Chairman and Chief Executive Officer's review

We are on track to deliver our vision of becoming the UK's best water and wastewater company, providing great service to our customers and creating value for our shareholders.

Overview

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

Customer focus

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

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

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

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

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

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

One new innovation contributing to this success is a targeted campaign, which we call Town Action Planning, where we visit customers in areas where deprivation is particularly high. The scheme is proving particularly successful in engaging with hard to reach customers, helping them understand our various support schemes and payment options to find the arrangement most suited to their circumstances. In addition, we have been able to identify customers eligible for Priority Services who would otherwise have been unknown to us.

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

Ended the year as a leading company in our peer group for customer satisfaction

Systems Thinking and innovation delivering ODI performance ahead of expectations

Additional £100m of new investment to improve resilience as outperformance earned

Pictured: Dr John McAdam, Chairman and Steve Mogford, Chief Executive Officer at our wastewater treatment works in Liverpool.

Financial performance

Group revenue was slightly lower than last year, reflecting the accounting impact of our Water Plus joint venture (JV) as we prepared ourselves for the opening of competition in the non-household retail market on 1 April 2017, partly offset by our allowed regulatory revenue changes.

Underlying operating profit was up £19 million, at £623 million. This reflects the new regulated price controls, slightly lower infrastructure renewals expenditure, only a marginal increase in depreciation (as we recognised some accelerations in depreciation last year) and a small decrease in the remaining cost base, partly offset by the accounting impact of our Water Plus JV. Reported operating profit was £606 million, up £38 million, mainly as a result of reduced profit last year which was principally due to costs associated with our water quality incident in Lancashire.

Underlying profit before tax was down £19 million to £389 million, as the £19 million increase in underlying operating profit was more than offset by a £36 million increase in underlying net finance expense. The increase in underlying net finance expense is mainly due to the impact of higher RPI inflation on our index-linked debt. Reported profit before tax was £442 million, up £89 million on the previous year, reflecting fair value gains on our debt and derivative instruments this year, versus fair value losses last year, along with other adjusting items as outlined in the underlying profit measures table on pages 44 to 45.

Underlying earnings per share was 46.0 pence, more than covering the dividend. Reported earnings per share was higher at 63.6 pence, mainly reflecting a deferred tax credit as a result of the UK Government's future planned reduction in the mainstream rate of corporation tax.

The board is proposing a final dividend of 25.92 pence per ordinary share, making a total of 38.87 pence per ordinary share for the 2016/17 financial year. This represents an increase of 1.1 per cent, in line with our policy of targeting an annual growth rate of at least RPI inflation through to 2020.

We have a robust capital structure, supported by our policy of targeting a gearing level, measured as net debt to regulatory capital value, within the range of 55 per cent to 65 per cent. We aim to maintain, as a minimum, our existing credit ratings of A3 with Moody's and BBB+ with Standard & Poor's for United Utilities Water Limited. This helps us retain efficient access to the debt capital markets throughout the economic cycle, and we have debt locked in at attractive rates versus Ofwat's cost of debt for the 2015-20 period.

Our pension scheme asset-liability matching approach has proven its effectiveness, providing us with stability in a time of turbulent market conditions this year and protecting us from the pension headwinds hurting much of the FTSE. Our pensions position remains strong and we had an IAS 19 surplus of £248 million at the 2016/17 financial year end.

Operational performance

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

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

Chairman and Chief Executive Officer's review

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

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

Systems Thinking

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

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

Performance against our regulatory contract

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

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

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

Retail competition for non-household customers

For a number of years, we have been building capability to ensure we were in a strong position ahead of the full opening of the non-household retail market in April of this year. With our Water Plus joint venture with Severn Trent up and running, this reinforces our position and gives us a first-mover advantage.

Combining the complementary skills of both companies gives Water Plus scope to deliver an attractive proposition for customers, as well as creating synergies to provide an efficient and cost-effective operation focused on improved customer service and growth.

Since going live with the joint venture in June 2016, the business has relocated to Stoke-on-Trent, migrated all customers into a single cloud-based billing system, recruited over 300 people and ensured all systems were fully market ready.

Long-term planning

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

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

An example of a large project we are currently undertaking, to address future supply and demand issues for customers, is our 100 kilometre Thirlmere pipeline project, which will extend our integrated network to encompass West Cumbria. This will provide a secure, long-term supply for the area and ease pressure on environmentally sensitive local water resources. The pipeline will cross some of the most special areas of the Lake District National Park and, as a result, we have developed a solution which respects this sensitivity whilst delivering the lowest whole-life cost. The project demands the highest levels of stakeholder engagement and consultation to secure support, and we have been engaging with local communities on the proposed route since 2013. We were particularly pleased last autumn to receive the third and final planning approval for this project.

Water 2020

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

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

Our employees

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

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

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

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

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

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

Strong corporate responsibility credentials

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

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

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

Our strong corporate responsibility and environmental credentials were recognised this year when we retained World Class rating in the Dow Jones Sustainability Index for the ninth consecutive year, an achievement we are particularly proud of in light of the ever-evolving standards.

In addition, at the Finance for the Future Awards in October 2016, we were honoured to win the Communicating Integrated Thinking award, an international award sponsored by Deloitte, Accounting for Sustainability and the Institute of Chartered Accountants in England and Wales.

Outlook

We are encouraged by our continued strong operational and environmental performance, as well as our improvements in customer satisfaction. We have plans to improve further, supported by our Systems Thinking approach to operating the business, and the acceleration of our capital investment programme. Overall, we are encouraged by our progress, in the early part of this regulatory period, and are confident that we can deliver our targets for both customers and shareholders. We continue to deliver sustainable dividend growth, with an annual growth target of at least RPI inflation through to 2020, supported by a robust financial position.

Finally, we would like to thank our employees, customers and wider stakeholders for their continued support.

Dr John McAdam
Chairman

Steve Mogford
Chief Executive Officer

The strategic report on pages 10 to 49 was approved at a meeting of the board on 24 May 2017 and signed off on its behalf by Steve Mogford, Chief Executive Officer.