

United Utilities Water PLC

Report and Financial Statements

31 March 2014



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Registered No: 2366678

Directors, advisers and other information

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BM May
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Terms used in this report:

United Utilities Water PLC's ultimate parent company is United Utilities Group PLC. 'UUG' means United Utilities Group PLC and 'United Utilities', 'the group' or 'the UUG group' means United Utilities Group PLC and its subsidiary undertakings.

The 'company' or 'UUW' means United Utilities Water PLC. The 'regulated business' or 'regulated activities', means the licensed water and wastewater activities undertaken by United Utilities Water PLC 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 company. 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 report and the company undertakes no obligation to update these forward-looking statements. Nothing in this report should be construed as a profit forecast.

Chairman's and Chief Executive Officer's statement

Performance

We are pleased to have delivered another year of good performance in what remains a difficult economic environment for customers in the North West of England. Underpinning all we do is our vision of becoming a leading North West service provider and one of the best UK water and wastewater companies and we have made progress against this objective on a broad front. High levels of customer satisfaction remain our core objective. We have again delivered a year of improvement as measured by our regulator, Ofwat's, Service Incentive Mechanism (SIM). This places us as one of the most improved companies for customer satisfaction over the last three years. Whilst comparison with other water and sewerage companies is an important benchmark for us, we recognise that customer expectations are often set by standards of service delivered by other companies operating in the North West. So we conduct a brand tracker survey and we are happy to find ourselves consistently ranked third out of ten leading companies, just behind the respected brands of John Lewis and Marks & Spencer.

Even so, we don't always get it right, and customer satisfaction will remain an area of focus for us – reducing service failure benefits both customers and shareholders. Targeted investment in our people, assets and processes is delivering results and we are ahead of schedule in delivering our regulatory outperformance targets.

Asset serviceability has again been stable or improving over the last twelve months and we have met our leakage target for the eighth consecutive year. Water quality over the year reflects our best performance for many years. The Environment Agency assessed us as an upper quartile company in 2012/13, and we have made more progress over the last twelve months. Much of our capital programme of over £3.5 billion for the period 2010–15 supports renewal and upgrade of our asset base to maintain serviceability but a significant proportion also delivers our capability to meet new environmental standards. We delivered our largest annual capital programme for a decade, investing £836 million – £49 million more than the previous year – in areas that included contributions to river and bathing water quality and inspecting the Haweswater aqueduct for the first time since it was built in the mid 1900s. We measure the effectiveness of our investment using our Time, Cost and Quality index, TCQi, and we scored 98 per cent for the year – ahead of our targets and a significant improvement on our performance of three years ago.

Our good performance in this five year regulatory period, AMP5, has created the ability for us to reinvest. We are investing around £200 million of capital savings into projects which improve service to customers or benefit the environment.

Around £40 million of our financing outperformance is supporting our private sewer network and we have committed a £75 million cash tax refund from HMRC to assist customers struggling to return to regular payment. We believe that this reflects a responsible approach to sharing the benefits of outperformance between customers and shareholders.

The North West remains a region with the highest proportion of disadvantaged households in England and reducing customer indebtedness continues to be a major challenge for us. Our collection teams have worked hard in another difficult year to hold bad debt levels at 2.2 per cent of revenue, with over 30,000 customers taking advantage of our many assistance schemes. Containing bad debt at this level will remain a challenge as benefit reforms continue to roll out across our region.

United Utilities are grasping the opportunities presented by reform of water regulation. We welcome the opening of the competitive business retail market for water and United Utilities Scotland has rapidly secured a profitable position as the largest new-entrant business retailer in Scotland, second only to the incumbent, Business Stream. The lessons learned in Scotland will be applied in the English market, delivering better customer service in the run up to market opening in 2017 and beyond. In mid 2013 we launched a range of on-site water and wastewater services to add value to non-household customers in our region.

Chairman's and Chief Executive Officer's statement (continued)

Strategy

During the last year, we updated our Strategic Direction Statement, 'Playing our part to support the North West', and this document reflects extensive consultation with customers and other stakeholders to generate our best view of what the next 25 years holds for the region. This includes economic, social and environmental developments such as the increasing impact of climate change.

Our business plan, published in December 2013, sets out our plans for the 2015-20 period. We sought the views of over 27,000 customers, as well as consulting with our regulators, to deliver a plan which we believe strikes the right balance for all our stakeholders.

The North West is home to some of the most beautiful rural areas of the UK, supporting a diverse and productive agricultural sector. These areas of natural beauty, combined with a long coastline, mean that tourism is an important sector in the regional economy, contributing some £3.2 billion per annum. The EU's Water Framework and Bathing Water Directives target the protection and enhancement of this environment and our plans set an appropriate pace for implementation of new environmental legislation, balanced against the size of bill that customers are prepared to pay.

Our plans recognise that as a lone agent United Utilities could not deliver the scale of required environmental improvement at an acceptable level of cost. Instead, we are committing to partnering with others who can support the achievement of the required outcomes. This includes our 'Turning Tides' partnership with the Environment Agency, Local Authorities, the Marine Conservation Society and others to improve bathing waters in the North West.

Our updated Water Resources Management Plan describes the expected pattern of water resource availability in our region until 2040. The majority of the North West is in surplus, benefitting from an integrated network that supports movement of water across the region to accommodate its changing supply and demand balance. Our business plan focuses on maintaining existing levels of service across the region, whilst acting to improve the security of supply to West Cumbria by connecting it to our integrated network. This is necessary because the need to protect the local environment puts West Cumbria's future supply and demand balance at risk.

A fair deal for customers

We have continued to invest heavily in schemes designed to mitigate the risk of flooding of our customers' homes. This includes incidence based targeting on areas more likely to experience flooding and more use of CCTV sewer surveys to identify issues. For 2015-20 we are targeting a further reduction in the risk of sewer flooding inside customers' properties, seeking opportunities to work in partnership with others to deliver cost-effective joint schemes and promoting the use of more sustainable drainage systems. Our wastewater network will continue to benefit from significant investment going forward as we adapt to weather patterns likely to result from climate change.

We are developing a new business operating model for our wholesale business area, embracing innovation in control technology and work processes. Delivery of this business model is critical to our future ability to offset the growth in bills arising from new environmental regulation whilst continuing to deliver our target return for shareholders. Our progress over the current regulatory period, combined with our plans for further improvements in the next five years, will mean average household bills will have grown by less than inflation in the decade to 2020.

Investing for performance

We remain on track to meet Ofwat's allowance on our capital programme, after reinvesting our operating expenditure outperformance. We plan to continue with high levels of investment for 2014/15. This includes bringing forward some of our scheduled 2015-20 spend to ensure a smoother investment profile. We have now invested over £2.9 billion in the first four years of the 2010-15 regulatory period, and we remain on track to deliver our planned five-year investment programme.

Chairman's and Chief Executive Officer's statement (continued)

Responsible business

We continue to listen to the views of all our stakeholders and endeavour to develop, manage and operate in an environmentally sustainable, economically beneficial and socially responsible manner. In recognition of the company's continued focus on responsible business, we retained both our 'World Class' rating, as measured by the Dow Jones Sustainability Index and our 'Platinum Big Tick' ranking in Business in the Community Corporate Responsibility Index. We are proud that we are one of only seven FTSE 100 companies (and the only water company) to hold both accolades.

The communities where we operate are where our customers and employees live and work and are vital to our business. We have continued to support these North West communities both financially and in terms of employee time through volunteering. For example, our 'Beachcare' employee volunteering scheme, working in partnership with the Environment Agency and others, helps to keep our region's beaches tidy.

Through our role as a major employer, training provider and wealth creator, we help to keep the North West's economy turning. Between 2010 and 2015, our activities will generate an estimated £7 billion for the region's economy, supporting 9,000 jobs, and securing a legacy for the future.

Our employees

The people in United Utilities are key to the delivery of the highest levels of service to our customers and we would like again to thank them for their dedication and continued hard work during the year. Notwithstanding the amount of change our business is undertaking, employee engagement sits at 79 per cent, well above the UK transitional norm and close to the norm for high performing companies in the UK.

We strive to continuously improve our safety culture and we have implemented a number of initiatives throughout the year. We launched a managers' guide for health and safety responsibilities and our transformation project, covering 13 key areas of focus across our business, is progressing well. These initiatives helped reduce the number of employee accidents in 2013/14 and this will remain a significant area of focus for us.

A committed, capable and motivated workforce is central to delivering our vision and we remain fully focused on maintaining high levels of employee development and engagement. We are always on the lookout for the best and brightest talent and we recruited a further 24 graduates and 32 apprentices in 2013/14 and we have plans to recruit a similar number in 2014/15.

Our board

As a board we are responsible to our shareholders, customers and other stakeholders for the performance and long-term success of our company. The way in which we operate, we believe, already reflects the highest standards of corporate governance. Our plc structure and governance standards ensure that our board and non-executive directors continue to provide sound and prudent governance which complies with the spirit of the UK Corporate Governance Codes, and follows the 'comply or explain' regime.

On behalf of the board, we say thank you and farewell to Nick Salmon, who will stand down at this year's AGM after over nine years as a non-executive director. We wish Nick all the best for the future. We are pleased to welcome Mark Clare to the board following his appointment last November as a non-executive director. Mark is a member of the UUG audit committee and the UUG nomination committee and will replace Nick as senior independent director. Mark is Group Chief Executive at Barratt Developments PLC and his expertise will be an asset to the board.

Chairman's and Chief Executive Officer's statement (continued)

Outlook

We believe that our sustained focus on operational performance, combined with continued substantial investment in our assets, is delivering benefits for customers, shareholders and the environment. We are on track to exceed our regulatory outperformance targets, with substantial financing and operating outperformance already secured. Our capital structure remains robust and we intend to continue with our dividend policy of targeting real growth through to at least 2015.

Looking ahead, our focus remains centred on driving further customer satisfaction, alongside operational and environmental improvements and we believe there is still plenty of scope to achieve this. We have now submitted our business plan for the 2015–20 period, as we aim to strike the right balance between all our stakeholders. We will continue constructive engagement with our regulators, ahead of the draft and final determinations from Ofwat later this year.

Dr JDG McAdam
Chairman
5 June 2014

SL Mogford
Chief Executive Officer
5 June 2014

Strategic report

Our vision and strategy

Our vision is to become a leading North West service provider and one of the best UK water and wastewater companies.

Our 25-year strategy

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

- climate change and its implications for water resources and flooding;
- the emergence of a more open, competitive UK water market;
- more rigorous environmental regulations; and
- the ever-present need to combine affordable bills with a modern, responsive water and wastewater service

By anticipating these changes and balancing them against our customers' priorities, we can meet the future with confidence.

Our Strategic Direction Statement, 'Playing our part to support the North West' (you can download this at corporate.unitedutilities.com/future) sets out our long-term strategy for the next quarter century. It examines the challenges ahead and explains how we will focus our resources and talents in order to meet them. We consulted with thousands of customers and stakeholders to make sure what they expect of us in the future are reflected in our plans. Their feedback helped us to create our five customer promises which, together with the 11 outcomes, will guide the way we deliver our services, now and long into the future.

The customer outcomes:

Provide great water

- Drinking water is safe and clean
- Customers have a reliable supply of water now and in the future

Dispose of wastewater

- Wastewater is removed and treated without customers ever noticing
- The risk of sewer flooding for homes and businesses is reduced

Give value for money

- Customer bills are fair
- We support those customers who are struggling to pay
- The North West's economy is supported by our activities and investments

Deliver a service customers can rely on

- Customers are highly satisfied with our service and find it easy to do business with us

Protect and enhance the environment

- The natural environment is protected and improved in the way we deliver our services
- The North West's bathing and shellfish waters are cleaner through our work
- Our services and assets are fit for a changing climate

Strategic report (continued)

Strategic delivery 2010-2015

Our current five-year plan for 2010– 2015 is designed to build a platform for us to be able effectively to deliver our long-term strategy.

Our five-year plan is focused on improving customer satisfaction, meeting our statutory obligations and delivering shareholder value. We aim to deliver high levels of service to customers at the lowest sustainable cost, all whilst acting responsibly.

The activities we undertake to outperform for our customers include striving to be a leading company in the areas our regulator benchmarks for the industry. Measures include customer satisfaction (both qualitative and quantitative) and how well we maintain our assets (serviceability). We also assess our performance against other leading organisations in the North West through an independent brand tracker survey.

Metrics for assessing lowest sustainable cost include our outperformance against opex, financing and capex levels set by Ofwat.

The degree to which our actions are viewed as responsible is taken from performance measures set by the industry regulator, the Environment Agency and those which measure global best practice, as defined by the Dow Jones Sustainability Index.

Our strategy

To deliver value by providing:

The best service to customers: Delivering excellent services to our customers by anticipating and responding to their needs.

Our areas of focus:

- Improving customers service performance
- Investing to reduce the risk of sewer flooding
- Providing safe and clean drinking water
- Reliable supply of water now and in the future
- Maintaining the standards of our assets
- Building capability to compete in the expanding retail market

Our performance will be measured by serviceability, qualitative SIM and quantitative SIM.

At the lowest sustainable cost: Providing the service as efficiently as possible on a cost basis that can be sustained over the long-term.

Our areas of focus:

- Delivering capital commitments efficiently, on time and to a high quality
- Innovating to improve our use of technology and to improve our efficiency
- Generating energy from sludge to help power our assets
- Meeting our regulatory commitments
- Enhancing debt collection activities
- Providing support for customers struggling to pay

Our performance will be measured by opex outperformance, financing outperformance and capex outperformance

Strategic report (continued)

In a responsible manner: Managing responsibly our interaction with the environment, the communities where we operate and our employees.

Our areas of focus:

- Maintaining leakage at or below a sustainable economic level
- Improving the North West's river and bathing water quality
- Reducing our carbon footprint
- Improving environmental performance
- Ensuring we have a committed, capable and motivated workforce
- Continuing to support community groups
- Reducing pollution incidents

Our performance will be measured by leakage, EA performance assessment and the Dow Jones Sustainability Index.

How we create value

Longer-term

Today we benefit from the strategic decisions and work delivered by our predecessors over the previous 150 years to provide the North West with good quality water and to reduce the environmental impact of the wastewater we treat. The work we do today will help to ensure customers of the North West continue to enjoy an effective, efficient service for many generations to come.

Employees

We can increase long-term value generation through the strategic direction and decisions we take and through the hard work of our employees. It is important that we create and retain an engaged and talented team in order to deliver this and we place a strong emphasis on providing comprehensive training and development opportunities. Management have a range of incentives which focus on performance over a number of years, rather than the current year in isolation, to encourage a longer-term approach.

Capital investment

Our fixed assets have a replacement cost of around £80 billion i.e. the estimated amount it would cost for another party to build competing assets and networks. This means that we are a natural regional monopoly. However, it is not the replacement cost of our assets upon which we are allowed to earn a return, through our revenues. We earn a return on our Regulatory Capital Value (RCV), which is currently close to £10 billion, so it is this asset value which is more important economically.

Many of our assets are long-term in nature: for example, our impounding reservoirs have a useful economic life of around 200 years with some sewers having a life of up to 300 years. By carefully reviewing our potential capital projects, considering the most efficient long-term solutions, we can save future operating costs, also helping to reduce future customer bills.

Since privatisation in 1989, total capital investment of over £13 billion has provided substantial benefits to our customers and our region's environment. Disciplined investment, along with RPI inflation, also grows our RCV, increasing future revenues.

We need to continue with a substantial investment programme for the foreseeable future in order to meet ever more stringent environmental standards and to maintain and improve the current standards of our assets and services.

However, in deciding on our investment strategy, we also have to be mindful of the impact on our customers' bills, and this is why, for example, we are spreading some of our currently required environmental spend over the next 15 years.

Strategic report (continued)

Capital structure

It is important that we continue to attract equity investors to support a robust and responsible capital structure, which enables us to raise new debt. Capital investment is largely financed through a mix of debt and cash generated from our operations. By efficiently raising debt at the best possible rates we can help keep our finance costs as low as possible and potentially outperform the industry allowed cost of debt, set by Ofwat every five years.

Regulatory environment

Over a long time frame the regulatory environment can change significantly. In the 25 years since the water industry was privatised we have seen substantial improvements in the regional standards of water quality and wastewater treatment and the cleanliness of rivers and bathing waters. We have also recently seen the progressive implementation of competition for business customers, with full market opening expected in 2017.

Maintaining a good reputation is important to enable positive participation in regulatory discussions. By positively engaging and utilising our industry knowledge, we can help influence future policy with the aim of achieving the best outcome for our customers, shareholders and other stakeholders. We can also help ensure we are well prepared for any changes to the regulatory landscape.

Natural environment

Our region's natural environment is also changing. Climate change is bringing more extreme weather patterns and we have a long-term strategy to help ensure we have sufficient water resources and are able to meet increased demand on our sewerage network. A phased, long-term approach ensures that the necessary work can be delivered and does not place too much pressure on customer bills.

Shorter-term (up to five years)

Ofwat, our economic regulator, determines the prices we can charge our customers to provide them with water and wastewater services. Ofwat sets our regulatory contract following the receipt of our five-year plan proposals.

By submitting a robust, balanced plan, we can help ensure we receive a contract that allows for an optimal outcome for our customers, shareholders and the environment.

Once each five-year regulatory contract is set we create value principally by delivering or outperforming it, by providing the best service to customers, at the lowest sustainable cost and in a responsible manner. Some of the key ways we create value over this shorter time frame are by:

- improving customer service will, in turn, improve efficiency and reduce costs. It will also reduce potential penalties/increase rewards from Ofwat, under its SIM incentive mechanism, maximising future revenues;
- delivering our regulatory commitments helps ensure we meet high customer service and environmental standards and avoid potential financial penalties;
- embracing innovation in our use of technology and work processes helps to make our service better, faster or cheaper;
- raising low cost finance helps us outperform the finance costs allowed in our regulatory contract;
- implementing our hedging strategies, such as fixing medium-term interest rates and power costs, reduce the volatility of our costs, helping us to meet our regulatory contract;

Strategic report (continued)

- minimising operating costs on a sustainable basis, such as on power, materials and property rates, helps us to meet or outperform operating costs allowed in our regulatory contract;
- enhancing our debt collection activities will reduce our retail costs. Alongside this, we continue to provide support for customers struggling to pay;
- meeting our economic leakage target provides water resource and customer supply benefits and avoids any unfunded expenditure requirements from our regulators;
- increasing our production of renewable energy from waste helps protect us from rising energy costs and reduces our carbon footprint.

Over the current 2010–15 regulatory period, outperformance is generated mainly through efficiency savings on operating costs, capital expenditure and financing costs. Ofwat's SIM incentive mechanism also rewards companies who perform well on customer service, or penalise companies who perform badly, relative to other water companies. Our current KPIs are reflective of these potential areas for outperformance.

Ofwat is evolving the regulatory framework so that, over the 2015–20 period, the way we can add value is changing. Operating costs and capital investment will no longer be separately assessed as they will be combined into a new 'Totex' methodology. There will be additional rewards or penalties based on performance as measured through a range of Outcome Delivery Incentives (ODIs). Ofwat is intending to continue with its SIM assessment for household customers and this is likely to provide a similar incentive and penalty framework. Companies will still be incentivised to outperform in the area of financing costs. The progressive opening up of the retail market for business customers will also provide additional opportunities to acquire further customers and earn higher returns. We will remain focused on improving our service to business customers to both help us win more out of area customers and importantly, to retain our existing customers.

Our approach to doing business

We believe that responsible business should be embedded within everything we do and this should be evident across all of our activities.

We are committed to delivering our services in a responsible way and our approach to responsible business practice is set out in our Business Principles document. This states that for United Utilities, being a responsible business means:

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

We've explained these in more detail below:

Customers: Our aim is to protect public health and provide excellent services to our customers. This means removing the need for customers to contact us unnecessarily to taking ownership of queries, satisfactorily resolving them as quickly as possible and keeping our customers informed along the way. We aim to provide bills that represent good value for money.

Strategic report (continued)

Environment: Whether it's treating and delivering drinking water for our customers, or returning treated wastewater to rivers and the sea, we're acutely aware of our responsibility to the environment. We continue to invest to protect and, where appropriate, enhance the natural environment of the North West. We continue to consider the impacts of climate change on the services we deliver and adapt accordingly.

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

Employees: Health and safety is paramount and we strongly focus on our health and safety performance. High employee engagement is a key contributor to our performance and we place significant emphasis on maintaining and strengthening levels of engagement. 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 possible and wherever it is safe and practical to do so. We value diversity, providing equality of opportunity and recruiting and promoting on merit. A UUG breakdown of male: female directors, senior managers and staff can be found in the table below.

	Male	Female
	2014	2014
Group Board	6 (75%)	2 (25%)
Senior Managers		
-Executive team*	5 (50%)	5 (50%)
-Other senior managers	38 (81%)	9 (19%)
Wider employees	3469 (63%)	2009 (37%)

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

We also have 14 (78%) male: 4(22%) female employees who are appointed as statutory directors of subsidiary group companies but who do not fulfil the Companies Act 2006 definition of 'senior managers'.

Delivering good value: We are committed to honouring our responsibility to our shareholders, credit investors and those who provide us with goods and services. We aim to operate as effectively as possible at the lowest sustainable cost and to retain a robust and sustainable financial profile to provide enduring shareholder value.

This annual report provides a comprehensive financial and operational review to help inform our investors of our performance. We work with suppliers whose business principles, conduct, and standards align with our own. Our key suppliers have committed to our Sustainable Supply Chain Charter, supporting us in the delivery of wider social, economic and environmental benefits.

Running our business with integrity

We have procedures and policies in place to ensure we act in accordance with the Universal Declaration of Human Rights.

Given the long life of our infrastructure, we take a long-term view of our operations and our aim is to deliver our strategic objectives in a more sustainable manner. Sustainability is fundamental to the manner in which we undertake our business and the group has, for many years, included corporate responsibility (CR) factors as a strategic consideration in its decision-making. Our UUG board level CR committee develops and oversees our CR strategy and this continuing focus helped the group retain our Dow Jones Sustainability Index 'World Class' rating and our 'Platinum Plus' ranking in the Business in the

Strategic report (continued)

Community CR Index. Details on our responsible business performance for the year can be found on our website at corporate.unitedutilities.com

Our operating environment

Our industry and market

Every day, over 50 million household and business consumers in England and Wales receive water and wastewater services. There are currently 10 licensed companies which provide both water and wastewater services to consumers in their respective regions.

Additionally, there are licensed companies which provide water-only services and tend to be smaller in size. As each company in the water sector operates as a regional monopoly for its services, they are subject to regulation in terms of both price and performance.

The privatisation of the industry over two decades ago has been widely perceived as a success, making a significant contribution to public health. It has led to improvements in the quality of services provided to customers, higher environmental standards and superior quality drinking water at lower estimated costs to customers than if the water sector was still owned by the UK Government. The water industry currently invests around £80 million a week in maintaining and improving assets and services.

Our customers

United Utilities Water hold licences to provide water and wastewater services to a population of approximately seven million people in the North West of England. We provide services to approximately three million households in our region and this generates around two thirds of our total revenues. We also serve approximately 200,000 businesses, ranging in size from large manufacturing companies down to small shops. Our focus over recent years has been on improving customer satisfaction.

For our business customers we have been extending the range of value added services United Utilities offer, including our on-site engineering solutions and water efficiency advice. By offering value-for-money, as well as the increased range of services, United Utilities have also been winning customers out of area.

Our households pay just over £1 per day on average for the combined water and wastewater services we provide. Our business plan for the 2015–20 period also means that customers would benefit from below inflation increases to average household bills for the decade to 2020. Our objective is to continue to provide our customers with high quality drinking water to meet all their daily needs and environmentally responsible wastewater collection and treatment at a price to customers that represents good value for money.

We are continuing to invest heavily for our customers. During the five year period to 2015, we have a capital investment programme of over £3.5 billion as we continue to improve our asset base, delivering further benefits for customers.

Capital investment is expected to be around this level again for the 2015–20 period and to remain high beyond 2020 as we continue to:

- upgrade our region's water and wastewater networks;
- maintain our ageing assets;
- deliver a cleaner environment;
- provide high quality water to our customers; and
- improve our customers' experience.

Strategic report (continued)

Our regulatory environment

Economic regulation

The water industry currently operates within five-year planning cycles known as Asset Management Plan (AMP) periods. Prior to the start of each five-year period, companies submit their business plans which include their projected capital expenditure costs to enhance and maintain their network and operating costs to maintain or improve their services. Following review of these plans, Ofwat sets the prices each company can charge their customers across the period. Price limits for the current 2010/15 (AMP5) period were set in November 2009, when Ofwat published their final determination.

Ofwat assesses companies' performance across a wide range of measures, including some of our key performance indicators such as Service Incentive Mechanism (SIM), Serviceability and Leakage. Where performance falls short of expectations, Ofwat can take actions, such as enforcement actions or fines, in order to protect customers' interests.

Our current price limits (published in November 2009)

UUW's profile of price limits for the current five-year period 1 April 2010 to 31 March 2015 is set out below:

Year	2010/11	2011/12	2012/13	2013/14	2014/15
K factor*	-4.3%	-0.2%	+0.6%	+1.0%	+1.2%**

*Added to RPI inflation to determine average price change

**We are applying a one-off special discount so that, on average, customer bills will rise by no more than RPI inflation for 2014/15

Ofwat review 2015–20

Ofwat is introducing a number of important changes for the 2015–20 (AMP6) price review, with the aim of evolving the sector in order to meet future challenges and placing greater focus on customers' needs.

Moving away from one single price control, there will be four separate price controls:

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

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

This proposed retail household model allows water companies only to charge its customers an amount based on the average costs of the industry plus any allowed company-specific adjustments.

- The way companies' operating and capital costs are assessed is being modified to encourage companies to utilise the most efficient, sustainable solutions under a new 'totex' model.
- There is a move to a more outcomes-based approach, with greater emphasis being placed on customer engagement to agree the outcomes.

Strategic report (continued)

We submitted our business plan to Ofwat on 2 December 2013.

Ofwat provided an initial view on our plan through its pre-qualification decisions publication in March 2014 and subsequently shared detailed feedback with us, which we are currently assessing. In line with our expectations and consistent with the company specific adjustments we highlighted when we submitted our initial business plan in December, two key areas we are focusing on are wastewater total expenditure (totex) and retail average cost to serve. Ofwat's initial view on wastewater totex indicated a £1.1 billion difference, compared with our business plan submission. In our submission, we asked for around £1 billion of wastewater totex to be given specific consideration. We are in detailed dialogue with Ofwat to understand this difference and provide any further evidence required to support our submission. We are also revising our outcome delivery incentives to include more symmetrical reward/penalty mechanisms. In addition, we are focusing on a number of adjustments relating to the 2010-15 period. These adjustments include a range of economic, performance and scope differences, compared with the assumptions made at the 2009 price review.

Environmental and quality regulation

The water and wastewater industry in the UK is subject to substantial domestic and European Union regulation, placing significant statutory obligations on water and wastewater companies with regard to, amongst other factors, the quality of drinking water supplied, wastewater treatment and the effects of their activities on the natural environment. Environmental regulation is the responsibility of the Secretary of State for Environment, Food and Rural Affairs together with:

- the Environment Agency (EA), which 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 KPI's;
- the Drinking Water Inspectorate, which is responsible for ensuring compliance with the drinking water regulations;
- Natural England, which is responsible for the protection of designated sites for nature conservation, e.g. Sites of Special Scientific Interest. Companies are required to manage these sites and to protect and enhance biodiversity; and
- the Consumer Council for Water, which represents customers' interests relating to price, service and value for money. It also investigations customer complaints about water quality.

Regulatory risks

Given the complex legal and regulatory environment within which we operate, there is a range of risks to which we are exposed. Risks can be in the form of possible non-compliance with existing laws or regulations or failure to meet the terms of our current 2010-15 regulatory contract. We also face risks in relation to potential future changes in legislation or regulation, particularly with regard to the 2015-20 price review period.

Impact of environmental legislation

European Union environmental legislation will require us and other UK water companies to incur additional capital investment to ensure compliance with more stringent standards. We do, however, recognise that in our region we cannot achieve this alone and we are committing to partnering with others who also have a role to play, such as the Environment Agency and Local Authorities and local interest groups.

- The revised Bathing Water Directive, effective from 2015, sets higher standards for bathing waters. Under the current standards North West beaches achieve over 90 per cent bathing water compliance. The new standards are likely to prove very challenging to meet. As one of many contributors to

Strategic report (continued)

bathing water quality we have included investment in our AMP6 business plan to help ensure compliance with the higher standards. We will work in partnership with other organisations to ensure investment is as efficient as possible.

- The Water Framework Directive sets an objective that European member states should achieve 'good' status for all surface water beyond 2027. Considerable capital investment is required to meet this and we are spreading this investment over the next three regulatory periods, balancing the needs of current and future customers.
- The Habitats Directive requires member states to maintain biodiversity by protecting natural habitats and certain wild species. To protect England's largest population of fresh water mussels in West Cumbria, in future we will have to extract less water, raising long-term supply and demand balance issues for the local population. To address this we are proposing work over AMP6 to connect our West Cumbrian supply network to our main integrated supply zone, which has surplus capacity. This proposed project is subject to the outcome of an independent Planning Inspectorate decision.

Our competitive environment

Comparative competition

Our main competitors to benchmark our performance against are the other nine water and wastewater companies (WaSCs) across England and Wales. We are the second largest WaSC based on the size of our asset base, as measured by Regulatory Capital Value (RCV). We, along with these other nine companies, comprise the vast majority of the total water and wastewater sector.

Although their relative sizes are generally far smaller than the water and wastewater companies, the remaining water-only companies are also important competitors as their relative performances are also included in Ofwat's published comparative information.

Away from the water sector, in line with our vision to be a leading North West service provider, we also benchmark our customer service performance against other leading service providers in our region. In addition, as United Utilities is a publicly listed FTSE 100 company, the other UK and worldwide listed utilities are competitors from an investment perspective.

Direct competition

Water supply competition was opened up in December 2005, when very large business customers (those with an annual consumption of over 50 megalitres per year at each site) were allowed to choose their water supplier. Under this arrangement, the new water supplier would buy water directly from the regional water company and be allowed to use their network for this water supply.

In December 2011, this market was opened up further, with the threshold being reduced to five megalitres a year. To date very few customers have switched supplier in England and Wales.

Looking ahead, under the new Water Act, introduced in May 2014, the water supply threshold will be reduced further to zero for non-household customers and also be expanded to include sewerage as well as water services, with a target date of 2017 at the earliest. This will effectively open up retail competition for all business customers. The UK Government has not expressed any intention to expand competition to include household customers.

United Utilities are exploiting the opportunity presented by the expansion of retail competition for business customers. Despite only obtaining a licence to trade in Scotland, a market that already offers full business retail competition, as recently as October 2012, United Utilities have quickly become the second largest water retailer there, behind only the incumbent provider. As well as winning new business, this is also helping the group to learn about what we need to offer to win out of area customers and this is important in the run up to the English market opening in 2017.

Strategic report (continued)

The Water Act also paves the way for the future introduction of competition for certain parts of the wholesale, or upstream, business (for example the input of raw or treated water into a water company's network or the removal of wastewater for treatment), although any upstream reforms are not expected until 2020 at the earliest.

The economic environment

UK gross domestic product has picked up over the last year as developed world economies look finally to recover from the 2008/09 global financial crisis, although UK output has still not recovered to its 2008 level.

The North West of England continues to face a particularly tough economic environment. The North West unemployment rate has not recovered as quickly as the national rate and remains well above the national average, at 7.7 per cent for the quarter ending March 2014, compared to 6.8 per cent nationally. A report 'Department for Communities and Local Government, Indices of Deprivation 2010', published in March 2011, highlighted that the North West had more of the most deprived areas in England than any other region.

Commercial volumes have shown a downward trend over recent years, impacted by the tough economic climate, and although volumes stabilised across 2013/14 it is too early to conclude that this is part of a sustained recovery. Bad debt remains a risk to which we are exposed, although Ofwat currently recognises this through a special factor allowance. Debt management continues to be a significant area of focus for us as we seek to use best practice in the recovery of debt and in helping customers back into making regular payment through use of manageable payment plans.

Whilst interest rates have increased somewhat during the year, they still remain below the long-term trend and our recently agreed £500 million loan should benefit from this as we draw it down. Comparatively low interest rates have also been beneficial to our future cost of debt as we continue with our interest rate hedging strategy.

RPI inflation has fallen away from the very high levels seen over 2011 and 2012 (around five per cent), ending 2013/14 at 2.5 per cent. The prices we charge our customers (and therefore revenues), as well as our asset base, are linked to RPI inflation, so lower RPI will mean slightly lower growth on these measures. However, we also have a large quantity of index-linked debt which means our finance costs decrease as inflation falls, providing a partial economic offset to revenue (although not a perfect hedge as changes to revenue and index-linked finance costs are based on differing lagged measures of inflation). Our pension liabilities are also linked to inflation, which also provides an additional economic offset against our asset base.

United Utilities' total contribution to the regional economy over 2010-15 is estimated at £7 billion. Direct economic contributions from our activities include the purchase of goods and services and providing extensive employment. There is also an indirect economic contribution, for example when our suppliers, in turn, make purchases from their suppliers and when people whose jobs are supported by United Utilities spend their personal incomes.

Our journey so far

Our focus on improving customer service

Great customer service relies on understanding what our customers need, anticipating problems, resolving complaints quickly and courteously and developing new, innovative services that fit into people's busy lifestyles. We want our customers to trust us and have confidence in our service.

Strategic report (continued)

Since completing the group disposal of its non-regulated businesses and establishing a new management team at the beginning of 2011, we have demonstrated significant progress against our customer-centric strategy.

We have developed new services and introduced a 'right first time' culture across our business. Improvements have included:

- the return of all contact centres back to the North West and a system that allows customers to speak to an advisor promptly, rather than navigating lengthy automated menus;
- a more sophisticated online service to allow customers to manage their water accounts;
- clearer, plain English bills;
- a welcome pack for home movers; and
- a specialist Careline team which supports customers who may need extra help, for example those suffering ill health, a bereavement, or with mental health issues.

The introduction of the Service Incentive Mechanism (SIM) as a measure of customer satisfaction over this regulatory period has provided us with a strong benchmark of water industry comparative performance. SIM results sit alongside our other, ongoing, research on customer expectations and satisfaction.

Key achievements to date include:

- The most improved water and wastewater company as measured under SIM in each of 2011/12 and 2012/13
- 42 per cent reduction in customer complaints to the Consumer Council for Water (CCW) from 2010/11 to 2013/14
- Complaints warranting CCW investigation reduced from 63 in 2010/11 to zero in 2012/13 and 2013/14
- Consistently third behind only John Lewis and Marks & Spencer on the customer service brand tracker measure out of ten leading service providers in the North West
- Awarded 'Best Utility' in the Top 50 Contact Centre Awards 2013
- United Utilities becoming the second largest water retailer in Scotland within one year of entering the market

Other operational improvements

We have been working hard to improve our performance in achieving statutory compliance and on-time delivery of schemes contributing to water quality and environmental improvement. In May 2014, however, we were fined £200,000 for each of two breaches of environmental permit conditions following an escape of 50,000 cubic metres of biogas at Stockport Wastewater Treatment Works in October 2011. The judge acknowledged our cooperation regarding this regrettable incident and we have since replaced the gas holder, retrained staff and put in new measures.

Highlights include:

- Delivered stable asset serviceability performance or better on all four water and wastewater measures for 2012/13 and 2013/14
- Upper quartile sector performance on Ofwat's annual Key Performance Indicators and on the Environment Agency's assessment of water and wastewater companies 2012/13
- Met or outperformed annual leakage targets in each of the last eight years
- Efficiency improvements in delivering capital programme allowing us to reinvest £200 million of savings into projects which improve services to customers or benefit the environment

Although we are pleased with our achievements over recent years, we know that we have more to do.

Strategic report (continued)

Key performance indicators

Our key performance indicators (KPIs)

We focus on a range of financial and operational KPIs to help assess our performance. We believe that the KPIs defined below provide a rounded view as to how we are performing against our primary objectives, helping us on our path to reaching our long-term strategic vision. These KPIs encompass the important areas of customer service and environmental performance, as well as financial indicators, taking consideration of the interests of all our stakeholders.

The company monitors a large number of financial and operational key performance indicators (KPI's) to enhance the visibility of its performance and to help drive improvements. Performance in 2013/14 against these KPI's is set out in the tables below.

Financial KPIs	2014	2013
Turnover	£1,670.0m	£1,604.7m
Regulatory capital expenditure	£836m	£787m
Operating profit	£678.7m	£635.3m
Profit before tax	£538.8m	£311.4m
RCV gearing	61%	64%
Interest cover	2.5	2.4

Financial performance

Turnover

The company has delivered a good set of financial results for the year ended 31 March 2014. Turnover increased by £65.3 million to £1,670.0 million, principally reflecting a 4.0 per cent nominal (1.0 per cent real price increase plus 3.0 per cent RPI inflation) allowed regulated price increase.

Operating profit

Reported operating profit increased by 7 per cent to £678.7 million, primarily as a result of an increase in revenue and benefitting from tight cost control with operating costs up at a lower rate than revenue.

Profit before taxation

Profit before taxation was £538.8 million, £227.4 million higher than last year, primarily due to a £184.0 million decrease in finance expenses, mainly due to fair value gains and a £43.4 million increase in operating profit as discussed above.

Taxation

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

Our tax policies and objectives, which are approved by the board on a regular 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;

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- are committed to an open, transparent and professional relationship with HMRC based on mutual trust and collaborative working.

Under the regulatory framework the company operates within, the majority of any benefit from reduced tax payments will typically not be retained by the company but will pass to customers via reduced bills. For 2013/14, the company has agreed, over and above the normal regulatory rules, to voluntarily share with customers the one-off net cash benefit of £74.6 million due to the company, following the Industry wide agreement with HMRC in relation to the abolition of industrial buildings allowances in 2008.

In any given year, the company's effective cash tax rate may fluctuate from the standard UK rate due to the available tax deductions on pension contributions and capital investment. 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.

The company's effective cash tax rate may also fluctuate from the standard UK rate due to unrealised profits or losses in relation to treasury derivatives where the corresponding profits or losses are only taxed when realised. These movements are purely timing differences and HMRC are now reviewing the relevant tax rules with the stated aim of achieving greater accounting and tax alignment. However, any changes are not expected to affect the company before year ended 31 March 2017.

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

For 2013/14, we paid corporation tax of £79.0 million which represents an effective cash tax rate of 15 per cent, 8 per cent lower than the mainstream rate of corporation tax of 23 per cent. For 2012/13, we paid corporation tax of £84.8 million (27 per cent), 3 per cent higher than the mainstream rate for that year. For both years, the key reconciling items to the respective mainstream rates were tax deductions on capital investment and pension contributions and timing differences in relation to certain unrealised profits/ losses on treasury derivatives, where the corresponding profits or losses are only taxed when realised.

For 2013/14, the company also received an exceptional cash tax refund of £74.6 million in relation to prior years' tax matters, covering a period of over 10 years in total. The amount principally related to tax deductions on capital expenditure and included the revised tax treatment for capital expenditure at water and sewage treatment works agreed between the Industry and HMRC, following the abolition of industrial buildings allowances. Taking account of this one-off repayment, the net effective cash tax rate for 2013/14 reduced to 1 per cent.

The current tax charge was £75.8 million in the year, compared with £84.0 million in the previous year. In addition, there was a current tax credit of £152.0 million relating to matters agreed with HMRC in respect of prior years.

For 2013/14, the company recognised a deferred tax charge of £45.4 million, compared with a credit of £0.1 million in 2012/13. In addition, the company has recognised a deferred tax credit of £141.5 million relating to the 3 per cent staged reduction in the mainstream rate of corporation tax, substantively enacted on 2 July 2013, to reduce the rate to 20 per cent by 2015/16. A deferred tax credit of £41.0 million relating to a similar one per cent reduction in the mainstream rate of corporation tax was included in 2012/13. The company also recognised a deferred tax charge of £140.3 million relating to prior years' matters.

An overall tax credit of £128.4 million has been recognised for 2013/14. Excluding the deferred tax impact of the future reduction in the corporation tax rate and the adjustments relating to recently agreed matters in relation to prior years, the total tax charge would have been £121.2 million or 22 per cent compared with a £83.9 million charge or 27 per cent in the previous year. This reduction in total tax rate is

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due to the decrease in the mainstream rate of corporation tax, together with the year-on-year movement in tax disallowable items.

In addition to corporation tax, the company 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, green taxes and other regulatory service fees such as water abstraction charges.

Cash flow

Net cash generated from continuing operating activities for the year ended 31 March 2014 was £1,122.0 million, compared with £987.2 million last year. This mainly reflects the reduction in the total pension contribution payments between the two periods, and an increase in operating profit. The company's net capital expenditure was £874.8 million, principally in the regulated water and wastewater investment programmes.

Net debt including derivatives at 31 March 2014 was £6,083.7 million, compared with £6,029.9 million at 31 March 2013. This slight increase reflects expenditure on the regulatory capital expenditure programmes and payments of dividends, interest and tax, alongside an increase in the principal of our index-linked debt, largely offset by operating cash flows, fair value gains on our debt and derivative instruments and the one off tax refund.

Debt financing and interest rate management

Gearing (measured as company net debt divided by the company's (UUV's) regulatory capital value adjusted for actual capital expenditure) decreased to 61 per cent at 31 March 2014, compared with 64 per cent at 31 March 2013, remaining well within Ofwat's 55 per cent to 65 per cent assumed gearing range. The company's pension accounting position has moved to a deficit of £116.5m million at 31 March 2014, compared with a small pension surplus of £29.3 million as at 31 March 2013. Taking account of the company's pension deficit, and treating it as debt, gearing would be 63 per cent.

At 31 March 2014, UUV had long-term credit ratings of A3/BBB+ from Moody's Investors Service and Standard & Poor's Ratings Services respectively. The split rating reflects differing methodologies used by the credit rating agencies. Standard & Poor's currently have the company's ratings on positive outlook, citing improving financial metrics and operational performance.

In December 2013, UUV agreed a new £500 million term loan facility with the European Investment Bank (EIB). As at 31 March 2014, UUV had drawn down £100 million on this facility as a floating rate amortising term loan with semi-annual repayments, a final maturity in 18 years and an initial capital repayment holiday of two and a half years. The remaining £400 million is expected to be drawn down in tranches over the next year or so. The company also renewed £80 million of committed bank facilities prior to 31 March 2014 and a further £40 million since the year end. The company has headroom to cover its projected financing needs into 2015.

The UUG group has access to the international debt capital markets through its €7 billion euro medium-term note programme which provides for the periodic issuance by United Utilities PLC and UUV of debt instruments on terms and conditions determined at the time the instruments are issued. The programme does not represent a funding commitment, with funding dependent on the successful issue of the debt securities.

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 2014, approximately 48 per cent of the company's net debt was in index-linked form, representing

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around 30 per cent of regulatory capital value, with an average real interest rate of 1.7 per cent. The long-term nature of this funding also provides a good match to the company's long-life infrastructure assets.

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

In line with this, the company fixed interest costs for a substantial proportion of its debt for the duration of the 2010–15 regulatory period around the time of the 2009 price review. In addition, we have already fixed just over half of our floating rate exposure over the 2015–20 period. Following Ofwat's 2015–20 cost of debt guidance, which was published as part of its risk and reward guidance in January, we intend to fix underlying interest rates on substantially all of the company's projected nominal debt for the duration of the 2015–20 regulatory period, during 2014/15.

Liquidity

Short-term liquidity requirements are met from the company's normal operating cash flow and its short-term bank deposits and supported by committed but undrawn credit facilities. In addition to the €7 billion euro medium-term note programme, the UUG group has a €2 billion euro-commercial paper programme, both of which do not represent funding commitments.

In line with the UUG board's treasury policy, the company aims to maintain a robust liquidity position. Available headroom at 31 March 2014 was £693.4 million based on cash, short-term deposits, medium-term committed bank facilities, along with the undrawn portion of the EIB term loan facility, net of short-term debt.

The company 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. UU's cash is held in the form of short-term money market deposits with either prime commercial banks or with triple A rated money market funds.

The company 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 2014, the company had net retirement benefit, or pension, deficit of £116.5 million, compared with a net pension surplus of £29.3 million at 31 March 2013. This £145.8 million adverse movement principally reflects the movement of long-term market rates during the period, particularly influenced by the significant reduction in corporate credit spreads. In contrast, the scheme specific funding basis does not suffer from volatility due to credit spread movements as it uses a prudent, fixed credit spread assumption.

Therefore, the recent 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.

The triennial actuarial valuations of the company's defined benefit pension schemes were carried out as at 31 March 2013 and the overall funding position has improved since March 2010. Following the de-risking measures we have implemented over recent years, our pension funding position remains well placed and

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in line with our expectations. There has been no material change to the scheduled cash contributions as assessed at the previous valuations in 2010. The company has already completed early all scheduled deficit repair payments through to March 2015.

Further detail is provided in note 21 (“Retirement benefits”) of these financial statements.

Operational KPI’s

	2014	2013
Best service to customers		
Serviceability ⁽¹⁾	1 x improving, 3 x stable	1 x improving, 3 x stable
Service incentive mechanism – qualitative (relative) ⁽²⁾	7	14
Service incentive mechanism – quantitative (absolute) ⁽³⁾	135	179
Lowest sustainable cost		
Opex outperformance (2010-15 target of at least £50m)	On track	On track
Financing outperformance (2010-15 target of at least £300m)	On track	On track
Capex outperformance (2010-15 target to meet regulatory allowance)	On track	On track
Responsible manner		
Leakage – rolling average annual leakage	452MI/d – Met target	457MI/d – Met target
Environment agency performance assessment ⁽⁴⁾	2 nd	3 rd
Dow Jones Sustainability Index rating	‘World Class’	‘World Class’
⁽¹⁾ 2014 ratings subject to regulatory assessment ⁽²⁾ Performance relative to 19 (2013: 21) water companies ⁽³⁾ Low number indicates good performance. 2014 number subject to regulatory assessment ⁽⁴⁾ Performance relative to 10 water and wastewater companies		

Our performance

Operational Performance

United Utilities (UU) aims to deliver long-term shareholder value by providing:

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

Best service to customers

Customer service – our continuing strong focus on dealing effectively with customer enquiries has helped us deliver further improvements in our performance, as measured by Ofwat’s service incentive mechanism (SIM). This is also reflected in a reduction in the number of customer complaints received, which has contributed to improvements in opex efficiency. In addition, the number of customer complaints made to the Consumer Council for Water (CCW) in 2013/14 has reduced by a further 11 per cent, compared with 2012/13. We are pleased to report that the total number of escalated complaints assessed by the CCW was again zero in 2013/14. This has helped us improve our SIM performance further, as detailed in the KPIs section to the right. We were particularly encouraged with our qualitative SIM performance for the fourth quarter of 2013/14, where we achieved fourth position out of the 19 water

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companies. We believe that our improvements should move the company to a neutral position on the SIM incentive mechanism, the outcome of which will be assessed by Ofwat based on performance across the 2011/12 to 2013/14 period.

Leading North West service provider – we were pleased to have been consistently ranked third out of ten leading organisations in the North West, through an independent brand tracker survey which is undertaken quarterly. We are behind only Marks & Spencer and John Lewis, but ahead of seven other major organisations covering utilities, telecoms, media and banking services.

Robust water supply – our customers continue to benefit from our robust water supply and demand balance, along with high levels of water supply reliability. In addition, we continue to supply a high level of water quality, with mean zonal compliance continuing to be over 99.9 per cent.

Mitigating sewer flooding – we have continued to invest heavily in schemes designed to mitigate the risk of flooding of our customers' homes, including incidence based targeting on areas more likely to experience flooding and defect identification through CCTV sewer surveys. Our wastewater network will continue to benefit from significant investment going forward as we adapt to weather patterns likely to result from climate change.

Asset serviceability – we have a range of actions to help support the serviceability of our assets. We are improving the robustness of our water treatment processes, refurbishing service reservoir assets, continuing with our comprehensive mains cleaning programme and optimising water treatment to reduce discoloured water events.

Extending our presence in the retail water market for business customers – United Utilities have been building capability and experience over the last two years to help ensure we are in a strong position as the competitive business retail market evolves and are very active in this expanding market. After obtaining a Scottish water supply licence in 2012 they have already won around 150 customers, covering around 2,000 sites and representing annual revenue in 2014/15 of around £10 million. They are the largest new entrant and have now established a position as the second largest water retailer in Scotland. They also have a significant pipeline of opportunities and are continuing to offer and develop their range of value-added services.

Improving customer service remains a significant area of management focus and we see opportunities to deliver further benefits for our customers.

Key performance indicators:

- **Serviceability** – Long-term stewardship of assets is critical and Ofwat measures this through its serviceability assessment (Ofwat defines serviceability as the capability of a system of assets to deliver a reference level of service to customers and to the environment now and in the future). We are currently assessed as 'improving' for our wastewater non-infrastructure assets and 'stable' for our water infrastructure, water non-infrastructure and wastewater infrastructure assets. The aim is to continue to hold at least a 'stable' rating for all four asset classes, which aligns with Ofwat's target.
- **Service incentive mechanism (SIM)** – The company continued its progress on Ofwat's combined (qualitative and quantitative) SIM assessment for 2012/13, moving up a further three places to joint 13th of the 21 water companies, compared with 2011/12. Further progress has continued in 2013/14, with a quantitative SIM score (which measures customer contacts) of 135 points, representing a further 25 per cent improvement compared with 2012/13. On the qualitative measure (which measures customers' satisfaction in respect of how their enquiries were handled), the company has improved its 2013/14 average score by 0.13 points to 4.56 points, significantly closing the gap to the top performers. From 2013/14, Ofwat assesses SIM out of 19 water companies and the company's

Strategic report (continued)

qualitative SIM improvement moves it to joint seventh position. Our continued progress is encouraging.

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. We have substantially locked in the cost of our power requirements through to 2015, via hedging, securing outperformance across the 2010–15 period.

Proactive network management – we are implementing a more proactive approach to asset and network management, with the aim of improving our modelling and forecasting to enable us to address more asset and network problems before they affect customers, thereby reducing the level of reactive work and improving efficiency.

Debt collection – we are continuing to enhance our proactive approach to debt collection and are implementing a detailed action plan. We recognise the financial difficulties facing many of our customers and provide a range of options to help those who are struggling to pay their bills, including our charitable trust, which have helped many customers back onto manageable payment plans. We have again delivered a good performance and have sustained bad debts at 2.2 per cent of regulated revenue for 2013/14, consistent with the 2012/13 full year position, mitigating the impact of recent benefit changes on customers' ability to pay.

Pensions – the company has placed its pension provision on a more sustainable footing in 2010 and has subsequently taken additional steps to de-risk the pension scheme further.

Capital delivery and regulatory commitments – the business is strongly focused on delivering its commitments efficiently and on time and has a robust commercial capital delivery framework in place. Regulatory capital investment in the year, including £165 million of infrastructure renewals expenditure, was £836 million. Including transitional spend of around £40 million, we would expect to deliver a similar level of investment for 2014/15. Following our rapid increase in our internal Time: Cost: Quality index (TCQi) score from around 50 per cent in 2010/11 to approximately 90 per cent in 2012/13, we have further improved our score to 98 per cent for 2013/14. This has already exceeded our internal target of 95 per cent, which we were aiming to achieve by the end of this regulatory period in 2015. We received a shortfalling revenue penalty of over £80 million at the last price review in 2009 but, with our improved TCQi performance, we expect to significantly reduce the penalty risk at the 2014 price review. We remain on track to deliver the five-year programme within the regulatory allowance of around £3.6 billion (excluding costs associated with private sewers, transitional and non-regulated investment) and we are reinvesting capex outperformance to deliver further customer benefits.

Private sewers – in 2013/14, private sewers opex was £8 million, IRE was £15 million and enhancement capex was £16 million. This brings cumulative private sewers spend since they were transferred in October 2011 to £22 million for opex, £35 million for IRE and £37 million for enhancement capex, at the lower end of our estimates. As such, our total spend is now expected to be moderately below our 2011–15 total cost estimate of £160 million.

Key performance indicators:

Financing outperformance – the company has secured over £300 million of financing outperformance across the 2010–15 period, when compared with Ofwat's allowed cost of debt of 3.6 per cent real, based on an average RPI inflation rate of 2.5 per cent per annum. As outlined previously, we expect to reinvest around £40 million of our financing outperformance in private sewers costs which were not reflected in price limits for the current period.

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Operating expenditure outperformance – the business is targeting total operating expenditure outperformance over the 2010–15 period of at least £50 million, or approximately two per cent, compared with the regulatory allowance. This is in addition to the base operating expenditure efficiency targets set by Ofwat, which equate to a total of approximately £150 million over the five years. We are ahead of schedule and expect to deliver cumulative operating expenditure outperformance of over £50 million across the 2010–15 period.

Capital expenditure outperformance – the company is continuing to deliver significant efficiencies in the area of capital expenditure and expects to meet Ofwat’s allowance after adjusting, through the regulatory methodology, for the impact of lower construction output prices. As outlined previously, we expect to reinvest around £200 million of capital expenditure outperformance for the benefit of our customers and the environment.

Responsible manner

Acting responsibly is fundamental to the manner in which we undertake our business and the company has for many years included corporate responsibility factors in its strategic decision-making.

Leakage – our strong, year round, operational focus on leakage and the implementation of a range of initiatives, such as active pressure management, enabled us to again beat our leakage target for 2013/14. Our leakage performance, alongside the network resilience improvements we are making, are helping us to maintain a robust water supply and demand balance and deliver high levels of reliability for our customers.

Environmental performance – this is a high priority for us and we are pleased to be an upper quartile company in the Environment Agency’s 2012/13 performance metrics (the latest available), as described in the KPIs section.

Carbon footprint – UU are committed to reducing its carbon footprint and increasing generation of renewable energy. In 2013/14, the group’s carbon footprint totalled 449,042 tonnes of carbon dioxide equivalent, a reduction of 11 per cent compared with the previous year. UU set a target of achieving at least a 21 per cent reduction in carbon emissions by 2015, measured from a 2005/06 baseline, and was encouraged by its performance in 2013/14 which was 23 per cent below the baseline.

The recently completed Davyhulme wastewater site has contributed to the group’s highest ever renewable energy production in 2013/14 of 133 GWh. This represents c17 per cent of total electricity consumption, up from c13 per cent last year, and has helped to avoid group energy purchase costs of around £10 million, as well as attracting renewable incentives of around £5 million. In addition, there are plans in place to further increase renewable energy production over the next few years.

Employees – a committed, capable and motivated workforce is central to delivering our vision and we remain strongly focused on high levels of employee development and engagement. In our most recent employee opinion survey, we achieved an engagement score of 79 per cent, which is close to the UK high performing norm even at a time of significant change. We continue to be successful in attracting and retaining people and have continued to expand our apprentice and graduate programmes, having recruited a further 24 graduates and 32 apprentices in 2013/14 and with plans to add a similar number in 2014/15. As part of our health and safety improvement programme, we implemented a number of initiatives throughout the year. We launched a manager’s guide for health and safety responsibilities and our transformation project, covering 13 key areas of focus across the business, is progressing well. These initiatives helped reduce the employee accident frequency rate to 0.137 accidents per 100,000 hours, compared with a rate of 0.188 last year. However, we recognise we have more to do to and health and safety will continue to be a significant area of focus, as we strive for continuous improvement.

Strategic report (continued)

Communities – we continue to support partnerships, both financially and in terms of employee time through volunteering, with other organisations across the North West that share our objectives. This year we set up Catchment Wise, our new approach to tackling water quality issues in lakes, rivers and coastal waters across the North West. As a first step, we have provided matched funding to all of the DEFRA Catchment partnerships in our region and a further £500,000 has been made available as part of a competitive improvement fund to make a difference on the catchments. Our ‘Beachcare’ employee volunteering scheme, working in partnership with the Environment Agency, Keep Britain Tidy and the Local Authority, helps to keep our region’s beaches tidy and this is just one example of over 26,000 hours of volunteering time. We also contributed approximately £2 million, to support local communities through schemes such as providing debt advisory services and our Community Fund, offering grants to local groups impacted by our capital investment programme.

Sharing benefits with customers and shareholders

- Reinvesting c£200 million of capex outperformance for customer and environmental benefits, which will earn a return through the regulated asset base
- Reinvesting c£40 million of financing outperformance in private sewers
- c£20 million special customer discount; offsetting allowed real price increase for 2014/15
- c£17 million of further support for customers struggling to pay
- Customer bills in 2015-2020 to benefit from c£90 million of tax savings

Key performance indicators:

Leakage – the company met its economic level of leakage rolling target for the eighth consecutive year in 2013/14, with a performance of 452 megalitres per day versus the regulatory target of 463 megalitres per day. The aim is to meet our regulatory leakage target each year.

Environmental performance – on the Environment Agency’s latest assessment (2012/13 draft report), which covers a broad range of operational metrics, we are an upper quartile company. Based on our performance across the range of metrics, this would indicate joint second position among the ten water and sewerage companies. This represents another step up on the previous year when we were in third position and aligns with our medium-term goal of being a first quartile company on a consistent basis.

Corporate responsibility – the group 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. The group has retained its ‘World Class’ rating and aims to retain this rating each year.

Our business plan 2015-20

On 2 December 2013, we submitted our business plan, covering the 2015–20 period (AMP6), to Ofwat. In building our plan we have taken account of the views of over 27,000 customers and other stakeholders to understand their priorities.

Our Customer Challenge group has also been extensively involved in formulating research and challenging resulting plans in detail. The result is a plan that we believe strikes the right balance between customer service, the environment and customer bills.

The key features of the delivery plans for each of the four price controls are set out below.

Wholesale water

The North West benefits from one of the youngest water networks in the country, with over 50 per cent of our network constructed or renewed in the last 30 years. This is a consequence of significant investment over previous regulatory cycles to improve water quality. We also benefit from historic investment in the

Strategic report (continued)

integration of our networks to create a core 'integrated supply zone.' The most recent addition to this was the West–East pipeline running approximately 50 kilometres between Liverpool and Manchester. As a consequence we are able to provide one of the most efficient and flexible water services in the sector.

Customers told us that they wanted to retain their current level of water services, but do not want to pay for water service improvements. This has driven our proposals for AMP6, where our core focus is to continue ongoing maintenance of the existing service to keep it working reliably now and in the future, managing costs carefully and reducing the number of customer contacts.

At Ennerdale Lake in West Cumbria, the Environment Agency's planned withdrawal of our abstraction rights for environmental reasons raises supply and demand balance issues for the local population. After careful evaluation of a number of alternative options in conjunction with the Environment Agency and other stakeholders, we are proposing a preferred solution which has broad support. This will see the development of a new treatment works near Thirlmere and connection of the West Cumbrian supply network to our integrated supply zone. This project is the main capital scheme for our water network.

Key features of our plan include that we will:

- maintain existing high levels of reliability in the delivery of day-today water services, making better use of technology to remotely monitor and control more of our source-to-tap assets;
- maintain existing high levels of water quality as measured at customers' taps and our water treatment works;
- reduce the number of contacts from customers regarding water quality;
- maintain leakage levels at 2014/15 target levels, which are at or below the sustainable economic level;
- limit the impact to customers of increases in operating costs such as power, chemicals and rates, by making cost savings elsewhere through the continuous improvement in the efficiency of our operations; and
- commence work to link 150,000 customers in West Cumbria to Thirlmere reservoir to ensure a long-term, reliable supply of drinking water and providing benefits to the environment at Ennerdale.

Wholesale wastewater

The region's geography, the legacy of the Industrial Revolution, population growth and long-term underinvestment in the region's wastewater infrastructure mean that new European environmental legislation has a significant impact on our plans for the next regulatory cycle and beyond. Furthermore, the North West has one of the country's largest combined waste and surface water infrastructures and this has significant implications for river and bathing water quality in the heavy rainfall events anticipated under climate change. These are significant new challenges for our wastewater service and will drive high levels of capital expenditure in meeting statutory obligations.

Against this backdrop, customers told us that for the most part they wanted their wastewater services to remain stable. Whilst they want to see progress in reducing sewer flooding and in improving the environment, they are concerned about the impact that service improvements will have on their bills. We have responded to this by devising a balanced programme of work over AMP6 and beyond that will progressively deliver UK Government compliance with European legislation.

This also takes account of customers' views on the acceptable level of future bill increases.

In AMP6 we will:

- build on the customer satisfaction improvements we have already delivered. We will continue to improve the way we operate our wastewater business, making better use of technology, automation and control to drive better customer service at reduced cost;

Strategic report (continued)

- reduce the risk of sewer flooding inside customers' properties by 40 per cent, seeking opportunities to work in partnership with others to deliver schemes cost-effectively and promote the use of more sustainable drainage systems;
- enhance the region's bathing waters and work with other organisations to support them in delivering improvements to our region's beaches;
- improve the water quality in the North West's rivers and lakes through investment in our treatment works and at overflows, reducing pollution. We are engaging with stakeholders to explore innovative catchment management techniques to control diffuse pollution in our catchments;
- increase our production of renewable energy from waste to help protect customers from rising energy costs and reducing our carbon footprint; and
- absorb significant additional costs for taking responsibility for all private sewers and private pumping stations across the region. Costs will be constrained through improvements to our operating model and efficient delivery of our programme.

Household retail

Our focus for the current regulatory period has been and continues to be to improve the customer experience. This involves being more proactive with customers, anticipating problems before they materialise and improving our communication channels so that we are easier to do business with. We aim to further reduce the number of complaints and to resolve them whenever we can, avoiding the need for complaints to be referred to the CCW.

We look to reduce the debt burden on the company and its customers by engaging with those who are struggling to pay, helping them to return to sustained payment behaviour. We are extending our options for assistance to hard-pressed customers by developing a social tariff that secures a high level of acceptability from customers. We remain committed to contribute annually to the United Utilities Trust fund, which has proven effective in helping customers in difficulty return to regular payment.

Our domestic retail plan also sees us continuing our efforts to reduce the cost to serve our customers through systems and process improvement. This is particularly important under the new price control methodology which uses an industry average retail cost to serve to determine part of customer bills.

Non-household retail

We welcome the opportunity offered through the opening of the English non-household retail market to competition. Over the last two years United Utilities have recruited a management team with other sector experience to lead the business retail area, and separated this team from the domestic retail and wholesale business areas. This team has embarked on a transformation programme focused on getting the basics right against core customer needs, creating the culture of a business-to-business retailer.

Early progress has been encouraging and the group's success in growing the United Utilities Scotland business has allowed us to learn about the propositions, processes and systems required to win, serve and retain non-household customers. Research has highlighted a need for a broader range of services targeted to different segments. The group are developing these in its non-appointed business ensuring that they are only paid for by customers who want these services.

Non-household customers tell us that the three most important things they look to their water supplier to deliver are: value for money; a reliable supply; and great customer service. With this in mind, through the course of AMP6 we will:

- install meters in all business customer premises that give automated meter reads (AMR) to facilitate billing for actual consumption;
- build stronger relationships with customers to develop tailored plans to meet their needs;
- give customers greater choice in how they contact and transact with us; and

Strategic report (continued)

- increase first point resolution and case ownership, reducing cost to serve and improving customer satisfaction.

Next steps

In line with the price review process we are scheduled to submit revisions to our business plan on 27 June. Ofwat is scheduled to publish a draft determination on 29 August and a final determination on 12 December 2014.

Principal risks and uncertainties

Risk is managed through the individual responsibility of each business area, supported by our Corporate Risk Framework, which aims for continuous improvement. With an overarching mandate and commitment by the UUG board, the framework consists of four key areas:

- Governance;
- Approach;
- Process; and
- Guidance.

The application of the framework involves the regular assessment of the internal and external risk environment by the business. We focus on the factors that could limit or prevent the achievement of our company objectives and involves the prioritised implementation of controls to mitigate exposure and build resilience and sustainability.

The most significant risks and the group's risk profile summary are reported to the executive and the UUG board twice a year. This supports the determination of the nature and extent of those risks we are willing to take in pursuing our objectives in line with good corporate governance practice. In addition the UUG audit committee regularly reviews the framework's effectiveness, and the group's compliance with it, reporting its findings to the UUG board.

Key features and developments over the last year

Key features for 2013/14 relate to the ongoing dominance of regulatory risks and the uncertainty which these continue to pose.

There continues to be one ongoing piece of material litigation worthy of note but, 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 company's financial position is remote.

- In March 2010, Manchester Ship Canal Company (MSCC) issued proceedings against United Utilities Water PLC (UW) alleging that UW was trespassing as a result of it discharging into the canal. MSCC is seeking damages and other relief. UW won a 'summary judgment' application regarding a significant element of the claim but an appeal of that judgment was considered by the Supreme Court at the beginning of May. We await the court's decision.

Also notable was the extent of mitigating activity across the business in response to the changing regulatory environment and our commitment to be a leading water and wastewater company and service provider. This included significant progress in customer satisfaction, operational service performance and environmental assessments carried out by the Environment Agency. In addition there was a step forward following activities tied to our ongoing commitment to a continuous and secure supply of water with a successful inspection of the largest aqueduct in Europe, detecting no urgent structural maintenance

Strategic report (continued)

required. Ongoing business change and transformation programmes also featured heavily during the year in both the wholesale and business retail businesses preparing for the opening of the English market in 2017. Ongoing innovative initiatives also played a key part in business transformation with a focus on reducing operating cost and the cost to serve.

Looking ahead

Following the price determination, we expect our risk profile to return to one based on operational performance, compliance and delivery risk. The ongoing development of the non-household market, including the extent of competitor activity and customer switching rates will continue to be a focus as will the uncertainty surrounding the form of upstream competition for water and sewerage services.

Determination of the principal risks

The five principal risks summarised below have been determined by considering our entire risk profile relative to the five principal risk categories contained within the group's Corporate Risk Framework (Strategic, Financial, Operational, Compliance and Hazard), drawing out key circumstances where there is a potential for material effect. In each case the summary illustrates a list of current issues and uncertainties along with the extent of control/mitigation to manage these areas.

Strategic Risk

1. The regulatory environment

Current issues or areas of uncertainty include:

- i) The PR14 price determination will reflect a lower assumed weighted average cost of capital (WACC) and may reflect lower cost allowances than incorporated in our proposed business plan. Regulatory penalties relating to the current regulatory period are also possible
- ii) Market reform (see 2 below)
- iii) Compliance with regulations (see 4 below)

Potential impact

Our proposed business plans are subject to final determination from Ofwat which may reflect a different view of the appropriate scope and/or cost of delivering customer benefits. Longer-term and less frequent changes to the mechanism may also cause increased costs of administration and also reduce income and margin. The water and wastewater sectors in England and Wales have benefitted from a stable and transparent regulatory regime based on a regulatory capital value. The evolution of regulation in the sector may involve incremental changes to this model, more variations in returns and, consequently, changes to the risk and return profile of companies operating in the sector.

Control/mitigation

Our business plan has been prepared based on extensive research and consultation from a wide range of stakeholders including customers, environmental and quality regulators and others in order to ensure that it is both affordable and sustainable, meets statutory and legal obligations, strikes an appropriate balance between the needs of customers and the environment, whilst still being financeable by investors.

We engage in relevant government and regulatory consultations and initiatives which may affect the future strategic decisions made about policy and regulation in the sectors where we operate. In addition, we proactively consider all the opportunities and threats associated with any potential change, exploiting opportunities and mitigating risks where appropriate.

Strategic report (continued)

2. Competition in the market

Current issues or areas of uncertainty include:

- i) Market reform including competition in the non-household retail sector
- ii) Competitor positioning in the market
- iii) Upstream reform
- iv) Compliance with regulations (see 4 below)

Potential impact

The opening of the market for retail services to non-household customers in England generates both opportunities to gain market share and scale in the group's non-regulated business, and risks of losing market share and margin erosion in the company. Longer-term, upstream competition has the potential to generate issues relating to underutilisation or stranding of assets, although there is much uncertainty surrounding the development of upstream competition.

Control/mitigation

United Utilities looks to retain existing and acquire new customers by striving to meet their needs more effectively. We monitor competitor activity and target a reduction in operating costs. We continue to engage with government and regulators on the shape of future competition and are actively engaged in the Open Water programme.

Financial Risk

3. The economy

Current issues or areas of uncertainty include:

- i) Stability of the world economy
- ii) Speed of economic recovery
- iii) Stability of financial institutions
- iv) Socio-economic deprivation in the North West
- v) Welfare Reform and the impact on domestic bad debt

Potential impact

Adverse market conditions can impact the company's profitability and financial condition in a number of ways. These range from price rises for goods and services affecting profit and cash flow to the availability and/or cost of funding and hedging. It may also lead to increased customer bad debt with the North West suffering a higher level of socio-economic deprivation than any other region of the UK. Differentials to predicted financial instrument yields can also affect the economic return on the RCV and on our pension schemes with a requirement for the company to make additional contributions. In extreme but remote cases adverse conditions can affect our debt obligations and credit rating and the ability of our financial counterparties to meet their debt obligations to us.

Control/mitigation

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 company also employs hedging strategies to stabilise market fluctuation for inflation, interest rates and commodities (notably energy prices). Sensitivity analysis is carried out as part of the

Strategic report (continued)

business planning process, influencing the various financial limits employed. Continuous monitoring of the markets takes place including equity movements.

Within our operations, contract and category management covers supplier price and price volatility of goods and services and the effect of the economy on our customers is monitored. We adopt best practice collection techniques including the segmentation of customers based on their credit risk profile.

Compliance Risk

4. Failure to comply with applicable law or regulations

Current issues or areas of uncertainty include:

- i) Ongoing legal, economic, environmental and regulatory requirements associated with operating in a highly regulated business
 - ii) Market reform (see 2 above)
 - iii) Material litigation
- Potential Impact

In addition to general UK and international laws, our activities are subject to significant additional obligations. In the context of changes in the regulatory environment there is a risk that we fail to adopt policies /processes to ensure compliance with emerging requirements. It is also difficult to predict the impact of future changes to laws or regulations or the introduction of new law or regulations that affect us and, from time to time, interpretation of existing laws or regulations may also change or the approach to enforcement may become more rigorous. We could face a range of impacts from this. These include financial payments, penalties (of up to 10 per cent of relevant regulated turnover), the imposition of an enforcement order requiring additional capital/operating expenditure or compensation following litigation. It could also lead to high levels of scrutiny by regulators, enforcement agencies or authorities with associated increase in operational costs. In more extreme but remote circumstances, impacts could ultimately include licence revocation or the appointment of a special administrator.

Control/mitigation

The company has robust processes in place to identify risks to its compliance with legal and regulatory obligations and seeks to take appropriate action to ensure compliance. This includes continually monitoring legislative and regulatory developments, the training of employees in new developments and the participation in consultations to influence their outcome, either directly or through industry trade associations for wider issues. Funding for any additional compliance costs in the regulated business is sought as part of the price determination process. The company also robustly defends litigation where appropriate and seeks to minimise its exposure by establishing provision and seeking recovery wherever possible.

Operational and Hazard Risk

5. Operational and Hazardous Events

Current issues or areas of uncertainty include:

- i) Future abstraction licencing
- ii) Supply demand balance in West Cumbria
- iii) Weather conditions
- iv) Population growth
- v) Investment requirements in wastewater infrastructure
- vi) Excavation, tunnelling and construction work

Strategic report (continued)

Potential Impact

Caused by both internal and external factors, operational impacts can range from performance related issues, such as leakage or discharge consent breaches to service related issues such as operational/asset failures and the effect on quality, supply or flooding. In exceptional and extremely remote circumstances which may include human error or malicious intervention, the impact could be more significant ranging from environmental damage, economic and social disruption to loss of life.

Depending on the circumstances the company could be exposed to increased regulatory scrutiny, regulatory penalties and/or additional operating or capital expenditure. In the more extreme situations the company could also be fined for breaches of statutory obligations, be held liable to third parties and sustain reputational damage.

Control/mitigation

Controls and mitigation relate to our core business processes, focusing on preventing negative impacts in order to support high levels of customer service and operation in a reasonable manner. Forecasting and monitoring is a fundamental element of our operational activity, with robust quality assurance procedures, risk assessments and rigorous sampling/testing regimes in place. Ongoing network maintenance and capital programmes aim to enhance standards and integration across the water and wastewater networks for both service and resilience. We also undertake major education programmes in both water usage and appropriate disposal into the sewer network in an attempt to minimise operational issues. In support of this, physical and technological security measures to protect the operational capability from malicious or accidental activity and governance and inspection regimes exist for key infrastructure assets (including aqueducts, dams, reservoirs and treatment works). We have also developed a strong safety and health and environmental culture throughout the organisation supported by health and safety management (HSMS) and environmental management systems (EMS) which are certified to OHSAS18001 and ISO14001 respectively.

Recognising that events can materialise we operate long-standing responsive controls. These include well tested and appropriately resourced incident response, business continuity, disaster recovery and escalation procedures which continue to be refined. We also maintain insurance cover in relation to losses and liabilities likely to be associated with significant risks, although potential liabilities arising from catastrophic events could exceed the maximum level of cover that can be obtained cost-effectively. The licence of the regulated business also contains a 'shipwreck' clause that, if applicable, may offer a degree of recourse to Ofwat/customers (by way of an interim determination) in the event of a catastrophic incident.

The Strategic report was approved by the board on 5 June 2014 and signed on its behalf by:

JR Houlden
Director



Directors' report

The directors present their report and the audited financial statements for the year ended 31 March 2014.

Profit and dividends

The results for the year, set out in the profit and loss account on page 53, show that profit for the year after tax was £667.2 million (2013: £234.6 million).

The directors have not recommended a final ordinary dividend (2013: £nil). An interim ordinary dividend of £153.0 million has been declared and paid during the year (2013: £223.5 million).

Principal activity

The principal activity of the company is to provide water and wastewater services in the North West of England. A description of the company's principal activities and business review together with the company's business model can be found within the Strategic Report earlier on within this annual report. The company is a public limited company registered in England and Wales.

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

Political and charitable donations

The company 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 company and political stakeholders. This includes promoting the company's activities at any of the main political parties' annual conferences, and occasional stakeholder engagement in Westminster.

The period 2013/14 saw us engage with our stakeholders along a number of policy themes as the Water Bill made its way through Parliament and Market Reform planning continued. The company incurred expenditure of £12,235 (2013: £16,211) as part of this process.

Research and development

The company 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.

The company 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 company also undertakes specific projects with these and other research and development providers, manufacturers and with universities.

Research and development costs expensed by the company totalled £2.4 million in the year ended 31 March 2014 (2013: £1.3 million). Development costs capitalised by the company amounted to £1.2 million in the year ended 31 March 2014 (2013: £0.6 million).

Events after the balance sheet date

There were no events arising after the balance sheet date that require recognition or disclosure in the financial statements for the year ended 31 March 2014.

Going concern

The directors' considerations in preparing these financial statements on a going concern basis are set out in the corporate governance report.

Directors' report (continued)

Directors

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

Non-executive directors

Dr CED Bell

P Heiden (retired 26 July 2013)

Dr JDG McAdam

NR Salmon

M Clare (appointed 1 November 2013)

SV Weller

BM May

Executive directors

JR Houlden

SL Mogford

SR Fraser (appointed 1 April 2013)

Company secretary

SR 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 company's business.

Directors' indemnities and insurance

The company has in place contractual entitlements for 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. The company 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.

Supplier payment policy and practice

Payment terms are specific to the type of contract and the relevant commercial arrangements, and are agreed with suppliers in advance. As at 31 March 2014, the average credit period taken for trade purchases was 39 days (2013: 49 days).

Financial instruments

The risk management objectives and policies of the company in relation to the use of financial instruments can be found in note 20 to the financial statements.

Directors' report (continued)

Tangible assets

The company holds significant land assets; however, the vast majority of these are water catchment assets which are an integral and essential part of the operation of the company's regulated business. The nature of these assets, which are primarily moorland areas and which could not be sold by the company, means that it is impractical to obtain meaningful market values for the land. Other land owned by the company, the majority of which relates to operational sites, does not have a market value materially different from historic cost.

Regulation

As required by paragraph 3.1 of Condition K of the Instrument of Appointment granted by the Secretary of State for the Environment of the company as a water and sewerage undertaker under the Water Industry Act 1991 ('the Licence'), the directors state that they are satisfied that as at 31 March 2014, if a special administration order had been made under section 23 of the Water Industry Act 1991 in respect of U UW, the company would have had available to it sufficient rights and assets (not including financial resources) to have enabled the special administrator to manage the affairs, business and properties of the company so that the purpose of the order could have been achieved.

The directors have issued a certificate under Condition F6A of the Licence stating that the company will have available to it sufficient financial and management resources and facilities to enable it to carry out, for at least 12 months, its regulated activities. This certificate also confirms that all contracts entered into with any associated company included all necessary provision and requirements concerning the standard of service to be supplied by the company to ensure that it is able to meet all its obligations as a water and sewerage undertaker.

The contract of appointment with the auditor satisfies the requirements of paragraph 9.2 of Condition F of the Licence, namely that 'the auditor will provide such further explanation or clarification of its reports, and such further information in respect of the matters which are the subject of its reports, as the Director General may reasonably require.

Regulatory accounts measures

	2014 £m	2013 £m
Appointed business only:		
Operating profit per historical cost profit and loss account	677.2	635.9
Exceptional operating costs *	4.4	2.6
Underlying operating profit	<u>681.6</u>	<u>638.5</u>

Atypical operating expenditure items

In accordance with the requirements of Ofwat's Regulatory Accounting Guidelines, atypical items including those items treated as exceptional operating costs under the requirements of UK accounting standards are analysed as follows:

	2014 £m	2013 £m
Severance related restructuring costs *	4.4	2.6

* see note 4 of the statutory financial statements

Directors' report (continued)

Significant movements in Infrastructure Renewals Charge and Current Cost Depreciation

The annual infrastructure renewals charge is based on infrastructure renewals spend for 2013/14, the Company Business Plan for Asset Management Plan (AMP) 5 and the Final Business Plan projections for AMP 6 and AMP 7 covering the period 2010 to 2025. The charge for the year ended 31 March 2014 is £145.2 million (2013: £149.6 million).

The current cost depreciation charge (net of deferred credits) for the year is £427.2 million (2013: £421.2 million). This increase of £6.0 million is mainly due to the impact of the 2.5 per cent RPI uplift of the asset base and increased depreciation from assets commissioned in the year, offset by depreciation on assets which became fully depreciated in the year, and lower accelerated depreciation in the year ended 31 March 2014.

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 company'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 company'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

Our board has decided to recommend KPMG LLP to be appointed as external auditor to the company at the AGM and an authority for the directors to set the remuneration of the auditor will also be sought.

Approved by the board and signed on its behalf by:



JR Houlden
Director
5 June 2014

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

The directors are responsible for preparing the Strategic Report, the Directors' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with UK Accounting Standards and applicable law (UK Generally Accepted Accounting Practice).

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

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

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

Corporate governance report

From John McAdam, Chairman:

At United Utilities we aspire to the highest standards of board leadership, transparency and governance, both at the regulated company board, United Utilities Water PLC ('UUW' or 'the company') and also at the board of its listed ultimate holding company United Utilities Group PLC ('UUG').

The UK Corporate Governance Code

UUW, as required by its licence, has also had regard to the UK Corporate Governance Code ('the Code', the current version of which was published by the Financial Reporting Council in 2012) since 2008. The company, in agreement with Ofwat, operates a structure that allows directors to be members of the boards of both the company and its ultimate holding company UUG in order to increase the efficiency and effectiveness of the corporate governance structure. These arrangements have been in place from the end of March 2011 and were in place throughout the year ended 31 March 2014. The only exception is Steven Fraser, managing director of the company's wholesale business, who was appointed as a director of UUW (only) on 1 April 2013. His appointment provides the UUW board with additional insight into the operational challenges faced by the company.

In January 2014, Ofwat issued its final 'Board leadership, transparency and governance – regulated company principles', and in April 2014, the final corresponding holding company principles. This was to develop governance standards in water industry holding companies and their regulated subsidiary companies and to encourage companies to self-regulate and adopt and publish voluntary codes of governance. A copy of our voluntary code can be found on our website at:

<http://corporate.unitedutilites.com/corporate-governance.aspx>

United Utilities, both at UUG and UUW levels, fully supports Ofwat's drive for the highest standards of board leadership, transparency and governance in the industry and is fully cognisant of the long-term nature of the industry and its stewardship of UUW and its assets, for future generations of customers. The boards of both UUG and UUW are satisfied that current practices and the application of the Code at both holding company and regulated company levels are entirely consistent with the principles proposed by Ofwat.

As a listed company and the ultimate holding company of UUW, UUG already complies with the Code, and did so fully for the year ended 31 March 2014. The UUW board complies with the spirit of the Code and follows the 'comply or explain' regime. The departures from the Code (primarily relating to the appointment of board committees) are explained at the end of this report. Although UUW does not duplicate the board committees already operating at the UUG level, it should be noted that UUW represents in excess of 98 per cent of the group's revenues. The activities of the UUG board committees, whose members are made up of entirely independent non-executive directors, are necessarily targeted towards UUW related matters, thus ensuring that the interests of UUW and its customers are safeguarded. Board meetings of UUG and UUW are, although 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.

The UUW directors are fully cognisant of their roles and responsibilities as directors of a regulated business. Collectively, the directors have many years of experience gained across a variety of areas and industries. Some have spent part of their careers overseas, and whilst there is a huge diversity in skills and experience, they have predominantly worked in regulated industries as is appropriate to UUW's business. 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 to the UUG board. Board succession is kept continually under review, in fact, the refreshing of the board is being maintained for the third consecutive year arising as a result of natural turnover, Nick Salmon steps down from the board in July 2014.

Corporate governance report (continued)

The board of directors

The biographical details of our directors are given on pages 47-51 and the details of the directors who served during the year and their attendance at scheduled board meetings are set out in the table below (figures shown in brackets show the maximum number of meetings which the directors could have attended).

Eight board meetings are scheduled each financial year and the board will meet more frequently if required. During the financial year ended 31 March 2014, eight meetings were held (financial year ended 31 March 2013: eight).

A number of additional meetings and telephone conferences were also held during the year. These additional meetings were mainly associated with the company's Price Review 2014 (PR14) submissions to Ofwat.

Board

Dr Catherine Bell	8 (8)
Mark Clare	2 (2)
Steve Fraser	7 (8)
Paul Heiden	4 (4)
Russ Houlden	8 (8)
Brian May	8 (8)
Dr John McAdam	8 (8)
Steve Mogford	8 (8)
Nick Salmon	8 (8)
Sara Weller	8 (8)

Notes:

(1) Paul Heiden retired from the board on 26 July 2013.

(2) Mark Clare was appointed to the board on 1 November 2013.

(3) Steve Fraser was appointed to the board on 1 April 2013. He was unable to attend one board meeting due to a pre-existing commitment which he had prior to joining the board.

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 as the regulated licence holder within the United Utilities group of companies. 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

Corporate governance report (continued)

and reviews the company's approach to business planning, risk management and development of policies including health and safety.

The board has formally delegated specific responsibilities to the executive capital investment committee to consider and approve expenditure and investment proposals within limits determined by the board and the internal control manual. The committee consists of the chief executive officer and the chief financial officer together with members of the senior management team. Any projects in excess of £50 million are approved by the UUG board. Additionally, the UUG board has oversight of any project in excess of £50 million and any project which materially increases the group's risk profile. The UUG board has a schedule of matters reserved for its own decision, a copy of which can be found on the United Utilities website at <http://corporate.unitedutilities.com/corporategovernance.aspx>. There are no specific matters relating to the operation of the regulated activities of UUG that are included therein.

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

UUG board activity in 2013/2014

Customer

- considered and approved the Charges Submission for 2014/15
- met on two occasions with representatives of the 'Customer Challenge Group' to discuss and debate the impact on customers of the company's plans for the next five year period
- were kept updated on UUG performance on Service Incentive Mechanism, Serviceability indicators, water service and leakage, wastewater services and water levels and reservoir stocks.

Business as usual

- briefed on UUG's capital programme and project portfolio by the Capital Delivery Director
- received updates on health and safety and on the Security and Emergency Measures Direction
- approved a number of projects that were above delegated limits and which required UUG board approval
- via the CEO's Operations Reports received updates on UUG's top 10 capital projects and recent health and safety accidents and near misses.

Regulatory and Governance

- debated on a monthly basis about progress with the price review submission process and received briefings from the Regulation Director.
- received quarterly updates on UUG's DWI water quality performance.
- received updates on the annual Regulatory Reporting process to Ofwat and reviewed and approved the 2013 Risk and Compliance Statement and KPI report. Approved the sale of a non-operational impounding reservoir.
- received an annual briefing on dam and reservoir safety.
- approved the August 2013 Data Submission as part of PR14.
- extensively debated and approved the PR14 Business Plan and listened to reports from advisors, consultants and internal and external audit on the Business Plan.
- noted the retirement of Paul Heiden from the UUG board and approved the appointment of Mark Clare as an independent non-executive director to the UUG board.
- approved the publication of UUG's Strategic Direction Statement.
- approved the change to Ofwat Licence Condition N.

Corporate governance report (continued)

- discussed extensively Ofwat's Board leadership, transparency and governance principles and being kept abreast of developments and responded to Ofwat on the matter and approving and publishing a voluntary code on the matter.
- granted Powers of Attorney to senior managers to authorise treasury and property related matters

Financial

- reviewed UUW's proposed treasury activities for 2013/14
- approved UUW's interim and final dividends and dividend policy
- Considered actuarial valuations for UUW's pension schemes.

Board composition

During the year, (apart from between 26 July 2013 and 1 November 2013 when Paul Heiden retired from the board and Mark Clare was appointed to the board respectively), five independent non-executive directors served on the UUW board (in addition to the non-executive Chairman and the three executive directors). This exceeded the company's licence obligation of three independent non-executive directors. As agreed with Ofwat, the non-executive directors will not be appointed to the board of any other group company other than UUG. Steven Fraser was appointed to the board as an additional executive director on 1 April 2013, he previously served on the board of the company between 15 July 2009 and 30 March 2011.

Senior independent director

Given the company's status as a subsidiary of UUG, the board had previously concluded that it was not appropriate to appoint a senior independent director. However, the senior independent director of UUG (Nick Salmon) provides a channel through which any concerns should be raised and he has also attended a number of Ofwat events throughout the year. When Nick retires from the board at the AGM of UUG on 25 July 2014, Mark Clare will assume the role of senior independent director of UUG.

Conflicts of interest

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

The directors are at all times fully mindful of the fact that they hold a directorship in both UUW and UUG (with the exception of Steven Fraser). Since UUG disposed of the majority of its non-regulated activities, the potential for situations where potential conflicts of interest could arise has significantly diminished. UUG and UUW 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

Corporate governance report (continued)

the board. A separate nomination committee is not felt to be necessary, as the succession planning needs of the board are dealt with by the UUG nomination committee.

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.

Induction and training

On joining the group directors receive a tailored induction programme, including an induction pack, time spent with other directors, the company secretary and the executive team. During the year, an induction programme for Mark Clare was planned and commenced. On appointment new directors are provided with information on the key duties of being a director of a regulated water company. This information is kept continually under review. During the year, the board's understanding of the regulatory environment in which the company operates was enhanced via additional briefings on the licence modification process. The board also received briefings on the preparation for the 2014 Price Review, retail competition, the treatment of customer debt as well as regular briefings on regulatory matters.

Performance evaluation

During the year the UUG board undertook an internally facilitated evaluation of its board, committees and directors which aimed to build upon the internally facilitated evaluation conducted during the previous year and the externally facilitated evaluation the previous year. Given that there is a high degree of overlap (and common board membership) between the UUG and UUG boards, the board evaluation posed questions that were relevant to both boards and the results and recommendations were also shared with both boards. (For further details see page 60 of the UUG accounts).

Internal controls and risk management

The board is responsible for determining the nature and extent of the risks that it is willing to take to achieve its strategic objectives and for ensuring that risk management and internal control systems are effectively managed across the business and receive an appropriate level of scrutiny. The board believes that the risk management processes are well embedded as business as usual activities.

The risks that must be managed are predominantly those of any water and wastewater company relating to its regulated activities and obligations. We adopt a prudent approach to the way in which we manage our business and the risks impacting it as is appropriate for a business that provides a vital service to our customers, that being said we are a commercial organisation operating within a regulated system and accepting some level of risk is a normal consequence of doing business. The UUG board is supported in this role by the UUG board and the UUG audit committee, the internal audit function, the financial control team and the external auditor in order to prevent duplication. The UUG audit committee, supported by the internal audit team, has an initial overview of these processes and provides information to the UUG board on the assessment of the suitability and effectiveness of these systems and processes throughout the business. It is the role of the board to ensure that the management team fully understand the risks associated with each activity of the business and that they undertake appropriate mitigating actions, ensuring that the activities of the group do not negatively impact UUG in accordance with the regulatory licence.

All areas of the business and support functions are responsible for monitoring changes to their areas of activity and identifying any associated risk as a result of these changes which might prevent us from

Corporate governance report (continued)

achieving our objectives and for identifying actions to mitigate those risks as far as is reasonably practicable and cost effective to do so. These internal control and risk management systems, which, are designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable and not absolute assurance against material misstatement or loss, have been in place continually for the year under review. The UUG board, supported by the UUG audit committee completed its annual review of the effectiveness of the risk management and internal control processes up to the date of the annual report in accordance with the revised Turnbull Guidance on Internal Control. There were no significant failings or weaknesses identified in this review.

Risks impacting the business due to regulatory matters have dominated board meetings. The principal risks and uncertainties to the business are explained on pages 30 to 34. We continue to work with all key parties to represent the best interests of our customers and stakeholders, and we are working hard to address future regulatory changes to our business in a pro-active manner.

Going concern

As part of its review of the financial report and accounts, the board considered whether the company had adequate financial resources to continue trading as a 'going concern'. FRC guidance requires that in order to be considered to be a 'going concern' the company should have adequate financial resources for at least 12 months from the date of approval of the financial statements.

The directors have a reasonable expectation that the company has adequate resources available to it to continue in operational existence for the foreseeable future and have therefore continued to adopt the going concern policy in preparing the financial statements. This conclusion is based on, amongst other matters, a review of the company's financial projections together with a review of the cash and committed borrowing facilities available to the company as well as consideration of the company's capital adequacy. In addition, the directors also considered the primary legal duty of United Utilities Water PLC's economic regulator, to ensure that the companies can finance their functions. The directors also took into account potential contingent liabilities and other risk factors as interpreted by the guidance given in 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009'.

Significant issues considered in relation to the financial statements

With regard to the UUG financial statements the UUG audit committee and the UUG board reviewed a number of principal areas of judgement, these are disclosed on pages 71 and 72 of the UUG accounts.

External Auditor

The company adheres to the UUG policy on non-audit services provided by the external auditor and in relation to auditor independence (see page 70 of the UUG accounts). The company's licence requires the preparation of audited regulatory accounts, given the statutory accounts. However, given the statutory accounts are already audited by KPMG, there are cost savings if KPMG also audits the regulatory accounts. Information on the assessment of the effectiveness of the external audit process can be found on page 70 of the UUG accounts.

The group last tendered its statutory audit in March 2011 when Deloitte were replaced by KPMG. The appointment of statutory auditor is a role delegated to the UUG audit committee, the committee intends to tender the audit at least every ten years and more frequently if thought beneficial to the needs of the business or in accordance with any new audit tender requirements.

Licence Obligations

The board receives reports about the performance of the company, and annually approves the Risk and Compliance Statement (the 'statement'). The statement sets out how the board pays particular regard, the awareness of and how it meets the obligations of its Licence.

Corporate governance report (continued)

Directors' remuneration

The details of directors' remuneration, can be found on pages 120 to 125. Further information on the group's approach to executive remuneration can be found in the Remuneration report within the UUG accounts.

Departures from the Code

Section C of the Code – Accountability

UUG has an audit committee and the group has a well resourced internal audit function in place (to which the UUG board has access and which reports to the UUG board on matters such as the company's regulatory returns to Ofwat). Accordingly, because the work of the audit committee is largely undertaken on behalf of the company, which represents over 98 per cent of the group's revenues, the board concluded that having a separate audit committee for the company was not necessary. Membership of the audit committee consists entirely of independent non-executive directors who are also members of the UUG board.

Section D of the Code – Remuneration

The board concluded that having its own remuneration committee was not necessary and would not improve governance, in particular because key areas of executive directors' remuneration (such as share incentive plans) can only operate at a group level. The company remunerates its executive directors and senior management subject to the confines of UUG's remuneration policy. (For further details please see the remuneration report within the UUG accounts). In accordance with their letters of appointment the non-executive directors do not receive any remuneration from the company for their services to the UUG board. Membership of the remuneration committee consists entirely of independent non-executive directors who are also members of the UUG board.

Section E of the Code – 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 on this in its annual report.

United Utilities group structure

As a group, United Utilities has a simple corporate structure. UUG is the main listed entity with around 100,000 registered shareholders. Below UUG, there are two intermediate holding companies, one is United Utilities PLC (UUPLC)* (which is also the holding company for a number of non-regulated and legacy/dormant companies) and United Utilities North West Ltd (UUNW)**. The regulated company UUG is a direct subsidiary of UUNW which in turn is a direct subsidiary of UUPLC. Neither UUPLC nor UUNW are operational entities, but are retained in the structure for legacy and administrative reasons.

*United Utilities PLC – was the listed entity prior to July 2008, when the group underwent a scheme of arrangement as part of the return of value to shareholders of the electricity distribution business.

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

Corporate governance report (continued)

Biographical details of the board of directors

The biographies of the board of directors are as follows:

Dr John McAdam (66) **Chairman**

Responsibilities

Is 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.

Current directorships/business interests

Chairman of Rentokil Initial plc, senior independent director of J Sainsbury plc and a non-executive director of Rolls-Royce Holdings plc. He is also Chairman and a director of United Utilities Group PLC and Chairman of its nomination committee.

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. There have been no changes to John's directorships during the year ended 31 March 2014.

Skills and experience

With over 15 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, John has a wealth of experience on which to draw in his role as Chairman and leader of the board.

Steve Mogford (57) **Chief Executive Officer**

Responsibilities

To manage the company's business and to implement the strategy and policy approved by the board.

Qualifications

BSc (Hons) Astrophysics/Maths/Physics.

Appointment to the board

March 2011.

Current directorships/business interests

Senior independent director of Carillion PLC, vice-president of Liverpool School of Tropical Medicine. He is also Chief Executive Officer and a director of United Utilities Group PLC.

Career experience

Previously chief executive of SELEX Galileo, the defence electronics company owned by Italian aerospace and defence organisation Finmeccanica. Previously chief operating officer at BAE Systems PLC, and a member of its PLC board, he spent his earlier career with British Aerospace PLC.

Corporate governance report (continued)

Skills and experience

Steve's experience of the highly competitive defence market and complex design, manufacturing and support programmes has brought renewed focus to customer service and operational performance at United Utilities, and his perspective of the construction and infrastructure sector provides valuable experience relating to United Utilities' capital investment programme.

Dr Catherine Bell (63) **Independent non-executive director**

Qualifications

MA Geography, PhD Economic History.

Appointment to the board

March 2011.

Current directorships/business interests

Non-executive director and executive board member of the Department of Health and a non-executive director of National Grid Gas plc and National Grid Electricity Transmission plc. She is also an independent non-executive director of United Utilities Group PLC and chair of its corporate responsibility committee.

Career experience

Formerly a non-executive director of the Civil Aviation Authority and prior to that a former civil servant and acting permanent secretary at the Department for Trade and Industry. Previously a non-executive director of Ensus Limited and Swiss Re GB Plc.

Skills and experience

Catherine's civil service background and understanding of the operation of government departments and utility regulation is particularly valued given the regulated framework within which the business operates.

Mark Clare (56) **Independent non-executive director**

Qualifications

Chartered Management Accountant (FCMA).

Appointment to the board

November 2013.

Current directorships/business interests

Group chief executive at Barratt Developments plc. He is also an independent non-executive director of United Utilities Group PLC.

Career experience

Mark has been group chief executive at Barratt Developments plc since October 2006 and is also a 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 both within Centrica plc and British Gas. Mark has also been a non-executive director of BAA plc, the airports operator.

Skills and experience

As the CEO of a listed company, Mark brings additional current operational experience to the board. His time at British Gas and BAA means he has a strong background operating in a regulated environment which will be invaluable as will his extensive knowledge of customer facing businesses which is particularly valuable as the industry prepares for increased competition and pursues its continuous drive to

Corporate governance report (continued)

improve customer service. Lastly, his financial background is of great value as a member of the UUG audit committee.

Steve Fraser (38) **Managing director, U UW Wholesale**

Responsibilities

To manage U UW's wholesale operations and contribute to the management of the company's business.

Qualifications

(BA Hons) Management Studies, MSc Engineering Project Management.

Appointment to the board

April 2013 (had previously served as a director between July 2009 and March 2011).

Current directorships/business interests

Supervisory Council Member of AS Tallinna Vesi

Career experience

Steve Fraser joined United Utilities in 2005 from Bethell Group, where he was Operations Director. Prior to his current position of managing director, U UW Wholesale, he was responsible for running UU's Energy and Contracting Services business.

Skills and experience

Steve's experience in the construction and infrastructure sector provides the company with valuable expertise with regard to its drive for improvements in customer service, operations and capital expenditure.

Russ Houlden (55) **Chief Financial Officer**

Responsibilities

To manage the company's financial affairs and to contribute to the management of the company's business.

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.

Current directorships/business interests

Russ is a Member of the Supervisory Board and Chairman of the Audit Committee of Orange Polska SA, a fixed and mobile telecommunications company listed on the Warsaw and London stock exchanges. 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 and a director of United Utilities Group PLC.

Career experience

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

Corporate governance report (continued)

Skills and experience

Russ's experience in accounting, finance and treasury management in other competitive and regulated companies, along with his extensive experience of driving performance improvement and managing large capital expenditure programmes, provides the company with valuable expertise with regard to its drive for improvements in customer service, operations, capital expenditure and financing.

Brian May (50)

Independent non-executive director

Qualifications

BSc (Hons) Actuarial Science, Chartered Accountant ACA.

Appointment to the board

September 2012.

Current directorships/business interests

Finance director at Bunzl plc. He is also an independent non-executive director of United Utilities Group PLC and chair of its audit and treasury committees.

Career experience

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

Skills and experience

Brian joined Bunzl in 1993 as head of internal audit before becoming group treasurer, then finance director, Europe and Australasia, and is currently group 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 committee and the treasury committee of UUG.

Nick Salmon (61)

Independent non-executive director

Qualifications

BSc (Hons) Mechanical Engineering.

Appointment to the board

March 2011.

Current directorships/business interests

Senior independent director of Asia Resource Minerals plc. He is also the senior independent director of United Utilities Group PLC.

Career experience

Chief executive of Cookson Group plc until December 2012 when Cookson demerged to create two new listed companies, Vesuvius plc and Alent plc. Formerly executive vice-president of Alstom S.A. and of ABB Alstom Power and chief executive of Babcock International Group plc. Previous senior management positions held at GEC and GEC Alsthom in the UK and France and the China Light and Power Company, Hong Kong.

Skills and experience

As an experienced former CEO of two FTSE listed companies, Nick brings extensive executive experience to the board table. In addition, his considerable experience in the management of large capital construction projects supports the board's oversight of the capital investment programme.

Corporate governance report (continued)

Sara Weller (52)
Independent non-executive director

Qualifications
MA Chemistry.

Appointment to the board
March 2012.

Current directorships/business interests

Non-executive director of Lloyds Banking Group plc and lead non-executive director for the Department for Communities and Local Government. Sara is also a board member at the Higher Education Funding Council for England (HEFCE). She is also an independent non-executive director of United Utilities Group PLC and chair of its remuneration committee.

Career experience

Sara has wide-ranging business experience having worked for Mars, Abbey National and Sainsbury's and most recently as managing director of Argos from 2004 to 2011. She served as the senior independent director at Mitchells and Butlers from 2003 to 2006 and also chaired its remuneration committee from 2003 to 2010.

Skills and experience

Sara's experience of customer facing businesses, together with her knowledge of operating within a regulated environment, will be major assets to the board as the water industry prepares for the opening up of the sector to more competition and in improving customer service.

Independent auditor's report

to the members of United Utilities Water PLC

We have audited the financial statements of United Utilities Water PLC for the year ended 31 March 2014 set out on pages 53 to 88. The financial reporting framework that has been applied in their preparation is applicable law and UK Accounting Standards (UK Generally Accepted Accounting Practice).

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

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 39, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 March 2014 and of its profit for the year then ended;
- have been properly prepared in accordance with UK Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matter prescribed by the Companies Act 2006

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

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the 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.



John Luke (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
St James' Square
Manchester
M2 6DS

Profit and loss account

for the year ended 31 March

	Note	2014 £m	2013 £m
Turnover		1,670.0	1,604.7
Total net operating expenses	3	(991.3)	(969.4)
Operating profit before exceptional costs		683.1	637.9
Exceptional operating costs	4	(4.4)	(2.6)
Operating profit		678.7	635.3
Net interest payable and similar charges	7	(139.9)	(323.9)
Profit on ordinary activities before taxation		538.8	311.4
Taxation credit/(charge) on profit on ordinary activities	8	128.4	(76.8)
Profit after taxation	23	667.2	234.6

All of the results shown above relate to continuing operations.

Statement of total recognised gains and losses

for the year ended 31 March

	2014 £m	2013 £m
Profit after taxation	667.2	234.6
Actuarial (losses)/gains on defined benefit pension schemes (see note 21)	(191.8)	33.0
Taxation on items taken directly to equity (see note 8c)	39.7	(7.7)
Total recognised gains for the year	<u>515.1</u>	<u>259.9</u>

Reconciliation of movements in shareholders' funds

for the year ended 31 March

	2014 £m	2013 £m
Profit after taxation	667.2	234.6
Dividends paid on equity shares (see note 9)	(153.0)	(223.5)
Actuarial (losses)/gains on defined benefit pension schemes (see note 21)	(191.8)	33.0
Taxation on items taken directly to equity (see note 8c)	39.7	(7.7)
Net increase in shareholders' funds	<u>362.1</u>	<u>36.4</u>
Opening shareholders' funds	2,053.7	2,017.3
Closing shareholders' funds	<u>2,415.8</u>	<u>2,053.7</u>

Balance sheet

at 31 March

	Note	2014 £m	2013 £m
Fixed assets			
Intangible assets	10	1.8	0.6
Tangible assets	11	9,029.8	8,650.7
Investments	12	0.1	0.2
		<u>9,031.7</u>	<u>8,651.5</u>
Current assets			
Stocks		9.3	5.6
Debtors: amounts falling due within one year	13a	476.9	420.4
Debtors: amounts falling due after more than one year	13b	363.7	505.8
		<u>849.9</u>	<u>931.8</u>
Creditors: amounts falling due within one year			
Trade and other creditors	14a	(422.1)	(437.4)
Borrowings	14b	(221.3)	(308.4)
		<u>(643.4)</u>	<u>(745.8)</u>
Net current assets		<u>206.5</u>	<u>186.0</u>
Total assets less current liabilities		<u>9,238.2</u>	<u>8,837.5</u>
Creditors: amounts falling due after more than one year			
Trade and other creditors	15a	(132.2)	(289.0)
Borrowings	15b	(6,216.0)	(6,119.9)
		<u>(6,348.2)</u>	<u>(6,408.9)</u>
Provisions for liabilities	17	(357.7)	(404.2)
Net assets excluding pension (liability)/surplus		<u>2,532.3</u>	<u>2,024.4</u>
Pension (liability)/surplus	21	(116.5)	29.3
Net assets including pension (liability)/surplus		<u>2,415.8</u>	<u>2,053.7</u>
Capital and reserves			
Called up share capital	22, 23	1,025.3	1,025.3
Share premium account	22, 23	647.8	647.8
Profit and loss account	23	742.7	380.6
Shareholders' funds		<u>2,415.8</u>	<u>2,053.7</u>

The financial statements of United Utilities Water PLC, registered number 2366678, were approved by the board of directors on 5 June 2014 and signed on its behalf by:



JR Houlden
Director

Cash flow statement

for the year ended 31 March

	2014 £m	2013 £m
Net cash inflow from operating activities (see note 25)	1,122.0	987.2
Returns on investments and servicing of finance		
Interest received	1.3	-
Interest paid	(173.4)	(170.2)
Non-equity dividends paid	(9.1)	(13.7)
Net cash outflow from returns on investments and servicing of finance	<u>(181.2)</u>	<u>(183.9)</u>
Taxation	(4.4)	(84.8)
Capital expenditure and financial investment		
Purchase of tangible fixed assets	(896.3)	(783.3)
Purchase of intangible assets	(1.2)	(0.6)
Grants and contributions received	20.3	24.0
Proceeds from sale of tangible fixed assets	2.3	1.6
Proceeds from sale of investments	0.1	-
Net cash outflow for capital expenditure and financial investment	<u>(874.8)</u>	<u>(758.3)</u>
Equity dividends paid (see note 9)	(153.0)	(223.5)
Cash outflow before management of liquid resources and financing	<u>(91.4)</u>	<u>(263.3)</u>
Financing (see note 27)	161.7	168.0
Increase/ (decrease) in cash and overdraft in the year	<u><u>70.3</u></u>	<u><u>(95.3)</u></u>

Notes to the financial statements

1. Accounting policies

The following accounting policies have been applied consistently throughout both the current and prior year.

Basis of preparation of financial statements

The financial statements of United Utilities Water PLC have been prepared in accordance with applicable United Kingdom accounting standards and, except for the treatment of certain grants and contributions (see below), with the Companies Act 2006. The financial statements have been prepared on the historical cost basis, except for the revaluation of financial instruments.

Going concern

The directors have set out factors considered on concluding the appropriateness of the going concern basis of preparation in the going concern section of the corporate governance report.

Related party transactions

The company has taken advantage of the exemption contained in Financial Reporting Standard 8 'Related party transactions' not to disclose transactions or balances with entities which form part of the group headed by United Utilities Group PLC.

Turnover

Turnover represents the income receivable in the ordinary course of business for services provided and excludes VAT. This includes the sales value of an estimate of the units supplied between the date of the last meter reading and the billing date.

The company recognises turnover generally at the time of delivery and when collection of the resulting debtors is reasonably assured. Should the company consider that the criteria for turnover recognition are not met for a transaction, turnover recognition would be delayed until such time as the transaction becomes fully earned or collectability is reasonably assured. Payments received in advance of turnover recognition are recorded as deferred income.

Research and development

Research and development expenditure is written off as incurred, except that when development expenditure incurred on an individual project is carried forward when its future recoverability can be reasonably regarded as assured. Any expenditure carried forward is amortised in line with the expected future income from the related projects.

Tangible fixed assets

Tangible fixed assets comprise infrastructure assets (mains, sewers, impounding and pumped raw water storage reservoirs, dams, sludge pipelines and sea outfalls) and other assets (including land and buildings and overground plant and machinery). Employee and other related costs that are directly attributable to implementing the capital schemes of the company are capitalised. Finance costs incurred in respect of the construction of tangible fixed assets are expensed as incurred.

Infrastructure assets

Infrastructure assets comprise a network of water and wastewater systems consisting of mains and sewers, impounding and pumped raw water storage reservoirs, sludge pipelines and sea outfalls. Expenditure on the infrastructure assets relating to increases in capacity or enhancements of the network are treated as additions, as are asset replacements to maintain the operating capability of the network in accordance with defined standards of service. Additions are included at cost after deducting related grants and contributions. Repairs to infrastructure assets are treated as operating expenditure.

The depreciation charge for infrastructure assets ("Infrastructure Renewals Charge") is the estimated level of annual expenditure required to maintain the operating capability of the network, less the estimated level of relevant annual grants and contributions, which is based on the company's independently certified asset management plan covering a five year period.

Notes to the financial statements (continued)

1. Accounting policies (continued)

Tangible fixed assets (continued)

Other assets

Additions are included at cost. Freehold land is not depreciated nor are assets in the course of construction until commissioned. 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, which are principally as follows:

- Buildings 10-60 years
- Operational assets 5-80 years
- Fixtures, fittings, tools and equipment (including computer software) 3-40 years

Depreciation on these assets commences in the month following commissioning.

Carrying value of tangible fixed assets

The carrying values of tangible fixed assets are reviewed for impairment wherever circumstances indicate that the carrying value of such assets may not be recoverable.

Grants and contributions

Grants and contributions receivable in respect of other tangible fixed assets, other than those relating to infrastructure assets, are treated as deferred income and released to the profit and loss account over the useful economic lives of the corresponding assets.

Grants and contributions receivable in respect of infrastructure assets are deducted from the cost of those assets.

The Companies Act (CA) 2006 provides that where grants and contributions are received in relation to tangible assets, the assets are stated at their purchase price or production cost and that the capital contributions are treated as deferred income and released to the profit and loss account over the useful economic life of the corresponding assets. However the directors are of the opinion that infrastructure assets do not have determinable finite useful economic lives and therefore, the capital contributions would remain in the balance sheet in perpetuity. Observing Section 393 of the CA, the directors conclude that the treatment otherwise required by the CA would not present a true and fair view of the company's effective investment in these assets. The financial effect of this accounting policy is set out in note 11.

Those grants and contributions relating to the maintenance of the operating capability of the infrastructure network are taken into account in determining the depreciation charged for infrastructure assets.

Leased assets

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 leases

Operating lease rentals are charged to the profit and loss account on a straight line basis over the period of the lease.

Stocks

Stocks are stated at the lower of cost and net realisable value.

Pensions

The company participates in the following pension schemes sponsored by the United Utilities group of companies: the United Utilities Pension Scheme (UUPS) and the United Utilities PLC Group of the Electricity Supply Pension Scheme (ESPS). UUPS has both a funded defined benefit section and a defined contribution section. The defined contribution section constitutes around 2 per cent of the total asset value of UUPS. ESPS is a funded defined benefit scheme. Both defined benefit schemes are closed to new employees.

Notes to the financial statements (continued)

1. Accounting policies (continued)

Pensions (continued)

Under FRS 17 'Retirement benefits', the current service cost is calculated using the projected unit credit method and will therefore normally increase as the members of the scheme approach retirement. The assets of the pension schemes are held in trust funds that are independent of the company's finances.

Actuarial valuations of the defined benefit schemes are performed at intervals of not more than three years and the rates of contribution payable are determined on agreement between the company and the Trustees on the advice of the actuary for each scheme having regard to the results of these actuarial valuations. In any intervening years, the actuaries review the continuing appropriateness of the contribution rates. The last actuarial valuations were carried out as at 31 March 2013.

Defined benefit assets are measured at fair value while liabilities are measured at present value. The difference between the two amounts is recognised as a surplus or obligation in the balance sheet.

The cost of providing pension benefits to employees relating to the current year's service (including curtailment gains and losses) is included within the profit and loss account within employee costs. The difference between the expected return on schemes' assets and interest cost on schemes' liabilities is included within the profit and loss account within net interest payable.

The actuarial assumptions adopted are determined by the company after taking advice from its actuarial advisers, Aon Hewitt Limited. The actuarial assumptions adopted affect the operating results and profit on ordinary activities before taxation and are disclosed in note 21; they include assumptions for the long-term investment return expected to be achieved on the schemes' assets and the long-term increases expected to apply to pensionable earnings, pension increases and deferred pension increases. Actual experience may differ from the assumptions adopted.

In addition, the company participates in the defined contribution section of the UUPS. Payments are charged to the profit and loss account as employee costs as they fall due. The company has no further payment obligations once the contributions have been paid.

The disclosure requirements of FRS 17 'Retirement benefits' are set out in note 21, together with details of pension and funding arrangements.

Financial instruments

Financial assets and financial liabilities are recognised and derecognised on the company's balance sheet on the trade date when the company becomes/ceases to be a party to the contractual provisions of the instrument.

Cash and current asset investments

Cash and current asset investments 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 cash flow statement and related notes, cash is stated net of bank overdraft.

Financial investments

Investments (other than short-term deposits) are initially measured at fair value, including transaction costs. Investments classified as available-for-sale 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 debtors

Trade debtors 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 debtor balance.

Trade creditors

Trade creditors are initially measured at fair value and are subsequently measured at amortised cost.

Notes to the financial statements (continued)

1. Accounting policies (continued)

Financial instruments (continued)

Financial liabilities and equity

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into. An equity instrument is any contract that evidences a residual interest in the assets of the company after deducting all of its liabilities.

Equity instruments

Equity instruments issued by the company are recorded at the proceeds received, net of direct issue costs.

Borrowing costs and finance income

All borrowing costs and finance income that are not directly attributable to the acquisition, issue or disposal of a financial asset or financial liability are recognised in the profit and loss account in the period in which they are accrued. 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.

Borrowings

The company's default treatment is that bonds, loans and overdrafts are initially measured at fair value being the cash proceeds received net of any direct issue costs. They are subsequently measured at amortised cost applying the effective interest method. The difference between the net cash proceeds received at inception and the principal cash flows due at maturity is accrued over the term of the borrowing.

The default treatment of measuring at amortised cost, whilst associated hedging derivatives are recognised at fair value, presents an accounting measurement mismatch that has the potential to introduce considerable volatility to both the income statement and the statement of financial position. Therefore, where feasible, the company takes advantage of the provisions under FRS 26 'Financial Instruments: Recognition and Measurement' to fair value its borrowing instruments to reduce this volatility and better represent the economic hedges that exist between the company's borrowings and associated derivative contracts.

Where feasible, the company 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 net interest payable in the profit and loss account.

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 net interest payable in the profit and loss account.

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 net interest payable in the profit and loss account.

The company enters into financial derivatives contracts to manage its financial exposure to changes in market rates (see note 20).

Notes to the financial statements (continued)

1. Accounting policies (continued)

Financial instruments (continued)

Derivatives and borrowings - valuation

Where an active market exists, designated borrowings and derivatives recorded at fair value are valued using quoted market prices. Otherwise, they are valued using a net present value 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 same 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.

The valuation of debt designated in a fair value hedge relationship is calculated based on the risk being hedged as prescribed by FRS 26 'Financial Instruments: Recognition and Measurement'. The company's policy is to hedge its exposure 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.

Provisions

Provisions are recognised when the company has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and the amount can be reliably estimated. Expenditure that relates to an existing condition caused by past operations and does not contribute to current or future earnings is expensed.

Taxation

Current tax is provided at amounts expected to be paid (or recovered) using the tax rates and laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax is recognised in respect of timing differences that have originated but not reversed at the balance sheet date where transactions or events that result in an obligation to pay more tax in the future or a right to pay less tax in the future have occurred. Timing differences are differences between the company's taxable profits and its results as stated in the financial statements that arise from the inclusion of gains and losses in tax assessments in periods different from those in which they are recognised in the financial statements.

Deferred tax is measured at the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse based on tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date. Deferred tax is measured on a discounted basis to reflect the time value of money over the period between the balance sheet date and the dates on which it is estimated that the underlying timing differences will reverse. The discount rates used reflect the post tax yields to maturity that can be obtained on government bonds with similar maturity dates and currencies to those of the deferred tax assets or liabilities.

Current and deferred taxation is charged or credited in the profit and loss account, except when it relates to items charged or credited to equity, in which case the taxation is also dealt with in equity.

2. Segmental information

The company operates in the United Kingdom in one class of business, which is the provision of water and wastewater services, therefore no segmental information is required to be disclosed.

Notes to the financial statements (continued)

3. Total net operating expenses

Operating profit is stated after charging:

	2014 £m	2013 £m
Employee costs (including directors)		
Wages and salaries	203.7	201.9
Social security costs	18.5	16.0
Post-employment benefits (see below)	25.8	20.9
	<u>248.0</u>	<u>238.8</u>
Less: charged to regulatory capital schemes	(122.6)	(114.8)
Charged to profit and loss account	<u>125.4</u>	<u>124.0</u>

Options over shares of the ultimate parent undertaking, United Utilities Group PLC, have been granted to employees of the company under various schemes. Details of the terms and conditions of each share option scheme are given in the United Utilities Group PLC Annual Report 2014. Included within wages and salaries is an expense of £4.4m (2013: £1.9m) relating to a recharge of share-based payment costs from the ultimate parent undertaking.

	2014 £m	2013 £m
Depreciation		
Non-infrastructure depreciation	300.8	298.6
Infrastructure depreciation (see note 11)	151.5	154.7
Total depreciation (see note 11)	<u>452.3</u>	<u>453.3</u>

	2014 £m	Re-presented* 2013 £m
Other operating expenses/(income)		
Property rates	87.6	80.2
Hired and contracted services	83.3	81.4
Power	62.7	60.1
Materials	50.4	54.4
Charge for bad and doubtful debts	37.1	35.5
Regulatory fees	36.2	34.3
Loss on disposal of tangible fixed assets	6.4	9.8
Operating leases:		
Land and buildings	3.4	2.7
Plant and machinery	0.8	0.9
Research expenditure	2.4	1.3
Rents receivable	(1.9)	(1.3)
Amortisation of grants and contributions (see note 16)	(6.9)	(6.7)
Other operating expenses	47.7	36.9
	<u>409.2</u>	<u>389.5</u>
Net operating expenses before exceptional costs	<u>986.9</u>	<u>966.8</u>
Exceptional operating costs (see note 4)	4.4	2.6
Total net operating expenses	<u>991.3</u>	<u>969.4</u>

*The comparatives have been re-presented to include regulatory fees of £34.3 million as a separate category, rather than within hired and contracted services and other as previously presented. In addition, auditor's remuneration is now included within other operating expenses, due to the inclusion of the table below.

Notes to the financial statements (continued)

3. Total net operating expenses (continued)

During the year, the company obtained the following services from its auditor, at the costs detailed below:

	2014 £000	2013 £000
Statutory audit - company	155	149
Regulatory audit service	30	30
Audit services	<u>185</u>	<u>179</u>
Audit related services	15	15
Other non-audit services	100	84
	<u>300</u>	<u>278</u>

The table below shows the nature of post-employment benefits:

	2014 £m	2013 £m
Defined benefit expense (see note 21)	17.7	15.4
Defined contribution pension costs (see note 21)	8.1	5.5
	<u>25.8</u>	<u>20.9</u>

4. Exceptional operating costs

	2014 £m	2013 £m
Restructuring costs	4.4	2.6
	<u>4.4</u>	<u>2.6</u>

5. Directors' emoluments

	2014 Number	2013 Number
Number of directors who received shares* in respect of qualifying services	3	2
Number of directors who exercised share* options	2	-
Number of directors with incentive plans vested	2	-

*Shares in the ultimate parent company United Utilities Group PLC.

	2014 £m	2013 £m
Aggregate emoluments in respect of qualifying services	4.7	4.0
Aggregate emoluments in respect of highest paid director	<u>2.0</u>	<u>2.0</u>

A recharge of £36,000 during the year ended 31 March 2014 (2013: £nil) was charged to other companies in the United Utilities group in relation to the provision of director services.

Details of the employee Sharesave scheme and the executive share option scheme operated by United Utilities Group PLC are given in that company's financial statements.

Notes to the financial statements (continued)

5. Directors' emoluments (continued)

All executive directors opted for a cash allowance in lieu of their defined contribution pension entitlement. No non-executive directors were members of the defined benefit section or the defined contribution section of the group's pension scheme during the year, nor were they entitled to a cash allowance in lieu of their defined contribution pension entitlement.

6. Employees

	Average 2014	Average 2013
Number of persons employed during the year	5,061	4,938

The 2014 employee costs of £248.0 million (2013: £238.8 million) disclosed in note 3 include the employee costs relating to the persons employed during the year noted above in addition to costs of £18.1 million (2013: £22.7 million) in relation to services provided by employees of United Utilities PLC who support U UW. These costs have been incurred directly by U UW 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 268 (2013: 358).

Notes to the financial statements (continued)

7. Net interest payable and similar charges

	2014 £m	2013 £m
Interest payable and similar charges		
On bank loans, overdraft and other loans	240.5	242.4
On borrowings from parent and fellow subsidiary undertakings	4.8	4.7
	<u>245.3</u>	<u>247.1</u>
Interest payable before preference share dividends and fair value adjustments		
Preference share dividends (see notes 9 and 14b)	9.1	9.1
	<u>254.4</u>	<u>256.2</u>
Fair value (gains)/losses on debt and derivative instruments ⁽¹⁾		
Fair value hedge relationships		
- Borrowings	(129.4)	73.9
- Designated swaps	116.2	(72.1)
	<u>(13.2)</u>	<u>1.8</u>
Financial instruments at fair value through profit or loss		
- Borrowings designated at fair value through profit or loss ⁽²⁾	(32.6)	17.6
- Held for trading derivatives – economic hedge	53.6	(13.5)
	<u>21.0</u>	<u>4.1</u>
Held for trading derivatives – 2010-2015 regulatory hedge	(68.0)	(12.6)
Held for trading derivatives – regulatory hedges > 2015	(67.6)	52.6
Held for trading derivatives – electricity hedges	4.2	1.5
Net payments on swaps and debt under fair value option	13.8	12.2
Held for trading derivatives – other ⁽³⁾	6.4	4.0
Other	(5.9)	(3.1)
	<u>(117.1)</u>	<u>54.6</u>
Net fair value (gains)/losses ⁽⁴⁾	<u>(109.3)</u>	<u>60.5</u>
Net pension interest (income)/expense (see note 21)	<u>(0.9)</u>	<u>7.3</u>
Total interest payable and other similar charges	<u>144.2</u>	<u>324.0</u>
Interest income		
External interest receivable and similar income	-	(0.1)
Interest receivable on taxation settlement	(4.3)	-
Total interest income	<u>(4.3)</u>	<u>(0.1)</u>
Net interest payable and similar charges	<u>139.9</u>	<u>323.9</u>

⁽¹⁾ Fair value losses on debt and derivative instruments includes foreign exchange gains of £25.8 million (2013: £4.6 million), excluding those on instruments measured at fair value through profit or loss. These gains are largely offset by fair value losses on derivatives.

⁽²⁾ Includes £11.1 million of losses (2013: £1.5 million) on the valuation of debt reported at fair value through profit or loss due to changes in credit spread assumptions.

⁽³⁾ Includes fair value movements in relation to other economic hedge derivatives relating to debt held at amortised cost.

⁽⁴⁾ Includes £13.6 million expense (2013: £12.2 million) due to interest on swaps and debt under fair value option.

Notes to the financial statements (continued)

8. Taxation (credit)/charge on profit on ordinary activities

(a) Analysis of (credit)/charge in the year

	2014 £m	2013 £m
Current taxation:		
UK corporation tax at 23% (2013: 24%)	75.8	84.0
Adjustment in respect of prior years	(152.0)	(4.1)
Total current taxation (credit)/charge	(76.2)	79.9
Deferred taxation:		
Origination and reversal of timing differences	45.4	(0.1)
(Increase)/decrease in discount	(96.4)	31.6
Effect of change in rate applied to opening deferred tax balance	(141.5)	(41.0)
Adjustment in respect of prior years	140.3	6.4
Total deferred taxation credit	(52.2)	(3.1)
Total taxation (credit)/charge on profit on ordinary activities	(128.4)	76.8

The above change in rate figures are calculated based on the undiscounted brought forward balances.

(b) Factors affecting the current taxation (credit)/charge for the year

	2014 £m	2013 £m
Profit on ordinary activities before taxation	538.8	311.4
UK corporation taxation at 23% (2013: 24%)	123.9	74.7
Capital allowances in excess of depreciation	(23.7)	(7.0)
Adjustment in respect of prior years	(152.0)	(4.1)
Other timing differences	(30.4)	(3.8)
Taxation on items taken directly to equity	1.9	10.9
Net non-deductible expenses	4.1	9.2
Actual current taxation (credit)/charge for the year	(76.2)	79.9

(c) Taxation on items taken directly to equity

	2014 £m	2013 £m
Current taxation:		
Relating to other pension movements	(1.8)	(10.9)
Deferred taxation:		
On actuarial (losses)/gains on defined benefit pension schemes	(38.4)	7.6
Relating to other pension movements	1.5	10.6
Change in taxation rate	(1.0)	0.4
Total taxation (credit)/charge on items taken directly to equity	(39.7)	7.7

Notes to the financial statements (continued)

9. Dividends

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

	2014	2013
	£m	£m
Interim dividend for the year ended 31 March 2014 at 16.4 pence per share (2013: 24.0 pence per share)	153.0	223.5

The directors have not recommended a final ordinary dividend (2013: £nil).

The company's redeemable preference shares are included in the balance sheet as a liability and, accordingly, the dividends payable on them are included in net interest payable (see notes 7 and 14(b)).

10. Intangible assets

	Development costs £m
Cost	
At 1 April 2013	0.6
Additions	1.2
At 31 March 2014	1.8

Development costs have been capitalised in accordance with SSAP 13 'Accounting for research and development'.

11. Tangible assets

	Freehold 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 2013	244.5	6,007.1	5,481.2	613.0	1,038.9	13,384.7
Additions	11.4	234.1	125.4	61.0	424.1	856.0
Grants and contributions	-	(12.7)	-	-	(2.6)	(15.3)
Transfers	19.8	133.8	323.3	56.6	(533.5)	-
Disposals	(2.4)	(1.4)	(31.3)	(41.0)	-	(76.1)
At 31 March 2014	273.3	6,360.9	5,898.6	689.6	926.9	14,149.3
Depreciation						
At 1 April 2013	75.2	2,249.1	2,025.1	384.6	-	4,734.0
Charge for the year	10.1	151.5	226.3	64.4	-	452.3
Transfers	-	-	(0.5)	0.5	-	-
Disposals	(2.0)	-	(25.6)	(39.2)	-	(66.8)
At 31 March 2014	83.3	2,400.6	2,225.3	410.3	-	5,119.5
Net book value						
At 31 March 2014	190.0	3,960.3	3,673.3	279.3	926.9	9,029.8
At 31 March 2013	169.3	3,758.0	3,456.1	228.4	1,038.9	8,650.7

Grants and contributions received relating to infrastructure assets have been deducted from the cost of fixed assets in order to show a true and fair view (see note 1). As a consequence, the cost of tangible fixed assets is £258.1 million (2013: £242.8 million) lower than it would have been had this treatment not been adopted.

Notes to the financial statements (continued)

11. Tangible assets (continued)

	2014 £m	2013 £m
Capital commitments		
Contracted but not provided for	363.3	371.5

In addition to these commitments, the company has long-term expenditure plans which include investments to achieve improvements in performance mandated by Ofwat, the Environment Agency and applicable legislation; and to provide for growth in demand for water and sewerage services.

12. Fixed asset investments

	Other investments £m
Cost and net book value at 1 April 2013	0.2
Disposals	(0.1)
Cost and net book value at 31 March 2014	0.1

Details of other investments, all of which are unlisted unless otherwise stated, held directly by the company and registered in England and Wales, are:

Other investments	Description of holding	Proportion held	Nature of business
WRc plc	'A' Ordinary shares of £1.00 each	16.97%	Water and wastewater research
PayPoint plc (listed)	Ordinary shares of 0.003 pence each	0.05%	Cash collection service
Lingley Mere Management Company Limited	Ordinary (non-voting) shares of £1.00 each	93.27%	Estate management

The company also has an interest in Rivington Heritage Trust which is limited by guarantee. The company is one of four equal guarantors of Rivington Heritage Trust. Its liability is limited to its guarantee of £1.00.

During the year, the company disposed of its loan stock investment in WRc plc for consideration of £0.1 million.

13. Debtors

(a) Amounts falling due within one year

	2014 £m	2013 £m
Trade debtors	182.5	184.0
Amounts owed by parent and fellow subsidiary undertakings – trading balances	7.3	2.9
Amounts owed by parent and fellow subsidiary undertakings – floating rate loans	40.0	40.0
Taxation and social security	50.0	-
Other debtors	18.6	17.1
Prepayments and accrued income	121.8	114.4
Derivative financial instruments (see note 20)	56.7	62.0
	<u>476.9</u>	<u>420.4</u>

(b) Amounts falling due after more than one year

	2014 £m	2013 £m
Derivative financial instruments (see note 20)	363.7	505.8

Notes to the financial statements (continued)

14. Creditors: amounts falling due within one year

(a) Trade and other creditors

	2014 £m	2013 £m
Trade creditors	40.1	47.6
Amounts owed to parent and fellow subsidiary undertakings	9.2	12.2
Amounts owed to related parties	0.1	-
Taxation and social security	-	32.4
Deferred grants and contributions (see note 16)	6.9	6.6
Accruals and deferred income	311.3	335.6
Derivative financial instruments (see note 20)	54.5	3.0
	<u>422.1</u>	<u>437.4</u>

(b) Borrowings

	2014 £m	2013 £m
Bonds, bank and other term borrowings	28.8	65.0
Bank overdraft	33.5	103.8
130,000,000 7.0 per cent £1.00 redeemable preference shares	130.0	130.0
Amounts owed to parent and fellow subsidiary undertakings	29.0	9.6
	<u>221.3</u>	<u>308.4</u>

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 company or the shareholder. Preference shareholders are not entitled to receive notice of, attend or vote at, any general meeting of the company. 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. The preference shares have a latest redemption date of 1 October 2099. Further information on the company's borrowings is given in note 19.

15. Creditors: amounts falling due after more than one year

(a) Trade and other creditors

	2014 £m	2013 £m
Other creditors	9.2	9.7
Deferred grants and contributions (see note 16)	70.7	72.9
Derivative financial instruments (see note 20)	52.3	206.4
	<u>132.2</u>	<u>289.0</u>

(b) Borrowings

	2014 £m	2013 £m
Bonds	3,793.1	3,863.8
Bank and other term borrowings	1,463.4	1,345.5
Amounts owed to parent and fellow subsidiary undertakings	959.5	910.6
	<u>6,216.0</u>	<u>6,119.9</u>

Further information on the company's borrowings is given in note 19.

Notes to the financial statements (continued)

16. Deferred grants and contributions

	2014 £m	2013 £m
At the start of the year	79.5	80.8
Received in the year	5.0	5.4
Credited to the profit and loss account (see note 3)	(6.9)	(6.7)
At the end of the year	<u>77.6</u>	<u>79.5</u>
Represented by:		
Amounts falling due within one year (see note 14a)	6.9	6.6
Amounts falling due after one year (see note 15a)	70.7	72.9
At the end of the year	<u>77.6</u>	<u>79.5</u>

17. Provisions for liabilities

	Deferred tax: pension (note 21) £m	Deferred tax: other (note 18) £m	Other £m	Total £m
At 31 March 2013 – disclosed separately in pensions (see note 21)	8.8	-	-	8.8
At 31 March 2013	-	394.3	9.9	404.2
	<u>8.8</u>	<u>394.3</u>	<u>9.9</u>	<u>413.0</u>
(Credited)/charged to profit and loss account	-	(52.2)	15.4	(36.8)
Taxation credit on items taken directly to equity	(37.9)	-	-	(37.9)
Utilised in the year	-	-	(9.7)	(9.7)
	<u>(37.9)</u>	<u>(52.2)</u>	<u>5.7</u>	<u>(84.4)</u>
At 31 March 2014 – disclosed separately in pensions (see note 21)	29.1	-	-	29.1
At 31 March 2014	-	342.1	15.6	357.7
	<u>29.1</u>	<u>342.1</u>	<u>15.6</u>	<u>357.7</u>

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

18. Deferred tax

Deferred tax is provided as follows:

	2014 £m	2013 £m
Accelerated capital allowances	989.7	974.3
Short-term timing differences	(1.2)	(30.0)
Undiscounted provision for deferred tax	<u>988.5</u>	<u>944.3</u>
Discount	(646.4)	(550.0)
Discounted provision for deferred tax (see note 17)	<u>342.1</u>	<u>394.3</u>

Notes to the financial statements (continued)

19. Borrowings

Terms and debt repayment schedule

The principal economic terms and conditions of outstanding borrowings were as follows:

	Currency	Year of final repayment	Fair value £m	2014 Carrying value £m	Fair value £m	2013 Carrying value £m
Borrowings in fair value hedge relationships			1,708.1	1,733.5	1,774.8	1,861.8
5.375% 150m bond	GBP	2018	173.7	167.7	179.9	178.6
4.25% 500m bond	EUR	2020	473.6	476.2	485.3	495.0
5.75% 375m bond	GBP	2022	432.4	409.2	451.5	441.0
5.625% 300m bond	GBP	2027	347.4	363.3	362.4	394.6
5.02% JPY 10,000m dual currency loan	JPY/USD	2029	68.1	79.7	80.1	96.6
5.00% 200m bond	GBP	2035	212.9	237.4	215.6	256.0
Borrowings designated at fair value through profit or loss			268.7	268.7	323.4	323.4
1.135% 3,000m bond	JPY	2013	-	-	21.0	21.0
6.875% 400m bond (owed to intermediate parent undertaking)	USD	2028	268.7	268.7	302.4	302.4
Borrowings measured at amortised cost			4,739.4	4,435.1	4,659.6	4,243.1
Short-term bank borrowings – fixed	GBP	2014	28.5	28.5	43.7	43.7
6.125% 425m bond	GBP	2015	466.2	427.3	483.7	428.6
1.97% + RPI 200m IL loan	GBP	2016	265.1	257.1	270.2	248.7
1.30% + LIBOR 5,000m (floating) bond	JPY	2017	30.0	29.7	37.3	35.4
2.46% + RPI 50m IL loan	GBP	2020	68.7	57.9	72.4	56.3
2.10% + RPI 50m IL loan	GBP	2020	67.2	57.8	70.6	56.3
1.93% + RPI 50m IL loan	GBP	2020	66.7	58.0	70.0	56.4
1.90% + RPI 50m IL loan	GBP	2020	66.6	58.1	69.9	56.5
1.88% + RPI 50m IL loan	GBP	2020	66.4	57.9	69.7	56.3
1.84% + RPI 50m IL loan	GBP	2020	66.5	58.1	69.7	56.6
1.73% + RPI 50m IL loan	GBP	2020	66.1	58.2	69.2	56.6
1.61% + RPI 50m IL loan	GBP	2020	65.7	58.3	68.7	56.7
0.47% + RPI 100m IL loan	GBP	2023	95.8	102.6	97.5	99.9
1.29% + RPI 50m IL loan	GBP	2029	55.4	54.8	58.3	53.4
1.23% + RPI 50m IL loan	GBP	2029	55.0	55.2	57.9	53.7
1.12% + RPI 50m IL loan	GBP	2029	53.6	54.4	56.4	52.9
1.10% + RPI 50m IL loan	GBP	2029	53.4	54.3	56.1	52.9
0.75% + RPI 50m IL loan	GBP	2029	49.5	53.1	52.1	51.7
1.15% + RPI 50m IL loan	GBP	2030	52.0	52.8	54.9	51.4
1.11% + RPI 50m IL loan	GBP	2030	50.8	52.9	54.2	51.5
0.76% + RPI 50m IL loan	GBP	2030	49.3	53.0	51.9	51.5
0.709%+LIBOR 100m (floating) loan	GBP	2032	89.2	100.0	-	-
3.375% + RPI 50m IL bond	GBP	2032	97.2	70.2	95.9	68.0
1.9799% + RPI 100m IL bond	GBP	2035	148.8	131.7	148.4	127.7
1.66% +RPI 35m IL bond	GBP	2037	45.5	42.6	45.3	41.4
2.40% + RPI 70m IL bond	GBP	2039	102.3	82.9	102.4	80.6
1.7829% + RPI 100m IL bond	GBP	2040	142.9	130.3	143.9	126.4
1.3258% + RPI 50m IL bond	GBP	2041	65.6	65.0	64.7	63.0
1.5802% + RPI 100m IL bond	GBP	2042	137.0	129.9	137.0	126.0
1.5366% + RPI 50m IL bond	GBP	2043	68.4	64.8	68.4	62.9

Notes to the financial statements (continued)

19. Borrowings (continued)

	Currency	Year of final repayment	Fair value £m	2014 Carrying value £m	Fair value £m	2013 Carrying value £m
Borrowings measured at amortised cost (continued)						
1.397% + RPI 50m IL bond	GBP	2046	66.0	65.0	66.1	63.0
1.7937% + RPI 50m IL bond	GBP	2049	73.8	64.7	69.9	62.7
Commission for New Towns loan – fixed	GBP	2053	51.9	29.5	55.9	29.9
1.847% + RPI 100m IL bond	GBP	2056	150.8	128.4	142.3	125.0
1.815% + RPI 100m IL bond	GBP	2056	148.7	127.9	140.3	124.4
1.662% + RPI 100m IL bond	GBP	2056	142.0	127.6	133.8	124.2
1.591% + RPI 25m IL bond	GBP	2056	34.6	31.8	32.6	31.0
1.5865% + RPI 50m IL bond	GBP	2056	69.5	63.8	65.3	62.1
1.556% + RPI 50m IL bond	GBP	2056	68.4	63.5	64.7	61.8
1.435% + RPI 50m IL bond	GBP	2056	65.9	63.2	62.0	61.5
1.3805% + RPI 35m IL bond	GBP	2056	45.3	44.3	42.6	43.1
1.702% + RPI 50m IL bond	GBP	2057	69.9	61.9	66.1	60.3
1.585% + RPI 100m IL bond	GBP	2057	133.9	122.8	126.0	119.5
Preference shares (owed to immediate parent undertaking)	GBP	2099	130.0	130.0	130.0	130.0
Amounts owed to parent and fellow subsidiary undertakings	GBP	Various	719.8	719.8	617.8	617.8
Bank overdrafts	GBP	2014	33.5	33.5	103.8	103.8
			6,716.2	6,437.3	6,757.8	6,428.3

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

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

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

20. Financial instruments

Risk management

The board (or as appropriate the group board) is responsible for treasury strategy and governance, which is reviewed on an annual basis. The annual treasury strategy review covers the company's funding, liquidity, capital management and interest rate management strategies, along with the delegation of specific funding and hedging authorities to the company's authorised officers.

The group treasury committee, a sub-committee of the group board, has responsibility for setting and monitoring the company'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 group 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 group treasury committee, which details the status of compliance with treasury policies and highlights the level of risk against the appropriate risk limits in place.

Notes to the financial statements (continued)

20. Financial instruments (continued)

Risk management (continued)

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

Liquidity risk

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

At 31 March 2014, the company had £939.7 million (2013: £662.3 million) of available liquidity, which comprised £539.7 million (2013: £662.3 million) of undrawn committed borrowing facilities and £400.0 million (2013: £nil) of undrawn term loan facility. Short-term deposits mature within three months and bank overdrafts are repayable on demand.

The company had available committed borrowing facilities as follows:

	2014 £m	2013 £m
Expiring within one year	25.0	100.0
Expiring after one year but in less than two years ⁽¹⁾	675.0	775.0
Expiring after more than two years	325.0	190.0
Total borrowing facilities	<u>1,025.0</u>	<u>1,065.0</u>
Facilities drawn	(485.3)	(402.7)
Undrawn borrowing facilities	<u>539.7</u>	<u>662.3</u>

⁽¹⁾ Figure includes £650.0 million (2013: £750.0 million) facility provided by intermediate parent undertaking.

At 31 March 2014, the company had additional committed borrowing facilities of £nil (2013: £80.0 million) expiring after more than two years, £nil (2013: £40.0 million) available to be drawn from September 2013 and £nil (2013: £40.0 million) available to be drawn from January 2014.

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 (continued)

20. Financial instruments (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 company's financial liabilities with agreed repayment periods and derivatives 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.

	Total ¹	Adjustment ²	1 year or less	1-2 years	2-3 years	3-4 years	4-5 years	More than 5 years
	£m	£m	£m	£m	£m	£m	£m	£m
At 31 March 2014								
Bonds	9,402.4		131.2	557.3	107.4	139.8	259.5	8,207.2
Bank borrowings and other	2,086.1		89.6	38.8	343.1	65.1	66.3	1,483.2
Preference shares	130.0		130.0	-	-	-	-	-
Parent and fellow subsidiary borrowings	1,362.9		52.5	509.8	22.8	23.3	24.5	730.0
Adjustment to carrying value	(6,544.1)	(6,544.1)						
Borrowings	6,437.3	(6,544.1)	403.3	1,105.9	473.3	228.2	350.3	10,420.4
Derivatives:								
Payable	635.6		85.8	51.6	38.3	71.4	24.9	363.6
Receivable	(991.2)		(129.8)	(68.0)	(65.0)	(114.3)	(52.0)	(562.1)
Adjustment to carrying value	42.0	42.0						
Derivatives – net assets	(313.6)	42.0	(44.0)	(16.4)	(26.7)	(42.9)	(27.1)	(198.5)
At 31 March 2013								
Bonds	8,851.2		152.2	131.9	557.7	107.6	145.1	7,756.7
Bank borrowings and other	2,030.5		173.3	26.3	37.0	330.4	55.3	1,408.2
Preference shares	130.0		130.0	-	-	-	-	-
Parent and fellow subsidiary borrowings	1,613.8		36.2	728.8	21.3	21.9	22.5	783.1
Adjustment to carrying value	(6,197.2)	(6,197.2)						
Borrowings	6,428.3	(6,197.2)	491.7	887.0	616.0	459.9	222.9	9,948.0
Derivatives:								
Payable	715.9		80.5	85.7	49.6	42.3	71.5	386.3
Receivable	(1,124.5)		(115.0)	(155.9)	(67.0)	(65.5)	(124.2)	(596.9)
Adjustment to carrying value	50.2	50.2						
Derivatives – net assets	(358.4)	50.2	(34.5)	(70.2)	(17.4)	(23.2)	(52.7)	(210.6)

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 3.00 per cent (2013:2.65 per cent) over the life of each instrument.

2. The carrying value of debt is calculated following various methods in accordance with FRS 26 'Financial Instruments: Recognition and Measurement' and, therefore, this adjustment converts the undiscounted forecast future cash flows to the carrying value of debt in the balance sheet.

Notes to the financial statements (continued)

20. Financial instruments (continued)

Credit risk

Credit risk arises principally from trading (the supply of services to customers) and treasury activities (the depositing of cash and holding derivative and foreign exchange instruments). The company does not believe it is exposed to any material concentrations of credit risk.

The company manages its risk from trading through the effective management of customer relationships. Concentrations of credit risk with respect to trade debtors are limited due to the company's customer base consisting of a large number of unrelated households and businesses. 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. However, allowance is made by the water regulator in the price limits at each price review for a proportion of debt deemed to be irrecoverable. Considering the above, the directors believe there is no further credit risk provision required in excess of the provision for bad and doubtful debts.

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

At 31 March 2014 and 31 March 2013, the maximum exposure to credit risk for the company is represented by the carrying amount of each financial asset in the balance sheet:

	2014 £m	2013 £m
Trade and other debtors	420.2	358.4
Derivative financial instruments	420.4	567.8
	<u>840.6</u>	<u>926.2</u>

The credit exposure on derivatives is disclosed gross of any collateral held. At 31 March 2014, the company held £28.5 million (2013: £43.7 million) as collateral in relation to derivative financial instruments (included within borrowings in note 19).

Market risk

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

Inflation risk

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

Notes to the financial statements (continued)

20. Financial instruments (continued)

Inflation risk (continued)

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

In addition, the company's pension obligations also provide an economic hedge of the company's regulatory assets. The pension scheme funding mechanism ensures that future contributions will be flexed for movements in RPI and smoothed over a rolling five year period, providing a natural hedge against any inflationary uplift on the RCV.

The company seeks to manage this risk by identifying opportunities to amend the economic hedge currently in place where deemed necessary subject to relative value.

Inflation risk is reported monthly to the group treasury committee in the operational compliance report.

The carrying value of the index-linked debt held by the company is as follows:

	2014	2013
	£m	£m
Index-linked debt	2,936.8	2,853.9

The sensitivity analysis set out below has been prepared on the basis of the amount of index-linked debt in place as at 31 March 2014 and 31 March 2013, respectively. As a result, this analysis relates to the position at the balance sheet date and is not indicative of the years then ended, as these factors would have varied throughout the year. The following table details the sensitivity of profit before taxation to changes in the RPI on the company's index-linked borrowings.

Increase/(decrease) in profit before taxation and equity

	2014	2013
	£m	£m
1 per cent increase in RPI	(29.9)	(29.1)
1 per cent decrease in RPI	29.9	29.1

This table excludes the hedging aspect of the company's regulatory assets which, being fixed assets, are not 'financial assets' as defined by FRS 25 'Financial Instruments: Disclosures and Presentation' and are typically held at cost or deemed cost less accumulated depreciation on the balance sheet. In addition the table excludes the hedging aspect of the company's pension obligation.

The analysis assumes a one per cent change in RPI 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 changes impact on the profit and loss and the analysis above does not incorporate this factor. The portfolio of index-linked debt is either calculated on a three or eight month lag basis. Therefore, at the balance sheet date the index-linked interest and principal adjustments impacting the profit and loss account are fixed and based on the annual RPI change either three or eight months earlier.

Notes to the financial statements (continued)

20. Financial instruments (continued)

Interest rate risk

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

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

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

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

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

Sensitivity analysis

The sensitivity analysis below has been prepared on the basis of the amount of net debt and the interest rate hedge positions in place as at 31 March 2014 and 31 March 2013, respectively. As a result, this analysis is not indicative of the years then ended, as these factors would have varied throughout the year.

The following assumptions were made in calculating the interest sensitivity analysis:

- fair value hedge relationships are fully effective;
- borrowings designated at fair value through profit or loss are effectively hedged by associated swaps;
- the main fair value sensitivity to interest rates in the balance sheet (excluding the effect of accrued interest) is in relation to the fixed interest rate swaps which manage the exposure to medium-term interest rates;
- cash flow sensitivity in the balance sheet to interest rates is calculated on floating interest rate net debt;
- the sensitivity excludes the impact of interest rates on post-retirement obligations;
- management has assessed one per cent as a reasonably possible movement in UK interest rates; and
- all other factors are held constant.

Increase/(decrease) in profit before taxation and equity

	2014	2013
	£m	£m
1 per cent increase in interest rate	100.6	96.7
1 per cent decrease in interest rate	(111.3)	(96.9)
	<u> </u>	<u> </u>

The exposure largely relates to the fair value exposure on the company's fixed interest rate swaps which manage the exposure to medium-term interest rates.

Notes to the financial statements (continued)

20. Financial instruments (continued)

Repricing analysis

The following tables categorise the 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 company's exposure to floating interest rate risk.

At 31 March 2014	Total	1 year or less	1-2 years	2-3 years	3-4 years	4-5 years	More than 5 years
	£m	£m	£m	£m	£m	£m	£m
Borrowings in fair value hedge relationships							
Fixed rate instruments	1,733.5	-	-	-	-	167.7	1,565.8
Effect of swaps	-	1,733.5	-	-	-	(167.7)	(1,565.8)
	1,733.5	1,733.5	-	-	-	-	-
Borrowings designated at fair value through profit or loss							
Fixed rate instruments	268.7	-	-	-	-	-	268.7
Effect of swaps	-	268.7	-	-	-	-	(268.7)
	268.7	268.7	-	-	-	-	-
Borrowings measured at amortised cost							
Fixed rate instruments	615.3	28.8	427.7	0.4	0.5	0.5	157.4
Floating rate instruments	883.0	883.0	-	-	-	-	-
Index-linked instruments	2,936.8	2,936.8	-	-	-	-	-
	4,435.1	3,848.6	427.7	0.4	0.5	0.5	157.4
Effect of a fixed interest rate hedge	-	(2,031.3)	-	325.0	252.1	250.0	1,204.2
Total and net borrowings	6,437.3	3,819.5	427.7	325.4	252.6	250.5	1,361.6
At 31 March 2013	Total	1 year or less	1-2 years	2-3 years	3-4 years	4-5 years	More than 5 years
	£m	£m	£m	£m	£m	£m	£m
Borrowings in hedge relationships							
Fixed rate instruments	1,861.8	-	-	-	-	-	1,861.8
Effect of swaps	-	1,861.8	-	-	-	-	(1,861.8)
	1,861.8	1,861.8	-	-	-	-	-
Borrowings designated at fair value through profit or loss							
Fixed rate instruments	323.4	21.0	-	-	-	-	302.4
Effect of swaps	-	302.4	-	-	-	-	(302.4)
	323.4	323.4	-	-	-	-	-
Borrowings measured at amortised cost							
Fixed rate instruments	632.2	44.0	0.3	429.0	0.4	0.5	158.0
Floating rate instruments	757.0	757.0	-	-	-	-	-
Index-linked instruments	2,853.9	2,853.9	-	-	-	-	-
	4,243.1	3,654.9	0.3	429.0	0.4	0.5	158.0
Effect of a fixed interest rate hedge	-	(2,231.3)	600.0	-	325.0	252.1	1,054.2
Total and net borrowings	6,428.3	3,608.8	600.3	429.0	325.4	252.6	1,212.2

Notes to the financial statements (continued)

20. Financial instruments (continued)

Electricity price risk

The company is allowed a fixed amount of turnover 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 company to volatility in its operating cash flows. The company's policy, therefore, is to manage this risk by fixing a proportion of electricity prices in a cost-effective manner.

The company has used electricity swap contracts, to fix the price of a substantial proportion of its anticipated electricity usage out to the end of the AMP in 2015.

Sensitivity analysis

The sensitivity analysis has been prepared on the basis of the amount of electricity swaps in place at the reporting date and as a result, this analysis is not indicative of the years then ended, as this factor would have varied throughout the year.

Increase/(decrease) in profit before taxation and equity

	2014 £m	2013 £m
10 per cent increase in commodity prices	2.6	4.4
10 per cent decrease in commodity prices	(2.6)	(4.4)

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

The company has no material net exposure to movements in currency rates.

Capital risk management

The company's objective when managing capital is to maintain a capital structure that enables the company to retain a credit rating of A3 from Moody's Investors Services (Moody's), which the company believes best mirrors the Water Services Regulation Authority's (Ofwat) assumptions in relation to capital structure. The strategy of targeting a credit rating of A3 has been consistently maintained since 2007.

One of Ofwat's primary duties is to ensure that water companies are able to finance their functions, in particular by securing a reasonable return on their capital. Therefore mirroring Ofwat's assumptions for credit ratings (and hence capital structure) should help safeguard the company's ability to earn a reasonable return on its capital, securing access to finance at a reasonable cost and enabling the company to continue as a going concern in order to provide returns for shareholders and credit investors and benefits for other stakeholders.

In order to maintain a credit rating of A3, the company needs to manage its capital structure with reference to ratings methodology and measures used by Moody's. The ratings methodology is normally based on a number of key ratios (such as RCV gearing and adjusted interest cover) and threshold levels as updated and published from time to time by Moody's.

The company 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 group 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 (continued)

20. Financial instruments (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.

At 31 March 2014	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	-	306.7	-	306.7
Derivative financial assets – held for trading ⁽¹⁾	-	113.7	-	113.7
Financial liabilities at fair value through profit or loss				
Derivative financial liabilities – held for trading ⁽¹⁾⁽²⁾	-	(106.8)	-	(106.8)
Financial liabilities designated as fair value through profit or loss	-	(268.7)	-	(268.7)
Financial liabilities for which fair value has been disclosed				
Financial liabilities in fair value hedge relationships	(1,640.0)	(68.1)	-	(1,708.1)
Other financial liabilities at amortised cost	(1,146.7)	(3,592.7)	-	(4,739.4)
	<u>(2,786.7)</u>	<u>(3,615.9)</u>	-	<u>(6,402.6)</u>
At 31 March 2013	Level 1 £m	Level 2 £m	Level 3 £m	Re-presented* Total £m
Financial assets at fair value through profit or loss				
Derivative financial assets – fair value hedge	-	422.8	-	422.8
Derivative financial assets – held for trading ⁽¹⁾	-	145.0	-	145.0
Financial liabilities at fair value through profit or loss				
Derivative financial liabilities – held for trading ⁽¹⁾⁽²⁾	-	(209.4)	-	(209.4)
Financial liabilities designated as fair value through profit or loss	-	(323.4)	-	(323.4)
Financial liabilities for which fair value has been disclosed				
Financial liabilities in fair value hedge relationships	-	(1,774.8)	-	(1,774.8)
Other financial liabilities at amortised cost	-	(4,659.6)	-	(4,659.6)
	-	<u>(6,399.4)</u>	-	<u>(6,399.4)</u>

^(*) The comparatives have been re-presented to include financial liabilities for which fair value has been disclosed, as a result of the inclusion of this enhanced disclosure in the current year table.

⁽¹⁾ Derivatives forming an economic hedge of the currency exposure on borrowings included in these balances were £83.2 million (2013: £143.5 million).

⁽²⁾ Includes amount owed to intermediate parent undertaking £3.7 million (2013: £10.2 million).

Notes to the financial statements (continued)

20. Financial instruments (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).

For the year ended 31 March 2014, the company has calculated fair values using quoted prices where an active market exists, which represents a change in accounting estimate this year. In the absence of an appropriate quoted price, the company has applied discounted cash flow valuation models utilising market available data in line with prior periods.

In respect of the total change during the year in the fair value of financial liabilities designated at fair value through profit or loss of £32.6 million gain (2013: £17.5 million loss), an £11.1 million loss (2013: £1.5 million loss) is attributable to changes in own credit risk. The cumulative amount recognised due to changes in credit spread was £63.6 million profit (2013: £74.7 million). The carrying amount is £66.6 million (2013: £99.2 million) higher than the amount contracted to settle at maturity.

21. Retirement benefits

The company 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 company's finances.

The last actuarial valuations of UUPS and ESPS were carried out as at 31 March 2013. These valuations have been updated to take account of the requirements of FRS 17 'Retirement Benefits' in order to assess the position at 31 March 2014 by projecting forward from the valuation date by the independent actuary, Aon Hewitt Limited.

The company made total contributions of £24.9 million (2013: £68.7 million) to its pension schemes for the year ended 31 March 2014.

Included in the contributions of £24.9 million (2013: £68.7 million), were regular accelerated deficit repair contributions of £nil (2013: £34.7 million) and an inflation funding mechanism payment of £8.2 million (2013: £10.0 million). Details of the inflation mechanism entered into with the company as part of a pension de-risking strategy, are included within the 2011 Report and Financial Statements.

Overall, the company expects to contribute around £26.5 million to its defined benefit schemes in the year ending 31 March 2015.

The main financial assumptions used by the actuary were as follows:

	2014 % p.a.	2013 % p.a.
Discount rate	4.3	4.6
Expected return on assets	4.3	4.6
Pensionable salary growth and pension increases	3.3	3.3
Price inflation	3.3	3.3

Notes to the financial statements (continued)

21. Retirement benefits (continued)

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

	2014 years	2013 years
Retired member – male	26.6	26.7
Non-retired member – male	28.4	28.5
Retired member – female	30.0	30.0
Non-retired member – female	31.9	31.9

At 31 March, the fair value of the schemes' assets and liabilities recognised in the balance sheet, and their expected long-term rates of return were as follows:

	Schemes' assets at 31		Schemes' assets at 31	
	March 2014 %	At 31 March 2014 £m	March 2013 %	At 31 March 2013 £m
Equities	6.1	104.8	12.8	208.4
Other non-equity growth assets	9.9	170.9	9.1	148.3
Gilts	13.6	235.1	2.1	33.8
Bonds	53.5	922.4	64.1	1,042.0
Other	16.9	291.8	11.9	194.3
Total fair value of assets	100.0	1,725.0	100.0	1,626.8
Present value of liabilities		<u>(1,870.6)</u>		<u>(1,588.7)</u>
Pension (liability)/surplus		(145.6)		38.1
Related deferred tax asset/(liability) (see note 17)		29.1		(8.8)
Net pension (liability)/surplus		<u><u>(116.5)</u></u>		<u><u>29.3</u></u>

To develop the expected long-term rate of return on asset assumptions, the company considered the current level of expected returns on risk free investments, the historical level of the risk premium associated with the other asset classes in which the portfolio is invested and the expectations for future returns of each asset class. The expected return for each asset class was then weighted based on the actual asset allocation to develop the expected long-term rate of return on asset assumptions for the portfolio. The company's actual return on schemes' assets was a gain of £129.8 million (2013: £205.3 million).

The assets as at 31 March 2014, in respect of the UUPS, included in the breakdown above, have been allocated to each asset class based on the return the assets are expected to achieve and not based on the physical assets held. The reason for this being that the UUPS has entered into a variety of derivative transactions in order to change the return characteristics of the physical assets held and in order to reduce undesirable market and liability risks.

The 'Other' element of the portfolio is set aside for collateral purposes linked to the derivative contracts entered into, as described above. The collateral portfolio, in addition to providing sufficient liquidity to maintain the derivative transactions, is expected to achieve a return in excess of LIBOR.

Notes to the financial statements (continued)

21. Retirement benefits (continued)

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

	2014 £m	2013 £m
At the start of the year	(1,588.7)	(1,439.9)
Interest cost on pension schemes' obligations	(72.0)	(70.8)
Actuarial losses	(248.7)	(108.8)
Curtailments/settlements arising on reorganisation	(1.4)	(0.6)
Member contributions	(6.3)	(6.3)
Benefits paid	62.8	52.5
Current service cost	(16.3)	(14.8)
At the end of the year	<u>(1,870.6)</u>	<u>(1,588.7)</u>

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

	2014 £m	2013 £m
At the start of the year	1,626.8	1,399.0
Expected return on pension schemes' assets	72.9	63.5
Actuarial gains	56.9	141.8
Member contributions	6.3	6.3
Benefits paid	(62.8)	(52.5)
Company contributions	24.9	68.7
At the end of the year	<u>1,725.0</u>	<u>1,626.8</u>

The net pension expense before taxation recognised in the profit and loss account in respect of the defined benefit schemes is summarised as follows:

	2014 £m	2013 £m
Current service cost	(16.3)	(14.8)
Curtailments/settlements arising on reorganisation	(1.4)	(0.6)
Pension expense charged to operating profit	<u>(17.7)</u>	<u>(15.4)</u>
Expected return on pension schemes' assets	72.9	63.5
Interest cost on pension schemes' liabilities	(72.0)	(70.8)
Pension income/expense credited/(charged) to net interest payable and similar charges (see note 7)	<u>0.9</u>	<u>(7.3)</u>
Net pension expense charged before taxation	<u>(16.8)</u>	<u>(22.7)</u>

The reconciliation of the opening and closing net pension (liability)/surplus included in the balance sheet is as follows:

	2014 £m	2013 £m
At the start of the year	38.1	(40.9)
Expense recognised in the profit and loss account	(16.8)	(22.7)
Contributions paid	24.9	68.7
Actuarial (losses)/gains gross of taxation	(191.8)	33.0
At the end of the year	<u>(145.6)</u>	<u>38.1</u>

Notes to the financial statements (continued)

21. Retirement benefits (continued)

Actuarial gains and losses are recognised directly in the statement of total recognised gains and losses. At 31 March 2014, a cumulative pre-tax loss of £273.7 million (2013: £81.9 million) had been recorded directly in the statement of total recognised gains and losses.

Under the prescribed FRS 17 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 an AA corporate bond rate, which comprises an underlying interest rate and a credit spread.

The company has de-risked its pension schemes through hedging strategies applied to the underlying interest rate and the forecast RPI. The underlying interest rate has been largely hedged through external market swaps, the value of which is included in the schemes' assets, and the forecast RPI has been largely hedged through the IFM, with RPI in excess of 3.0 per cent per annum being funded through an additional schedule of deficit contribution.

As a consequence, the balance sheet position under FRS 17 remains volatile to changes in credit spread which have not been hedged, primarily due to the difficulties in doing so over long durations; changes in inflation, as the IFM results in changes to the IFM deficit contributions rather than a change in the schemes' assets; and, to a lesser extent, changes in mortality as management has decided not to hedge this exposure due to its lower volatility in the short-term.

In contrast, the schemes' specific funding basis, which forms the basis for regular (non-IFM) deficit repair contributions, is unlikely to suffer from volatility due to credit spread or inflation. This is because a prudent, fixed credit spread assumption is applied, and inflation linked contributions are included within the IFM.

In the FRS 17 assessment of the balance sheet position at 31 March 2014, although the discount rate has fallen by 0.3 per cent this masks a rise in underlying interest rates offset by a credit spread reduction of 0.5 per cent. This credit spread reduction results in substantially all of the reported £183.7 million deterioration. During the year ended 31 March 2014, there has not been any material change in the deficits on a scheme specific funding basis and therefore the level of deficit repair contributions.

The history of the schemes for the current and prior years is as follows:

	2014 £m	2013 £m	2012 £m	2011 £m	2010 £m
Present value of defined benefit obligations	(1,870.6)	(1,588.7)	(1,439.9)	(1,245.2)	(1,195.3)
Fair value of schemes' assets	1,725.0	1,626.8	1,399.0	1,102.3	1,005.6
Net retirement benefit (obligations)/ surplus	(145.6)	38.1	(40.9)	(142.9)	(189.7)
Experience adjustments on schemes' liabilities (£)	(194.5)	3.9	(22.0)	39.5	3.2
Experience adjustments on schemes' assets (£)	56.9	141.8	161.1	14.3	198.6

During the year, the company made £8.1 million (2013: £5.5 million) of contributions to defined contribution schemes.

Notes to the financial statements (continued)

22. Called up share capital and share premium account

	2014 £m	2013 £m
Allotted and fully paid share capital		
931,930,000 ordinary shares of £1.00 each	931.9	931.9
93,437,000 zero per cent preference shares of £1.00 each	93.4	93.4
130,000,000 7 per cent cumulative redeemable preference shares of £1.00 each	130.0	130.0
	<u>1,155.3</u>	<u>1,155.3</u>
Less: 130,000,000 7 per cent cumulative redeemable preference shares of £1.00 each designated as borrowings (see note 19)	(130.0)	(130.0)
	<u>1,025.3</u>	<u>1,025.3</u>
Share premium account	<u>647.8</u>	<u>647.8</u>

Zero per cent preference shareholders are not entitled to receive notice of, attend or vote at, any general meeting of the company. 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 FRS 25 'Financial Instruments: Disclosures and 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. See note 14(b).

23. Share capital and reserves

	Called up share capital £m	Share premium account £m	Profit and loss account £m	Total £m
At 1 April 2013	1,025.3	647.8	380.6	2,053.7
Profit after taxation	-	-	667.2	667.2
Actuarial losses on defined benefit pension schemes (see note 21)	-	-	(191.8)	(191.8)
Taxation on items taken directly to equity (see note 8c)	-	-	39.7	39.7
Dividends paid on equity shares (see note 9)	-	-	(153.0)	(153.0)
At 31 March 2014	<u>1,025.3</u>	<u>647.8</u>	<u>742.7</u>	<u>2,415.8</u>

24. Operating lease commitments

The company is committed to make the following payments under non-cancellable leases during the next year:

	Land and buildings 2014 £m	Plant and machinery 2014 £m	Land and buildings 2013 £m	Plant and machinery 2013 £m
Non-cancellable operating leases which expire:				
Within one year	0.1	0.2	0.3	0.2
Between two and five years	0.4	0.6	0.5	0.6
After five years	2.7	-	2.1	-
	<u>3.2</u>	<u>0.8</u>	<u>2.9</u>	<u>0.8</u>

Notes to the financial statements (continued)

25. Reconciliation of operating profit to net cash inflow from operating activities

	Re-presented*	
	2014	2013
	£m	£m
Operating profit	678.7	635.3
Depreciation (see note 3)	452.3	453.3
Amortisation of grants and contributions (see note 3)	(6.9)	(6.7)
Loss on disposal of tangible fixed assets (see note 3)	6.4	9.8
Increase in stocks	(3.7)	(0.6)
Increase in debtors	(3.4)	(29.5)
Increase/(decrease) in creditors	0.1	(23.0)
Increase in provisions	5.7	1.8
Pension contributions paid less pension expense charged to operating profit	(7.2)	(53.2)
Net cash inflow from operating activities	<u>1,122.0</u>	<u>987.2</u>

*The comparatives have been re-presented to include increase in provisions of £1.8 million and pension contributions paid less pension expense charged to operating profit of £53.2 million as separate categories, rather than within movement in other provisions (including pension surplus/liability), as previously presented.

26. Reconciliation of net cash flow to movement in net debt

	2014	2013
	£m	£m
Decrease/(increase) in overdraft in the year	70.3	(95.3)
Net cash inflow from increase in debt and lease financing	(144.5)	(149.6)
Net cash inflow from derivatives ⁽¹⁾	(3.4)	(6.4)
Changes in net debt resulting from cash flows	<u>(77.6)</u>	<u>(251.3)</u>
Non-cash adjustments	23.8	(149.0)
Movement in net debt in the year	<u>(53.8)</u>	<u>(400.3)</u>
Net debt at 1 April	<u>(6,029.9)</u>	<u>(5,629.6)</u>
Net debt at 31 March	<u>(6,083.7)</u>	<u>(6,029.9)</u>

Non-cash adjustments include fair value movements and indexation.

⁽¹⁾ Cash flows on derivatives include £nil financing inflow (2013: £0.7 million)

27. Financing

	2014	2013
	£m	£m
New loans	1,005.7	634.3
Loans repaid	(844.0)	(467.0)
	<u>161.7</u>	<u>167.3</u>
Financing cash flows on derivatives	-	0.7
Net cash inflow from financing	<u>161.7</u>	<u>168.0</u>

Included in these cash flows are amounts drawn down and repaid on a loan facility provided by the intermediate parent undertaking.

Notes to the financial statements (continued)

28. Analysis of changes in net debt

	At 1 April 2013 £m	Cash flow £m	Non-cash movements £m	At 31 March 2014 £m
Overdraft	(103.8)	70.3	-	(33.5)
Parent and fellow subsidiary undertaking loans	40.0	-	-	40.0
	<u>(63.8)</u>	<u>70.3</u>	<u>-</u>	<u>6.5</u>
Debt due after one year	(6,119.9)	(162.8)	66.7	(6,216.0)
Debt due within one year	(204.6)	18.3	(1.5)	(187.8)
	<u>(6,324.5)</u>	<u>(144.5)</u>	<u>65.2</u>	<u>(6,403.8)</u>
Net debt excluding derivatives	(6,388.3)	(74.2)	65.2	(6,397.3)
Derivatives	358.4	(3.4)	(41.4)	313.6
Net debt including derivatives	<u>(6,029.9)</u>	<u>(77.6)</u>	<u>23.8</u>	<u>(6,083.7)</u>

29. Related party transactions

The aggregate disclosable transactions with the related parties of the company were with Lingley Mere Management Company Limited as follows:

	2014 £m	2013 £m
Sales of services	0.5	0.4
Purchases of goods and services	0.7	0.7
Amounts owed to related party	0.1	-

Lingley Mere Management Company Limited is a 100% owned subsidiary of Lingley Mere Business Park Development Company Limited, which is a 50% owned joint venture company established between United Utilities Property Services Limited and MUSE Developments Limited. United Utilities Property Services Limited is a 100% owned subsidiary of United Utilities PLC.

Sales of services to related party were on the company's normal trading terms.

No guarantees have been given or received. No amounts have been written-off during the year (2013: £nil).

30. Ultimate parent undertaking and controlling party

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

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

Notes to the financial statements (continued) /

30. Ultimate parent undertaking and controlling party (continued)

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

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.