2,600.3 million (2017: £2,682.1 million)<br>Refer to pages 98 and 148 (accounting policy), and pages 133 to 139 (financial disclosures).</td></tr>
<tr><td>The Risk<br><br>Estimation in valuation of retirement obligations:<br><br>The group's retirement benefit surplus is the difference between the fair value of the pension assets and the retirement benefit obligation.<br><br>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.</td><td>Our Response<br><br>Our procedures included:<br><br>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 and life expectancy assumptions used against externally derived data. We performed a comparison of key assumptions against our own benchmark ranges which are derived from available data as well as comparing against those used by other companies reporting on the same period; and</td></tr>
</table>

# Independent auditor's report

**to the members of United Utilities Water Limited**

<table>
<tr><td></td><td>Assessing transparency – Assessing the group's disclosure in respect of the sensitivity of the liabilities to changes in the key assumptions.<br><br>Our results:<br><br>The results of our testing were satisfactory and we found the obligation recognised to be acceptable.</td></tr>
<tr><td colspan="2"><u>Risk relevant to Parent Company and the Group</u><br><br>Water plus loan carrying value<br>£100.0 million (2017: £100.0 million)<br>Refer to pages 98 and 142 (accounting policy), and pages 140 to 141 (financial disclosures).</td></tr>
<tr><td>The Risk<br><br>Forecast-based estimate valuation:<br><br>The group's loans to Water Plus are significant. The estimated recoverable amount is subjective due to the inherent uncertainty involved in forecasting future cash flows. The estimate of the value in use of Water Plus is also sensitive to the discount rate used.</td><td>Our procedures included:<br><br>Benchmarking assumptions – Evaluating assumptions used, in particular those relating to discount rate, terminal growth rate, and the normalised level of working capital in the business, using our own valuation specialist and comparing to externally derived data;<br><br>Sensitivity analysis – Performing sensitivity analysis on the assumptions noted above; and<br><br>Assessing transparency – Assessing whether the group's disclosures are appropriate.<br><br>Our results:<br><br>We found the resulting estimate of the recoverable amount of the loans to Water Plus to be acceptable.</td></tr>
</table>

## 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 £18.51 million (2017: £18.51m), determined with reference to a benchmark of profit before tax, normalised to exclude net fair value gains or losses on debt and derivative instruments as disclosed in note 5, of £389.0 million, of which it represents 4.8% (2017: 4.6%). Materiality for the parent company financial statements as a whole was set at £18.50 million (2017: £18.50 million), determined with reference to a benchmark of company profit before tax, normalised to exclude net fair value gains or losses on debt and derivative instruments as disclosed in note 5, of £389.0 million, of which it represents 4.8% (2017: 4.6%). We agreed to report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.5 million, in addition to other identified misstatements that warranted reporting on qualitative grounds.

## 4. We have nothing to report on going concern

We are required to report to you if we have concluded that the use of the going concern basis of accounting is inappropriate or there is an undisclosed material uncertainty that may cast

# Independent auditor's report

**to the members of United Utilities Water Limited**

significant doubt over the use of that basis for a period of at least twelve months from the date of approval of the financial statements. We have nothing to report in these respects.

## 5. We have nothing to report on the other information in the Annual Report

The directors are responsible for the other information presented in the Annual Report together with the financial statements. Our opinion on the financial statements does not cover the other information and, accordingly, we do not express an audit opinion or, except as explicitly stated below, any form of assurance conclusion thereon.

Our responsibility is to read the other information and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work we have not identified material misstatements in the other information.

*Strategic report and directors' report*

Based solely on our work on the other information:

- we have not identified material misstatements in the strategic report and the directors' report;
- in our opinion the information given in those reports for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act *2006.*

## 6. We have nothing to report on the other 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.

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

We have nothing to report in these respects.

## 7. Respective responsibilities

*Directors' responsibilities*

As explained more fully in their statement set out on page 84, the directors are responsible for the preparation of the financial statements including being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of the financial statements that ae free from material misstatement, whether due to fraud or error; assessing the Group and parent Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern, and using the going concern basis of accounting unless they either intend to liquidate the Group or parent Company or to cease operations, or have no realistic alternative but to do so.

*Auditor's responsibilities*

# Independent auditor's report
**to the members of United Utilities Water Limited**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or other irregularities (see below), or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud, other irregularities or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

*Irregularities – ability to detect*

We identified areas of laws and regulations that could reasonably be expected to have a material effect on the financial statements from our sector experience and through discussion with the directors and other management (as required by auditing standards).

We had regard to laws and regulations in areas that directly affect the financial statements including financial reporting (including related company legislation) and taxation legislation. We considered the extent of compliance with those laws and regulations as part of our procedures on the related financial statement items.

In addition, we considered the impact of laws and regulations in the specific areas of environmental law, health and safety, anti-bribery, employment law, regulatory capital and liquidity and certain aspects of company legislation recognising the financial and regulated nature of the group's activities and its legal form. With the exception of any known or possible non-compliance and, as required by auditing standards, our work in respect of these was limited to enquiry of the directors and other management and inspection of regulatory and legal correspondence. We considered the effect of any known or possible non-compliance in these areas as part of our procedures on the related financial statement items.

We communicated identified laws and regulations throughout our team and remained alert to any indications of non-compliance throughout the audit.

As with any audit, there remained a higher risk of non-detection of non-compliance with relevant laws and regulations, as these may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal controls.

## 8. The purpose of our audit work and whom we owe our responsibilities

This report is made solely to the Company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

**William Meredith**

for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
St Peter's Square, Manchester M2 3AE
12 June 2018

# Consolidated income statement

**for the years ended 31 March**

| | Note | 2018 £m | 2017 £m |
|---|---|---|---|
| Revenue | 1 | 1,716.6 | 1,680.3 |
| Employee benefits expense | 2 | (147.8) | (145.9) |
| Other operating costs | 3 | (413.4) | (417.2) |
| Other income | 3 | 3.6 | 4.1 |
| Depreciation and amortisation expense | 3 | (375.3) | (363.7) |
| Infrastructure renewals expenditure | | (149.5) | (150.8) |
| **Total operating expenses** | | (1,082.4) | (1,073.5) |
| **Operating profit** | | 634.2 | 606.8 |
| Investment income | 4 | 8.5 | 10.7 |
| Finance expense | 5 | (226.5) | (208.0) |
| Investment income and finance expense | | (218.0) | (197.3) |
| **Profit before tax** | | 416.2 | 409.5 |
| Current tax charge | 6 | (21.4) | (45.5) |
| Deferred tax charge | 6 | (55.6) | (34.0) |
| Deferred tax credit – change in tax rate | 6 | - | 57.8 |
| **Tax** | 6 | (77.0) | (21.7) |
| **Profit after tax** | | 339.2 | 387.8 |

All of the results shown above relate to continuing operations.

# Consolidated statement of comprehensive income

**for the years ended 31 March**

| | Note | 2018 £m | 2017 £m |
|---|---|---|---|
| **Profit after tax** | | 339.2 | 387.8 |
| **Other comprehensive income** | | | |
| Remeasurement gains/(losses) on defined benefit pension schemes | 14 | 34.6 | (70.5) |
| Tax on items taken directly to equity | 6 | (5.9) | 15.4 |
| **Total comprehensive income** | | 367.9 | 332.7 |

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 | 2018 £m | 2017 £m |
|---|---|---|---|
| **ASSETS** | | | |
| **Non-current assets** | | | |
| Property, plant and equipment | 9 | 10,738.9 | 10,361.0 |
| Intangible assets | 10 | 197.7 | 187.7 |
| Investments | A1 | 0.1 | 0.1 |
| Trade and other receivables | 11 | 100.0 | 100.0 |
| Retirement benefit surplus | 14 | 264.1 | 194.5 |
| Derivative financial instruments | A5 | 297.8 | 544.0 |
| | | 11,598.6 | 11,387.3 |
| **Current assets** | | | |
| Inventories | | 8.1 | 9.0 |
| Trade and other receivables | 11 | 298.0 | 343.2 |
| Cash and short-term deposits | 12 | 499.6 | 196.9 |
| Derivative financial instruments | A5 | 218.5 | 76.2 |
| | | 1,024.2 | 625.3 |
| **Total assets** | | 12,622.8 | 12,012.6 |
| **LIABILITIES** | | | |
| **Non-current liabilities** | | | |
| Trade and other payables | 17 | (642.0) | (587.9) |
| Borrowings | 13 | (7,302.5) | (7,079.8) |
| Deferred tax liabilities | 15 | (1,078.1) | (1,016.6) |
| Derivative financial instruments | A5 | (96.8) | (235.5) |
| | | (9,119.4) | (8,919.8) |
| **Current liabilities** | | | |
| Trade and other payables | 17 | (262.5) | (309.5) |
| Borrowings | 13 | (817.4) | (384.4) |
| Current tax liabilities | | (1.3) | (15.4) |
| Provisions | 16 | (20.4) | (22.9) |
| Derivative financial instruments | A5 | (4.2) | (14.2) |
| | | (1,105.8) | (746.4) |
| **Total liabilities** | | (10,225.2) | (9,666.2) |
| **Total net assets** | | 2,397.6 | 2,346.4 |
| **EQUITY** | | | |
| **Capital and reserves attributable to equity holders of the company** | | | |
| Share capital | 18 | 100.0 | 100.0 |
| Retained earnings | | 2,297.6 | 2,246.4 |
| **Shareholder's equity** | | 2,397.6 | 2,346.4 |

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 12 June 2018, and signed on its behalf by:

Russ Houlden
Chief Financial Officer

# Consolidated and company statement of changes in equity

**for the years ended 31 March**

**Group and company**

| | Share capital £m | Retained earnings £m | Total £m |
|---|---|---|---|
| At 1 April 2017 | 100.0 | 2,246.4 | 2,346.4 |
| Profit after tax | - | 339.2 | 339.2 |
| **Other comprehensive income/(expense)** | | | |
| Remeasurement gains on defined benefit pension schemes (see note 14) | - | 34.6 | 34.6 |
| Tax on items taken directly to equity (see note 6) | - | (5.9) | (5.9) |
| **Total comprehensive income** | - | 367.9 | 367.9 |
| Dividends (see note 7) | - | (316.7) | (316.7) |
| **At 31 March 2018** | 100.0 | 2,297.6 | 2,397.6 |

| | 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 |

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 not materially different from the group.

# Consolidated and company statement of cash flows

**for the years ended 31 March**

**Group and company**

| | Note | 2018 £m | 2017 £m |
|---|---|---|---|
| **Operating activities** | | | |
| Cash generated from operations | A2 | 1,004.4 | 1,007.1 |
| Interest paid | | (150.6) | (161.9) |
| Interest received and similar income | | 4.4 | 3.6 |
| Tax paid | | (35.5) | (42.4) |
| Tax received | | - | 1.2 |
| **Net cash generated from operating activities** | | 822.7 | 807.6 |
| **Investing activities** | | | |
| Purchase of property, plant and equipment | | (690.6) | (658.7) |
| Purchase of intangible assets | | (36.1) | (52.4) |
| Proceeds from sale of property, plant and equipment | | 1.4 | 4.0 |
| Grants and contributions received | 17 | 23.7 | 29.0 |
| Loans to related parties | A7 | - | (100.0) |
| **Net cash used in investing activities** | | (701.6) | (778.1) |
| **Financing activities** | | | |
| Proceeds from borrowings | | 858.4 | 675.8 |
| Repayment of borrowings | | (345.4) | (478.6) |
| Dividends paid to equity holders of the company | 7 | (316.7) | (229.7) |
| **Net cash from/(used in) financing activities** | | 196.3 | (32.5) |
| **Net increase/(decrease) in cash equivalents** | | 317.4 | (3.0) |
| Cash and cash equivalents at beginning of the year | | 170.6 | 173.6 |
| Cash and cash equivalents at end of the year | 12 | 488.0 | 170.6 |

# 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. 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 2018, have had no material impact on the group's financial statements:

- amendments to IAS 12 'Income Taxes', clarifying how to account for deferred tax assets related to debt instruments measured at fair value;
- amendments to IAS 7 'Statement of Cash Flows'; requiring disclosures that enable evaluation of changes in liabilities arising from financing activities; and
- improvements to IFRS (2016) (Amendment to IFRS 12 'Disclosure of Interests in Other Entities', effective date 1 January 2018).

**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 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.

# Accounting policies

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. Management considers that where customers have not paid their bills within the last two years, or have not cleared previously outstanding arrears aged more than two years, collectability is not deemed to be reasonably assured, and therefore amounts billed to these customers are not recognised as revenue. This resulted in £20.3 million of amounts billed not being recognised as revenue during the year (net of cash receipts and credits). Had management made an alternative judgement that collectability was not reasonably assured where customers had not paid within one year or within three years, or had not cleared previously outstanding arrears within these time frames, this would have resulted in £0.9 million of revenue not being recognised during the year or £9.4 million additional revenue being recognised during the year respectively. 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. At 31 March 2018 the allowance for doubtful receivables of £63.2 million was supported by a six-year cash collection projection. Based on a five-year or seven-year cash collection projection the allowance for doubtful receivables would have been £62.3 million or £64.2 million respectively.

*Accounting estimate* – the company raises bills in accordance with its entitlement to receive revenue in line with the limits established by the periodic 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. Revenue recognised for unbilled amounts for these customers at 31 March 2018 was £40.2 million. Had actual consumption been five per cent higher or lower than the estimate of units supplied this would have resulted in revenue recognised for unbilled amounts being £3.8 million higher or lower respectively. 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. Enhancement spend was 30 per cent of total spend in relation to infrastructure assets during the year. A change of +/- one per cent would have resulted in £2.3 million less/more expenditure being charged to the income statement during the period. In addition, management capitalises time and resources incurred by the group's support functions on capital programmes, which

# Accounting policies

requires accounting judgements to be made in relation to the appropriate capitalisation rates. Support costs allocated to PPE represent 58 per cent of total support costs. A change in allocation of +/- one per cent would have resulted in £0.9 million less/more expenditure being charged to the income statement during the period.

*Accounting estimate* - the estimated useful economic lives of PPE and intangible assets is 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 and intangibles investment to the group, variations between actual and estimated useful economic lives could impact operating results both positively and negatively. As such this is a key source of estimation uncertainty, although historically few changes to estimated useful economic lives have been required. The depreciation and amortisation expense for the year was £375.3 million. A 10 per cent increase in average asset lives would have resulted in a £33.6 million reduction in this figure and a 10 per cent decrease in average asset lives would have resulted in a £42.3 million increase in this figure.

***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. 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. Sensitivities in respect of the assumptions used during the year are disclosed in note A6.

**Joint ventures**

*Accounting estimate* - the group has interests relating to its joint ventures in the form of loans receivable, the recoverability of which are considered with reference to the present value of the estimated future cash flows of the joint ventures. Management tests whether any impairment exists in relation to the loans receivable if adverse changes in conditions associated with the joint ventures suggest that this is appropriate. The estimated present value of these future cash flows is sensitive to the discount rate and terminal growth rate used in the calculation, together with the normalised level of working capital in the joint venture, all of which require management judgement. Testing of the carrying value has been performed during the year, which has involved a number of scenarios being modelled. Based on this testing, management believes there is sufficient headroom to support the carrying value of the group's interests in joint ventures, although it is possible, on the basis of existing knowledge, that outcomes within the next financial year that are different from the assumptions used could require a material adjustment to the carrying amount of assets.

***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. Sensitivities relating to derivative financial instruments are included in note A5.

# Accounting policies

***Provisions and contingencies***

*Accounting estimates* - 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. 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. The provisions in respect of these claims, based on management's best estimates, totalled £17.8 million as at 31 March 2018 as set out in the "Other" category in note 16; due to an inherent level of estimation uncertainty management estimate that there is an 80 per cent probability that the outcomes of these items will fall within a range of £10 million to £25 million. 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.

***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 £24.0 million loss would have been recognised in other comprehensive income rather than within the income statement.

The new standard has moved to a principles-based approach to align hedge accounting to the risk management activities of the entity, broadening the scope of what can be included within a hedge relationship. This change will see the requirement for cross currency basis spread adjustments to be incorporated in the test for the effectiveness of a hedge to be removed. The portion of the change in fair value due to changes in the cross currency basis spread will be recognised in other comprehensive income rather than within profit or loss. If the standard had been adopted in the current year, a £7.2 million gain would have been recognised in other comprehensive income rather than within the income statement.

The changes in hedge accounting may present increased opportunities in the future to put non-financial risks into hedge relationships, however we do not expect this to have any material impact on the financial statements in the period of initial application.

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. Consequently, judgement will be required in forming an expectation of future credit losses, particularly in relation to the group's trade receivable balances. The group currently employs a model that uses historic cash collection rates to form an expectation of the estimated recoverability of trade receivables at a point in time as this is the best information available on which an expectation can be formed. As such, there will be no significant change to the model currently used although the group will continue to explore ways in which it might be further refined, and will take into consideration any

# Accounting policies

significant economic changes that may have a bearing on expected credit losses. This is not expected to have a material impact on the overall level of allowances for bad and doubtful receivables.

The group is not required to restate 2018 comparative information for balances affected by the adoption of IFRS 9 in the year of transition.

***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'. The standard requires revenue to be recognised in line with the satisfaction of performance obligations identified within contracts between an entity and its customers, at an amount that reflects the transaction price allocated to each performance obligation.

Particular challenges exist within the water industry as formal written contracts do not exist for most transactions with customers. Contracts are instead implied through statute and regulation. Judgement is therefore required in identifying the services contained within the contract and the customer with who the contract is entered into, which in turn impacts on how the performance obligations are considered and therefore revenue recognised.

There are two main areas of the group's activities that will be impacted by the adoption of IFRS 15:

- Core water and wastewater services, accounting for more than 97 per cent of the group's revenue under current accounting standards, and

- Capital income streams accounting for less than 2 per cent of the group's revenue in the income statement under current accounting standards, but where around £600 million of balances are currently included within deferred grants and contributions on the statement of financial position.

Other ancillary revenue streams are not expected to be significantly impacted, and no significant judgements are required in relation to these.

*Core water and wastewater services*

These services relate to: (i) the supply of clean water; and (ii) the removal and treatment of wastewater, with provision of each of these services deemed to be a distinct performance obligation under the contract with customers, though following the same pattern of transfer to the customer who simultaneously receives and consumes both of these services over time. No significant judgements are required in identifying customers of these services. In accordance with IFRS 15, revenue relating to these activities will be recognised over time as these performance obligations are satisfied. The adoption of the new standard is not expected to have any impact on the timing and amount of revenue recognised in these services.

*Capital income*

Capital income refers to the group's income streams relating to transactions, typically with property developers, which impact the group's capital network assets. It should be noted that this area remains under active consideration within the industry and the accounting profession more broadly, and that the accounting treatment ultimately adopted by the group in this area could therefore be impacted by the outcome of these ongoing discussions. We set out below our current assessment of the impact of IRFS 15 in relation to the transactions.

# Accounting policies

There are two categories of capital income, both of which will be impacted by the adoption of IFRS 15:

- Diversions relating to the relocation of water and wastewater assets, and

- Activities that facilitate the creation of an authorised connection through which properties can obtain water and wastewater services.

The adoption of IFRS 15 will not result in any net income statement impact relating to diversions, where income is currently recognised in line with the completion of diversion work. However, whereas this income is currently included in the income statement as a credit within infrastructure renewals expenditure (IRE) due to it representing a contribution towards these costs, under IFRS 15 it will be recognised within revenue resulting in an increase in both the revenue and IRE expense balances. If the standard had been adopted in the current year this would have resulted in revenue and IRE both increasing by £7.9 million.

Significant judgement is required in relation to accounting for activities that facilitate an authorised network connection through which water and wastewater services can be delivered. Establishing such an authorised connection can involve a number of activities performed opposite developers which are considered to be neither separable nor distinct and instead form a bundle of activities necessary to establish an authorised connection from which network access can be obtained and water and wastewater services can be provided. These are considered to form part of the group's ordinary activities associated with the operation, maintenance and expansion of a water and wastewater network, and because they are deemed to result in an exchange transaction we have determined that they fall within the scope of IFRS 15 as transactions arising from contracts with customers.

In addition, as the group has a legal obligation to keep a connection in place for as long as a property requires water and wastewater services these initial connection activities are deemed to result in a broader ongoing performance obligation that is not distinct from the ongoing supply of water and wastewater services. The right to benefit from this connection and obtain water and wastewater services through it is deemed to be transferable from the initial developer to subsequent occupants of a connected property. Accordingly, under IFRS 15 the element of the performance obligation associated with the connection activities will be deemed to be satisfied over the period of time that water and wastewater services are expected to be provided through the connection, compared with the current treatment under which deferred amounts are released to the income statement over the useful economic life of the related assets or, for certain items, immediately to the income statement. This estimated period is a matter of judgement. We estimate that an average connection will be in place for a period of around 60 years and therefore revenue associated with connection activities will be recognised evenly over this period.

We intend to apply IFRS 15 retrospectively with the cumulative effect of initially applying the standard recognised as an adjustment to the opening retained earnings balance at the date of initial application. The standard permits that, where this approach is used, contracts that have been completed in accordance with current accounting standards at the date of initial application will not be restated on an IFRS 15 basis. Based on the deferred balance held on the statement of financial position relating to connection activities where the contract has not been completed as at 31 March 2018, the adjustment to retained earnings on the transition date of 1 April 2018 is expected to be a reduction in deferred grants and contributions and a corresponding increase in retained earnings of £2.7 million. In the year of adoption, revenue of £12.3 million is expected to be recognised in the income statement in relation to the updated deferred balances held on the statement of financial position relating to connection activities at 1 April 2018, compared with £8.9 million under current accounting standards. In addition, around £0.1 million of revenue is expected to be recognised in relation to balances that will be newly deferred under IFRS 15, compared with around £4 million that would have been expected to be recognised in the year ending 31 March 2019 under accounting standards adopted at 31 March 2018.

# Accounting policies

The net effect of these changes is that the total amount of annual revenue recognised in relation to these items is expected to fall by around £0.5 million as a result of the adoption of IFRS 15, compared with the group's treatment under accounting standards adopted at the reporting date.

***IFRS 16 'Leases'***

The standard is effective for periods commencing on or after 1 January 2019. 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.

The key judgements associated with adoption of this standard relate to the identification and classification of contracts containing a lease within the scope of IFRS 16, and the discount rate to use in calculating the present value of future lease payments on which the reported lease liability and right-of-use asset is based when the rate is not implicit in the lease contract.

Work to ensure the correct identification and classification of leases remains ongoing and will continue over the course of the coming year.

The discount rate is a key determinant in calculating the present value of future lease payments. The appropriate rate to use remains an area of active discussion, the outcome of which is likely to have a material impact on the valuation of the right-of-use asset and lease liability on adoption. Accordingly, as we do not yet have clarification on this point, we have not sought to quantify the impact of adoption at this stage.

We intend to use the modified retrospective transitional approach permitted by the standard in which the right-of-use asset and lease liability brought onto the balance sheet will be based on the present value of future lease payments at the adoption date calculated using the appropriate discount rate. The discount rate will be based on the company's incremental cost of borrowing at the point of adoption where the interest rate is not implicit in the lease contract. As such, the impact on adoption will be sensitive to the group's incremental borrowing costs as at the 1 April 2019 adoption 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 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 | 2018 £m | 2017 £m |
|---|---|---|
| Fees to non-executive directors | 0.7 | 0.7 |
| Salaries | 1.6 | 1.5 |
| Benefits | 0.4 | 0.4 |
| Bonus | 0.8 | 0.7 |
| Share-based payment charge | 1.9 | 1.8 |
| | 5.4 | 5.1 |

Included within the above are aggregate emoluments of £2.3 million (2017: £2.2 million) in respect of the highest paid director.

A recharge of £0.4 million during the year ended 31 March 2018 (2017: £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 (2017: three directors) received shares in United Utilities Group PLC in respect of qualifying services. Three directors (2017: three directors) had long-term incentive plans which vested during the year. Aggregate amounts receivable relating to long-term incentive plans were £0.8 million (2017: £1.1 million*), were recognised during the year.

*The 2017 figure has been restated to reflect amounts that became receivable during the year relating to long-term incentive plans rather than including amounts that could become receivable in future years.

**Remuneration of key management personnel**

| | 2018 £m | 2017 £m |
|---|---|---|
| Salaries and short-term employee benefits | 5.3 | 5.5 |
| Severance | 0.6 | - |
| Post-employment benefits | - | 0.1 |
| Share-based payment charge | 2.4 | 2.6 |
| | 8.3 | 8.2 |

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)**

| | 2018 £m | 2017 £m |
|---|---|---|
| Wages and salaries | 220.4 | 219.6 |
| Social security | 22.8 | 21.7 |
| Severance | 3.7 | 7.0 |
| Post-employment benefits: | | |
| Defined benefit pension expense (see note 14) | 29.6 | 22.8 |
| Defined contribution pension expense (see note 14) | 12.1 | 11.2 |
| | 41.7 | 34.0 |
| Employee benefits expense before recharges | 288.6 | 282.3 |
| Amounts recharged to parent and fellow subsidiary companies | (3.0) | (3.4) |
| Amounts recharged to related parties at nil margin under transitional service agreements (see note A7) | - | (4.0) |
| Charged to regulatory capital schemes | (137.8) | (129.0) |
| Employee benefits expense | 147.8 | 145.9 |

Within employee benefits expense were £5.9 million (2017: £9.8 million) of restructuring costs.

A recharge of £3.0 million during the year ended 31 March 2018 (2017: £7.4 million) was charged to other companies in the UUG group in relation to the provision of employee services.

Conditional share awards in relation to shares of the ultimate parent undertaking, United Utilities Group PLC, have been granted to employees of the group under various schemes. Details of the terms and conditions of each scheme are given in the 2018 UUG annual report and financial statements. Included within wages and salaries is an expense of £3.2 million (2017: £3.3 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)**

| | 2018 number | 2017 number |
|---|---|---|
| Average number of employees during the year | 4,964 | 5,033* |

The 2018 total employee benefits expense, before recharges, of £288.6 million (2017: £282.3 million) includes the employee costs relating to the persons employed during the year noted above in addition to costs of £19.8 million (2017: £19.0 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 259 (2017: 277*).

*Re-presented due to improvements in headcount data.

# Notes to the financial statements

## 3. Operating profit

| | 2018 £m | 2017 £m |
|---|---|---|
| **Other operating costs** | | |
| Hired and contracted services | 96.8 | 98.2 |
| Property rates | 90.5 | 91.2 |
| Power | 72.9 | 70.5 |
| Materials | 66.9 | 67.5 |
| Regulatory fees | 29.7 | 28.6 |
| Charge for bad and doubtful receivables (see note 11) | 20.7 | 29.8 |
| Loss on disposal of property, plant and equipment | 6.4 | 3.3 |
| Legal and professional expenses | 4.8 | 4.0 |
| Operating leases payable: | | |
| Property | 3.3 | 3.6 |
| Plant and equipment | 0.7 | 0.6 |
| Impairment of property, plant and equipment (see note 9) | - | 0.2 |
| Compensation from insurers | (3.6) | (12.3) |
| Amortisation of deferred grants and contributions (see note 17) | (6.4) | (6.7) |
| Other expenses | 30.7 | 38.7 |
| | 413.4 | 417.2 |
| **Other income** | | |
| Other income | (3.6) | (4.1) |
| | (3.6) | (4.1) |
| **Depreciation and amortisation expense** | | |
| Depreciation of property, plant and equipment (see note 9) | 346.9 | 335.0 |
| Amortisation of intangible assets (see note 10) | 28.4 | 28.7 |
| | 375.3 | 363.7 |

As a result of two significant flooding incidents caused by Storms Desmond and Eva in December 2015, there were £5.3 million (2017: £13.8 million) of expenses incurred, comprising £2.9 million (2017: £11.1 million) of operating costs, £2.4 million (2017: £2.5 million) of infrastructure renewals expenditure, and a £nil (2017: £0.2 million) impairment of property, plant and equipment. Insurance compensation of £3.6 million (2017: £12.3 million) relating to the flooding incidents has been recognised as part of a final settlement of the insurance claim. The group does not expect there to be any further costs or insurance receipts in respect of the flooding incidents.

In addition, there were £1.0 million (2017: £5.8 million) of market reform restructuring costs relating to the non-household retail market opening to competition in April 2017.

Total other operating costs are stated net of £1.4 million (2017: £14.5 million) of costs recharged to Water Plus at nil margin under transitional service agreements.

Research and development expenditure for the year ended 31 March 2018 was £1.2 million (2017: £2.3 million).

During the year, the group obtained the following services from its auditor, with a total value of £312,000 (2017: £297,000), which are broken down as follows:

| | 2018 £'000 | 2017 £'000 |
|---|---|---|
| **Audit services** | | |
| Statutory audit – group and company | 216 | 200 |
| Statutory audit – subsidiary | 17 | 16 |
| | 233 | 216 |

# Notes to the financial statements

## 3. Operating profit (continued)

| | 2018 £'000 | 2017 £'000 |
|---|---|---|
| **Non-audit services** | | |
| Regulatory audit services provided by the statutory auditor | 46 | 53 |
| Other non-audit services | 33 | 28 |
| | 312 | 297 |

## 4. Investment income

| | 2018 £m | 2017 £m |
|---|---|---|
| Interest receivable on short-term bank deposits held at amortised cost | 1.0 | 0.8 |
| Interest receivable on loans to joint ventures of the UUG group held at amortised cost (see note A7) | 2.0 | 1.5 |
| Net pension interest income (see note 14) | 5.5 | 8.4 |
| | 8.5 | 10.7 |

## 5. Finance expense

| | 2018 £m | 2017 £m |
|---|---|---|
| **Interest payable** | | |
| Interest payable on borrowings held at amortised cost(1) | 242.0 | 201.3 |
| Interest payable on borrowings from parent and fellow subsidiary undertakings | 2.6 | 2.8 |
| Preference share dividends (see note 7) | 9.1 | 9.1 |
| | 253.7 | 213.2 |
| **Fair value (gains)/losses on debt and derivative instruments**(2) | | |
| Fair value hedge relationships: | | |
| Borrowings | (81.6) | 26.0 |
| Designated swaps | 91.0 | (35.8) |
| | 9.4 | (9.8) |
| **Financial instruments at fair value through profit or loss** | | |
| Borrowings designated at fair value through profit or loss(3) | (27.8) | 37.5 |
| Associated swaps(4) | 63.7 | (30.1) |
| | 35.9 | 7.4 |
| Fixed interest rate swaps(4) | (87.4) | 0.8 |
| Electricity swaps(4) | (8.0) | (9.6) |
| Net payments on swaps and debt under fair value option | (0.1) | 5.9 |
| Other swaps(4)(5) | 2.2 | (5.0) |
| Realisation of fair value loss on settlement of borrowings held at amortised cost6) | 23.1 | - |
| Other | (2.3) | 5.1 |
| | (72.5) | (2.8) |
| **Net fair value gains on debt and derivative instruments**(7) | (27.2) | (5.2) |
| | 226.5 | 208.0 |

# Notes to the financial statements

## 5. Finance expense (continued)

Notes:

(1) Includes a £137.8 million (2017: £80.7 million) non-cash inflation uplift expense in relation to the group's index-linked debt.

(2) Includes foreign exchange gains of £6.0 million (2017: £59.1 million losses), excluding those on instruments measured at fair value through profit or loss. These gains/losses are largely offset by fair value losses/gains on derivatives.

(3) Includes a £24.0 million loss (2017: £11.9 million) 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) This fair value loss results from the partial close-out of £50.0m RPI index-linked notes due April 2043. The portion of the notes closed out had a nominal value of £30.0 million (carrying value £43.0 million), and were purchased at a fair value of £64.4 million resulting in a £23.1 million fair value loss.

(7) Includes £3.7 million income (2017: £5.7 million expense) due to interest on swaps and debt under fair value option.

Interest payable is stated net of £39.7 million (2017: £29.2 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 3.6 per cent (2017: 3.0 per cent) to expenditure on such assets as prescribed by IAS 23 'Borrowing Costs'.

## 6. Tax

| | 2018 £m | 2017 £m |
|---|---|---|
| **Current tax** | | |
| UK corporation tax | 26.8 | 53.5 |
| Adjustments in respect of prior years | (5.4) | (8.0) |
| Total current tax charge for the year | 21.4 | 45.5 |
| **Deferred tax** | | |
| Current year | 49.5 | 27.9 |
| Adjustments in respect of prior years | 6.1 | 6.1 |
| | 55.6 | 34.0 |
| Change in tax rate | - | (57.8) |
| Total deferred tax charge/(credit) for the year | 55.6 | (23.8) |
| Total tax charge for the year | 77.0 | 21.7 |

The prior year deferred tax credit of £57.8 million reflects the enacted reduction in the headline rate of corporation tax to 17 per cent from 1 April 2020. The adjustments in respect of prior years relate 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:

| | 2018 £m | 2018 % | 2017 £m | 2017 % |
|---|---|---|---|---|
| Profit before tax | 416.2 | | 409.5 | |
| Tax at the UK corporation tax rate | 79.1 | 19.0 | 81.9 | 20.0 |
| Adjustments in respect of prior years | 0.7 | 0.2 | (1.9) | (0.5) |
| Change in tax rate | - | - | (57.8) | (14.1) |
| Net income not taxable/other | (2.8) | (0.7) | (0.5) | (0.1) |
| Total tax charge and effective tax rate for the year | 77.0 | 18.5 | 21.7 | 5.3 |

**Tax on items taken directly to equity**

| | 2018 £m | 2017 £m |
|---|---|---|
| **Current tax** | | |
| Relating to other pension movements | - | (7.6) |
| | - | (7.6) |
| **Deferred tax (see note 15)** | | |
| On remeasurement gains/(losses) on defined benefit pension schemes | 5.9 | (12.7) |
| Relating to other pension movements | - | 6.8 |
| Change in tax rate | - | (1.9) |
| | 5.9 | (7.8) |
| Total tax charge/(credit) on items taken directly to equity | 5.9 | (15.4) |

The prior year deferred tax credit of £1.9 million reflects the enacted reduction in the headline rate of corporation tax to 17 per cent from 1 April 2020.

## 7. Dividends

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

| | 2018 £m | 2017 £m |
|---|---|---|
| **Ordinary shares** | | |
| Interim dividend for the year ended 31 March 2016 at 0.7 pence per share (2015: 119.4 pence) | - | 0.7 |
| Interim dividend for the year ended 31 March 2018 at 127.9 pence per share (2017: 128.3 pence) | 127.9 | 128.3 |
| Interim dividend for the year ended 31 March 2018 at 94.7 pence per share (2017: 65.3 pence) | 94.7 | 65.3 |
| Interim dividend for the year ended 31 March 2017 at 29.32 pence per share | 29.3 | - |
| Interim dividend for the year ended 31 March 2018 at 64.75 pence per share (2017: 35.4 pence) | 64.8 | 35.4 |
| Dividend relating to the transfer of non-household retail business(see note 8) | - | 18.4 |
| | 316.7 | 248.1 |

The directors have not recommended a final ordinary dividend (2017: £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 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 |
| Additions | 2.4 | 70.7 | 120.4 | 10.1 | 529.0 | 732.6 |
| Transfers | 12.0 | 72.6 | 141.4 | 23.4 | (249.4) | - |
| Disposals | (1.4) | (0.1) | (46.4) | (3.7) | - | (51.6) |
| At 31 March 2018 | 369.2 | 5,386.2 | 7,205.5 | 530.2 | 1,215.0 | 14,706.1 |
| **Accumulated depreciation** | | | | | | |
| At 1 April 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 |
| Charge for the year | 9.4 | 39.5 | 259.0 | 39.0 | - | 346.9 |
| Disposals | (1.3) | - | (39.4) | (3.1) | - | (43.8) |
| At 31 March 2018 | 120.0 | 385.4 | 3,088.3 | 373.5 | - | 3,967.2 |
| **Net book value** | | | | | | |
| At 31 March 2017 | 244.3 | 4,897.1 | 4,121.4 | 162.8 | 935.4 | 10,361.0 |
| At 31 March 2018 | 249.2 | 5,000.8 | 4,117.2 | 156.7 | 1,215.0 | 10,738.9 |

# Notes to the financial statements

## 9. Property, plant and equipment (continued)

At 31 March 2018, the group and company had entered into contractual commitments for the acquisition of property, plant and equipment amounting to £430.1 million (2017: £335.2 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 2016 | 310.3 |
| Additions | 54.5 |
| Transfer to assets classified as held for sale | (8.2) |
| At 31 March 2017 | 356.6 |
| Additions | 38.4 |
| Disposals | - |
| At 31 March 2018 | 395.0 |
| **Accumulated amortisation** | |
| At 1 April 2016 | 147.9 |
| Charge for the year | 28.7 |
| Transfer to assets classified as held for sale | (7.7) |
| At 31 March 2017 | 168.9 |
| Charge for the year | 28.4 |
| Disposals | - |
| At 31 March 2018 | 197.3 |
| Net book value at 31 March 2017 | 187.7 |
| Net book value at 31 March 2018 | 197.7 |

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

At 31 March 2018, the group and company had entered into contractual commitments for the acquisition of intangible assets amounting to £2.8 million (2017: £1.7million).

# Notes to the financial statements

## 11. Trade and other receivables

| Group and company | 2018 £m | 2017 £m |
|---|---|---|
| Trade receivables | 105.6 | 116.9 |
| Amounts owed by parent and fellow subsidiary undertakings (see note A7): | | |
| Trading balances | 6.1 | 17.5 |
| Floating rate loan | 40.0 | 40.0 |
| Amounts owed by other related parties (see note A7) | 142.2 | 140.8 |
| Other debtors and prepayments | 40.8 | 63.9 |
| Accrued income | 63.3 | 64.1 |
| | 398.0 | 443.2 |

At 31 March 2018, the group and company had £100.0 million (2017: £100.0 million) 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 | 2018 £m | 2017 £m |
|---|---|---|
| At the start of the year | 85.3 | 94.3 |
| Amounts charged to operating expenses (see note 3) | 20.7 | 29.8 |
| Trade receivables written off | (44.6) | (38.8) |
| Amounts charged to deferred income | 1.6 | - |
| Amounts charged to infrastructure renewals expense | 0.2 | - |
| At the end of the year | 63.2 | 85.3 |

Amounts charged to deferred income relate to amounts invoiced for which revenue had not yet been recognised in the income statement.

Amounts charged to infrastructure renewals expenditure relate to amounts invoiced in relation to contributions towards the cost of infrastructure renewals incurred as a result of carrying out infrastructure diversions works.

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 2018 and 31 March 2017, 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 £m | Aged between one year and two years £m | Aged greater than two years £m | Carrying value £m |
|---|---|---|---|---|
| **Trade receivables** | | | | |
| At 31 March 2018 | 76.9 | 24.5 | 4.2 | 105.6 |
| At 31 March 2017 | 79.9 | 32.0 | 5.0 | 116.9 |

At 31 March 2018, the group and company had no trade receivables that were not past due (2017: £nil).

# Notes to the financial statements

## 12. Cash and cash equivalents

| Group and company | 2018 £m | 2017 £m |
|---|---|---|
| Cash at bank and in hand | 0.1 | 0.6 |
| Short-term bank deposits | 499.5 | 196.3 |
| **Cash and short-term deposits** | 499.6 | 196.9 |
| Book overdrafts (included in borrowings, see note 13) | (11.6) | (26.3) |
| **Cash and cash equivalents in the statement of cash flows** | 488.0 | 170.6 |

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 | 2018 £m | 2017 £m |
|---|---|---|
| **Non-current liabilities** | | |
| Bonds[1] | 4,375.7 | 3,976.0 |
| Bank and other term borrowings | 2,349.5 | 2,207.4 |
| Amounts owed to intermediate parent undertaking (see note A7) | 577.3 | 896.4 |
| | 7,302.5 | 7,079.8 |
| **Current liabilities** | | |
| Bonds | 150.8 | 37.3 |
| Bank and other term borrowings | 127.1 | 126.2 |
| Book overdrafts (see note 12) | 11.6 | 26.3 |
| 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)[2] | 397.9 | 64.6 |
| | 817.4 | 384.4 |
| | 8,119.9 | 7,464.2 |

Note:

[1] For the company, bonds includes £1,021.1 million (2017: £438.7 million) of amounts owed to subsidiary undertakings.

[2] For the company, £0.2 million (2017: £0.2 million) of amounts is 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.

# 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** | 2018 £m | 2017 £m |
|---|---|---|
| Current service cost | 25.6 | 18.3 |
| Curtailments/settlements | 2.2 | 2.8 |
| Administrative expenses | 1.8 | 1.7 |
| **Pension expense charged to operating profit** | 29.6 | 22.8 |
| Net pension interest income credited to investment income (see note 4) | (5.5) | (8.4) |
| **Net pension expense charged before tax** | 24.1 | 14.4 |

Defined benefit pension costs excluding curtailments/settlements included within employee benefit expense were £27.4 million (2017: £20.0 million) comprising current service costs and administrative expenses.

Total post-employment benefits expense excluding curtailments/ settlements charged to operating profit of £39.5 million (2017: £31.2 million) comprise the defined benefit costs described above of £27.4 million (2017: £20.0 million) and defined contribution pension costs of £12.1 million (2017: £11.2 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** | 2018 £m | 2017 £m |
|---|---|---|
| At the start of the year | 194.5 | 226.9 |
| Expense recognised in the income statement | (24.1) | (14.4) |
| Contributions paid | 59.1 | 52.5 |
| Remeasurement gains/(losses) gross of tax | 34.6 | (70.5) |
| **At the end of the year** | 264.1 | 194.5 |

Included in the contributions paid of £59.1 million (2017: £52.5 million) were deficit repair contributions of £32.7 million (2017: £32.7 million), and an inflation funding mechanism payment of £0.3 million made during the year (2017: £nil). Following the 2016 actuarial valuation, contributions in relation to current service cost increased to £24.6 million (2017: £17.6 million).

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** | 2018 £m | 2017 £m |
|---|---|---|
| The return on plan assets, excluding amounts included in interest | (46.5) | 416.8 |
| Actuarial gains/(losses) arising from changes in financial assumptions | 63.3 | (538.5) |
| Actuarial gains arising from changes in demographic assumptions | 31.6 | 37.9 |
| Actuarial (losses)/gains arising from experience | (13.8) | 13.3 |
| Remeasurement gains/(losses) on defined benefit pension schemes | 34.6 | (70.5) |

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 £12.1 million (2017: £11.2 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 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 |
| Charged to the income statement (see note 6) | 37.5 | 5.9 | 12.2 | 55.6 |
| Charged to equity (see note 6) | - | 5.9 | - | 5.9 |
| At 31 March 2018 | 1,047.3 | 44.9 | (14.1) | 1,078.1 |

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 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 |
| Charged to the income statement | 3.7 | 1.0 | 4.7 |
| Utilised in the year | (4.8) | (2.4) | (7.2) |
| At 31 March 2018 | 2.6 | 17.8 | 20.4 |

The group and company had no provisions classed as non-current at 31 March 2018 or 31 March 2017.

The severance provision as at 31 March 2018 and 31 March 2017 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 | 2018 £m | 2017 £m |
|---|---|---|
| **Non-current** | | |
| Deferred grants and contributions | 617.0 | 570.7 |
| Other creditors | 25.0 | 17.2 |
| | 642.0 | 587.9 |
| **Current** | | |
| Trade payables | 27.0 | 34.5 |
| Amounts owed to parent and fellow subsidiary undertakings (see note A7) | 2.2 | 2.4 |
| Amounts owed to other related parties (see note A7) | 0.8 | 12.1 |
| Other tax and social security | 5.3 | 5.1 |
| Deferred grants and contributions | 8.8 | 8.5 |
| Accruals and other creditors | 178.5 | 207.5 |
| Deferred income | 39.9 | 39.4 |
| | 262.5 | 309.5 |
| | 904.5 | 897.4 |

Included within accruals and other creditors as at 31 March 2018 was £4.8 million (2017: £2.5 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 (2017: 23 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** | 2018 £m | 2017 £m |
|---|---|---|
| At the start of the year | 579.2 | 526.4 |
| Amounts capitalised during the year | 23.7 | 29.0 |
| Transfer of assets from customers | 34.2 | 33.5 |
| Credited to the income statement – revenue | (3.3) | (3.0) |
| Credited to the income statement – other operating costs (see note 3) | (6.4) | (6.7) |
| Credited to allowance for bad and doubtful receivables | (1.6) | - |
| | 625.8 | 579.2 |

## 18. Share capital

| **Group and company** | 2018 £m | 2017 £m |
|---|---|---|
| **Issued, called up and fully paid** | | |
| 100,000,000 (2017: 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 2018 £m | Plant and equipment 2018 £m | Property 2017 £m | Plant and equipment 2017 £m |
|---|---|---|---|---|
| **Commitments under non-cancellable operating leases due:** | | | | |
| Within one year | 2.6 | 0.6 | 2.8 | 0.6 |
| In the second to fifth years inclusive | 9.3 | 0.4 | 10.1 | 0.4 |
| After five years | 279.7 | - | 277.8 | - |
| | 291.6 | 1.0 | 290.7 | 1.0 |

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 2018 by either the group or the company (2017: 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 2018.

## 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 | 2018 £m | 2017 £m |
|---|---|---|
| Profit before tax | 416.2 | 409.5 |
| Adjustment for investment income (see note 4) and finance expense (see note 5) | 218.0 | 197.3 |
| **Operating profit** | 634.2 | 606.8 |
| Adjustments for: | | |
| Depreciation of property, plant and equipment (see note 9) | 346.9 | 335.0 |
| Amortisation of intangible assets (see note 10) | 28.4 | 28.7 |
| Impairment of property, plant and equipment (see note 9) | - | 0.2 |
| Loss on disposal of property, plant and equipment (see note 3) | 6.4 | 3.3 |
| Loss on disposal of intangible assets | - | 0.5 |
| Amortisation of deferred grants and contributions (see note 17) | (6.4) | (6.7) |
| Other non-cash movements | (3.3) | (3.0) |
| Changes in working capital: | | |
| Decrease in inventories | 0.9 | 0.9 |
| Decrease in trade and other receivables | 42.1 | 61.7 |
| (Decrease)/Increase in trade and other payables | (12.8) | 1.4 |
| (Decrease)/Increase in provisions (see note 16) | (2.5) | 8.0 |
| Pension contributions paid less pension expense charged to operating profit | (29.5) | (29.7) |
| **Cash generated from operations** | 1,004.4 | 1,007.1 |

The group and company have received property, plant and equipment of £34.2 million (2017: £33.5 million) in exchange for the provision of future goods and services (see notes 17 and A8).

## A3 Net debt

| Group and company | 2018 £m | 2017 £m |
|---|---|---|
| **At the start of the year** | 6,856.8 | 6,582.7 |
| Net capital expenditure | 701.6 | 678.1 |
| Dividends (see note 7) | 316.7 | 229.7 |
| Loans to joint ventures of the UUG group | - | 100.0 |
| Interest | 146.2 | 158.3 |
| Inflation uplift on index-linked debt (see note 5) | 137.8 | 80.7 |
| Tax | 35.5 | 41.2 |
| Other | 1.9 | 4.3 |
| Fair value movements[1] | (27.1) | (11.1) |
| Cash generated from operations (see note A2) | (1,004.4) | (1,007.1) |
| **At the end of the year** | 7,165.0 | 6,856.8 |

[1] Fair value movements includes net fair value gains on debt and derivative instruments of £27.2 million (2017: £5.2 million gains), less £0.1 million (2017: plus £5.9 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 2018 £m | Carrying value 2018 £m | Fair value 2017 £m | Carrying value 2017 £m |
|---|---|---|---|---|---|---|
| **Borrowings in fair value hedge relationships** | | | **2,468.2** | **2,462.9** | **2,041.2** | **2,022.9** |
| 5.375% 150m bond | GBP | 2018 | 157.9 | 150.8 | 164.3 | 156.8 |
| 4.25% 500m bond | EUR | 2020 | 478.8 | 466.4 | 478.9 | 469.7 |
| 5.75% 375m bond | GBP | 2022 | 435.3 | 411.5 | 455.4 | 429.3 |
| 2.0% 300m bond(1) | GBP | 2025 | 299.6 | 301.5 | - | - |
| 2.92% 739m bond(1) | HKD | 2026 | 65.9 | 66.9 | - | - |
| 1.129% 52m bond(1) | EUR | 2027 | 45.0 | 44.5 | 43.5 | 43.6 |
| 2.37% 830m bond(1) | HKD | 2027 | 70.6 | 72.4 | - | - |
| 5.625% 300m bond | GBP | 2027 | 388.6 | 393.2 | 408.7 | 412.1 |
| 5.02% JPY 10bn dual currency loan | JPY/USD | 2029 | 86.9 | 95.0 | 97.7 | 105.8 |
| 2.058% 30m bond(1) | EUR | 2030 | 27.0 | 26.7 | 27.0 | 26.3 |
| 1.641% 30m bond(1) | EUR | 2031 | 25.7 | 25.0 | 25.7 | 24.6 |
| 2.9% 600m bond(1) | HKD | 2031 | 52.4 | 48.3 | 61.1 | 56.4 |
| 1.707% 28m bond(1) | EUR | 2032 | 23.9 | 24.7 | - | - |
| 1.653% 26m bond(1) | EUR | 2032 | 21.9 | 22.4 | - | - |
| 1.70% 30m bond(1) | EUR | 2033 | 25.4 | 26.4 | - | - |
| 5.0% 200m bond | GBP | 2035 | 263.3 | 287.2 | 278.9 | 298.3 |
| **Borrowings designated at fair value through profit or loss** | | | **347.7** | **347.7** | **375.5** | **375.5** |
| 6.875% 400m bond (owed to intermediate parent) | USD | 2028 | 347.7 | 347.7 | 375.5 | 375.5 |
| **Borrowings measured at amortised cost** | | | **6,438.4** | **5,309.3** | **6,262.0** | **5,065.8** |
| 1.30% + LIBOR 5bn bond | JPY | 2017 | - | - | 36.3 | 37.3 |
| Short-term bank borrowings - fixed | GBP | 2018 | 45.0 | 45.0 | 66.9 | 66.9 |
| 1.61% + RPI 50m EIB IL loan | GBP | 2020 | 67.6 | 63.7 | 67.8 | 61.2 |
| 1.73% + RPI 50m EIB IL loan | GBP | 2020 | 67.8 | 63.6 | 68.0 | 61.2 |
| 1.84% + RPI 50m EIB IL loan | GBP | 2020 | 67.9 | 63.5 | 68.2 | 61.1 |
| 1.90% + RPI 50m EIB IL loan | GBP | 2020 | 67.9 | 63.4 | 68.2 | 61.0 |
| 1.93% + RPI 50m EIB IL loan | GBP | 2020 | 67.9 | 63.4 | 68.2 | 60.9 |
| 1.88% + RPI 50m EIB IL loan | GBP | 2020 | 67.7 | 63.3 | 68.1 | 60.9 |
| 2.10% + RPI 50m EIB IL loan | GBP | 2020 | 68.0 | 63.2 | 68.5 | 60.8 |
| 2.46% + RPI 50m EIB IL loan | GBP | 2020 | 68.6 | 63.2 | 69.3 | 60.8 |
| 0.80% + LIBOR 100m loan | GBP | 2022 | 102.6 | 100.0 | 102.6 | 100.0 |
| 0.47% + RPI 100m IL loan | GBP | 2023 | 117.9 | 112.2 | 116.5 | 107.9 |
| 0.49% + RPI 100m IL loan | GBP | 2025 | 116.2 | 107.9 | 115.6 | 103.8 |
| 0.013% + RPI 25m IL bond(1) | GBP | 2025 | 28.1 | 26.9 | 28.1 | 25.9 |
| 0.1275% + RPI 100m IL loan | GBP | 2026 | 111.7 | 106.5 | 112.3 | 102.4 |
| 0.01% + RPI 20m IL bond(1) | GBP | 2028 | 22.1 | 22.9 | 22.0 | 22.3 |
| 1.23% + RPI 50m EIB (amortising) IL loan | GBP | 2029 | 51.2 | 47.4 | 55.1 | 49.7 |
| 1.29% + RPI 50m EIB (amortising) IL loan | GBP | 2029 | 53.4 | 49.2 | 57.4 | 51.5 |
| 1.12% + RPI 50m EIB (amortising) IL loan | GBP | 2029 | 52.6 | 48.8 | 56.5 | 51.0 |
| 1.10% + RPI 50m EIB (amortising) IL loan | GBP | 2029 | 52.5 | 48.8 | 56.3 | 51.0 |
| 0.75% + RPI 50m EIB (amortising) IL loan | GBP | 2029 | 52.9 | 49.8 | 56.5 | 51.9 |
| 0.76% + RPI 50m EIB (amortising) IL loan | GBP | 2030 | 52.8 | 49.6 | 56.4 | 51.7 |
| 1.15% + RPI 50m EIB (amortising) IL loan | GBP | 2030 | 53.7 | 49.4 | 57.5 | 51.5 |
| 1.11% + RPI 50m EIB (amortising) IL loan | GBP | 2030 | 53.7 | 49.6 | 57.6 | 51.7 |
| 0.178% + RPI 35m IL bond(1) | GBP | 2030 | 40.4 | 37.6 | 40.2 | 36.2 |
| 0.245% + CPI 20m IL bond(1) | GBP | 2031 | 20.3 | 20.6 | 20.2 | 20.0 |

# Notes to the financial statements

## A4 Borrowings (continued)

| | Currency | Year of final repayment | Fair value 2018 £m | Carrying value 2018 £m | Fair value 2017 £m | Carrying value 2017 £m |
|---|---|---|---|---|---|---|
| **Borrowings measured at amortised cost (continued)** | | | | | | |
| 0.01% + RPI 38m IL bond(1) | GBP | 2031 | 42.4 | 42.6 | 42.2 | 41.3 |
| 3.375% + RPI 50m IL bond | GBP | 2032 | 122.4 | 76.9 | 124.1 | 74.2 |
| 0.709% + LIBOR 100m EIB (amortising) loan | GBP | 2032 | 86.6 | 87.5 | 94.9 | 93.8 |
| 0.691% + LIBOR 150m EIB (amortising) loan | GBP | 2032 | 134.4 | 135.9 | 146.4 | 145.3 |
| 0.573% + LIBOR 100m EIB (amortising) loan | GBP | 2033 | 92.0 | 93.8 | 100.2 | 100.0 |
| 0.511% + LIBOR 150m EIB (amortising) loan | GBP | 2033 | 141.6 | 145.3 | 149.6 | 150.0 |
| 0.01% + RPI 100m EIB (amortising) IL loan | GBP | 2033 | 109.6 | 106.4 | 107.9 | 102.3 |
| 0.01% + RPI 75m EIB (amortising) IL loan | GBP | 2034 | 82.2 | 79.7 | 80.9 | 76.7 |
| 0.01% + RPI 75m EIB (amortising) IL loan | GBP | 2034 | 81.8 | 79.3 | 80.7 | 76.2 |
| 0.01% + RPI 75m EIB (amortising) IL loan | GBP | 2034 | 81.8 | 79.3 | 80.7 | 76.2 |
| 1.9799% + RPI 100m IL bond | GBP | 2035 | 208.3 | 143.9 | 212.4 | 138.9 |
| 0.873%+LIBOR 100m EIB (amortising) loan | GBP | 2035 | 99.6 | 100.0 | - | - |
| 0.840%+LIBOR 75m EIB (amortising) loan | GBP | 2035 | 75.2 | 75.0 | - | - |
| 0.01% + RPI 26.5m IL bond(1) | GBP | 2036 | 30.1 | 31.8 | 30.3 | 31.0 |
| 0.379% + CPI 20m IL bond(1) | GBP | 2036 | 20.7 | 20.6 | 20.9 | 20.0 |
| 0.01% + RPI 29m IL bond(1) | GBP | 2036 | 32.9 | 32.5 | 32.2 | 31.5 |
| 0.093% + CPI 60m IL bond(1) | GBP | 2037 | 58.8 | 61.4 | 59.0 | 59.6 |
| 1.66% + RPI 35m IL bond | GBP | 2037 | 61.9 | 46.5 | 62.7 | 44.7 |
| 2.40% + RPI 70m IL bond | GBP | 2039 | 135.9 | 90.7 | 132.2 | 87.2 |
| 1.7829% + RPI 100m IL bond | GBP | 2040 | 219.0 | 142.4 | 207.5 | 137.5 |
| 1.3258% + RPI 50m IL bond | GBP | 2041 | 100.7 | 71.1 | 95.7 | 68.6 |
| 1.5802% + RPI 100m IL bond | GBP | 2042 | 214.7 | 142.0 | 202.6 | 137.0 |
| 1.5366% + RPI 20m IL bond | GBP | 2043 | 43.2 | 28.3 | 41.0 | 27.4 |
| 1.5366% + RPI 30m IL bond | GBP | 2043 | - | - | 61.4 | 41.0 |
| 1.397% + RPI 50m IL bond | GBP | 2046 | 109.1 | 71.0 | 102.9 | 68.5 |
| 0.359% + CPI 32m IL bond(1) | GBP | 2048 | 32.0 | 32.4 | - | - |
| 1.7937% + RPI 50m IL bond | GBP | 2049 | 122.9 | 70.7 | 118.0 | 68.2 |
| Commission for New Towns (amortising) loan – fixed | GBP | 2053 | 56.2 | 27.9 | 56.1 | 28.4 |
| 1.847% + RPI 100m IL bond | GBP | 2056 | 232.2 | 140.3 | 224.1 | 135.0 |
| 1.815% + RPI 100m IL bond | GBP | 2056 | 231.7 | 139.8 | 221.5 | 134.4 |
| 1.662% + RPI 100m IL bond | GBP | 2056 | 222.0 | 139.5 | 218.2 | 134.2 |
| 1.5865% + RPI 50m IL bond | GBP | 2056 | 109.2 | 69.7 | 105.8 | 67.0 |
| 1.591% + RPI 25m IL bond | GBP | 2056 | 54.7 | 34.8 | 52.5 | 33.4 |
| 1.556% + RPI 50m IL bond | GBP | 2056 | 108.6 | 69.3 | 105.3 | 66.7 |
| 1.435% + RPI 50m IL bond | GBP | 2056 | 105.9 | 69.1 | 102.5 | 66.5 |
| 1.3805% + RPI 35m IL bond | GBP | 2056 | 73.5 | 48.4 | 71.0 | 46.5 |
| 1.585% + RPI 100m IL bond | GBP | 2057 | 218.9 | 134.2 | 208.6 | 129.1 |
| 0.387% + CPI 33m IL bond(1) | GBP | 2057 | 33.2 | 33.0 | - | - |
| 1.702% + RPI 50m IL bond | GBP | 2057 | 112.9 | 67.7 | 107.9 | 65.1 |
| 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 | 627.5 | 627.5 | 585.5 | 585.5 |
| Book overdrafts (see note 12) | GBP | 2018 | 11.6 | 11.6 | 26.3 | 26.3 |
| | | | **9,254.3** | **8,119.9** | **8,678.7** | **7,464.2** |

# Notes to the financial statements

## A4 Borrowings (continued)

| | |
|---|---|
| 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 in the table are unsecured. Funding raised in foreign currencies is swapped to sterling to match funding costs to income.

During the year, there has been a partial close-out of the £50.0 million RPI index-linked notes due April 2043. The nominal value of the portion of the notes closed-out was £30.0 million. In order to provide a prior year comparison on a like-for-like basis, the carrying and fair values of the RPI index-linked notes as at 31 March 2017 have been split to reflect this partial close-out.

(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 2018, the group and company had £1,025.0 million (2017: £951.5 million) of available liquidity, which comprised £499.6 million cash and short-term deposits (2017: £196.9 million), £525.4 million (2017: £579.6 million) of undrawn committed borrowing facilities and £nil (2017: £175.0 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** | 2018 £m | 2017 £m |
|---|---|---|
| Expiring within one year | 80.0 | 130.0 |
| Expiring after one year but in less than two years [1] | 260.0 | 170.0 |
| Expiring after more than two years | 315.0 | 315.0 |
| **Total borrowing facilities** | 655.0 | 615.0 |
| Facilities drawn[2] | (129.6) | (35.4) |
| **Undrawn borrowing facilities** | 525.4 | 579.6 |

Note:
[1] Figure includes £140.0 million (2017: £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 2018 | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** | **£m** |
| Bonds | 8,208.4 | | 258.2 | 552.0 | 83.3 | 459.4 | 63.9 | 6,791.6 |
| Bonds – UUWF | 1,252.0 | | 14.6 | 14.5 | 14.5 | 14.5 | 14.5 | 1,179.4 |
| Bank and other term borrowings | 3,001.5 | | 171.6 | 125.2 | 682.5 | 124.5 | 355.3 | 1,542.4 |
| Preference shares | 130.0 | | 130.0 | - | - | - | - | - |
| Parent borrowings | 1,073.8 | | 420.8 | 199.7 | 69.0 | 18.6 | 18.4 | 347.3 |
| Adjustment to carrying value(2) | (5,545.8) | (5,545.8) | | | | | | |
| Borrowings | 8,119.9 | (5,545.8) | 995.2 | 891.4 | 849.3 | 617.0 | 452.1 | 9,860.7 |
| Derivatives: | | | | | | | | |
| Payable | 1,034.4 | | 56.3 | 475.6 | 28.6 | 22.4 | 19.7 | 431.8 |
| Receivable | (1,416.5) | | (280.8) | (546.9) | (28.7) | (28.7) | (51.6) | (479.8) |
| Adjustment to carrying value(2) | (33.2) | (33.2) | | | | | | |
| Derivatives – net assets | (415.3) | (33.2) | (224.5) | (71.3) | (0.1) | (6.3) | (31.9) | (48.0) |

| **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) |

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 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 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 2018, Water Plus was the group's single largest debtor, with amounts outstanding in relation to wholesale services of £42.2 million (2017: £40.8 million). During the year, sales to Water Plus in relation to wholesale services were £500.1 million (2017: £402.7 million). Details of transactions with Water Plus can be found in note A7.

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. Credit limits are refreshed annually and reviewed in the event of any credit rating action. Additionally, 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 2018 and 31 March 2017, 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** | 2018<br>£m | 2017<br>£m |
|---|---|---|
| Cash and short-term deposits (see note 12) | 499.6 | 196.9 |
| Trade and other receivables (see note 11) | 398.0 | 443.2 |
| Derivative financial instruments | 516.3 | 620.2 |
| | 1,413.9 | 1,260.3 |

# Notes to the financial statements

## A5 Financial risk management (continued)

### Credit risk (continued)

The credit exposure on derivatives is disclosed gross of any collateral held. At 31 March 2018, the group and company held £45.2 million (2017: £66.9 million) as collateral in relation to derivative financial instruments (included within short-term bank borrowings - fixed in note A4).

### 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. Currently the group's regulatory assets are linked to RPI inflation, however, following Ofwat's decision to transition to the use of CPIH for inflation indexation for the 2020-25 regulatory period, from 2020 the group's RCV will be 50 per cent linked to RPI inflation and 50 per cent linked to CPIH inflation, with any new additions being added to the CPIH portion of the RCV.

In addition, the group's defined benefits pension schemes have continued to hedge inflation exposure, partly though a market hedge using RPI swaps and index-linked gilts, and partly through an inflation funding mechanism (see note A6), whereby company contributions are flexed for movements in RPI inflation and smoothed over a rolling five-year period. It is anticipated that the schemes will progressively increase their market hedges of inflation, with a corresponding reduction and/or removal of the inflation funding mechanism, as part of a long-term de-risking strategy.

In light of these changes, the group has reviewed its inflation hedging policy and has adopted a revised policy with the aim of maintaining around half of the group's net debt in index-linked form (where it is economic to do so), by issuing index-linked debt and/or swapping a portion of nominal debt. This is expected to remain mostly in RPI-linked form until CPI and/or CPIH debt and swaps become available in sufficient size at an economic cost.

The group believes this is an appropriate inflation hedging policy taking into account a balanced assessment of the following factors: economic hedge of its RCV and revenues; cash flow timing mismatch between allowed cost of debt and the group's incurred cost of debt; the inflation risk premium that is generally incorporated into nominal debt costs; income statement volatility; hedging costs; debt maturity profile mismatch risk; and index linked hedging positioning relative to the water sector.

As a result of the evaluation of the above factors, the group will continue to identify opportunities to maintain around 50 per cent of the group's net debt being hedged for inflation, which can be evidenced by the issuing of £65.0 million (2017: £100.0 million) of CPI indexed-linked debt during the year. Inflation risk is reported monthly to the treasury committee in the operational compliance report.

The carrying value of index-linked debt held by the group was £3,729.8 million at 31 March 2018 (2017: £3,602.3 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.

# Notes to the financial statements

## A5 Financial risk management (continued)

**Inflation risk (continued)**
**Sensitivity analysis (continued)**

**Increase/(decrease) in profit before tax and equity**

| Group and company | 2018 £m | 2017 £m |
|---|---|---|
| 1 per cent increase in RPI/CPI | (37.7) | (36.4) |
| 1 per cent decrease in RPI/CPI | 37.7 | 36.4 |

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 group currently earns an economic return on its RCV, comprising a real return through revenues, 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 (see inflation risk section for changes being introduced by Ofwat to inflation indexation from 2020).

In the next regulatory period Ofwat intends to continue using materially the same methodology in setting a fixed real cost of debt in relation to embedded debt (currently assumed to be 70 per cent of net debt), but will introduce a debt indexation mechanism in relation to new debt (currently assumed to be 30 per cent of net debt).

The group has therefore reviewed its interest rate hedging policy, retaining most elements of the existing policy as Ofwat's embedded debt methodology is materially unchanged.

Sterling index-linked debt is left unswapped at inception, in accordance with our inflation hedging policy goal to maintain around half of the group's net debt in index-linked form. Conventional nominal debt is hedged as set out below.

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 10 years in advance on a reducing balance basis, mirroring Ofwat's expected split of 70 per cent embedded and 30 per cent new debt. However, the group will no longer substantively fix the residual floating underlying interest rates on projected nominal net debt at the start of each regulatory period, leaving this element floating until it is fixed via the above 10-year reducing balance basis, which should more closely mirror Ofwat's new debt indexation mechanism.

This interest rate hedging policy dovetails with our revised inflation hedging policy should we need to swap a portion of nominal debt to real rate form to maintain our desired mix of nominal and index-linked debt.

# Notes to the financial statements

## A5 Financial risk management (continued)

**Interest rate risk (continued)**

The group seeks to manage its risk by maintaining its interest rate exposure within a board approved range. Interest rate risk is reported to the 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**

| Group and company | 2018 £m | 2017 £m |
|---|---|---|
| 1 per cent increase in interest rate | 126.5 | 154.2 |
| 1 per cent decrease in interest rate | (136.7) | (152.5) |

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.

***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**<br>At 31 March 2018 | 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 | 2,462.9 | 150.8 | 466.4 | - | 411.5 | - | 1,434.2 |
| Effect of swaps | - | 2,312.1 | (466.4) | - | (411.5) | - | (1,434.2) |
| | 2,462.9 | 2,462.9 | - | - | - | - | - |
| **Borrowings designated at fair value through profit or loss** | | | | | | | |
| Fixed rate instruments | 347.7 | - | - | - | - | - | 347.7 |
| Effect of swaps | - | 347.7 | - | - | - | - | (347.7) |
| | 347.7 | 347.7 | - | - | - | - | - |

# Notes to the financial statements

## A5 Financial risk management (continued)

***Repricing analysis (continued)***

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Borrowings measured at amortised cost** | | | | | | | |
| Fixed rate instruments | 203.0 | 45.6 | 0.6 | 0.6 | 0.7 | 0.8 | 154.7 |
| Floating rate instruments | 1,376.5 | 1,376.5 | - | - | - | - | - |
| Index-linked instruments | 3,729.8 | 3,729.8 | - | - | - | - | - |
| | 5,309.3 | 5,151.9 | 0.6 | 0.6 | 0.7 | 0.8 | 154.7 |
| Effect of fixed interest rate swaps | - | (3,006.3) | 925.4 | 252.1 | 50.0 | 164.5 | 1,614.3 |
| **Total borrowings** | 8,119.9 | 4,956.2 | 926.0 | 252.7 | 50.7 | 165.3 | 1,769.0 |
| Cash and short-term deposits | (499.6) | (499.6) | - | - | - | - | - |
| **Net borrowings** | 7,620.3 | 4,456.6 | 926.0 | 252.7 | 50.7 | 165.3 | 1,769.0 |

| 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 |

**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.

# Notes to the financial statements

## A5 Financial risk management (continued)

**Electricity price risk (continued)**

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 | 2018 £m | 2017 £m |
|---|---|---|
| 20 per cent increase in electricity commodity prices | 9.4 | 9.8 |
| 20 per cent decrease in electricity commodity prices | (9.4) | (9.8) |

**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, 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 its targeted minimum 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 2018 | 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 | - | 337.3 | - | 337.3 |
| Derivative financial assets – held for trading(1) | - | 179.0 | - | 179.0 |
| **Financial liabilities at fair value through profit or loss** | | | | |
| Derivative financial liabilities – fair value hedge | - | (24.2) | - | (24.2) |
| Derivative financial liabilities – held for trading(1)(2) | - | (76.8) | - | (76.8) |
| Financial liabilities designated as fair value through profit or loss | - | (347.7) | - | (347.7) |
| **Financial liabilities for which fair value has been disclosed** | | | | |
| Financial liabilities in fair value hedge relationships | (2,192.4) | (275.8) | - | (2,468.2) |
| Other financial liabilities at amortised cost | (2,425.6) | (4,012.8) | - | (6,438.4) |
| | (4,618.0) | (4,221.0) | - | (8,839.0) |

| 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) |

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 £151.8 million (2017: £215.7 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 £4,618.0 million (2017: £2,200.6 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 £2,714.4 million increase (2017: £811.7 million reduction) in 'level 1' fair value measurements is largely due to an increase in the number of observable quoted bond prices in active markets at 31 March 2018.

During the year, the fair value of financial liabilities designated at fair value through profit or loss fell, resulting in a £27.8 million gain (2017: £37.5 million loss). Included within this was a £24.0 million loss (2017: £11.9 million) attributable to changes in own credit risk. The cumulative amount recognised in the income statement due to changes in credit spread was £38.2 million profit (2017: £62.2 million). The carrying amount is £145.6 million (2017: £173.4 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.

During the year ending 31 March 2019 the majority of active members in the defined benefit sections of the UUPS will transition to a hybrid section incorporating both defined benefit and defined contribution elements. The changes have had no impact on the financial statements for the year ended 31 March 2018 as they will only take effect for pensionable service from 1 April 2018. Benefits relating to pensionable service before this date are unaffected by the changes. This transition is a consequence of an increase in future service costs and is intended to reduce the overall costs and risk to the group whilst balancing the interests of employees by maintaining an element of defined benefit pension provision.

The group also operates a series of historic 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 | 2018 £m | 2017 £m |
|---|---|---|
| Total value of current employees benefits | 847.8 | 853.6 |
| Deferred members benefits | 429.2 | 458.1 |
| Pensioner members benefits | 1,323.3 | 1,370.4 |
| **Total defined benefit obligation** | 2,600.3 | 2,682.1 |

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 2016 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,

# Notes to the financial statements

## A6 Retirement benefits (continued)

### Funding requirements (continued)

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.

A retirement benefit surplus was recognised as an asset at both 31 March 2018 and 31 March 2017 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 2021 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.

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 corporate bonds and gilts, supplemented by swap and gilt long-term hedges of interest and inflation rates, which perform in line with the liabilities so as to hedge against changes in interest and inflation rates. Further details of the derivatives used in reducing investment risk are disclosed in the 'Further reporting analysis' section of this appendix.

Under the Inflation Funding Mechanism (IFM), the schedule of deficit contributions are calculated for a notional amount of liabilities (UUPS: £1,572.0 million; ESPS: £192.0 million) based on a fixed RPI inflation assumption of 3.0 per cent, being 1.0 per cent above Bank of England CPI target inflation. Each year the out-turn RPI inflation rate is compared to the fixed assumption and applied to the notional amount of liabilities to determine the IFM amount. This IFM amount, which may be positive or negative, represents a true-up for RPI inflation for the year in question. A cumulative total is maintained, and where this represents a payment due to the pension scheme, 20 per cent of the outstanding balance is contributed as an additional deficit contribution. This approach seeks to smooth the impact of RPI inflation, which is expected to vary around the fixed assumption, and recognises that payments can only flow into the pension scheme. The IFM does not have an accounting impact except to the extent that resulting payments give rise to a cash flow from the group and an increase in the level of scheme assets, as for any other deficit contribution.

The group expects to make contributions of £40.9 million in the year ending 31 March 2019, comprising £32.1 million to the UUPS and £0.7 million to the ESPS in respect of deficit repair contributions, £6.3 million and £0.5 million in respect of regular contributions to UUPS and ESPS respectively, £0.3 million in respect of expenses to the ESPS, and contributions of £0.9 million and £0.1 million are expected to be made under the IFM for UUPS and ESPS respectively.

The schemes' funding plans are reviewed every three years, and the next funding valuation for UUPS and ESPS is due no later than 31 March 2019.

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 and part of the inflation exposure has been hedged through external market swaps and gilts, the value of which is included in the schemes' assets. The remaining inflation exposure has been hedged through the IFM, with RPI in excess of 3.0 per cent per annum being funded through an additional schedule of deficit contributions.

# Notes to the financial statements

## A6 Retirement benefits (continued)

**Impact of scheme risk management on IAS 19 disclosures (continued)**

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 when hedged through the IFM, 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 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 bases, which form the basis for regular (non-IFM) deficit repair contributions, are 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.

Pension benefits under the defined benefit element of the new UUPS hybrid section that will be effective for pensionable service from 1 April 2018 will be linked to CPI rather than RPI.

In the year ended 31 March 2018, the discount rate increased by 0.05 per cent (2017: 0.85 per cent decrease), which includes a 0.05 per cent decrease in credit spreads (2017: 0.6 per cent) and a 0.1 per cent increase (2017: 0.25 per cent decrease) in swap yields over the year. The IAS 19 remeasurement gain of £34.6 million (2017: £70.5 million loss) reported in note 17 has largely resulted from the impact of the decrease in credit spreads during the year, partially offset by the reduction in gilt swap spreads, the favourable impact of changes in mortality during the year and growth asset gains.

**Reporting and assumptions**

The results of the latest funding valuations at 31 March 2016 have been adjusted for IAS 19 in order to assess the position at 31 March 2018, 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 valuations as at 31 March 2016 for both UUPS and ESPS.

***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:

| | 2018<br>% p.a. | 2017<br>% p.a. |
|---|---|---|
| Discount rate | 2.60 | 2.55 |
| Pensionable salary growth and pension increases | 3.35 | 3.40 |
| Price inflation - RPI | 3.35 | 3.40 |
| Price inflation - CPI | 1.95 | - |

**Sensitivity of the key scheme assumptions**

***Demographic assumptions***

At both 31 March 2018 and 31 March 2017, mortality in retirement is assumed to be in line with the Continuous Mortality Investigation's (CMI) S2PA year of birth tables, with scaling factor of 108 per cent for males and 102 per cent for females, reflecting actual mortality experience. At 31 March 2018, mortality in retirement is based on CMI 2016 (2017: CMI 2015) long-term improvement factors, with a long-term annual rate of improvement of 1.75 per cent (2017: 1.75

# Notes to the financial statements

## A6 Retirement benefits (continued)

**Sensitivity of the key scheme assumptions (continued)**

per cent). The current life expectancies at age 60 underlying the value of the accrued liabilities for the schemes are:

| | 2018 years | 2017 years |
|---|---|---|
| Retired member – male | 27.0 | 27.0 |
| Non-retired member – male | 28.7 | 29.0 |
| Retired member – female | 29.4 | 29.8 |
| Non-retired member – female | 31.1 | 31.9 |

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 £55.0 million (2017: £55.5 million) decrease/increase in the schemes' liabilities at 31 March 2018, 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 £51.5 million (2017: £51.9 million) increase/decrease in the schemes' liabilities at 31 March 2018, 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 2018, 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 £95.6 million (2017: £100.4 million) increase/decrease in the schemes' liabilities at 31 March 2018. 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.

# Notes to the financial statements

## A6 Retirement benefits (continued)

***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 % | 2018 £m | Schemes' assets % | 2017 £m |
|---|---|---|---|---|
| Equities | 10.5 | 301.3 | 10.1 | 290.1 |
| Other non-equity growth assets | 5.3 | 152.4 | 4.8 | 138.1 |
| Gilts | 48.2 | 1,380.3 | 49.8 | 1,431.9 |
| Bonds | 39.6 | 1,135.7 | 39.0 | 1,123.1 |
| Other | (3.6) | (105.3) | (3.7) | (106.6) |
| Total fair value of schemes' assets | 100.0 | 2,864.4 | 100.0 | 2,876.6 |
| Present value of defined benefit obligations | | (2,600.3) | | (2,682.1) |
| **Net retirement benefit surplus** | | 264.1 | | 194.5 |

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.

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**<br>At 31 March 2018 | Underlying assets £m | Fair value of derivatives £m | Combined £m |
|---|---|---|---|
| Equities | 295.8 | 5.5 | 301.3 |
| Other non-equity growth assets | 152.4 | - | 152.4 |
| Gilts | 1,380.3 | - | 1,380.3 |
| Bonds | 1,137.5 | (1.8) | 1,135.7 |
| Other | 131.3 | (236.6) | (105.3) |
| **Total fair value of schemes' assets** | 3,097.3 | (232.9) | 2,864.4 |

# Notes to the financial statements

## A6 Retirement benefits (continued)

***Further reporting analysis (continued)***

At 31 March 2017

| | | | |
|---|---|---|---|
| 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 |

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 £3.9 million (2017: £15.1 million) and currency forwards with a value of £1.6 million (2017: £9.6 million);
- Derivatives are used within both the UUPS and ESPS bond portfolio to hedge non-sterling exposure back to sterling:
  - the UUPS value comprises credit default swaps with a value of £nil (2017: £(8.5) million), interest rate swaps with a value of £(3.2) million (2017: £nil) and currency forwards with a value of £0.9 million (2017: £nil); and
  - the ESPS total value of £0.5 million (2017: £nil) relates to interest rate swaps.
- Derivatives are used within both the UUPS and ESPS 'other' portfolios to manage liability risks. Both schemes use a range of derivatives to target a high level of interest rate and inflation hedging, comprising £(236.7) million (2017: £(188.6) million) in the UUPS and £0.1 million (2017: £6.0 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 £(236.7) million (2017: £(188.6) million) comprises asset swaps with a value of £(22.6) million (2017: £(110.0) million), interest rate swaps with a value of £208.7 million (2017: £432.2 million), gilt repurchase agreements with a value of £(428.2) million (2017: £(543.0) million) and RPI inflation swaps with a value of £5.4 million (2017: £(32.2) million).
  - the ESPS value of £0.1 million represents gilt repurchase agreements with a value of £0.4 million and RPI inflation swaps with a value of £(0.3) million. The value at 31 March 2017 of £6.0 million represented the total value of pooled funds which made use of derivatives (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 £440.9 million (2017: £691.8 million).

# Notes to the financial statements

## A6 Retirement benefits (continued)

***Further reporting analysis (continued)***

Movements in the fair value of the schemes' assets were as follows:

| | 2018<br>£m | 2017<br>£m |
|---|---|---|
| At the start of the year | 2,876.6 | 2,410.5 |
| Interest income on schemes' assets | 72.7 | 81.3 |
| The return on plan assets, excluding amounts included in interest | (46.5) | 416.8 |
| Member contributions | 4.7 | 4.9 |
| Benefits paid | (100.4) | (87.7) |
| Administrative expenses | (1.8) | (1.7) |
| Group contributions | 59.1 | 52.5 |
| At the end of the year | 2,864.4 | 2,876.6 |

The group's actual return on the schemes' assets was a gain of £26.2 million (2017: £498.1 million), principally due to gains on derivatives hedging the schemes' liabilities.

Movements in the present value of the defined benefit obligations are as follows:

| | 2018<br>£m | 2017<br>£m |
|---|---|---|
| At the start of the year | (2,682.1) | (2,183.6) |
| Interest cost on schemes' obligations | (67.2) | (72.9) |
| Actuarial gains/(losses) arising from changes in financial assumptions | 63.3 | (538.5) |
| Actuarial gains arising from changes in demographic assumptions | 31.6 | 37.9 |
| Actuarial (losses)/gains arising from experience | (13.8) | 13.3 |
| Curtailments/settlements | (2.2) | (2.8) |
| Member contributions | (4.7) | (4.9) |
| Benefits paid | 100.4 | 87.7 |
| Current service cost | (25.6) | (18.3) |
| At the end of the year | (2,600.3) | (2,682.1) |

The equalisation of Guaranteed Minimum Pensions (GMP), for which the UK Government intends to implement legislation, is expected to have a widespread impact on defined benefit schemes operating in the UK. Such legislation could result in an increase in GMP for certain individuals, which would increase the defined benefit obligation of the schemes. At this stage, until the Government has further developed its proposals in light of ongoing legal review, 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 | |
|---|---|---|---|---|---|---|
| **Group** | 2018 £m | 2017 £m | 2018 £m | 2017 £m | 2018 £m | 2017 £m |
| Ultimate parent undertaking | - | - | - | - | (3.2) | (3.3) |
| Intermediate parent undertaking | - | 7.0 | - | - | 0.8 | 1.3 |
| Fellow subsidiaries | - | 1.4 | 2.6 | 2.0 | 2.7 | 3.0 |
| Joint ventures of the UUG group | 495.4 | 403.3 | 0.7 | 0.7 | 1.4 | 18.5 |
| | 495.4 | 411.7 | 3.3 | 2.7 | 1.7 | 19.5 |

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, £2.0 million (2017: £1.5 million) 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 £15.6 million (2017: £4.8 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 (2017: £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 | |
|---|---|---|---|---|
| **Group** | 2018 £m | 2017 £m | 2018 £m | 2017 £m |
| Ultimate parent undertaking | - | - | 1.8 | 2.2 |
| Intermediate parent undertaking | 45.4 | 56.6 | 975.5 | 961.2 |
| Immediate parent undertaking | - | - | 130.0 | 130.0 |
| Fellow subsidiaries | 0.7 | 0.9 | 0.1 | - |
| Joint ventures of the UUG group | 142.2 | 140.8 | 0.8 | 12.1 |
| | 188.3 | 198.3 | 1,108.2 | 1,105.5 |

At 31 March 2018, amounts owed by related parties were £188.3 million (2017: £198.3 million), comprising £48.3 million (2017: £58.3 million) of trade balances and £140.0 million (2017: £140.0 million) relating to loans.

Trade balances are unsecured and will be settled in accordance with normal credit terms. Included within these balances was £42.2 million (2017: £40.8 million) owed by Water Plus and £6.1 million (2017: £17.5 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 (2017: £100.0 million) 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 (2017: £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 (2017: £nil).

At 31 March 2018, amounts owed to related parties were £1,108.2 million (2017: £1,105.5 million), comprising £2.7 million (2017: £14.3 million) of trade balances, £975.2 million (2017: £961.0 million) of borrowings (see note 13) and its associated accrued interest of £0.3 million (2017: £0.2 million) owed to United Utilities PLC, and £130.0 million (2017: £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 £0.8 million (2017: £12.1 million) owed to Water Plus and £1.8 million (2017: £2.2 million) owed to United Utilities Group PLC.

During the year, guarantees with an aggregate limit of £24.0 million (2017: £24.0 million) 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 £1,021.1 million (2017: £438.7 million) in respect of borrowings (see note A4), and £4.8 million (2017: £2.5 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.

# Notes to the financial statements

## 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 96 to 99.

**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.

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.

**Joint ventures**

Joint ventures are entities in which the group holds an interest on a long-term basis and which are jointly controlled with one or more parties under a contractual arrangement. The group’s share of joint venture results and assets and liabilities is incorporated using the equity method of accounting. Under the equity method, an investment in a joint venture is initially recognised at cost and adjusted thereafter to recognise the group’s share of the profit or loss. In the parent company accounts, investments in joint ventures are held at cost less provision for impairment.

On losing control of a subsidiary disposed of to a joint venture, the group recognises the gain or loss attributable to measuring the investment retained in the former subsidiary at its fair value at the date when control is lost.

**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.

# Notes to the financial statements

## A8 Accounting Policies (continued)

### 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

Tax on the profit or loss for the year comprises current and deferred tax. Tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity. 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, tax authorities in a number of jurisdictions. A current tax provision is only recognised when the group has a present obligation as a result of a past event and it is probable that the group will be required to settle that obligation to a taxing authority.

#### *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.

#### *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.

# Notes to the financial statements

## A8 Accounting Policies (continued)

**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.

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.

***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.

***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

# Notes to the financial statements

## A8 Accounting Policies (continued)

### Property, plant and equipment (continued)

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.

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.

# Notes to the financial statements

## A8 Accounting Policies (continued)

**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.

***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

# Notes to the financial statements

## A8 Accounting Policies (continued)

**Financial instruments (continued)**

***Borrowings (continued)***

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).

***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

# Notes to the financial statements

## A8 Accounting Policies (continued)

**Financial instruments (continued)**

***Derivatives and borrowings – valuation (continued)***

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 'Employee Benefits', 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 pension cost under IAS 19 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 A5.

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.

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

# Notes to the financial statements

## A8 Accounting Policies (continued)

**Provisions (continued)**

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.