

**Consultation on the regulatory framework for
the infrastructure provider that will deliver the
Thames Tideway Tunnel Project**

About this document

The purpose of this document is to seek comments on a suite of draft regulatory documents that we intend will regulate any infrastructure provider appointed to deliver the Thames Tideway Tunnel Project.

We are consulting on the following draft regulatory documents.

- A draft Project Licence that we will issue to the infrastructure provider.
- Draft economic guidance that we will issue, setting out how we intend to regulate the infrastructure provider.
- A draft explanatory note that we will issue jointly with the Environment Agency, setting out how we are both likely to apply our existing enforcement policies in the context of the Thames Tideway Tunnel Project.

In this document, we set out:

- an overview of the regulatory framework for specified infrastructure projects;
- a summary of the purpose of the regulatory documents on which we are consulting;
- the process that will be followed before granting the Project Licence;
- a series of consultation questions; and
- a proposed timetable.

<p>The consultation period was extended on 31 October 2014. The new closing date for this consultation is 17 November 2014.</p>
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Other supporting documents

[Annex 1: Draft Project Licence](#)

[Annex 2: Draft Project Licence explanatory memorandum](#)

[Annex 3: Draft economic guidance](#)

[Annex 4: Draft explanatory note on enforcement](#)

Consultation questions

Q1 Do you have any comments on the form and content of the draft Project Licence?

Q2 Do you have any comments on our proposal to issue a letter stating that we are unlikely to amend the revenue provisions in appendix 1 to the Project Licence during construction?

Q3 Do you have any comments on the draft economic guidance?

Q4 Do you have any comments on the draft explanatory note to enforcement?

Q5 Do you have any questions on the proposed timetable?

Q6 Do you want to comment on any other aspect of any of the attached documents?

Responding to this consultation

We welcome your responses to this consultation by close of business on
17 November 2014.

You can email your responses to mandy.taylor@ofwat.gsi.gov.uk or post them to:

Mandy Taylor
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA.

If you wish to discuss any aspect of this consultation, please contact Mandy Taylor on 0121 644 7762 or by email at mandy.taylor@ofwat.gsi.gov.uk.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

Please note that this consultation is taking place alongside the procurement process being carried out by Thames Water for an infrastructure provider to deliver the Thames Tideway Tunnel. Bidders to that procurement may submit comments to us as part of this consultation or through the bidding process.

1. Introduction

The Thames Tideway Tunnel Project ('the Project') is of unprecedented scale, size and complexity in the water sector in England and Wales, and will be the first project to be delivered under a new regulatory framework. That framework allows for certain large and complex infrastructure projects to be delivered by infrastructure providers that:

- are appointed by the incumbent undertaker following a competitive procurement; and
- are regulated by Ofwat under a project licence.

2. Overview of the regulatory framework for specified infrastructure projects

This new framework was introduced by the Flood and Water Management Act 2010 which, among other things, amended the Water Industry Act 1991 ('the Act') by inserting a new part ('Part 2A – Regulation of Provision of Infrastructure'). The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 ('the Regulations') were made under Part 2A of the Act on 27 June 2013 and came into force on 28 June 2013.

The Regulations provide that:

- the Secretary of State or Ofwat may specify certain infrastructure projects which must be put out to competitive tender by the incumbent water or sewerage undertaker;
- the Secretary of State or Ofwat may specify an infrastructure project to be put out to tender only if the Secretary of State or Ofwat is of the opinion that:
 - the infrastructure project is of a size or complexity that threatens the incumbent undertaker's ability to provide services for its customers; and
 - specifying the infrastructure project is likely to result in better value for money than would otherwise be the case;
- where an infrastructure project has been specified, the incumbent water or sewerage undertaker will be prohibited from undertaking the project itself other than in relation to certain preparatory work; and
- the successful company that is awarded the tender may be designated by the Secretary of State or Ofwat as an 'infrastructure provider' ('the IP') for the purposes of the Regulations and the Act, and may be directly regulated by Ofwat under the terms of a newly-established 'Project Licence'.

For the purpose of regulating specified infrastructure projects, the Regulations introduce new provisions into the Act and also apply particular provisions of the Act with or without modification (referred to below as 'the modified Act'). So, for example:

- new provisions enable Ofwat to issue a project licence to a designated IP, subject to any conditions that Ofwat considers to be requisite or expedient (sections 17FA and 17HA of the modified Act);
- the special administration regime is made to apply to a licensed IP (modified sections 23–26 of the modified Act); and

- Ofwat is required to take enforcement action against a licensed IP if that IP breaches its licence conditions or the modified Act (modified section 18 of the modified Act).

On 4 June 2014, following a public consultation, the Secretary of State specified the Project under the Regulations. The Project Specification Notice became effective on 5 June 2014. At the same time, the Secretary of State issued a Preparatory Work Notice in respect of the Project. The issue of these documents means that:

- the modified Act now applies to the Project;
- Thames Water (as the incumbent undertaker) is required to put the Project out to tender, which it did on 10 June 2014, placing a contract notice in the Official Journal of the European Union ('OJEU'); and
- the works set out in the Preparatory Work Notice are works in relation to the Project which Thames Water must (and in some cases may) carry out.

The intention is that once the successful bidder for the Project is selected, we will consider designating it as an IP under the Regulations and issuing it with a project licence in the form of the draft Project Licence attached to this consultation (see annex 1). Thereafter, the IP will be required to carry out all activities described in the Project Specification Notice apart from those activities that Thames Water is to carry out under the Preparatory Work Notice. Following a public consultation, the Secretary of State issued the Preparatory Work Notice at the same time as the Project Specification Notice. The Project Specification Notice and the Preparatory Work Notice are available on the gov.uk website.

The Project Specification Notice sets out the scope of the Project and, at a high level, describes the Project as including:

- the design, construction, testing and commissioning of the Thames Tideway Tunnel and associated infrastructure; and
- once constructed and accepted by Thames Water, the operation and maintenance of certain IP-owned structures.

3. The Project Licence

In annex 1, we set out a draft Project Licence that we intend to issue to the successful bidder. We are empowered to issue a project licence under section 17FA of the modified Act, and a project licence may be made subject to conditions under section 17HA of the modified Act. We must consult before issuing a project licence under section 17FA(2) of the modified Act.

3.1 Enabling provisions

The relevant provisions are as follows.

“17FA Licensing of infrastructure providers

- (1) The Authority may grant to a company a licence ('a project licence') in connection with the undertaking of a particular infrastructure provider project specified under regulation 4(1) of the Regulations.
- (2) Before granting a project licence, the Authority must consult –
 - (a) the incumbent undertaker;
 - (b) the Secretary of State;
 - (c) the relevant quality regulator; and
 - (d) any other person the Authority thinks is appropriate.
- (3) A project licence must not be granted to a company unless –
 - (a) The company has been designated under regulation 8(1) of the Regulations as the infrastructure provider for the infrastructure project to which the licence relates; and
 - (b) The company is not a relevant undertaker.
- (4) A project licence must –
 - (a) be in writing; and
 - (b) unless revoked or suspended in accordance with any condition contained in it, continue in force for such period as may be specified in or determined under the licence.”

“17HA Conditions of project licences

- (1) A project licence may include –
 - (a) such conditions as appear to the Authority to be requisite or expedient having regard to the duties imposed on it by part 1 of this Act; and

- (b) conditions requiring the rendering to the Secretary of State of a payment on the grant of the project licence, or payments while the licence is in force, or both, of such amount or amounts as may be determined under the conditions.
- (2) Conditions included in a project licence may –
- (a) require the holder of the licence to comply with any direction given by a specified relevant person as to specified matters or matters which are of a specified description;
 - (b) require the holder of the licence to do or not do specified things or things which are of a specified description except in so far as a specified relevant person consents to the holders not doing or doing them; and
 - (c) provide for the reference to and determination by specified relevant person of specified questions or questions which are of a specified description, which arise under or in connection with the licence.
- (3) ...
- (4) Conditions included in a project licence may contain provision for the conditions to have effect, cease to have effect or be modified at such times and in such manner and in such circumstances, as may be specified in or determined in accordance with the conditions.”¹

Our general duties with respect to the water industry (as set out in section 2 of the modified Act) apply to the exercise of our power to issue a project licence. This means that in exercising our power to issue a project licence, we must act in a manner which we consider is best calculated to:

- protect the interests of consumers, wherever appropriate by promoting effective competition;
- secure that the functions of undertakers and licensed infrastructure providers are properly carried out; and
- secure that undertakers and licensed infrastructure providers are able to finance the proper carrying out of those functions (in particular by securing a reasonable return on their capital).

¹ There are proposals to amend section 17HA (as given effect by Schedule 1 of the SIP Regulations) so as to give Ofwat power to impose conditions in an IP’s Project Licence which provide for certain questions or other matters to be referred to the Competition and Markets Authority for determination.

3.2 General approach to the Project Licence

This is the first Project Licence that we will issue under the Regulations and it must address the unique circumstances of the Project.

There are three distinct phases to the Project.

- The first is the design, financing and construction of the tunnel.
- The second is a transitional phase, when the tunnel has been built, but its operation is still being tested, and the first periodic price review for the IP has not yet been carried out.
- The third is when the tunnel is fully operational.

The Project Licence will be in place from the start of the construction period and will remain in place in perpetuity unless amended or revoked. However, the regulation of the IP will differ in some respects in the different phases of the Project. The approach adopted in drafting the Project Licence seeks to address this by:

- putting those provisions that are unique to the construction and transitional phases in two appendices to the licence (appendix 1 and appendix 2). These appendices will cease to have effect at the end of the transitional phase;
- including in the main body of the Project Licence provisions that require Ofwat to regulate the IP in the operational phase in a way that is very similar to the regulation of undertakers. The IP will, for example, be subject to a five-year price review in line with the wholesale price control of undertakers and the normal ring-fencing provisions that apply to undertakers will apply to the IP; and
- putting the customer protection provisions of the licence in an appendix (appendix 3) as these will only become effective in the unlikely event that the IP charges end user customers directly. The intention is that Thames Water will bill its customers for the IP's activities. However, under the Regulations, the IP has the option of either charging the undertaker or, once the tunnel is built, charging end user customers that will benefit from the tunnel directly.

3.3 Bespoke regulatory provisions that will operate during the construction and transitional phases

The draft Project Licence contains a number of unique regulatory provisions that will apply to the Project during the construction and transitional phases. These provisions are considered necessary to deliver a proposition that will receive (and maintain) an investment grade credit rating and deliver value for money to customers. They draw on best practice in the delivery of major infrastructure projects from other sectors. These provisions are necessary to:

- protect customers;
- introduce incentives to ensure that the IP's costs are efficient and the Project is delivered on time; and
- build in risk mitigation.

The most important of these unique provisions are that:

- the IP must appoint an independent technical assessor who will review all project costs (whether incurred or to be incurred by Thames Water or the IP) and report on those costs to a Liaison Committee. We will have the right to attend all Liaison Committee meetings;
- the cost of capital will be set by competition as bidders will be asked to bid the weighted average cost of capital (BWACC) that will apply during the construction period, and the BWACC will be used in the building blocks set out in appendix 1 to the Project Licence in order to determine the IP's allowed revenue during construction;
- during construction, equity investors in the IP will be obliged to finance construction costs up to a pre-determined threshold ('the threshold outturn'). Above the threshold outturn, the IP can apply to us for an increase in allowed revenue. It can also decide whether it wishes to commit additional equity or it can ask the UK Government to provide equity finance;
- during construction all allowed costs will, together with a one-year forward forecast, be dealt with in the regulatory capital value ('RCV') of the IP with an annual reconciliation of the RCV and of actual and forecast capital expenditure (capex);
- there will be incentives in place to ensure delivery is on time, but if there is significant delay in the construction of the Project, the IP will have the right to ask us for an extension of time;

- there will be a cost of debt mechanism to protect the IP against market (and only market) movements in the real cost of debt beyond a specified deadband. The proposed mechanism maintains incentives to raise efficient debt;
- from the third charging year onwards, there will be an under-recovery mechanism which allows the IP to recover any revenue shortfalls two years in arrears; and
- there will be an incentive mechanism that will reward the IP for outperforming the target cost and penalise it for exceeding the target cost. This incentive will complement the time and cost incentives for the contractors and Thames Water within the construction and alliancing arrangements. These are set out as part of the procurement process that Thames Water is running for the main construction contractors for the Project.

The revenue that may be collected during construction is calculated in accordance with the revenue building blocks set out in appendix 1 to the draft Project Licence, and the revenue that may be collected during the transitional phase and the incentive adjustments to the IP's RCV and revenue are set out in appendix 2 to the draft Project Licence. As these are drafted formulaically, we have included a narrative (see annex 2 to this document) to help explain the revenue building blocks and the revenue and incentive adjustments. The narrative in annex 2 will not form part of the final Project Licence but may be included as an explanatory memorandum to the final licence to enable readers to better understand these particular provisions.

3.4 Awarding the Project Licence

We will conduct a review to determine if shortlisted bidders in the IP procurement are competent bodies to hold a project licence. This is an entirely separate but parallel process to that being carried out by Thames Water to procure an IP to deliver the Thames Tideway Tunnel (the IP procurement). Once Thames Water has announced its preferred bidder for the Project, it is envisaged that we will designate the preferred bidder as an IP and thereafter will conduct a further consultation before granting a project licence to the designated IP. The Project Licence that will be attached to that further consultation will be the final version of the attached draft licence, having taken into account comments received to this consultation and having taken into account comments, if any, from bidders.

3.5 Revenue provisions of the Project Licence to remain in place until after construction

Section 17IA of the modified Act allows us to modify Project Licence conditions with the agreement of the IP, and section 17K of the modified Act allows us to refer proposed Project Licence modifications to the Competition and Markets Authority (CMA) for a decision on those modifications. In deciding whether to allow a modification to a Project Licence referred to it under this section, the CMA will apply a public interest test. This is the same as for incumbent undertakers' licences.

In general, one of the primary purposes in competitively procuring a project is to fix a contract price on the basis that the bid price has been accepted as the most economically advantageous tender relative to the other tenders. In this instance, once the Project is specified, the procurement is required by statute. In the IP procurement, bidders will be required to bid a BWACC for the Project during the construction period. The BWACC will become part of the revenue building blocks set out in appendix 1 of the draft Project Licence. Subsequently modifying, by regulatory action, the successful bidder's BWACC, other revenue building blocks or the underlying methodology upon which the IP's revenue is calculated, could undermine both the purpose of the procurement and the statutory basis for it. It is our view that it is unlikely to be in the public interest to do this. In addition, limiting the scope for subsequent changes to the BWACC, other revenue building blocks or the underlying methodology upon which the IP's revenue is calculated is consistent with the procurement principles of fairness, transparency and non-discrimination between bidders.

We consider it to be better value for money for customers that there is certainty about the IP's revenue during the construction and transitional phases as the bidders are not expected to price in a premium for uncertainty.

For these reasons, we consider it unlikely to be in the public interest for us to refer a proposed modification to appendix 1 to the CMA where the IP does not agree with such a modification and we propose to issue a letter to that effect to prospective IP bidders in order to provide them with assurance of our intention in this regard. Such an approach is proportionate for the following reasons.

- This only applies to appendix 1 and not to the rest of the Project Licence.
- Appendix 1 is focused on the design, financing and construction phase and its application is time limited as it will cease to have effect from 1 April following the first periodic review. The first periodic review will take place concurrently with the first periodic review of Thames Water's wholesale activities that takes place following acceptance of the completed Project.

4. Economic guidance

Annex 3 to this consultation comprises draft guidance that sets out our likely approach to how we will economically regulate the IP during the construction and operational phases of the Project. The primary purpose in issuing this guidance is to provide greater regulatory certainty about the IP's allowed revenue in the operational phase.

The draft guidance recognises that in setting the cost of capital during the operational phase we will take into account our statutory duties and also the risks inherent in delivering the day-to-day activities of the IP. The guidance does this by providing examples of the factors that could be anticipated to influence the Project risk profile and thus the cost of capital when we set it for the IP.

Factors where we consider the IP may face increased risk relative to a wholesale sewerage company in the operational period include:

- exposure to credit risk associated with a single customer (Thames Water or its relevant successor);
- re-financing risks, given a higher proportion of the IP's revenues will likely be accounted for by financing costs; and
- asset intensity. After construction, there will be less ongoing capex and operating expenditure (opex) and this provides less scope for operational outperformance. This means there could be greater regulatory risk associated with the cost of capital.

Factors where we consider the IP may face reduced risk relative to a wholesale sewerage company in the operational period include:

- operating costs are expected to be less volatile;
- maintenance risks are expected to be lower given this will be a new, single asset; and
- the IP is unlikely to need to raise significant financing for new capex.

The draft economic guidance states that the cost of capital is likely to be set on a forward-looking basis and so we will not take into account returns earned in the period prior to the post-construction review (that is, the review that takes place after construction is completed).

The draft economic guidance also states that the IP can take comfort from:

- our long track record in determining allowed revenues at price reviews;
- our statutory duty to secure that licensed infrastructure providers can finance their functions (in particular, by securing a reasonable return on their capital);
and
- protections incorporated in the regulatory framework, including allowed revenue re-opening mechanisms (that is, being able to apply for interim determinations). These additional protections become available to the IP in the operational phase.

5. Explanatory note on enforcement

The draft explanatory note on enforcement will be a statement of how Ofwat and the Environment Agency are likely to apply their existing guidance and Statements of Policy in the context of the Thames Tideway Tunnel Project. It is not-statutory guidance and it is not intended to replace any other guidance issued by Ofwat or the Environment Agency. The draft explanatory note on enforcement is set out in annex 4.

The explanatory note on enforcement provides that Ofwat will take into account the circumstances of a breach of licence or statute, and whether Thames Water or the IP caused or contributed to a breach, and that we will take enforcement action against the party responsible for the breach.

It also sets out the Environment Agency's role with regard to the Project. The Environment Agency regulates Thames Water as Thames Water holds permits for existing combined sewer overflows (CSOs) along the tidal Thames, and will hold new permits for CSOs to be constructed as part of the Project. The IP will not own or operate a CSO or any other discharge point into the tidal Thames and therefore the IP will not be subject to the regulation of any environmental permit issued by the Environment Agency. However, as part of its overall pollution responsibilities, the Environment Agency may investigate any unlawful discharge activity, whether a permit is involved or not.

As the draft explanatory note does not set out new policy of either Ofwat or the Environment Agency, comments on the explanatory note should be limited to presentational issues (for example, is the document useful? Should it be more or less detailed?).

6. Modifications to Thames Water's Instrument of Appointment

In order to facilitate the delivery of the Project by an IP, certain conditions in Thames Water's Instrument of Appointment ('licence') require modification. It is anticipated that a separate consultation on these licence modifications will be conducted later this year.

7. Indicative timetable

Process	Timing
Thames Water procurement for an IP to deliver the Thames Tideway Tunnel.	Issue of OJEU notice on 10 June 2014 Invitation to negotiate issued to pre-qualified bidders on 7 October 2014
Consultation on Project Licence and other regulatory documents.	7 October 2014 to 17 November 2014
Short-listed bidders will submit information to Ofwat as part of an application for a Project Licence, and Ofwat will carry out an assessment of whether short-listed bidders are competent bodies to hold a Project Licence.	November 2014 – April 2015
Ofwat to review comments on Project Licence and regulatory documents and issue final documents to bidders.	February 2015
Thames Water will announce the preferred bidder for IP	May 2015
Ofwat will consider designating the preferred bidder as an IP under the SIP Regulations and will consult on a proposal to grant a Project Licence to the designated IP. As part of the consultation, a final Project Licence and final versions of the economic guidance and explanatory note on enforcement will be published.	May – June 2015
Financial close of the procurement and Project Licence award.	July 2015



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