Thames Water Utilities Limited (“TWUL”)

Tax on ODI Payments Response to 2022-23 In-Period Draft Determination

October 2023

EXECUTIVE SUMMARY

Introduction

Thames Water welcomes the opportunity to respond to Ofwat's draft determination of our in-period outcome delivery incentives ("ODI") for 2022-23.

We are pleased that Ofwat has confirmed that our 2022-23 ODI performance is as reported in our Annual Performance Report ("APR") published in July and note Ofwat's comments in relation to leakage. As detailed in our Reporting Criteria, we have classified one overall component as non-compliant with the common guidance on leakage (household night use). We continue to adapt our approach for the inclusion of continuous flows in our calculation. We are also developing tools to allow us to improve the accuracy of our night usage in small blocks of flats. We hope to have improvements in place for APR24.

However, we disagree with Ofwat's draft determination in relation to retaining a marginal tax rate of 25% on ODI payments for 2022-23 that will impact 2024-25 allowed revenue as we believe this has a material adverse impact on our customers.

This response sets out the key considerations of Ofwat's draft determination on Thames Water Utilities Limited ("TWUL") and the material adverse impact on customers. It also provides further support for the application of a zero marginal tax rate on Thames Water's ODI payments.

In addition, this response clarifies how Thames Water's efficient management of its tax affairs over several AMPs delivers benefits to customers as the routine restriction of capital allowances claims by TWUL in order to utilise tax losses from other group companies has minimised tax allowances, thereby reducing customer bills.

Marginal Tax Rate and Gross-Up for ODI Payments

The key considerations on the marginal rate of tax in respect of the gross-up for ODI payments are:

- It is in customers' interests that the marginal tax rate on ODI payments is reduced in AMP7, and not left to be adjusted as part of PR24:
  - It avoids Thames Water being forced to reduce 2024-25 expenditure due to lower revenues, in a period where it is already committed to significantly overspend totex assumed in the PR19 Final Determination to deliver improved customer outcomes;
  - It mitigates the volatility in customer bill profiles between the end of AMP7 and the beginning of AMP8, particularly in the context of the ongoing cost of living crisis.

- TWUL has very high confidence that we will not incur any tax payment in AMP7, and consequently the decision over the tax rate to apply to ODI payments should not be deferred as part of PR24.

- TWUL anticipates being in a zero tax liability position throughout the 2020–25 period. We therefore request that Ofwat reconsider our request to apply a 0% marginal tax rate to the ODI payments for 2022-23 that will impact 2024-25 allowed revenue, and that the marginal tax rates applied to the 2020-21 and 2021-22 in-period determinations are retrospectively amended to 0% to be consistent with the approach taken for Welsh Water and Southern Water; these adjustments would need to be made during the setting of our 2024-25 allowed revenues and tariffs.

Surrender of Tax Losses

Thames Water has a well-established approach to managing its tax affairs efficiently, as part of a tax group including other companies in the Kemble Group, which is to the long-term benefit of its customers.

We note that:

- 2022-23 was an exceptional year with significant tax-deductible costs incurred in excess of those allowed in the PR19 Final Determination, thereby leading to significant tax losses. The costs causing these losses were not used to determine allowed revenues and the majority of them were surrendered to other companies in the Kemble Group. Therefore, it does not appear appropriate for the surrender of losses in itself to have any bearing on the tax gross-up for future ODI payments.

- As noted, 2022-23 was an exceptional year with the surrender of losses by TWUL, whereas the norm is for losses to be surrendered by other group companies to TWUL, which has delivered true ongoing value for customers over several AMPs. Thames Water's efficient management of its tax affairs includes the routine restriction of capital allowances claims by TWUL in order to utilise tax losses from other group companies. This has resulted in higher capital allowances pool values, leading to the availability of higher capital allowances claims in subsequent years, such that tax allowances in future AMPs are minimised, thereby reducing customer bills.

- If the surrender of losses by TWUL is to be considered for 2022-23 ODI payments, then it appears wholly appropriate to review the longer-term benefit to customers since TWUL became a member of the current tax group and has historically been the recipient of surrendered losses. Compared to the c.£506m of tax losses surrendered by TWUL in 2022-23, from AMP4 to AMP7 to date, losses totalling c.£2,290m have been surrendered by other group companies to TWUL.

- If tax losses are not surrendered to other companies in the Kemble Group, then the 2022-23 tax losses would be carried forward by TWUL and no benefits to customers would be forecast to be derived from them within either the 2020-25 period or within AMP8.

- If Ofwat consider that the receipt of value from the surrender of 2022-23 tax losses to other group companies means that the precedent set by the in-period determinations applied to Welsh Water and Southern Water and the benefits to customer bill stability do not apply to TWUL, then based on Ofwat guidance, we request that any tax gross-up applied to the ODI payments for 2022-23 is limited to the tax allowance actually funded by customers in AMP7; any additional gross-up constitutes an unfair gain for customers.

Conclusions

In summary:

- It is in customers' interests that the marginal tax rate on ODI payments is reduced in AMP7 and not left to be adjusted as part of PR24 to avoid TWUL having to reduce expenditure that would otherwise be spent on delivering improved customer outcomes and to ensure smoother customer bill profiles between AMPs.

- TWUL anticipates being in a zero tax liability position throughout the 2020–25 period; therefore, a 0% marginal rate should apply to the ODI payments for 2022-23 and also retrospectively be applied to the 2020-21 and 2021-22 in-period determinations.

- If the receipt of value from the surrender of 2022-23 tax losses by TWUL to group companies means that a tax gross-up should be applied to ODIs for 2022-23, then any such gross-up should be limited to the tax allowance actually received for AMP7 because:
  - Ofwat guidance states that (i) ODI payments return funding to customers, and (ii) the full tax value of any losses surrendered is deducted from the tax allowance; and
  - the underlying costs which caused the exceptional 2022-23 tax losses were not used to determine allowed revenues, and therefore any receipts from the surrender of such tax losses should be excluded from any ODI tax gross-up calculation to avoid customers unduly gaining.

- If instead of surrendering tax losses to group companies the 2022-23 tax losses are carried forward by TWUL, no benefits to customers are forecast to be derived within either the 2020-25 period or within AMP8.

- Based on currently available forecasts, we can provide Ofwat with a high degree of certainty that there is nothing that we are aware of that would cause us to believe that the above conclusions would change during the remainder of AMP7.

BACKGROUND

In August 2023, we submitted representations requesting Ofwat to consider applying a 0% marginal tax rate to Thames Water's ODI payments for 2022-23 that will impact 2024-25 allowed revenues, and that the marginal tax rates applied to the 2020-21 and 2021-22 in-period determinations are retrospectively amended to 0% to be consistent with the approach taken for Welsh Water and Southern Water; we requested that these adjustments would be made during the setting of our 2024-25 allowed revenues.

In September 2023, Ofwat published its draft determination of in-period ODI's for 2022-23 ("Ofwat DD") stating the following:

> *"In our 2022-23 in-period ODI draft determination, we retain a tax rate of 19% because the evidence submitted by the company did not convince us that a different tax rate should be applied at this time. We note that the company's tax computations show it expects to*

> *be profitable in 2023-24 and 2024-25, and that it expects tax on these profits to be covered by the available capital allowances. The company also confirms that it is surrendering tax losses to group companies and receiving tax credits. The total value of tax losses surrendered will be finalised by March 2024. As these tax losses have a value if other group companies are able to use them, we consider it is possible that the company will benefit within the 2020-25 period from the additional tax losses. We will be in a better position to consider whether such an adjustment to tax is appropriate as part of our decisions for the 2024 price review (PR24) determinations, when we will have information on the value of tax losses surrendered by the company over 2020-25 and the company's proposed opening tax loss balance at PR24."*

On 4 October 2023, a meeting was held between representatives from Ofwat and Thames Water to clarify and understand the reasons for Ofwat's draft determination prior to our response.

The following sections set out the key considerations for why we disagree with Ofwat's draft determination in relation to retaining a tax gross-up on ODI payments.

KEY CONSIDERATIONS

1. Why the marginal tax rate on ODI payments should be reduced in AMP7 rather than adjusted within PR24

The Ofwat DD states:

> *"We will be in a better position to consider whether such an adjustment to tax is appropriate as part of our decisions for the 2024 price review (PR24) determinations…"*

We consider that it is in our customers' interests to properly reflect the tax impact of AMP7 ODI's within the same AMP rather than being deferred to PR24 as this results in a more appropriate representation of the outcome in customer bills. Our PR24 Business Plan shows a need for sizeable customer bill increases as we enter AMP8. Having a material reduction in bills for the final year of AMP7 relative to what they otherwise would be, only to have an even steeper increase in the subsequent years of AMP8, is not consistent with the desire of customers to have stable bills with as smooth a bill profile as possible.

As set out in our August 2023 representation, the impact on our 2024-25 allowed revenues of applying a 25%[1] marginal tax rate to the 2022-23 ODI payments rather than a 0% marginal tax rate is c.£43m (nominal prices). Leaving this matter to be adjusted as part of the PR24 process will have a significant negative impact on 2024-25 operating cash flow. [redacted] Thames Water would have to take direct action to reduce expenditure in 2024-25 by c.£43m on operational activities and resources that would otherwise deliver improved outcomes for customers.

As noted in our August 2023 representation, we appreciate that Ofwat have previously stated that adjustments to allowed revenues due to the actual tax payable position of a water company in AMP7 being different to the position assumed in the PR19 Final Determination would be

[1] The corporation tax rate increased from 19% to 25% with effect from April 2023.

considered at PR24[2]. However, due to the material adverse impact of applying a 25% marginal tax rate to ODI payments on our allowed revenues for 2024-25, we believe that using a 0% marginal tax rate will be in the best interests of customers, avoiding a reduced level of expenditure on delivering customer outcomes and providing less bill volatility, particularly as we move from AMP7 into AMP8 as set out below:

- The PR24 Financial Model (see Appendix 1) is forecasting a tax allowance in AMP8 of [redacted] (nominal prices), and so if the c.£43m marginal tax rate adjustment is deferred to PR24, the overall impact of tax on AMP8 allowed revenues would increase to [redacted] when converted to real 2022-23 prices.

- Our PR24 Business Plan submissions also include the Tax Reconciliation model which, amongst other items, reflects the impact of changes in tax rates and changes to the capital allowances regime that were outside the company's control. The Tax Reconciliation model has produced a [redacted] (2017/18 real prices) increase in the AMP7 tax allowance. However, as the Tax Reconciliation is an end-of-period reconciliation that takes the form of a revenue adjustment, the required adjustment will be made at PR24 and would affect companies' allowed revenue over the 2025-30 period[3].

- Therefore, deferring the c.£43m marginal tax rate adjustment to PR24 would increase the overall impact of tax on AMP8 allowed revenues to [redacted] when converted to real 2022-23 prices (i.e.[redacted] AMP8 inherent tax allowance, plus [redacted] tax reconciliation, plus £43m ODI payments tax gross-up adjustment, restated in real 2022-23 prices).

- On the other hand, reducing the ODI payments tax gross-up impact on 2024-25 allowed revenues instead of deferring it to PR24 will keep customer bills throughout AMP8 at a lower level than they otherwise would be, and thereby result in a smoother customer bill profile from the last year of AMP7 into AMP8.

[redacted] we have very high confidence/near certainty, that even with significant variance to plan[4] we will not incur any tax payment in AMP7 (see Appendix 2). As TWUL anticipates to be in a zero tax liability position throughout the 2020–25 period, we request that Ofwat reconsider our request to apply a 0% marginal tax rate to the 2022-23 ODI payments that will impact 2024-25 allowed revenue, and that the marginal tax rates applied to the 2020-21 and 2021-22 in-period determinations are retrospectively amended to 0% to be consistent with the approach taken for Welsh Water and Southern Water; these adjustments would need to be made during the setting of our 2024-25 allowed revenues and tariffs.

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[2] Sector overview: Final determinations of in-period outcome delivery incentives for 2020-21, section 2.2.4, Ofwat, November 2021.

[3] PR19 Reconciliation Rulebook: Guidance Document, page 141.

[4] The forecasts in Appendix 2 show capital allowances disclaimers of [redacted] in 2023-24 and [redacted] in 2024-25. Therefore, profits would have to increase by over [redacted] and [redacted] in each of these years respectively before brought forward tax losses would start to be partially utilised, resulting in any tax liability in AMP7.

As a result of the above, there is no material uncertainty in relation to our tax payment profile in AMP7 and so the decision over the tax rate to apply to ODI payments should not be deferred as part of PR24.

2. Maximum amount of tax gross-up to be applied to AMP7 ODIs

The Ofwat DD states (emphasis added):

> *"ODIs act as an incentive for companies to deliver their committed levels of performance, **returning funding to customers** for foregone benefits if they deliver less than is expected."*

As noted in our August 2023 representation, the tax allowances inherent within our AMP7 allowed revenues per the PR19 Final Determination[5] amounted to £3.8m (2017/18 real prices). It follows from the above statement in the Ofwat DD that the return of funding to customers through any allowed revenue reduction due to tax on ODI payments cannot exceed the £3.8m tax allowance actually received for AMP7. On this basis customers are not losing out and equally are not unduly gaining.

3. Surrender of 2022-23 tax losses to group companies

After many years of tax losses being surrendered to TWUL as part of our efficient management of the Group's corporation tax affairs (see section 7), 2022-23 was an exceptional year where significant tax losses were incurred and tax losses were surrendered by TWUL to other group companies.

As noted in our August 2023 representations, our APR23 and TWUL Group's[6] 2022-23 statutory accounts reflect the provisional surrender of c.£506m of tax losses from TWUL Group to other group companies giving rise to a tax credit in TWUL Group and a corresponding provisional group relief receivable balance of c.£96m calculated at the statutory 19% corporation tax rate; i.e. TWUL would receive full value for the surrendered tax losses at the prevailing statutory tax rate.

The Ofwat DD states:

> *"The company also confirms that it is surrendering tax losses to group companies and receiving tax credits. The total value of tax losses surrendered will be finalised by March 2024. As these tax losses have a value if other group companies are able to use them, we consider it is possible that the company will benefit within the 2020-25 period from the additional tax losses."*

However, Ofwat's PR19 guidance[7] states (emphasis added):

> *"…if a company transfers losses from the appointed business to another group company, these should be paid for at full value (based on the headline tax rate). **We will deduct the full tax value of any losses surrendered in this way from the tax allowance**. **This approach***

[5] PR19 final determinations: Thames Water – Allowed revenue appendix, Ofwat, December 2019.

[6] "TWUL Group" comprises Thames Water Utilities Ltd ("TWUL") and its financing subsidiary, Thames Water Utilities Finance plc ("TWUF").

[7] Delivering Water 2020, Our methodology for the 2019 price review, Appendix 12: Aligning risk and return, page 107.

> *will ensure that customers do not lose out as a result of losses being transferred out of the company that could otherwise be offset against tax liabilities in the future*"

and equivalent guidance was issued for PR24[8].

The first underlined statement above provides further support for limiting the return of funding to customers through any allowed revenue reduction due to tax on ODI payments to the £3.8m tax allowance actually received for AMP7.

With regard to the second underlined statement above, it should be noted that any comparison of the value of tax losses surrendered to group companies against the value of tax losses carried forward should take account of the net present value of the forecast benefits to customers of offsetting carried forward losses against future tax liabilities – see section 8.

4. Has the 2022-23 tax loss arisen from costs that were used to determine allowed revenues?

TWUL is forecast to incur [redacted] of tax losses in 2022-23; incurring tax losses of this magnitude is highly unusual for this company. As opposed to factors such as high capital allowances claims[9], the most significant driver for this tax loss was the impact of increased inflation in 2022-23 on TWUL Group's portfolio of RPI linked debt resulting in a significant amount of interest expense. Consequently, 2022-23 accounting profit suffered a [redacted] charge from RPI accretion on swaps and loans, all of which is tax deductible.

However, as the [redacted] of debt accretion costs was not funded by customers in PR19 or through any subsequent true up process, and as these costs are included in the c.£506m of tax losses that have been surrendered to group companies in respect of which TWUL receives value, it follows that customers should not benefit from the receipt of such value. Therefore, in these circumstances, there appears to be no justifiable basis to use the receipt of value from the surrender of TWUL's 2022-23 tax losses to gross-up 2022-23 ODI payments.

On the other hand, it should be noted that customers will benefit from the [redacted] of tax losses carried forward from 1 April 2023[10] even though this loss has arisen from costs that were not used to determine allowed revenues:

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[8] Creating tomorrow, together: Our final methodology for PR24, Appendix 10 – Aligning risk and return, page 36-37.

[9] The PR19 Final Determination included a [redacted] tax loss for 2022-23 which was based on full capital allowances claims per Ofwat's Price Review methodology. However, the [redacted] forecast tax loss for 2022-23 is based on capital allowances claims being minimised as far as possible in order to minimise the tax loss, as customers are likely to benefit faster from higher future capital allowances claims to reduce future tax allowances as opposed to waiting for tax losses carried forward to offset against future taxable profits (i.e. due to the operation of the tax loss restriction rules which limit the use of brought forward tax losses to 50% of taxable profits).

[10] TWUL is forecast to incur [redacted] of tax losses in 2022-23, of which [redacted] is forecast to be used by TWUL's subsidiary, TWUF (i.e. utilised within TWUL Group) leaving TWUL Group with a net loss for the year of [redacted]. Of this, c.£506m is forecast to be used by group companies outside of TWUL Group, and [redacted] is forecast to be carried forward by TWUL for use in future periods. The 2022-23 tax loss is based on minimised claims for capital allowances claims as far as possible. This benefits customers as capital allowances pool values are higher, leading to higher capital allowances claims in future years such that tax allowances in future AMPs are lower, thereby reducing customer bills.

- Tax losses carried forward offset against future taxable profits, thereby reducing tax allowances in future AMPs.
- As the [redacted] 2022-23 tax loss derives from the [redacted] debt accretion costs, it follows that the [redacted] losses carried forward also derive from such debt accretion costs.
- Therefore, customers will benefit from the [redacted] losses carried forward even though they have not arisen from costs that were used to determine allowed revenues.

5. Is there a benefit within the 2020-25 period from the surrender of 2022-23 tax losses to group companies?

The Ofwat DD states:

> *"As these tax losses have a value if other group companies are able to use them, we consider it is possible that the company will benefit within the 2020-25 period from the additional tax losses."*

and

> *"…we will have information on…the company's proposed opening tax loss balance at PR24".*

It is not clear why the receipt of value from the surrender of tax losses should directly impact the marginal tax rate applied to ODI payments.

- Where tax losses arise from costs that have been funded by customers, and if those tax losses are sold to group companies, then perhaps in such a scenario grossing up ODI payments to recover such loss of value to customers could be understood.
- However, as set out in section 4, the 2022-23 tax loss was exceptional and has arisen from costs that have not been used to determine allowed revenues. Therefore, in our case, grossing up ODI payments to recover the value of losses sold to group companies does not appear to be appropriate.

In any case, if instead of surrendering tax losses to group companies the 2022-23 tax losses are carried forward by TWUL, no benefit to customers is forecast to be derived within the 2020-25 period:

- As noted above, [redacted] of tax losses are forecast to be carried forward by TWUL from 2022-23 for use in future periods. The opening brought forward tax losses forecast in the PR24 Financial Model is also [redacted] (see Appendix 1). This is because our calculations supporting the opening tax loss balance for AMP8 are based on disclaiming capital allowances in 2023-24 and 2024-25 in order to avoid creating further tax losses (see Appendix 2); as noted in footnote 10, the disclaimer of capital allowances benefits customers.
- Therefore, none of the [redacted] of tax losses carried forward from 2022-23 are forecast to be used during the 2020-25 period. Consequently, if instead of surrendering the c.£506m of tax losses to group companies, TWUL's 2022-23 final tax return is submitted to HMRC

in March 2024 on the basis that [redacted] of losses are carried forward, none of the additional tax losses carried forward would be utilised during the 2020-25 period. As none of these additional losses carried forward are forecast to generate any tax savings during AMP7, there is no benefit to customers forecast to be derived from such tax losses in this period.

For analysis of any benefit to customers in future AMPs, see section 8.

Furthermore, as grossing up the 2022-23 ODI payments reduces 2024-25 allowed revenues by c.£43m, it may be considered that this would generate additional tax losses in 2024-25 in respect of which the company could benefit. However, TWUL routinely restricts its capital allowances claims in order to avoid creating tax losses as far as possible (see footnotes 9 & 10). Therefore, if 2024-25 revenues were reduced, to offset this, additional capital allowances would be disclaimed such that there would be no additional tax loss created in 2024-25, and hence there would no forecast tax benefit to the company (or to customers) from any gross-up of ODI payments within AMP7.

Based on currently available forecasts, there is nothing that we are aware of that would cause us to believe that the above conclusions would change during the remainder of AMP7.

6. Value of tax losses surrendered by the company over 2020-25

The Ofwat DD states:

> *"We will be in a better position to consider whether such an adjustment to tax is appropriate as part of our decisions for the 2024 price review (PR24) determinations, when we will have information on the value of tax losses surrendered by the company over 2020-25"*

We are not aware of anything in the PR24 submissions that show if TWUL receives value for the 2022-23 tax losses it is currently forecast to surrender to group companies. Likewise, we are not aware of anything in the PR24 submissions that show whether any losses in 2023-24 and 2024-25 are expected to be surrendered to group companies.

In any case, the following should be noted for the 2020-25 period:

- No tax losses were surrendered by TWUL Group to group companies in 2020-21 or 2021-22; instead tax losses were surrendered to TWUL in both of these periods leaving the company with zero taxable profits (see section 7);
  - it should be noted that the 2020-21 and 2021-22 ODI payments suffered tax gross-ups even though the company was in a zero taxable profits position, no tax allowance was received in respect of those years, and there was no surrender of tax losses by TWUL to group companies in either of those years.

- The tax loss position for 2022-23 is covered in detail above.

- Based on currently available forecasts for both 2023-24 and 2024-25[11], it is not expected that TWUL would be surrendering tax losses to other group companies;
  - as noted in section 5 and as set out in Appendix 2, our calculations supporting the opening tax loss balance for AMP8 are based on disclaiming capital allowances in 2023-24 and 2024-25 in order to avoid creating tax losses (i.e. leaving the company with zero taxable profits;
  - alternatively, as with 2020-21 and 2021-22, for the actual tax returns submitted to HMRC, it is expected that further capital allowances would be disclaimed to enable losses to be surrendered to TWUL for both 2023-24 and 2024-25 leaving the company with zero taxable profits.

Even if tax losses do subsequently arise in 2023-24 and 2024-25 which are surrendered to group companies, as explained above, to the extent that the losses are not caused by costs that have been funded by customers, then any value received should be excluded from the calculation of allowed revenues.

Therefore, based on currently available forecasts, there is nothing that we are aware of that would cause us to believe that the above conclusions would change during the remainder of AMP7.

7. Group relief actually received by TWUL during AMP7

The significant tax loss incurred by TWUL in 2022-23 was very unusual. TWUL Group has never incurred such tax losses in prior periods and has never previously surrendered tax losses to group companies; i.e. 2022-23 is the first time that this scenario has arisen.

If the surrender of losses by TWUL is to be considered for 2022-23 ODI payments then it appears wholly appropriate to review the longer-term benefit to customers since TWUL became a member of the current tax group and has historically been the recipient of surrendered losses. TWUL routinely disclaims capital allowances in order to create sufficient taxable profits to offset tax losses from its parent company, Thames Water Utilities Holdings Ltd ("TWUHL"). For example, during AMP7 to date, TWUL Group received tax losses from TWUHL of c.£48m and c.£90m in 2020-21 and 2021-22 respectively leaving TWUL with zero overall taxable profits. In prior AMPs, TWUL received the following amounts of tax losses from group companies:

- AMP4 £980m
- AMP5 £746m
- AMP6 £425m.

So, compared to the c.£506m of tax losses surrendered by TWUL in 2022-23, from AMP4 to AMP7 to date, losses totalling c.£2,290m have been surrendered by other group companies to TWUL.

It should be noted that our regular management of our corporation tax affairs generates benefits for customers as our routine capital allowance disclaimers over several years in order to utilise tax

[11] These forecasts were based on there being no reduction in allowed revenue from any tax gross-up of 2022-23 ODI payments.

losses from other group companies have resulted in higher capital allowances pool values, leading to the availability of higher capital allowances claims in future years, such that tax allowances in future AMPs are minimised, thereby reducing customer bills.

Payments to group companies for the use of tax losses are akin to tax payments to HMRC. However, it should be noted that we have not sought to recover such tax payment amounts within a tax allowance as we have understood that customer funding is calculated on the basis of full claims for capital allowances within Ofwat's Price Review methodology. In addition, Ofwat guidance at PR19[12] and PR24[13] states:

> *"We will not seek to recover any additional amounts where group relief has been used to offset tax liabilities in excess of the tax allowance for the 2020-25 period, as those liabilities have not been funded by customers."*

Therefore, as payments to group companies for the use of tax losses in excess of the tax allowance (i.e. as explained above where we have disclaimed capital allowances in prior periods) are not recovered from customers through mechanisms administered by Ofwat (as they have not been funded by customers), it follows that the receipt of value from the surrender of our 2022-23 tax losses in excess of the tax allowance should not benefit customers through mechanisms administered by Ofwat (as they have not been funded by customers – see section 4)[14].

8. Value of 2022-23 tax losses in future AMPs if carried forward instead of surrendered to group companies

As noted above, Ofwat's PR19 guidance states (emphasis added):

> *"…if a company transfers losses from the appointed business to another group company, these should be paid for at full value (based on the headline tax rate). We will deduct the full tax value of any losses surrendered in this way from the tax allowance. This approach will* ***ensure that customers do not lose out as a result of losses being transferred out of the company that could otherwise be offset against tax liabilities in the future****."*

and equivalent guidance was issued for PR24.

The PR24 Financial Model is forecasting a tax allowance in AMP8 of [redacted] (nominal prices) and significant tax losses carried forward (see Appendix 1):

- In addition to the [redacted] of tax losses brought forward from AMP7, tax losses are forecast to be generated in 2025-26, 2026-27 and 2027-28 of [redacted][15], [redacted] and [redacted] respectively.
- After the maximum use of brought forward tax losses[16], taxable profits of [redacted] and [redacted] are forecast to arise in 2028-29 and 2029-30 respectively, giving rise to

[12] Delivering Water 2020, Our methodology for the 2019 price review, Appendix 12: Aligning risk and return, page 107.
[13] Creating tomorrow, together: Our final methodology for PR24, Appendix 10 – Aligning risk and return, page 36.
[14] If relevant, this analysis would equally apply in due course to both 2023-24 and 2024-25.
[15] The 2025-26 tax losses primarily result from the "full expensing" capital allowances rules announced in the Governments' March 2023 Budget.
[16] As noted at footnote 9 above, the operation of the tax loss restriction rules limits the use of brought forward tax losses to 50% of taxable profits.

corresponding tax allowances of [redacted] and [redacted] at 25%; i.e. a total of [redacted] over AMP8.

- At the end of AMP8, [redacted] of tax losses are forecast to be carried forward into AMP9.

As noted in the section 5, if instead of surrendering the c.£506m of 2022-23 tax losses to group companies, TWUL's 2022-23 final tax return is submitted to HMRC in March 2024 on the basis that its losses are carried forward (i.e. then [redacted] in total), none of the additional tax losses are forecast to be utilised during the 2020-25 period.

Per Appendix 1, [redacted] of the [redacted] of tax losses currently carried forward from 2022-23 are forecast to be utilised during AMP8. If the [redacted] of losses were increased by c.£506m to [redacted], there is no forecasted additional taxable profits capacity in AMP8 available to utilise such additional losses; in this scenario, carried forward tax losses at the end of AMP8 would increase from [redacted] to [redacted]. As none of these additional tax losses are forecast to generate any tax savings during AMP8, there is no benefit to customers forecast to be derived from such tax losses in that period.

Given the very large amount of tax losses ([redacted]) forecast to be carried forward from AMP8 into AMP9, it would take a substantial increase in taxable profits in AMP8 before customers could benefit from the use of such losses in AMP8. Consequently, the above analysis demonstrating that for AMP8 "customers do not lose out as a result of losses being transferred out of the company that could otherwise be offset against tax liabilities in the future" can be relied upon with a high degree of certainty.

In addition, unless there is a substantial increase in taxable profits in AMP9 and subsequent AMPs, it could take a very long time before such tax losses are actually forecast to be utilised[17] to reduce future tax allowances in order to benefit customers through reduced bills.

As noted in section 3, any comparison of the value of tax losses surrendered to group companies against the value of tax losses carried forward should take account of the net present value of the forecast benefits to customers of offsetting carried forward losses against future tax liabilities. If required by Ofwat, an estimate of the NPV of this distant future benefit to customers in our case could be prepared and used as a basis for limiting the gross-up of ODI payments. However, given how far out into the future such forecasts would have to go, we consider that such an analysis would likely be of questionable reliability in the context of determining an appropriate tax gross-up for ODI payments.

[17] As noted at footnote 9 above, the operation of the tax loss restriction rules limits the use of brought forward tax losses to 50% of taxable profits.

APPENDIX 1
Extract from PR24 Financial Model

[redacted]

APPENDIX 2
Forecast tax computations for TWUL Group for remainder of AMP7 (used as basis for PR24 Financial Model)

[redacted]

APPENDIX 2 (continued)

Forecast tax computations for TWUL Group for remainder of AMP7 (used as basis for PR24 Financial Model)

[redacted]