

Chairman and Chief Executive Officer's review



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

This is the first year of the new 2015–20 regulatory period and one in which, notwithstanding several challenges, we took another step towards our vision of becoming the UK's best water and wastewater company, providing customers with great service.

Financial performance

We improved performance for shareholders and customers over the last regulatory period providing a strong platform for us to deliver further value across the 2015–20 period, including sustainable dividends.

Group revenue was slightly higher than last year, up £10 million at £1,730 million, as the impact of lower allowed regulated revenue for 2015/16 was more than offset by higher than assumed volumes and an increase in sales in our non-regulated business. Underlying operating profit, at £604 million, was in line with management expectations, albeit £60 million lower than 2014/15, following the new regulated price controls and impacted by the planned acceleration in our investment programme. Underlying profit before tax, at £408 million, was down by £39 million, as we benefitted from a £21 million reduction in underlying net finance expense. Underlying earnings per share was 47.7 pence, more than covering the dividend. The board is proposing a final dividend of 25.64 pence per ordinary share, making a total of 38.45 pence per ordinary share for the 2015/16 financial year. This represents an increase of 2.0 per cent, in line with our policy of targeting an annual growth rate of at least RPI inflation through to 2020.

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 of A3 with Moody's and BBB+ with Standard & Poor's for United Utilities Water Limited.

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 (see case study, page 32) 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 (see case study, page 35). 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 (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.

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.

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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.

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 secured our Scottish retail licence in 2012 and have since been a leading competitor in the Scottish non-household (business) retail market. We now have approximately 300 customers, covering around 3,500 sites. Overall, our business retail operation has achieved a net increase in annualised revenue of £18 million. During this period, we have seen a significant increase in the number of active market participants in Scotland and the Water Act 2014 has confirmed plans to open the English business retail market for water and wastewater services in 2017.

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, we saw the benefit of combining our 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 we announced that we had entered into a joint venture (JV) to combine the two companies' 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 companies, 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, United Utilities 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, 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.

Our environmental and sustainability performance has received external recognition. We retained our ‘World Class’ rating as measured by the Dow Jones Sustainability Index and again achieved industry leading status in the multi-utility/water sector. In addition, at the PwC 2015 Building Public Trust Awards, United Utilities was selected as joint winner for ‘Excellence in reporting in the FTSE 100’.

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.

We would like to say thank you and farewell to Catherine Bell who will be standing down at the company’s general meeting in July, after nine years on the board. Catherine is chair of the corporate responsibility committee and a member of the 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. For shareholders, we are targeting dividend growth of at least RPI inflation each year through to 2020, all underpinned by a robust capital structure.



Dr John McAdam
Chairman



Steve Mogford
Chief Executive Officer

The strategic report on pages 4 to 49 was approved at a meeting of the board on 25 May 2016 and signed off on its behalf by Steve Mogford, Chief Executive Officer.