Chief Financial Officer's statement

Sustainable and responsible financing

"As with our day-to-day operational decisions, taking a sustainable approach to financing is crucial to ensuring the long-term stability of our services."

Performance overview

We made the decision to increase investment in some critical areas during the year to drive long-term improvement. This saw investment levels, at £1.2 billion, break the £1 billion barrier once again, which is three times the annual investment compared to the five years pre-privatisation. Over the last 15 years we've invested over £15 billion in the business.

We also increased our operating expenditure during the year to continue to drive improvements in customer service. Higher employment costs combined with the costs associated with adverse weather effects drove a £60.4 million year-on-year increase. As a result, underlying operating profits fell to £454.0 million (restated 2018[1]: £505.9 million). To fund this additional spend, we announced last year that there would be no dividends paid to external shareholders for the three years to 2020 – a key decision that was supported by our external shareholders, in order to focus on investment to drive improvements.

1 The prior year results have been restated due to the impact of the transition to new accounting standard IFRS 15 'Revenue from Contracts with Customers' on 1 April 2018 as discussed on pages 170–173 as well as other restatements which are discussed on pages 215–220.

"We're investing three times more a year compared to the five years pre-privatisation".

Financial performance

Year ended	31 March 2019			31 March 2018[1]		
	Underlying	BTL*	Total	Underlying	BTL*	Total
Revenue (£m)	2,036.9	47.5	2,084.4	2,018.0	26.9	2,044.9
Operating expenses (£m)	(1,654.7)	(0.3)	(1,655.0)	(1,594.2)	(0.4)	(1,594.6)
Operating profit (£m)**	454.0	47.2	501.2	505.9	26.5	532.4
Net finance expense (£m)	(364.7)	–	(364.7)	(409.4)	–	(409.4)
Net (losses) / gain on financial instruments (£m)	(37.7)	–	(37.7)	40.9	–	40.9
Profit before tax (excl. sale of NHH) (£m)***	51.6	47.2	98.8	137.4	26.5	163.9
Sale of NHH (£m)	–	–	–	89.7	–	89.7
Profit before tax (£m)	51.6	47.2	98.8	227.1	26.5	253.6
Profit after tax (£m)	45.5	44.4	89.9	193.9	24.9	218.8
Capital expenditure including intangibles (£m)	1,188.7	n/a	1,188.7	1,148.8	n/a	1,148.8
Net debt (£m)	11,619.8	–	11,619.8	10,981.5	–	10,981.5
Dividends paid to immediate parent company (£m)	60.0	–	60.0	55.0	–	55.0
Dividends paid to external shareholders (£m)	–	–	–	–	–	–
Interest cover (PMICR)****	1.6	–	–	1.6	–	–
Gearing (%)*****	82.2	–	–	81.3	–	–
Credit rating******	–	–	Baa1 negative	–	–	Baa1 negative

* Refer to page 161 for information about the Bazalgette Tunnel Limited ("BTL") arrangement
** Operating profit includes revenue and other operating income (disclosed in note 2), offset by operating expenses
*** This measure is statutory profit before tax less the profit recognised on sale of the non-household (NHH) business in 2017/18 per Note 5 on page 187
**** As defined on page 178
***** Ratio of covenant net debt to Regulatory Capital Value ("RCV"), defined on page 304
****** Representing the consolidated Corporate Family Rating assigned by Moody's, defined on page 26

1 The prior year results have been restated due to the impact of the transition to new accounting standard IFRS 15 'Revenue from Contracts with Customers' on 1 April 2018 as discussed on pages 170–173 as well as other restatements which are discussed on pages 215–220.

Increasing transparency and improving financial resilience

One of the big themes I talked about in last year's Annual Report was the importance of increasing transparency as a key step in building trust. This remains one of our highest priorities and I'm very pleased that we've made real progress on a number of fronts:

- **Promoted under the Company Monitoring Framework**, which is Ofwat's assessment of whether companies are communicating in a clear, accessible and transparent way and that the information gives a fair view of how a company is performing
- **"Low risk" status confirmed by HMRC**, based on its assessment including behavioural factors, such as systems and delivery, governance and approach to tax compliance
- **Reducing our gearing level:** Our gearing (the amount of net debt relative to the regulatory capital value) at 31 March 2019 was 82.2% (2018: 81.3%) before considering the de-gearing impact of a cash injection of £250 million[1], equivalent to 1.8% of our 31 March 2019 RCV, completed in April 2019.

1 This was effected via a £220 million reduction in the principal of the intercompany loan due to Thames Water Utilities Limited, with the remainder used to repay the accrued interest associated with the intercompany loan.

- **More closely aligned our financing with our environmental focus**, by structuring our main £1.65 billion bank facilities so the margin is tied to environmental performance, with any savings being payable to charitable causes
- **Simplified our corporate structure**, with the removal and liquidation of the Cayman Islands subsidiaries and the closure of a number of other overseas companies from our past as an international company
- **Clarified our reporting**, with this Annual Report and consolidated financial statements presenting the combined results of Thames Water Utilities Limited and its sole subsidiary Thames Water Utilities Finance plc ("the TWUL Group") as if it were a single economic entity. This provides all interested parties with a complete overview of the operating company and the finances in place to support its operations and enhance understanding, presenting the results of operations, financing and financial position in one place.

Our business plan for 2020 to 2025 sets out our ambitions around strengthening financial resilience – ensuring that customers are protected even in extreme circumstances. In our April 2019 revision, we expressed our desire to de-gear the company to 77.7% by 2025, including by further reducing more of an inter company loan due to Thames Water Utilities Limited, the operating company.

We have again analysed our long term viability over a ten year time horizon to reflect the very long-term nature of our business and assets. This is set out in the Long Term Viability Statement on pages 45–49.

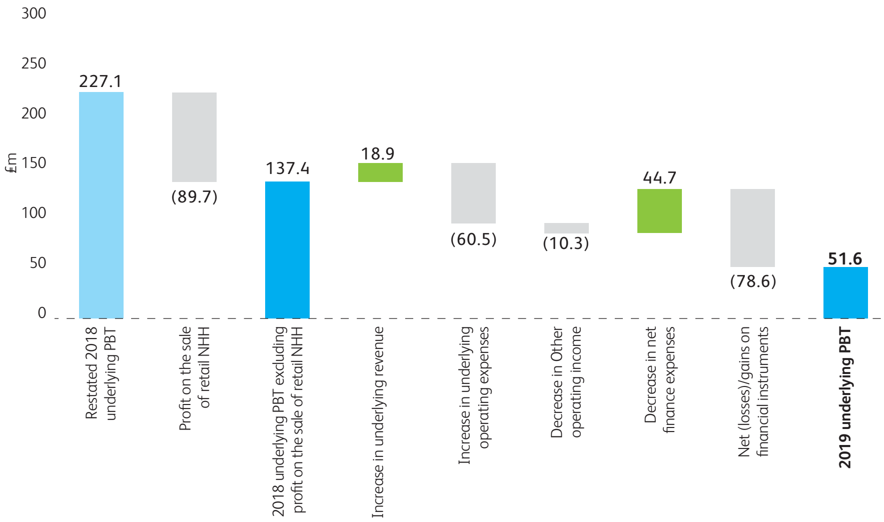
Delivering efficiently

Looking ahead, it is clear we must focus on delivering more for customers without increasing bills. Our business plan is based on a 22.5% reduction in the base operating cost of serving a customer property. To deliver this stretching outcome, we have launched a wide-ranging cost transformation programme to ensure we target our resources on front-line service delivery that matters most to customers, and we spend every pound efficiently – completing as many jobs as possible first time, which is clearly best for customers.

Our five year plan is based on delivering what our customers have asked us for, with the revised April plan providing a broad customer-centric package of outcomes, with a combined, household water bill reduction of £5, or 1.3% in real terms, over the regulatory period.

Chief Financial Officer's statement continued

A summary of the movement in our underlying Profit Before Tax (PBT)



Environment, Social and Governance (ESG)

To support our strategic priorities and our approach to sustainability, the past 12 months have seen our continued efforts to put the Environment, Social and Governance (ESG) agenda at the heart of our financial decision making, following the first issue under our green bond framework last year. In November 2018, we increased the size of our revolving credit facility with the margin tied to our sustainability performance, and committed that any outperformance would be applied to charitable causes. The interest on this five year, £1.65 billion facility is tied to our annual performance against ESG metrics, as determined by our Infrastructure Global Real Estate Sustainability Benchmark score (GRESB). Any costs associated with underperformance would effectively be borne by our external shareholders.

GRESB is an independent external ESG benchmark which assesses the sustainability performance of real estate and infrastructure portfolios and assets worldwide. Our current GRESB score is 86 out of 100, against an average participant score of 62.

£398

Our average annual combined household bill for 2019/20 is £398, which is the third lowest in England and Wales.

Revenue

As a regulated business, we undergo a price review process every five years, which determines the revenues we collect through customer bills based on the costs of investment and of operating the business. Underlying revenue is therefore not subject to significant year-on-year fluctuations.

Total revenue for the year ended 31 March 2019 has increased by £39.5 million to £2,084.4 million compared to the previous year.

Our bills for wastewater customers include amounts relating to the costs of the Thames Tideway Tunnel. As we collect the cash, it is passed over to Bazalgette Tunnel Limited ("BTL"), the independent company appointed to construct the tunnel (to the public the company is known as Tideway). As this money is not retained by us, we exclude it from our underlying results. The annual amounts included in our bills are driven by the phasing of construction works, which is the primary reason for the large increase in revenue related to BTL, from £26.9 million during the year ended 31 March 2018 to £47.5 million during the year ended 31 March 2019.

Overall, underlying revenue for the year ended 31 March 2019 has increased by £18.9 million to £2,036.9 million compared to the previous year. The primary reason for this is an increase in the year-on-year allowed revenue as set out in the Final Determination issued by Ofwat at the start of the current five year regulatory period.

This has however been offset by £40.3 million of Outcome Delivery Incentive[1] (ODI) penalties that the Company chose to return to customers early and additional under-recoveries against our allowed revenue due to lower than forecast property numbers and consumption volumes compared to those assumed when our charges for the year were set.

For details on how we spent every pound in 2018/19 see page 33.

1 For more information on ODIs see page 62.

Overall performance

Previously, for the year ended 31 March 2018 we had presented the accounts of TWUL as a single statutory entity. Our overall performance, as discussed below, for the current year includes the consolidated results for the TWUL Group.

Total profit before tax ("PBT") for the year ended 31 March 2019 was £98.8 million (31 March 2018: £253.6 million). As noted above, our financial statements include the effect of revenues billed in relation to the construction of the Thames Tideway Tunnel, which are passed to BTL, the third party responsible for the construction of the tunnel. Stripping out these revenues gives the underlying PBT of £51.6 million (31 March 2018: £137.4 million, excluding profit on sale of NHH business). A summary of the movement in our underlying profit before tax is provided on this page.

Operating expenses

Our total operating expenses have increased by £60.4 million (3.8%) to £1,655.0 million (restated 31 March 2018: £1,594.6 million). The increase can be attributed to:

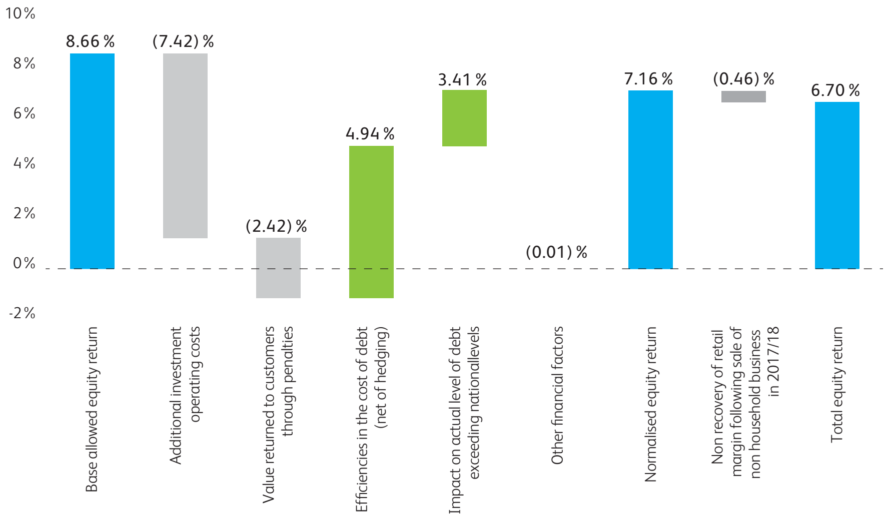
- A £16.3 million increase in power costs as a result of a 15% increase in the unit price, coupled with higher water treatment volumes during the hot and dry summer. We had to bring additional (and more operationally expensive) sites online over the summer to deal with the demand.
- An increase in employee costs of £45.0 million, reflecting the increased internal resource to improve our service to customers, as well as annual pay inflation of £5.3 million. In addition, £9.0 million can be attributed to Guaranteed Minimum Pensions (GMP). GMP is discussed in more detail on page 27.
- Increase in spend to find and fix leaks in order to get our leakage performance back on track.
- Additional costs associated with preparing and assuring our business plan submissions. We incur this every five years.
- A £19.1 million increase in depreciation and amortisation, as we continue with our significant investment programme.

Financial flows

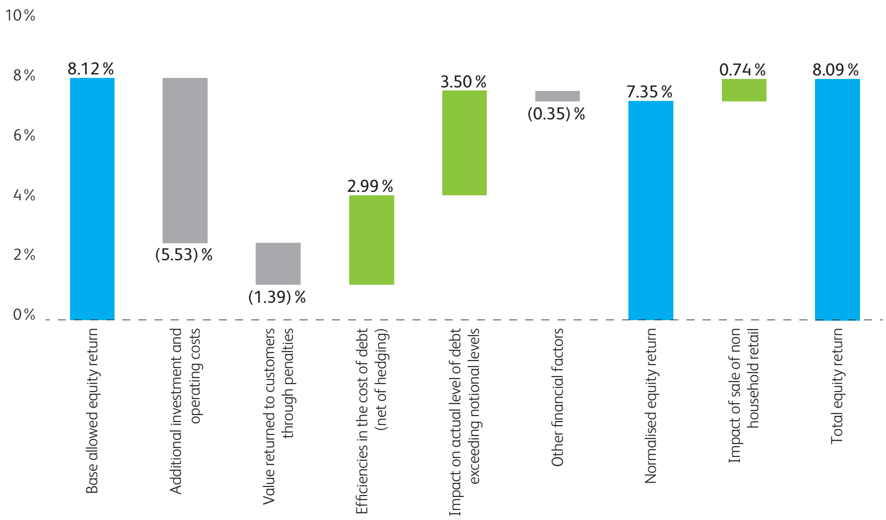
Breakdown of 2018/19 actual return

Our revenues are set according to a very detailed regulatory process which allows for the recovery of efficient costs plus a return for investors in the business. The actual return to external shareholders in any period is therefore determined by these allowed revenues, and by the degree to which actual costs are higher or lower than the efficient levels allowed. Other key factors affecting returns are the level of rewards or

Breakdown of 2018/19 actual return



Breakdown of actual return for the past four years



penalties, and the amount of equity invested by the external shareholders. The analysis on page 25 refers to the Company and is only based on the regulatory accounts.

In order to provide a consistent metric capable of being used as a basis of comparison, we are presenting returns based on a measure of "regulatory equity" that has been developed with Ofwat. Here, the value of equity is calculated as the Regulatory Capital Value ("RCV") less the amount of net debt in the regulated business. Directly observable share prices of listed companies in the sector show that market values of equity have historically been higher than this "regulatory equity" value, but this is not factored in to this analysis.

In the year to 31 March 2019, the allowed level of return for external shareholders for a company with the notional capital structure (i.e. debt equal to 62.5 % of RCV) was 8.66 %. This return includes 3.06 % of RCV growth arising from RPI inflation.

Total external shareholder return on an equivalent basis was 7.16 % (before the impact arising from the sale of the retail non-household business in 2017/18), which is 1.50 % below the allowed base level. As the retail non-household business was sold, we no longer recover the corresponding retail margin which was awarded in the PR14 Final Determination. This results in a 0.46 % reduction in return, giving an overall return of 6.70 %.

Outperformance in this financial year has been driven primarily by our cost of debt being lower than the allowed level, and by the level of debt being higher than the "notional" level, giving higher returns of 4.94 % and 3.41 %, respectively. Taking the cost of debt first, there are two drivers:

- Firstly, lower underlying cost of debt than the allowance, before considering the effects of inflation; and
- Secondly, because around half of our debt is fixed rate, its cost does not increase with inflation.

When it comes to overall gearing (i.e. the ratio of debt to RCV), levels above the regulatory assumption of 62.5 % amplify the percentage return to external shareholders, because debt is less expensive than equity. Another impact of higher gearing levels is that it increases the volatility of external shareholder returns, which become proportionately more sensitive to levels of out or under performance. Our average gearing level in 2018/19 was around 82 %, which resulted in a 3.41 % increase in overall shareholder returns.

We are responsible for financing our business as efficiently as possible. Our financing structure, the Whole Business Securitisation, offers additional protections to debt investors enabling us to have higher levels of debt without reducing our credit worthiness. For the avoidance of doubt, any additional risk associated with having a higher level of debt remains with our external shareholders, and is not transferred to customers.

Placing a number of the other factors in context, our total expenditure ("Totex") associated with investing in and operating the business was £170.9 million above our allowance for the year. Further, we are returning £59.8 million to customers through penalties.

Of the total regulatory return noted above, the vast majority (86 %) was retained in the business, with the remainder distributed to cover financing costs elsewhere in the group. No dividends were paid to external shareholders.

Based on an average of the past four years, actual external shareholder return was lower by 0.77 % than the allowed return, prior to the impact from the sale of the retail non-household business, as shown to the left. Operational underperformance (including penalties) outweighed the benefits from financial factors. The operational underperformance is mainly driven by the additional totex spend in excess of our allowance which reflects our commitment to prioritise customer interests through higher investment levels. The increase in financial outperformance over the period is mostly due to increases in inflation over the past four years.

Net (losses)/gains on financial instruments

We raise debt in a variety of currencies and use derivative contracts to manage the foreign exchange risk exposure on this debt along with the interest rate risk and inflation risk that we are exposed to. Fluctuations in external market variables such as changes in interest rates, inflation and foreign exchange rates do generate changes in the balance sheet

Chief Financial Officer's statement continued

value of these financial instruments and this impacts profit. We only use derivatives for risk management purposes and both the debt and derivative contracts are generally held until maturity, so there is no cash impact due to these changes. This year, we made a loss on financial instruments of £37.7 million (2018: gain of £40.9 million). The loss of £37.7 million this year was comprised of exchange losses on foreign currency denominated debt of £68.0 million due to a weakening in sterling, offset by gains arising on swaps of £64.5 million and a £34.2 million loss due to a cash flow hedge being transferred from equity.

Cash flow

Underlying net cash generated from operating activities for the year ended 31 March 2019 was £1,085.7 million, and therefore broadly consistent with £1,065.1 million generated in the previous year.

Capital expenditure

During the year, we invested a total of £1,188.7 million (31 March 2018: £1,148.8 million) in our assets. The total investment by area is summarised, by area, in the table below.

Area	Non infra-structure	Infra-structure	Total
Water (£m)	304.5	268.1	572.6
Waste (£m)	377.7	238.4	616.1
Total (£m)	682.2	506.5	1,188.7

Key projects within the above capital expenditure include:

- £52.9 million on our metering programme (water)
- £92.2 million on connecting our network to the Thames Tideway Tunnel
- £29.6 million on a customer relationship management and billing system
- £26.9 million on our scheme aimed to reduce the risk of flooding (waste)
- £31.9 million on upgrading our sewage treatment works at Deephams (waste)

Bad debt

Bad debt arises predominantly from those who choose not to pay their bill, despite being financially able to, as opposed to those who cannot pay. This year we had an overall increase in bad debt cost of £5.1 million to £62.6 million (2018: £57.5 million). This is split between bad debt relating to current year bills (amounts that are not expected to be collected when invoiced) of £33.4 million, which is shown as a deduction in revenue, and bad debt relating to bills from prior years of £29.2 million, which is shown within operating expenses. The overall increase in bad debt is attributed to increased risk from debt relating to non-household bills pre-market opening.

Dividends

During the year, we paid dividends of £60.0 million (2018: £55.0 million) to our immediate parent company, Thames Water Utilities Holdings Limited ("TWUHL"), with all of the current year dividends being applied to servicing debt obligations and working capital requirements of other companies within the Kemble Water Group.

No dividends were paid by the Kemble Water Holdings Group to external shareholders for 2018/19 in line with our commitment to withhold paying an external dividend until 2020/21. This commitment will continue to help us increase our equity buffer[1] and broaden financial resilience, to improve our service to customers.

1 Equity buffer is defined as the regulatory capital value less net debt.

Taxation

In 2018/19, we paid over £211 million in business rates, national insurance contributions, PAYE and other taxes. We incurred £147 million directly, mainly through business rates, and collected £64 million on behalf of our employees. As in prior years, we have not paid any corporation tax to HMRC primarily because of interest costs and tax relief for our capital investment programme.

The 2018/19 corporation tax charge of £8.9 million consists of a deferred tax charge of £4.6 million and a current tax charge of £4.3 million, the latter of which arises because Thames Water Utilities Limited pays for tax losses from other Group companies, which should ultimately benefit customers through lower tax funding in future regulatory settlements. The overall tax charge is lower than the prior year due to the decrease in accounting profits.

Credit ratings

In May 2018, Moody's affirmed our Baa1 Corporate Family Rating ("CFR") but placed us on negative outlook (31 March 2018: negative outlook). This continues to align with our ratings of A3 and Baa3 for our Class A and Class B debt respectively. The change to negative outlook reflects a change in assessment of the stability and predictability of the UK water regulatory regime rather than a reflection of Thames Water specifically. In July 2018, S&P re-affirmed our credit rating of BBB+ and BBB- (31 March 2018: BBB+ & BBB-) in respect of our Class A debt and our Class B debt respectively and placed us on negative outlook (31 March 2018: stable outlook). We retain credit ratings that allow us to access efficiently priced debt to fund our investment programme, whilst keeping bills affordable for our customers.

Borrowings carrying value – £m

GBP EIB loans	858.3
US Private Placements	1,187.5
GBP index-linked bonds	2,656.8
GBP fixed rate bonds	5,177.2
Foreign currency bonds	385.3
GBP other loans	1,352.5

Financing arrangements

In anticipation of our 2020 to 2025 investment programme and being financially prudent, we have increased the size of our RCF from £950 million to around £1.65 billion during the year, with a five year term (and two one-year extension options). This upsizing was strongly supported by our relationship bank group. Through Kemble Water Finance Limited, a holding company within the wider group, around £650 million of new Sterling debt was committed in November 2018 (of which £310.0 million was drawn at 31 March 2019 and £340.0 million in April 2019), using the bank and private placement markets. £400 million of this was used to refinance the £400 million bond guaranteed by Kemble Water Finance Limited which was repaid in April 2019. The remaining amount, roughly £250 million, was used to de-gear Thames Water Utilities Limited in April 2019. This is in line with the de-gearing plan outlined in our business plan.

Financing our investment

As we continue to invest heavily in the business, our statutory net debt (as defined on page 178) has increased by £638.3 million to £11,619.8 million (2018: £10,981.5 million). This has been accompanied by an increase in the Regulatory Capital Value ("RCV") of £568.9 million to £14,273.7 million (2018: £13,704.8 million), meaning that overall gearing (on a covenant basis*), as at March 2019 before the £250 million cash injection in April 2019, was 82.2% (2018: 81.3%), below the mandated maximum of 95.0%. Additionally, our PMICR (see PMICR definition on page 178) in 2018/19 was 1.6x (2018: 1.6x) and was above the mandated minimum of 1.1x.

We continue to borrow through external public and private debt capital markets and through financial institutions across a diverse range of currencies, geographies and sources. The past year has seen us continue to focus on increasing diversity including the issue of a further £227 million equivalent US Private Placement which was priced in January and funded in April 2019 along with a number of new bilateral loans. The overall debt mix is shown on page 26, excluding the impact of intercompany swaps:

* Ratio of covenant net debt to Regulatory Capital Value ("RCV") defined on page 304

Borrowings carrying value – £m

The associated net finance expense has decreased by £44.7 million to £364.7 million (2018: £409.4 million), which has been driven by the lower RPI accretion on borrowings. Some of our interest expense is incurred in relation to borrowings raised to deliver major capital projects.

Under IFRS accounting rules we are able to capitalise the interest costs related to major capital projects with the finance expense in the income statement being shown net of these capitalised costs.

Capitalised interest costs were £109.3 million this year (2018: £100.7 million).

Pensions

We operate three pension schemes for our employees – two defined benefit schemes (Thames Water Pension Scheme ("TWPS") and Thames Water Mirror Image Pension Scheme ("TWMIPS")) and one defined contribution scheme. During the year ended 31 March 2019, we contributed £11.0 million (31 March 2018: £8.1 million) to our defined contribution scheme.

Our defined benefit scheme accounting valuation has been updated to 31 March 2019 on our behalf by independent consulting actuaries, Hymans Robertson LLP.

The total net retirement benefit obligation for the two schemes as at 31 March 2019 was £293.0 million (restated 2018: £250.2 million[1]), which includes a pension deficit of £338.8 million (2018: £300.8 million) for the TWPS scheme, offset by a pension surplus of £45.8 million (restated 2018: £50.6 million) for the TWMIPS scheme and we have been taking measures to reduce the overall deficit including regular contributions and deficit repair payments.

The increase in the deficit is mostly driven by a change in actuarial assumptions, specifically a decrease in the discount rate for both schemes, resulting in an actuarial loss. In addition to this, we recognised a past service cost in the current year income statement of £9.0 million relating to Guaranteed Minimum Pensions ("GMP") which has been discussed in more detail in the GMP section.

As part of the last triennial valuation, dated 21 March 2016, a recovery plan to reduce the deficit to zero was agreed with the trustees. The Company has agreed to make deficit repair payments of £22.0 million (indexed) per annum until 2027. The triennial valuation dated 31 March 2019 will be undertaken by Aon (the schemes' actuaries). The deadline for completing this is 30 June 2020, but is expected to be performed earlier.

1 The net deficit on our defined benefit schemes for 31 March 2018 was restated following the recognition of the previously unrecognised TWMIPS pensions scheme surplus which is discussed in more detail below.

Recognition of pension surplus (TWMIPS scheme)

In previous years, the Directors had reviewed the scheme rules of the defined benefit pension schemes and concluded that for the TWMIPS scheme, the provisions of IFRIC 14 applied. This resulted in a restriction of the surplus for the scheme and as such no surplus was recognised.

Our retirement benefit obligations consisted of a deficit within the TWPS scheme and a restricted surplus[1] in the TWMIPS scheme.

Following a review into our approach, the Directors have concluded that a different interpretation of IFRIC 14 provided a truer, fairer picture of our pension scheme arrangements for our stakeholders.

The Trust Deed provides the Company with an unconditional right to a refund of surplus assets assuming the full settlement of plan liabilities in the event of a plan wind-up. Furthermore, in the ordinary course of business the Trustee can only force a wind up once all benefits have been distributed and any surplus taken by the Company. Based on these rights, any net surplus in the scheme is recognised in full. We have therefore restated our pension figure for the previous year, such that our net pension deficit reduced from £300.8 million to £250.2 million following the recognition of the £50.6 million TWMIPS surplus, at 31 March 2018.

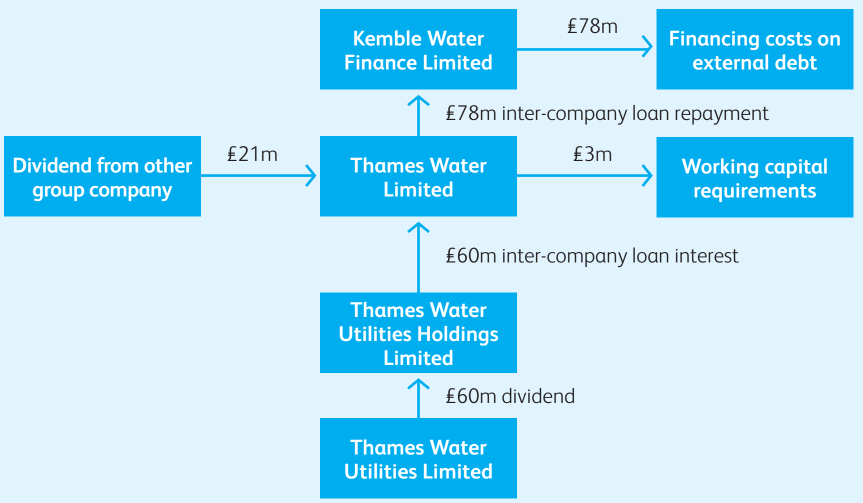
Guaranteed Minimum Pensions

On 26 October 2018, the High Court concluded on the case involving the Lloyds Banking Group's defined benefit pension schemes. Guaranteed Minimum Pensions ("GMPs") built up in our pension schemes between their commencement and 5 April 1997. They form a part of the overall pension and needed to be provided before April 1997 as a condition of our opting out of the earnings related part of the state pension, as a result of which Thames Water Utilities Limited and the pension scheme members paid reduced rate national insurance contributions up to April 2016. GMPs are subject to increase in payment and in deferment at different rates from the increases to benefits in excess of GMP.

Even though state pension ages are now the same for men and women, GMPs for women are generally higher than those for men. Despite the equalisation of state pension ages, GMPs are still required to come into payment on the 60th birthday of women and the 65th birthday for men. As such, GMPs are unequal between men and women of identical ages, salary histories and periods of service. The Lloyds case requires this inequality to be remedied and has given rise to additional pension liabilities for the Group.

Our actuaries, Hymans Robertson LLP have factored in the cost of equalisation into the accounting valuation as at 31 March 2019. This has resulted in a past service cost recognised in the 2018/19 income statement of £6.8 million for TWPS and £2.2 million for TWMIPS, a total of £9.0 million across the two schemes.

Dividends



Brandon Rennet
Chief Financial Officer
27 June 2019