Thames Water

Our finances explained.

October 2017

About our finances.

Every day, 365 days a year, we provide 2.6 billion litres of one of life's essential ingredients - high quality drinking water - to nearly 10 million people, and treat 15 million customers' wastewater before safely returning it to the natural environment. With London and the Thames Valley in our catchment, our essential services are also vital to the smooth running of the UK economy. We don't take this responsibility lightly.

We know there's a live debate about the structure of our sector – the most important thing to us is that we're structured in a way that allows us to deliver the best for our customers. We've invested over £12 billion in our network over the last 12 years, and we need to continue investing for the benefit of our customers, both now and in the future. This rate of investment is, on average, three times higher a year than before privatisation.

Even though we're running the industry's largest ever investment programme, we manage our finances securely and efficiently to minimise the impact on our customers. Our combined water and wastewater bill is the third lowest in England and Wales at just over £1 a day per household (£374 on average a year for 2017/18).

We know we're in a hugely privileged position with life-long investment from our customers through their bills, and we need to be smart and disciplined about how we spend the money to drive maximum benefit and ensure resilience of their essential services. We must make every penny count.

The large sums of money involved, and the strict legislation and regulation we are required to follow, can make our financing appear complex. This, our fourth edition of Our finances explained, has been designed to help you understand exactly how our finances work, using figures for the 2016/17 financial year. If you have questions about our finances, you can email us at **ourfinances@thameswater.co.uk**.

Brandon Rennet
Chief Financial Officer

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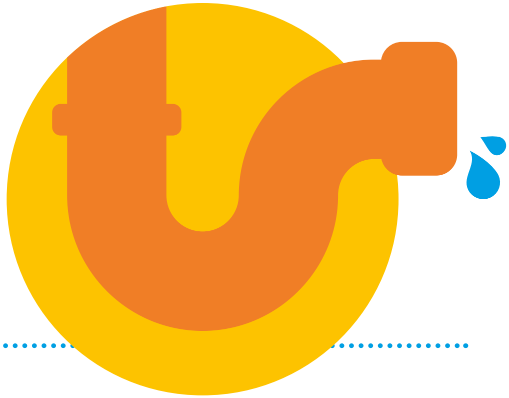
Thames Water in numbers for 2016/17

We employ around
5,000
people

Approximately
25%
of our existing water pipes were laid in the Victorian times



£20 million
average investment in infrastructure every week.

We serve about
25%
of the population of England and Wales

We generated enough electricity from sewage to power

86,000

homes

£374

our average combined annual water and wastewater bill for **2017/18**

We paid

£170 million

in business rates, PAYE and national insurance contributions

We helped

6,161

customers with **£4.5 million** of debt through our customer assistance fund

We raised

£350,147

with a further

£93,000

pledged to our WaterAid campaign to improve water services in Malawi

*Using figures from 2016/17 financial statements

What did we spend our money on in 2016/17?

1 Net investment in our network
£1,241 million

Otherwise known as capital expenditure, or capex, this is the money we use to renew and improve our network and infrastructure. We've invested over £1 billion, on average, every year for the last 12 years.

As well as the £5 billion we expect to spend on our network between 2015 and 2020, we've committed to increasing investment in our large 'trunk' water mains by £97 million during the next three years.

We've been working on some of our largest water pipes including at Upper Street, Islington, following the major burst which affected customers in the area in 2016.

2 Day-to-day operational expenses
£981 million

Operational expenditure, or opex, is the money we use to operate and maintain our network, pay our employees, cover our energy costs and pay our technology bills. With a vast network of 140,000km of pipes and 449 treatment works, this money is used to help us ensure our business runs efficiently and we provide the best for our customers.

Together, operational and capital expenditure are known as total expenditure, or totex. Our management of totex is how we are assessed by the economic water regulator, Ofwat.

3 Net financing costs, repayment of loans and dividends
£373 million

We borrow money from banks and other lenders, such as pension funds and insurance companies, to help fund our 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, and to shareholders as a return on their investment.

Investing in the future

£120 million to revolutionise our customer relationship management and billing capabilities to help improve systems resilience and customer service

£250 million to upgrade Deephams, one of our largest sewage treatment works, to accommodate population growth and reduce odour in the local community

£1.4 billion buying land and connecting our network to the landmark Thames Tideway Tunnel, which is set to transform the Capital's rivers

£60 million on two water projects in Wiltshire and Oxfordshire as part of our investment programme outside London

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 for our defined benefit schemes, which support our ability to pay pensions, are held completely separate from those of any Thames Water group companies. 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 deficit in March 2017 was £379.8 million. Every three years, our defined benefit schemes are valued by an independent actuary and these valuations are updated annually.

> “We saved £24 million off our annual energy bill in 2016/17 by using renewables.

For 2016/17, we paid £38.3 million into our defined benefit pension schemes, which included both regular contributions and deficit repair payments. This is part of our recovery plan to sustainably reduce our pension deficit to zero, which was agreed with the scheme trustees as part of the valuation.

We contributed £6.8 million to the defined contribution scheme, which currently serves 55% of our employees.

Bad debt

Treating our customers in a fair way is something we are passionate about. Most ‘bad debt’ (failure to pay) actually comes from those who choose not to pay rather than those who genuinely can’t, and money is added to all customer bills to account for it. We remain committed to taking measures to help ensure the vast majority who pay their bills, on time, are not penalised by those who don’t pay their fair share. Our new, award-winning debt management system and processes led to a £14.6 million reduction in bad debt in 2016/17.

Power

It costs over £100 million a year to power our business making it one of our largest operational costs. We generated 267GWh of electricity from sewage in 2016/17, our best ever performance and enough to power 86,000 homes a year. We’re also using more solar power, including the floating solar array on our QE2 reservoir. Our use of renewables in 2016/17 saved us £24 million off our annual energy bill. Alongside this, we’re also doing what we can to drive energy efficiency across the business.

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 bills remain the third lowest in England and Wales, at £374 per year (17/18).

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

Through the capital allowances scheme we are able to keep our bills lower than they would otherwise be (further detail on page 17).

Helping our customers

We offer a range of options to help our financially vulnerable customers, including two social tariffs (watersure and watersure plus), a range of payment plan options, free meter fits, water efficiency freebies and our customer assistance fund. With the latter we helped 6,161 customers with nearly £4.5 million of debt in 2016/17.

Setting our bills

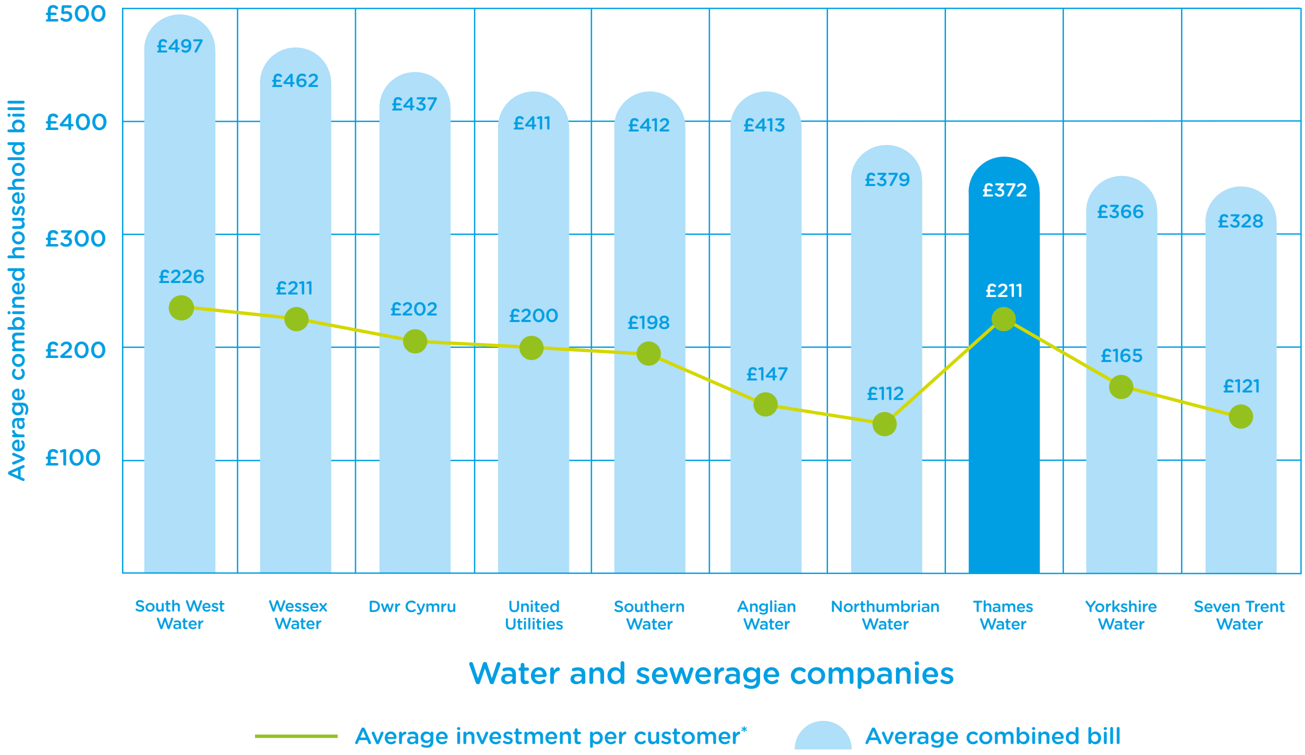
Making our bills affordable, while setting them at a level that enables us to meet our commitments, is something we need to get right. We consult with our customers at length about what they value most from Thames Water and what they are willing to pay for. We are also challenged independently by representative 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 agree this with Ofwat. This is a very rigorous process, known as a price review. At our last price review, completed in early 2015, we were the only company deemed by Ofwat to be more efficient than the official benchmark for both water and wastewater services. We're currently working hard on our next price review – PR19 – and have heavily involved our customers in the preparations.

> "Our average combined bills remain the third lowest in England and Wales.

Bills versus investment per customer*



Source: Industry data share 2016/17 and discover water.
*Defined as net wholesale water capex per water customer, plus net wholesale wastewater capex per wastewater customer

Thames Tideway Tunnel

To minimise the costs for our customers, we ran a comprehensive and competitive process to identify the best company to build the Thames Tideway Tunnel. In August 2015, an independent company, Bazalgette Tunnel Limited (BTL), secured a licence from Ofwat as a separate regulated utilities business to deliver the landmark construction project, which will divert millions of tonnes of sewage away from the River Thames.

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. Approximately £13 is already included in the 2017/18 bill. As we collect the cash, we pass it on to BTL for the construction of the tunnel. Amounts relating to BTL are presented separately in our financial statements. In 2016/17 our bills included £33 million.

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 2016/17 we incurred a penalty of £18.4 million and a reward of £3.2million.

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

Target: Stable
Performance in 16/17: Marginal
Penalty: £4.7 million

P

Condition of our above ground water network

Target: Stable
Performance in 16/17: Stable
On target

P

Drinking water compliance

Target: 99.94%
Performance in 16/17: 99.96%
On target

P

Condition of our below ground wastewater network

Target: Stable
Performance in 16/17: Stable
On target

P

Condition of our above ground wastewater network

Target: Stable
Performance in 16/17: Stable
On target

P

Security of supply index

Target: 100
Performance in 16/17: 99
Penalty: £2.3 million

P

Leakage

Target: 630 Ml/D
Performance in 16/17: 677 Ml/D
Penalty: £8.6 million

PR

Supply interruptions lasting more than four hours

Target: 0.13
Performance in 16/17: 0.12
Reward: £3.1 million

PR

Sewer flooding other causes

Target: 1,126
Performance in 16/17: 1,214
Penalty: £0.5 million

PR

Sewage treatment works discharge compliance

Target: 100%
Performance in 16/17: 98.28%
Penalty: £2.3 million

P

Pollution incidents

Target: 340
Performance in 16/17: 315
On target

PR

Reduction in the number of properties affected by odour

Target: 793
Performance in 16/17: 1,305
Reward: £0.1 million

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

Deephams sewage treatment works upgrade and Thames Tideway Tunnel connecting works

Performance in 16/17: Deephams sewage treatment works upgrade:
Delivered

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: Limited online
Performance in 16/17:
Limited online
On target

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

Ofwat metric:
Calculated over the AMP

Performance in 16/17: 77.3

PR

Reduce the amount of phosphorus entering rivers

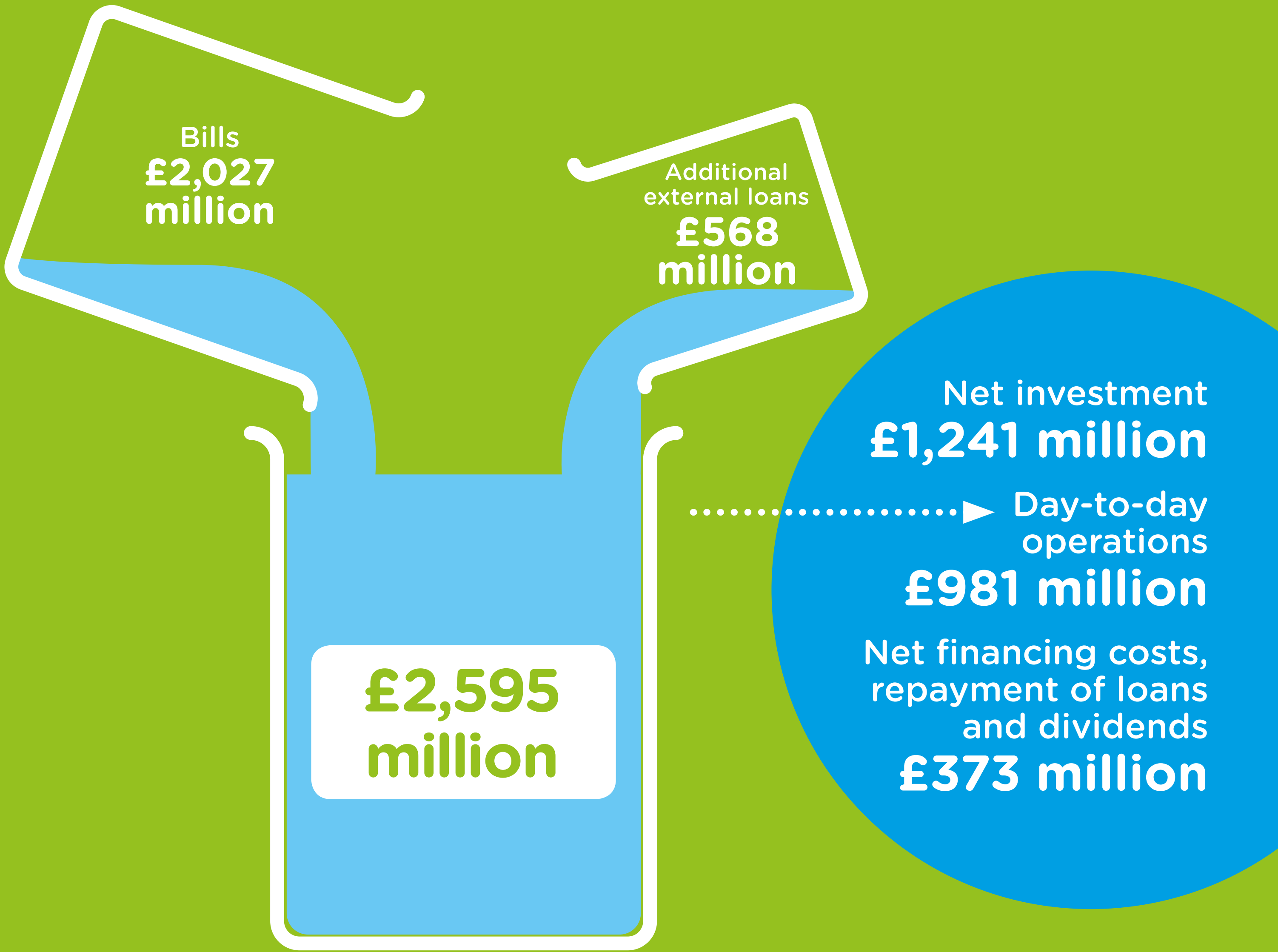
End of AMP target.

PR

P Can incur penalty

PR Can incur penalty or reward

Bridging the gap



For every £1 we collect from bills, we need an additional 28 pence (2016/17) to help fund our spending (page 6). To bridge this gap and avoid significant increases 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.

Our borrowings

Borrowings

We borrow money through a combination of bank loans and 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 a strong credit rating, 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. Although our S&P rating was downgraded from A- to BBB+ in July 2017, this still represents a strong investment grade rating and is three notches above the minimum required by Ofwat. Our Moody's corporate family rating of Baa1 is also strong investment grade. All our ratings are strongly placed in our peer group.

Interest on our debt

The water industry is considered a low risk investment, making it particularly attractive for pension funds and other similar financial institutions. This is reflected in our strong credit ratings and allows us to raise long term funding at competitive rates which, in turn, allows us to keep costs down for customers. We maintain conservative long-dated debt maturities (currently with an average tenor of approximately 18 years) to minimise refinancing risks. The average interest rate we incurred over the last year was 4.9% and we paid £352 million of interest 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 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. This reduces volatility in customer bills as they are protected from adverse movements in inflation rates and other financial risks.

What is 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 the 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 2017 our net debt was £10.7 billion, meaning our gearing ratio was 81.5%. By maintaining this level of gearing and a credit rating stronger than that required by Ofwat under our licence we are, in the long run, able to keep our bills a lot lower than they would otherwise be.

Cayman financing company

We are often asked why we have an international financing company registered in the Cayman Islands. This company exists solely to market and issue corporate bonds on the public market on behalf of Thames Water.

All of the funds are lent to Thames Water. This use of a Cayman Islands incorporated company is to address historic UK company law governing the repayment of the debt raised by the original group of shareholders in 2006 to acquire Thames Water. It is a structure used by a number of other UK based companies both within and outside the water sector. Everything this company does is entirely transparent to UK authorities and it is fully registered for, and subject to, tax in the UK. It also operates wholly from our UK office and provides us, our shareholders and investors with no tax advantage.

Our taxes explained

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

In 2016/17 we paid over £170 million in business rates, PAYE and national insurance contributions, which help fund the vital public services we all rely on. We incurred £124 million directly, mainly through business rates, and collected and paid £53 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 environment. Due to the size of our company and the amount we're investing, our taxes can appear complex. We've produced a separate document - **Our taxes explained** - to fulfil our commitment to be open and honest with our customers and explain our taxes in a simple way. It can be found at **corporate.thameswater.co.uk/About-us/Our-investors**.

> **"In 2016/17 we paid over £170 million in business rates, PAYE and national insurance contributions**

Our tax strategy

Our tax strategy is straightforward and is underpinned by five key policies to ensure we're a good corporate citizen.

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

We have been doing a great deal of work with our stakeholders in recent years to improve our dialogue on tax. In 2016/17, HMRC classified us as 'low risk' for the first time.

Our corporation tax

Governments across the world help companies to invest in critical infrastructure and in the UK there is a capital allowances framework. While we've been paying an average of more than £3 million a week in other taxes, like a lot of companies which spend billions of pounds on infrastructure, our payment of corporation tax is delayed while we invest so heavily to improve our vast and ageing network. As well as ensuring the resilience of our infrastructure to provide one of life's most essential ingredients, capital allowances also keep our customer bills lower than they would otherwise be.

In addition to capital allowances, our interest costs on debt, tax losses within our group of companies, pension contributions and depreciation of our infrastructure are just some of the other adjustments taken into account when calculating our corporation tax.

Our net "deferred" tax liability, as shown in our financial statements, is £877 million (end of March 2017).

Profits and dividends

Profits
Our profit is the revenue we have left after taking into account all of our day-to-day running costs, finance expense and taxes. In 2016/17 our profit after tax was £108.4 million which excludes the money passed over to BTL for the Thames Tideway Tunnel.

Dividends
Dividends are used for two purposes:

1 To pay for holding company obligations

Thames Water 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. Thames Water's dividends are initially paid to its immediate parent company (commonly referred to as a 'holding company'), Thames Water Utilities Holdings Limited, for distribution. These dividends flow through the group, in part to enable the group companies to pay for their own debt obligations and their own working capital requirements.

The money used to pay for the interest on group debt comes directly out of the dividend paid by Thames Water, so the cost of this debt is carried by the external shareholders, not customers. Any remaining dividends are paid to external shareholders.

In 2016/17 £57 million was paid to holding companies and other group companies to service their debt and pay for day-to-day cash needs.

2 Shareholder Returns

Our shareholders provide an essential source of funding. To attract the long term profile of investor that a company like ours requires, we are committed to distributing dividends when it is appropriate to do so.

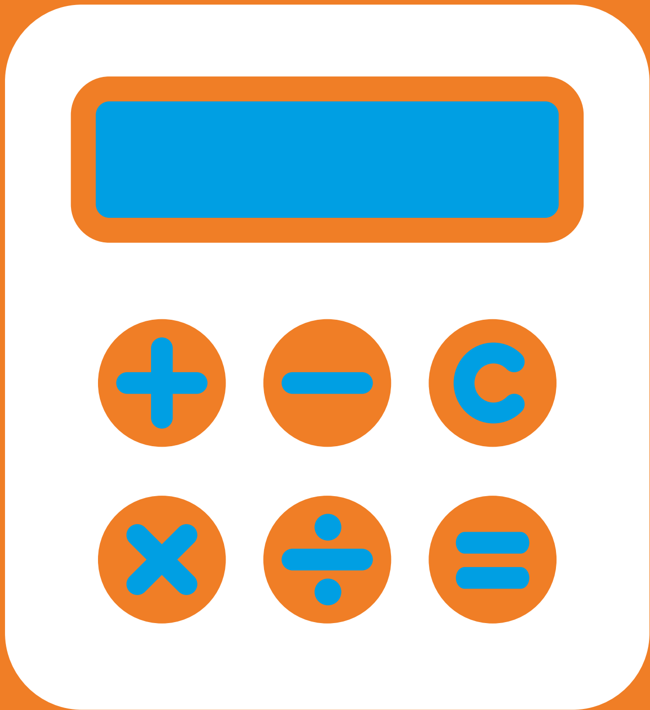
The level of dividend we choose to pay is determined by our operational and financial performance, and is not guaranteed. We make sure they are set at a level which enables us to continue to meet our obligations, maintain low bills for customers and keep investment at a high level. When we perform well, any dividend we pay to our external shareholders is seen as a return on the money they invested into our business.

£100 million was paid to external shareholders relating to 2016/17. Added to the £57 million paid to Group companies to service their debt obligations and working capital requirements, the distributions for 2016/17 represented a cash yield of 2.6% in 2016/17. This is calculated as the ratio between total dividend payments from Thames Water and a market-derived valuation of the business.

In 2015/16 no external dividend was paid while we managed the risks associated with selecting the independent company to construct the Thames Tideway Tunnel, even though investment in our infrastructure was over £1 billion that year.

Between 2006 and 2017 we invested over £12 billion in infrastructure and paid £1.257 billion in dividends to our external shareholders.

Pollution fine
In March 2017, we incurred a £19.75 million fine for a group of pollution incidents, which occurred between 2012 and 2014. The cost of this fine was borne by the shareholders, not customers.



Our ownership

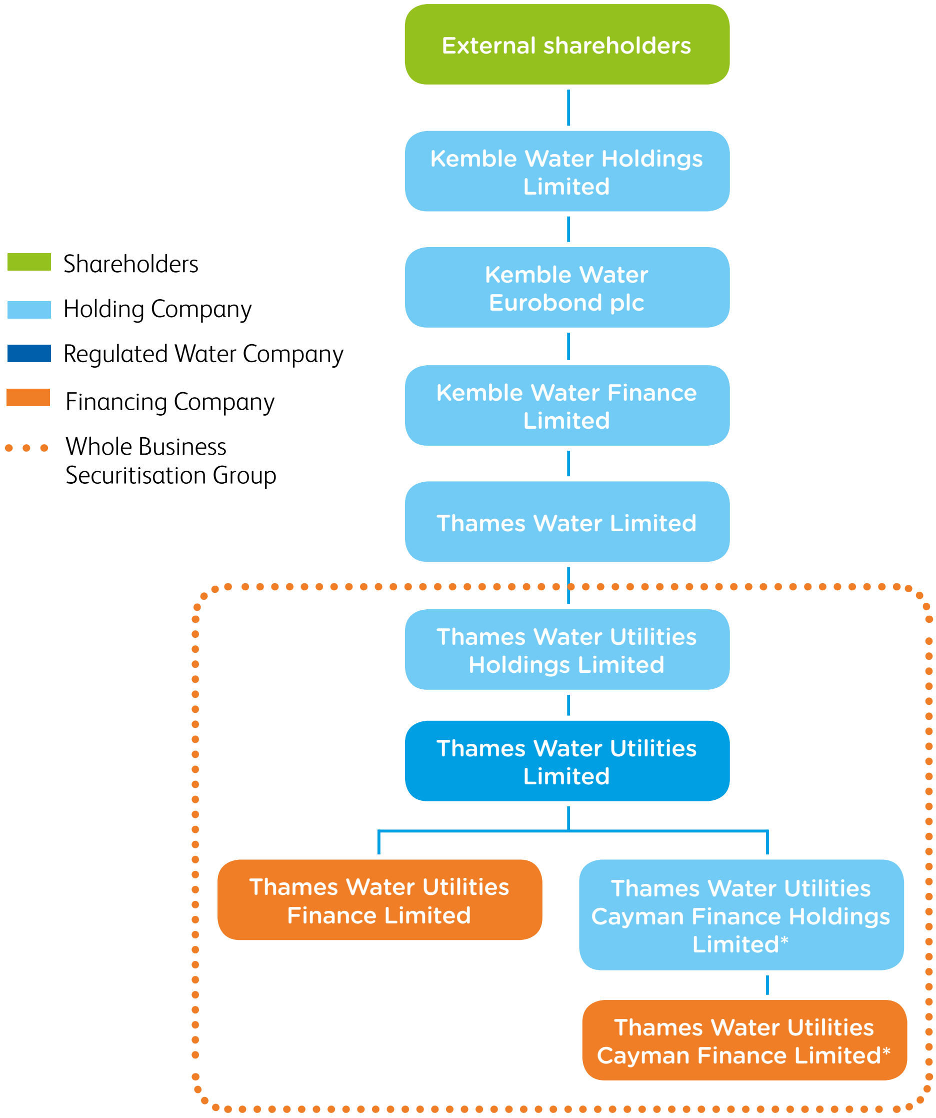
May 2017 saw a change in our largest shareholder. Ontario Municipal Employees Retirement System ("OMERS"), one of Canada's largest pension plans, and Wren House, the global direct infrastructure investment arm of the Kuwait Investment Authority, acquired the 26.3% managed stake from Macquire an Australian bank. OMERS has since agreed to increase its investment by a further 5.530%.

When our recent sales complete towards the end of 2017, Thames Water will be jointly owned by 14 institutional investors – made up mostly of pension funds and sovereign wealth funds. The three largest investors will represent pension funds – one based in Canada and two in the UK. All of our investors take a long-term view of the company's infrastructure, its customers and the natural environment.

Establishing a 'whole of business securitisation' structure

In 2007 a 'whole of 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



*Both Cayman Island companies are, and always have been, registered in the United Kingdom for tax purposes.
** You can find a full list of our current shareholders at corporate.thameswater.co.uk/About-us/Our-investors

> “We’ve been investing, on average per year, triple the amount we did per year for the five years before privatisation.

Our investment history

Average yearly investment in 2016/17 prices.

Five years prior to privatisation
£350 million

The water industry was privatised in 1989

1989 - 2001
£629 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
£716 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 and our operational performance has improved significantly as a result. OMERS and Wren House agreed to acquire the Macquarie-managed stake in May 2017.

*Investment in UK business.

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Our finances explained
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This leaflet can be supplied in large print, braille, or audio format upon request.

Cover image: Award-winning photograph of the Lee Tunnel by Matthew Joseph

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