Thames Water

Our taxes explained.

A guide to our tax strategy and tax profile
June 2017

Keeping it clear.

A clear tax strategy and greater tax transparency

At Thames Water, we take pride in fulfilling our responsibilities on tax and being transparent about how much we pay and why. 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.

A better understanding of taxation and what companies pay, and why, is vital. Taxes help fund crucial public services and civil infrastructure, without which a well-functioning society could not exist. Also, the recent erosion of public confidence in national and global tax regimes has contributed to a collapse of trust in Big Business – with damaging consequences for all. Each company has to demonstrate that it is a good corporate citizen.

Tax transparency is therefore a cornerstone in building trust with our customers and other stakeholders. Due to the size of our company and the amount we're investing in our business – over £12 billion in the last 12 years – our taxes can appear complex.

This document - *Our taxes explained* - has been designed to fulfil our commitment to be open and honest with our customers and explain our taxes in a simple way. In the next few pages you'll find our tax strategy and tax code of conduct, as well as information on our tax profile.

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. We've also adopted the Financial Reporting Council's recommendations on tax disclosures in our Annual Report, which was published in June 2017 and can be found on our website.

In 2016/17 we paid over £170 million in business rates, PAYE and national insurance contributions, which help fund those vital public services we all rely on. We incurred £124 million directly, mainly through business rates, and collected £53 million on behalf of our employees.

While we contributed over £170 million to the UK Government's finances, like a lot of companies which spend billions of pounds on infrastructure, we have not paid Corporation Tax. Governments across the world encourage companies to invest in critical infrastructure and in the UK there is a capital allowances scheme.

Under the scheme, which helps companies invest in UK infrastructure, our payment of corporation tax is delayed while we invest so heavily to improve our vast and ageing network - we're currently spending the equivalent of £20 million a week. 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.

Our financing company can attract misconceptions. Although we have a financing company and an insurance company incorporated overseas for legacy reasons, any profits generated by the entities are fully subject to tax in the UK.

This tax report is the first of its kind and we hope that it provides a better understanding of Thames Water and tax. This is just the start and we welcome your feedback on this document so we can enhance our tax transparency in future years.

Brandon Rennet
Chief Financial Officer

Our tax strategy.

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

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

Our contributions in 2016/17

6,161
Customers in hardship helped through our customer assistance fund

70
Apprentices or graduates recruited into the business

£177m
Total tax contribution in the UK

6,632
Hours given by employees to local causes

2.6bn
Litres of water delivered to customers every day

20%
Of energy generated from our own renewable sources

103km
Of water pipes replaced or repaired

£740,000
Invested in biodiversity projects

£20m
Invested in infrastructure in the region every week

20,000
School children met as part of our education programme

WaterAid
£93,000 pledged to our WaterAid campaign

Investing in critical infrastructure

1 We've invested over £12 billion in UK infrastructure during the last 12 years.

2 We're investing three times more a year than we did pre-privatisation.

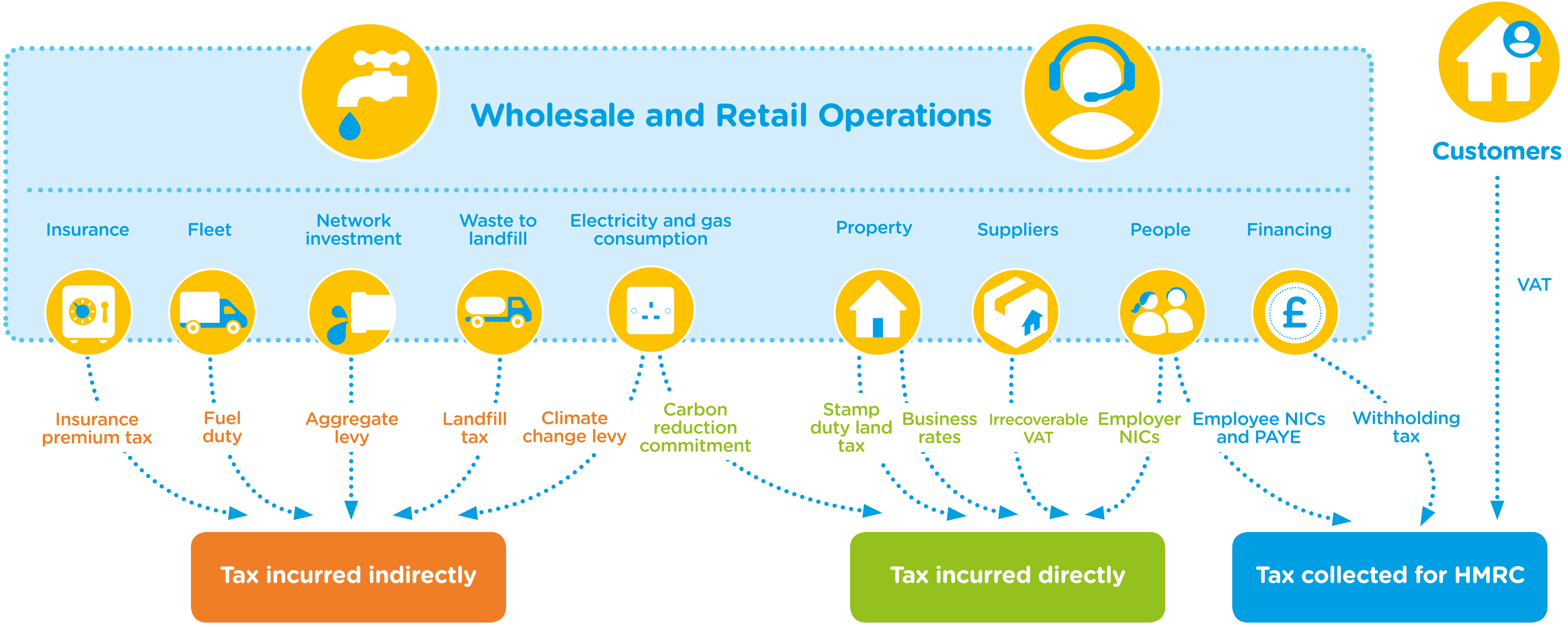
3 We've committed to investing a further £97 million in our largest water mains between now and 2020, in addition to over £4 billion we're spending as part of our 2015-2020 investment programme.

Just some of the projects we're working on

- A £250 million project to upgrade Deephams, one of our largest sewage treatment works
- Investing £120 million before 2020 in a multi-faceted solution to update our customer relationship management and billing capabilities to help improve our service to customers
- By 2020, we expect to have spent a total of £1.4 billion buying land and connecting our network to the landmark Thames Tideway Tunnel, which is set to transform the capital's rivers.
- We're investing heavily in important schemes outside the capital too including nearly £60 million on two water projects in Wiltshire and Oxfordshire and £8.4 million on a waste project in Didcot.

Our value chain.

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



Taxes paid in 2016/17

We incurred £124 million of taxes directly and collected a further £53 million on behalf of our employees in 2016/17. In total we paid £177 million over to HMRC

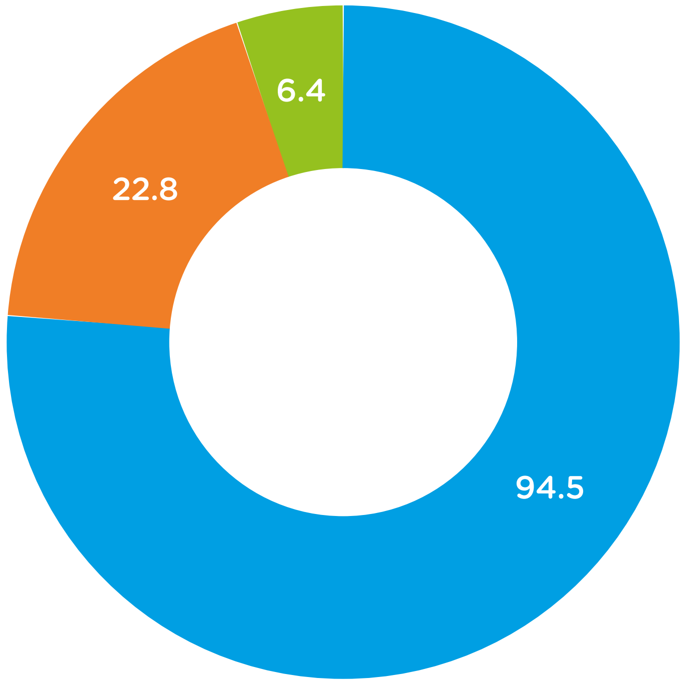
Key phrases referred to in our value chain

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

The taxes

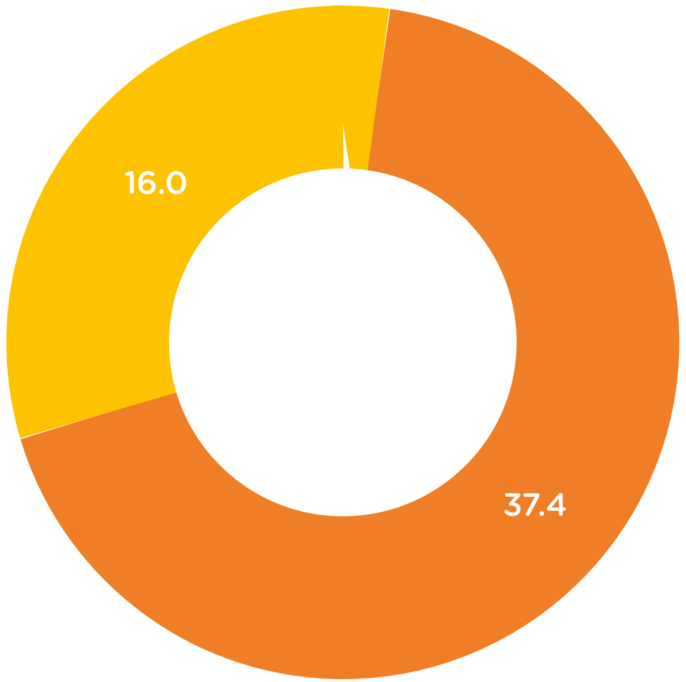
- **Insurance Premium Tax** – a tax levied on insurance premiums
- **Fuel Duty** – a duty on petrol, diesel and fuel used in vehicles
- **Aggregate Levy** – a tax on the extraction of rock, gravel and sand
- **Landfill Tax** – a tax on waste disposed of to landfill
- **Climate Change Levy** – a tax on 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
- **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

Whilst we incur and collect all of the above, only the largest amounts are shown opposite.



Taxes incurred directly (£124 million)

- Business rates
- Employer NICs
- Carbon reduction commitment



Taxes collected (£53 million)

- Employee PAYE
- Employee NICs

VAT has no net cost to us because our suppliers charge us VAT, which we recover from HMRC. We also collect VAT from customers which we pay over to HMRC.

Our Corporation Tax

> "We don't currently pay corporation tax mainly due to our huge investment programme - £12 billion in the last 12 years. The Government's capital allowances regime effectively allows us to delay payment of this tax until a time when our level of investment is lower."

We make significant investments in the UK and have invested £12 billion over the past 12 years, building and upgrading the water supply and waste water networks and services relied upon by our 15 million customers.

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 – they help to incentivise private capital to fund the critical infrastructure that would otherwise have to be paid for by public borrowing, or not built at all. The UK Government also provides tax relief to businesses for interest costs on debt raised to fund investment, again to stimulate activity that would otherwise have to be funded by the taxpayer.

It is difficult to reliably estimate when we will become Corporation Tax paying due to a number of uncertainties, including: our profitability, which is influenced by our performance and regulatory return; our level of capital investment, which drives capital allowances; and tax legislation and accounting changes.

Our 2016/17 draft Corporation Tax calculation

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 (20% in 2016/17, due to fall to 17% by 2020).

A representation of the draft tax computation for Thames Water Utilities Limited for 2016/17 is shown here.

We have taken tax deductions for:

1. **Capital allowances** – companies can claim a deduction for investment in critical infrastructure.
2. **Interest costs on debt**, as 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 whole profits of the group.
4. **Pension contributions**, as some contributions are not recognised in the income statement. This encourages pension savings.
5. **New service connections to our network** – this income is taxed by reducing capital allowances.

Our draft Corporation Tax computation 2016/17	£m's
Profit before tax per statutory accounts	71
Deduct:	
Capital allowances 1	(545)
Interest costs on debt 2	(76)
Group relief 3	(130)
Pension contributions 4	(31)
New services connections to our network 5	(26)
Add back:	
Depreciation of infrastructure 6	520
Fair value losses on derivatives 7	176
Disallowable costs (e.g. fines) 8	10
Large pension contributions 9	31
Taxable profits	**Nil**

We have added back the following:

6. **Depreciation of infrastructure** as capital allowances are deducted instead. In the early years, the depreciation costs are lower than capital allowances, which defers our tax
7. **Derivatives**, which are taxed based on their cash flows rather than accounting profits or losses.
8. **Disallowable costs**, for example fines.
9. **Large pension contributions** – tax deductions for particularly large pension contributions need to be spread over a number of years, so an adjustment is required

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. We no longer have any overseas trading activities, although continue to comply with administrative requirements for legacy companies incorporated overseas.

We have an insurance company incorporated in Guernsey which manages historic insurance claims, and a finance company incorporated in the Cayman Islands. It is important to note that **any profits generated by these entities are fully subject to tax in the UK**.

Guernsey company

Our captive insurance company manages legacy insurance claims against the Group for historic policies written up to 2008 (no new insurance contracts have been written since then and it is in a "run-off" phase). Although the company pays no tax in Guernsey and is not tax resident in the UK, **any profits arising in the company are fully taxable in the UK** under UK Controlled Foreign Company rules.

Country of incorporation	Tax residence	Tax paid (£m)	Revenue (£m)	(Loss) before tax (£m)	Reported current tax (charge) /credit (£m)	Number of employees /directors	Net assets/ liabilities (£m)
UK entities	UK	-	2,064.6	(122.7)	2.2[A]	4,974	1,368.1
Guernsey	Guernsey	–	–	(0.2)	–	4	5.6
Cayman Islands	UK	-	–	(81.7)	(1.2)[B]	4	(174.8)
Rest of world	Overseas	-	–	(0.1)	–	6	–
Total as per 2016/17 Group accounts		-	**2,064.6**	**(204.7)**	**1.0**[C]		**1,198.9**

[A] Includes group relief receivable from Thames Water Utilities Cayman Finance Limited (TWUCF)
[B] Relates to group relief payable by TWUCF
[C] No cash tax refund was actually received by the Group. This income statement credit relates to the release of an accounting provision for uncertain tax positions

Cayman companies

In 2007 we incorporated a finance company and a holding company in the Cayman Islands. A finance company raises funding for the group, for example by issuing bonds, and manages treasury aspects such as derivatives. The funds raised by the finance company have been lent to Thames Water Utilities Limited, primarily to fund our infrastructure investment programme. The holding company holds shares in the finance company and is inactive.

The use of a Cayman Islands incorporated finance company was solely to address the requirements of UK company law that existed at the time. In 2007, it was not possible for a UK company to issue public bonds to repay debt provided by investors to help finance its acquisition. These restrictions have now largely been amended or removed.

Although the companies are registered in the Cayman Islands for the historical legal reasons outlined above, they are, and always have been, resident in the UK for tax purposes. **This means that they are subject to tax in the UK**. There is no tax benefit associated with the companies being registered in the Cayman Islands and the companies operate and are managed wholly from our UK office.

OECD Country by Country Reporting rules

The Organisation for Economic Cooperation and Development (OECD) has developed rules requiring multinationals to provide information regarding their allocation of income, economic activity and taxes paid, among countries. The UK Government has implemented these rules, and they will apply to the Group in relation to 2016/17. An abbreviated version of the information that we expect to disclose to HMRC for these purposes is provided opposite.

Group structure

We have included a group structure on page 70 of our 2016/17 annual accounts, and also on our website, showing the ownership of Thames Water.

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.

Our tax strategy.

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

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

In 2016, HMRC categorised us as "low risk" for the first time in our history. We have worked hard to achieve this coveted status, and the tax policies that we are publishing here will ensure that our behaviour is consistent with, and contributes towards us maintaining, this status.

Tax policy 1.

To comply with all tax legislation requirements at all times, both within the letter and spirit of the law

Our principles:

- submitting all tax returns on time with accurate information and full disclosure;
- making tax payments on time, and;
- not applying an aggressive interpretation of the tax legislation.

How is this achieved?

Our Tax Department of five experienced professionals ensure all tax returns and payments are made on time. The Corporation Tax computations we submit to HMRC also include explanatory notes to ensure full disclosure.

The team use their experience and judgement to identify situations where the tax treatment of transactions may be uncertain. In such circumstances, we ensure that our position is fully supportable and the legislation is being applied in the manner in which it is intended, i.e. it is not an aggressive interpretation. In order to understand the intention of the legislation, we consider published HMRC guidance, leading tax commentary and, if necessary, obtain external tax advice.

Tax policy 2.

Not to use tax avoidance schemes or aggressive tax planning

What does 'tax avoidance' mean?

There is no universal definition of "tax avoidance" but HMRC says the following might indicate tax avoidance is taking place: "…the scheme is artificial or contrived; a tax haven is involved; the scheme involves money going around in a circle; the scheme involves arrangements which seem complex given what you want to do; offshore companies are involved with no commercial reason…". Taxpayers will generally know when they are engaging in a tax avoidance scheme; it is not entered into by mistake.

What does 'aggressive tax planning' mean?

Tax planning can mean anything from tax avoidance to a simple plan to utilise government tax reliefs in the manner in which they are intended. HMRC acknowledges that a taxpayer is "entitled to plan [their] tax affairs in a way that makes sure [they] do not have to pay more tax than [they] have to".

In our view, tax planning becomes "aggressive" when it is not underpinned by commercial and economic substance, or applies an aggressive interpretation of the tax legislation, in order to achieve a favourable tax position.

What is our attitude to tax avoidance and tax planning?

Our principles:

- we do not engage in tax avoidance schemes;
- we do not engage in aggressive tax planning, i.e. planning that is not underpinned by commercial and economic substance, or applies an aggressive interpretation of the tax legislation, and;
- we do plan our tax affairs to be efficient;

Tax planning in the context of one-off business transactions

Generally speaking, one-off business transactions such as disposals and debt refinancing can provide opportunities for tax planning and therefore it is important for our tax policy to be clear on this. The Tax Department is involved at the early stages of all significant business transactions in order to understand the potential options and the associated regulatory, accounting, commercial, and reputational implications.

Some options may have a more favourable tax outcome than others, and whilst we have a duty to shareholders and customers to keep tax costs low, only solutions that comply with our Tax Code of Conduct are implemented.

Our Tax Code of Conduct

- Ensures that non-tax considerations are taken into account when determining the most appropriate approach;
- Prevents us from undertaking transactions with no commercial or economic substance, or from taking an aggressive interpretation of the tax legislation;
- Requires external tax advice to be sought where the tax treatment is uncertain. This ensures that we understand the technical position, risks and benefits, and what might be regarded as an aggressive interpretation;
- Outlines the circumstances in which we will seek formal advance clearance from HMRC on a potential transaction;
- Outlines the circumstances in which we will disclose a transaction to HMRC on a real time basis and seek less formal confirmation on the tax treatment;

A paper is prepared for all significant business transactions outlining how it complies with our Tax Code of Conduct, and the associated risks and benefits. This paper is reviewed and approved by the CFO. The Tax Department works with the business throughout the life of a transaction to ensure that its implementation is in accordance with its original scope.

Tax reliefs

Tax reliefs and incentives are sometimes introduced by the Government to encourage investment and employment. We claim Government tax reliefs including R&D tax credits and capital allowances on fixed assets. We use external tax advisors to ensure that we comply with the rules, do not over (or under) claim, and understand what might be considered aggressive.

Use of tax havens

Whilst we have companies incorporated in Guernsey and the Cayman Islands, we do not use these for tax avoidance purposes, as explained previously.

Tax policy 3.

To engage fully and transparently with HMRC and other Government bodies, and to seek to resolve disputes in a co-operative manner

What do we mean?

HMRC's role is to ensure that taxpayers comply with the tax legislation. We acknowledge the importance of this role, and are committed to full and transparent discussion with HMRC on all tax matters. Tax legislation is complex and there are often areas of uncertainty which give rise to disagreements with HMRC. Where such situations arise, we are committed to full and open dialogue, and resolution based on the practical and technical arguments.

Where the Government issues public consultation documents on tax legislation which could materially affect us, we will submit representations with our views.

How do we achieve this?

We have regular discussions with HMRC to explain business transactions and issues to HMRC on a real time basis, and to listen to their views. We respond to any HMRC questions promptly and maintain dialogue even where we disagree with HMRC's position.

We acknowledge that errors do occasionally arise and we are committed to communicating any issues to HMRC, with proposed solutions, as soon as the facts become available.

Tax policy 4.

To adopt a conservative approach to tax risk management and apply a strong tax governance framework.

What does tax risk management mean?

Tax risk management means identifying the tax risks in our business, implementing suitable controls and determining what level of risk is acceptable. Tax risks can arise in a number of situations:

- Business transaction risk. For example, reorganisations, financing transactions and disposals can all give rise to tax risk. Under a low risk approach the business would not undertake reorganisations purely for tax avoidance purposes, or undertake refinancing transactions without consulting the tax department;
- Operational risk. For example, new operating models, new billing systems and IT platforms can all give rise to tax risk. Under a low risk approach the business would not implement a new billing system without consulting the tax department, instead sign off procedures would be in place;
- Compliance risk. For example, insufficient resources, system changes, legislative changes, lack of management, etc. can all give rise to tax risk. A low risk approach would address these aspects.

What does tax governance mean?

Tax governance refers to the responsibility and oversight of the Group's tax affairs. For example, the reporting framework for tax matters, and the seniority level at which tax is considered.

Our tax risk management

Overall policy

The Group's overall risk management policy is to be risk aware but not overly averse, except where it concerns health and safety, our reputation, or might result in a breach of legal or regulatory responsibilities (in which cases we are very averse). Our approach to tax risk management is consistent with this overall policy, i.e. we adopt a conservative approach in order to mitigate any potential adverse reputational implications.

Framework for managing tax risk

We are large and continually evolving. Evolution in the business arises from regulatory changes and change projects. Examples of recent change include the Thames Tideway Tunnel arrangements, the sale of our non-household retail business, market opening for non-household retail services and the introduction of new billing systems. As a consequence, there is potential for tax risk:

- Transaction tax risk arising from one-off business transactions is mitigated to an acceptably low level through the application of our Tax Code of Conduct, as previously explained;
- Potential operational and compliance tax risks are identified by the Tax Department through regular dialogue with senior members of the business units and central functions;
- All potential tax risks have been assessed by likelihood and impact, and processes and controls have been implemented to mitigate the risks to an acceptably low level. The controls are reviewed regularly for effective operation and improvements;
- The above framework allows the Group to comply with its Senior Accounting Officer (SAO) obligations;
- Our Audit and Assurance Department also reviews the Group's internal controls annually. Part of this review requires business unit CFO's to certify that their controls operate effectively and to notify the Tax Department of any changes;

A corporate risk register is maintained by the Audit and Assurance Department which documents risks, their potential impact and mitigating controls. The Group Tax Manager and CFO regularly review Thames Water's tax risks. The top corporate risks are communicated to and discussed at the Company's Audit, Risk and Regulatory Committee (ARRC) and Board. As the Group's principal activity is the delivery of water and sewerage services, the risks of the Group are largely the same as the Company.

Our tax governance

The day-to-day management of the Group's tax affairs is the responsibility of the Tax Department. The structure, roles and responsibilities of the Tax Department are clearly defined in a centrally held manual. The Tax Department is managed by the Group Tax Manager who reports to the CFO. The CFO is the Senior Accounting Officer (SAO) and has ultimate responsibility for the tax affairs of the Group.

The Board has ultimate responsibility for risk management and internal control. The Executive Team is responsible for ensuring effective risk management and internal controls, including maintaining the risk register and ensuring risks are mitigated within the risk appetite agreed by the Company's Board. The ARRC is responsible for providing risk management and internal control assurance to the Board, and overseeing the risk management process.

Significant tax developments potentially impacting the Group are communicated to the Company and Group Boards through the monthly management performance pack and Board meetings. Significant decisions concerning tax are escalated to the ARRC, Group Audit Committee and their respective Boards where deemed necessary by the CFO and Group Tax Manager.

Tax policy 5.

To accept only a low level of tax risk in relation to taxation.

What does "level of risk" mean?

The "level of risk" means the likelihood and impact of adverse tax consequences materialising. Adverse tax consequences has a wide meaning and includes any potential reputational damage, downgrading of our HMRC risk rating, unexpected tax liabilities, penalties etc. A high risk approach (e.g. using tax avoidance schemes) has the potential to create value and reduce costs, but has the significant associated risk of reputational damage, unexpected tax liabilities, and exposure to penalties. Conversely, a "no risk" approach may create little value and be costly to maintain, but has reputational benefits.

Level of risk acceptable

We are willing to accept only a low level of risk in relation to taxation. We believe that this is consistent with our approach to tax risk management and governance, and our attitude to tax planning, as explained previously.

Our policy on the level of acceptable tax risk has been agreed by the Board and provides a clear and sustainable framework for the future. It is influenced by our perception of what our customers, employees, the wider public and media expect of us, and the potential adverse reputational implications that might arise if we were to adopt a higher risk policy.

Like any large group, there will be occasions where we disagree with HMRC. However, our tax policies reduce the likelihood and impact of such instances. Where disagreements do arise, we will be robust in our defence where we believe we are applying the legislation in the manner in which Parliament intended

We regard the publication of our tax strategy on pages 18 to 22 as complying with our duty under paragraph 16(2) of Schedule 19 Finance Act 2016 in the current financial year of 31 March 2018.

Glossary

20XX/XY	Year ending 31 March 20XY	NIC	National Insurance contributions
CFO	Chief Financial Officer	PAYE	Pay As You Earn
Company	TWUL	Thames Water	Thames Water Utilities Limited
Group	KWH and its subsidiaries	TWUL	Thames Water Utilities Ltd
HMRC	Her Majesty's Revenue & Customs	VAT	Value Added Tax
KWH	Kemble Water Holdings Ltd		

Get in touch.

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

Thames Water

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