Independent auditor's report to the members of United Utilities Group PLC 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 Group PLC for the year ended 31 March 2016 set out on pages 116 to 161. 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):

Revenue recognition £1,730.0 million (2015: £1,720.2 million) and provision for customer debts £94.4 million (2015: £100.5 million)

Refer to page 77 audit committee report, pages 122 to 123 accounting policies and note 14 financial disclosures.

The risk

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; and
- identifying properties where there is little prospect cash will be received for revenue that has been billed due to either the occupier not being able to be identified or a past history of non-payment of bills relating to that property; and
- assessing the recoverability of trade debtors as a proportion of customers do not or are unable to pay their bills.

Our response

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;
- 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 £665.8 million (2015: £728.5 million)

Refer to page 77 audit committee report, page 122 accounting policies and note 9 financial disclosures.

The risk

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 staff, which is also inherently judgemental and could lead to over capitalisation of expenses.

Our response

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 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 budget;

– 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; and

– assessing the adequacy of the group's disclosures of its capitalisation policy and other related disclosures.

Retirement benefit surplus £275.2 million (2015: £79.2 million)

Refer to page 77 audit committee report, page 123 accounting policies and notes 18 and A5 financial disclosures.

The risk

Significant estimates are made in valuing the group's retirement benefit surplus. Small changes in assumptions and estimates used to value the group's pension obligation (before deducting scheme assets) would have a significant effect on the group's financial position.

Our response

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.

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Derivative financial instrument valuations £503.9 million (2015: £477.4 million)

Refer to page 77 audit committee report, page 123 accounting policies and note A4 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 risk 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; – comparing valuations derived from our internal valuation model for a sample of instruments to the fair values determined by the group; – considering the adequacy of the group's disclosures about the valuation basis and inputs used in the fair value measurement; and – 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 £20.0 million (2015: £25.0 million), determined with reference to a benchmark of group profit before tax, normalised to exclude net fair value losses on debt and derivative instruments (see note 5) and the adjusting item relating to a one-off water quality incident (see note 3). Materiality represents 4.9 per cent (2015: 5.6 per cent) of normalised group profit before tax, reflecting industry consensus levels. Specific audit procedures have been performed over 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 warrant reporting on qualitative grounds.

Of the group's six (2015: five) reporting components, we subjected five (2015: four) to audit, of which the most significant is United Utilities Water Limited which makes up the vast majority of the assets, liabilities, income and expense of the group. These components covered 99 per cent of group revenue (2015: 99 per cent), 100 per cent of group profit before tax (2015: 100 per cent) and 100 per cent of group total assets (2015: 99 per cent). The audit work on these components was performed by the group team. For the remaining component, we performed an analysis at group level to re-examine our assessment that there were no significant risks of material misstatements within this.

The component materialities ranged from £1.2 million for the smallest component to £19.0 million for United Utilities Water Limited, determined having regard to the mix of size and risk profile of the group across the components.

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 50 to 102 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 71 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 122 in the accounting policies' note to the financial statements concerning the use of the going concern basis of accounting.

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 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.

Under the Listing Rules we are required to review:

– the directors' statement, set out on page 71, in relation to going concern; and

– the part of the corporate governance statement on pages 50 to 102 relating to the company's compliance with the 11 provisions of the 2014 UK Corporate Governance Code specified for our review.

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

Scope of responsibilities

As explained more fully in the directors' responsibilities statement set out on page 109, 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.

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25 May 2016