Registered No: 2366678

United Utilities Water Limited

Annual Report and Financial Statements

31 March 2016

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Regulatory reporting:
Regulatory reporting information for the year ended 31 March 2016 is contained in the separate Annual Performance Report, which has been prepared in accordance with regulatory reporting guidelines, and will be available separately once filed with Ofwat.

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

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

Strategic report

Chairman and Chief Executive Officer's review

Performance
This is the first year of the new 2015–20 regulatory period and one in which we took another step towards our vision of becoming the UK's best water and wastewater company, providing customers with great service. We are pleased to report a continuing improvement in underlying performance and customer satisfaction, in a year that presented some difficult operational challenges.

Customers
In recent years, we have made great strides in improving customer satisfaction, underpinned by better operational performance. We are pleased to report another year in which underlying customer satisfaction has again improved. However, the last 12 months presented a number of very significant operational challenges and we feel it is appropriate to note the enormous effort by the company's employees, its partners and other stakeholders to sustain water and wastewater services to customers.

Water quality incident
On 5 August 2015, routine sampling identified contamination by cryptosporidium of water leaving our treatment works at Franklaw, affecting over 300,000 homes and businesses in Lancashire. With public health our first priority, we quickly moved to issue an advice notice to affected customers advising they boil their water before drinking it, whilst we sought to identify and eliminate the source of contamination. Having made so much progress in recent years, we were disappointed to have inconvenienced customers and we are enormously appreciative of their patience and understanding whilst we worked to address the incident.

We have already acted on lessons learned from the incident and we have worked closely with our water quality regulator, the Drinking Water Inspectorate, on a lengthy and complex investigation into its cause. We await the Inspectorate's report on the matter. We would like to thank all those who gave their support and assistance during the incident.

Flooding
December 2015 will be remembered as an awful time for many customers in Cumbria, Lancashire and Greater Manchester when communities were inundated by flooding caused by unprecedented rainfall. The storms at the beginning of December affected over 85 of our wastewater treatment works and a number of other facilities. Dealing with the earlier water quality incident had heightened our readiness. Once again, our appreciation goes to our employees, suppliers and partners who worked tirelessly to maintain the supply of water and return wastewater treatment facilities to service, giving up their Christmas to help families and businesses affected by the floods.

Underlying improvement
Notwithstanding the impact on our customers of the water quality incident and the severe flooding events, we were pleased to see a further improvement in customer satisfaction with an increase in our score on Ofwat's service incentive mechanism (SIM) compared with last year. Considering the challenges associated with the storms, we were particularly pleased that customers rated us 'very highly' for wastewater services where we achieved first place among the 10 water and sewerage companies for the winter period and second place over the full year. We recognise that we have more to do, particularly in respect of our water services. Whilst we are one of the water and wastewater companies with the fewest customer complaints, we are no better than average in how well customers feel we address their complaint. This is an area of particular focus for us and we are revising our training, policies, processes and systems to drive improvement. In addition, we are implementing a new customer relationship management

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(CRM) system aimed at offering an improved customer experience, as well as delivering further efficiencies in our customer-facing operations. The incidents we experienced last year showed us there is more we can do to help customers at such times and we launched our new 'Priority Services' offer in May 2016. With the help of third sector groups and other stakeholders, we developed an approach to provide targeted support to customers who are experiencing short or long term difficulties and we are working hard to encourage customers to register with the scheme.

Systems thinking

We have coined the phrase 'systems thinking' to capture the key themes of our new operating model, aimed principally at improving the operational efficiency and effectiveness of our wholesale business. We are investing in our new operating model over this five-year regulatory period with efficiency savings contributing to achievement of our totex targets. Those key themes are:

The reliable and efficient operation of our assets

This is critical to both customer service and our environmental performance and we are driving a shift from a reactive to proactive mind-set, seeking, where possible, to address problems before they affect customer service. We are in the final stages of commissioning our new asset management system to deliver much improved preventative and 'on condition' maintenance scheduling and control. We are progressively deploying engineering teams in the field to ensure best performance of our assets throughout their expected life-span – often saving capital expenditure through more effective operational interventions.

Better use of data to monitor, control and optimise asset performance

Our new integrated control centre (ICC) acts as the data hub where we plan, monitor and increasingly control assets. We are close to completing installation of our new telemetry backbone, which acts as the 'data highway' between our assets and the ICC. Under this programme, production sites are being equipped to monitor and optimise site performance.

Think system

Our 91 water treatment works form part of an integrated water supply network and our new production planning system provides real time modelling capability to optimise the cost of total production. It provides us with the capability to re-plan as events occur and this proved invaluable in addressing the considerable water quality challenges created by the storms last year. On wastewater, we are piloting whole drainage area system management, fusing weather and asset data to predict problem 'hotspots' and act to optimise drainage system performance for the benefit of customers and the environment.

Organisation and empowerment

We have shifted away from the typical functional organisation in the water sector to a 'production line' model where multi-disciplinary teams are aligned to water or wastewater production sites and networks. This is delivering much higher levels of performance through increased end-to-end ownership of our assets.

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Operational performance

Targeted investment in our assets, processes and the people who operate them has supported sustained improvement in recent years in our environmental performance, as measured by the Environment Agency (EA). We have again been assessed by the EA as one of the best performers in our sector. Performance of our water business scored average or above on four out of six metrics used by the Drinking Water Inspectorate to assess our performance in 2015. However, over the same period, we saw a disappointing growth in the number of water quality events across the business, positioning us in the lower quartile for the sector. We have grasped this issue and set about a number of improvements in training, processes and asset standards. Early results are encouraging and this area will remain a focus of management attention until we are satisfied that the improvement is sustainable.

Performance against our final determination

In setting pricing, we are very conscious of the need to balance investment requirements against the impact on customer bills, particularly given the high levels of economic deprivation in the communities we serve. Our price review settlement includes some challenging total expenditure targets to help deliver this balance. We have worked hard to find ways to make these savings and are pleased to report that we are implementing a range of initiatives to deliver over £400 million of savings to meet our total expenditure allowance, as set by Ofwat. This will still enable us to invest substantially in our assets for the benefit of our customers and the environment. A key feature will be improving resilience, the importance of which was emphasised by the operational incidents we faced this year.

Our economic regulator, Ofwat, has introduced a new set of incentives for this five-year regulatory period called outcome delivery incentives, or ODIs. Each carries a potential for penalty or reward based on the company's performance in achieving the operational targets, which generally become tougher over the five-year period. Consultation with customers ahead of submission of our five-year business plan indicated that they were generally content with the level of service provided and so there was little support for rewards attached to ODI performance. As a consequence, our cumulative ODIs are skewed toward penalty with very few areas in which we can earn a substantive reward. At the beginning of last year, we set out a soft target range for our cumulative ODI performance between a £100 million net penalty and a £50 million net reward. We are pleased to report a better than expected performance over the last year resulting in a £2.5 million net reward and we have revised our target range to between £70 million net penalty and £30 million net reward over the five years.

ODIs and the serviceability they represent will benefit from our investment programme in this regulatory period and we have accelerated our £3.5 billion investment programme to deliver improvements as early as possible. During the year we invested £799 million in our assets and systems, around one-third more than the first year of the last regulatory period, and our time, cost and quality index, which measures how effectively we are making that investment, has once again scored highly at around 90 per cent. We expect this front-end loading of investment to continue into the second year of this regulatory period.

Robust capital structure

To support the retention of a robust capital structure, we aim to maintain efficient access to debt capital markets throughout the economic cycle. We have debt costs locked-in at attractive rates and are on track to beat Ofwat's allowed cost of debt for the 2015–20 period. The board believes it is appropriate to keep gearing, measured as net debt to regulatory capital value, within our existing target range of 55 to 65 per cent. We aim to maintain, as a minimum, our existing credit ratings for the company of A3 with Moody's and BBB+ with Standard & Poor's.

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Economic environment

Although unemployment in the North West has reduced over the last 12 months, our region continues to have the highest proportion of economically deprived households in England. We have more customers who struggle to pay, with customer indebtedness continuing to be a significant challenge for us.

We place significant focus on helping customers who are struggling to pay and continue to offer a wide range of ways to help them back into regular payment. This includes a new social tariff and an independently administered trust fund for which we increased our annual contribution following a cash tax refund from HMRC. Our new Priority Services scheme supports those customers who may be suffering physical or mental illness as well as those in financial difficulty.

Our debt management processes have been independently assessed as being of a very high standard. We recently implemented a data sharing process with the credit reference agency 'Equifax' and this is helping to distinguish between those customers who are facing genuine hardship and those who try to avoid paying their bill for other reasons.

Non-household retail

We are well advanced in our preparations for full English market opening, having implemented a new customer relationship management system at the end of 2014. However, recognising the relationship between scale and cost to serve for a retail organisation, United Utilities saw the benefit of combining its business retail operation with that of another company to create a competitive proposition for the English and Scottish market. We were delighted to find similar thinking in Severn Trent and on 1 March 2016 the UUG group announced that it had entered into a joint venture (JV) to combine the two groups' non-household water and wastewater retail businesses, principally comprising billing and customer service activities, to be centrally located in Stoke-on-Trent.

This new company, 'Water Plus', will combine the complementary skills of both United Utilities and Severn Trent, including business strategy, sales, customer service and credit management, to deliver an attractive and competitive choice for large and small business customers across England and Scotland. Bringing the businesses together will create a joint venture with the synergies to provide an efficient and cost-effective operation focused on improved customer service and growth.

We are delighted that the JV has received the approval of the Competition and Markets Authority and we are in the process of progressively transferring operations to the new location.

Long-term planning

Our Strategic Direction Statement, 'Playing our part to support the North West', reflects extensive consultation with customers and other stakeholders to create our best view of what the next 25 years holds for our region. This includes economic, social and environmental developments such as the predicted impact of climate change.

Our Water Resources Management Plan, which describes the projected pattern of water resource activity in our region until 2040, projects that the majority of the North West will be in surplus. Customers benefit from an integrated network that supports movement of water around the region to accommodate its changing supply and demand balance. Our plan includes a new Thirlmere pipeline to extend our integrated network to encompass West Cumbria.

As a lone agent, the group could not deliver the scale of required environmental improvement at an acceptable level of cost. Instead we are committed to partnering with others who can support the achievement of our required outcomes – such as our 'Turning tides' partnership with the EA,

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local authorities, the Marine Conservation Society and other interested parties to improve bathing waters in the North West.

Water 2020

Ofwat is assessing a range of options for the next price review, including competition in the areas of water resources and sludge processing, along with the possible transition from RPI to CPI inflation. We have been actively involved in discussions with the industry and regulators and have submitted comprehensive responses to Ofwat's various consultation papers. Ofwat has recently published its views on a range of options for Water 2020 and we are currently undertaking a detailed review of these documents. We will respond in due course, with customers and shareholders at the heart of our thinking.

Responsible business

We aim to build on our notable achievements across the 2010–15 regulatory period and remain highly focused on delivering the best service to customers, at the lowest sustainable cost, while acting in a responsible manner.

The environmental and sustainability performance of the UUG group has received external recognition due primarily to the contribution of United Utilities Water Limited. United Utilities retained its 'World Class' rating as measured by the Dow Jones Sustainability Index and again achieved industry leading status in the multi-utility/water sector.

We continue to support partnerships, both financially and in terms of employee time through volunteering, with other organisations across the North West. We recently set up 'Catchment Wise', our new approach to tackling water quality issues in lakes, rivers and coastal waters across the North West.

Our employees

We would not have been able to deliver the significant improvements for customers over recent years without the enthusiasm and commitment of our employees. We are proud of their unrelenting dedication and of our sub-contracting partners who have worked very hard all year round in supporting customers and the environment and we would like to thank them for their significant contribution.

The company has seen significant change over the last few years, and we continue to move through a period of transformation as we respond to the demands of the new regulatory price control. We remain focused on maintaining high levels of employee engagement. Although it has fallen slightly this year at 75 per cent, this continues to demonstrate that our employees have a strong capability to adapt. We have been successful in attracting and retaining good people and have continued to expand our apprentice and graduate programmes, with many now having secured permanent roles across our business. We have received external recognition for our apprentice and graduate schemes.

Health and safety will always be a key focus area and, as part of our health and safety improvement programme, we have implemented a number of initiatives which helped reduce the employee accident frequency rate further in 2015/16. However, we recognise that we still have more to do, as we strive for continuous improvement.

Our board

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

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We would like to say thank you and farewell to Catherine Bell who will be standing down at the UUG general meeting in July, after nine years on the board. Catherine is chair of the UUG corporate responsibility committee and a member of the UUG nomination, audit and remuneration committees and has provided invaluable guidance to United Utilities throughout her time on the board.

We are pleased to welcome Alison Goligher to the board with effect from 1 August 2016. Alison's industrial and engineering background from her roles with Royal Dutch Shell and Schlumberger will be a great asset to the board.

Outlook

We are confident that we can build on our strong operational and environmental performance and improve further as we progress through this new regulatory period, supported by our 'systems thinking' approach to operating the business. We are accelerating our 2015–20 capex programme and substantial investment in our assets will continue, driving benefits for our customers and the environment. Our progress over the first year of this new regulatory period underpins our confidence in delivering our targets.

Dr John McAdam
Chairman

Steve Mogford
Chief Executive Officer

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How we create value within 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. These are served by 10 licensed companies which provide both water and wastewater services.

We are the second largest of these 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.

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. Since privatisation, the water industry has invested over £100 billion in maintaining and improving assets and services.

Competitive environment
The other water companies in England and Wales are naturally our main competitors and we benchmark our performance against them using comparative performance reports from our economic regulator, Ofwat, and our environmental regulator, the Environment Agency. Away from the water sector, in line with our vision to be the best UK water and wastewater company, we also benchmark our customer service performance against other leading service providers in our region. In addition, as our ultimate parent company, United Utilities Group PLC, is a publicly listed FTSE 100 company, the other UK and worldwide listed utilities are competitors from an investment perspective.

The customers we serve
United Utilities Water holds 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 to small shops.

Our vision

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

Over the last five years we have made significant progress towards our vision, having achieved industry-leading status on many performance metrics used by our regulators and other

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stakeholders. We realise, however, that we have more to do and that the environment in which we operate is changing – adding to both the challenge and opportunity.

We were one of the most improved companies in our sector for customer satisfaction over the last regulatory period and underlying performance last year showed another year on year improvement. Our ambition is to be highly regarded by the customers we serve and so, in addition to water sector measures, we regularly rank customer perception of our performance against other leading brands operating in the North West. We score well in this survey, just behind the well-regarded brands of John Lewis and Marks and Spencer. What is clear is that customer expectations are ever increasing. Improvements since privatisation mean that water supply interruption is very much the exception and customers' expectation of compensation for service failure is growing. Our service proposition must adapt accordingly and we are investing in a complete overhaul of our day to day customer service proposition to provide customers with a best-in-class offering. In addition, the incidents we experienced last year showed us that there is more we can do to help customers at difficult times in their lives and in May 2016 we launched our 'Priority Services' offering to provide targeted support to customers who are experiencing short or long term difficulty.

The 2015 storms in the North West demonstrated the importance of infrastructure resilience and the ability to minimise the impact of severe weather events. Climate change predictions indicate that we can expect more frequent periods of intense rainfall and drought across the UK. Whilst it is impractical to believe we can protect customers fully from the implications of climate change, we can take measures aimed at reducing the impact of weather events and enabling recovery to be as fast as possible. Over recent years, we have invested significantly in enhancing the resilience of our systems and this proved to be of considerable benefit during last year's events. Our plans over this five year regulatory period include investment in enhanced resilience. Water companies are currently working with other stakeholders, including Defra, our regulators and leading research establishments, to consider what additional measures we can take both individually and collectively to enhance our resilience to climate change. We are playing an active role in this dialogue.

In order to deliver our vision, we will need to continue to make significant improvements in our operational efficiency. We have looked for best practice inside and outside our sector and we are progressively transforming our operating model using what we call 'systems thinking'. For water, our philosophy is to consider our landscape of reservoirs, aqueducts, process sites and distribution networks as a 'big system' and to use processes and technology to deliver uninterrupted, wholesome water to customers at lowest cost. It means changing the culture of our organisation from reactive to proactive, finding and fixing problems before they affect our services to customers. A recent example is our Thirlmere pipeline project where our integrated approach enabled us to consider a wide range of factors in determining what we believe to be the best solution for customers, shareholders, local communities and the environment. The project is designed to protect the environment as well as providing long-term resilience of water supplies in West Cumbria.

On wastewater, we are currently piloting the integration of our assets across a full drainage area to understand how we can improve our response to weather and customer activity. Through this work we are seeking to develop systems to optimise the performance of our wastewater network in different conditions, to benefit environmental outcomes, energy generation from renewables and reduce operating cost. Our first 'systems thinking' investment was delivered towards the end of the last regulatory period with the opening of our new integrated control centre and more capability will be delivered over the next 18 months. Our plans for the next regulatory period are

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currently being developed, taking learning from using the capability in this period and looking to exploit falling sensor costs and developments in artificial intelligence.

Our vision recognises that the market in which we operate is changing. The Water Act 2014 introduced the potential for wide ranging change, commencing with the opening of the non-household retail market to competition in April 2017. The UK Government recently asked our economic regulator, Ofwat, to consider the merits of opening the household retail market to competition and Ofwat will present its conclusions later this year. In addition, under a strategy of progressive evolution of the water market, Ofwat declared its intent to open the market for water resources and sludge processing to competition from 2020.

These developments represent the most significant structural change for the water sector since privatisation and we are working constructively with the government and our regulators to understand the implications for customers and shareholders and offer solutions for their effective implementation. We will continue to put effort into being competition ready as is evidenced by United Utilities' recent move in forming a joint venture with Severn Trent for the non-household retail market and our investment in new systems to provide an enhanced offering to business customers.

How we create value

We create value for our stakeholders principally by agreeing and then delivering, or outperforming, our regulatory contract. The way we use our key resources, manage our internal environment and interact with our ever-evolving external environment, influenced by our long-term strategic approach, helps to achieve value creation. This facilitates the delivery of outcomes for our customers, employees, the environment and communities, alongside ensuring investors receive an appropriate return. This is represented in the diagram on the next page.

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

'Systems thinking' lies at the heart of our day-to-day decision making, right through from approving our capital expenditure programmes to agreeing our supply-chain partners. Whilst the financial impact is a key driver in decision-making, this is always set in the context of the impact on customers, shareholders, the environment, employees and communities. For many years we have included corporate responsibility (CR) factors as strategic consideration, supported by our UUG CR committee which is chaired by one of our non-executive directors (more details are provided in the corporate governance section on pages 44 to 64).

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

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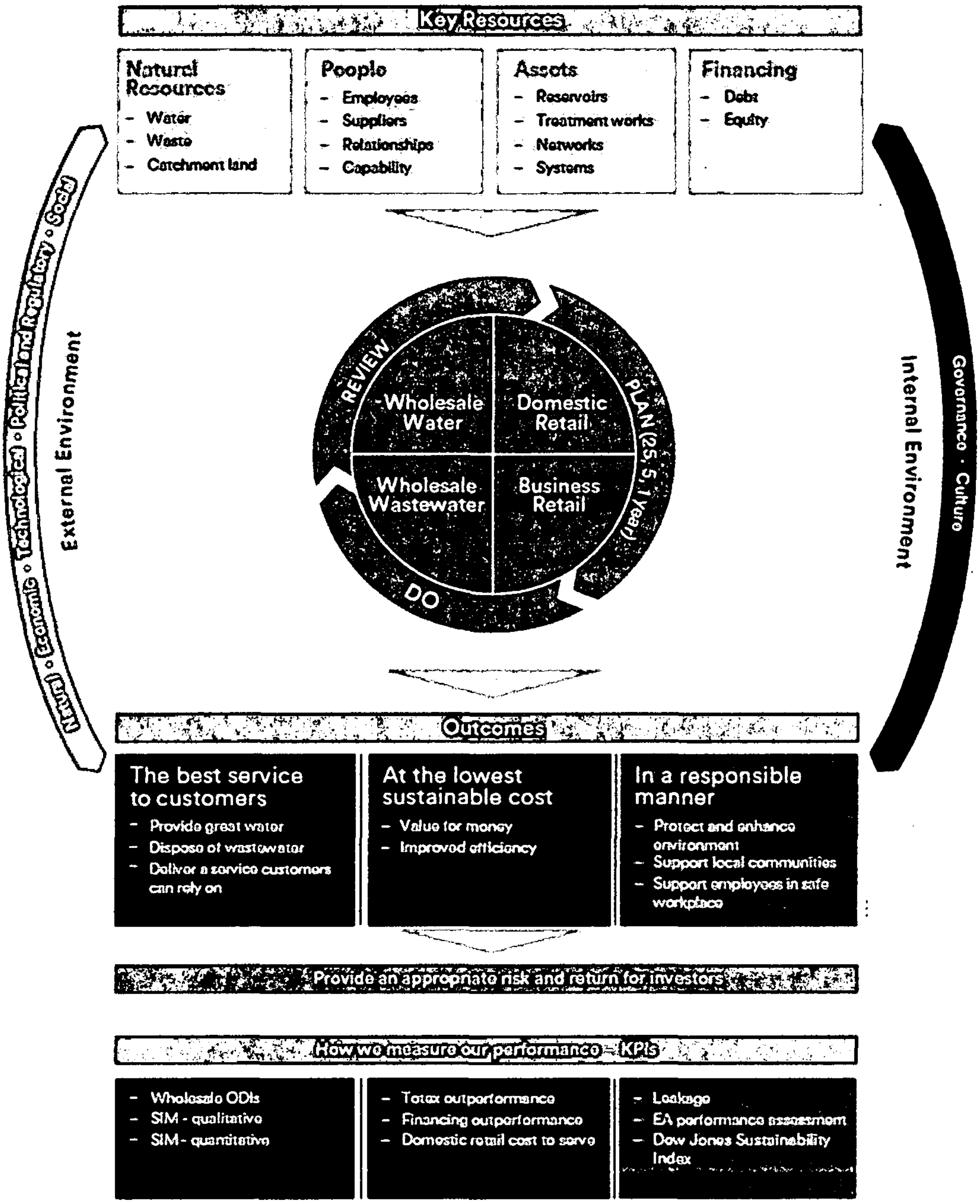
How we create value within our operating environment

Our business model



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Key resources

Natural resources

Whilst rainfall in the North West of England is greater than other parts of the country, and thus supply is not as constrained, it is still in everyone's interest to make the most of this precious resource. We have encouraged customers to use water more efficiently and have increased the number of households fitted with meters. We also have a regulatory annual leakage target, based on the sustainable economic level of leakage, which we aim to meet each year.
We own over 55,000 hectares of land around our reservoirs. Our sustainable catchment management programme (SCAMP) has shown that we can effectively manage these catchments to protect and enhance water quality and to provide other benefits such as an improved natural environment. Our new Catchment Wise project is looking at working with others to improve the lakes, rivers and coastal waters where we return wastewater to benefit the natural environment of the North West.

As well as water and our catchment land, another key resource is waste. Sludge from wastewater can be processed to generate renewable energy, helping to save power costs and protect the environment. Our advanced digestion facility at Davyhulme is one of the largest works of its type in the world and in 2016 we began injection of biogas from Davyhulme's wastewater treatment into the national gas network. We also recycle waste by supplying treated biosolids to agriculture, which provides a valuable resource to farmers.

In order to utilise these key natural resources to create value for our business, our 'Instrument of Appointment' or Licence is integral. This was granted to us as part of the privatisation of the water industry in 1989.

People

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

We place a strong emphasis on providing comprehensive training and development opportunities to develop our existing employees, improving our internal skill-base as well as providing a more engaged workforce. By enhancing our understanding of best business practices in other companies and sectors around the world and bringing this learning back to our business we have increased our organisational knowledge and capability, which has been integral to developing our 'systems thinking' approach to operating our business. Our award-winning apprentice scheme, coupled with our graduate recruitment programme, is helping to ensure we can continue to attract and train up a high calibre of engineers, in a profession which has seen declining numbers in the UK in recent years.

All of our employees are paid at least the Living Wage as defined by Living Wage Foundation and independent studies have shown that this enhances the quality of work of staff, increases staff retention, reduces absenteeism as well as providing societal benefits. Management has a range of incentives which focus on performance over a number of years, rather than just the current year, to encourage the delivery of benefits over the longer term.

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

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

We value diversity, providing equality of opportunity and recruiting and promoting on merit, which we believe provides the benefits of a more comprehensive and balanced skills-set. Despite being a highly engineering-based organisation, women are represented at all levels of our company, with one-third of the UUG group combined board and executive team being female, as shown in the table below:

	Male **2016**	Female **2016**
UUG group board	6 (75%)	2 (25%)
Senior managers		
- Executive team*	4 (57%)	3 (43%)
- Other senior managers	38 (81%)	9 (19%)
Wider employees	3,411 (63%)	2,209 (37%)

*Figures exclude CEO and CFO who are included in UUG group board figures
There are also 13 male (81 per cent) and 3 female (19 per cent) employees who are appointed as statutory directors of subsidiary group companies within the United Utilities group but who do not fulfil the Companies Act 2006 definition of 'senior managers'.

The health and safety of our employees is fundamental, most importantly to the welfare of our employees but also to the reputation and performance of our company. This continues to be a significant area of focus as we strive for continuous improvement. We have implemented a number of initiatives over recent years which have helped to reduce the employee accident frequency rate.

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

Maintaining a good relationship with our key stakeholders such as our suppliers, investors, regulators and customers is vital for the success of our business. For example, on large capital projects we work closely with our suppliers and by maintaining a good relationship and working towards the same goals we can help ensure the delivery of projects on time, to budget and with minimum customer impact. Maintaining regular contact and positive relations with investors may help encourage them to buy or retain our shares or finance our future capital programmes. Engagement with regulators may help positively influence future policy. Our stakeholder relationships are influenced by our reputation and so we try to ensure our strong values and performance are accurately portrayed externally.

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

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

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

We expect to invest around £3.5 billion across 2015–20 and to continue with a substantial investment programme for the foreseeable future in order to meet more stringent environmental standards from the European Union and to maintain and improve the current standards of our assets and services. When deciding on our investment strategy we have to be mindful of the impact on our customers' bills and this is why, for example, we are spreading some of the environmental spend required by European legislation over the next 15 years.

Financing

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

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

External environment

Natural

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

We plan far into the future to ensure we are prepared for the changing natural environment, most notably the effects of climate change. With severe dry periods becoming increasingly common, we must ensure we continue to have resilient water resources and an infrastructure capable of moving water efficiently around the region. The potential effect of climate change on our future water resources is included in our 25-year Water Resource Management Plan.

We must tackle flooding incidents caused by the intensive bursts of rainfall which are becoming more frequent due to changing weather patterns. This was evident in December 2015, when

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Honister in Cumbria broke existing UK records for the most rainfall over a 24-hour period, with the consequential devastating flooding across the region.

Additionally, we must ensure we are able to meet increased demand on our sewerage network as the regional population is expected to increase. A phased, long-term approach ensures that the necessary work can be delivered whilst not placing too much pressure on customer bills.

We have a responsibility to return water to the environment safely. Spills from our network can lead to pollution which can damage the natural environment and could lead to loss of reputation and financial penalties, depending on their severity. Our number of serious pollution incidents has decreased over recent years and it is an important area of focus within our 25-year Strategic Direction Statement. The Environment Agency assesses water companies' performance across a basket of measures including pollution and its overall assessment is included as one of our KPIs (see pages 27 to 28) with all of the pollution sub-measures also reported within our Corporate Responsibility pages on our website at: *corporate.unitedutilities.com/cr-environment*

We can make an important contribution to protecting and enhancing the natural environment by using fewer natural resources. We have been driving down our carbon footprint over the last decade (22 per cent fall in CO2 emissions since 2005/06) and have plans to reduce further going forward. Less than 10 per cent of our waste goes to landfill and our use of recycled products is increasing. This provides environmental benefits and adds value through energy cost savings.

Economic

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

In recent years, unemployment in the North West has generally been higher than the national average. However, over the last year the North West unemployment rate has improved faster than the national average and is now broadly in line. A report from the Department for Communities and Local Government, published during 2015/16, reaffirmed that the North West continues to have more of the most deprived areas in England than any other region. Even as the North West economy recovers it is unlikely to have a significant impact on deprivation, which is the principal driver of our higher than average costs to serve our household customers. This is currently recognised by Ofwat through a special allowance for deprivation of £20 million per annum over the 2015–20 period.

Bad debts remain a risk to which we are exposed, particularly with the continuing tightening of real disposable incomes and the impact of recent welfare reforms likely to intensify. Whilst our debt management processes have been externally benchmarked as efficient and effective, we will continue to refine and enhance them whilst also helping customers back into making regular payment through use of manageable payment plans.

Interest rates have remained below the long-term trend and we have benefitted from this as we drew down or raised over £600 million of new debt in 2015/16. Comparatively low interest rates have also been beneficial to our future cost of debt as we continue with our interest rate hedging strategy.

Despite picking up recently to 1.6 per cent at March 2016, RPI inflation has been relatively low over the last couple of years, impacted by the falls in oil and commodity prices. The prices we

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charge our customers (and therefore revenues), as well as our asset base, are linked to RPI inflation, so lower RPI has meant slightly lower growth on these measures.

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

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

Technological

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

We have also been utilising technology within our energy self-generation. For example, our Davyhulme sludge recycling centre employs a ground-breaking configuration of thermal hydrolysis to maximise energy generation from sludge and won an Annual Institute of Chemical Engineers award for innovation in 2013/14.

We also have to be mindful of our customers' ever increasing use of technology. We have recognised the increasing power of social media as communication channels for customers in doing business with us and we recently completed investment in a new digital external communications capability and a number of website improvements. This proved invaluable in handling the unprecedented increase in communication necessary with customers during the Lancashire water quality incident in summer 2015.

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

Political and regulatory

Over a long time frame the political and regulatory environment can change significantly. In the 27 years since the water industry was privatised by the UK Government, we have seen substantial tightening of laws and regulations. Whilst to some extent, changes to the regulatory environment are outside of our direct control, maintaining a good reputation is important to enable positive participation in regulatory discussions. By positively engaging and using our industry knowledge, we can help influence future policy with the aim of achieving the best outcome for our customers, shareholders and other stakeholders.

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

Ofwat introduced a number of important changes for the 2015–20 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 are now four separate price controls:

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

The way companies' operating and capital costs are assessed has been modified to encourage companies to utilise the most efficient, sustainable solutions under a new 'totex' model. Where companies outperform their totex allowance, this gain would be shared between investors and customers, ensuring both receive the benefit.

There was also a move to a more outcomes-based approach, with greater emphasis being placed on customer engagement to agree the outcomes. Companies' performance will be measured through a range of outcome delivery incentives (ODIs) covering a wide range of measures assessing operational and environmental performance, with associated rewards or penalties.

Ofwat's SIM assessment is continuing, which will reward companies who perform well on customer service, or penalise companies who perform badly, relative to other water companies.

Each year all water companies are required to publish an annual performance report, the first of which is due in July 2016 and our report will be made available on our website at *corporate.unitedutilities.com*

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

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Changes in regulation – Opening up the competitive arena
Currently only very large business customers are 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 its network for this water supply. Although very few users have switched supplier in England, the 2014 Water Act aims to open up future retail competition to all business customers, including sewerage as well as water services from 2017. United Utilities is well positioned for this expansion of competition following our recently announced joint venture with Severn Trent, combining our business retail businesses (see page 44 for more details on this joint venture).

Following a request from government, Ofwat is currently assessing the potential costs and benefits of extending retail competition to household customers, with a paper scheduled to be published in the next few months. Ofwat expects to factor in the UK Government's conclusions and decisions in this area at its next price review in 2019.

The Water Act also paves the way for the future introduction of competition for certain parts of the wholesale, or upstream, business. Following this, Ofwat proposed, in its Water 2020 consultation document in December 2015, to open up competition in the areas of water resources and sludge treatment from 2020. We are fully engaged with regards to market reform, being always mindful of the potential impact on our customers and the value implications for United Utilities' shareholders.

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

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

The Environment Agency controls how much water can be drawn from the environment and the quality of water returned to rivers and the sea. The EA produces an assessment of water and wastewater companies' annual performance, and we include this as one of our KPIs, see page 28. *www.gov.uk/government/organisations/environment-agency*

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

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

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

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

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

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.

Internal environment

Governance
Good governance lies at the heart of all successful organisations and leads to better management decisions as well as helping to avoid exposure to potential risks. We strive to operate in a manner that reflects the highest standards of corporate governance. Our company structure and governance standards are designed to ensure that our board continues to provide sound and prudent governance in compliance with the principles of the UK Corporate Governance Code.

As you would expect of the provider of an essential service, we adopt a prudent approach to managing risks to our business. That being said, accepting some level of risk is a normal consequence for a commercial organisation. Also, 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 2015–20 regulatory contract.

We also face risks in relation to potential future changes in legislation or regulation.
An important risk to our business is ensuring that we get the constituent elements of our five-yearly business plans correct to ensure our financeability, and that they are agreed by Ofwat in its final determination, as we are bound by these plans for the following five-year period with limited opportunity to change them. See pages 38 to 43 for more details on what we consider to be our top risks.

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

The governance section of the annual report on pages 44 to 64 presents information on the board of United Utilities Water Limited and its activities. It also sets out how the board demonstrates leadership, effectiveness and its accountability to the company's stakeholders.

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Culture
We operate under the three core values of integrity, innovation and customer focus. Acting with integrity, both at board level and as a company, underpins our approach to responsible business and building trust. Our employees are integral to value creation and we actively encourage our people to express their opinions and views, through, for example, our annual 'Your Opinion Survey'.
Innovation is a critical enabler in creating value, helping to keep us ahead of our competitors. Our employees are given the opportunity to develop and present their ideas to senior management, facilitating an innovative environment. Utilising innovation from our suppliers is part of our supply chain approach, which also provides another avenue to benefit from new ideas and technologies.

Over recent years, we have instilled a more customer-centric approach right across our organisation and this evolving culture has been a key driver to the major improvements in customer service we have been able to deliver. Putting customers right at the heart of what we do has also helped deliver benefits for shareholders and wider stakeholders.

Our business model

In line with Ofwat's evolution from one single price control to four (see political and regulatory environment on page 17), we have structured our business into four distinct areas: Wholesale water; Wholesale wastewater; Domestic retail; and Business retail.

Each business area undertakes both long-term and shorter-term planning to identify how it can best deliver its outcomes. We adopt an integrated approach which considers a whole range of stakeholders including customers, investors, the environment, our employees and local communities. These plans also take into account the internal and external factors described on pages 15 to 21. Underpinning our approach to planning, we undertake a cycle of continuous assessment using KPIs and other performance measures which helps formulate future plans, with a view to delivering further improvements for our various stakeholders.

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

Allowed costs within the domestic retail price control are determined using a water industry average cost to serve approach, rewarding companies who are able to achieve costs below industry average costs. The business price control is being increasingly opened up, with full competition expected from 2017, providing a strong incentive for water companies to deliver efficiencies and service improvements in this area.

Planning

Planning – 25 years+
In order to maintain a reliable, high quality water service for our customers in the future, we have to look a long way ahead and anticipate those changes and core issues that are likely to impact on our activities. Our long-term strategy helps us to define what we need to deliver over the shorter term, which in turn helps to create value.

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

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

By anticipating these changes we can ensure that we continue to deliver what customers want at a fair price and in a responsible way.

Our Strategic Direction Statement, 'Playing our part to support the North West' (which can be downloaded at *corporate.unitedutilities.com/future*), sets out our long-term strategy for the next quarter of a 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 ensure their expectations are reflected in our plans.

Some of the key ways we create value over this longer time frame are by:

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

Planning for future water demand

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

Read more online at *unitedutilities.com/waterresourcesplan*

Planning – 5 years

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

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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.

Our five-year plan for 2010–15 was focused on improving customer satisfaction, meeting our statutory obligations and delivering shareholder value and we delivered on all fronts. We were the most improved water company as measured in Ofwat's SIM assessment, with customer complaints down approximately 75 per cent over 2010–15. We achieved upper quartile performance on Ofwat's and the Environment Agency's respective KPIs in both 2013/14 and 2014/15, met our annual leakage target each year and retained our 'World Class' status in the Dow Jones Sustainability Index. Our outperformance was generated mainly through efficiency savings on operating and capital expenditure and, in particular, by securing debt costs at below Ofwat's allowed industry cost of debt. Our good performance over 2010–15 has provided a strong platform to deliver further value over the 2015–20 period.

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

- improving customer service, which will improve efficiency, reduce costs and reduce potential penalties/increase rewards from Ofwat, under its service incentive mechanism (SIM);
- enhancing our debt collection activities, which will reduce our retail costs. Alongside this, we continue to provide comprehensive support for customers struggling to pay;
- raising low-cost finance, which helps us outperform the finance costs allowed in our regulatory contract. This is our main area of outperformance potential in the 2015–20 period.
- implementing our hedging strategies, such as fixing medium-term interest rates and power costs, to reduce the volatility of these costs, helping us meet our regulatory contract;
- minimising total costs on a sustainable basis, such as on power, materials and property rates, which helps us meet or outperform totex costs allowed in our regulatory contract;
- delivering our operational and regulatory commitments, which helps ensure we achieve high levels of customer service and meet environmental standards. Our performance can also result in potential financial rewards or penalties such as those linked to our outcome delivery incentives (ODIs), which include reliably delivered high-quality water and reducing pollution and sewer flooding incidents;
- maintaining a robust supply and demand balance, which provides water resource and customer supply benefits and avoids any penalties or unfunded expenditure requirements from our regulators; and
- increasing our production of renewable energy from waste, which helps protect us from rising energy costs and reduces our carbon footprint.

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

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Wholesale water

- maintain existing high levels of reliability in the delivery of day-to-day water services, making better use of technology to monitor remotely and control more of our source-to-tap assets;
- maintain existing high levels of water quality as measured at customers' taps and our water treatment works;
- reduce the number of contacts from customers regarding water quality;
- maintain leakage at or below the sustainable economic level;
- limit the impact on customers of increases in operating costs, such as chemicals and rates, by making cost savings elsewhere through 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 to support the sensitive ecology in that area.

Wholesale wastewater

- 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;
- reduce the number of our customers' properties exposed to sewer flooding by over 40 per cent, seeking opportunities to work in partnership with others to deliver schemes cost-effectively and promote the use of more sustainable drainage systems;
- improve the region's bathing waters, in light of tougher regulatory standards;
- 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 reduce our carbon footprint; and
- constrain costs associated with taking responsibility for all private sewers and private pumping stations across the region, through improvements to our operating model and efficient delivery of our programme.

Domestic retail

- continue to improve the customer experience by being more proactive with customers, anticipating problems before they materialise and improving our communication channels so that we are easier to do business with;

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- reduce further the number of customer complaints and to resolve them whenever we can, avoiding the need for complaints to be referred to the Consumer Council for Water;
- reduce the debt burden on the company and its customers by engaging with those who are struggling to pay, helping them to return to sustained payment behaviour. We are extending our options for assistance to hard-pressed customers, developing a new social tariff from 2015, and 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; and
- 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.

Business retail

- 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;
- increase first point resolution and case ownership, reducing cost to serve and improving customer satisfaction;
- install meters in all business customer premises that give automated meter reads (AMR) to facilitate billing for actual consumption; and
- offering value-add additional services such as leakage detection and repair and ways in which to reduce water use.

We are already starting to plan for the next price review which will cover the 2020–25 period in order to achieve the optimal plan for our stakeholders. In light of the 2014 price review, a key area of focus is to compile more robust evidence to support our cost requirements reflecting our significant regional differences. For example, we have a higher proportion of industrial customers whose potent wastewater is more expensive to treat. We also have many designated sites of environmental importance, such as the Lake District, which requires us to treat wastewater to higher standards.

Planning – 1 year

Each financial year we develop a business plan, approved by the board, which sets our annual targets to help deliver further improvements and move us towards achievement of our five-year goals. This business plan covers a broad range of measures across the three strategic areas of best service to customers, lowest sustainable cost and responsible manner. Senior management has quarterly business review meetings with the executive directors to monitor and assess performance to help ensure we are on track to deliver our targets.

At the end of every financial year, our performance is assessed against this basket of measures and this determines employees' annual bonuses right through the organisation. As well as annual targets, our directors are assessed against three-year performance covering total shareholder return, sustainable dividends and customer service through long-term incentive plans. Details of the 2015/16 annual bonus and vested long-term incentive plans for our executive directors are shown on pages 60 to 63.

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Outcomes

By delivering our strategy in both the long and shorter term we aim to deliver the following key outcomes for our stakeholders:

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

Outcome: Give value for money – customer bills are fair

Our households currently pay just over £1 per day on average for the combined water and wastewater services we provide. Our price determination for 2015–20 means customers will benefit from below inflation increases to average household bills for the decade to 2020.

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Our key performance indicators (KPIs) 2015-2020

To help measure our progress on how well we are adding value for our stakeholders and delivering the outcomes described on page 26, we focus on a range of financial and operational KPIs, as defined below. These KPIs are set for the five-year period of our short-term planning horizon and encompass the important areas of customer service and environmental performance, as well as financial indicators, taking into consideration the interests of all of our stakeholders. Strong performance across these KPIs would indicate that our strategy is delivering on our targeted outcomes, helping us on our path to reaching our long-term strategic goals.

Our operational KPIs have evolved to reflect the move to a totex price control for the 2015–20 regulatory period, with a totex outperformance measure replacing the previous separate opex outperformance and capex outperformance measures. We now include an outcome delivery incentive (ODI) KPI in our wholesale business to monitor our performance against these important new operational measures. This replaces the previous serviceability KPI which is incorporated within the ODI measures. With the retail household price control now being separated, we have introduced a new KPI to measure our costs in this area.

Operational KPIs

These operational KPIs feed through from our three strategic themes: the best service to customers; at the lowest sustainable cost; and in a responsible manner

Company objective/KPI	Definition	Target	Performance
Best service to customers			
Wholesale outcome delivery incentive (ODI) composite	Net reward/(penalty) accrued across United Utilities' 19 wholesale financial ODIs	Range of +£30m to -£70m over 2015–20	**2015/16: £2.5m net reward** ODIs only introduced in 2015/16 so no prior year comparators
Service incentive mechanism – qualitative	Ofwat derived index based on quarterly customer satisfaction surveys, measuring the absolute and relative performance of the 18 water companies (previously 19 in 2014/15). Each company receives a score in the range of zero to five, with five being the highest attainable score	To move towards the upper quartile in the medium-term	**2015/16: 4.27** 2014/15: 4.24 New methodology for 2014/15, hence no prior year comparators
Service incentive mechanism – quantitative	Ofwat derived composite index based on the number of customer contacts, assessed by type, measuring the absolute and relative performance of the 18 water companies (previously 19 in 2014/15). Each company receives a SIM point total, where the lowest score represents the best performance	To move towards the upper quartile in the medium-term	**2015/16: 95** 2014/15: 99 New methodology for 2014/15, hence no prior year comparators

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

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Our performance and the progress we have made against our objectives and their associated KPIs are included within the business performance section below.

Our performance 2015/16

Strong operational and environmental performance

- Accelerated investment to deliver early operational benefit; £799 million invested in 2015/16 and TCQi[1] at 90 per cent
- £2.5 million net reward achieved for 2015/16 on outcome delivery incentives
- Benefitting from 'systems thinking' operational approach and improved resilience of network
- Retained Dow Jones Sustainability Index 'World Class' rating and sector leading status

(1) *Time; Cost; Quality index (TCQi), which is an internal measure of the overall effectiveness of delivery of the capital investment programme*

Further improvements in customer satisfaction

- Service incentive mechanism score improved compared with last year
- Customers continue to rate us very highly on wastewater services

Implementing efficiency plans to eliminate totex gap

- Business plan initiatives in place to meet totex allowance
- Good progress achieved in first year of the five-year regulatory period

'Water Plus' Business retail JV with Severn Trent approved by the CMA

- First mover advantage and economies of scale, ahead of full market opening in 2017

Good financials

- Robust capital structure
- Strong credit ratings

Operational performance

United Utilities 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 substantial improvements in our performance over recent years and this was recognised by Ofwat in the final determination, with United Utilities averting a possible revenue penalty for the 2015–20 period. This is also reflected in a reduction of approximately 75

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per cent in the overall number of customer complaints received over the 2010–15 period, which has also contributed to improvements in opex efficiency.

We have continued to develop our systems and processes to deliver the experience our customers seek when they need to contact us, including multi-channel contact centre technology. We have placed a strong emphasis on striving for first time resolution of customer enquiries, keeping customers informed of progress until resolution. This has been underpinned by investment in our people in terms of better training and improved systems. We have also enhanced our customer feedback process to help us respond to customers' evolving needs and continually improve.

Adjusting for the water quality incident, domestic customer complaints in 2015/16 were lower than last year. Ofwat has amended its SIM methodology for the 2015-20 period, based on domestic retail only and with more emphasis on qualitative performance. This revised methodology is based on a different data set and, as we have highlighted previously, quarterly results may well produce wider fluctuations compared with the last regulatory period. Our SIM scores for 2015/16 have also improved slightly on last year, as outlined in the KPIs section below, despite the operational incidents we experienced in the year.

Improving customer service will continue to be a key area of management focus and we see opportunities to deliver further benefits for our customers.

Leading North West service provider – we are consistently ranked third out of 10 leading organisations in the North West, through an independent brand tracker survey which is undertaken quarterly. This covers key attributes such as 'reputation', 'trustworthy' and 'customer service'. We are behind only Marks and Spencer and John Lewis, and 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. We continue to supply a high level of water quality, with an improvement in our water quality index ODI, despite the incident last August, although we did separately incur compensation and other associated costs of around £25 million. We have consistently delivered high quality water and believe this incident was a one-off event for us. We have consistently delivered a reliable water service, although we experienced some water no-supply incidents in 2015/16. Whilst this is disappointing, we have improved internal processes and systems detection capability to help reduce the risk of these incidents occurring in the future. We will also benefit from our integrated control centre, enabling us to take corrective action before the customer is impacted.

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

Ofwat KPIs – our strong overall operational performance is reflected in Ofwat's latest (2014/15) key performance indicators report, which was published in September. The balance of ratings for United Utilities across the 14 assessment measures represents a joint first position, in respect of the 10 water and sewerage companies. We are pleased that our good performance has been recognised, although remain strongly focused on improving further.

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Key performance indicators:
Outcome delivery incentives (ODIs) – as outlined at our full year results in May 2015, ODIs, which are a new feature of the 2015–20 regulatory period, will form an important KPI composite to monitor the operational performance of our wholesale business. This replaces the previous serviceability KPI which is incorporated within the ODI measures. There are 19 wholesale financial ODIs and the risk is skewed to the downside, with 10 attracting a penalty only. We will report each year on our performance and provide a net reward or penalty position across the range of our wholesale ODIs.

The impact of the Lancashire water quality incident has not had a material impact on our ODIs, but we have already incurred £25 million of associated costs, as outlined previously. Our sewer flooding ODI is particularly challenging, although there are a number of other areas where we have made a good start, such as private sewers and pollution incidents. Overall, we are encouraged to have achieved a net reward of £2.5 million. We have benefitted from our proactive management approach and the planned acceleration of our investment programme. Our main areas of reward came through our good performance in the areas of private sewers and pollution, with our main penalty being on reliable water service where we experienced some no supply events in the year.

Whilst this overall outcome was better than our initial expectations, the ODI targets get tougher as we move through the five-year regulatory period. Therefore, we need to make further improvements to avoid penalties and this will be very challenging for us. Nonetheless, our progress this year gives us the confidence to improve our target to reflect a cumulative net ODI outcome over the 2015–20 period of between plus £30 million and minus £70 million.

Service incentive mechanism (SIM) – United Utilities was the most improved company on SIM during the 2010–15 regulatory period, although we recognise that there is still more to do. Our target is to move towards upper quartile in the medium-term.

Qualitative: Ofwat has now undertaken the four surveys for 2015/16 and United Utilities has improved its score to 4.27 points, compared with 4.24 points in 2014/15, despite the Lancashire water quality incident and the unprecedented flooding events. In particular, customers scored us highly for our wastewater service. For 2015/16, United Utilities was in 12th position out of the 18 water companies.

Quantitative: the quantitative assessment measures customer contacts and performance is assessed on both an absolute and relative basis. Relative performance can only be assessed following the end of each full financial year when the other companies publish their respective results. On absolute performance for 2015/16, our score of 95 points represents a slight improvement on the previous year when we scored 99 points.

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 also substantially locked in our power commodity costs across 2015–20, providing greater cost certainty for the regulatory period.

Proactive network management – as part of our 'systems thinking' approach to the way we run our business, we are being more proactive in the management of our assets and networks. We aim to improve 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.

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Debt collection – our region suffers from high levels of income deprivation and we offer wide-ranging schemes to help customers struggling to pay, including our trust fund into which we paid a £6 million contribution in 2015/16. Notwithstanding our industry-leading debt management processes, deprivation remains the principal driver of our higher than average bad debt and cost to serve and we expect this to continue to be a challenging area for us.

In 2015/16, we have reduced bad debt expense to 2.3 per cent of regulated revenue from 3.1 per cent last year. This reflects our ongoing strong focus on managing bad debts, along with a reduction in certain charges, related to our review last year of operational debt processes and bad debt provisions, which were not expected to continue at the same level.

Pensions – United Utilities has taken progressive steps to de-risk its pension provision. UUW had an IFRS retirement benefit surplus of £226.9 million as at 31 March 2016, an increase in surplus from £74.8 million as at 31 March 2015. Further details are provided in the pensions section on pages 37 to 38.

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. To improve efficiency further, we implemented new contracting arrangements for the 2015–20 regulatory period to help deliver our regulatory capital investment programme of over £3.5 billion. We re-tendered our engineering and construction partners and selected a single engineering partner and four new design and construction partners. We are involving our partners much earlier in project definition and packaging projects by type, geography and timing to deliver efficiencies. Projects will be allocated to partners on an incentive basis or competed between the partners and, where appropriate, third parties. Our partners have come forward with a range of solutions, innovations and pricing and early results are encouraging.

We also continue to drive more effective and efficient delivery of our capital programme and, for this regulatory period, we are applying a tougher measurement mechanism to our Time: Cost: Quality index (TCQi) score. This includes measuring cost in terms of totex (previously capex only) and giving a greater weighting in the cost element to our biggest capital projects. This has resulted in a recalibration of the index. Despite this tougher approach, our TCQi score remains high at 90 per cent which represents a very good performance above our internal target of 84 per cent for the first year of this regulatory period.

We have made a good start to the 2015–20 investment programme and, as planned, are accelerating the five-year programme to maintain and improve services for customers and deliver early operational and environmental benefits. Regulatory capital investment in 2015/16, including £169.3 million of infrastructure renewals expenditure, was £798.6 million, in line with our expectations.

Key performance indicators:
Financing outperformance – The low cost of debt we have already locked-in places the group in a strong position to deliver our target for the 2015–20 period of beating Ofwat's industry allowed cost of debt.

Total expenditure (totex) outperformance – our KPIs have evolved to reflect the move by Ofwat to a totex price control, with totex outperformance for our wholesale business now replacing the previous separate opex outperformance and capex outperformance measures. We exceeded our 2010–15 outperformance targets for both opex and capex. Although our totex allowance is tough, we are implementing a range of initiatives and are confident of meeting our target of delivering our promises to customers within the cumulative 2015–20 wholesale totex final determination allowance. Progress in the first year has been good and we are on track to meet the five-year target.

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Domestic retail cost to serve – with the retail household price control now being separated for the 2015–20 period, we are introducing a new KPI to measure our costs in this area. Overall, it will be very challenging to meet the regulatory assumptions for domestic retail costs. This is primarily due to Ofwat's price review methodology at PR14 which made no allowance for inflation in the domestic retail business and, in our view, made insufficient allowance for dual service (water and wastewater) companies. The regulatory assumptions for domestic retail costs become progressively tougher as we move through the 2015–20 period. Our target is to minimise our costs compared with Ofwat's revenue allowance. We have delivered a good performance in 2015/16 and outperformed this year's revenue allowance by around £10 million.

Responsible manner

Acting responsibly is fundamental to the manner in which we undertake our business and the group has, for many years, included corporate responsibility factors in its strategic decision making. Our environmental and sustainability performance across a broad front has received external recognition. Earlier in the 2015/16 financial year, United Utilities retained its 'World Class' rating in the Dow Jones Sustainability Index for the eighth consecutive year primarily due to the contribution by the group, again achieving industry leading performance status in the multi-utility/water sector. Retaining 'World Class' status for this length of time is a significant achievement, particularly as the assessment standards continue to increase and evolve.

Leakage – strong, year round, operational focus on leakage, alongside our network resilience improvements and the implementation of a range of initiatives, such as active pressure management, enabled us to again meet our leakage target in 2015/16.

Environmental performance – this is a high priority for us and we were again an upper quartile company in the Environment Agency's latest performance metrics, as described in the KPIs section below.

Carbon footprint – we are committed to reducing our carbon footprint and increasing our generation of renewable energy. In 2015/16, our carbon footprint totalled 454,857 tonnes of carbon dioxide equivalent, which is a 22 per cent reduction over the last 10 years (for further information please visit *corporate.unitedutilities.com/cr-environment*).

Employees – we continue to work hard to engage all of our employees in the transformation of the group's performance. Although employee engagement has fallen slightly from last year, at 75 per cent this continues to demonstrate that our employees have a strong capability to adapt. We remain focused on maintaining high levels of employee engagement.

We have been successful in attracting and retaining people and have continued to expand our apprentice and graduate programmes for 2015/16. We now have a total of 54 graduates and 93 apprentices across the business. Our investment in recruiting graduates and apprentices is already benefitting the company, with 49 of them now having secured permanent roles across our business.

As part of our health and safety improvement programme, we have implemented a number of initiatives which helped reduce further the employee accident frequency rate to 0.104 accidents per 100,000 hours for 2015/16, compared with a rate of 0.112 in 2014/15, 0.137 in 2013/14 and 0.188 in the previous year, although we recognise that we still have more to do. Health and safety will continue to be a significant area of focus, as we strive for continuous improvement.

Communities – we continue to support partnerships, both financially and in terms of employee time through volunteering, with other organisations across the North West. We recently set up Catchment Wise, our new approach to tackling water quality issues in lakes, rivers and coastal waters across the North West, and our 'Beachcare' employee volunteering scheme helps to

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keep our region's beaches tidy. We continue to support local communities, through contributions and schemes such as providing debt advisory services and our Community Fund, offering grants to local groups impacted by our capital investment programme.

Key performance indicators:
Leakage – Although leakage is included within our outcome delivery incentives, we intend to continue publishing our leakage position separately, with it being an important measure from a corporate responsibility perspective. We delivered a good performance in 2015/16 and have again met our regulatory leakage target of 463 megalitres per day.

Environmental performance – On the Environment Agency's latest assessment (2014/15 report), which covers a broad range of operational metrics, United Utilities is again an upper quartile company. Based on our performance across the range of metrics, this indicates we were in joint second position among the 10 water and sewerage companies and aligns with our medium-term goal of being a first quartile company on a consistent basis.

Corporate responsibility – United Utilities has a strong focus on operating in a responsible manner and is the only UK water company to have a 'World Class' rating as measured by the Dow Jones Sustainability Index. In 2015/16, we retained our 'World Class' rating for the eighth consecutive year and aim to retain this rating again this year.

Financial performance

Financial KPIs	2016	2015
Turnover	£1,691.7m	£1,700.0m
Operating profit	£575.3m	£656.2m
Profit before tax	£348.8 m	£328.3 m
RCV gearing	64%	63%
Interest cover	2.7	3.0

Revenue

The group has delivered a good set of financial results for the year ended 31 March 2016. Revenue was down £8.3 million at £1,691.7 million. This principally reflects the new regulated price controls, offset by higher than expected volumes this year and the fact that last year was impacted by a £20.7 million special discount applied to customer bills.

Operating profit

Reported operating profit decreased by £80.9 million, to £575.3 million, reflecting the new regulated price controls and an expected increase in depreciation and other costs, partly offset by a reduction in bad debts, power and regulatory fees. In line with our planned acceleration, there was also a £21.1 million increase in infrastructure renewals expenditure this year. During the year there was compensation and operating costs, totalling £24.8 million, in relation to the Lancashire water quality incident in summer 2015 and an £11.1 million charge relating to market reform restructuring costs incurred preparing the business for open competition in the business retail market.

There was also a net credit of £0.6 million in relation to the unprecedented flooding incidents which occurred in December 2015. We incurred an £11.4 million impairment charge on our property, plant and equipment plus £1 million on infrastructure renewals expenditure and £7.0 million of other operating costs. However, these costs were more than offset by insurance proceeds recognised of £20.1 million.

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Investment income and finance expense

Reported net finance expense of £226.5 million was significantly lower than the £327.9 million expense in 2014/15. This £101.4 million decrease principally reflects a change in the fair value gains and losses on debt and derivative instruments, from a £141.8 million loss in 2014/15 to a £62.6 million loss in 2015/16. The fair value losses in both years were largely due to a decrease in medium-term interest rates, which impact our derivatives hedging interest rates. The fair value loss in 2014/15 was greater than that in 2015/16, as the decrease in medium-term interest rates was larger in 2014/15. The group uses these swaps to fix interest rates on a substantial proportion of its debt to better match the financing cash flows allowed by the regulator at each price review. The group has fixed the substantial majority of its non index-linked debt for the 2015–20 financial period.

In addition, the reduction in net finance expense reflects a lower cost of debt locked-in on the group's nominal debt and the impact of lower RPI inflation on the portion of the group's index-linked debt with an eight month lag. Interest on non index-linked debt of £121.4 million was £19.8 million lower than last year, due to the lower rates locked in on our interest rate swaps from 2015, compared with our 2010–15 swaps. The indexation of the principal on our index-linked debt amounted to a net charge in the income statement of £37.9 million, compared with a net charge of £46.6 million last year. As at 31 March 2016, the group had approximately £3.4 billion of index-linked debt at an average real rate of 1.5 per cent.

Profit before tax

Profit before tax was £348.8 million, £20.5 million higher than last year, primarily due to the lower operating profit having been more than offset by the aforementioned £101.4 million reduction in net finance expenses.

Tax

Consistent with our wider business objectives, we are committed to acting in a responsible manner in relation to our tax affairs. Full details of our tax policies and objectives are set out on page 64.

In 2015/16, we paid corporation tax of £26.4 million compared with £50.0 million for 2014/15. The amount for 2015/16 was broadly half of the expected liability as in 2015/16 the company's cash tax position was adjusted to align with the external quarterly payment regime to HMRC, whereby half of the total liability is paid in year with the balance paid in the following year.

The total tax credit for 2015/16 is £38.7 million as compared to a total charge of £70.2 million for 2014/15, the main difference being the current year deferred tax credit of £111.9 million, relating to the enacted reduction in the headline rate of corporation tax to 18 per cent from 1 April 2020.

In addition to corporation tax, the group pays and bears further annual economic contributions, typically of around £130-140 million per annum, in the form of business rates, employer's national insurance contributions, environmental taxes and other regulatory service fees such as water abstraction charges.

Cash flow

Net cash generated from operating activities for the year ended 31 March 2016 was £694.6 million, compared with £766.7 million in the previous year. This reduction mainly reflects lower operating profit offset by an improvement in working capital cash flows and lower corporation tax paid. The group's net capital expenditure was £650.6 million, principally in the regulated water and wastewater investment programmes. This excludes infrastructure renewals expenditure which is treated as an operating cost under IFRS.

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Net debt including derivatives at 31 March 2016 was £6,582.7 million, compared with £6,359.0 million at 31 March 2015. This increase reflects regulatory capital expenditure and payment of dividends, interest and tax, partly offset by operating cash flows.

Fair value of debt

The group's gross borrowings at 31 March 2016 had a carrying value of £7,190.1 million. The fair value of these borrowings was £7,681.0 million. This £490.9 million difference principally reflect the significant fall in real interest rates, compared with the rates at the time we raised our index-linked debt. This difference has decreased from £713.2 million at 31 March 2015 due primarily to an increase in credit spreads.

Debt financing and interest rate management

Gearing (measured as group net debt divided by UUW's regulatory capital value) was 64 per cent at 31 March 2016, an increase of 1 per cent compared with the position at 31 March 2015, remaining within Ofwat's 55 per cent to 65 per cent assumed gearing range.

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

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

Cash and short-term deposits at 31 March 2016 amounted to £204.3 million. Over 2015–20 we have financing requirements totalling around £2.5 billion to cover refinancing and incremental debt, supporting our 2015–20 investment programme and we have now already raised around £1.4 billion of this requirement (including the most recent £250 million loan with the European Investment Bank (EIB), signed in April 2016). In December 2013, UUW agreed a new £500 million term loan facility with the EIB and we drew down the final £150 million on this facility during the first half of 2015/16, all on a floating rate basis. In March 2015, UUW signed a new £250 million index-linked term loan facility with the EIB. This is an amortising facility with an average loan life of 10 years and a final maturity of 18 years from draw down and as at 31 March 2016 we had drawn down £175 million on this facility. In March 2015, UUW arranged a £100 million, 10-year index-linked loan with an existing relationship bank.

In April 2015, UUW's financing subsidiary, United Utilities Water Finance PLC (UUWF), issued two index-linked notes totalling £60 million, consisting of a £25 million, 10-year maturity and a £35 million, 15-year maturity. UUWF also issued a €52 million note (swapped to floating sterling) with a 12-year maturity. All these notes were issued via private placement off our EMTN programme.

In the second half of 2015/16, UUW arranged two £100 million loans with existing relationship banks; a seven-year floating rate loan, drawn down in December 2015 and a 10-year index-linked loan, drawn down in March 2016. UUWF issued a €30 million private placement note (swapped to floating sterling), with a 15-year maturity, off our EMTN programme in October 2015. In addition, the group agreed £50 million of new five-year committed bank facilities.
In April 2016, UUW signed a £250 million index-linked term loan facility with the EIB to support the delivery of UUW's AMP6 investment programme. This is an amortising facility with an average loan life of 10 years and a final maturity of 18 years from draw down and is the first tranche of an anticipated £500 million funding package for AMP6 from the EIB, with the second tranche expected to be made available for signature later in the AMP.

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

Long-term sterling inflation index-linked debt provides a natural hedge to assets and earnings. At 31 March 2016, approximately 52 per cent of the group's net debt was in index-linked form, representing around 34 per cent of UUW's regulatory capital value, with an average real interest rate of 1.5 per cent. The long-term nature of this funding also provides a good match to the company's long-life infrastructure assets and is a key contributor to the group's average term debt maturity profile, which is around 20 years.

Where nominal debt is raised in a currency other than sterling and/or with a fixed interest rate, the debt is generally swapped to create a floating rate sterling liability for the term of the debt. To manage exposure to medium-term interest rates, the group fixes underlying interest costs on nominal debt out to 10 years on a reducing balance basis. This is supplemented by fixing substantially all remaining floating rate exposure across the forthcoming regulatory period around the time of the price control determination.

In line with this, the group has fixed interest costs for substantially all of its floating rate exposure over the 2015-20 period, locking in an average annual interest rate of around 3.7 per cent (inclusive of credit spreads). For 2015/16, the rate was slightly higher, as we transitioned between the two regulatory periods.

Liquidity

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

Available headroom at 31 March 2016 was £138.5 million based on cash, short-term deposits, committed bank facilities, along with the undrawn portion of the EIB term loan facilities (signed at that time), net of short-term debt as well as committed facilities and term debt falling due within 12 months.

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

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

Pensions

As at 31 March 2016, the group had an IAS 19 net pension surplus of £226.9 million, compared with a net pension surplus of £74.8 million at 31 March 2015. This £152.1 million favourable movement mainly reflects the impact of a significant increase in credit spreads, reducing the IAS19 pension liability, partially offset by an increase in inflation assumptions. In contrast, the scheme specific funding basis does not suffer from significant volatility due to inflation and credit spread movements as it uses a fixed inflation assumption via the inflation funding mechanism and a prudent, fixed credit spread assumption. Therefore, the recent inflation and credit spread movements have not had a material impact on the deficit calculated on a scheme specific funding basis or the level of deficit repair contributions.

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

Principal risks and uncertainties

We identify and manage risks using our risk management framework.

As a business our strategy is to deliver value by providing the best service to customers, at the lowest sustainable cost and in a responsible manner. In doing so the group is exposed to a range of internal and external risks of varying types which can impact upon these objectives. We therefore maintain a risk management framework to continually identify, assess and manage risks. Our long term viability statement can be found on pages 52 and 53.

All parts of the UUG group use the same risk management framework ensuring consistency of approach and supporting risk management and monitoring. The framework includes: an embedded governance and reporting process; an assessment and management process which is aligned to ISO 31000: 2009; and a central database, tools and guidance to further support consistency, embedment and continuous improvement.

Leaders within the group's individual business areas and functions are responsible for the assessment and management of risk including the identification and escalation of new/emerging circumstances and the monitoring and reporting on risk and control effectiveness. All event types (strategic, financial, operational, compliance and hazard) are considered in the context of their potential impact on the delivery of our business objectives. The assessment is based on the likelihood of an event occurring and the financial and reputational impact should the event occur. The assessment takes into account a gross position (without controls or assuming that all controls fail), a current position benefitting from existing controls and a targeted position where further mitigation is required to meet objectives or obligations.

The resulting risk profile is reported to the UUG board twice a year. The report covers four areas: the 10 highest ranked risks (based on likelihood x impact); a further five risks included due to the potential severity of their impact; risks that fall outside these categories but are included due to potential reputational impact or new/emerging circumstances; and a summary of all of the event-based risks within the profile relative to 10 principal risks (see pages 40 to 43) that could seriously affect the performance, future prospects or reputation of the business.

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

- determine the nature and extent of the principal risks it is willing to take in achieving its strategic objectives;
- oversee the management of those risks and provide challenge to executive management where appropriate;
- express an informed opinion on the long-term viability of the company (see pages 52 to 53); and
- monitor risk management and internal control systems and review their effectiveness.

Our risk profile currently consists of around 200 event-based risks. By their nature, these will include all combinations of high to low likelihood and high to low impact. Heat maps are typically used in various managerial and group reports either as a method to collectively evaluate the

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extent of multiple risks within a certain profile or to evaluate the effectiveness of mitigation for a single risk relative to the initial gross position.

Key features and developments

Regulatory, operational, compliance and delivery risks remain key features of the group's risk profile. The introduction of outcome delivery incentives by Ofwat after PR14 creates a regime of potential penalties and rewards based on meeting targets for the delivery of operational and capital programmes. In the context of customer service and operational performance, the Lancashire water quality incident in the summer of 2015 reinforced the requirement to consistently deliver clean, safe drinking water and to further mitigate risks to a continuous service through implementing greater resilience in the asset base.

Market Reform and the introduction of non-household retail competition in April 2017 requires significant preparation so that the group's retail and wholesale functions are in a position to operate compliantly and in accordance with the 'level playing field'.

Looking further ahead, the expected introduction of competition in sludge and water resource activities and the further promotion of the existing inset regime and the UK Government's consideration (announced November 2015) of legislation to enable household retail activities to become competitive at some future date all place risk on the group.

Climate change is also recognised as one of the sector's biggest challenges with significant and permanent implications on the water cycle and the long-term sustainability of the water and wastewater service including: water abstraction; supply and treatment capability; drainage and sewer capacity; and wastewater treatment and discharge efficiency and effectiveness.

Principal risks

The principal risks (aggregated clusters of event-based risks), which have been set out in the table on pages 40 to 43 reflect the categories of risks that define business activity or contributing factors where value can be lost or gained and could have a material impact on the business model, future performance, solvency or liquidity of the group. In each case the magnitude of the potential effect is highlighted together with the extent of management/mitigation. To ensure relevance with the current environment, issues or areas of uncertainty are also illustrated.

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

- In March 2010, Manchester Ship Canal Company (MSCC) issued proceedings seeking, amongst other relief, damages alleging trespass against United Utilities Water Limited (UUW) in respect of UUW's discharges of water and treated effluent into the canal. Whilst the matter has not reached a final conclusion, the Supreme Court has found substantively in UUW's favour on a significant element of the claim and the High Court has upheld UU's position on the remainder of the proceedings. We await to see whether MSCC pursue a further claim to introduce additional matters for determination.

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Principal risks and uncertainties

Risk description	Main business objective	Potential impact	Current key risks, issues or areas of uncertainty include:	Risk exposure	Management and mitigation
Regulatory environment and framework The potential change in the regulatory environment and/or frameworks.	Lowest Sustainable Cost	Changes to regulation and the regulatory regime (either through political or regulatory events) may increase costs of administration, reduce income and margin and lead to greater variability of returns.	▪ Market reform including non-household and upstream competition and, further ahead, the potential for the introduction of household competition ▪ A possible change from using the retail prices index to the consumer prices index for regulatory indexation	Increasing	We engage in relevant government and regulatory consultations which may affect policy and regulation in the sectors where we operate. We also consult with customers to understand their requirements and proactively consider all the opportunities and threats associated with any potential change, exploiting opportunities and mitigating risks where appropriate.
Corporate governance and legal compliance The failure to meet all legal and regulatory obligations and responsibilities.	Responsible Manner	Non-compliance with existing or future laws/regulations (principally relating to the regulated business, but also including non-regulated activity/ commitment) can result in additional workload, financial penalties, additional capital/ operating expenditure (from enforcement orders or legal defence) and compensation following litigation. In more remote but extreme circumstances, penalties of up to 10 per cent of relevant turnover and ultimately revocation of our licence or the appointment of a special administrator are possible.	▪ Competition law and regulatory compliance whilst preparing for and operating within a changing competitive market ▪ Current material litigation ▪ New higher fine levels for environmental offences	Increasing	Legislative and regulatory developments are continually monitored. Risk-based training of employees is undertaken and we participate in consultations to influence legislative and regulatory developments. Funding for any material additional compliance costs in the regulated business is sought as part of the price determination process. The group also robustly defends litigation where appropriate and seeks to minimise its exposure by establishing provisions and seeking recovery wherever possible.
Water service The inability to provide a secure and resilient supply of clean, safe drinking water.	Best Service to Customers	Operational performance problems or service or asset failures can lead to additional operating or capital expenditure and/or increased regulatory scrutiny and regulatory penalties. In more extreme situations the group could also be fined for breaches of statutory obligations, be subject to enforcement action, be held liable to third parties and sustain reputational damage.	▪ Population growth ▪ Climate change ▪ Meeting infrastructure investment requirements ▪ Expected change to the abstraction licensing regime ▪ Catchment management ▪ Raw water quality ▪ Drinking water safety and security	Stable	Mitigation is provided through core business processes, including forecasting, quality assurance procedures, risk assessments and rigorous sampling/testing regimes. Ongoing system and network integration improves service provision and measures of success have been developed to monitor performance. Following the Lancashire water quality incident in 2015 we are further enhancing our approach to operational risk and resilience.
Wastewater service The inability to remove, treat and return wastewater to the environment in an effective, resilient and compliant manner.	Best Service to Customers			Stable	

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Security The inability to protect people, information and assets from malicious or accidental activity.	Best Service to Customers	Our resources, assets and infrastructure are exposed to various threats (malicious or accidental) which could impact the provision of vital services and/or harm people or commercial businesses.	▪ Cybercrime ▪ Terrorism ▪ Other criminality relating to assets or operations	Stable	Physical and technological security measures combined with strong governance and inspection regimes aim to protect infrastructure, assets and operational capability. Recent initiatives include awareness training across the business relating to seven key areas of security and the implementation of a security governance model to oversee all aspects of security and security strategy. Ongoing system and network integration improves operational resilience and we maintain robust incident response, business continuity and disaster recovery procedures. We also maintain insurance cover for loss and liability and the licence of the regulated business also contains a 'shipwreck' clause that, if applicable, may offer a degree of recourse to Ofwat/customers in the event of a catastrophic incident.
Human, technological and physical resource The inability to support/deliver effective and efficient business activity.	Responsible Manner	The capacity or capability associated with human, technological and physical resource (including information, operational technology, skill sets, systems and telephony) can impact the efficiency and effectiveness of business activity, the ability to make appropriate decisions and ultimately meet targets. This can also affect the ability to recruit and retain knowledge/expertise or to recover effectively following an incident. In remote but extreme circumstances there is also the potential for higher levels of regulatory scrutiny, financial penalties, reputational damage and missed commercial opportunities.	▪ Delivering required employee engagement ▪ Personal development and talent management ▪ Technological innovation ▪ Asset management	Stable	Developing our people with the right skills and knowledge, combined with delivering effective technology are important enablers to support the business to meet its objectives. Employees are kept informed regarding business strategy and progress through various communication channels. Training and personal development programmes exist for all employees in addition to talent management programmes and apprentice and graduate schemes. We focus on change programmes and innovative ways of working to deliver better, faster and more cost-effective operations.
Financial risk The inability to appropriately finance the business due to capital, credit, market, funding, liquidity or tax-related risk.	Lowest Sustainable Cost	The failure of financial counterparties could result in additional financing cost, an adverse impact on the income statement and potential reputational damage. Variability in inflation (as measured by the UK Retail Prices Index) and changes in interest rates, funding costs and other market risks could adversely impact the economic	▪ Stability of financial institutions and the world economy ▪ Economic uncertainty ▪ Inflation/deflation ▪ Financial market conditions, interest rates and funding costs	Increasing	Refinancing is long-term with staggered maturity dates to minimise the effect of short-term downturns. Counterparty credit, exposure and settlement limits exist to reduce any potential future impacts. These are based on a number of factors, including the credit rating and the size of the asset base of the individual counterparty. The group also employs hedging strategies to stabilise market fluctuation for inflation, interest rates and commodities (notably

Strategic report

		return on the regulatory capital value (RCV) and affect our pension schemes with a requirement for the group to make additional contributions. In extreme but remote cases adverse market conditions could affect our access to debt capital markets and subsequently available liquidity and credit ratings.	▪ Brexit		energy prices). Sensitivity analysis is carried out as part of the business planning process, influencing the various financial limits employed. Continuous monitoring of the markets takes place including movements in credit default swap prices and movements in equity levels.
Programme delivery The ineffective or inefficient delivery of capital, operational and change programmes.	Lowest Sustainable Cost	Failure to deliver capital or change programmes against relevant time, cost or quality measures could result in a failure to secure competitive advantage or operating performance efficiency and cost benefits. There is also the risk of increased delivery costs or a failure to meet our obligations and customer outcomes which, depending on the nature and extent of failure, could result in an impact at future price reviews, regulatory or statutory penalties and negative reputational impact with customers and regulators.	▪ Security of supply ▪ Delivery of solutions ▪ Quality and innovation ▪ New contract delivery partnerships for the 2015–2020 period with a new approach to construction and design ▪ Price volatility	Stable	We have a developed and clear view of our investment priorities which are built into our programmes, projects and integrated business and asset plans. We have created better alignment and integration between our capital delivery partners and engineering service provider including alignment with our operating model. Our programme and project management capabilities are well established with strong governance and embedded processes to support delivery, manage risks and achieve business benefits. We utilise a time, cost and quality index (TCQi) as a key performance indicator and enhance our performance through a dedicated programme change office to deliver change in a structured and consistent way. Supply chain management is utilised to deliver end-to-end contract management which includes contract strategy and tendering, category management, security of supply, price and price volatility and financial and operational service level performance.
Revenues The inability to maintain revenues and margin due to customer service provision.	Lowest Sustainable Cost	Poor service to customers can result in financial penalties issued by the regulator through components of the service incentive mechanism for household customers. There is also much uncertainty surrounding the form of upstream reform which is now anticipated to materialise after 2019.	▪ Socio-economic deprivation in the North West ▪ Welfare reform and the impact on domestic bad debt ▪ Brexit ▪ Market Reform and the ability to treat other participants equally	Increasing	For Domestic Retail there is a transformation plan in place covering a wide range of initiatives and activities to improve customer service, with a number of controls in place to monitor achievement against the plan. We monitor competitor activity and target a reduction in operating costs. Within our wholesale department processes, systems, data and organisational capacity and capability to deal with market participants and the central market operator are being prepared. The new market requirements will require all market participants to treat other participants equally ('on a level playing field') whilst maintaining compliance with existing regulations.

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Health, safety and environmental The potential harm to employees, contractors, the public or the environment.	Responsible Manner	Working with and around water, sewage, construction and excavation sites, plant and equipment exposes people and the environment to various man-made and naturally occurring hazards. The nature and extent of exposure could result in harm to people, wildlife and natural habitats. Depending on the circumstances, the group could be fined for breaches of statutory obligations, be held liable to third parties and sustain reputational damage.	▪ Excavation, tunnelling and construction work ▪ Working with water and wastewater ▪ Chemicals ▪ All weather conditions ▪ Driving, vehicle movement	Increasing	We have developed a strong health, safety and environmental culture where 'nothing we do at United Utilities is worth getting hurt for'. This is supported by strong governance and management systems which include policies and procedures which are certified to OHSAS 18001 and ISO 14001.

The Strategic report was approved by the board on 10 June 2016 and signed on its behalf by:

Russ Houlden
Chief Financial Officer

Corporate governance report

Introduction from Dr John McAdam, Chairman:

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

Our year

2015/16 has been a challenging year for the group. Key areas of focus for the board have included ensuring that the programme of building water and wastewater assets for the new AMP is well underway with around £800 million of the total £3.5 billion having been spent in the first year. Secondly, we announced on 1 March 2016, that we would enter into a joint venture agreement with Severn Trent combining the two companies' non-household water and wastewater retail businesses subject to obtaining clearance from the Competition and Markets Authority (CMA). Clearance was announced by the CMA on 3 May 2016 and the transaction completed on 1 June 2016. The board's view was that the synergies created through combining the two businesses would provide an efficient and cost effective operation focused on improved customer service, increased efficiency and enhanced value for shareholders. Thirdly, we have had some major operational challenges during the year that have impacted a large number of our customers in Lancashire and Cumbria, which will have tested to the full their faith in our commitment to customer service. The board was kept fully informed of the progress of these incidents and held a number of board teleconference calls to discuss the approach being taken by management to restore normal service to customers. The board were extremely disappointed that these incidents occurred and with the inconvenience caused to our customers. In addition to an investigation of the matter by the Drinking Water Inspectorate the board asked Mark Clare, our senior independent director, to undertake our own investigation in order that lessons could be learnt and appropriate actions taken.

Our approach

As individual directors we are cognisant of our statutory duties and in particular to promote the long-term success of the company. As a board we have a strong sense of common purpose; our intention as directors is to hand over the business to our successors in a better and more sustainable position for the future. Information on our vision and strategy and the way in which we create value is included in the strategic report on pages 9 to 26.

Our people

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

Catherine Bell will be stepping down from the board at the AGM on 22 July 2016. Catherine has been a key component in driving forward the group's corporate responsibility agenda. We announced on 5 May 2016 that Alison Goligher will join the board as an independent non-executive director with effect from 1 August 2016 (see page 66 of the UUG annual report for the year ended 31 March 2016).

We have maintained our target of at least 25 per cent of our board being comprised of women. In terms of diversity of experience, skills and personal attributes, I believe we have great diversity around our board; the directors have many years of experience gained across a variety of industries, with regulatory backgrounds. Good board dynamics are vital to the proper interaction and working of a board of directors. Board directors need to work together effectively for the good of the company and, in short, they need to get on with each other. Clashes of personality are to be avoided as they do not facilitate constructive debate, challenge and effective

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communication. I believe we have individuals who will apply their skills and experience to the benefit of our business and speak up if they disagree but, equally, listen to the views of others.

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

At the time of signing the UUG annual report on 25 May 2016, 40 per cent of our executive team was made up of women. We are keen to develop our female senior managers so that, over time, they can be considered for executive board appointments or as potential candidates for non-executive directorships in other companies. We believe a non-executive appointment provides an excellent opportunity for both personal and career development and it is a way of gaining valuable experience that may be applied at United Utilities so long as no conflicts of interest occur.

Our culture and values

Our aim is to act as a responsible business, and our business principles can be found on our website at *unitedutilities.com/united-utilities-business-principles*

Our core values of acting with integrity and focusing on our customers provides the framework of our business culture and for our employees in the way in which they go about their daily work. It is the board's role to set these strategic objectives and ensure that management is responsible for ensuring implementation. Should our employees have concerns about wrongdoing or potential breaches of our business principles then they can raise their concerns anonymously via a confidential whistleblowing telephone service. Any concerns reported would then be investigated.

Notwithstanding the challenges of the water quality incident in Lancashire, what shone through for the board was the behaviour of our employees. The 'tone from the top' was demonstrated by Steve Mogford's personal leadership of the incident, and our staff worked tirelessly to restore water quality as quickly as possible. On behalf of the board, I wish to extend our gratitude to them – this provides but one example of the dedicated approach our employees have to serving our customers and their importance as an asset of our business.

Our approach to risk

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

Finally, I would like to wish Catherine every success for the future and thank her for her extensive contribution to the board and United Utilities.

Dr John McAdam

Chairman

Corporate governance report

Code principle: Leadership

The UK Corporate Governance Code

UUW, as required by its licence, has 'had regard to' the UK Corporate Governance Code ('the Code', the current version of which was published by the Financial Reporting Council in 2014, a copy of which can be found at *https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf*), since 2008. The company, in agreement with Ofwat, operates a structure that allows directors to be members of the boards of both the company and its ultimate holding company UUG in order to increase the efficiency and effectiveness of the corporate governance structure. These arrangements have been in place since March 2011 and were in place throughout the year ended 31 March 2016. The only exception is Steven Fraser, managing director of the company's wholesale business, who is a director of UUW only. As a board member he provides the UUW board with additional insight into the operational challenges faced by the company.

The boards, of both UUG and UUW, fully support Ofwat's drive for the highest standards of board leadership, transparency and governance in the industry, and are fully cognisant of the long-term nature of the industry and its stewardship of UUW and its assets for future generations of customers. We are satisfied that current practices and the application of the Code at both holding company and regulated company levels are entirely consistent with the Ofwat principles (see pages 47 to 48). A copy of our voluntary code can be found on our website at *corporate.unitedutilities.com/corporate-governance*

As a listed company and the ultimate holding company of UUW, UUG complies with the Code, and did so fully for the year ended 31 March 2016. The UUW board also complies with the Code or explains any deviations from it, primarily that UUW does not duplicate the board committees already operating at the UUG level (details can be found on page 54), as UUW represents 98 per cent of UUG group 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. An explanation of how the UUG board committees complied during the year ended 31 March 2016 with the provisions of the Code can be found on pages 50 to 102 of the UUG 2016 annual report.

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.

Corporate governance report

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

Ofwat Regulated Company Principles	Our response
Transparency – reporting must meet or exceed the standards set out in the Disclosure and Transparency Rules of the UK Listing Authority	This corporate governance report, incorporated by reference into the Directors' Report, meets the requirements of the Disclosure and Transparency Rules of the UK Listing Authority. Our Remuneration Report is included on pages 60 to 63.
The regulated company must act as if it is a separate public listed company An effective Board is fully focused on the regulated company's obligations	UUW represents 98 per cent of UUG revenues. The UUW Board (whose directors' biographies can be found on pages 56 to 59, and includes a strong independent representation with a diverse range of backgrounds and experience) is fully focused on meeting the company's regulated obligations and activities as an appointee in accordance with its Licence as a provider of water and wastewater services*. The UUW board is responsible for the decisions it takes, is advised by the director of regulation and company secretary, and can seek independent advice on any matter it sees fit.
There must be significant independent representation on the Board Independent non-executive directors are essential to securing strong Board leadership and governance In line with best practice, boards should have the appropriate balance of skills, experience, independence and knowledge of the company	Directors' biographies can be found on pages 56 to 59. Five out of the nine directors fulfil the independence criteria of the UK Corporate Governance Code with which a listed company is required to comply (or explain its reasons for not complying) and the Chairman, on appointment as Chair of the UUG Board, fulfilled the Code's independence criteria. Information on succession planning and the appointment process for directors can be found in the UUG annual report in the report of the Nomination committee on pages 64 to 68. The outcome of the annual board evaluation, in which all directors participated, can be found on pages 60 to 61 of the UUG annual report. All directors have attended all scheduled board meetings during the year.
The Chair must be independent of management and investors	The biography of the Chairman can be found on page 56. In Dr McAdam the board has an experienced leader. He shares with the group his experience of other governance practices gained throughout his career and is an effective chair of board meetings who is meticulous in his preparation and planning of all aspects ahead of meetings. Dr McAdam has not declared any interests which conflict with the business of UUW, nor UUG. The role of Chairman and CEO are

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	separate.
Board committees, including but not limited to audit and remuneration committees, will operate at the regulated company level There should be a majority of independent members on the audit and remuneration committees	As agreed with Ofwat in 2010, UUW does not duplicate board committees already in operation at the UUG level. This is because UUW represents in excess of 98 per cent of the UUG group's revenues. Therefore the activities of the UUG board committees, whose memberships are made up entirely of independent non-executive directors and who are also independent non-executive directors of UUW, are necessarily targeted towards UUW matters, thus ensuring that the interests of UUW and its customers are safeguarded. Details of attendance at the UUG committee meetings can be found on page 60 of the UUG annual report.
The group structure must be explained in a way that is clear and simple to understand.	The group structure is shown on page 55.

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

The board of directors

The biographical details of our directors are given on pages 56 to 59 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). There were also a number of ad hoc board meetings held by means of telephone conferencing facilities, a number of which related to the Lancashire water quality incident and the joint venture with Severn Trent.

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

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

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Overview of the board's responsibilities

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

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

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

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

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

UUW board activity in 2015/16

Customer

- Received and discussed regular updates on the Lancashire water quality incident and progress with the action plan
- Considered and approved the Charges Submission for 2016/17
- Reviewed updates on the service incentive mechanism, social tariffs, help to pay scheme and the customer experience programme
- Received an update on IT, cyber security and cyber crime
- Considered and approved the decision to enter into a joint venture with Severn Trent combining the two companies' non-household water and wastewater retail operations

Business as usual

- Received updates on the Security and Emergency Measures Directive
- Approved a number of projects that were above delegated limits and which required the board's approval including the West Cumbria Future Strategy Project and the Morecambe WwTW Catchment Strategy
- Received updates on UUW's top 10 capital projects and recent health and safety accidents and near misses

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- Reviewed the wholesale operating model and the operation of the engineering function within the group
- Received briefings on sewer flooding and UUW's approach of increased monitoring of the network to facilitate early intervention
- Received an update on progress of implementation of the energy strategy to focus on reducing consumption, increasing self-generation and improving the operating efficiency of assets
- Received briefings on the market opening to competition for business customers, public sector, charitable and not-for-profit customers in April 2017
- Considered and approved the decision to enter into a joint venture with Severn Trent combining the two companies' non-household water and wastewater retail operations
- Received an annual briefing on dam and reservoir safety and a reservoir engineers' update
- Received monthly updates on health and safety performance

Regulatory

- Received a briefing on Ofwat's AMP6 annual performance reporting
- Received quarterly updates and the annual report on UUW's DWI water quality performance
- Received updates on the Environment Agency's performance assessment
- Received updates on the annual Regulatory Reporting process to Ofwat and reviewed and approved the 2015 Risk and Compliance Statement and KPI report

Governance

- Granted Powers of Attorney to senior managers to authorise treasury and property related matters
- Noted the retirement of Dr Catherine Bell from the Board and approved the appointment of Alison Goligher as an independent non-executive director with effect from 1 August 2016

Financial

- Reviewed UUW's proposed treasury activities for 2015/16
- Approved UUW's dividends
- Approved the UUW annual report and financial statements and regulatory accounts
- Reviewed the reconciliation of the PR14 Business Plan submissions with actual out-turns and considered the impact on the RCV

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.

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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 the board. A separate nomination committee is not felt to be necessary, as the succession planning needs of the board are dealt with by the UUG nomination committee as the interests of the two boards are aligned and given that UUW represents 98 per cent of the UUG group's revenues.

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

Code principle: Effectiveness

Induction and training
An induction programme is devised for each new non-executive director. It would include one-to-one meetings with the Chairman and each of the existing non-executive directors. They will have one-to-one-meetings with the CEO, CFO, managing director of the wholesale business and the company secretary along with other members of the executive team. They will also meet members of the operational teams and visit some of the key operational sites and capital projects to ensure they get a first-hand understanding of the water and wastewater business.

New directors receive a briefing on the key duties of being a director of a regulated water company including the role of the regulated company's holding company, and they will also meet with the director of regulation. They will also meet with representatives of Ofwat.

Performance evaluation
Our board evaluation was conducted internally this year building on last year's external evaluation conducted by Lintstock Consultants. The internal evaluation was facilitated by the company secretary and his team. Given that there is a high degree of overlap (and common board membership) between the UUW and UUG boards, the board evaluation posed questions that were relevant to both boards. (For further details see page 60 of the UUG annual report).

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Code principle: Accountability

Board's approach to risk management and internal control
The board is responsible for determining the nature and extent of the risks that it is willing to take to achieve its strategic objectives. The board is also responsible for ensuring that the company's risk management and internal control systems are effectively managed across the business and that they receive an appropriate level of scrutiny and board time. The company's risks predominantly reflect those of all regulated water and wastewater companies. One of the most significant is that of failing to achieve our regulatory performance targets or failing to fulfil our obligations in any five-year planning cycle, leading potentially to the imposition of fines and penalties. 2015/16 has been the first year of our current five-year planning cycle, and in terms of our capital programme we have had a smooth start.

During the year, the board engaged an independent review of the effectiveness of the risk management framework as part of the internal investigation led by the Senior Independent Director of the Lancashire water quality incident. The independent review concluded that the risk management framework was robust and reflected best practice and there was active engagement with risk management by senior management, the executive team and the board, but could be strengthened. The recommendations of this internal investigation included: the need for centralisation of the drinking water safety plans within wholesale to aid consistency; improved application of the risk management process; further embedding existing risk management processes within wholesale and improving system integration; and increasing the focus on reputational and operational risks.

The UUG board concluded, following the review by the UUG audit committee, that it was appropriate to adopt the going concern basis of accounting (see page 122 of the UUG annual report). Similarly, in accordance with the principles of the Code, the UUG board concluded, following a recommendation from the UUG audit committee, that it was appropriate to provide a long-term viability statement for UUG (as set out on page 71 of the UUG annual report). Assurance supporting these statements was provided by the review of: the company's key financial measures; the key credit financial ratios; the company's liquidity and the company's on-going ability to meet its financial covenants; and the contingent liabilities of the company.

As part of the assurance process, the board also took into account the principal risks and uncertainties facing the company, and the actions taken to mitigate those risks. These principal risks and uncertainties are detailed on pages 46 to 49 of the UUG accounts, as are the risk management processes and structures used to monitor and manage them. Biannually, the UUG board receives a report detailing management's assessment of the most significant risks facing the company. The report gives an indication of the level of exposure, subject to the mitigating controls in place, for the risk profile of the company. The UUG board also receives information during the year from the UUG treasury committee (to which the board has delegated matters of a treasury nature) including such matters as liquidity policy, the group's capital funding requirements and interest rate management.

Accordingly, given that UUW represents 98 per cent of the UUG group's revenues, the UUW board similarly concluded that it was appropriate to adopt the going concern basis of accounting (see page 79) and provide a long-term viability statement as set out below.

Long term viability statement

The directors have assessed the viability of the group, taking account of the group's current position, the potential impact of the principal risks facing the business in severe but reasonable scenarios, and the effectiveness of any mitigating actions. Based on this assessment, the directors have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the five-year period to March 2021.

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This statement has been based upon the group's strategic planning process, which is aligned to the price control period and the group's robust capital solvency position with a debt to RCV ratio of around 64 per cent, providing considerable capital headroom and supporting any increase in medium-term liquidity if required. The group has a proven track record of being able to raise new forms of finance in most market conditions, and expects to continue to do so into the future. In addition, the board has considered the protections which exists from the regulatory and economic environment within which it operates. From an economic perspective, given the nature of water and wastewater services, threats to the group's viability from risks such as reduced market share, substitution of services and reduced demand are low compared to those faced by many other industries. From a regulatory perspective the group benefits from a rolling 25-year licence which, coupled with the price control set by Ofwat, provides a high degree of certainty of cash flows during the current price control period (which runs to March 2020), while between price control periods there exists additional protection afforded by Ofwat's primary legal duty to ensure that water and wastewater companies are able to finance their functions. For these reasons the board considers it appropriate to provide a medium-term viability statement of five years.

The directors have assessed the group's viability considering the principal risks as set out on pages 40 to 43, and its ability to absorb a number of severe but reasonable scenarios, taking into account those event-based risks assessed to have the highest possibility of occurrence and the most severe impact. These include political and regulatory risks, as well as the potential for a restriction to the availability of financing resulting from a global capital markets crisis. The viability assessment has considered the potential impacts of these risks on the group's business model, future performance, solvency and liquidity over the period. As well as the protections which exist from the regulatory environment within which it operates, a number of mitigating actions are available in the extreme scenarios considered, including the restriction of dividend payments. These actions provide the group with significant scope to improve its liquidity and capital position to further absorb such threats.

The directors also considered it appropriate to prepare the financial statements on the going concern basis, as explained in the basis of preparation paragraph on page 79.

Significant issues considered in relation to the financial statements
With regard to the UUW financial statements the UUG audit committee and the UUW board reviewed a number of principal areas of judgement. These are disclosed on pages 76 to 78 of the UUG accounts.

External auditor
KPMG are appointed as statutory auditor to all wholly owned companies in the United Utilities group. The company adheres to the UUG policy on non-audit services provided by the external auditor and in relation to auditor independence (see page 75 of the UUG annual report). The company's licence requires the preparation of audited regulatory accounts, therefore there are many advantages and efficiencies if KPMG also audits the regulatory accounts. Information on the assessment of the effectiveness of the external audit process can be found on page 75 of the UUG accounts.

The UUG group last tendered its statutory audit in March 2011 when Deloitte were replaced by KPMG. The appointment of statutory auditor is a role delegated to the UUG audit committee, as is the responsibility for agreeing the audit fee and the appointment of the audit engagement partner. An explanation is included on page 76 of the UUG annual report of the audit committee's current intention that a competitive tender would next be conducted for the financial year ended 31 March 2022.

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

Code principle: Remuneration

Directors' remuneration
The details of directors' remuneration can be found on pages 60 to 63. 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 – Code principle Accountability
UUG has an audit committee and the UUG group has a well-resourced internal audit function (see page 78 of the UUG annual report) in place to which the UUW board has access and which reports to the UUW board on matters such as the company's regulatory returns to Ofwat. As the work of the audit committee is largely undertaken on behalf of the company, the UUW board concluded that having a separate audit committee for the company was not necessary. Membership of the audit committee consists entirely of independent non-executive directors who are also members of the UUW board. The report of the UUG audit committee can be found on pages 74 to 79 of the UUG accounts.

Section D of the Code – Code principle Remuneration
As UUG has a remuneration committee and because many aspects of executive directors' remuneration (in particular, employee share plans) operate at a UUG group level, the company remunerates its executive directors and senior management subject to the confines of UUG's remuneration policy. (For further details 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 UUW board. Membership of the UUG remuneration committee consists entirely of independent non-executive directors, who are also members of the UUW board.

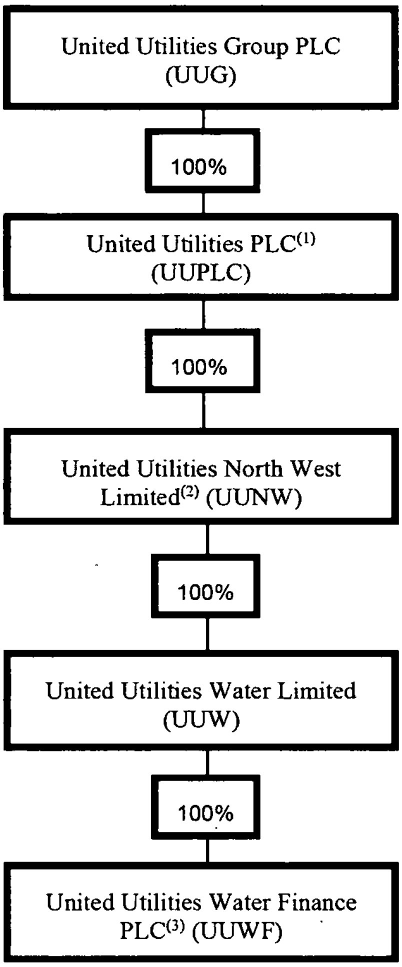
Section E of the Code – Code principle Relations with shareholders
As a wholly owned subsidiary of UUG, this provision is not relevant to the company. UUG complies fully with this provision and makes a full disclosure in its annual report.

United Utilities group structure
As a group, United Utilities has a simple corporate structure (see summary structure chart on page 55). UUG has a primary listing on the London Stock Exchange with a stock code of 'UU'; it has around 90,000 registered shareholders. Below UUG, there are two intermediate holding companies, one is United Utilities PLC (UUPLC)(1) (which is also the holding company for a number of non-regulated and legacy/dormant companies) and United Utilities North West Limited (UUNW)(2). The regulated company UUW is a direct subsidiary of UUNW which in turn is a direct subsidiary of UUPLC. Neither UUPLC nor UUNW are operational entities.

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

Corporate governance report

United Utilities group structure chart



[1]United Utilities PLC – was the listed ultimate holding company prior to July 2008, when the group underwent a scheme of arrangement as part of the return of value to shareholders from the proceeds of the sale of the electricity distribution business. This company is used from time to time to raise debt financing. Details of the UUG group's debt financing can be found on pages 42 to 43 of the UUG 2016 annual report and accounts.

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

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

Corporate governance report

Biographical details of the board of directors

Dr John McAdam (68)
Chairman

Responsibilities: Responsible for the leadership of the board, setting its agenda and ensuring its effectiveness on all aspects of its role.
Qualifications: BSc (Hons) Chemical Physics, Diploma Advanced Studies in Science, PhD.
Appointment to the board: March 2011.
Skills and experience: With over 17 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.
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.
Current directorships/business interests: Chairman of Rentokil Initial plc, senior independent director of J Sainsbury plc (stepping down at the AGM to be held on 6 July 2016) and a non-executive director of Rolls-Royce Holdings plc. He is also Chairman of United Utilities Group PLC.
Independence: John met the Code's independence criteria at the time of his initial appointment as Chairman of UUG.

Steve Mogford (59)
Chief Executive Officer (CEO)

Responsibilities: To manage the company's business and to implement the strategy and policies approved by the board.
Qualifications: BSc (Hons) Astrophysics/Maths/Physics.
Appointment to the board: March 2011.
Skills and experience: Steve's experience of the highly competitive defence market and complex design, manufacturing and support programmes has 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.
Career experience: Previously chief executive of SELEX Galileo, the defence electronics company owned by Italian aerospace and defence organisation Finmeccanica and chief operating officer at BAE Systems PLC, and a member of its PLC board, he spent his earlier career with British Aerospace PLC. He stepped down as senior independent director at Carillion PLC in September 2015 and from the board in December 2015.
Current directorships/business interests: Appointed as senior independent director of G4S PLC in May 2016. He is also Chief Executive Officer of United Utilities Group PLC.

Russ Houlden (57)
Chief Financial Officer (CFO)

Responsibilities: To manage the company's financial affairs and to contribute to the management of the group'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.
Skills and experience: Russ's skills and experience in accounting, treasury, tax, M&A and investor relations in other commercial and regulated companies, along with his extensive experience of driving performance improvement and managing large capital investment programmes, provides the company with valuable expertise with regard to its drive for

Corporate governance report

improvements in customer service, business development, operations, capital investment and financing.
Career experience: Chief financial officer at Telecom New Zealand. Previously Finance Director of Lovells, BT Wholesale, BT Networks and Information Services, ICI Polyurethanes and ICI Japan.
Current directorships/business interests: Member of the supervisory board and chairman of the audit committee of Orange Polska SA, the largest listed telecommunications company in Poland. He is a member of the main committee and chairman of the financial reporting committee of the 100 Group. He is also Chief Financial Officer of United Utilities Group PLC.

Dr Catherine Bell (65)
Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board and to lead the board's agenda on acting responsibly as a business.
Qualifications: MA Geography, PhD Economic History.
Appointment to the board: March 2011.
Skills and experience: Catherine's civil service background and understanding of the operation of government departments and utility regulation are particularly valued given the regulated framework within which the business operates.
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.
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.

Catherine will step down from the Board with effect from 22 July 2016.

Stephen Carter (52)
Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board
Qualifications: Bachelor of Law.
Appointment to the board: September 2014.
Skills and experience: As the CEO of a FTSE listed company, Stephen brings current operational experience to the board. His time spent in public service provides additional insights to the board regarding regulation and government relations, and his experience in the media and technology industries provides a new perspective for the board's discussions.
Career experience: Prior to his appointment as group chief executive at Informa plc on 1 January 2014, he was appointed CEO designate on 1 September 2013, having previously served on its board as an independent non-executive director and member of the audit committee. He has also held non-executive director positions at Travis Perkins plc and Royal Mail Holdings plc. Previous roles include president/managing director, Europe, Middle East & Africa, and a member of the executive management board at Alcatel Lucent Inc. Stephen has also held a number of public service roles, serving a term as the founding chief executive of Ofcom. He was formerly chairman of the board at Ashridge Business School. He is a Life Peer.
Current directorships/business interests: Group chief executive at Informa plc and a governor of the Royal Shakespeare Company. He is also an independent non-executive director of United Utilities Group PLC.

Corporate governance report

Mark Clare (58)
Independent non-executive director

Responsibilities: Is responsible, in addition to his role as an independent non-executive director, for discussing any concerns with shareholders of UUG that cannot be resolved through the normal channels of communication with the Chairman or CEO.
Qualifications: Chartered Management Accountant (FCMA).
Appointment to the board: November 2013.
Skills and experience: As a former CEO of a FTSE 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 and his extensive knowledge of customer-facing businesses is particularly valuable as the industry prepares for increased competition and pursues its continuous drive to improve customer service.
Career experience: Mark retired from his position as chief executive at Barratt Developments plc in July 2015, a role he held for nine years. He is a former trustee of the Building Research Establishment and the UK Green Building Council. Prior to joining Barratt, he was an executive director of Centrica plc and held a number of senior roles within both Centrica plc and British Gas. Mark has also been a non-executive director of BAA plc, the airports operator.
Current directorships/business interests: He is the Senior Independent Director of United Utilities Group PLC.

Steve Fraser (40)
Managing director, UUW Wholesale

Responsibilities: To manage UUW'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).
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.
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, UUW Wholesale, he was responsible for running UU's Energy and Contracting Services business.
Current directorships/business interests: Supervisory Council Member of AS Tallinna Vesi.

Brian May (52)
Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board and to lead the UUG audit committee.
Qualifications: BSc (Hons) Actuarial Science, Chartered Accountant FCA.
Appointment to the board: September 2012.
Skills and experience: Brian joined Bunzl plc in 1993 as head of internal audit before becoming group treasurer, then finance director, Europe and Australasia, and is currently Finance Director. Brian's background and the various finance roles that he has held are major assets to the board in chairing both the UUG 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.
Current directorships/business interests: Finance director at Bunzl plc. He is also an independent non-executive director of United Utilities Group PLC.

Corporate governance report

Sara Weller (54)
Independent non-executive director

Responsibilities: To challenge constructively the executive directors and monitor the delivery of the strategy within the risk and control framework set by the board and to lead the board's activities concerning directors' remuneration.
Qualifications: MA Chemistry.
Appointment to the board: March 2012.
Skills and experience: Sara's experience of customer-facing businesses, together with her knowledge of operating within a regulated environment, is a major asset to the board as the water industry prepares for the opening up of the sector to more competition and in improving customer service.
Career experience: Sara has wide-ranging business experience having worked for Mars, Abbey National and J Sainsbury plc and latterly as Managing Director of Argos from 2004 to 2011. She served as the senior independent director at Mitchells and Butlers from 2003 to 2006 and also chaired its remuneration committee from 2003 to 2010.
Current directorships/business interests: Non-executive director of Lloyds Banking Group plc and former lead non-executive director for the Department for Communities and Local Government. Sara is chair of the Planning Inspectorate, (an executive agency of the Department of Communities and Local Government), a board member at the Higher Education Funding Council for England and a council member at Cambridge University. She is also an independent non-executive director of United Utilities Group PLC.

Corporate governance report

Directors' remuneration report

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

With the exception of Steve Fraser, all directors of UUW are also directors of United Utilities Group PLC and further details of their remuneration can be found in the Annual Report and Accounts of United Utilities Group PLC.

For the purposes of this disclosure, the company's directors can be split into two categories:
- executive directors of UUW; and
- non-executive directors of UUW.

Non-executive directors
As outlined in the Annual Report and Accounts of United Utilities Group PLC, the non-executive Chairman and non-executive directors do not participate in the company's incentive arrangements (i.e. annual bonus or share schemes).

Executive directors' remuneration 2015/16

	Salary £'000	Taxable benefits £'000	Bonus [1] £'000	Long-term incentives [2] £'000	Cash allowance in lieu of pension £'000	Total £'000
Steve Mogford	707	26	501	1,440	156	2,830
Russ Houlden	446	23	313	688	98	1,568
Steve Fraser	312	16	172	283	69	852

Note:

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

[2]See pages 62 to 63 below for further detail on the long-term incentives.

A recharge of £299,000 during the year ended 31 March 2016 (2015: £312,000) was charged to other companies in the United Utilities group in relation to the provision of executive director services (£256,000) and non-executive director services (£43,000).

Directors' remuneration report (continued)

2015/16 annual bonus

During 2014/15 the Committee reviewed the annual bonus measures to ensure that they were aligned to the delivery of the business strategy for regulatory period 2015-20. The 2015/16 bonus measures and outcome is shown in the table below:

	Steve Mogford		Russ Houlden		Steve Fraser	
Measure	**Max. %**	**Actual %**	**Max. %**	**Actual %**	**Max. %**	**Actual %**
Underlying operating profit	30.0	10.5	30.0	10.5	20.0	7.0
Customer service in year						
Service Incentive Mechanism – Qualitative	12.0	3.4	12.0	3.4	12.0	3.4
Service Incentive Mechanism – Quantitative	4.0	1.8	4.0	1.8	4.0	1.8
Maintaining and enhancing services for customers						
Wholesale outcome delivery incentive composite	20.0	11.6	20.0	11.6	20.0	11.6
Time, cost and quality of capital programme (TCQi)	20.0	14.2	20.0	14.2	20.0	14.2
Corporate responsibility						
Dow Jones Sustainability Index rating	4.0	4.0	4.0	4.0	4.0	4.0
Personal objectives	10.0	9.0	10.0	8.5	20.0	19.0
Total as % bonus maximum	**100.0**	**54.5**	**100.0**	**54.0**	**100.0**	**61.1**
Total as % base salary	**130.0**	**70.8**	**130.0**	**70.1**	**90.0**	**55.0**
Total £'000		**501**		**313**		**172**

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

Corporate governance report

Directors' remuneration report (continued)

Long-term incentives

Details of UUG shares previously granted to UUW executive directors which vested in 2015/16, or whose performance period ended in 2015/16, are as follows:

Director	Number of shares vesting				Value of shares vesting £'000			
	2013 LTP(1)	MSIS(2)	DSAS(3)	Total	2013 LTP(4)	MSIS(5)	DSAS(6)	Total
Steve Mogford	44,737	109,264	n/a	154,001	412	1,028	n/a	1,440
Russ Houlden	28,233	46,238	n/a	74,471	261	427	n/a	688
Steve Fraser	9,519	n/a	22,121	31,640	88	n/a	195	283

Note:

(1)The 2013 Long Term Plan (LTP) awards were granted in July 2013. The performance period started on 1 April 2013 and ended on 31 March 2016. The final outcome for the customer service excellence measure (which forms 33% of the award) will not be known until Ofwat publishes the combined service incentive mechanism (SIM) score for the company and its comparator water companies (expected to be published in late summer 2016). The number and value of the vested 2013 LTP awards in the table above is therefore estimated. Awards granted to Steve Fraser are expected to vest once the combined SIM scores are published. Awards granted to Steve Mogford and Russ Houlden will normally vest in April 2018, following an additional two year holding period. The awards accrue dividend equivalents.

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

Performance measure	Weighting	Estimated achievement
Total Shareholder Return (TSR) over the performance period, relative to the median TSR of FTSE 100 companies (excluding financial services, oil and gas and mining companies)	33.3%	25.3% out of 33.3%
Sustainable dividends. Dividend growth in each year of the performance period, with an underlying dividend cover underpin	33.3%	8.3% out of 33.3%
Customer service excellence. Ranking for the year ended 31 March 2016 versus 18 other water companies using Ofwat's SIM combined score	33.3%	0% out of 33.3%
Total vesting		**33.6%**

Corporate governance report

Directors' remuneration report (continued)

Note:

(2)When Steve Mogford and Russ Houlden joined the company in 2010/11, they received one-off Matched Share Investment Scheme (MSIS) awards as part of their terms of appointment. They acquired shares in the company at their own expense ("investment shares") which would be matched under the MSIS on a 1:1 basis ("matching shares") provided that they remained employees within the group until the fifth anniversaries of their dates of joining the company and did not sell their investment shares. The matching shares accrued dividend equivalents. The figures in the table above show the number and value of the matching shares which vested during 2015/16. Steve Mogford's awards vested on 5 January 2016 and Russ Houlden's awards vested on 1 October 2015.

(3)Steve Fraser was granted a retention award under the Deferred Share Award Scheme on 3 July 2012 which vested on 6 July 2015. The vesting of these awards was conditional on satisfactory performance and continued employment for the three year vesting period. The awards accrued dividend equivalents.

(4)The value of the 2013 LTP awards has been calculated by multiplying the number of shares vesting by the average share price over the three month period 1 January 2016 to 31 March 2016 (923 pence per share).

(5)The value of the MSIS awards has been calculated by multiplying the number of shares vesting by the closing share price on the date of vesting (941 pence per share for Steve Mogford and 925 pence per share for Russ Houlden).

(6)The value of the DSAS awards has been calculated by multiplying the number of shares vesting by the closing share price on the date of vesting (883 pence per share).

Directors' remuneration 2016/17

With the exception of the annual salary and fee review, no other changes are expected to director's remuneration arrangements for the forthcoming year.

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

Corporate governance report

Tax policies and objectives

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

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

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

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

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

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

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

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

In addition to corporation tax, the group pays and bears further annual economic contributions, typically of around £130 to £140 million per annum, in the form of business rates, employer's national insurance contributions, environmental taxes and other regulatory service fees, such as water abstraction charges.

Directors' report

The directors present their management report and the audited financial statements for the year ended 31 March 2016.

Profit and dividends

The results for the year, set out in the consolidated income statement on page 74 show that profit for the year after tax was £387.5 million (2015: £258.1 million).

The directors have not recommended a final ordinary dividend (2015: £nil). Interim ordinary dividends of £186.1 million has been declared and paid during the year (2015: £180.6 million).

Business model

A description of the group's business model can be found on pages 12 to 21 within the Strategic Report included within this annual report.

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

Corporate governance report

The corporate governance report on pages 44 to 64 including the remuneration report is hereby incorporated into this directors' report by reference. A copy of the 2014 UK Corporate Governance Code (the Code) as published by the Financial Reporting Council can be found at *https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf*

Political and charitable donations

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

The group incurred expenditure of £5,360 (2015: £21,600) as part of this process. At the 2015 UUG AGM, an authority was taken to cover such expenditure. A similar resolution will be put to the UUG shareholders at the 2016 AGM to authorise such expenditure.

Research and development

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

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

Research and development costs expensed by the group totalled £2.3 million in the year ended 31 March 2016 (2015: £2.1 million).

Directors' report

Events after the balance sheet date

On 3 May 2016, the Competition and Markets Authority approved the joint venture agreement between the company's ultimate parent and Severn Trent PLC detailed in note 11 to the financial statements. The transaction was completed on 1 June 2016.

There were no further events arising after the reporting date that require recognition or disclosure in the financial statements for the year ended 31 March 2016.

Going concern basis of accounting

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

Directors

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

Non-executive directors
Dr John McAdam
Dr Catherine Bell
Stephen Carter
Mark Clare
Brian May
Sara Weller

Executive directors
Steve Mogford
Steve Fraser
Russ Houlden

Secretary
Simon Gardiner

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

Directors' indemnities and insurance

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

Employment policies

Our policies on maternity, paternity, adoption, personal and special leave go beyond the minimum required by law. For disabled applicants and existing employees, we are committed to fulfilling our obligations in accordance with the relevant legislation. Applicants with disabilities are given equal consideration in the application process. Disabled colleagues have equipment and working practices modified for them as far as is possible and wherever it is safe and practical to do so. A copy of our business principles are available on our website at

Directors' report

corporate.unitedutilities.com/united-utilities-business-principles, which explains the way in which we do business and makes it clear that our employees must seek to act with integrity and fairness and observe legal requirements. Anyone with serious concerns that the company may not be adhering to these principles is encouraged to speak up via their line manager or through a confidential telephone line. Importance is placed on strengthening employees' engagement, measuring their views annually, then taking action to improve how they feel about the company and understand its direction. Employees are provided with regular information to enable them to understand the financial and economic factors affecting the company's performance. Employees are encouraged to hold shares in UUG through the all employee share incentive plan. Information on the average number of employees can be found in note 2 to the financial statements on page 84.

Financial instruments

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

Share capital

At 31 March 2016, the issued ordinary share capital of the company was £100.0 million divided into 100,000,000 ordinary shares of £1.00 each. Details of our share capital and movements in our issued share capital are shown in note 18 to the financial statements on page 96.

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

Disclosure of information to the auditor

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

1. so far as he or she is aware, there is no relevant audit information of which the group's auditor is unaware; and
2. he or she has taken all the steps that he/she ought to have taken as a director in order to make himself/herself aware of any relevant audit information and to establish that the group's auditor is aware of that information.

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

Auditor

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

Approved by the board and signed on its behalf by:

Russ Houlden
Chief Financial Officer
10 June 2016

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

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

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

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the group and parent company and of their profit or loss for that period. In preparing each of the group and parent company financial statements, the directors are required to:

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

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

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

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

Signed on behalf of the board:

Russ Houlden
Chief Financial Officer
10 June 2016

Independent auditor's report

to the members of United Utilities Water Limited only

Opinions and conclusions arising from our audit

1. Our opinion on the financial statements is unmodified

We have audited the financial statements of United Utilities Water Limited for the year ended 31 March 2016 set out on pages 74 to 124. In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 March 2016 and of the Group's profit for the year then ended;
- the Group financial statements have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU);
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation.

2. Our assessment of risks of material misstatement

In arriving at our audit opinion above on the financial statements the risks of material misstatement that had the greatest effect on our audit, in decreasing order of audit significance, were as follows (unchanged from 2015).

<table>
<tr><td colspan="2">Revenue recognition £1,691.7 million (2015: £1,700.0 million) and provision for customer debts £94.3 million (2015: £100.5 million)
Refer to page 80 accounting policy, and note 10 financial disclosures.</td></tr>
<tr><td>The risk</td><td>Our response</td></tr>
<tr><td>Revenue recognition and provision for customer debts are key areas of judgement, particularly in relation to: the estimate of the revenue value of water supplied to metered customers between the last meter reading and the period end; identifying properties where there is little prospect that cash will be received for revenue that has been billed due to either the occupier not being able to be identified or a past history of non-payment of bills relating to that property; and assessing the recoverability of trade debtors as a proportion of customers do not or are unable to pay their bills.</td><td>Our audit procedures included

▪ Assessing whether appropriate revenue recognition policies are applied through comparison with relevant accounting standards and industry practice, including the policy of not recognising revenue where it is not probable that cash will be received;

▪ Testing the Group's controls over revenue recognition and provision for customer debts including reconciliations between sales and cash receipts systems and the general ledger;</td></tr>
</table>

Independent auditor's report

to the members of United Utilities Water Limited only

	▪ Assessing the assumptions used to calculate the metered accrued income by ensuring inputs to the calculation have been derived appropriately and recalculating the accrued income with the support of our own modelling specialists; ▪ Assessing the appropriateness of the customer debt provisioning policy based on historical cash collections, credits, re-bills and write off information; and ▪ Assessing the adequacy of the Group's disclosures of its revenue recognition and customer debt provisioning policies, including the estimation uncertainty involved in recording revenue and the bad debt provision.
Capital expenditure £633.7 million (2015: £722.6 million) Refer to page 80 accounting policy and note 8 financial disclosures.	
The risk	***Our response***
The Group has a substantial capital programme which has been agreed with the Water Services Regulation Authority ('Ofwat') and therefore incurs significant annual expenditure in relation to the development and maintenance of both infrastructure and non-infrastructure assets. Expenditure in relation to increasing the capacity or enhancing the network is treated as capital expenditure. Expenditure incurred in maintaining the operating capability of the network is expensed in the year in which it is incurred. Capital projects often contain a combination of enhancement and maintenance activity which are not distinct and therefore the allocation of costs between capital and operating expenditure is inherently judgemental. The costs capitalised include an allocation of overhead costs, relating to the proportion of time spent by support function staffs, which is also inherently judgemental and could lead to over capitalisation of expenses.	Our audit procedures included: ▪ Assessing the Group's capitalisation policy for compliance with relevant accounting standards; ▪ Testing controls over the application of the policy to spend incurred on capital projects in the period including attending capital approval meetings to observe the judgements made and evaluating the documented final conclusions; ▪ Critically assessing the costs capitalised for a sample of projects against the capitalisation policy, focusing on those where actual costs differed significantly to budgeted; ▪ Agreeing overhead costs incurred to supporting documentation on a sample basis and performed comparative analysis of overheads absorbed into capital projects by category; ▪ Testing a sample of capital accruals to assess the existence of the costs being capitalised through review of ageing of specific project accruals;

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	▪ Assessing the adequacy of the Group's disclosures of its capitalisation policy and other related disclosures.

Retirement benefit surplus £226.9 million (2015: £74.8 million)

Refer to page 81 accounting policy and notes 14 and A6 financial disclosures.

The risk	*Our response*
The Group has a substantial capital programme which has been agreed with the Water Services Regulation Authority ('Ofwat') and therefore incurs significant annual expenditure in relation to the development and maintenance of both infrastructure and non-infrastructure assets. Expenditure in relation to increasing the capacity or enhancing the network is treated as capital expenditure. Expenditure incurred in maintaining the operating capability of the network is expensed in the year in which it is incurred. Capital projects often contain a combination of enhancement and maintenance activity which are not distinct and therefore the allocation of costs between capital and operating expenditure is inherently judgemental. The costs capitalised include an allocation of overhead costs, relating to the proportion of time spent by support function staffs, which is also inherently judgemental and could lead to over capitalisation of expenses.	Our audit procedures included: ▪ Challenging the key assumptions supporting the Group's retirement benefit obligations valuation with input from our own actuarial specialists, including comparing the discount rate, inflation rate, salary, pension increase rates and life expectancy assumptions used against externally derived data; and ▪ Assessing the Group's disclosure in respect of the sensitivity of the surplus to changes in the key assumptions.

Derivative financial instrument valuations £363.1 million (2015: £340.3 million)

Refer to page 81 accounting policy, and note A5 financial disclosures.

The risk	*Our response*
The Group has significant derivative financial instruments, the valuation of which is determined through the application of valuation techniques which often involve the exercise of judgement and the use of assumptions and estimates. Due to the significance of financial instruments and the related estimation uncertainty, there is a risks that the related financial assets and liabilities are misstated.	Our audit procedures included: ▪ Assessing controls over the identification, measurement and management of derivative financial instruments; ▪ Evaluating the methodologies, inputs and assumptions used by the Group in determining fair values, with the help of our own valuation specialist; ▪ Challenging the observable inputs into valuation models, such as quoted prices, by reference to externally available market data to assess whether appropriate inputs are used in the valuation;

Independent auditor's report

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	▪ Comparing valuations derived from our internal valuation model for a sample of instruments to the fair values determined by the Group; and • Considering the adequacy of the group's disclosures about the valuation basis and inputs used in the fair value measurement. Assessing whether the financial statement disclosures of fair value risks and sensitivities appropriately reflect the Group's exposure to valuation risk.

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

Materiality for the group financial statements as a whole was set at £19.0m (2015: £24.0m), determined with reference to a benchmark of profit before taxation, normalised to exclude net fair value losses on debt and derivative instruments (see Note 5) and adjusting items relating to a one off water quality incident (see Note 3), of which it represents 4.6% (2015: 5.3%), reflecting industry consensus levels. Specific audit procedures have been performed over the items excluded from the normalised profit before tax.

We report to the Audit Committee any corrected or uncorrected identified misstatements exceeding £0.5 million (2015: £0.5 million), in addition to other identified misstatements that warranted reporting on qualitative grounds.

We subjected the group's two (2015: two) components, to audit, covering 100% of group revenue (2015: 100%), 100% of group profit before taxation (2015: 100%) and 100% of group total assets (2015: 100%). The audit work on these component were performed by the group team to a materiality of £1.2m.

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

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006;
- 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; and
- information given in the Corporate Governance Statement set out on pages 44 to 64 with respect to internal control and risk management systems in relation to financial reporting processes and about share capital structures is consistent with the financial statements.

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

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

- the directors' viability statement on page 52, concerning the principal risks, their management, and, based on that, the Directors' assessment and expectations of the group continuing in operation over the five years to 31 March 2021; or
- the disclosures on page 79 and in the Accounting Policies note of the financial statements concerning the use of the going concern basis of accounting.

Independent auditor's report

to the members of United Utilities Water Limited only

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

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

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

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

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the parent company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit; or
- a corporate governance statement has not been prepared by the company.

In addition to our audit of the financial statements, the Directors have engaged us to review their Corporate Governance Statement as if the Company were required to comply with the Listing Rules and Disclosure Rules and Transparency Rules of the Financial Conduct Authority in relation to those matters. Under the terms of our engagement we are required to review:

- the directors' statement, set out on page 53, in relation to going concern; and
- the part of the corporate governance statement on pages 44 to 64 relating to the Company's compliance with the eleven provisions of the 2014 UK Corporate Governance Code specified for our review.

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

Scope and responsibilities

As explained more fully in the Directors' Responsibilities Statement set out on page 68, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. A description of the scope of an audit of financial statements is provided on the Financial Reporting Council's website at www.frc.org.uk/auditscopeukprivate. This report is made solely to the company's members as a body and is subject to important explanations and disclaimers regarding our responsibilities, published on our website at www.kpmg.com/uk/auditscopeukco2014a, which are incorporated into this report as if set out in full and should be read to provide an understanding of the purpose of this report, the work we have undertaken and the basis of our opinions.

John Luke

John Luke (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants
St Peters' Square
Manchester
M2 3AE
10 June 2016

Consolidated income statement

for the year ended 31 March

	Note	2016 £m	2015 £m
Revenue	1	1,691.7	1,700.0
Employee benefits expense	2	(140.4)	(138.6)
Other operating costs	3	(446.0)	(407.3)
Other income	3	3.0	3.1
Depreciation and amortisation expense	3	(363.7)	(352.8)
Infrastructure renewals expenditure		(169.3)	(148.2)
Total operating expenses		(1,116.4)	(1,043.8)
Operating profit		575.3	656.2
Investment income	4	4.4	0.2
Finance expense	5	(230.9)	(328.1)
Investment income and finance expense		(226.5)	(327.9)
Profit before tax		348.8	328.3
Current tax charge	6	(49.4)	(47.2)
Deferred tax charge	6	(23.8)	(23.0)
Deferred tax credit – change in tax rate	6	111.9	-
Tax	6	38.7	(70.2)
Profit after tax		387.5	258.1

All of the results shown above relate to continuing operations.

Consolidated statement of comprehensive income

for the year ended 31 March

	Note	2016 £m	2015 £m
Profit after tax		387.5	258.1
Other comprehensive income			
Remeasurement gains on defined benefit pension schemes	14	124.6	214.7
Tax on items taken directly to equity	6	(20.4)	(42.9)
Total comprehensive income		491.7	429.9

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

Consolidated and company statement of financial position

at 31 March

Group and company

	Note	2016 £m	2015 £m
ASSETS			
Non-current assets			
Property, plant and equipment	8	9,997.9	9,714.9
Intangible assets	9	162.4	144.9
Investments	A1	0.1	0.1
Retirement benefit surplus	14	226.9	74.8
Derivative financial instruments	A5	624.1	544.8
		11,011.4	10,479.5
Current assets			
Inventories		9.9	9.3
Trade and other receivables	10	406.2	388.6
Current tax assets		-	4.4
Cash and short-term deposits	12	204.3	180.0
Assets classified as available for distribution	11	18.3	-
		638.7	582.3
Total assets		11,650.1	11,061.8
LIABILITIES			
Non-current liabilities			
Trade and other payables	17	(529.3)	(479.9)
Borrowings	13	(6,589.4)	(6,205.0)
Deferred tax liabilities	15	(1,048.2)	(1,115.9)
Derivative financial instruments	A5	(255.8)	(196.6)
		(8,422.7)	(7,997.4)
Current liabilities			
Trade and other payables	17	(326.2)	(373.8)
Borrowings	13	(600.7)	(714.3)
Current tax liabilities		(18.6)	-
Provisions	16	(14.9)	(12.2)
Derivative financial instruments	A5	(5.2)	(7.9)
		(965.6)	(1,108.2)
Total liabilities		(9,388.3)	(9,105.6)
Total net assets		2,261.8	1,956.2
EQUITY			
Capital and reserves attributable to equity holders of the company			
Share capital	18	100.0	100.0
Retained earnings		2,161.8	1,856.2
Shareholder's equity		2,261.8	1,956.2

These financial statements for the group and United Utilities Water Limited (company number: 2366678) were approved by the board of directors on 10 June 2016 and signed on its behalf by:

Russ Houlden
Chief Financial Officer

Consolidated and company statement of changes in equity

for the year ended 31 March

Group and company

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

	Share capital £m	Share premium account £m	Other reserve £m	Retained earnings £m	Total £m
At 1 April 2014	1,025.3	647.8	174.7	(140.9)	1,706.9
Profit after tax	-	-	-	258.1	258.1
Other comprehensive income					
Remeasurement losses on defined benefit pension schemes (see note 14)	-	-	-	214.7	214.7
Tax on items taken directly to equity (see note 6)	-	-	-	(42.9)	(42.9)
Total comprehensive income	-	-	-	429.9	429.9
Bonus issue of shares (see note 18)	174.7	-	(174.7)	-	-
Capital reduction (see note 18)	(1,100.0)	(647.8)	-	1,747.8	-
Dividends (see note 7)	-	-	-	(180.6)	(180.6)
At 31 March 2015	100.0	-	-	1,856.2	1,956.2

During the year ended 31 March 2015, the company adopted IFRS and, as a result, the other reserve was recognised. Following the transition to IFRS, the other reserve was used to issue bonus shares, which were subsequently cancelled. These transactions resulted in a transfer from the other reserve to retained earnings during the year ended 31 March 2015.

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

Consolidated and company statement of cash flows

for the year ended 31 March

Group and company

	Note	2016 £m	2015 £m
Operating activities			
Cash generated from operations	A2	893.3	950.3
Interest paid		(173.9)	(187.0)
Interest received and similar income		1.6	0.1
Tax paid		(26.4)	(50.0)
Tax received		-	53.3
Net cash generated from operating activities		694.6	766.7
Investing activities			
Purchase of property, plant and equipment		(603.2)	(661.0)
Purchase of intangible assets		(66.1)	(63.4)
Proceeds from sale of property, plant and equipment		1.4	2.0
Grants and contributions received	17	17.3	18.1
Net cash used in investing activities		(650.6)	(704.3)
Financing activities			
Proceeds from borrowings		658.1	1,482.1
Repayment of borrowings		(498.9)	(1,173.9)
Dividends paid to equity holders of the company	7	(186.1)	(180.6)
Net cash (used in)/generated from financing activities		(26.9)	127.6
Net increase in cash equivalents		17.1	190.0
Cash and cash equivalents at beginning of the year		156.5	(33.5)
Cash and cash equivalents at end of the year	12	173.6	156.5

Accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below.

Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU). They have been prepared on the historical cost basis, except for the revaluation of financial instruments, accounting for the transfer of assets from customers and the revaluation of infrastructure assets to fair value on transition to IFRS. The preparation of financial statements, in conformity with IFRS, requires management to make estimates and assumptions that affect the amounts of assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting periods presented. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results ultimately may differ from these estimates.

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

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

Adoption of new and revised standards

The following standards, interpretations and amendments, effective for the year ended 31 March 2016, have had no material impact on the group's financial statements.

- Amendments to IAS 19 'Employee Benefits', in respect of employee contributions to defined benefit plans; and
- Improvements to IFRS (2012) and IFRS (2013), comprising a collection of narrow-scope amendments across a number of standards.

Critical accounting judgements and key sources of estimation uncertainty

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

On an ongoing basis, the group evaluates its estimates using historical experience, consultation with experts and other methods considered reasonable in the particular circumstances. Actual results may differ significantly from the estimates, the effect of which is recognised in the period in which the facts that give rise to the revision become known.

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

Accounting policies

Property, plant and equipment

The group recognises property, plant and equipment (PPE) on its water and wastewater infrastructure assets where such expenditure enhances or increases the capacity of the network, whereas any expenditure classed as maintenance is expensed in the period it is incurred. Determining enhancement from maintenance expenditure is a subjective area, particularly when projects have both elements within them. In addition, management capitalise time and resources incurred by the group's support functions on capital programmes.

The estimated useful economic lives of PPE are based on management's judgement and experience. When management identifies that actual useful economic lives differ materially from the estimates used to calculate depreciation, that charge is adjusted prospectively. Due to the significance of PPE investment to the group, variations between actual and estimated useful economic lives could impact operating results both positively and negatively, although historically few changes to estimated useful economic lives have been required, which could impact operating results positively or negatively.

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

Revenue recognition and allowance for doubtful receivables

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

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

At each reporting date, the company and each of its subsidiaries evaluate the recoverability of trade receivables and record allowances for doubtful receivables based on experience. These allowances are based on, amongst other things, a consideration of actual collection history. The actual level of receivables collected may differ from the estimated levels of recovery,

Provisions and contingencies

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

Reasonable estimates involve judgements made by management after considering information including notifications, settlements, estimates performed by independent parties and legal

Accounting policies

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

Retirement benefits

The group operates two defined benefit schemes which are independent of the group's finances. Actuarial valuations of the schemes are carried out as determined by the trustees at intervals of not more than three years. The pension cost under IAS 19 'Employee Benefits' is assessed in accordance with the advice of a firm of actuaries based on the latest actuarial valuation and assumptions determined by the actuary. The assumptions are based on information supplied to the actuary by the company, supplemented by discussions between the actuary and management. The assumptions are disclosed in note A6. Profit before tax and net assets are affected by the actuarial assumptions used. The key assumptions include: discount rates, pay growth, mortality and increases to pensions in payment and deferred pensions. It should be noted that actual rates may differ from the assumptions used due to changing market and economic conditions and longer or shorter lives of participants.

Derivative financial instruments

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

Tax

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

New and revised standards not yet effective

At the date of authorisation of these financial statements, the following relevant standards were in issue but not yet effective. The directors anticipate that these standards may have a material impact on the group's financial statements and that the group will adopt these standards on their effective dates.

IFRS 9 'Financial Instruments'

The standard is effective for periods commencing on or after 1 January 2018 but has not yet been endorsed by the EU. Under the provisions of this standard, where the group has chosen to measure borrowings at fair value through profit or loss, the portion of the change in fair value due to changes in the group's own credit risk will be recognised in other comprehensive income rather than within profit or loss. If this standard had been adopted in the current year, a £15.1 million gain would have been recognised in other comprehensive income rather than within the income statement.

The standard also broadens the scope of what can be included within a hedge relationship, which may enable the group's regulatory swaps to be designated within cash flow hedge relationships. If the standard had been adopted in the current year, with all such swaps being designated and all hedges being fully effective, £46.2 million of fair value losses would have been recognised in other comprehensive income rather than within the income statement.

Accounting policies

IFRS 16 'Leases'

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

The impact of IFRS 16 has yet to be quantified, but if the standard had been adopted in the current year a depreciation charge in relation to the right-of-use asset and a lease interest charge would be recognised in the income statement in place of the operating lease charge of £5.0 million.

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

Notes to the financial statements

1. Revenue and segment reporting

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

The group has a large and diverse customer base and there is no significant reliance on any single customer.

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

2. Directors and employees

Directors' remuneration

	2016 £m	2015 £m
Fees to non-executive directors	0.6	0.6
Salaries	1.5	1.4
Benefits	0.4	0.4
Bonus	0.5	0.7
Share-based payment charge	1.1	1.5
	4.1	4.6

Included within the above are aggregate emoluments of £1.8 million (2015: £2.2 million) in respect of the highest paid director. The highest paid director exercised share options during the current year.

A recharge of £299,000 during the year ended 31 March 2016 (2015: £312,000) was charged to other companies in the United Utilities group in relation to the provision of director services. No executive directors accrued benefits under defined benefit schemes, and all executive directors opted for a cash allowance in lieu of their defined contribution pension entitlement during the current and prior year.

Three directors (2015: three directors) received shares in United Utilities Group PLC in respect of qualifying services, and three directors (2015: three directors) exercised nil-cost share options in United Utilities Group PLC during the year. Three directors (2015: three directors) had long-term incentive plans which vested during the year. Aggregate amounts receivable of £2.4 million (2015: £2.4 million), were recognised during the year relating to long-term incentive plans.

Remuneration of key management personnel

	2016 £m	2015 £m
Salaries and short-term employee benefits	4.9	5.9
Post-employment benefits	0.1	0.2
Share-based payment charge	1.8	2.4
	6.8	8.5

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

Notes to the financial statements

2. Directors and employees (continued)

Employee benefits expense (including directors)

	2016 £m	2015 £m
Wages and salaries	212.5	206.3
Social security	19.1	18.1
Severance	(0.2)	6.7
Post-employment benefits:		
Defined benefit pension expense (see note 14)	23.3	23.1
Defined contribution pension costs (see note 14)	9.9	8.8
	33.2	31.9
Recharges	(3.7)	(3.3)
Charged to regulatory capital schemes	(120.5)	(121.1)
Employee benefits expense	140.4	138.6

Within employee benefits expense were £0.7 million (2015: £10.6 million) of restructuring costs.

A recharge of £3.7 million during the year ended 31 March 2016 (2015: £3.3 million) was charged to other companies in the United Utilities group in relation to the provision of employee services.

Options over shares of the ultimate parent undertaking, United Utilities Group PLC, have been granted to employees of the company under various schemes. Details of the terms and conditions of each share option scheme are given in the United Utilities Group PLC Annual Report. Included within wages and salaries is an expense of £2.3 million (2015: £2.9 million) relating to a recharge of share-based payment costs from the ultimate parent undertaking.

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

	2016 number	2015 number
Average number of employees during the year	5,054	5,057

The 2016 employee benefits expense of £264.6 million (2015: £263.0 million) includes the employee costs relating to the persons employed during the year noted above in addition to costs of £15.4 million (2015: £15.7 million) in relation to services provided by employees of United Utilities PLC who support United Utilities Water Limited. These costs have been incurred directly by United Utilities Water Limited 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 211 (2015: 221).

Notes to the financial statements

3. Operating profit

	2016 £m	*Re-presented 2015 £m
Other operating costs		
Hired and contracted services	105.8	91.5
Property rates	86.5	80.3
Materials	67.1	58.3
Power	65.0	68.8
Charge for bad and doubtful receivables (see note 10)	39.1	53.0
Regulatory fees	27.9	29.2
Impairment of property, plant and equipment (see note 8)	11.4	-
Loss on disposal of plant, property and equipment	5.4	5.1
Legal and professional expenses	4.3	4.1
Operating leases payable:		
Property	4.0	3.7
Plant and equipment	0.8	0.7
Loss on disposal of intangible assets	-	0.5
Amortisation of deferred grants and contributions (see note 17)	(6.9)	(7.7)
Compensation from insurers	(20.1)	-
Other expenses	55.7	19.8
	446.0	407.3
Other income		
Other income	(3.0)	(3.1)
	(3.0)	(3.1)
Depreciation and amortisation expense		
Depreciation of property, plant and equipment (see note 8)	332.5	323.9
Amortisation of intangible assets (see note 9)	31.2	28.9
	363.7	352.8

* The comparatives have been re-presented to allocate £7.0 million accommodation, £3.4 million movements in other provisions, and £2.1 million research and development, to categories which better reflect the underlying nature of these costs.

During the year, there were £19.5 million (2015: £nil) of expenses incurred as a result of two significant flooding incidents caused by storms Desmond and Eva (see page 3) comprising an £11.4 million impairment of property, plant and equipment, £7.0 million of operating costs and £1.1 million of infrastructure renewals expenditure. Insurance compensation of £20.1 million relating to the flooding incidents has been recognised to the extent that the group considers the recovery to be 'virtually certain' at 31 March 2016. The group expects there to be further substantial recovery of the flooding incident costs under its insurance cover in the year ending 31 March 2017, though at this stage it is not practicable to estimate the value of this.

In addition, there were £24.8 million (2015: £nil) of costs, largely comprising customer compensation payments included within other expenses, incurred in relation to a large water quality incident (see page 3) and £11.1 million (2015: £1.1 million) in relation to market reform restructuring costs incurred preparing the business for open competition in the business retail market.

Research and development expenditure for the year ended 31 March 2016 was £2.3 million (2015: £2.1 million).

During the year, the group obtained the following services from its auditor:

	2016 £000	2015 £000
Audit services		
Statutory audit – group and company	170	223
Statutory audit – subsidiary	15	1
Regulatory reporting	45	30
	230	254
Audit-related services	20	-
Other non-audit services	100	112
	350	366

Notes to the financial statements

4. Investment income

	2016 £m	2015 £m
Interest receivable on short-term bank deposits held at amortised cost	1.6	0.2
Net pension interest income (see note 14)	2.8	-
	4.4	0.2

5. Finance expense

	2016 £m	2015 £m
Interest payable		
Interest payable on borrowings held at amortised cost[1]	176.9	185.4
Interest payable on borrowings from parent and fellow subsidiary undertakings	3.9	4.6
Preference share dividends (see note 7)	9.1	9.1
	189.9	199.1
Fair value losses/(gains) on debt and derivative instruments[2]		
Fair value hedge relationships:		
Borrowings	55.2	68.2
Designated swaps	(57.6)	(78.2)
	(2.4)	(10.0)
Financial instruments at fair value through profit or loss		
Borrowings designated at fair value through profit or loss[3]	4.3	65.0
Associated swaps[4]	(23.5)	(73.5)
	(19.2)	(8.5)
Fixed interest rate swaps[4]	46.2	129.8
Electricity swaps[4]	14.2	(6.0)
Net payments on swaps and debt under fair value option	1.1	19.1
Other swaps[4][5]	(3.0)	1.1
Other	4.1	(2.2)
	62.6	141.8
Net fair value losses on debt and derivative instruments[6]	41.0	123.3
Net pension interest expense (see note 14)	-	5.7
	230.9	328.1

[1] Includes a £37.9 million (2015: £46.6 million) non-cash inflation uplift expense in relation to the group's index-linked debt.

[2] Includes foreign exchange losses of £48.7 million (2015: £53.9 million gains), excluding those on instruments measured at fair value through profit or loss. These losses/gains are largely offset by fair value gains/losses on derivatives.

[3] Includes a £15.1 million gain (2015: £4.6 million loss) on the valuation of debt reported at fair value through profit or loss due to changes in credit spread assumptions.

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

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

[6] Includes £0.9 million expense (2015: £18.0 million) due to interest on swaps and debt under fair value option.

Notes to the financial statements

5. Finance expense (continued)

Interest payable is stated net of £21.3 million (2015: £20.9 million) borrowing costs capitalised in the cost of qualifying assets within property, plant and equipment and intangible assets during the year. This has been calculated by applying a capitalisation rate of 2.7 per cent (2015: 3.1 per cent) to expenditure on such assets as prescribed by IAS 23 'Borrowing Costs'.

6. Tax

	2016 £m	2015 £m
Current tax		
UK corporation tax	55.1	56.6
Adjustments in respect of prior years	(5.7)	(9.4)
Total current tax charge for the year	49.4	47.2
Deferred tax		
Current year	18.5	14.6
Adjustments in respect of prior years	5.3	8.4
	23.8	23.0
Change in tax rate	(111.9)	-
Total deferred tax (credit)/charge for the year	(88.1)	23.0
Total tax (credit)/charge for the year	(38.7)	70.2

The deferred tax credit of £111.9 million (2015: £nil) reflects the enacted reduction in the headline rate of corporation tax to 18 per cent from 1 April 2020. An additional reduction to 17 per cent effective from 1 April 2020 was announced in the Chancellor's Budget on 16 March 2016. Subject to enactment, this will result in a future deferred tax credit currently estimated at around £56.0 million.

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

	2016 £m	2016 %	2015 £m	2015 %
Profit before tax	348.8		328.3	
Tax at the UK corporation tax rate	69.8	20.0	68.9	21.0
Adjustments in respect of prior years	(0.4)	(0.1)	(1.0)	(0.3)
Change in tax rate	(111.9)	(32.1)	-	-
Net income not taxable/other	3.8	1.1	2.3	0.7
Total tax (credit)/charge and effective tax rate for the year	(38.7)	(11.1)	70.2	21.4

Notes to the financial statements

6. Tax (continued)

Tax on items taken directly to equity

	2016 £m	2015 £m
Deferred tax (see note 15)		
On remeasurement gains on defined benefit pension schemes	24.9	42.9
Change in tax rate	(4.5)	-
Total tax charge on items taken directly to equity	20.4	42.9

The deferred tax credit of £4.5 million (2015: £nil) reflects the enacted reduction in the headline rate of corporation tax to 18 per cent from 1 April 2020.

7. Dividends

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

	2016 £m	2015 £m
Ordinary shares		
Interim dividend for the year ended 31 March 2015 at 119.4 pence per share (2015: 12.5 pence per share[1])	119.4	116.6
Interim dividend for the year ended 31 March 2016 at 62.2 pence per share (2015: 64.0 pence per share)	62.2	64.0
Interim dividend for the year ended 31 March 2016 at 4.5 pence per share (2015: nil pence per share)	4.5	-
	186.1	180.6

[1] Based upon 931,930,000 shares prior to a capital reduction on 26 January 2015, see note 18.

The directors have not recommended a final ordinary dividend (2015: £nil).

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

Notes to the financial statements

8. Property, plant and equipment

Group and company	Land and buildings £m	Infra-structure assets £m	Operational assets £m	Fixtures, fittings, tools and equipment £m	Assets in course of construction £m	Total £m
Cost						
At 1 April 2014	274.2	4,555.7	5,924.4	485.7	926.3	12,166.3
Additions	8.3	112.8	90.9	19.9	490.7	722.6
Transfers	27.2	219.9	272.8	18.3	(538.2)	-
Disposals	(4.1)	(0.4)	(27.2)	(33.6)	-	(65.3)
At 31 March 2015	305.6	4,888.0	6,260.9	490.3	878.8	12,823.6
Additions	4.5	98.0	76.1	7.4	447.7	633.7
Transfers	19.1	134.8	156.5	11.1	(321.5)	-
Disposals	(0.3)	(0.1)	(44.4)	(7.0)	-	(51.8)
At 31 March 2016	328.9	5,120.7	6,449.1	501.8	1,005.0	13,405.5
Accumulated depreciation						
At 1 April 2014	83.5	239.8	2,227.8	291.9	-	2,843.0
Charge for the year	15.9	35.4	233.2	39.4	-	323.9
Disposals	(3.8)	-	(22.6)	(31.8)	-	(58.2)
At 31 March 2015	95.6	275.2	2,438.4	299.5	-	3,108.7
Charge for the year	9.1	34.6	249.2	39.6	-	332.5
Impairment	-	-	11.4	-	-	11.4
Disposals	(0.3)	(0.1)	(39.2)	(5.4)	-	(45.0)
At 31 March 2016	104.4	309.7	2,659.8	333.7	-	3,407.6
Net book value						
At 31 March 2016	224.5	4,811.0	3,789.3	168.1	1,005.0	9,997.9
Net book value						
At 31 March 2015	210.0	4,612.8	3,822.5	190.8	878.8	9,714.9

At 31 March 2016, the group and company had entered into contractual commitments for the acquisition of property, plant and equipment amounting to £439.0 million (2015: £394.5 million).

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

Notes to the financial statements

9. Intangible assets

Group and company	Total £m
Cost	
At 1 April 2014	229.2
Additions	64.2
Disposals	(29.5)
At 31 March 2015	263.9
Additions	67.0
Disposals	-
Transfer to assets classified as held for distribution (see note 11)	(20.6)
At 31 March 2016	310.3
Accumulated amortisation	
At 1 April 2014	119.1
Charge for the year	28.9
Disposals	(29.0)
At 31 March 2015	119.0
Charge for the year	31.2
Disposals	-
Transfer to assets classified as held for distribution (see note 11)	(2.3)
At 31 March 2016	147.9
Net book value at 31 March 2016	162.4
Net book value at 31 March 2015	144.9

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

At 31 March 2016, the group and company had entered into contractual commitments for the acquisition of other intangible assets amounting to £8.3 million (2015: £2.3 million).

10. Trade and other receivables

Group and company	2016 £m	2015 £m
Trade receivables	172.7	171.2
Amounts owed by parent and fellow subsidiary undertakings:		
Trading balances	5.3	2.7
Floating rate loan	40.0	40.0
Amounts owed by related parties (see note A7)	0.1	0.1
Other debtors	55.1	22.8
Prepayments and accrued income	133.0	151.8
	406.2	388.6

At 31 March 2016 and 31 March 2015, the group and company had no trade and other receivables classified as non-current.

Notes to the financial statements

10. Trade and other receivables (continued)

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

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

Group and company	2016 £m	2015 £m
At the start of the year	100.5	97.7
Amounts charged to operating expenses (see note 3)	39.1	53.0
Trade receivables written off	(45.3)	(50.2)
At the end of the year	94.3	100.5

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

At 31 March 2016 and 31 March 2015, the group and company had no trade receivables that were past due and not individually impaired.

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

Group and company	Aged less than one year	Aged between one year and two years	Aged greater than two years	Carrying value
	£m	£m	£m	£m
Trade receivables				
At 31 March 2016	126.0	37.5	5.1	168.6
At 31 March 2015	124.5	43.5	3.2	171.2

At 31 March 2016, the group and company had £4.1 million (2015: £nil) of trade receivables that were not past due.

11. Assets available for distribution

During the year, the United Utilities group entered into an agreement which will involve the disposal of the company's non-household water and wastewater retail business, principally comprising billing and customer service activities, into a new joint venture with Severn Trent PLC. As at 31 March 2016, completion of the disposal was expected within 12 months, subject to clearance from the Competition and Markets Authority, and so £18.3 million of intangible assets within the company have been classified as available for distribution as they will be distributed to other United Utilities group companies prior to the disposal. See note 21 for events occurring after 31 March 2016.

Notes to the financial statements

12. Cash and cash equivalents

Group and company	2016 £m	2015 £m
Cash at bank and in hand	2.5	2.4
Short-term bank deposits	201.8	177.6
Cash and short-term deposits	204.3	180.0
Book overdrafts (included in borrowings, see note 13)	(30.7)	(23.5)
Cash and cash equivalents in the statement of cash flows	173.6	156.5

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

Book overdrafts, which result from cash management practices, represent the value of cheques issued that had not cleared as at the balance sheet date.

13. Borrowings

Group and company	2016 £m	2015 £m
Non-current liabilities		
Bonds[1]	3,646.3	3,457.1
Bank and other term borrowings	2,069.6	1,827.7
Amounts owed to intermediate parent undertaking	873.5	920.2
	6,589.4	6,205.0
Current liabilities		
Bonds	-	425.9
Bank and other term borrowings	364.1	57.1
Book overdraft	30.7	23.5
130,000,000 7.0 per cent £1.00 redeemable preference shares	130.0	130.0
Amounts owed to intermediate parent undertaking	75.9	77.8
	600.7	714.3
	7,190.1	6,919.3

[1] For the company, bonds includes £126.6 million (2015: £nil) of amounts owed to subsidiary undertakings.

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

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

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

Notes to the financial statements

14. Retirement benefit surplus

Defined benefit schemes

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

Group and company	2016 £m	2015 £m
Current service cost	20.7	16.7
Curtailments/settlements	0.9	4.8
Administrative expenses	1.7	1.6
Pension expense charged to operating profit	23.3	23.1
Net pension interest (income)/expense (credited)/charged to investment income (see note 4)/finance expense (see note 5)	(2.8)	5.7
Net pension expense charged before tax	20.5	28.8

Defined benefit pension costs excluding curtailments/settlements included within employee benefit expense were £22.4 million (2015: £18.3 million) comprising current service costs and administrative expenses. Total post-employment benefits expense excluding curtailments/ settlements charged to operating profit of £32.3 million (2015: £27.1 million) comprise the defined benefit costs described above of £22.4 million (2015: £18.3 million) and defined contribution pension costs of £9.9 million (2015: £8.8 million) (see note 2).

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

Group and company	2016 £m	2015 £m
At the start of the year	74.8	(145.6)
Expense recognised in the income statement	(20.5)	(28.8)
Contributions paid	48.0	34.5
Remeasurement gains gross of tax	124.6	214.7
At the end of the year	226.9	74.8

Included in the contributions paid of £48.0 million (2015: £34.5 million) were deficit repair contributions of £24.7 million (2015: £8.0 million). No inflation funding mechanism payments were made during the year (2015: £4.5 million).

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

Notes to the financial statements

14. Retirement benefit surplus (continued)

Group and company	2016 £m	2015 £m
The return on plan assets, excluding amounts included in interest	48.2	550.0
Actuarial gains/(losses) arising from changes in financial assumptions	71.4	(372.4)
Actuarial (losses)/gains arising from changes in demographic assumptions	(34.8)	8.0
Actuarial gains arising from experience	39.8	29.1
Remeasurement gains on defined benefit pension schemes	124.6	214.7

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

Defined contribution schemes

During the year, the group and company made £9.9 million (2015: £8.8 million) of contributions to defined contribution schemes which are included in employee benefit expense (see note 2).

15. Deferred tax liabilities

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

Group and company	Accelerated tax depreciation £m	Retirement benefit obligations £m	Other £m	Total £m
At 1 April 2014	1,080.3	(29.1)	(1.2)	1,050.0
Charged/(credited) to the income statement	43.5	1.9	(22.4)	23.0
Charged to equity (see note 6)	-	42.9	-	42.9
At 31 March 2015	1,123.8	15.7	(23.6)	1,115.9
(Credited)/charged to the income statement	(87.7)	4.8	(5.2)	(88.1)
Charged to equity (see note 6)	-	20.4	-	20.4
At 31 March 2016	1,036.1	40.9	(28.8)	1,048.2

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

Notes to the financial statements

16. Provisions

Group and company	Severance £m	Other £m	Total £m
At 1 April 2014	2.3	13.3	15.6
Charged/(credited) to the income statement	6.7	(3.4)	3.3
Utilised in the year	(4.2)	(2.5)	(6.7)
At 31 March 2015	4.8	7.4	12.2
(Credited)/charged to the income statement	(0.2)	11.4	11.2
Utilised in the year	(3.7)	(4.8)	(8.5)
At 31 March 2016	0.9	14.0	14.9

The group and company had no provisions classed as non-current at 31 March 2016 or 31 March 2015.

The severance provision as at 31 March 2016 and 31 March 2015 relates to severance costs as a result of group reorganisation.

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

17. Trade and other payables

Group and company	2016 £m	2015 £m
Non-current		
Deferred grants and contributions	517.4	476.7
Other creditors	11.9	3.2
	529.3	479.9
Current		
Trade payables	43.6	39.6
Amounts owed to parent and fellow subsidiary undertakings	1.4	9.1
Other tax and social security	4.9	4.7
Deferred grants and contributions	9.0	9.1
Accruals and deferred income	267.3	311.3
	326.2	373.8
	855.5	853.7

Included within accruals and deferred income as at 31 March 2016 was £0.7 million (2015: £nil) of accrued interest, which at the company level was owed to subsidiary undertakings.

The average credit period taken for trade purchases is 28 days (2015: 29 days).

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

Notes to the financial statements

17. Trade and other payables (continued)

Deferred grants and contributions

Group and company	2016 £m	2015 £m
At the start of the year	485.8	450.7
Cash received during the year	17.3	18.1
Transfer of assets from customers	32.8	27.0
Credited to the income statement – revenue	(2.6)	(2.3)
Credited to the income statement – other operating expenses (see note 3)	(6.9)	(7.7)
	526.4	485.8

18. Share capital

Group and company	2016 £m	2015 £m
Issued, called up and fully paid		
100,000,000 (2015: 100,000,000) ordinary shares of £1.00 each	100.0	100.0
130,000,000 7 per cent cumulative redeemable preference shares of £1.00 each	130.0	130.0
	230.0	230.0
Less: 130,000,000 7 per cent cumulative redeemable preference shares of £1.00 each designated as borrowings (see note 13)	(130.0)	(130.0)
	100.0	100.0

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

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

On 26 January 2015 the company made a bonus share issue of 174,707,158 £1 ordinary shares from the other reserve created on adoption of IFRS, which increased the company share capital to £1,200.0 million.

On 26 January 2015 the company passed a resolution to reduce its capital, whereby the company cancelled 1,006,637,158 £1 ordinary shares; 93,437,000 £1 zero per cent coupon preference shares and £647.8 million from the share premium account. The reduction in share capital of £1,747.8 million that resulted was credited to retained earnings.

Notes to the financial statements

19. Operating lease commitments

Group and company	Property 2016 £m	Plant and equipment 2016 £m	Property 2015 £m	Plant and equipment 2015 £m
Commitments under non-cancellable operating leases due:				
Within one year	3.0	0.7	3.3	0.7
In the second to fifth years inclusive	10.3	0.5	11.4	0.5
After five years	278.5	-	280.3	-
	291.8	1.2	295.0	1.2

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

20. Contingent liabilities

As at 31 March 2016, the company has guaranteed loans of £126.1 million (2015: £nil) issued by its subsidiary undertaking, United Utilities Water Finance PLC, under the United Utilities PLC and United Utilities Water Finance PLC multi-issuer EUR 7 billion Euro Medium Term Note Programme.

No performance guarantees have been entered into as at 31 March 2016 by either the group or the company (2015: none).

21. Events after the reporting period

On 3 May 2016, the Competition and Markets Authority approved the joint venture agreement between the company's ultimate parent and Severn Trent PLC detailed in note 11. The transaction was completed on 1 June 2016.

There were no further events arising after the reporting date that require recognition or disclosure in the financial statements for the year ended 31 March 2016.

22. Ultimate parent undertaking

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

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

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

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

Notes to the financial statements

A1 Subsidiaries and other group undertakings

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

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

[1] See note A7 for further information.

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

Notes to the financial statements

A2 Cash generated from operations

Group and company	2016 £m	2015 £m
Profit before tax	348.8	328.3
Adjustment for investment income (see note 4) and finance expense (see note 5)	226.5	327.9
Operating profit	575.3	656.2
Adjustments for:		
Depreciation of property, plant and equipment (see note 8)	332.5	323.9
Amortisation of intangible assets (see note 9)	31.2	28.9
Impairment of property, plant and equipment (see note 8)	11.4	-
Loss on disposal of property, plant and equipment (see note 3)	5.4	5.1
Amortisation of deferred grants and contributions (see note 17)	(6.9)	(7.7)
Loss on disposal of intangible assets (see note 3)	-	0.5
Other non-cash movements	(3.6)	(1.2)
Changes in working capital:		
Increase in inventories	(0.6)	-
Increase in trade and other receivables	(17.6)	(18.9)
Decrease in trade and other payables	(11.8)	(21.7)
Increase/(decrease) in provisions (see note 16)	2.7	(3.4)
Pension contributions paid less pension expense charged to operating profit	(24.7)	(11.4)
Cash generated operations	893.3	950.3

The group and company have received property, plant and equipment of £32.8 million (2015: £27.0 million) in exchange for the provision of future goods and services (see notes 17 and A8).

A3 Net debt

Group and company	2016 £m	2015 £m
At the start of the year	6,359.0	6,083.7
Net capital expenditure	650.6	704.3
Dividends (see note 7)	186.1	180.6
Interest	172.3	186.9
Tax	26.4	(3.3)
Fair value movements[1]	39.9	104.2
Inflation uplift on index-linked debt (see note 5)	37.9	46.6
Other	3.8	6.3
Operating cashflow	(893.3)	(950.3)
At the end of the year	6,582.7	6,359.0

[1] Fair value movements includes net fair value losses on debt and derivative instruments of £41.0 million (2015: £123.3 million), less £1.1 million (2015: £19.1 million) of net payments on swaps and debt under fair value option (see note 5).

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

Notes to the financial statements

A4 Borrowings

Terms and debt repayment schedule

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

Group and company	Currency	Year of final repayment	Fair value 2016 £m	Carrying value 2016 £m	Fair value 2015 £m	Carrying value 2015 £m
Borrowings in fair value hedge relationships			**1,845.9**	**1,918.1**	**1,777.6**	**1,803.3**
5.375% 150m bond	GBP	2018	169.6	162.5	175.1	167.0
4.25% 500m bond	EUR	2020	455.9	455.1	427.5	424.1
5.75% 375m bond	GBP	2022	449.5	434.5	457.9	432.4
1.129% 52m bond(1)	EUR	2027	38.4	41.0	-	-
5.625% 300m bond	GBP	2027	382.7	411.1	391.2	408.1
5.02% JPY 10,000m dual currency loan	JPY/USD	2029	81.4	96.1	75.4	86.3
2.058% 30m bond(1)	EUR	2030	23.7	25.1	-	-
5.00% 200m bond	GBP	2035	244.7	292.7	250.5	285.4
Borrowings designated at fair value through profit or loss			**338.0**	**338.0**	**333.7**	**333.7**
6.875% 400m bond (owed to intermediate parent)	USD	2028	338.0	338.0	333.7	333.7
Borrowings measured at amortised cost			**5,497.1**	**4,934.0**	**5,521.2**	**4,782.3**
6.125% 425m bond	GBP	2015	-	-	447.6	425.9
Short-term bank borrowings – fixed	GBP	2016	53.9	53.9	46.7	46.7
1.97% + RPI 200m IL loan	GBP	2016	269.9	267.4	271.9	264.1
1.30% + LIBOR 5,000m bond	JPY	2017	31.7	32.0	29.2	28.8
2.46% + RPI 50m IL loan	GBP	2020	65.7	59.3	67.0	58.5
2.10% + RPI 50m IL loan	GBP	2020	64.7	59.3	65.8	58.5
1.93% + RPI 50m IL loan	GBP	2020	64.5	59.4	65.5	58.6
1.90% + RPI 50m IL loan	GBP	2020	64.5	59.5	65.5	58.7
1.88% + RPI 50m IL loan	GBP	2020	64.2	59.3	65.2	58.6
1.84% + RPI 50m IL loan	GBP	2020	64.4	59.6	65.3	58.8
1.73% + RPI 50m IL loan	GBP	2020	64.2	59.6	65.1	58.8
1.61% + RPI 50m IL loan	GBP	2020	63.9	59.7	64.8	58.9
0.80%+LIBOR 100m loan	GBP	2022	98.3	100.0	-	-
0.47% + RPI 100m IL loan	GBP	2023	105.0	105.2	105.0	103.8
0.49% + RPI 100m IL loan	GBP	2025	101.1	101.2	101.6	99.9
0.013%+RPI 25m IL bond(1)	GBP	2025	24.2	25.2	-	-
0.1275%+RPI 100m IL loan	GBP	2026	96.4	100.0	-	-
1.29% + RPI 50m IL (amortising) loan	GBP	2029	58.6	54.2	59.3	55.4
1.23% + RPI 50m IL (amortising) loan	GBP	2029	54.6	52.5	59.1	55.8
1.12% + RPI 50m IL (amortising) loan	GBP	2029	57.6	53.7	58.2	55.0
1.10% + RPI 50m IL (amortising) loan	GBP	2029	57.4	53.7	58.0	54.9
0.75% + RPI 50m IL (amortising) loan	GBP	2029	55.2	54.4	55.6	53.7
0.76% + RPI 50m IL (amortising) loan	GBP	2030	55.0	54.3	55.4	53.6
1.15% + RPI 50m IL (amortising) loan	GBP	2030	56.2	54.1	56.8	53.4
1.11% + RPI 50m IL (amortising) loan	GBP	2030	56.2	54.2	56.8	53.5
0.178%+RPI 35m IL bond(1)	GBP	2030	33.6	35.3	-	-
0.709% + LIBOR 100m (amortising) loan	GBP	2032	95.6	100.0	97.7	100.0
0.691%+ LIBOR 150m (amortising) loan	GBP	2032	142.9	150.0	146.2	150.0
3.375% + RPI 50m IL bond	GBP	2032	107.6	72.8	110.9	72.0
0.573% + LIBOR 100m (amortising) loan	GBP	2033	93.7	100.0	96.1	100.0
0.511%+LIBOR 150m (amortising) loan	GBP	2033	140.0	150.0	-	-

Notes to the financial statements

A4 Borrowings (continued)

	Currency	Year of final repayment	Fair value 2016 £m	Carrying value 2016 £m	Fair value 2015 £m	Carrying value 2015 £m
Borrowings measured at amortised cost (continued)						
0.01%+RPI 100m (amortising) IL loan	GBP	2033	94.7	99.7	-	-
0.01%+RPI 75m (amortising) IL loan	GBP	2034	71.1	74.7	-	-
1.9799% + RPI 100m IL bond	GBP	2035	171.4	136.4	174.9	135.0
1.66% +RPI 35m IL bond	GBP	2037	51.6	43.6	52.9	43.0
2.40% + RPI 70m IL bond	GBP	2039	113.5	85.0	117.2	83.8
1.7829% + RPI 100m IL bond	GBP	2040	172.8	135.0	177.4	133.6
1.3258% + RPI 50m IL bond	GBP	2041	78.9	67.3	80.7	66.7
1.5802% + RPI 100m IL bond	GBP	2042	166.6	134.5	171.7	133.2
1.5366% + RPI 50m IL bond	GBP	2043	82.5	67.1	85.0	66.5
1.397% + RPI 50m IL bond	GBP	2046	81.8	67.3	85.0	66.6
1.7937% + RPI 50m IL bond	GBP	2049	91.1	67.0	95.0	66.3
Commission for New Towns (amortising) loan – fixed	GBP	2053	52.5	28.7	55.6	29.3
1.847% + RPI 100m IL bond	GBP	2056	180.8	131.6	186.8	129.9
1.815% + RPI 100m IL bond	GBP	2056	179.4	131.0	185.5	129.3
1.662% + RPI 100m IL bond	GBP	2056	173.1	130.8	178.8	129.1
1.591% + RPI 25m IL bond	GBP	2056	42.4	32.6	43.6	32.2
1.5865% + RPI 50m IL bond	GBP	2056	85.6	65.3	86.9	64.5
1.556% + RPI 50m IL bond	GBP	2056	84.5	65.0	86.9	64.2
1.435% + RPI 50m IL bond	GBP	2056	82.0	64.8	84.2	63.9
1.3805% + RPI 35m IL bond	GBP	2056	56.7	45.3	58.2	44.7
1.702% + RPI 50m IL bond	GBP	2057	86.1	63.5	88.7	62.6
1.585% + RPI 100m IL bond	GBP	2057	165.1	125.9	172.1	124.2
Preference shares (owed to immediate parent undertaking)	GBP	2099	130.0	130.0	130.0	130.0
Amounts owed to intermediate parent undertaking	GBP	Various	611.4	611.4	664.3	664.3
Book overdrafts (see note 12)	GBP	2016	30.7	30.7	23.5	23.5
			7,681.0	7,190.1	7,632.5	6,919.3

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 for 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.

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

Notes to the financial statements

A5 Financial risk management

Risk management

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

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

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

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

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

Liquidity risk

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

At 31 March 2016, the group and company had £854.3 million (2015: £1,099.0 million) of available liquidity, which comprised £204.3 million cash and short-term deposits (2015: £180.0 million), £575.0 million (2015: £519.0 million) of undrawn committed borrowing facilities and £75.0 million (2015: £400.0 million) of undrawn term loan facilities. Short-term deposits mature within three months.

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

Group and company	2016 £m	2015 £m
Expiring within one year	115.0	25.0
Expiring after one year but in less than two years [1]	220.0	165.0
Expiring after more than two years	240.0	330.0
Total borrowing facilities	575.0	520.0
Facilities drawn	-	(1.0)
Undrawn borrowing facilities	575.0	519.0

[1] Figure includes £90.0 million (2015: £50.0 million) facility provided by intermediate parent undertaking.

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

Notes to the financial statements

A5 Financial Risk Management (continued)

Maturity analysis

Concentrations of risk may arise if large cash flows are concentrated within particular time periods. The maturity profile in the following table represents the forecast future contractual principal and interest cash flows in relation to the group and company's financial liabilities 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.

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

Group and company At 31 March 2015	Total[(1)] £m	Adjustment[(2)] £m	1 year or less £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m
Bonds	9,102.5		554.4	104.5	134.7	256.5	484.6	7,567.8
Bank and other term borrowings	2,466.2		113.8	348.9	84.2	85.8	86.9	1,746.6
Preference shares	130.0		130.0	-	-	-	-	-
Parent borrowings	1,176.3		101.6	74.3	75.4	409.7	69.5	445.8
Adjustment to carrying value[(2)]	(5,955.7)	(5,955.7)						
Borrowings	6,919.3	(5,955.7)	899.8	527.7	294.3	752.0	641.0	9,760.2
Derivatives:								
Payable	680.8		62.1	67.3	96.6	46.4	383.0	25.4
Receivable	(1,032.7)		(79.6)	(81.0)	(156.7)	(210.6)	(502.3)	(2.5)
Adjustment to carrying value[(2)]	11.6	11.6						
Derivatives – net assets	(340.3)	11.6	(17.5)	(13.7)	(60.1)	(164.2)	(119.3)	22.9

[(1)] Forecast future cash flows are calculated, where applicable, using forward interest rates based on the interest environment at year-end and are, therefore, susceptible to changes in market conditions. For index-linked debt it has been assumed that RPI will be three per cent over the life of each instrument.
[(2)] The carrying value of debt is calculated following various methods in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' and therefore this adjustment reconciles the undiscounted forecast future cash flows to the carrying value of debt in the statement of financial position.

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

Notes to the financial statements

A5 Financial Risk Management (continued)

Credit risk

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

The group manages its risk from trading through the effective management of customer relationships. Concentrations of credit risk with respect to trade receivables are limited due to the group'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. In addition, under the group's revenue recognition policy, revenue is only recognised when collection of the resulting receivable is reasonably assured. Considering the above, the directors believe there is no further credit risk provision required in excess of the allowance for doubtful receivables (see note 10).

The group's counterparty credit risk is managed on a UUG 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 UUG treasury committee through the operational compliance report.

At 31 March 2016 and 31 March 2015, the maximum exposure to credit risk for the group and company is represented by the carrying amount of each financial asset in the statement of financial position:

Group and company	2016 £m	2015 £m
Cash and short-term deposits	204.3	180.0
Trade and other receivables	406.3	388.6
Derivative financial instruments	624.1	544.8
	1,234.7	1,113.4

The credit exposure on derivatives is disclosed gross of any collateral held. At 31 March 2016, the group and company held £53.9 million (2015: £46.7 million) as collateral in relation to derivative financial instruments (included within borrowings in note A4).

Market risk

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

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

Notes to the financial statements

A5 Financial risk management (continued)

Inflation risk

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

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

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

The group seeks to manage this risk by identifying opportunities to amend the economic hedge currently in place where deemed necessary and subject to relative value. Inflation risk is reported monthly to the UUG treasury committee in the operational compliance report.

The carrying value of the index-linked debt held by the group and company was £3,447.3 million at 31 March 2016 (2015: £3,083.8 million).

Sensitivity analysis

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

Increase/(decrease) in profit before tax and equity

Group and company	2016 £m	2015 £m
1 per cent increase in RPI	(35.0)	(31.4)
1 per cent decrease in RPI	35.0	31.4

The sensitivity 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 income statement, and the analysis does not incorporate this factor. The portfolio of index-linked debt is calculated on either a three or eight-month lag basis. Therefore, at the reporting date the index-linked interest and principal adjustments impacting the income statement are fixed and based on the annual RPI change either three or eight months earlier.

Notes to the financial statements

A5 Financial risk management (continued)

Interest rate risk

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

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

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

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

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

Sensitivity analysis

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

Increase/(decrease) in profit before tax and equity

Group and company	2016 £m	2015 £m
1 per cent increase in interest rate	173.8	171.2
1 per cent decrease in interest rate	(181.6)	(188.3)

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

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

Notes to the financial statements

A5 Financial risk management (continued)

Repricing analysis

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

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

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

Notes to the financial statements

A5 Financial risk management (continued)

At 31 March 2015	Total £m	1 year or less £m	1-2 years £m	2-3 years £m	3-4 years £m	4-5 years £m	More than 5 years £m
Borrowings in fair value hedge Relationships							
Fixed rate instruments	1,803.3	-	-	-	167.0	424.1	1,212.2
Effect of swaps	-	1,803.3	-	-	(167.0)	(424.1)	(1,212.2)
	1,803.3	1,803.3	-	-	-	-	-
Borrowings designated at fair value through profit or loss							
Fixed rate instruments	333.7	-	-	-	-	-	333.7
Effect of swaps	-	333.7	-	-	-	-	(333.7)
	333.7	333.7	-	-	-	-	-
Borrowings measured at amortised cost							
Fixed rate instruments	632.0	473.1	0.4	0.5	0.5	0.6	156.9
Floating rate instruments	1,066.5	1,066.5	-	-	-	-	-
Index-linked instruments	3,083.8	3,083.8	-	-	-	-	-
	4,782.3	4,623.4	0.4	0.5	0.5	0.6	156.9
Effect of fixed interest rate swaps	-	(2,656.3)	(250.0)	(125.0)	(50.0)	1,127.1	1,954.2
Total borrowings	6,919.3	4,104.1	(249.6)	(124.5)	(49.5)	1,127.7	2,111.1
Cash and short-term deposits	(180.0)	(180.0)	-	-	-	-	-
Net borrowings	6,739.3	3,924.1	(249.6)	(124.5)	(49.5)	1,127.7	2,111.1

Electricity price risk

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

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

Sensitivity analysis

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

Increase/(decrease) in profit before tax and equity

Group and company	2016 £m	2015 £m
20 per cent increase in electricity commodity prices	7.7	9.5
20 per cent decrease in electricity commodity prices	(7.7)	(9.5)

Notes to the financial statements

A5 Financial risk management (continued)

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

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

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

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

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

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

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

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

Notes to the financial statements

A5 Financial risk management (continued)

Fair values

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

Group and company

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

At 31 March 2015	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	-	384.3	-	384.3
Derivative financial assets – held for trading[1]	-	160.5	-	160.5
Financial liabilities at fair value through profit or loss				
Derivative financial liabilities – held for trading[1][2]	-	(204.5)	-	(204.5)
Financial liabilities designated as fair value through profit or loss	-	(333.7)	-	(333.7)
Financial liabilities for which fair value has been disclosed				
Financial liabilities in fair value hedge relationships	(1,702.2)	(75.4)	-	(1,777.6)
Other financial liabilities at amortised cost	(2,530.3)	(2,990.9)	-	(5,521.2)
	(4,232.5)	(3,059.7)	-	(7,292.2)

[1] These derivatives form economic hedges and, as such, management intend to hold these through to maturity.
[2] Derivatives forming an economic hedge of the currency exposure on borrowings included in these balances were £177.2 million (2015: £152.2 million).

Notes to the financial statements

A5 Financial risk management (continued)

Fair values (continued)

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

The group has calculated fair values using quoted prices where an active market exists, which has resulted in £3,012.3 million (2015: £4,232.5 million) of 'level 1' fair value measurements. In the absence of an appropriate quoted price, the group has applied discounted cash flow valuation models utilising market available data in line with prior years. The £1,220.2 million reduction (2015: £1,445.8 million increase) in 'level 1' fair value measurements is largely due to the maturity of a £425.0 million bond during the year and a decrease in the number of observable quoted bond prices at 31 March 2016.

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 £4.3 million loss (2015: £65.0 million), a £15.1 million gain (2015: £4.6 million) is attributable to changes in own credit risk. The cumulative amount recognised in the income statement due to changes in credit spread was £74.1 million profit (2015: £59.0 million). The carrying amount is £135.9 million (2015: £131.6 million) higher than the amount contracted to settle on maturity.

A6 Retirement benefits

Defined benefit schemes

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

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

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

None of the executive directors accrue benefits under defined benefit schemes. See note 2 for further information about the pension arrangements for executive directors.

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

Notes to the financial statements

A6 Retirement benefits (continued)

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

Group and company	2016 £m	2015 £m
Total value of current employees benefits	763.1	768.0
Deferred members benefits	338.7	366.8
Pensioner members benefits	1,081.8	1,107.7
Total defined benefit obligation	2,183.6	2,242.5

The duration of the combined schemes is around 20 years. The schemes' duration is an indicator of the weighted-average time until benefit payments are settled, taking account of the split of the defined benefit obligation between current employees, deferred members and the current pensioners of the schemes.

Funding requirements

The latest funding valuation of the schemes was carried out by an independent qualified actuary as at 31 March 2013 and reported a deficit. The basis on which liabilities are valued for funding purposes differs from the basis required under IAS 19. Under UK legislation there is a requirement that pension schemes are funded prudently.

The group has a plan in place with the schemes' trustees to address the funding deficit by 31 December 2020, through a series of annual deficit recovery contributions.

The group and trustees have agreed long-term strategies for reducing investment risk in each scheme.

For UUPS, this includes an asset-liability matching policy which aims to reduce the volatility of the funding level of the pension plan by investing in assets such as fixed income swaps and gilts which perform in line with the liabilities so as to hedge against changes in swap and gilt yields. For ESPS, a partial hedge is in place to protect against changes in swap and gilt yields.

In addition, the group has had an Inflation Funding Mechanism (IFM) in place since 2010; details of this are outlined in the 2011 annual report. In 2013, it extended the mechanism to the ESPS and increased the fixed percentage rate used to 3.0 per cent per annum from 2.75 per cent per annum. To the extent that inflation, as measured by the RPI index at each 31 March preceding the payment due date, is different from 3.0 per cent per annum, the inflation reserve will increase/decrease. Additional contributions are then payable annually based on the size of the inflation reserve.

The group expects to make contributions of £52.3 million in the year ending 31 March 2017, comprising £32.1 million to UUPS and £0.7 million to ESPS in respect of deficit repair contributions, £18.8 million and £0.4 million in respect of regular contributions to UUPS and ESPS respectively, and £0.3 million in respect of expenses to the ESPS.

Notes to the financial statements

A6 Retirement benefits (continued)

Impact of scheme risk management on IAS 19 disclosures

Under the prescribed IAS 19 basis, pension scheme liabilities are calculated based on current accrued benefits. Expected cash flows are projected forward allowing for RPI and the current member mortality assumptions. These projected cash flows are then discounted by an AA 'corporate bond' rate, which comprises an underlying interest rate and a credit spread.

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

As a consequence, the reported statement of financial position under IAS 19 remains volatile to changes in credit spread which have not been hedged, primarily due to the difficulties in doing so over long durations; changes in inflation, as the IFM results in changes to the IFM deficit contributions rather than a change in the schemes' assets; and, to a lesser extent, changes in mortality as management has decided not to hedge this exposure due to its lower volatility in the short term and the relatively high hedging costs.

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

In the year ended 31 March 2016, the discount rate has increased by 0.3 per cent, which includes a 0.7 per cent increase in credit spreads offset by a decrease in swap yields over the year. The IAS 19 remeasurement gain of £124.6 million reported in note 14 has largely resulted from the impact of the increase in credit spreads during the year, partially offset by the impact of a 0.2 per cent increase in inflation.

Reporting and assumptions

The results of the latest funding valuations at 31 March 2013 have been adjusted to take account of the requirements of IAS 19 in order to assess the position at 31 March 2016, by taking account of experience over the period, changes in market conditions, and differences in the financial and demographic assumptions. The present value of the defined benefit obligation, and the related current service costs, were measured using the projected unit credit method.

Financial assumptions

The main financial and demographic assumptions used by the actuary to calculate the defined benefit surplus of UUPS and ESPS are outlined below:

	2016 % p.a.	2015 % p.a.
Discount rate	3.4	3.1
Pensionable salary growth and pension increases	3.2	3.0
Price inflation	3.2	3.0

During the year, the group has undertaken a review of its pension assumptions and has made a number of amendments as a result. To align with market practice, the discount rate is now based on an AA 'corporate bond' curve rather than a broader AA 'non-gilt' curve that was previously used. This has resulted in a 0.2 per cent increase in the discount rate during the year and a 0.2 per cent increase in credit spreads. In addition, the allowance for inflation risk premium has been removed from the basis of the inflation rate assumption to better align with the risk management strategy, which has increased the inflation assumption by 0.3 per cent.

Notes to the financial statements

A6 Retirement benefits (continued)

Demographic assumptions

Mortality in retirement is assumed to be in line with the Continuous Mortality Investigation's (CMI) S1NA year of birth tables, with a one-year age rating for males in the UUPS only, reflecting actual mortality experience; and CMI 2014 (2015: CMI 2014) long-term improvement factors, with a long-term annual rate of improvement of 1.75 per cent (2015: 1.5 per cent). The current life expectancies at age 60 underlying the value of the accrued liabilities for the schemes are:

	2016 years	2015 years
Retired member – male	27.1	26.6
Non-retired member – male	29.2	28.3
Retired member – female	30.7	30.2
Non-retired member – female	32.9	32.0

Sensitivity of the key scheme assumptions

The measurement of the group's defined benefit surplus is sensitive to changes in key assumptions, which are described above. The sensitivity calculations presented below allow for the specified movement in the relevant key assumption, whilst all other assumptions are held constant. This approach does not take into account the inter-relationship between some of these assumptions or any hedging strategies adopted.

Asset volatility
If the schemes' assets underperform relative to the discount rate used to calculate the schemes' liabilities, this will create a deficit. The schemes hold some growth assets (equities, diversified growth funds and emerging market debt) which, though expected to outperform the discount rate in the long term, create volatility in the short term. The allocation to growth assets is monitored to ensure it remains appropriate given the schemes' long-term objectives.

Discount rate
An increase/decrease in the discount rate of 0.1 per cent would have resulted in a £42.9 million (2015: £45.0 million) decrease/ increase in the schemes' liabilities at 31 March 2016, although as long as credit spreads remain stable this will be largely offset by an increase in the value of the schemes' bond holdings and other instruments designed to hedge this exposure. The discount rate is based on AA 'corporate bond' yields of a similar duration to the schemes' liabilities.

Price inflation
An increase/decrease in the inflation assumption of 0.1 per cent would have resulted in a £40.7 million (2015: £42.3 million) increase/decrease in the schemes' liabilities at 31 March 2016, as a significant proportion of the schemes' benefit obligations are linked to inflation. In some cases, caps on the level of inflationary increases are in place to protect against extreme inflation. The majority of the assets are either unaffected by or loosely correlated with inflation, meaning that an increase in inflation will also increase the deficit. Any change in inflation out-turn results in a change to the cash contributions provided under the IFM.

Life expectancy
An increase/decrease in the mortality long-term annual rate of improvement of 0.25 per cent would have resulted in a £33.4 million (2015: £34.5 million) increase/decrease in the schemes' liabilities at 31 March 2016. The majority of the schemes' obligations are to provide benefits for the life of the member and, as such, the schemes' liabilities are sensitive to these assumptions.

Notes to the financial statements

A6 Retirement benefits (continued)

Further reporting analysis

At 31 March, the fair value of the schemes' assets recognised in the statement of financial position were as follows:

	Schemes' assets %	2016 £m	Schemes' assets %	2015 £m
Group				
Equities	9.8	236.8	9.8	227.2
Other non-equity growth assets	9.4	226.2	10.3	238.1
Gilts	41.1	990.4	16.5	382.4
Bonds	40.5	975.8	43.2	1,000.8
Other	(0.8)	(18.7)	20.2	468.8
Total fair value of schemes' assets	100.0	2,410.5	100.0	2,317.3
Present value of defined benefit obligations		(2,183.6)		(2,242.5)
Net retirement benefit surplus		226.9		74.8

The fair values in the table above are all based on quoted prices in an active market, where applicable.

The assets, in respect of UUPS, included in the table above, have been allocated to each asset class based on the return the assets are expected to achieve as UUPS has entered into a variety of derivative transactions to change the return characteristics of the physical assets held in order to reduce undesirable market and liability risks. As such, the breakdown shown separates the assets of the schemes to illustrate the underlying risk characteristics of the assets held.

Both of the schemes employ a strategy where the asset portfolio is made up of a growth element and a defensive element. Assets in the growth portfolio are shown as equities and other non-equity growth assets above, while assets held in the defensive portfolio represent the remainder of the schemes' assets.

The defensive element of the portfolio contains a proportion of assets set aside for collateral purposes linked to the derivative contracts entered into, as described above. The collateral portfolio, comprising cash and eligible securities readily convertible to cash provides sufficient liquidity to manage the derivative transactions and is expected to achieve a return in excess of LIBOR.

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

	2016 £m	2015 £m
At the start of the year	2,317.3	1,725.0
Interest income on schemes' assets	71.2	73.4
The return on plan assets, excluding amounts included in interest	48.2	550.0
Member contributions	5.5	5.9
Benefits paid	(78.0)	(69.9)
Administrative expenses	(1.7)	(1.6)
Group contributions	48.0	34.5
At the end of the year	(2,410.5)	(2,317.3)

The group's actual return on the schemes' assets was a gain of £119.4 million (2015: £152.3 million), principally due to gains on derivatives hedging the schemes' liabilities.

Notes to the financial statements

A6 Retirement benefits (continued)

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

	2016 £m	2015 £m
At the start of the year	(2,242.5)	(1,870.6)
Interest cost on schemes' obligations	(68.4)	(79.1)
Actuarial gains/(losses) arising from changes in financial assumptions	71.4	(372.4)
Actuarial (losses)/gains arising from changes in demographic assumptions	(34.8)	8.0
Actuarial gains arising from experience	39.8	29.1
Curtailments/settlements	(0.9)	(4.8)
Member contributions	(5.5)	(5.9)
Benefits paid	78.0	69.9
Current service cost	(20.7)	(16.7)
At the end of the year	(2,183.6)	(2,242.5)

A contingent liability exists in relation to the equalisation of Guaranteed Minimum Pension (GMP). The UK Government intends to implement legislation which could result in an increase in the value of GMP for males. This would increase the defined benefit obligation of the schemes. At this stage, until the Government develops its proposals and publishes guidance, it is not possible to quantify the impact of this change.

A7 Related party transactions

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

Group and company	2016 £m	2015 £m
Sales of services	0.2	0.1
Purchases of goods and services	0.7	0.6
Amounts owed to related parties	-	-
Amounts owed by related parties	0.1	0.1

Lingley Mere Management Company Limited is a 100% controlled subsidiary of Lingley Mere Business Park Development Company Limited, which is itself 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 parties were on the group's normal trading terms.

There were no guarantees in place with related parties (2015: £nil). No expense or allowance has been recognised for bad and doubtful receivables in respect of the amounts owed by related parties (2015: £nil).Transactions between the company and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note.

Notes to the financial statements

A8 Accounting policies

Of the accounting policies outlined below, those deemed to be the most significant for the group are those that align with the critical accounting judgements and key sources of estimation uncertainty set out on pages 79 to 82.

Basis of consolidation

The group financial statements consolidate the financial statements of the company and entities controlled by the company (its subsidiaries). The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from the date control is obtained or until the date that control ceases, as appropriate.

Subsidiaries

Subsidiaries are entities controlled by the group. Control is achieved where the group is exposed to, or has the rights to, variable returns from its involvement in an entity and has the ability to affect those returns through its power over the entity. In the parent company accounts, investments are held at cost less provision for impairment.

On acquisition, the assets and liabilities and contingent liabilities of a subsidiary are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair values of the identifiable net assets acquired is recognised as goodwill. Any deficiency of the cost of acquisition below the fair values of the identifiable net assets acquired is credited to the income statement in the period of acquisition. All intra-group transactions, balances, income and expenses are eliminated on consolidation.

Revenue recognition

Revenue represents the fair value of the income receivable in the ordinary course of business for goods and services provided, exclusive of value added tax. Where relevant, this includes an estimate of the sales value of units supplied to customers between the date of the last meter reading and the period end.

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

Operating profit

Operating profit is stated after charging operational expenses but before investment income and finance expense.

Borrowing costs and finance income

Except as noted below, all borrowing costs and finance income are recognised in the income statement on an accruals basis.

Transaction costs that are directly attributable to the acquisition or issue of a financial asset or financial liability are included in the initial fair value of that instrument.

Where borrowing costs are attributable to the acquisition, construction or production of a qualifying asset, such costs are capitalised as part of the specific asset.

Notes to the financial statements

A8 Accounting Policies (continued)

Tax

The tax expense represents the sum of current tax and deferred tax.

Current tax

Current tax is based on the taxable profit for the period and is provided at amounts expected to be paid or recovered using the tax rates and laws that have been enacted or substantively enacted at each reporting date.

Taxable profit differs from the net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible.

Current tax is charged or credited in the income statement, except when it relates to items charged or credited to equity, in which case the tax is also dealt with in equity.

Deferred tax

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit. Deferred tax liabilities are provided, using the liability method, on all taxable temporary differences at each reporting date. Such assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries, except where the group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred tax is measured at the average tax rates that are expected to apply in the periods in which the temporary timing differences are expected to reverse based on tax rates and laws that have been enacted or substantively enacted at each reporting date.

The carrying amount of deferred tax assets is reviewed at each reporting date and is reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited to equity, in which case the deferred tax is also dealt with in equity.

Property, plant and equipment

Property, plant and equipment comprises of water and wastewater infrastructure assets and overground assets.

The useful economic lives of these assets are primarily as follows:

- Water and wastewater infrastructure assets:
  - Impounding reservoirs 200 years;
  - Mains and raw water aqueducts 30 to 300 years;
  - Sewers and sludge pipelines 60 to 300 years;
  - Sea outfalls 77 years;
- Buildings 10 to 60 years;
- Operational assets 5 to 80 years; and
- Fixtures, fittings, tools and equipment 3 to 40 years.

Notes to the financial statements

A8 Accounting Policies (continued)

Property, plant and equipment (continued)

Employee and other related costs incurred in implementing the capital schemes of the group are capitalised.

Water and wastewater infrastructure assets

Infrastructure assets comprise a network of water and wastewater pipes and systems. Expenditure on the infrastructure assets, including borrowing costs where applicable, relating to increases in capacity or enhancements of the network is treated as additions. Amounts incurred in maintaining the operating capability of the network in accordance with defined standards of service are expensed in the year in which the expenditure is incurred. Infrastructure assets are depreciated by writing off their cost (or deemed cost for infrastructure assets held on transition to IFRS), less the estimated residual value, evenly over their useful economic lives.

Other assets

All other property, plant and equipment is stated at historical cost less accumulated depreciation.

Historical cost includes expenditure that is directly attributable to the acquisition of the items, including relevant borrowing costs, where applicable, for qualifying assets. Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the group and the cost of the item can be measured reliably. All other repairs and maintenance costs are charged to the income statement during the financial period in which they are incurred.

Freehold land and assets in the course of construction are not depreciated. Other assets are depreciated by writing off their cost, less their estimated residual value, evenly over their estimated useful economic lives, based on management's judgement and experience.

Depreciation methods, residual values and useful economic lives are reassessed annually and, if necessary, changes are accounted for prospectively. The gain or loss arising on the disposal or retirement of an asset is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognised in other operating costs.

Transfer of assets from customers and developers

Where the group receives from a customer or developer an item of property, plant and equipment (or cash to construct or acquire an item of property, plant and equipment) that the group must then use, either to connect the customer to the network, or to provide the customer with ongoing access to a supply of goods or services, or to do both, such items are capitalised at their fair value and included within property, plant and equipment, with a credit of the same amount to deferred grants and contributions. The assets are depreciated over their useful economic lives and the deferred contributions released to revenue over the same period (or where the receipt of property, plant and equipment is solely to connect the customer to the network, the deferred contribution is released immediately to revenue). This interpretation has been applied to transfers of assets from customers received on or after 1 July 2009.

Assets transferred from customers or developers are accounted for at fair value. If no market exists for the assets then incremental cash flows are used to arrive at fair value.

Notes to the financial statements

A8 Accounting Policies (continued)

Intangible assets

Intangible assets are measured initially at cost and are amortised on a straight-line basis over their estimated useful economic lives. The carrying amount is reduced by any provision for impairment where necessary. On a business combination, as well as recording separable intangible assets already recognised in the statement of financial position of the acquired entity at their fair value, identifiable intangible assets that arise from contractual or other legal rights are also included in the acquisition statement of financial position at fair value.

Internal expenditure is capitalised as internally generated intangibles only if it meets the criteria of IAS 38 'Intangible Assets'.

Intangible assets, which relate primarily to computer software, are amortised over a period of three to 10 years.

Impairment of tangible and intangible assets

Intangible assets and property, plant and equipment are reviewed for impairment at each reporting date to determine whether there is any indication that those assets may have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss, if any. Where the asset does not generate cash flows that are independent from other assets, the group estimates the recoverable amount of the cash generating unit to which the asset belongs.

The recoverable amount is the higher of fair value less costs to sell, and value in use. Value in use represents the net present value of expected future cash flows, discounted on a pre-tax basis, using a rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (or cash generating unit) is reduced to its recoverable amount. Impairment losses in respect of non-current assets are recognised in the income statement within operating costs.

Where an impairment loss subsequently reverses, the reversal is recognised in the income statement and the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but not so as to exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

Non-current assets classified as available for distribution

Non-current assets classified as available for distribution are measured at their carrying value. Non-current assets are classified as available for distribution when management is committed to distribute the asset to the company's shareholder. This condition is regarded as having been met only when the asset is available for immediate distribution in its present condition and the distribution is highly probable. Management must have taken actions to initiate the completion of the distribution and the distribution should be expected to be completed within one year from the date of classification.

Notes to the financial statements

A8 Accounting Policies (continued)

Financial instruments

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

Cash and short-term deposits

Cash and short-term deposits include cash at bank and in hand, deposits and other short-term highly liquid investments which are readily convertible into known amounts of cash, have a maturity of three months or less from the date of acquisition and which are subject to an insignificant risk of change in value. In the consolidated statement of cash flows and related notes, cash and cash equivalents include cash and short-term deposits, net of book overdrafts.

Financial investments

Investments (other than interests in subsidiaries and fixed deposits) are initially measured at fair value, including transaction costs. Investments classified as available for sale in accordance with IAS 39 'Financial Instruments: Recognition and Measurement' are measured at subsequent reporting dates at fair value. Gains and losses arising from changes in fair value are recognised directly in equity, until the security is disposed of or is determined to be impaired, at which time the cumulative gain or loss previously recognised in equity is included in the net profit or loss for the period.

Trade receivables

Trade receivables are initially measured at fair value, and are subsequently measured at amortised cost, less any impairment for irrecoverable amounts. Estimated irrecoverable amounts are based on historical experience of the receivables balance.

Trade payables

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

Financial liabilities and equity

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

Equity instruments

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

Borrowings

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

The default treatment of measuring at amortised cost, whilst associated hedging derivatives are recognised at fair value, presents an accounting measurement mismatch that has the potential to introduce considerable volatility to both the income statement and the statement of financial position. Therefore, where feasible, the group takes advantage of the provisions under IAS 39 'Financial Instruments: Recognition and Measurement' to make fair value adjustments to its

Notes to the financial statements

A8 Accounting Policies (continued)

Financial instruments (continued)

Borrowings (continued)

borrowing instruments to reduce this volatility and better represent the economic hedges that exist between the group's borrowings and associated derivative contracts.

Where feasible, the group designates its financial instruments within fair value hedge relationships. In order to apply fair value hedge accounting, it must be demonstrated that the hedging derivative has been, and will continue to be, a highly effective hedge of the risk being hedged within the applicable borrowing instrument.

Borrowings designated within a fair value hedge relationship

Where designated, bonds and loans are initially measured at fair value being the cash proceeds received net of any direct issue costs. They are subsequently adjusted for any change in fair value attributable to the risk being hedged at each reporting date, with the change being charged or credited to finance expense in the income statement.

Hedge accounting is discontinued prospectively when the hedging instrument is sold, terminated or exercised, or where the hedge relationship no longer qualifies for hedge accounting.

Borrowings designated at fair value through profit or loss

Designation is made where the requirements to designate within a fair value hedge cannot be met at inception despite there being significant fair value offset between the borrowing and the hedging derivative. Where designated, bonds and loans are initially measured at fair value being the cash proceeds received and are subsequently measured at fair value at each reporting date with changes in fair value being charged or credited to finance expense in the income statement.

Derivative financial instruments

Derivative financial instruments are measured at fair value at each reporting date with changes in fair value being charged or credited to finance expense in the income statement. The group enters into financial derivatives contracts to manage its financial exposure to changes in market rates (see note A5).

Derivatives and borrowings – valuation

Where an active market exists, designated borrowings and derivatives recorded at fair value are valued using quoted market prices. Otherwise, they are valued using a net present value valuation model. The model uses applicable interest rate curve data at each reporting date to determine any floating cash flows. Projected future cash flows associated with each financial instrument are discounted to the reporting date using discount factors derived from the applicable interest curves adjusted for counterparty credit risk where appropriate. Discounted foreign currency cash flows are converted into sterling at the spot exchange rate at each reporting date. Assumptions are made with regard to credit spreads based on indicative pricing data.

The valuation of debt designated in a fair value hedge relationship is calculated based on the risk being hedged as prescribed by IAS 39 'Financial Instruments: Recognition and Measurement'. The group's policy is to hedge its exposure to changes in the applicable underlying interest rate and it is this portion of the cash flows that is included in the valuation model (excluding any applicable company credit risk spread).

The valuation of debt designated at fair value through the profit or loss incorporates an assumed credit risk spread in the applicable discount factor. Credit spreads are determined based on indicative pricing data.

Notes to the financial statements

A8 Accounting Policies (continued)

Inventories

Inventories are stated at the lower of cost and net realisable value. For properties held for resale, cost includes the cost of acquiring and developing the sites, including borrowing costs where applicable.

Net realisable value represents the estimated selling price less all estimated costs of completion and costs to be incurred in marketing, selling and distribution.

Employee benefits

Retirement benefit obligations

The group operates two defined benefit pension schemes, which are independent of the group's finances, for its employees. Actuarial valuations of the schemes are carried out as determined by the pension scheme trustees using the projected unit credit method at intervals of not more than three years, the rates of contribution payable and the pension cost being determined on the advice of the actuaries, having regard to the results of these valuations. In any intervening years, the actuaries review the continuing appropriateness of the contribution rates.

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 statement of financial position.

The cost of providing pension benefits to employees relating to the current year's service (including curtailment gains and losses) is included within the income statement within employee benefits expense. The net interest on the schemes' surplus/obligation is included in the income statement within investment income or finance expense.

Remeasurement gains and losses are recognised outside the income statement in retained earnings and presented in the statement of comprehensive income.

In addition, the group also operates a defined contribution pension section within the United Utilities Pension Scheme. Payments are charged as employee costs as they fall due. The group has no further payment obligations once the contributions have been paid.

Provisions

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

Foreign currency translation

Transactions and balances

Transactions in foreign currencies are recorded at the exchange rates applicable on the dates of the transactions. At each reporting date, monetary assets and liabilities denominated in foreign currencies are translated into sterling at the relevant rates of exchange applicable on that date. Gains and losses arising on retranslation are included in net profit or loss for the period.

In order to hedge its exposure to certain foreign exchange risks, the group enters into derivative instruments (see note A5).

Notes to the financial statements

A8 Accounting Policies (continued)

Grants and contributions

Grants and contributions receivable in respect of property, plant and equipment are treated as deferred income, which is credited to the income statement over the estimated useful economic lives of the related assets.

Leases

Leases are classified according to the substance of the transaction. Operating leases are leases that do not transfer substantially all the risks and rewards of ownership to the lessee.

Operating lease rentals are charged to the income statement on a straight-line basis over the period of the lease.