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Environmental Compliance and Regulatory Investigations Summary

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In the interests of ensuring that TWUL is investible and financeable, TWUL is engaging with Ofwat, the Environment Agency and the Drinking Water Inspectorate in respect of significant uncertainties relating to TWUL's exposure to unfunded costs and/or fines across a range of investigations and environmental programmes, and related delivery constraints.

This presentation provides an update on TWUL's environmental compliance and regulatory investigations and uncertainties around these as at 25 October 2024.

Ofwat and Environment Agency Investigations into Storm Overflows

- On 18th November 2021 Ofwat and the Environment Agency announced their respective investigations into non-compliance by all water and wastewater companies in England and Wales at wastewater treatment works.

Environment Agency Investigation

- The investigation by the Environment Agency (“Operation Standard”) continues. Currently, there is no indication of any date for this investigation to reach a conclusion. The potential penalty for an environmental offence is a criminal conviction and an unlimited fine (in accordance with the Environment Offences Sentencing Guidelines).

Ofwat Investigation

- On 6 August 2024 Ofwat published details of its proposed findings of breach, proposed financial penalty (£104.5 million) and draft enforcement order from its investigation into wastewater compliance for three companies, including TWUL. These proposed findings were subject to public consultation until 10 September 2024, and we submitted our response to the consultation on this date. Enforcement cases remain open in relation to seven additional companies, with Ofwat continuing to monitor compliance with existing undertakings for a further company.
- Ofwat’s proposed findings, both on the substance of the contraventions as well as the implications in terms of the regulation, appeared to have a number of potential consequences from a funding perspective. Notably, initially Ofwat’s proposed interpretation of the Urban Wastewater Treatment Regulations 1994 (“UWWTR”) appeared to establish a new compliance standard beyond existing permit requirements (which we would require funding to meet). There were also other areas where Ofwat’s proposed expectations, as articulated both in its decision and draft enforcement order, appeared to go beyond existing requirements. Following extensive recent engagement between the parties (including on an industry wide basis), Ofwat has clarified a number of significant aspects of its position in relation to future compliance standards and funding requirements.

Ofwat and Environment Agency Investigations into Storm Overflows

Ofwat Investigation (continued)

- Following recent discussions with Ofwat in relation to its proposed findings, TWUL estimates that the costs of complying with the requirements of Ofwat's proposed findings to be £1.7 billion in AMP8.
- £1.044 billion of the £1.7 billion was requested in TWUL's response to Ofwat's Draft PR24 Determination as enhancement funding for TWUL's Waste Asset Assurance Programme, as TWUL does not believe that the necessary capital investment has been funded in previous price reviews. However, in recent discussions with Ofwat, it was suggested that Ofwat may take the view that such costs were historically funded through botex. The extent to which Ofwat will allow TWUL's enhancement funding in its Final Determination is therefore unclear.
- The remaining £650 million of the £1.7 billion funding represents the cost of complying with the requirements set out in Ofwat's proposed findings related to Dry Day Spills. This funding requirement was not requested in TWUL's response to Ofwat's Draft PR24 Determination, because of the lack of certainty in relation to what the permit requirements in respect of Dry Day Spills will be following the outcome of the Environment Agency's ongoing consultation. TWUL has now performed a high-level assessment of the potential cost of complying with Dry Day Spill requirements and is seeking clarity from Ofwat on how it can access the necessary funding through its PR24 price review or in respect of future AMPs. Until such time as Ofwat's PR24 price review provides a mechanism for assessing such costs, TWUL is exposed to up to £650 million of unfunded costs in respects of meeting Dry Day Spill requirements.
- Should TWUL be required to undertake further capital investment programmes to comply with Ofwat's finding that go beyond compliance with existing EA permit requirements, such investment would need to be delivered over a multi-AMP period to allow sufficient time to grow the relevant supply chain and address the need to keep wastewater treatment plants in operation during the carrying out of any capital works. TWUL would seek funding for this work in future price reviews.
- This is the latest stage in an ongoing investigation process, and we will continue to cooperate fully. Ofwat is now considering our consultation response and may consider it appropriate to clarify its proposed findings or decide to impose a reduced financial penalty. Alternatively, Ofwat could decide not to issue an enforcement order and to impose a substantially reduced financial penalty (or no penalty) in response to formal commitments ("undertakings") from the company to take appropriate measures to secure compliance and provide redress for failures identified by Ofwat.
- We will continue to engage with Ofwat on its interpretation of the UWWTR and, to the extent that it becomes clear that Ofwat is seeking to require companies to work to different operating standards than they previously have, on how Ofwat views the compliance standards that companies will be required to achieve in future, and how this would be funded.

Environmental Compliance between 2025 and 2030

- Substantially all of TWUL's proposed capital investment in AMP8 is required to meet the requirements of environmental legislation and programmes. Any failure to comply with these requirements may result in investigation by our regulators (Ofwat, the Environment Agency and/or the Drinking Water Inspectorate), fines being levied against us, ODI penalties, PCD penalties and/or, in certain circumstances, criminal prosecution.
- Our exposure to these risks is in part a function of:
 - the extent to which Ofwat's Final Determination allows funding for relevant capital expenditure
 - the extent to which Ofwat's Final Determination and other regulators' decisions expose TWUL to penalties, fines, and remediation
 - TWUL being confident that it has the capacity to physically deliver the relevant capital programmes.
- Over the course of AMP7, TWUL received prosecutions from the Environment Agency relating to five of its sites. The fines associated with each prosecution ranged from £2m to £4m. Earlier this year, the Environment Agency announced that it has expanded the size of its regulatory team such that water company inspections will be increased tenfold. It is anticipated that enforcement will increase proportionately.
- Each of our regulators have made it clear to us that under the law as it currently stands, neither lack of funding nor physical deliverability constraints, such as lack of supply chain capacity, will preclude investigations and/or enforcement action (including criminal prosecution) being taken against us, if we fail to deliver the requirements of environmental legislation or the Water Industry National Environmental Programme.
- We are continuing to suggest to our regulators and Defra that a pragmatic solution to the concerns outlined above relating to market capacity could be to agree a long-term delivery programme that will allow companies to invest into their assets in a manner that, over time, improves water quality in our waterways to the new standards that public policy now demands. Such a programme in this area could also act as a catalyst to much needed growth in the supply chain for specialist services required in the wastewater sector. This is an approach that other regulated infrastructure sectors have taken when faced with similar challenges.

Environmental Compliance between 2025 and 2030

Water Industry National Environmental Programme - WINEP

- The WINEP is designed to enable companies to meet new legal obligations and regulatory expectations in relation to the environment. Actions required under the WINEP are designed to ensure compliance with requirements of UK environmental legislation. Companies and their stakeholders have limited influence over the associated investment.
- Failing to deliver elements of the WINEP that are required by statute may result in companies being in breach of legal and regulatory expectations, leading to investigation, penalties and, potentially, criminal prosecution.
- The costs associated with water and wastewater companies delivering their WINEP programmes are intended to be funded by their customers. Our latest customer research confirms that customers support the achievement of positive environmental outcomes and that the issue of storm overflows is a high priority for our customers.

Environmental Compliance between 2025 and 2030

WINEP7

- TWUL is scheduled to complete approximately 85% of the actions that the WINEP for the period 2019 to 2024 (“WINEP7”) requires it to complete.
- It is anticipated that the balance of these actions will not be completed by the end of AMP7 due to a combination of lack of funding and delivery capacity.
- TWUL has put in place plans to accelerate the delivery of these outstanding actions and intends to complete them as soon as is practicably possible across the 146 relevant sites.
- Our funding allowance for PR19 was significantly lower than the actual cost to deliver the actions required by WINEP7.
 - TWUL estimates that the cost of completing the WINEP7 outputs that it will complete in AMP8 to be £1.7 billion.
 - In its response to Ofwat’s Draft Determination, TWUL requested funding of £1.2 billion towards completion of its WINEP7 programme.

Environmental Compliance between 2025 and 2030

WINEP8

- The WINEP for the period 2025-2030 (“WINEP8”) was issued to water and wastewater companies by the Environment Agency in July 2023, and was the subject of clarificatory discussions until early 2024. The investment requirement for delivery of our WINEP8 programme is approximately five times greater than the investment requirement for our WINEP7 programme.
- TWUL is currently facing two significant challenges in relation to the physical delivery of WINEP programmes:
 - Despite doubling the size of its capital delivery function since the end of AMP6, the scale of investment required by the WINEP (especially when taken together with actions required by other statutory programmes that we are required to deliver) goes significantly beyond the boundaries of TWUL’s delivery capacity. This is largely due to supply chain constraints; and
 - Since submitting our PR24 business plan to Ofwat in October 2023, we have met with Ofwat, the Environment Agency and Defra on several occasions to discuss our concerns related to lack of supply chain capacity. Our regulators and Defra all acknowledge that there is a supply chain capacity issue (as reflected in Ofwat’s draft determination), although each of them have made it clear to TWUL that under the law as it currently stands, neither lack of supply chain capacity nor lack of funding will preclude investigations and/or enforcement action (including criminal prosecution) being taken in the event of failure to comply with the requirements of environmental legislation.
- Depending on the outcome of Ofwat’s investigation into storm overflows and its final interpretation of the operating standards that the requirements of the UWWTR demand of companies, the above challenges could be compounded by Ofwat’s final decision.

Environmental Compliance between 2025 and 2030

Industrial Emissions Directive and Security and Emergency Measures Direction

- TWUL estimates that it will be required to invest in excess of £1.2 billion in AMP8 in order to comply with the requirements of the Industrial Emissions Directive and the Security and Emergency Measures Direction.
 - Ofwat's Draft Determination allowed TWUL £0.7 billion for these investment requirements and, in its DD response, TWUL requested a further £0.5 billion.
 - The extent to which this additional investment requirement will be allowed by Ofwat in its Final Determination is currently unclear.
- TWUL's ability to physically deliver the necessary AMP8 investment across its 25 sludge treatment centres in order to comply with the requirements of the Industrial Emissions Directive is constrained by the delivery capacity challenges that our WINEP programmes are exposed to, as well as the logistical issues associated with the operational impact of temporarily decommissioning sites in order to undertake the necessary capital works.

Ofwat Dividend Investigation

- In October 2023, TWUL paid interim dividends of £37.5 million to its immediate parent Thames Water Utilities Holdings Limited and informed Ofwat accordingly at that time. As requested by Ofwat, TWUL subsequently provided further information on this matter and the basis on which this decision was made by its board (the “Board”).
- On 10 May 2024, a draft ‘minded to’ letter was received stating that Ofwat has preliminarily found evidence of a potential breach of condition P(30) by TWUL of its licence. In particular, the draft ‘minded to’ letter alleges that: (i) TWUL has not satisfied Ofwat that it has a dividend policy which has been approved by the Board and which complies with the principles contained in Condition P30; and (ii) the Board gave insufficient weight to how the dividend payment could be justified given the company’s performance, including and beyond headline Performance Commitments performance, as it is required to do so under condition P(30).
- In order to remedy the alleged breach, the letter contains a draft proposal to impose: (i) an enforcement order directing TWUL’s compliance with condition P(30) of the Licence (pursuant to section 18 Water Industry Act 1991); and (ii) a penalty of £44 million.
- TWUL firmly rejects these allegations, and has responded to the draft ‘minded to’ letter in full setting out its arguments and evidence for the absence of any such breach. Ofwat is currently considering TWUL’s submissions and it is therefore too early to know the outcome of Ofwat’s investigation and the extent and content of any enforcement action including financial penalties which may result from it. If Ofwat decides that it is minded to continue with the enforcement case and publishes a draft notice of enforcement, TWUL (and third parties) will be able to make representations and/or objections in relation to the allegations and the proposed enforcement approach at that time and under the statutory consultation process.
- Separately, on 24 June 2024, TWUL received a request for information from Ofwat in relation to the March 2024 interim dividend and in particular the Company’s decision to approve a dividend for the purpose of surrendering of FY23 tax losses from TWUL. The Company responded to Ofwat’s request on 5 July 2024. Ofwat is currently considering TWUL’s response and it is therefore too early to know the outcome of Ofwat’s enquiries and the extent and content of any enforcement action including financial penalties which may result from it.