Thames Water

Our finances explained

November 2019

Responsible and sustainable finances

“In the last 15 years we’ve invested £15 billion in our assets”

2018/19 was another important year in our evolution as we build a better future for our customers and communities. During the year we developed our business plan for 2020 to 2025; launched a new ‘One Thames’ operating model to drive efficiency across the business; and completed a major overhaul of our governance.

Our refreshed approach to the management of Thames Water is based on the spirit of promoting openness and transparency. We’ve reached some important milestones related to our finances during the year, which underline that ethos.

- We were promoted to “targeted” status by our economic regulator, Ofwat, under their Company Monitoring Framework assessment. This is a measure of the quality and transparency of the information a water company provides
- We’ve simplified our corporate structure with the removal and liquidation of our Cayman Islands subsidiaries, transferring all liabilities and assets to a UK company
- Our “low risk” tax classification was reconfirmed by HMRC in 2019
- We’re reducing our gearing level helped by a £250 million cash injection in April 2019
- We’ve combined the Annual Report and financial statements of Thames Water Utilities Limited and its sole subsidiary Thames Water Utilities Finance plc as if they are a single economic entity.

Near-term priorities

As we move through the next year, we're focused on delivering key priorities which will set us up for the successful delivery of our business plan for 2020 to 2025. Alongside a reduction in complaints, a reduction in leakage and a successful transition of all customers to our new customer relationship management and billing system, we're committed to driving cost efficiency. We need to ensure every penny we spend creates value for our customers and society, in a way that protects and enhances the natural environment. We're currently going through a rigorous cost transformation process to make sure our business aligns with that principle.

Investing in the future

During 2018/19, we again invested over £1 billion in our assets, triple the average annual amount compared to the five years pre-privatisation. In the last 15 years we've invested over £15 billion to improve our services, and we're committed to maintaining high levels of investment to increase the resilience of our services in the face of heightening challenges such as population growth and climate change. The latter was brought into sharper focus in 2018 when two extreme weather events – March's freeze-thaw, quickly followed by the joint hottest summer on record – tested our operational performance.

As well as spending £1 million a day on leakage reduction activities and maintaining our water network during 2018/19, one of our other key investment areas during the last few years has been our major new customer relationship management and billing system. It will transform our approach to customer service and we're on track to transition the majority of our customers by March 2020. We've also been investing in smart meters, acoustic loggers and sewer depth monitors to give us greater visibility of our network and allow us to become 'smarter' in our approach to network repair and maintenance.

Responsible financing

As well as relying on us to spend their money wisely, our customers expect us to manage our finances in a sustainable and responsible way. During the year we restructured our main £1.65 billion bank facilities, our Revolving Credit Facility, so the margin is tied to environmental performance, with any savings being payable to charitable causes. To increase accessibility of our sustainability information, we also produced our first ever Environment, Social and Governance Statement in October 2018.

Given the nature of our business, we know our finances, including our corporation tax position, can appear complex. As such, we publish this annual booklet to explain our finances in a simple way, based on our financial performance during the previous financial year. This, our sixth *Our finances explained* includes figures published in our combined Annual Report and Annual Performance Report for 2018/19.

If you have any comments or feedback on this document please get in touch at ourfinances@thameswater.co.uk.

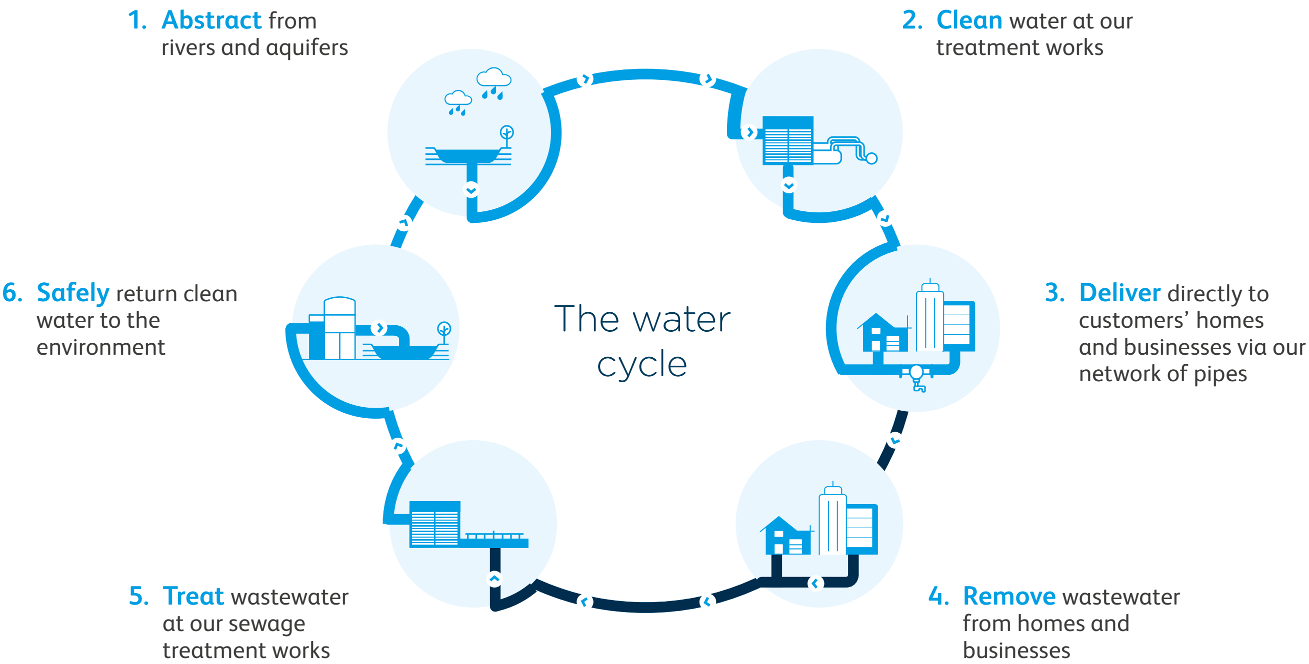
Brandon Rennet
Chief Financial Officer

The value we create

We provide clean and safe drinking water, and environmentally responsible wastewater treatment, to our customers every day. Our service is one of the building blocks of a healthy and prosperous society, both now and in the future. What we do is essential, and the way we do it is of critical importance.

How we generate revenue

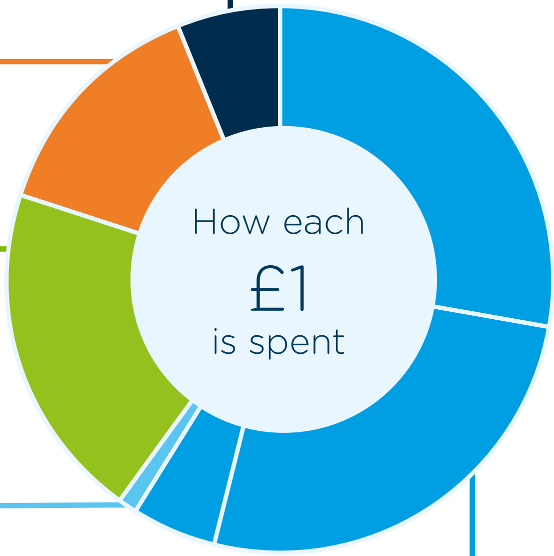
We collect revenue from our customers for the provision of our essential services. Our current average annual combined household bill is £398 (2019/20) per year, the third lowest in England and Wales.



The value we share

6p Government

We paid over £211 million in business rates, PAYE and national insurance contributions in 2018/19



16p Our people

To deliver essential services for our customers and protect the environment

17p Lenders

By borrowing money at efficient rates, we're able to continue investing heavily in our infrastructure while keeping customer bills as low as we can

1p net profit which is reinvested

External shareholders
Our external shareholders will not receive a dividend until the start of the next regulatory period, so the money can be reinvested in the business to build a better future

61p Customers (and suppliers)

27p – Operational expenditure
To provide our essential services and improve our service to customers

28p – Investment in our infrastructure
To ensure a resilient network today, and for future generations

5p – Energy to power our operations
To keep our energy costs down, we self-generate some of our electricity

What we spent our money on in 2018/19

1

Net investment in our network

£1,186 million*

This is the money we use to renew and improve our network and infrastructure. We've invested over £15 billion during the last 15 years and we're currently investing triple the amount per year compared to the five years pre-privatisation.

2

Day-to-day operational expenses

£951 million*

This is the money we use to operate and maintain our network; pay our employees; cover our energy costs; and pay for the technology that we need. With a vast network of 140,000km water and sewer pipes and 451 treatment works, this money is used to help us ensure our business runs efficiently, so we can provide the best for our customers.

3

Net financing costs and dividends

£325 million*

We borrow money from banks and other lenders, such as pension funds and insurance companies, to help fund investment in our network. We keep customer bills low by borrowing debt on as favourable terms as possible and by spreading the repayment costs over a longer period. We also pay a dividend to our holding companies, in order for them to fund their debt obligations and working capital requirements. We did not pay any dividends to external shareholders in 2017/18 or 2018/19 and will not pay any during the rest of the current regulatory period, while we focus on improving performance for our customers.

External shareholders is the term used to describe the ultimate owners of the company. Most of our external shareholders are pension funds. They own the shares in our ultimate parent company, Kemble Water Holdings Limited. See structure chart on page 28.

* Numbers based on cash flow

Some key expenses

Pensions

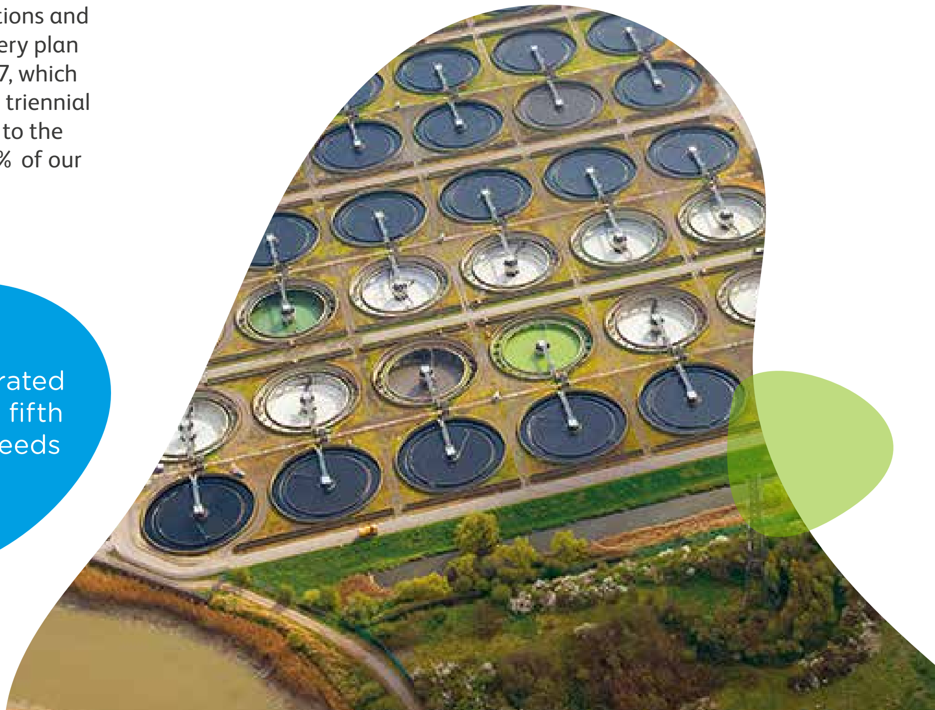
We currently run three pension schemes to support our employees during retirement – two defined benefit schemes and one defined contribution scheme. The assets of our defined benefit schemes, which support our ability to pay pensions, are held separately from those of any Thames Water Group company. Both the value of these assets and our pension obligations – the amount we need to pay retired employees – are affected by interest rate fluctuations and other external market factors. Like many large companies, changes in market factors have led to our obligations being larger than the value of our assets, so we currently have a net pension deficit on one of our defined benefit schemes. Our net deficit at 31 March 2019 was £293.0 million. Every three years, our defined benefit schemes are valued by an independent actuary and these valuations are updated biannually, for accounting purposes.

For 2018/19, we paid £53.4 million into our defined benefit pension schemes, which included both regular contributions and payments to reduce the deficit. This is part of our recovery plan to sustainably reduce our pension deficit to zero by 2027, which was agreed with the scheme trustees as part of the last triennial valuation in June 2017. We also contributed £11 million to the defined contribution scheme, which currently serves 55% of our employees.

Power

It costs more than £124 million a year to power our business making it one of our largest operational costs. In 2018/19 we self-generated one fifth of our electricity needs, including 293GWh from sewage. That would be enough to power 95,000 homes, and is equivalent to £32.6 million a year in electricity costs. Alongside this, we're also doing what we can to drive energy efficiency across the business. We're also using more solar power, including from the floating solar panel array on our QE2 reservoir.

We self-generated more than one fifth of our energy needs in 2018/19



Building a better future

We've been spending money in some critical areas to improve our services to customers

Investing over £250 million on a major upgrade of Deephams sewage treatment works to accommodate population growth and reduce odour.

£1.4 billion buying land and connecting our network to the landmark Thames Tideway Tunnel.

Nearly £100 million extra to improve our largest water pipes.

Over £100 million in a new customer relationship management and billing system, to improve service.

£1 million a day on leakage prevention and network maintenance activities.

£60 million in IT infrastructure.

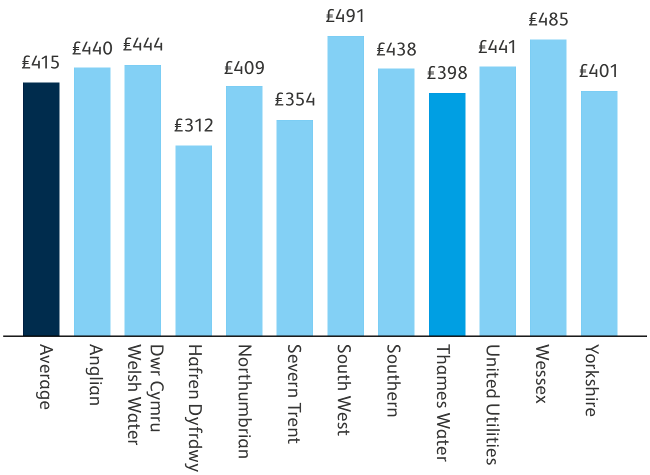
Our bills

Offering value for money

We provide water and wastewater services for an average of just over £1 per day per household. Our average combined household bills are the third lowest in England and Wales, at £398 per year (2019/20). We keep our bills low through a combination of factors including:

- **Efficient operations and investment**
  Operating our network efficiently drives down unnecessary costs.
- **Low-cost financing**
  We borrow money in competitive markets to minimise our cost of debt.
- **Investment allowances**
  Together with other factors, the Government's capital allowances scheme enables us to keep our corporation tax bills lower than they would otherwise be (further detail on page 22).

Comparison of annual combined water and wastewater household bills (2019/20)



Helping our customers

We have a socially and geographically diverse customer base and we need to ensure we cater to their individual needs as well as those collectively as a group. We recognise our region has some of the most deprived areas in the country and we're committed to helping those who need extra support.

We offer a range of options to help our customers in financially vulnerable circumstances, which includes providing 50% discounts. In 2018/19 we helped over 82,000 households via our two discounted (social) tariffs – Watersure and Watersure plus – up over 20% on the previous year. As part of our plan for 2020-2025 we plan to increase this number to 200,000.

We run a customer assistance fund to support customers with their water debt, with the fund helping over 6,700 customers with a total of £4.5 million in 2018/19. We also offer a range of payment plan options, free meter fits and water efficiency devices to help our customers.

We understand customers in water debt may also have wider financial issues, so we also help customers with basic living costs outside our services, through a dedicated trust fund. The fund was set up in 2009 and is an independent charity. We contributed £645,000 to the fund in 2018/19.

> "Our average combined household bills are the third lowest in England and Wales, at £398 per year (2019/20)."

Setting our bills

Making our bills affordable, while setting them at a level that enables us to meet our commitments, is something we need to get right. We consult with our customers at length about what they value most from Thames Water and what they are willing to pay for. We are also challenged independently by representative bodies such as our Customer Challenge Group ("CCG"). We continually evaluate what we need to do to maintain and improve our services to customers and undertake research to understand the future impact of things like climate change and population growth on our network.

Price reviews

In a monopoly sector like the water industry it's our economic regulator, Ofwat, which provides an alternative to competition and sets limits on the prices we can charge. Every five years we develop our plans and bills for the next five year regulatory period, based on our extensive planning and customer research, and seek to agree this with Ofwat. This is a very rigorous process, known as a price review. We submitted our proposed plan for 2020-2025 to Ofwat on 3 September 2018 and a revised plan in April 2019. In July 2019, Ofwat issued the draft determination. Our response to the draft determination was published in August 2019. You can find our full business plan and response to the draft determination at thameswater.co.uk.

Thames Tideway Tunnel

The Thames Tideway Tunnel will be a 15 mile long sewer which will divert millions of tonnes of sewage away from the River Thames.

To minimise the costs and remove risk for our customers, we ran a comprehensive and competitive process to identify the best company to build the tunnel. In August 2015, an independent company, Bazalgette Tunnel Limited (BTL), secured a licence from Ofwat as a separate regulated utility business to deliver the landmark construction project.

As a result of this robust process, the impact on customers' wastewater bills will be significantly lower than was originally anticipated – initial estimations of an average increase of up to £80 a year were reduced to a maximum of £25. Just under £19 is included in the 2019/20 bill with £9.33 passed to BTL for the construction, and £9.20 being used by us for our connecting works. As part of the cash isn't retained by us, we present amounts relating to BTL separately in our financial statements.

We're investing £1.4 billion buying land and connecting our network to the Thames Tideway Tunnel.

Rewards and penalties

We work closely with our customers to set performance commitments for each regulatory period, designed to deliver what is most important to our customers in the most cost effective way. For some of these commitments we are able to earn financial rewards if we perform above expectations, but we can also incur penalties for underperformance.

For 2018/19 we incurred penalties of £55.1 million and earned rewards of £3.5 million. £35.1 million of the total penalty was for leakage.

Customer Service Incentive Mechanism

The penalty associated with customer service performance is likely to be significant due to our position when compared to others in the industry, however, the final assessment will not be completed until the end of this current five year regulatory period.

Drinking water compliance

Target: 100.00%

Performance in 18/19: 99.96%

P

Condition of our below ground water network (includes supply interruptions of more than 12 hours)

Target: Stable

Performance in 18/19: Marginal

Penalty: £4.7 million

P

Condition of our above ground water network

Target: Stable

Performance in 18/19: Stable

On target

P

Security of supply index

Target: 100

Performance in 18/19: 98

Penalty: £4.5 million

P

Condition of our below ground wastewater network

Target: Stable

Performance in 18/19: Stable

On target

P

Condition of our above ground wastewater network

Target: Stable

Performance in 18/19: Stable

On target

P

Sewer flooding other causes

Target: 1,085

Performance in 18/19: 1,032

Reward: £2.9 million

PR

Leakage

Target: 612 Ml/d

Performance in 18/19: 690 Ml/d

Penalty: £35.1 million

PR

Supply interruptions lasting more than four hours

Target: 0.13

Performance in 18/19: 0.26

Penalty: £10.7 million

PR

Reduction in the number of properties affected by odour

Target: 6,593

Performance in 18/19: 8,931

Reward: £0.5 million

PR

Sewage treatment works discharge compliance

Target: 100%

Performance in 18/19: 98.85%

Penalty: £0.1 million

P

Pollution incidents

Target: 340

Performance in 18/19: 295

On target

PR

Deephams sewage treatment works upgrade and Thames Tideway Tunnel connecting works

Performance in 18/19: Deephams sewage treatment works upgrade: Delivered in 2016/17

Thames Tideway Tunnel connecting works: On target

P

Site security compliance (and with notes) - two performance commitments

End of AMP target

P

Sustainable urban drainage

End of AMP target

PR

Implement new online account management

Target: Online self-serve channel

Performance in 18/19: Online self-serve channel

P

Properties flooding from rainfall including Counters Creek

End of AMP target

PR

Water efficiency

End of AMP target

P

Customer Service - service incentive mechanism score

Calculated over the AMP

Performance in 18/19: 75.0

PR

Compliance with environmental regulations - two performance commitments

End of AMP target

P

Resilience of sites to future extreme weather events - water and wastewater

End of AMP target

P PR

Reduce the amount of phosphorus

End of AMP target

PR

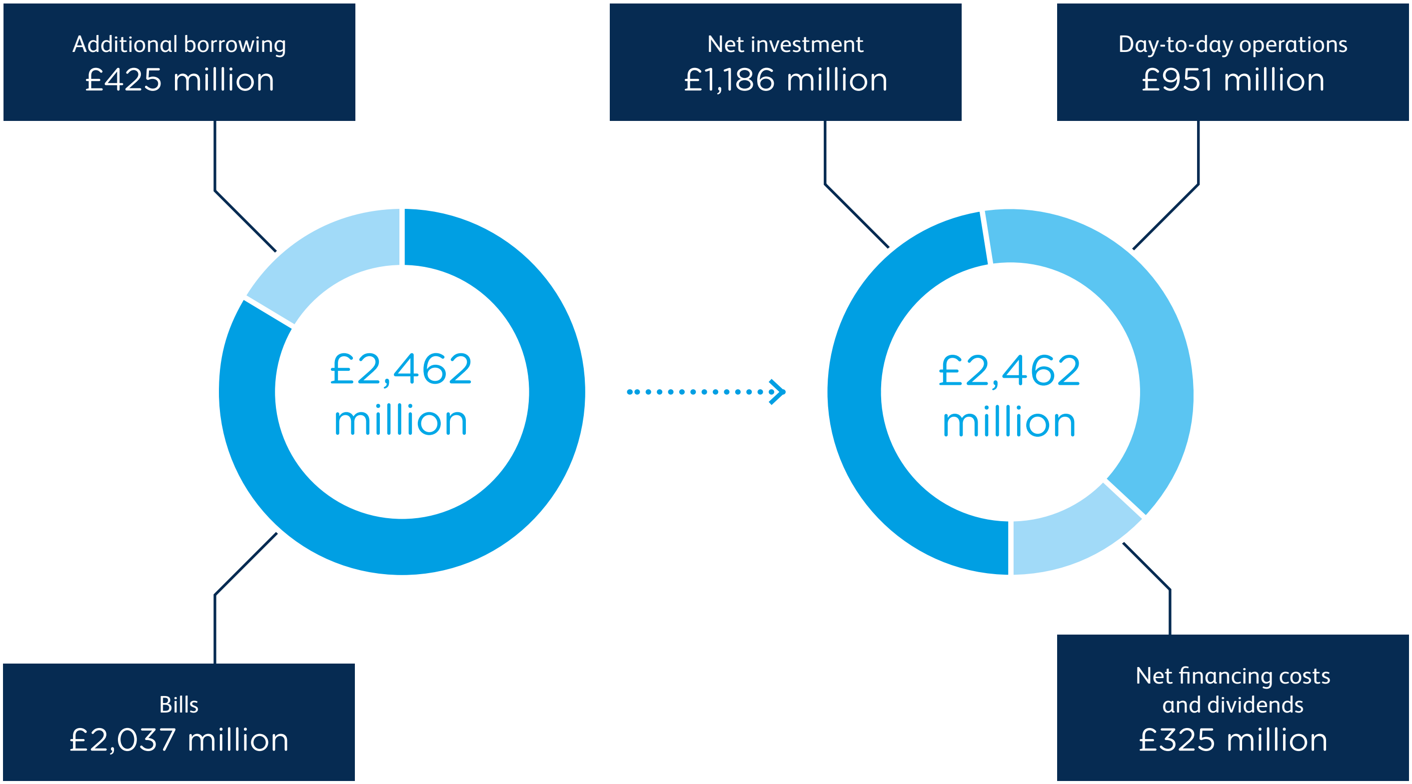
P Can incur penalty

PR Can incur penalty or earn reward

Bridging the gap

For every £1 we collect from bills, we need an additional 17 pence (2018/19) to help fund our spending (page 6).

To bridge this gap and avoid significant fluctuations to bills, we borrow money at attractive rates. By spreading the cost of our investment and managing our debt over a number of years we also ensure the generations that will benefit from the improvements are those who will be helping to pay for it – this makes our bills fairer and more sustainable.



* Numbers based on cash flow

Our borrowings

We borrow money through a combination of loans from banks and institutions as well as corporate bonds. Our corporate bonds are typical debt 'instruments' that feature in many UK companies. They are sold to third party investors such as pension fund managers and insurance companies and, like any other loan, we pay interest on these bonds. Most of our bonds are publicly listed on major stock exchanges such as the London Stock Exchange and Irish Stock Exchange. Whilst the majority of our funding requirement is in Sterling, we monitor investor demand in other currencies to optimise our average cost of funding.

Our credit rating

The responsible way in which we operate our finances ensures we maintain investment grade credit ratings, as assigned by external ratings agencies Moody's and Standard & Poor's ("S&P"). The ongoing assessment of Thames Water by these two agencies provides an independent view of our performance and future outlook. The majority of our debt is rated A3 by Moody's and BBB+ by S&P, both with negative outlook, allowing us to continue to raise funding at competitive rates which, in turn, allows us to keep costs down for customers.

Interest on our debt

The water industry has traditionally been considered low risk, making it particularly attractive investment for pension funds and other similar financial institutions who seek long-term, steady returns. We maintain conservative long-dated debt maturities (currently with an average tenor of approximately 15 years) to minimise refinancing risks. The average interest rate we incurred during 2018/19 was 4.9% and we paid net interest of £264 million on our debt.

Managing financial risk

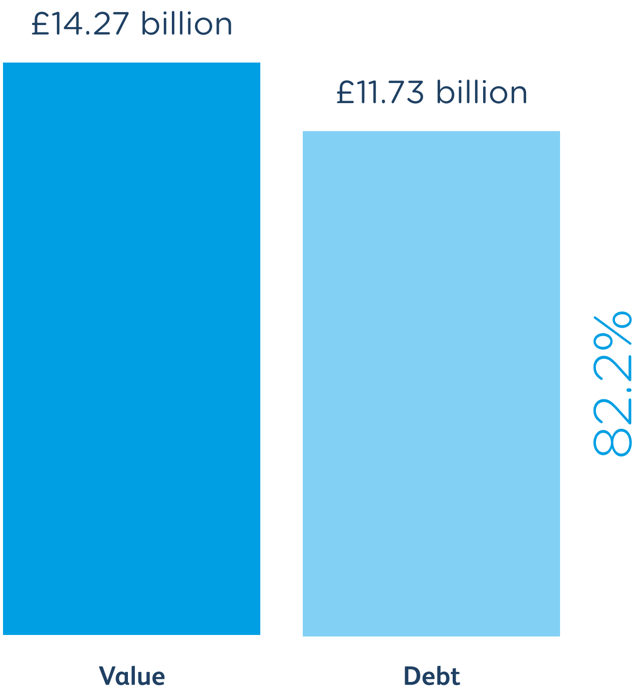
As with any company, our normal business activities expose us to a variety of financial risks, including changes to inflation and interest rates. By borrowing money from different sources, on different interest payment bases and for varying lengths of time, we are able to proactively manage and spread these risks, reducing them to an acceptable level. As a regulated water company, our bills are linked to movements in inflation, which increases or decreases the amount of money we have available to pay for the interest on our debt. For that reason we have also linked around half of our debt to inflation. Most of the remaining debt is borrowed at fixed rates of interest, sometimes for many years, which helps provide certainty and maintains stable borrowing charges relative to changes in revenue.

Our gearing

We are financed by a combination of debt from our lenders and shareholder equity retained in the company. After deducting cash and other cash-like assets, the amount we have borrowed from lenders is referred to as our net debt. Our financial gearing is calculated as the ratio between our net debt and our regulatory capital value ("RCV"), which represents the value of a company's assets as agreed with Ofwat. This relationship – also known as the 'gearing ratio' – shows the extent to which our operations are funded by our debt investors, rather than by shareholders. At 31 March 2019 our net debt (covenant basis) was £11.73 billion and our RCV was £14.27 billion, meaning our gearing ratio was 82.2%. In April 2019, a £250 million cash injection was used to pay down net debt, reducing gearing by about 1.8%.

You could consider this similar to funding the purchase of a house with a mortgage, where the loan-to-value ratio is the value of debt (mortgage) relative to the value of the house.

Our lenders require the Group to operate within certain financial metrics, including a maximum gearing level. The covenant net debt figure used in these calculations was £11.73 billion, which is slightly higher than the £11.62 billion statutory net debt shown in our 2018/19 accounts.



At the beginning of 2019/20 we injected **£250 million*** to reduce gearing.

Gearing ratio calculation:

$$82.2\%\ \text{Gearing} = \frac{\text{£11.73 billion net debt}}{\text{£14.27 billion value (debt and equity)}}$$

* Of this £250 million, £220 million reduced an intercompany loan with the remainder settling outstanding interest.

Our taxes explained

Tax transparency is a cornerstone in building trust with our customers and other stakeholders.

In 2018/19 we paid over £211 million in business rates, PAYE, national insurance contributions and other taxes, which helped fund the vital public services we all rely on. We incurred £147 million directly, mainly through business rates, and collected and paid £64 million on behalf of our employees.

We manage our taxes appropriately and efficiently within both the letter and the spirit of tax legislation, for the benefit of our customers, shareholders and the communities they live in. Our tax strategy can be found as a standalone document on our website.

The Corporate Criminal Offence of the Failure to Prevent the Facilitation of Tax Evasion

These rules require companies to have procedures in place to prevent the facilitation of tax evasion. We take this responsibility very seriously and this is reflected in our policies which include:

- Ensuring that we have prevention procedures in place, including obtaining assurances from suppliers, training our employees, providing a whistle-blowing hotline, and reviewing our processes regularly.
- Applying a zero tolerance attitude towards the facilitation of tax evasion and reporting any instances to the authorities.
- Not using suppliers who are unable to provide assurance that they have prevention procedures.

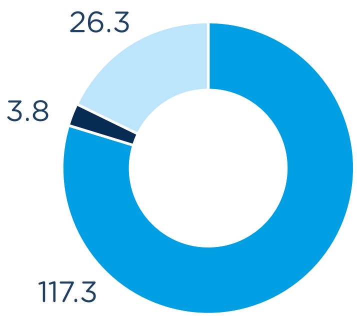
Our tax strategy

Our tax strategy is straightforward and is underpinned by five key policies to ensure we're a responsible business. It applies to all our Group entities. Our policies are:

1. We comply with all tax legislation requirements at all times, both within the letter and spirit of the law.
2. We do not use tax avoidance schemes or aggressive tax planning.
3. We engage fully and transparently with HMRC and other Government bodies, and seek to resolve disputes in a co-operative manner.
4. We adopt a conservative approach to tax risk management and apply a strong tax governance framework.
5. We accept only a low level of risk in relation to taxation.

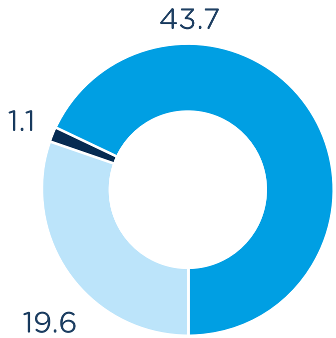
In 2019, HMRC reconfirmed our classification as 'low risk'. We work hard to maintain this coveted status, and the tax policies above ensure our behaviour is consistent with, and contributes towards us, maintaining this status.

Our tax position 2018/19



Taxes incurred directly (£147 million)

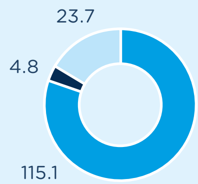
- Business rates
- Employer NICs
- Energy and other taxes



Taxes collected (£64 million)

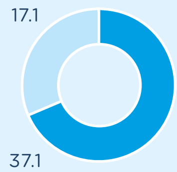
- Employee PAYE
- Employee NICs
- Other taxes withheld

2017/18



Taxes incurred directly (£144 million)

- Business rates
- Employer NICs
- Carbon reduction commitment

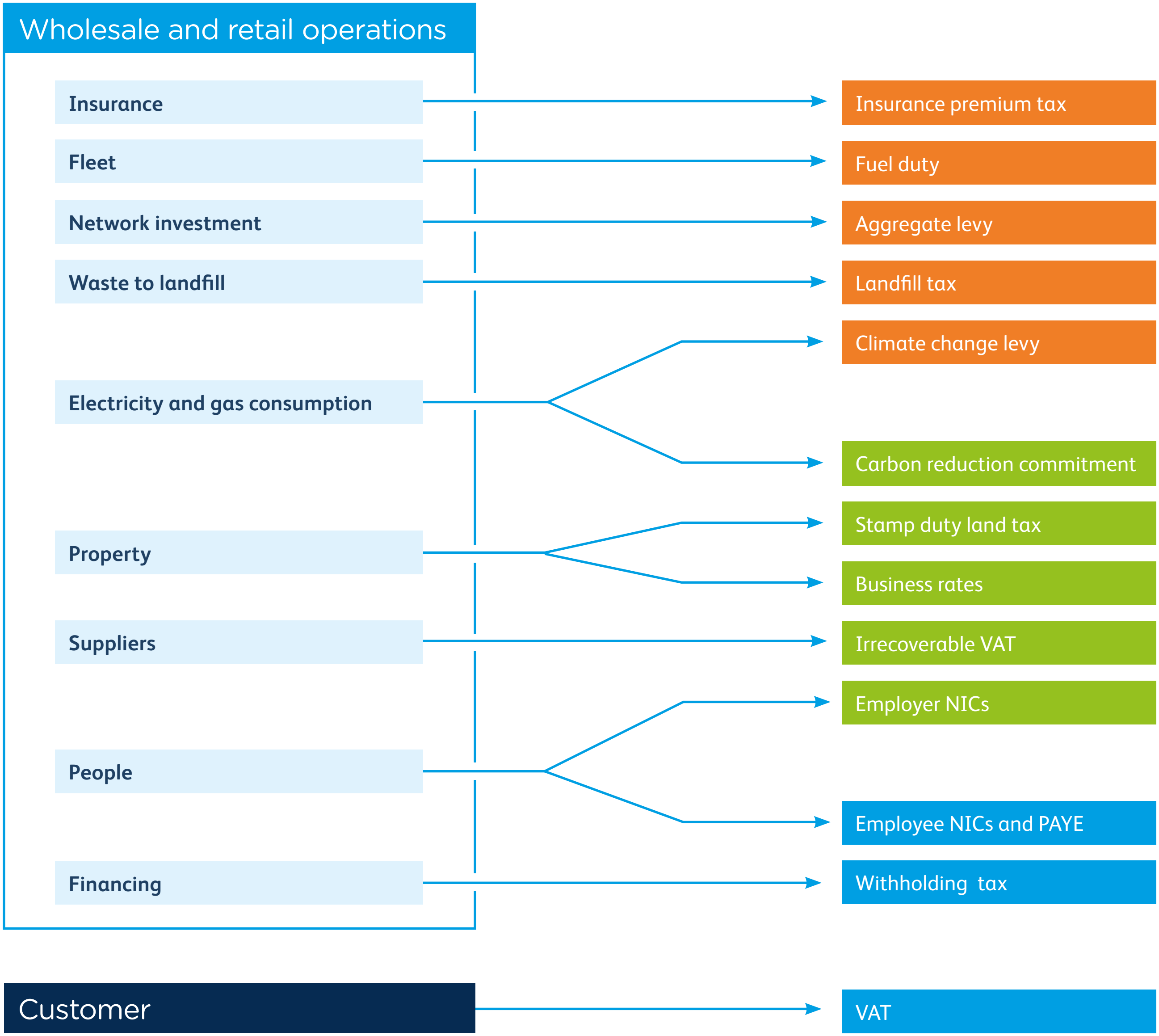


Taxes collected (£54 million)

- Employee PAYE
- Employee NICs

Our value chain

This illustration shows the areas in our value chain where we incur and collect taxes.



Tax incurred indirectly

Taxes incurred indirectly are taxes that represent a cost to us, but are included in the costs our suppliers and contractors charge us. Therefore, we do not pay these directly to the Government, but incur them indirectly as a consequence of our activities.

Tax incurred directly

Taxes incurred directly are taxes that represent a cost to us, are accounted for in our financial statements, and are paid directly to the UK Government by us.

Tax collected for HMRC

Taxes collected by us are tax costs of another party which we collect on their, or the Government's, behalf. These costs do not effect our financial results. As we undertake the commercial activity, it generates the tax which contributes to the economy.

Tax descriptions

Whilst we incur and collect all of the below, only the largest amounts are shown on page 19.

- **Insurance Premium Tax**
  A tax levied on insurance premiums.
- **Fuel Duty**
  A duty on petrol, diesel and fuel used in vehicles.
- **Aggregate Levy**
  A tax on the extraction of rock, gravel and sand.
- **Landfill Tax**
  A tax on waste sent to landfill.
- **Climate Change Levy**
  A tax on the industrial or commercial use of electricity, gas and solid fuels.
- **Carbon Reduction Commitment**
  A tax on gas and electricity consumption, calculated by reference to associated carbon dioxide emissions.
- **Stamp Duty Land Tax**
  A tax on the purchase of land and property.
- **Business Rates**
  A tax on non-domestic properties we own or occupy.
- **VAT**
  A tax levied on the sale of goods and services.
- **National Insurance (NIC)**
  A tax on wages incurred by employers and employees.
- **PAYE**
  Pay As You Earn income tax incurred by employees on their wages. It is deducted by employers and paid to Her Majesty's Revenue & Customs (HMRC).
- **Withholding tax**
  A tax on interest payments on loans.

Our corporation tax

"The reduced cost associated with us not paying corporation tax is fully passed on to customers through lower bills, so our customers benefit fully from us not paying corporation tax."

The UK Government has for many years allowed companies to claim tax relief on capital investment in their UK operations - these allowances are a common feature of national tax regimes across the world. At the same time, the UK Government also provides tax relief for interest costs on debt which has been raised to fund investment.

Due to our significant capital investment programme and interest costs on our debt we don't currently pay corporation tax. Our interest costs are deductible for tax purposes and are substantial at the moment. The Government's capital allowances regime allows us to delay payment of corporation tax (creating a "deferred tax" liability) until a time when our level of investment is lower. Our deferred tax liability on fixed assets was £1.1 billion at 31 March 2019.

You can find our draft tax calculation for Thames Water Utilities Limited and subsidiaries for 2018/19 on page 24. The reduced cost associated with us not paying corporation tax is fully passed on to customers through lower bills, so our customers benefit from us not paying corporation tax.

If our investment levels were to reduce, our capital allowances claim would also reduce. This would lead to an increase in our taxable profits and we would pay corporation tax. Although tax we pay would be funded through customer bills, any increase in bills to cover our corporation tax charge would be offset by a bill reduction due to lower investment costs. The long life span of our assets would also protect customers from a sudden bill increase, if and when the deferred tax becomes payable.

It is difficult to reliably estimate when the Group as a whole (see structure chart on page 28) will become corporation tax paying. It depends on a number of factors:

- our profitability, which is influenced by our performance
- the regulatory return and level of debt
- our level of capital investment, which gives rise to capital allowances
- tax legislation and accounting changes.

Although our latest plan for 2020 to 2025 submitted to Ofwat requested funding to cover tax costs in our operating company, Thames Water Utilities Limited, the Group as a whole may not be corporation tax paying because of losses in other Group companies.


CAT
550K

Our draft corporation tax calculation

This calculation is for Thames Water Utilities Limited and subsidiaries* in 2018/19. Our largest deductions are for capital allowances and interest.

A company's UK corporation tax liability is based on its accounting profit before tax, as shown in its statutory accounts. Tax adjustments must be made to that accounting profit, and the resulting "taxable profits" are multiplied by the corporation tax rate, which was 19% in 2018/19 and is due to fall to 17% from 1 April 2020.

	£m
Profit before tax per statutory accounts**	99
Deduct:	
1 Capital allowances	(454)
2 Interest costs on debt	(109)
3 Group relief	(67)
4 New service connections to our network	(26)
5 Fair value gains on derivatives	(19)
Add back:	
6 Depreciation of infrastructure	554
7 Pension contributions	19
8 Disallowable costs (e.g. fines)	3
Taxable profits	Nil

* The assets and liabilities in our Cayman Islands subsidiaries were transferred on 31 August 2018 to our subsidiary, Thames Water Utilities Finance Plc. Our Cayman Islands subsidiaries were subsequently closed and are no longer part of the group.
**Interest costs on debt of £365m, which are deductible for tax purposes, are already included in the profit before tax figure.

Calculating corporation tax

Tax deductions

1. **Capital allowances**
Companies can claim a deduction for investment in critical infrastructure.

2. **Interest costs on debt**
Some costs are not recognised in the income statement.

3. **Group relief**
Tax losses generated from interest expenses in our holding companies can be transferred under “group relief” rules. Broadly speaking, these rules ensure that corporation tax is paid on the profits of the whole group.

4. **New service connections to our network**
This income is taxed by reducing capital allowances instead.

5. **Derivatives**
These are taxed based on their cash flows rather than accounting profits or losses.

Added back

6. **Depreciation of infrastructure**
Capital allowances are deducted instead. In the early years, the depreciation costs are generally lower than capital allowances, which defers our tax.

7. **Pension contributions**
Only actual pension contributions are deductable which are less than the cost in the income statement.

8. **Disallowable costs**
e.g. fines

Country by country reporting

Our operations

All of the Group's operational activities are located in the UK. Historically we have traded in overseas countries, and as a result have legacy entities incorporated in Thailand, Singapore and Puerto Rico. There are no trading activities in these overseas entities, and we are in the process of closing them down. However, this process can take some time and in the meantime they continue to comply with the relevant administrative requirements incurring a low level of administrative costs.

In 2018/19 we closed our Cayman Islands subsidiaries. Although the finance company and holding company were registered in the Cayman Islands, they were always resident in the UK for tax purposes and were subject to tax in the UK. There was no tax benefit associated with the companies being registered in the Cayman Islands rather than the UK, and the companies operated and were managed wholly from our UK office.

Guernsey

During 2018/19 we had an insurance company in Guernsey, which managed legacy insurance claims against the Group for historic policies written up to 2008 (no new insurance contracts had been written since then and it was in a "run-off" phase). Although the company paid no tax in Guernsey and was not tax resident in the UK, any profits arising in the company were fully taxable in the UK under UK Controlled Foreign Company rules. The company generated losses for many years, offsetting profits generated in 2018/19. As part of our commitment to simplify our structure and support transparency we disposed of this subsidiary in October 2019.

Green financing

Our commitment to becoming more sustainable extends to the way we run our finances.

In 2018, we signed an agreement to link the interest rate on our £1.4 billion 5-year Revolving Credit Facility (RCF) to our annual performance against Environmental, Social and Governance (ESG) metrics, for the first time. The deal made us the first UK corporate to tie the interest rate we pay on the RCF to such a measure. We used our Infrastructure Global Real Estate Sustainability Benchmark (GRESB) score. GRESB is an independent, external ESG benchmark which assesses the sustainability performance of real estate and infrastructure portfolios and assets worldwide. With a score of 86/100 in 2018 for infrastructure, we ranked 3rd in Europe out of 173 participants. Outperforming the ESG benchmark will result in a lower interest rate, with any financial gains going to our charitable fund.

This agreement followed the creation of our green bond framework and our inaugural green bond, which we issued in March 2018. Proceeds from this green bond have been used to refinance major projects including the upgrade of Deephams sewage treatment works, our metering programme and the rehabilitation of water mains.

We published our first Environment, Social and Governance statement in October 2018, to increase the accessibility of information. Giving a balanced view of performance against key ESG measures over three years, the statement can be found on our website.

Kemble Water Group structure

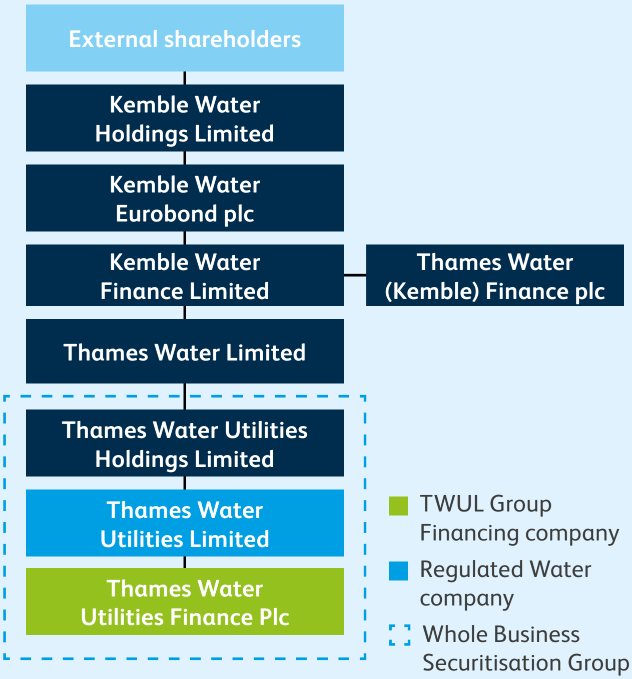
Thames Water Utilities Limited is one company within a larger group of companies, known as the Kemble Water Group. Each of the companies within our Group serves its own function.

Our investors have invested equity and debt in the Group. The debt provided by our shareholders of £310 million is listed, which allows interest payments to be paid free from withholding tax under the Government's "quoted Eurobond" rules.

Establishing a 'whole business securitisation' structure

In 2007 a 'whole business securitisation' debt structure was established to insulate Thames Water's credit worthiness from that of its ultimate shareholders and holding companies. It introduced comprehensive covenant and security arrangements within Thames Water Utilities Limited for secured creditors to ensure the company would be able to secure and maintain a strong investment grade credit rating.

Our structure explained



This chart sets out an abridged version of the Kemble Water Holdings Limited Group Structure.

Companies in the Kemble Water group

Kemble Water Holdings Limited
This is the ultimate, UK incorporated company of the Group, set up in 2006 for investors to hold shares in the group.

Kemble Water Eurobond plc
This is a UK incorporated company, originally set up to raise debt from shareholders to help buy TWUL in 2006.

Kemble Water Finance Limited
This is a UK incorporated company, originally set up to raise debt from external lenders to help buy TWUL in 2006. External lenders require greater security than shareholders so their debt is held in a separate company, which is closer to TWUL. The company also held our insurance company (see page 26).

Thames Water Limited
This is a UK incorporated company, and was at one point listed on the London Stock Exchange. Now it holds pension obligations and other non-regulated companies.

Thames Water Utilities Holdings Limited
This is a UK incorporated company, set up in 2007 for the whole business securitisation (WBS), and provides security to WBS lenders over the shares in TWUL.

Thames Water Utilities Limited (TWUL)
This is our regulated operating company which provides water and sewerage services.

Thames Water Utilities Finance Plc
This is a UK incorporated company, which raises debt to fund investment in our water and sewerage network.

Ownership

Thames Water is jointly owned by 10 institutional investors – made up mostly of pension funds and sovereign wealth funds. The two largest investors represent pension funds – one based in Canada and one in the UK. All of our investors take a long-term view of the company's infrastructure, our customers and the natural environment.

Our external shareholders

	% holding
Ontario Municipal Employees Retirement System (OMERS) OMERS is the defined benefit pension plan for 482,000 active, deferred and retired employees of nearly 1,000 municipalities, school boards, libraries, police and fire departments, and other local agencies in communities across Ontario, Canada.	31.777
Universities Superannuation Scheme (USS) Universities Superannuation Scheme was established in 1975 as the principal pension scheme for universities and other higher education institutions in the UK. It has circa 390,000 scheme members across more than 350 institutions and is one of the largest pension schemes in the UK, with total fund assets of over £60 billion (as at March 2017).	10.939
Infinity Infinity Investments S.A is a subsidiary of the Abu Dhabi Investment Authority (ADIA). ADIA manages a global investment portfolio that is diversified across more than two dozen asset classes and sub-categories.	9.900
Wren House Wren House Infrastructure Management Limited, an English limited liability company, was set up in late 2013 as the global direct infrastructure investment vehicle of the Kuwait Investment Authority ("KIA"). The KIA is the sole shareholder of Wren House. Wren House has been assigned responsibility for building partnerships, sourcing and execution of transactions, as well as asset management. Wren House's strategy is targeting the creation of a long-term focused, sustainable infrastructure platform and Wren House seeks to do so through partnership investment models for sizeable transactions where large sums of capital can be deployed.	8.772
bcIMC bcIMC is one of Canada's largest institutional investors within the capital markets. It invests on behalf of public sector clients in British Columbia and its activities help finance the retirement benefits of more than 538,000 plan members, as well as the insurance and benefit funds that cover over 2.3 million workers in British Columbia.	8.706
Hermes (BT Pension Scheme) Hermes GPE is one of Europe's leading independent specialists in global private markets. It manages its investment in Thames Water on behalf of the BT Pension Scheme, which has 300,000 scheme members. Hermes GPE invests in and advises on infrastructure, private equity and credit products on behalf of its clients and is specialised in co-investments, primary fund and secondary investments.	8.669
Cicero Investment Corporation As a sovereign wealth fund, Cicero Investment Corporation is a vehicle to diversify China's foreign exchange holdings and seek maximum returns for its shareholder within acceptable risk tolerance.	8.688
QIC QIC is a global diversified alternative investment firm offering infrastructure, real estate, private equity, liquid strategies, and multi-asset investments. It is one of the largest institutional investment managers in Australia.	5.352
Aquila Aquila GP Inc. is a leading infrastructure management firm and a wholly owned subsidiary of Fiera Infrastructure Inc., a leading investor across all subsectors of the infrastructure asset class.	4.995
PGGM (Stichting Pensioenfonds Zorg en Welzijn) PGGM are a pension fund service provider and manage the pensions for different pension funds, the affiliated employers and their employees.	2.172

Profits and dividends

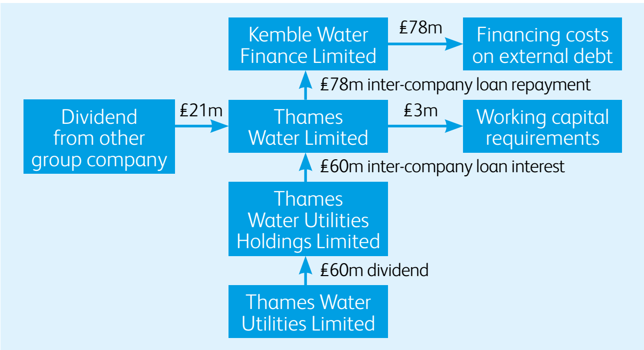
Profits

Our profit is the revenue we have left after taking into account all of our day-to-day running costs, depreciation and amortisation, finance expense and taxes. In 2018/19 our underlying profit after tax was £45.5 million which excludes the money passed over to Bazalgette Tunnel Limited for the Thames Tideway Tunnel.

Dividends

Dividends are used for two purposes:

- **To pay for holding company obligations**
  Thames Water's dividends are initially paid to its immediate parent company (see pages 28 and 29), and then money will flow up through the Group, in part to enable the holding companies to pay for their own debt obligations and their own working capital requirements. In 2018/19 £60 million was paid to holding companies and other group companies to service their debt and cover day-to-day cash needs.
- **External shareholder returns**
  While we focus on meeting the performance expectations of customers, our investors support the Board's decision not to pay any distributions to external shareholders for the rest of the current regulatory period, so the money they would have received can be reinvested. Our newest external shareholders will not have received dividends or interest for the first three years of ownership from 2017 to 2020.



A fair dividend policy

We recognise the importance of paying dividends in future years to continue attracting the right type of long-term investors who will remain committed to our long-term goals. The Board is also mindful of the privilege of our position as a monopoly provider of essential services and has agreed the parameters of a new and fair dividend policy, with full support of shareholders, which has the following features:

- Payment of a proposed dividend should not impair short-term liquidity or compliance with our covenants.
- Payment of a proposed dividend should not impair the longer- term financeability of the company's business.
- Assessment of the impact that payment of the dividend may have on all stakeholders including employees, pension members and customers.
- Our financial performance, that underpins the opportunity to pay the dividend, is as a result of operational performance that meets the level required of a supplier of essential services.
- If a net dividend is declared above Ofwat's 5% dividend yield guidance, applied to Ofwat's notional company, the Board will consider whether the additional returns result from performance (including progress towards de-gearing) that has benefited customers and may therefore be reasonably applied to finance a dividend.

When dividends are paid, we will be clear about their level, how they relate to delivery for customers and why they have been awarded.

Remuneration

We are committed to ensuring our remuneration framework supports our strategy and our approach is based on key principles:

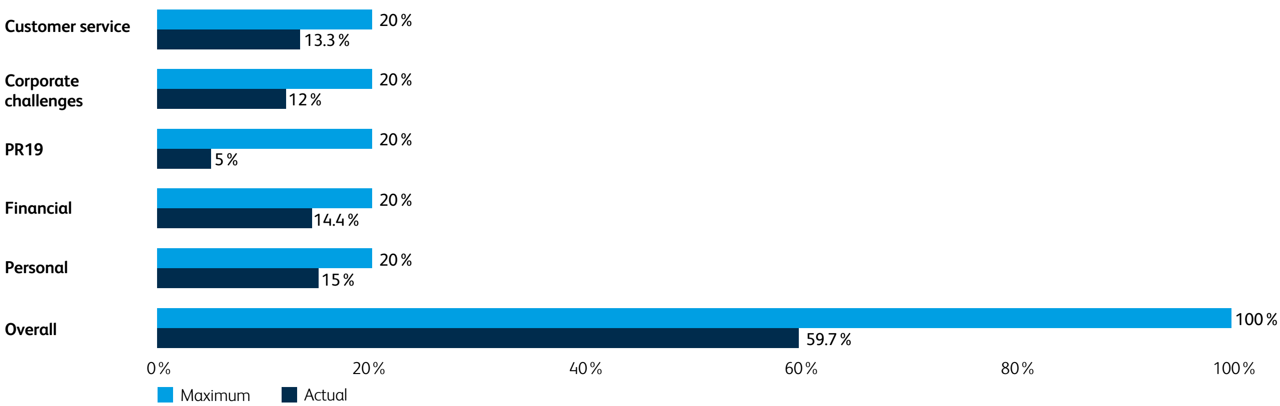
- Be aligned with customers' needs and the long-term objectives of all stakeholders.
- Drive behaviours that support what our customers want, need and expect.
- Demonstrate a clear link between performance-related pay and operational performance.
- Seek to offer reasonable and competitive pay and benefits which are simple, transparent and fair.

Structure of the targets for the 2018/19 ‘Annual Managers bonus’ (excluding the CEO).

Annual Management Bonus 2018/19

Bonus element	Objective	Weighting as a % of maximum
Customer services	Project Spring* Customer NPS on track Non-contactor NPS on track	20%
Corporate challenges	“One Thames” organisation design Company Monitoring Framework	20%
PR19	PR19 successful outcome	20%
Financial	Group EBITDA	20%
Personal	Annual personal performance assessment	20%
Total payable		

The actual performance against maximum targets of 2018/19 Annual Management Bonus scheme is as follows:

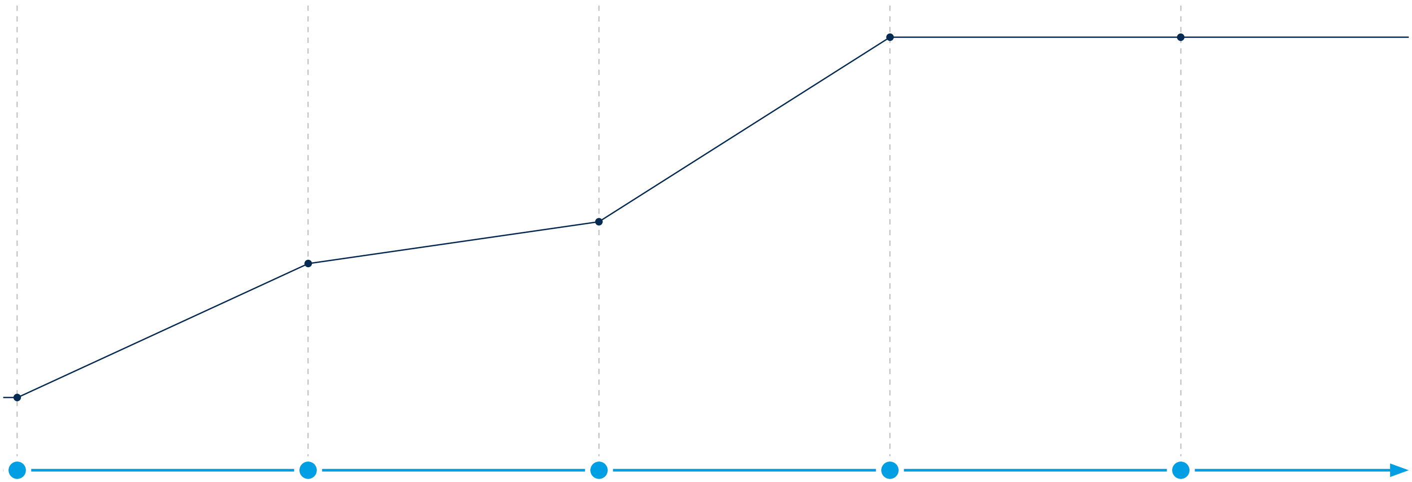


We are currently recruiting for a new Chief Executive Officer. In the meantime Ian Marchant is acting as Interim Executive Chairman.

* our new customer relationship management and billing system.

Our investment history

Average yearly investment in 2018/19 prices.



Five years prior to privatisation

£357 million

The water industry was privatised in 1989

1989 – 2001

£641 million

Post-privatisation – rebuilding infrastructure as Thames Water Plc (floated on the London Stock Exchange)

One of the key reasons the industry was privatised was to address the many years of underinvestment in water and wastewater infrastructure during public ownership. During this period, we constructed the Thames Water ring main, and upgraded our major treatment works in London.

2001 – 2006

£730 million*

International expansion as part of RWE

After the German utility company, RWE acquired Thames Water, we accelerated the rate of our international expansion. As part of this, we purchased the US' largest privately owned water company, American Water Works.

2006 – 2017

£1.1 billion

Focusing on the UK as part of the Kemble Group

After the Kemble Group, made up of national and international investors, bought Thames Water in 2006, all of our global interests were sold or closed. This allowed us to focus our attention on the UK.

2017 – present

£1.1 billion

Current ownership

Since 2017, new investors, OMERS, USS and Wren House have, in aggregate, acquired over 51% of Thames Water. The new shareholder base has agreed not to take dividends until at least 2020, as we focus on improving performance for our customers.

*Investment in UK business


Thames Water
Thames Water

This booklet can be supplied in large print, braille, or audio format upon request.

Get in touch

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Our Finances Explained
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