August 2015

Trust in water

Explanatory memorandum to the Project Licence issued to Bazalgette Tunnel Limited

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About this document

While the Thames Tideway Tunnel project is being built and commissioned, the IP will benefit from a bespoke regulatory framework that will allow it to start generating revenues when construction begins. The provisions in Appendix 1 to the Project Licence underpin this regulatory framework.

While typically in the UK water industry revenues of incumbent water and sewerage undertakers are determined by Ofwat on a five-yearly look forward basis, in the case of the IP, there are three different stages – construction, initial operation and long-term operation – with different allowed revenue calculation methodologies applying to each stage.

In certain circumstances, the revenues of the IP will be subject to adjustments. On the one hand, there will be adjustments intended to mitigate certain risks the IP may be exposed to during the construction period – such as adjustments to protect against a revenue under-recovery due to doubtful debt or movements in the market cost of debt. On the other hand, there will be adjustments intended to incentivise the IP to complete the Project on time and on budget.

The purpose of this explanatory memorandum is to assist users of the Project Licence better understand the provisions of Appendix 1 and Appendix 2 to the Project Licence. This explanatory memorandum is not intended to be a substitute for understanding the provisions of those appendices. If this note contradicts any element of the Project Licence, then the Project Licence shall take precedence.

For context, this explanatory memorandum also provides an overview of the main body of the Project Licence.

Contents

A. Overview of Appendix 1: Calculation of allowed revenue

1. Introduction

1.1 Appendix 1 comprises two parts. One part (Part A) sets out the conditions for calculating the IP's allowed revenues during the construction period, which will run until (and including) 31 March following the Post Construction Review[1]. The other part (Part B) sets out the conditions for calculating the IP's allowed revenues during the initial operational period, which will run from 1 April following the Post Construction Review until (and including) 31 March following the First Periodic Review, unless the Post Construction Review and First Periodic Review are held concurrently, in which case there will be no initial operational period (see paragraph A4(b) below). Part B also sets out the mechanics for determining the regulatory capital value of the IP that will apply during the long-term operational period (i.e. from (and including) 1 April following the First Periodic Review), as well as the incentives for the IP to complete the Project on time and on budget.

1.2 Throughout Appendix 1 prices are expressed either in real or nominal values, with indexation and deflation mechanics being applied in certain circumstances such that calculations are always done on a like-for-like basis. To achieve this, Appendix 1 provides for all calculations to be done in 2014-15 prices. For this reason, for the purposes of this explanatory memorandum, all values should be assumed to be expressed in 2014-15 prices, unless otherwise specified. However, Addendum B provides a summary of the inflation and deflation principles that apply to different values referred to in Appendix 1 to the Project Licence.

1.3 Ofwat considers that it is unlikely to be in the public interest for it to refer a proposed modification of Appendix 1 to the CMA. It therefore considers that any modification of Appendix 1 is likely to only be made with the agreement of the IP.

[1] Capitalised terms used in this explanatory memorandum are defined in Addendum A hereto or, where not defined, have the meaning given in the Project Licence. Definitions that apply throughout the Project Licence are in Appendix 4 of the Project Licence. Definitions that are used in Appendices 1 and/or 2 are defined in paragraph 1 of Appendix 1 or paragraph 1 of Appendix 2.

2. Allowed revenues during the construction period

2.1 Calculation of allowed revenues during the construction period

(a) The allowed revenues during the construction period (that is, from Licence Award until (and including) 31 March following the Post Construction Review) are calculated by reference to a number of building blocks. This is a well-established method for calculating revenues in price reviews in the water industry in England and Wales. The building blocks are as follows.

(RoC + Li + Op + FCA + Tax) +/- RA +/- BBRA + ARoC + Ali

(b) These building blocks can broadly be grouped into the following categories.

(i) Building blocks that provide the IP with its basic revenue – these include the **Return on Capital (RoC) building block** and the **Liquidity (Li) building block**.

(ii) Building blocks that are generally assumed to be zero, but may increase in the event of a change in law or accounting principles, thus providing the IP with certain change in law and accounting policy protection – this includes the **Opex (Op) building block**.

(iii) Building blocks dealing with tax the IP may be required to pay – this is the **Tax building block**.

(iv) Building blocks that are intended to mitigate certain finance risks the IP may be exposed to during construction – these include the **Financing Cost Adjustment (FCA) building block** and the **Revenue Adjustment (RA) building block**.

(v) Building blocks that provide for a true-up mechanism to take account of the difference between forecast or estimated values and the actual outturn values – this includes the **building block for reconciliation adjustments (BBRA)**.

(vi) Building blocks that provide the IP with additional revenues that relate to cost overruns above a pre-determined threshold (termed the 'Threshold Outturn'[2]) – these include the **Additional Return on Capital (ARoC) building block** and the **Additional Liquidity (ALi) building block**, which are subject to a separate Ofwat determination.

[2] The Threshold Outturn is £4,087,715,382.

2.2 Revenue building blocks

(a) The revenue building blocks are intended to provide the IP with a return on capital and liquidity allowance in each Charging Year during the construction period.

Return on capital

(b) The return on capital is calculated by reference to the BWACC and the RCV. The RCV represents the cumulative costs (termed the ‘Allowable Project Spend’) incurred by the IP up to the start of the Charging Year in question, as well as forecast to be incurred by the IP in the Charging Year in question. The average RCV for a Charging Year is then multiplied by the BWACC to calculate the RoC building block. This building block therefore provides a return on the costs that have been incurred and funded by the IP. (See below for a discussion on Allowable Project Spend.)

Liquidity

(c) The liquidity building block is designed to recognise the fact that the IP may need to draw down on funding for future spend as well as current spend because of the liquidity requirements it faces. It therefore provides a return on the following Charging Year’s expected spend to compensate for the finance cost of drawing down funding early to meet the liquidity requirements. It is calculated by reference to the BWACC and the difference between the forecast average RCV for the Charging Year ahead and the average RCV in the Charging Year in question. This effectively means that the IP earns a return on capital on its one year forward RCV.

BWACC

(d) The BWACC will be used in the above calculations throughout the construction period until the earlier of (i) 31 March 2030 and (ii) 31 March following the Post Construction Review[3], but the BWACC will only apply in respect of capital costs up to the Threshold Outturn.

(e) Note that the return on capital earned by the IP during the construction period may be subject to a penalty for delay in achieving Acceptance, administered retrospectively at the Post Construction Review. This steps down the BWACC for any delay in Acceptance beyond the Planned System

[3] See A3 below in respect of the initial operational period after 31 March following the Post Construction Review.

Acceptance Date (see paragraphs A3.5 (i) – (q) below for further details on the step down).

(f) If Acceptance has not occurred or is not likely to occur before 1 May 2029, then on and from 1 April 2030 for the remainder of the construction period, the real weighted average cost of capital, as determined by Ofwat before the commencement of each Charging Year falling within such period, will be used in calculating the allowed revenue for the relevant Charging Year instead of the BWACC. Guidance on how this cost of capital will be determined can be found in the economic guidance provided by Ofwat.[4]

Allowable Project Spend

(g) Allowable Project Spend represents the cumulative costs incurred or to be incurred by the IP in connection with the Project on and from Licence Award but prior to 1 April following the Post Construction Review up to the Threshold Outturn, with any approved additional costs above the Threshold Outturn being treated as Additional Allowable Project Spend (as discussed below in paragraph A2.3 (d)).

(h) Equity investors in the IP will be required to fund the Allowable Project Spend (that is, up to Threshold Outturn). However, they will not be obliged to fund any additional capital costs above the Threshold Outturn, but will have the option to do so.

Excluded Project Spend

(i) It is expected that all costs to be incurred by the IP prior to the Post Construction Review will be included in the RCV except for a pre-defined set of costs which will be excluded from the Allowable Project Spend. The following costs are defined as 'Excluded Project Spend':

  (i) financing costs, fees and expenses;

  (ii) any operating costs that are not treated by Ofwat as capital expenditure; however, it is expected that all costs will be treated as capital expenditure during construction and therefore these will be zero during this period;

[4] Ofwat guidance on approach to the economic regulation of the infrastructure provider for the Thames Tideway Tunnel

(iii) tax (other than non-recoverable tax incurred in respect of the Allowable Project Spend or the Additional Allowable Project Spend)[5];

(iv) any equity distributions, including any payment of dividends, bonus issues, return of capital, fees, interest, principal or other amounts (by way of loan, loan repayment or otherwise) (in cash or in kind) to any person deemed to be related to equity; note that payments made pursuant to management services and other arrangements entered into in connection with the Project on *bona fide* arm's length terms in the ordinary course will be included in the allowed capital costs;

(v) any expenditure funded by any amount payable by insurers or reinsurers;

(vi) any expenditure incurred due to the fraud, wilful misconduct or gross negligence of the IP (or its agents or contractors), except to the extent incurred towards a contractor of the IP due to the fraud, wilful misconduct or gross negligence of another contractor of the IP and not recoverable against such other contractor;

(vii) fines that the IP incurs (including any indemnity payments to TWUL in respect of fines levied on TWUL by the Environment Agency due to acts or omissions of the IP);

(viii) costs which are not justified by the IP's accounts and records;

(ix) costs which should not have been paid by the IP to its contractors or suppliers in accordance with their contracts, other than compromise or settlement payments made by the IP, which have either been approved by Ofwat or have an aggregate value of less than £1,000,000 and have been approved unanimously by the liaison committee pursuant to the Liaison Agreement;

(x) any expenditure in respect of which the IP has exercised a right of set-off or withholding (unless and until such set-off or withholding is successfully challenged under the relevant dispute resolution process); and

(xi) any expenditure funded by payments received by the IP under the Alliance Agreement.

[5] For example, a landfill tax and stamp duty on property documents might be a legitimate project cost that was non-recoverable and this would not constitute Excluded Project Spend.

Lease Chargeable Gain

(j) The Project Licence provides the IP with certain protection against a Lease Chargeable Gain. This is broadly defined as corporation tax payable in respect of any chargeable gain arising on the commencement of the lease between TWUL and the IP save to the extent arising or increased due to change in tax law or accounting principles and policies adopted in the water industry.

(k) In order for the IP to receive protection against a Lease Chargeable Gain, it must consult Ofwat in advance on any valuation associated with the Lease Chargeable Gain and any agreement with HM Revenue & Customs (or other competent authority) in relation to its quantum. The IP will then need to notify Ofwat of the quantum agreed with HM Revenue & Customs (or other competent authority) and the due date for payment and request Ofwat to elect whether any Lease Chargeable Gain will be recoverable by the IP through the Tax building block or through Allowable Project Spend. Ofwat has a three-month period from request to notify the IP of its election on the approach to recovering the Lease Chargeable Gain.

(l) When making an election, Ofwat may disallow any amount of the Lease Chargeable Gain that arises solely as a consequence of the IP's capital structure. Also, Ofwat may reduce the Lease Chargeable Gain to take account of any losses and credits or refunds relating to corporation tax or other income based tax to which the IP has or may become entitled, that would otherwise have been available to reduce the Lease Chargeable Gain.

(m) Any amount included in the IP's Allowed Project Spend in respect of a Lease Chargeable Gain will be disregarded for the purposes of calculating the cost incentive (see the cost adjustment discussed in paragraphs A3.5 (b) – (h) below).

2.3 Additional revenue building blocks

(a) If the IP predicts that its capital costs in connection with the Project will exceed the Threshold Outturn, Ofwat may permit the IP to earn additional return on capital and receive an additional liquidity allowance in respect of its additional costs (such costs are termed the 'Additional Allowable Project Spend').

(b) The additional return on capital and the additional liquidity allowance would be calculated in a similar manner to the basic revenues received by the IP, save that a real weighted average cost of capital specific to this additional spend, as determined by Ofwat at the relevant time, would be applied to the additional costs above the Threshold Outturn that are allowed onto the RCV rather than BWACC. Note that if Acceptance is delayed and does not occur before 1 May 2029, then this real weighted average cost of capital will be replaced with the one determined by Ofwat on an annual basis, as discussed in paragraph A2.2 (f).

(c) As with the Allowable Project Spend, Excluded Project Spend would not be treated as Additional Allowable Project Spend.

Additional Allowable Project Spend

(d) In the event that the costs necessary to complete the Project are forecast to exceed the Threshold Outturn (termed a Predicted Overrun), the IP may apply to Ofwat to approve Additional Allowable Project Spend in excess of the Threshold Outturn in order to enable the IP to finance the Predicted Overrun. Ofwat will then determine whether to approve the Additional Allowable Project Spend and the rate of return that will apply to it. It will determine the Additional Allowable Project Spend using the Ex Ante Approach, unless the IP has opted for the Ex Post Approach as part of its application and Ofwat has agreed to use that approach.

(e) The Ex-Ante Approach means that a structurally similar framework to that which applies when calculating the return on capital and liquidity allowance in respect of costs below the Threshold Outturn would apply to calculating the return on capital and liquidity allowance in respect of capital costs above the Threshold Outturn (up to a cap set by Ofwat). However, a different incentive framework may apply to such additional costs, as determined by Ofwat, to mitigate the risk to customers of a further overrun of costs.

(f) Unlike the Ex Ante Approach, under the Ex Post Approach, Ofwat would not impose any cap on the additional costs of the IP. Instead, at the Post Construction Review, Ofwat would determine what additional costs incurred by the IP would be allowed, adjusted or disallowed in the RCV following the Post Construction Review on the basis of what is economic and efficient expenditure. This determination will be made in accordance with the policies and guidelines of Ofwat in place at the time.

(g) Both approaches assume that Ofwat will determine the real weighted average cost of capital specific to the Project that will apply in respect of the Additional Allowable Project Spend. This cost of capital would only apply to the additional spend above threshold, with the BWACC continuing to apply to the costs incurred below Threshold Outturn. If, however, Acceptance is delayed and does not occur before 1 May 2029, then on and from 1 April 2030 until the end of the construction period the real weighted average cost of capital determined by Ofwat on an annual basis, as discussed in paragraph A2.2 (f), will apply both in respect of the Additional Allowable Project Spend and the costs incurred below Threshold Outturn.

(h) There are a number of factors that Ofwat will take into account when making a determination on Additional Allowable Project Spend. In particular, Ofwat will (as applicable):

(i) determine what Additional Allowable Project Spend and what cap on Additional Allowable Project Spend (if applicable) is appropriate and reasonable in all the circumstances taking into account Ofwat's policies and guidelines in place at the time;

(ii) determine whether any of the Additional Allowable Project Spend could be or could have been avoided by prudent management action;

(iii) have regard to the views of the Independent Technical Assessor;

(iv) not carry out an ex-post review of costs incurred by the IP below Threshold Outturn to assess whether they were economic and efficient, but may take into account the economy and efficiency of additional costs to be incurred by the IP and the extent to which those costs may be or may have been avoided by prudent management action; and

(v) not take into account the existence of the contingent equity support agreement entered into between, amongst others, the IP and the Secretary of State on or around Licence Award.

(i) Ofwat has a three-month period from application to notify the IP of its decision on the approach to Additional Allowable Project Spend, failing which the IP may require Ofwat to refer the matter to the CMA for determination. Equally, if the IP disputes any determination by Ofwat regarding its decision on the approach to Additional Allowable Project Spend, IP may require Ofwat to refer the matter to the CMA for determination.

(j) The above approach (in paragraphs (d) to (i)) will also apply in relation to any further cost overruns above the new cap set by Ofwat.

2.4 Opex and Tax building blocks

Operating costs

(a) It is expected that the Opex (Op) building block will be zero as all operating costs incurred or to be incurred during the construction period will be treated as capital costs and included in the RCV. Should this not be the case due to a change in generally accepted accounting principles (or IFRS)[6] and policies adopted in the water industry and/or a determination by Ofwat, the IP will be able to recover its operating costs that cannot be capitalised through the Opex building block (with an adjustment to the Annual Base Case Forecasts as set out in paragraph A2.8 (c)). The recovery will be based on actual efficient operating costs incurred by the IP (if already incurred by the IP) and forecast efficient operating costs to be incurred by the IP in the year-ahead.

Tax

(b) In the period until (and including) Handover, it is assumed that the IP will not be trading and therefore that the Tax building block, which relates to income based tax payable, will be zero, unless there is a change in tax law or in generally accepted accounting principles (or IFRS) and policies adopted in the water industry which results in the IP being required to pay an amount in respect of corporation tax or other income based tax that the IP would not have otherwise been required to pay. In this case, the IP will, through the Tax building block, be compensated for its increased income tax liabilities net of any income tax credit or refund to which the IP is or may be entitled.

(c) In the period following Handover until the end of the construction period, the Tax building block will include corporation tax or other income based tax, if any, payable by the IP in the relevant Charging Year.

(d) Any corporation tax or other income based tax permitted to be recovered through the Tax building block will be net of any losses and credits or refunds relating to the same and to which the IP has or may become entitled (including any payment received or which may be payable to the IP

[6] International Financial Reporting Standards.

for the surrender of losses relating to corporation tax or other income based tax to an associated company by way of group relief).

(e) As mentioned above, the IP may also recover through the Tax building block any Lease Chargeable Gain payable on or prior to 31 March following the Post Construction Review, but only to the extent that Ofwat elects to treat it as such.

2.5 Financial risk building blocks

Financing Cost Adjustment

(a) The Financing Cost Adjustment is designed to provide revenue compensation to the IP for movements in the underlying market real cost of debt outside a pre-defined cap and collar.

(b) It is intended to apply from first debt raising (but with a two-year lag) and in respect of net debt remaining outstanding until (and including) 31 March 2030. For these purposes:

(i) ‘debt’ means any indebtedness (other than any capitalised financing costs, fees and expenses) under or in connection with (A) monies borrowed and debit balances at banks or other financial institutions, (B) monies borrowed pursuant to the market disruption liquidity facility entered into between the Secretary of State and the IP on or about Licence Award, and (C) any note, purchase facility or the issue of bonds, notes, debentures, loan stock or any similar instrument; and

(ii) ‘net debt’ means the IP’s aggregate debt outstanding as at the end of the relevant Charging Year together with all indexation accrued on such liabilities (excluding: (A) any loans made by any associated company of the IP (other than those made in compliance with Condition K of the Project Licence by the IP Finco or an associated company that ranks as a secured creditor and *pari passu* with other senior lenders to the IP), and (B) any uncrystallised mark to market amounts relating to any ISDA[7] Master Agreement and any treasury transactions thereunder, entered into by the IP), *less* all amounts (including any loans to any associated company of the IP) standing to any account of the IP (including any capex or other similar reserve account held by the IP and any cash cover or swap collateral accounts).

[7] International Swaps and Derivatives Association Inc.

(c) The Financing Cost Adjustment will be calculated by reference to a benchmark index equal to the reference rate for the cost of relevant BBB rated debt issuances over the previous 12-months' period (as judged using iBoxx indices for UK corporate non-financials with a 10+ year maturity).

(d) The adjustment for financing costs in any Charging Year Yt will depend on the difference between the benchmark index as at 31 March 2015 (the 'base reference point') and the benchmark index as at 31 March of Charging Year Yt-2 (the 'annual reference point'). If the difference is a positive number (such that the annual reference point exceeds the base reference point), then the adjustment factor will be expressed as a positive number and consequently result in an increase in the overall allowed revenue in the relevant year. Conversely, if the difference is a negative number (such that the base reference point exceeds the annual reference point), then the adjustment factor will be expressed as a negative number and consequently result in a reduction of the overall allowed revenue in the relevant year.

(e) The adjustment factor is subject to a floor and ceiling, so where the difference between the base reference point and the annual reference point is:

   (i) equal to or less than 50bps – the adjustment factor will be equal to zero;

   (ii) greater than 50bps but not exceeding 100bps – the adjustment factor will be equal to 50% of the amount by which the difference exceeds 50bps; and

   (iii) greater than 100bps – the adjustment factor will be equal to the amount by which the difference exceeds 75bps.

   So, if the difference between the base reference point and the annual reference point in the relevant year is 130bps, the adjustment factor will be 55bps (that is, 130bps-75bps).

(f) The adjustment factor will be applied to the increase in net debt outstanding as at two years prior. However, the financing cost protection will only be given to the extent that the net debt in any Charging Year does not exceed 62.5% of the cumulative RCV as at the end of that Charging Year. This percentage is intended to represent an estimate of the amount of the RCV that will be funded by debt. The overall adjustment to allowed revenue in a year will be the summation of that year's adjustment value and previous years' adjustment values to reflect the build-up of the market cost of debt protection over time.

(g) To address the mismatch between the time that the debt is raised and the protection derived from the Financing Cost Adjustment as applied, there will be a net present value adjustment, calculated using the BWACC. Also, any Financing Cost Adjustment based on net debt as at Charging Years ending 2028/29 and 2029/30, will (at Ofwat's election, following consultation with the IP) be included in the allowed revenue for either (i) Charging Years 2030/31 and 2031/32, respectively, or (ii) Charging Year 2035/36. In the latter case, there will be an equitable net present value adjustment to take account of the value of the delay in compensation.

Revenue Adjustment

(h) The IP's allowed revenues for each Charging Year will be collected by TWUL by adding those revenues to the wastewater charges TWUL levies on its customers. To the extent those revenues have been recovered by TWUL from its customers, it will pass them through to the IP under the Revenue Agreement. This creates the risk of doubtful debts from customers for the IP. The Revenue Adjustment building block mitigates this risk by allowing any amounts under-recovered through TWUL to be added to IP's revenues with a two-year lag. So, if in Charging Year Yt the IP was entitled to allowed revenues equal to £1,000,000, but it was only able to recover £950,000 from TWUL due to non-payment by TWUL's customers, the under-recovered amount of £50,000 would be added to the IP's revenues for Charging Year Yt+2. Similarly, the Revenue Adjustment building block allows for any amount of over-recovery to be subtracted from the IP's revenues with a two-year lag. Either way, this revenue adjustment will apply from the third Charging Year onwards (given the two-year lag).

(i) The Revenue Adjustment will be subject to a net present value adjustment, calculated using the BWACC, in order to take account of the value of the delay in adjustment.

(j) If the Revenue Adjustment produces a positive number, it will be added to the allowed revenue for the following year and, conversely, if it produces a negative number, it will be subtracted from the allowed revenue for the following year.

2.6 Building block for reconciliation adjustments

(a) The building block for reconciliation adjustment effectively provides for a true-up mechanism such that the Return on Capital building block, the Liquidity building block, the Opex building block, the Financing Cost Adjustment building block, the Tax building block, the Additional Return on Capital building block and the Additional Liquidity building block for the previous Charging Year are adjusted to take account of the difference between the estimated or forecast costs originally used to calculate those building blocks and the actual values incurred for those building blocks.[8] This adjustment will be calculated on a net present value neutral basis and will be applied from the following 1 April. The net present value adjustment will be calculated using the BWACC, except that in the case of the Additional Return on Capital building block and the Additional Liquidity building block it will be based on the real weighted average cost of capital applicable to the same.

(b) If the reconciliation adjustment produces a positive number, it will be added to the allowed revenue for the following year and, conversely, if it produces a negative number, it will be subtracted from the allowed revenue for the following year.

2.7 Timing of revenue calculations

(a) Subject to the exceptions discussed below, the allowed revenue for each Charging Year during the construction period will be calculated and finalised in the immediately preceding Charging Year and notified by the IP to TWUL in accordance with the Project Licence. TWUL will then collect the IP's revenues and pass through the collected amounts to the IP during the Charging Year in question in accordance with the Revenue Agreement.

(b) There are exceptions in respect of the allowed revenue for the first and (if applicable) second Charging Years with different rules applying depending on when Licence Award occurs. These are discussed below and illustration of timing of calculation and payment of these revenues is provided in Addendum C.

Exception for early collection of revenue

[8] To the extent that actual costs incurred are already incorporated into the Opex building block, these costs will not be subject to a cost adjustment.

(c) If Licence Award does not occur by 15 September 2015, then under the terms of its instrument of appointment, TWUL may request Ofwat to provide an estimate of the IP's likely allowed revenue for the period from (and including) the date when Licence Award is likely to occur (as determined by Ofwat) to (and including) 31 March 2017. This is to allow TWUL to commence early collection of IP revenues from customers from 1 April 2016. In the ordinary course, these amounts collected by TWUL (together with accrued interest) will be passed on to the IP under the terms of the Revenue Agreement and the Project Licence following Licence Award, unless otherwise directed by Ofwat.

(d) If Ofwat has provided an estimate for early revenue collection purposes, the IP will still be required to calculate its allowed revenue for the first Charging Year (calculated from actual Licence Award) and (depending on when Licence Award occurred) the second Charging Year. The IP's calculation will be used for all purposes in relation to the Project Licence, the Revenue Agreement and TWUL's instrument of appointment other than for determining the amounts to be collected by TWUL in respect of the first and (if applicable) the second Charging Year because these amounts will have already been collected or be in the process of being collected in respect of that period.

(e) To the extent that the amounts collected early by TWUL are insufficient to cover the IP's allowed revenue in the first Charging Year and (if applicable) the second Charging Year, the shortfall will be collected in the following Charging Years through the Revenue Adjustment building block.

Other exceptions

(g) In the event that:

- (i) Licence Award occurs by 15 September 2015;
- (ii) TWUL makes no request to Ofwat for an estimate of the IP's likely allowed revenue for early collection purposes;
- (iii) Ofwat provides no such estimate; or
- (iv) Ofwat provides an estimate but Licence Award occurs on or after 1 April 2017,

then allowed revenues for the first Charging Year will be calculated and finalised by 24 December of the first Charging Year but will only be payable in the second Charging Year together with the allowed revenues for the second Charging Year. The reason for this is that by Licence Award, TWUL will not have been able to include the IP's allowed revenues for the first Charging Year in the calculation of the wastewater charges levied by TWUL on its customers in respect of the first Charging Year.

(h) The allowed revenues for the second Charging Year may be subject to a similar delay if the allowed revenue for the second Charging Year has not been calculated and finalised by 24 December of the first Charging Year. In this case, the calculation and finalisation of allowed revenue for both the first and second Charging Years will be delayed until the second Charging Year with payments of the allowed revenue for those Charging Years being made in the third Charging Year.

(i) The revenues that are delayed in this way will be subject to a net present value adjustment for the period of delay, calculated based on the BWACC in order to take account of the value of this delay.

2.8 Annual Base Case Forecasts and adjustments

(a) The IP is incentivised to deliver the Project on budget. This is achieved through an incentive mechanism discussed in paragraphs A3.5 (b) – (h) below, which compares actual expenditure of the IP against the base case forecasts.

(b) The cost forecasts are based on the Annual Base Case Forecasts set out in Annex A to Appendix 1 and represent an estimate of the costs to be incurred by the IP in each Charging Year necessary to complete the Project and achieve Acceptance. The Original Base Case Forecast represents the summation of all Annual Base Case Forecasts.

Adjustments due to change in accounting principles

(c) Should there be a change in generally accepted accounting principles (or IFRS) and policies adopted in the water industry and/or a determination by Ofwat that results in the IP not being able to capitalise an operating cost, the Annual Base Case Forecasts for the affected Charging Years will be subject to an adjustment by Ofwat to take account of the decreased expenditure of the IP included in the RCV during those Charging Years.

Other adjustments

(d) The Annual Base Case Forecasts are also subject to adjustment in a number of circumstances referred to as 'Base Case Adjustment Trigger Events'. A Base Case Adjustment Trigger Event is where, after Licence Award, there is:

(i) a change in the material scope of the Project;

(ii) an application to the IP of any legal requirement or any change to any legal requirement which applies to the IP; or

(iii) a change in the material technical requirements of the Project,

in each case, which (having taken into account any costs and savings resulting from it) is likely to result in the costs to be incurred by the IP in connection with the Project up to (and including) Acceptance increasing or decreasing by more than £10 million.

(e) If a Base Case Adjustment Trigger Event (together with all previous Base Case Adjustment Trigger Events and associated costs and savings) is likely to result in the IP's costs increasing or decreasing by more than 2% of the Original Base Case Forecast, the Annual Base Case Forecasts for the affected Charging Years occurring on or prior to the Planned System Acceptance Date may be adjusted, as determined by Ofwat.

(f) In making its determination to adjust the Annual Base Case Forecasts, Ofwat will:

(i) determine what increased or decreased (as applicable) costs are appropriate and reasonable for the IP to incur in all the circumstances taking into account the relevant Base Case Adjustment Trigger Event and all previous Base Case Adjustment Trigger Events;

(ii) (if applicable) determine whether any of that increased costs could be avoided by prudent management action;

(iii) determine what savings (if any) the IP is reasonably likely to make up to (and including) Acceptance as a result of the relevant Base Case Adjustment Trigger Event and all previous Base Case Adjustment Trigger Events; and

(iv) have regard to the views of the Independent Technical Assessor.

(g) Ofwat has a three-month period from application by the IP to notify the IP of its decision on adjusting the Annual Base Case Forecasts, failing which the IP may require Ofwat to refer the matter to the CMA for determination.

3. Allowed revenues during the initial operational period

3.1 Purpose of the Post Construction Review

(a) The Post Construction Review will be undertaken by Ofwat following Acceptance being achieved. The purpose of the Post Construction Review is to determine the RCV that will apply after the construction period and in perpetuity taking into account any adjustments due to delays and/or Project overspend or underspend. Therefore, as part of the Post Construction Review, the incentive adjustments will be calculated and put into effect.

(b) If the IP disputes Ofwat's determination at the Post Construction Review, it may require Ofwat to refer the matter to the CMA for determination.

3.2 Initial operational period

(a) If Acceptance occurs prior to 1 May 2028, there will be a short initial operational period from (and including) 1 April following the Post Construction Review until (and including) 31 March 2030, following which the long-term operational period will commence.

(b) If Acceptance occurs on or after 1 May 2028 but prior to 1 January 2029, there will be no initial operational period and, consequently, the IP's allowed revenue for the period on and from 1 April 2030 will be determined at the First Periodic Review and at any subsequent periodic reviews.

(c) If Acceptance occurs on or after 1 January 2029, it will not be possible to carry out a First Periodic Review for implementation on and from 1 April 2030. Consequently, the First Periodic Review will be postponed and the Project will enter into an initial operational period that will run from (and including) 1 April following the Post Construction Review until (and including) 31 March following the First Periodic Review.

3.3 Calculation of allowed revenues during the initial operational period

(a) The allowed revenue during the initial operational period will be calculated by reference to a number of building blocks that take into account the different risk profile of the IP during such period (as compared with the construction period). Most notably, the return on capital will initially be earned against the RCV set by Ofwat at the Post Construction Review and based on forecast and estimated values (termed the ‘Provisional Post Construction Review RCV’) and subsequently revisited by Ofwat based on actual outturn values (termed the ‘Post Construction Review RCV’). Also, as construction will be complete, the IP will no longer benefit from a liquidity building block and the financing cost adjustment mechanism (if applicable) will only continue in respect of net debt outstanding until (and including) 31 March 2030.

(b) The calculation of the allowed revenues during the initial operational period will be based on the following building blocks.

(RoC + Op + FCA +/- RA + Tax) – DA +/- BBRA

(c) An explanation of each of the above building blocks is provided below.

(i) **Return on Capital (RoC) building block:** this accounts for the return on capital the IP is entitled to receive in each Charging Year during the initial operational period in respect of the Provisional Post Construction Review RCV (in the case of the first Charging Year of the initial operational period) and the Post Construction Review RCV (in the case of the second and each subsequent Charging Year during the initial operational period), in each case, as adjusted based on the incentive framework (see paragraph A3.5 below). The return on capital is calculated by reference to a real weighted average cost of capital that will depend on when Acceptance occurs. So, if Acceptance occurs prior to 1 May 2028, it will be equal to the BWACC, or, if Acceptance occurs on or after 1 January 2029, it will be specific to the Project and determined by Ofwat in the Post Construction Review. Guidance on how this return will be determined can be found in the economic guidance provided by Ofwat. As mentioned above, if Acceptance occurs on or after 1 May 2028 but prior to 1 January 2029, there will be no initial operational period and, consequently, the IP’s allowed revenue for the period on and from 1 April 2030 will be determined at the First Periodic Review and at any subsequent periodic reviews.

(ii) **Opex (Op) building block:** this accounts for the operating costs allowance the IP will be entitled to recover. This allowance will be determined by Ofwat at the Post Construction Review taking into account the operating expenditure forecast by the IP in its business plan submitted to Ofwat prior to the Post Construction Review.

(iii) **Financing Cost Adjustment (FCA):** this accounts for the financing cost adjustment, if applicable, for net debt outstanding in Charging Years 2028/29 and 2029/30, but only if Ofwat has elected (following consultation with the IP) for this adjustment to be included in the allowed revenue during the initial operational period (see paragraph A2.5(g) above).

(iv) Revenue Adjustment (RA) for under-/over-recovered allowed revenue: this accounts for adjustments to the allowed revenue to take into account any under-/over-recovery of revenue experienced by the IP in previous Charging Years with a two year lag. This building block works on the same basis as the RA building block during the construction period.

(v) **Tax building block:** this accounts for Ofwat's estimate of tax to be paid or received by the IP in the relevant Charging Year and any Lease Chargeable Gain payable during the initial operational period, but only to the extent that Ofwat elects to treat it as part of this Tax building block.

(vi) **Delay Adjustment (DA)**: this accounts for the penalty the IP will be subject to if Acceptance is not achieved by the Planned System Acceptance Date, as described in paragraph A3.5 (i) – (q) below.

(vii) **Reconciliation Adjustment (BBRA)**: this accounts for the true-up mechanism to take account of the difference between the Provisional Post Construction Review RCV and the Post Construction Review RCV. This reconciliation adjustment will be subject to a net present value adjustment, calculating by using the weighted average cost of capital applicable during the first Charging Year following the Post Construction Review.

(d) The allowed revenue for each Charging Year during the initial operational period will be calculated in the immediately preceding Charging Year.

3.4 Provisional Post Construction Review RCV and Post Construction Review RCV

(a) At the Post Construction Review Ofwat will determine the Provisional Post Construction Review RCV. The Provisional Post Construction Review RCV will comprise:

(i) the aggregate of all Allowable Project Spend incurred by the IP as at the Post Construction Review, as verified by the Independent Technical Assessor;

(ii) the estimated costs incurred by the IP as at the Post Construction Review, but not yet verified by the Independent Technical Assessor;

(iii) the costs forecast to be incurred by the IP following the Post Construction Review up to (and including) 31 March following the Post Construction Review;

(iv) the Additional Allowable Project Spend incurred by the IP as at the Post Construction Review, as verified by the Independent Technical Assessor and (if applicable) allowed by Ofwat;

(v) the Additional Allowable Project Spend incurred by the IP as at the Post Construction Review, but not yet verified by the Independent Technical Assessor, and (if applicable) allowed by Ofwat; and

(vi) the Additional Allowable Project Spend forecast to be incurred by the IP following the Post Construction Review up to (and including) 31 March following the Post Construction Review, and (if applicable) allowed by Ofwat.

(b) Once actual outturn costs incurred by the IP become available and have been verified by the Independent Technical Assessor, Ofwat will within a period of three months thereafter re-calculate the Post Construction Review RCV that will apply in perpetuity. The Post Construction Review RCV will comprise:

(i) the aggregate of all Allowable Project Spend incurred by the IP as at (and including) 31 March following the Post Construction Review, as verified by the Independent Technical Assessor; and

(ii) the Additional Allowable Project Spend incurred by the IP as at (and including) 31 March following the Post Construction Review, as verified by the Independent Technical Assessor and (if applicable) allowed by Ofwat, and as adjusted by the incentive framework applicable to it.

3.5 Adjustments to the Provisional Post Construction Review RCV and Post Construction Review RCV

(a) The Provisional Post Construction Review RCV and the Post Construction Review RCV will be subject to an upward or downwards adjustment based on two incentive frameworks: one framework rewards cost savings and penalises cost overruns, and the other incentivises the IP to complete the Project on time.

Cost Adjustment

(b) The IP is incentivised to incur costs annually in line with the Annual Base Case Forecasts and there is an adjustment based on the cost profile in the construction phase to reflect cost over-runs or savings in particular years. Cost overruns early in the construction period are more costly to customers as the allowed revenue will be higher for the rest of the construction period as a result of the cost over-run (as the cost over-run goes into RCV which then earns a return from customers). This effectively means that the IP is under-/over-recovering revenue in comparison to the Annual Base Case Forecast from the moment that the under-/overspend occurs. This adjustment seeks to penalise/reward the IP for 40% of the annual cost under-/overspend.

(c) This adjustment mechanism is based on the net present value of any overspend or underspend occurring in each Charging Year prior to (and including) Acceptance (or, if later, the Planned System Acceptance Date). The net present value is calculated using the BWACC.

(d) If the Allowable Project Spend incurred by the IP in any Charging Year prior to (and including) Acceptance (or, if later, the Planned System Acceptance Date) is below the Annual Base Case Forecast for that Charging Year (as adjusted for any Base Case Adjustment Trigger Events), the IP will receive an increase in its Provisional Post Construction Review RCV and Post Construction Review RCV equal to 40% of the net present value of the underspend.

(e) If the Allowable Project Spend incurred by the IP in any Charging Year prior to (and including) Acceptance (or, if later, the Planned System Acceptance Date) is above the Annual Base Case Forecast for that Charging Year (as adjusted for any Base Case Adjustment Trigger Events), there will be a decrease in the Provisional Post Construction Review RCV and Post Construction Review RCV equal to 40% of the net present value of the overspend.

(f) If the Original Base Case Forecast exceeds the aggregate Allowable Project Spend incurred by the IP as at Acceptance, then there will be a further decrease in the Provisional Post Construction Review RCV and Post Construction Review RCV equal to 10% of such difference.

(g) Annex A to Appendix 1 sets out the Annual Base Case Forecast for each Charging Year in the period from Licence Award until the Planned System Acceptance Date. For any period thereafter the Annual Base Case Forecast is set at zero. This is based on the assumption that the Project should reach Acceptance on or by the Planned System Acceptance Date. Therefore, if the Project has not achieved Acceptance on or by the Planned System Acceptance Date, any costs incurred by the IP after this date will be treated as a 100% overspend. Conversely, if the Project achieves Acceptance prior to the Planned System Acceptance Date, then any Allowable Project Spend from (and including) Acceptance until (and including) the Planned System Acceptance Date will for present purposes be deemed equal to zero. This means that the IP may in the period following Acceptance until the Planned System Acceptance Date potentially have an underspend.

(h) If the IP disputes the Acceptance date, then the date determined as a result of such dispute under the Interface Agreement will be used as the Acceptance date for the purposes of calculating the above cost adjustment. If the dispute is resolved after the completion of the Post Construction Review, there will be a recalculation of the RCV adjustment based on the Acceptance date determined as a result of such dispute and an adjustment will be made and reflected in the allowed revenue of the IP at the earliest opportunity.

Delay Adjustment

(i) The IP is incentivised to achieve Acceptance by the Planned System Acceptance Date, failing which it will be subject to a penalty in the form of a step down in the weighted average cost of capital earned by the IP during the period of delay or, if earlier, until (and including) 31 March 2030 as the BWACC does not apply thereafter. To ensure this step down does not negatively impact financeability during the construction period, the IP will continue to receive the BWACC throughout the construction period up until (and including) 31 March 2030. The step down will therefore be applied retrospectively through a delay adjustment mechanism calculated as part of the Post Construction Review.

(j) The delay adjustment is calculated by applying this step down in BWACC to the average RCV received by the IP in each year of delay. A net present value calculation of the penalties in each of the years of delay is then determined by using the BWACC to take account of the delay in imposing the penalty.

(k) Different step downs will apply during different periods.

(l) For any delays in Acceptance of up to 18 months from the Planned System Acceptance Date (termed a 'Minor Delay Period'), the BWACC (stated in real terms) for this period will be replaced by the lesser of:

(i) the IWACC; and

(ii) the BWACC *less* 100bps.

(m) For any delays in Acceptance beyond the Administrative Penalty End Date (i.e. 18 months from the Planned System Acceptance Date) until (and including) the earlier of (i) the actual date of Acceptance and (ii) 31 March 2030 (termed a 'Major Delay Period'), the BWACC for this period will be replaced by a real weighted average cost of capital determined by Ofwat at the time of this delay and revisited on the anniversary of the Administrative Penalty End Date if the delay still continues.

(n) For clarity, if Acceptance occurs on or after 1 May 2029, there will be no further delay adjustment for the period on and from 1 April 2030 for the remainder of the construction period and the real weighted average cost of capital, as determined by Ofwat before the commencement of each Charging Year falling within such period, will be used when calculating the allowed revenue for each such Charging Year instead of the BWACC (see paragraph A2.2 (f) above).

(o) 50% of the value of the aggregate delay adjustments will be applied by reducing the Provisional Post Construction Review RCV and the Post Construction Review RCV.

(p) The other 50% of the aggregate delay adjustments will be applied by reducing the allowed revenue the IP is entitled to receive in the first Charging Year following the Post Construction Review subject to a cap of £15 million (as indexed) or such higher amount as elected by the IP by notice to Ofwat or such lower amount as agreed by Ofwat and the IP. If the delay adjustments have not been fully recovered in the first Charging Year due to the cap, any remaining amounts will be carried forward into the next Charging Year and so on until it is fully recovered, provided that the annual reduction will never exceed the above cap. Carried forward amounts will be subject to indexation each Charging Year until recovered based on changes in RPI and a net present value adjustment calculated using the weighted average cost of capital applicable to the IP's allowed revenue during the immediately preceding year.

q) If the IP disputes the Acceptance date, then the date determined as a result of such dispute under the Interface Agreement will be used as the Acceptance date for the purposes of calculating the above delay adjustment. If the dispute is resolved after the completion of the Post Construction Review, there will be a recalculation of the delay adjustment based on the Acceptance date determined as a result of such dispute and an adjustment will be made and reflected in the allowed revenue of the IP at the earliest opportunity.

4. Allowed revenues during the long-term operational period

(a) The allowed revenue for any Charging Year following the First Periodic Review will be determined at the First Periodic Review and each subsequent Periodic Review and calculated by Ofwat in accordance with Condition B (Allowed Revenue) of the Project Licence. When making its determination and without prejudice to the above incentive framework, Ofwat will not take into account any cost savings or overruns of the IP prior to the Post Construction Review. Guidance on how the allowed revenue will be determined can be found in the economic guidance provided by Ofwat.

(b) If the Post Construction Review occurs concurrently with the First Periodic Review, the Post Construction Review and the First Periodic Review will be carried out simultaneously and there will be no initial operating period.

However, the RCV for the first Charging Year following the First Periodic Review will be equal to the Provisional Post Construction Review RCV and the RCV for any Charging Year thereafter will be equal to the Post Construction Review RCV, in each case, as adjusted based on the above incentive framework.

(c) The IP may include in its business plan, submitted to Ofwat prior to the Post Construction Review, a proposal that the RCV be amortised (or "run off") at any time from 1 April following the First Periodic Review, including the run off rate. To the extent that Ofwat accepts such proposal, an allowance will be included in the allowed revenue for such run off.

B. Overview of Appendix 2: Non-revenue conditions

1. Introduction

1.1 Appendix 2 sets out the non-revenue related conditions that apply to the IP during the construction period and initial operational period up until (and including) 31 March following the First Periodic Review.

2. General IP obligations in respect of the Project

2.1 The IP must use reasonable endeavours to commence construction of the Project within 12 months of Licence Award.

2.2 The IP will not be required to finance the IP Regulated Assets in the event that the Project is Discontinued (or deemed Discontinued) in accordance with the Discontinuation Agreement.

2.3 The IP is required to use any payments received under the Alliance Agreement towards funding costs (other than any Excluded Project Spend) incurred or to be incurred by the IP in connection with the Project prior to 1 April following the Post Construction Review. For this purpose, the IP must also ensure that any revenue statement it delivers to Ofwat under the Project Licence in respect of its calculations of allowed revenues also sets out the amounts it received or are forecast to be received under the Alliance Agreement in the prior, current and forthcoming Charging Years.

3. Timing of the Post Construction Review

3.1 The Post Construction Review will take place on 1 November following Acceptance, unless Acceptance occurs between 1 May and 31 October, in which case it will take place on 1 November in the immediately following year. Also, if Acceptance has not occurred within three years from the date of Handover, Ofwat may, by notice to the IP, determine to conduct an interim Post Construction Review prior to Acceptance.

3.2 The IP is required to submit to Ofwat its business plan setting out the works and services it is required to perform during the long-term operational period (and initial operational period, if any). The business plan must also set out the operating costs the IP forecasts it will need to incur during each Charging Year following the Post Construction Review until (and including) 31 March following the First Periodic Review. The business plan must be submitted to Ofwat no less than six months prior to the Post Construction Review. This is in order to give Ofwat sufficient time to take account of the business plan for the purposes of the Post Construction Review and for the purposes of determining IP's allowed revenues following the Post Construction Review.

4. Information requirements

4.1 The IP is required to provide certain information to Ofwat in accordance with the requirements of the Liaison Agreement.

4.2 The IP is required to appoint the Independent Technical Assessor and maintain such appointment until the Post Construction Review. Among other things, the services of the Independent Technical Assessor will include verifying the Allowed Project Spend incurred by the IP during the construction period.

4.2 The IP is required to co-operate with the Independent Technical Assessor and give the Independent Technical Assessor rights of inspection, measuring and testing in order to enable the Independent Technical Assessor to perform its services.

5. Delays in Acceptance beyond the Longstop Date

5.1 The IP is required to complete the Project by no later than the Longstop Date, being 18 months following the Planned System Acceptance Date.[9] Failure to do so may give rise to Ofwat taking enforcement action against the IP.

5.2 In order to avoid enforcement action being taken by Ofwat, Appendix 2 provides for an early warning mechanism that allows the IP to apply for an extension of the Longstop Date.

5.3 If the IP becomes aware of any incident, circumstance or event of any nature that is likely to result in Acceptance not occurring by the Longstop Date, it must notify Ofwat of the same. Any such notice must set out details of the delay event, including its nature, extent and reasons for it occurring, the corrective actions already undertaken or to be undertaken to mitigate the consequences of the delay event, and the effect on the timing of Acceptance.

[9] The Planned System Acceptance Date is 28 February 2027 and the Longstop Date is 31 August 2028.

5.4 If the delay event cannot be mitigated such that Acceptance can occur prior to the Longstop Date, the IP is required to apply to Ofwat for an extension of the Longstop Date, in which case Ofwat will determine whether to approve the extension.

5.5 In making its determination to approve an extension of the Longstop Date, Ofwat will take into consideration whether the delay event was caused or contributed to by one or more of the following:

(a) a breach, default, act of prevention or omission of TWUL;

(b) an act of a third party (excluding Ofwat or any other competent authority);

(c) an act or omission of Ofwat or any other competent authority;

(d) an event for which the construction contractors are entitled to an extension of time to their completion date pursuant to the construction contracts for the construction of the Project;

(e) any changes to the Project Specification Notice (but only to the extent that such extension of time to the Longstop Date has been agreed as part of those changes);

(f) the exercise by TWUL of its suspension rights under the Interface Agreement for reasons of health and safety, emergency or operational necessity (other than as a result of the act or negligence of the IP or its contractors);

(g) an act of prevention or default of the IP.

5.6 Ofwat will notify the IP of its decision as to whether to extend the Longstop Date within three months of application for such extension by the IP, failing which the IP may require Ofwat to refer the matter to the CMA for determination.

5.7 The same process will apply to any further required extensions of the Longstop Date.

5.8 If the IP wishes to apply for an extension of the Longstop Date and approval of Additional Allowable Project Spend at the same time, such applications may be made as a single application, in which case they will both be considered simultaneously by Ofwat.

6. Ofwat fees payable prior to the First Periodic Review

6.1 On 1 April (and, if Ofwat so determines, on 1 January) of each Charging Year during the construction period until 1 April following the Post Construction Review and during the initial operational period until 1 April following the First Periodic Review, the IP will pay Ofwat an amount(s) to cover costs estimated by Ofwat as likely to be incurred by it in the Charging Year in question (or as already incurred by it in the preceding Charging Year but not previously recovered) in the regulation, monitoring of the IP and enforcement of the IP's regulatory obligations. Such amounts will be determined by Ofwat after consultation with the IP.

6.2 The total of all such amounts that the IP will be required to pay Ofwat will be subject to the Regulation Fee Cap, which varies depending on the period when amounts are levied by Ofwat. So, during the construction period up until the 1 April immediately following the Post Construction Review, the Regulation Fee Cap will be £11,500,000 or such higher figure as the IP may from time to time agree (not to be unreasonably withheld or delayed), and thereafter up until 1 April following the First Periodic Review the Regulation Fee Cap will be an amount to be determined by Ofwat at the Post Construction Review.

6.3 In the event that the IP makes an application to Ofwat for an extension of the Longstop Date and/or approval of Additional Allowable Project Spend and/or there has been a determination in respect of a Mandatory Variation Dispute (see paragraph 8 below), the Regulation Fee Cap may be modified by Ofwat as required to cover the costs estimated by Ofwat as likely to be incurred by it (or already incurred by it) as a result of the application and/or determination. (The costs incurred or to be incurred by Ofwat in determining a Mandatory Variation Dispute will be divided equally between the IP and TWUL.)

6.4 If a reference is made to the CMA (where permitted under Appendix 1 or Appendix 2 to the Project Licence), the IP will also be liable to pay Ofwat the sum of Ofwat's estimation, after consulting the CMA, of the costs incurred by the CMA in the previous Charging Year in relation to the reference made to it.

7. Licence revocation

7.1 Ofwat may revoke the Project Licence after consultation with TWUL by giving at least 30 days' notice to the IP if the Project is Discontinued (or deemed Discontinued) in accordance with the Discontinuation Agreement. In this case, the IP will be required to do all things necessary to comply with any direction issued by Ofwat to the IP, requiring the IP to:

(a) take steps to effect the transfer to another company(-ies), at nil value, of so much of the IP's business as Ofwat directs; and

(b) secure and make safe the IP Regulated Assets pending a transfer to another company(-ies) as described above. The associated costs of the IP (to the extent that they are economic and efficient) will be treated as expenditure incurred or to be incurred by the IP in connection with the Project (and so included in the RCV).

7.2 If the Project is Discontinued (or deemed Discontinued), Ofwat will direct TWUL as to the treatment of any revenue collected by TWUL with respect to IP's allowed revenue, but not already passed on to the IP and any revenues which may subsequently be collected by TWUL in respect of IP's allowed revenue. This will not constitute funding for TWUL to carry on with the delivery of the Project. This will apply whether or not Ofwat has given the IP a revocation notice in respect of the Project Licence. Before issuing any such direction, Ofwat will consult the IP and TWUL.

8. Mandatory Variation Disputes

8.1 The IP is required to refer certain disputes under the Liaison Agreement relating to variations that must be implemented in relation to the Project (termed 'Mandatory Variation Disputes') to Ofwat for determination. Any such disputes will be determined by Ofwat on such terms as it considers appropriate. In doing so, Ofwat will need to be mindful of factors set out in the Project Licence, which include its duties under the Water Industry Act 1991 (as applied by the SIP Regulations).

8.2 Ofwat's determination may include whether the relevant variations that are the subject of the Mandatory Variation Dispute should be implemented by the IP or TWUL with or without modification or whether they should not be implemented. Any such determination will be binding on the IP.

8.3 The costs incurred or to be incurred by Ofwat in determining a Mandatory Variation Dispute will be divided equally between the IP and TWUL and will constitute amounts payable by the IP and TWUL as fees due to the Secretary of State.

C. Overview of the main body of the Project Licence

Although in substance the Project Licence conditions are similar to an undertaker's conditions of appointment, a simplified format has been used for some of the Project Licence conditions. Where appropriate, the language and structure has been simplified in order to make the document more streamlined and accessible. Conditions that are no longer used in practice have been deleted – for example, condition J (service targets) and condition L (asset management plans); and some conditions have been consolidated – for example, all the information provisions now appear in one consolidated condition M, and all the ring-fencing provisions now appear in one consolidated condition K. Terms that are capitalised below are defined in Addendum A hereto, or where not defined, have the meaning given in Appendix 4 to the Project Licence.

Licence condition	Summary
Principal duties	The principal duties of the IP will be: 1. to design, construct, finance, test, commission, operate and maintain the IP Regulated Assets so as to achieve Acceptance by a specified date; and 2. from the date of Acceptance, to own, finance, operate and maintain the IP Regulated Assets so that they can be used in conjunction with TWUL's sewer network and are capable of being operated in accordance with TWUL's environmental permits and with the operating techniques (agreed between TWUL and the Environment Agency).
B: Allowed revenue	Prior to the Post Construction Review, the IP's allowed revenue will be determined by the provisions of Appendix 1 and Appendix 2 to the Project Licence and during operations its allowed revenue will be determined under condition B at a five-yearly price review that will take place concurrently with the wholesale price control of TWUL. In the normal course of events, the IP will charge TWUL for its services rather than end-users. The IP will submit an invoice to TWUL for the IP Charge and TWUL will include the IP Charge in its charges to wastewater customers. Condition B also includes standard interim determination provisions, but these will not be operable until after the Post Construction Review. Similar to an undertaker, the IP may appeal a price determination to the CMA.

<table>
<tr><th>Licence condition</th><th>Summary</th></tr>
<tr><td>F: Regulatory accounts</td><td>Unlike an undertaker’s instrument of appointment, condition F of the Project Licence will only focus on regulatory accounts (the ring-fencing provisions, which normally appear in an undertaker’s condition F have been consolidated and are dealt with in condition K and the reporting provisions have been consolidated and are dealt with in condition M). The remaining provisions are similar to condition F of an undertaker. They set out details of the accounts and financial information that the IP will be required to deliver to Ofwat.</td></tr>
<tr><td>J: Levels of service information and service targets</td><td>Condition J has been omitted from the Project Licence, because in practice it is no longer used.</td></tr>
<tr><td>K: Regulatory ring-fence and disposals of land</td><td>This consolidates all the ring-fencing provisions that are currently in an undertaker’s conditions F, K and P. It provides the same protection for customers as is currently in undertakers’ instrument of appointment, including requiring the IP to:
at all times have sufficient rights and assets available to enable a special administrator to manage the IP’s business;
trade at arm’s length with associates;
have a dividend policy in place;
obtain legally enforceable undertakings from its owners; and
maintain not less than three independent non-executive directors on its board.
The disposal of protected land is dealt with in condition L (see below).</td></tr>
<tr><td>L: Asset management plans</td><td>In practice, condition L has become redundant because undertakers are required to include asset management plans as part of their business plans for a price review. The IP will be subject to the price control during the operational period and a standard condition L has therefore not been included in the draft Project Licence.

Instead, condition L deals with all the provisions on land disposals. These provisions are similar to the provisions that apply to the disposal of protected land for undertakers.</td></tr>
<tr><td>M: Provision of information</td><td>This condition consolidates various information provisions in one condition. It achieves the same as the equivalent conditions for undertakers. It provides for the IP to provide Ofwat with information it reasonably requires to carry out its functions.</td></tr>
<tr><td>N: Fees</td><td>This condition is different in effect from the equivalent condition for undertakers. It allows Ofwat to recover actual regulatory costs from the IP during construction, subject to a cap. During operations, it</td></tr>
</table>

Licence condition	Summary
	provides that the cap on regulatory costs will be set by Ofwat at the Post Construction Review and this figure will then be increased annually in line with RPI. In addition to recovering Ofwat's costs, the condition also allows Ofwat to recover the costs involved in carrying out Price Reviews, Mandatory Variation Disputes and the costs of any references to the CMA.
O: Revocation	This allows the Secretary of State to revoke the Project Licence on 25 years' notice; it allows Ofwat to revoke the Project Licence on two years' notice if the RCV of the IP will, by the expiry of the notice, depreciate to zero; and it allows Ofwat to revoke the Project Licence in the event the IP is put into special administration and the special administration fails (that is, the Project Licence is not transferred to a replacement IP and the IP is not rescued as a going concern). Ofwat may also revoke the Project Licence with the consent of the IP. If the Project Licence is revoked, the assets of the IP will transfer by agreement between the IP and the replacement IP via a transfer scheme made under Schedule 2 of the modified Water Industry Act 1991 (Ofwat must approve such a scheme). If no scheme is agreed, Ofwat must direct to whom assets held by the IP should transfer. The direction given may be subject to conditions including in respect of the valuation of the IP regulated assets.
P: The roles of the IP's owners	In line with the simplified template, this condition has been incorporated into condition K which deals with ring-fencing.
Appendix 1: Calculation of Allowed Revenue	The appendix sets out the formulae for calculating the IP's allowed revenue during construction and early operations – see section A above. Appendix 1 will fall away on 1 April following the First Periodic Review, unless otherwise determined by Ofwat.
Appendix 2: Non-revenue conditions	This appendix sets out the non-revenue conditions that only apply during construction and early operations – see section B above. Appendix 2 will fall away on 1 April following the First Periodic Review, unless otherwise determined by Ofwat.
Appendix 3: Direct charging conditions	Appendix 3 sets out additional Project Licence conditions that will apply should the IP ever charge end-users instead of charging the incumbent undertaker. All of these provisions will be suspended until Ofwat gives the IP notice. Ofwat may only give notice if the Revenue Agreement terminates and the IP has notified Ofwat that it intends charging end user customers. Appendix 3 includes additional provisions for:

Licence condition	Summary
	• condition B (enabling Ofwat to set a retail price control); • condition D (requiring the IP to have a charges scheme in place); • condition E (requiring the IP to ensure that its charges to end users do not show undue discrimination); • condition G (customer information). This consolidates all the current customer information conditions into one condition; and • condition N (including a provision for an additional fee to cover the costs of the Consumer Council for Water).

Addendum A: Definitions

Acceptance means the acceptance of all of the IP Regulated Assets, as well as the sewerage assets procured and financed by TWUL, in accordance with the Interface Agreement.

Alliance Agreement means the alliance agreement entered into between, amongst others, the IP and TWUL on or about Licence Award.

BWACC means the weighted average cost of capital bid by the IP.

Charging Year or **CY** means a calendar year commencing on 1 April of one calendar year and ending on 31 March of the immediately following calendar year.

CMA means the Competition and Markets Authority.

Conditions Precedent and Escrow Agreement means a conditions precedent and escrow agreement entered into between, amongst otherwise, the IP, the Secretary of State and TWUL.

Discontinuation Agreement means the discontinuation agreement entered into between, amongst others, the IP and the Secretary of State on or around Licence Award.

Discontinuation Notice means a notice issued (or deemed issued) by the Secretary of State under the Discontinuation Agreement.

Discontinued means the Secretary of State has issued (or deemed to have issued) a Discontinuation Notice in accordance with the Discontinuation Agreement.

First Periodic Review means the first review of the IP's licensed business following Acceptance; the First Periodic Review will take place in year 2029, unless Acceptance has not occurred prior to 1 January 2029, in which case it will not take place in year 2029 and will instead be timed to occur either concurrently with the next periodic review of the TWUL's wholesale activities that takes place after 1 April 2030 or, if that next periodic review precedes the Post Construction Review, then it will occur concurrently with the next periodic review of the TWUL's wholesale activities that takes place after the Post Construction Review.

Handover means the completion of construction of all of the IP Regulated Assets, as well as the sewerage assets procured and financed by TWUL, as evidenced by the issuance of a handover certificate in accordance with the Interface Agreement.

Independent Technical Assessor means the company appointed by the IP as an independent technical assessor in accordance with the Liaison Agreement.

Interface Agreement means the interface agreement entered into between, amongst others, the IP and TWUL on or about Licence Award.

IP means the licensed infrastructure provider.

IP Finco means any subsidiary or holding company of the IP and any subsidiary of any holding company of the IP, the sole purpose of which is to raise finance on behalf of the IP for the purpose of the IP's licensed activities.

IP Regulated Assets means:

(i) prior to Acceptance, the sewerage assets to be constructed and maintained by the IP in accordance with the Project Specification Notice (excluding, from Handover, the pump exercising system fitted to the storm pumping stations at each of Hammersmith, Falconbrook, Earl and Shad Thames pumping stations); and

(ii) from Acceptance, the IP owned structures.

IWACC means the post-tax cost of equity with a pre-tax cost of debt weighted average cost of capital for the relevant services, as determined and published by Ofwat following a periodic review (excluding any small company adjustments) and applied generally at the relevant time in respect of the relevant services on an industry-wide basis.

Liaison Agreement means the liaison agreement entered into between the IP, the Secretary of State and TWUL on or about Licence Award.

Licence Award means the date on which the Project Licence comes into effect.

NPV means net present value.

Planned System Acceptance Date means the date on which Acceptance is scheduled to be achieved, being 28 February 2027.

Post Construction Review means the date on which Ofwat issues its final determination on its review of the IP's licensed business, which is to take place on 1 November following Acceptance, unless Acceptance occurs between 1 May and 31 October, in which case it will take place on 1 November in the immediately following year; if however Acceptance has not occurred within three years from the date of Handover, Ofwat may, by notice to the IP, determine to conduct an interim Post Construction Review prior to Acceptance.

Project means the financing, design, construction, commissioning, Acceptance, maintenance, operation and ownership of the sewerage assets known as the Thames Tideway Tunnel project and its integration into the asset to be known as the London Tideway Tunnels as specified in the Project Specification Notice.

Project Licence means the licence granted to the IP by Ofwat pursuant to section 17FH of the Water Industry Act 1991 (as given effect by the SIP Regulations) in relation to the Project.

Project Specification Notice means the Thames Tideway Tunnel Project Specification Notice made by the Secretary of State on 4 June 2014 pursuant to regulation 4(1) of the SIP Regulations.

RCV means regulatory capital value.

Revenue Agreement means the revenue agreement entered into between TWUL and the IP on or about Licence Award.

Secretary of State means the Secretary of State for Environment, Food and Rural Affairs.

SIP Regulations means the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (as may be in force from time to time).

TWUL means Thames Water Utilities Limited.

Addendum B: Indexation

This addendum summarises the inflation and deflation principles that apply to different values referred to in Appendix 1 to the Project Licence.

Revenue calculations

The costs incorporated into the RCV are deflated using RPI. Costs incurred in years previous to the revenue calculation being undertaken are deflated using the Applicable Change in Cost RPI, which is based on actual observed RPI. Costs that are only estimates or forecasts are deflated using the 2014/15 RPI Adjustment Factor which is based on forecast as well as actual observed RPI. When calculating the allowed revenue, the RCV value is then indexed upwards by the Applicable Change in Revenue RPI. This is based on the actual observed RPI up to November of the previous charging year, which is the latest available RPI value at the time at which the revenue calculations are undertaken. For the Return on Capital and Liquidity building blocks, this indexed value is then multiplied by BWACC, which is stated in real terms.

Cost calculations

Value	Original calculation: real/nominal	Indexed	Deflated	Comment
Allowable Project Spend (APS)	Nominal	n/a	n/a	
Additional Allowable Project	Nominal	n/a	n/a	

Value	Original calculation: real/nominal	Indexed	Deflated	Comment
Spend (AdAPS)				
Annual Actual Project Spend (AnAPS)	Nominal	n/a	Deflated based on the Applicable Change in Cost RPI, except that for the purposes of calculating the P/O and the point at which the ACPS is equal to the T/O the deflation is based on the Applicable Change in Cost Indices	Deflation carried out in respect of a Charging Year. This is carried out to ensure that values added to the RCV all have a consistent indexation base date.
Actual Cumulative Project Spend (ACPS)	Nominal	n/a	Deflated based on the Applicable Change in Cost RPI, except that for the purposes of calculating the P/O the deflation is based on the Applicable Change in Cost Indices	The ACPS is defined by reference to the aggregate of AnAPS for each Charging Year, so the same deflation principle by implication applies to the ACPS.
Estimated Allowable Project Spend (EAPS)	Nominal	n/a	Deflated based on the 2014/15 RPI Adjustment Factor, except that for the purposes of calculating the P/O the deflation is based on the Applicable Change in Cost Indices	
Forecast Allowable Project	Nominal	n/a	Deflated based on the 2014/15	

Value	Original calculation: real/nominal	Indexed	Deflated	Comment
Spend (FAPS)			RPI Adjustment Factor, except that for the purposes of calculating the P/O the deflation is based on the Forecast Cost Adjustment Factor	

Incentive calculations

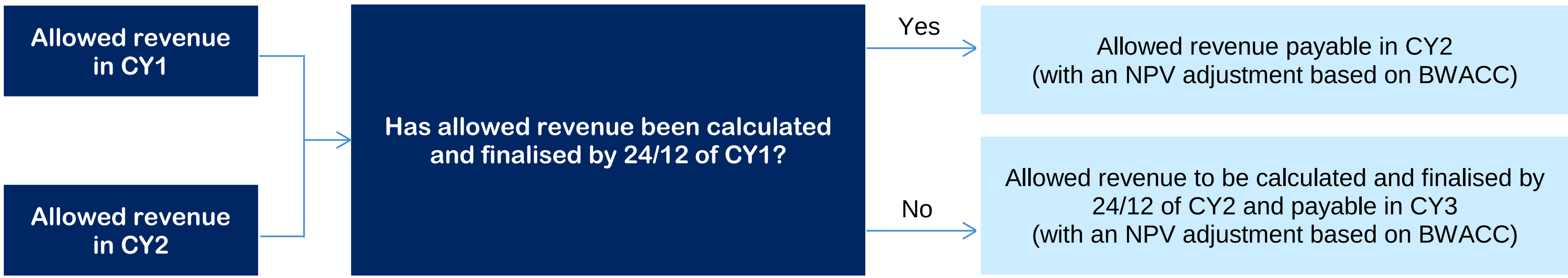
Value	Original calculation: real/nominal	Indexed	Deflated	Comment
Annual Base Case Forecast (ABCF)	Real	Indexed based on the Applicable Change in Cost Indices	Deflated based on the Applicable Change in Cost RPI	Indexation and deflation carried out in respect of each Charging Year falling within the period from (and including) Licence Award until (and including) the Charging Year in question. The inflation is done to provide protection for the IP against general movement in construction inflation. The deflation takes place so that any incentives/penalties are calculated on a consistent basis with the RCV base date.

Value	Original calculation: real/nominal	Indexed	Deflated	Comment
Original Base Case Forecast (OBCF)	Real	Indexed based on the Applicable Change in Cost Indices	Deflated based on the Applicable Change in Cost RPI	The OBCF is defined by reference to the aggregate of ABCF for each Charging Year, so the same inflation/deflation principles by implication apply to the OBCF.
Predicted Overrun (P/O)	Nominal	n/a	n/a	Whilst the P/O itself will not be subject to any inflation or deflation, the individual costs included in the P/O calculation will be subject to inflation and deflation.
Threshold Outturn (T/O)	Real	n/a	n/a	

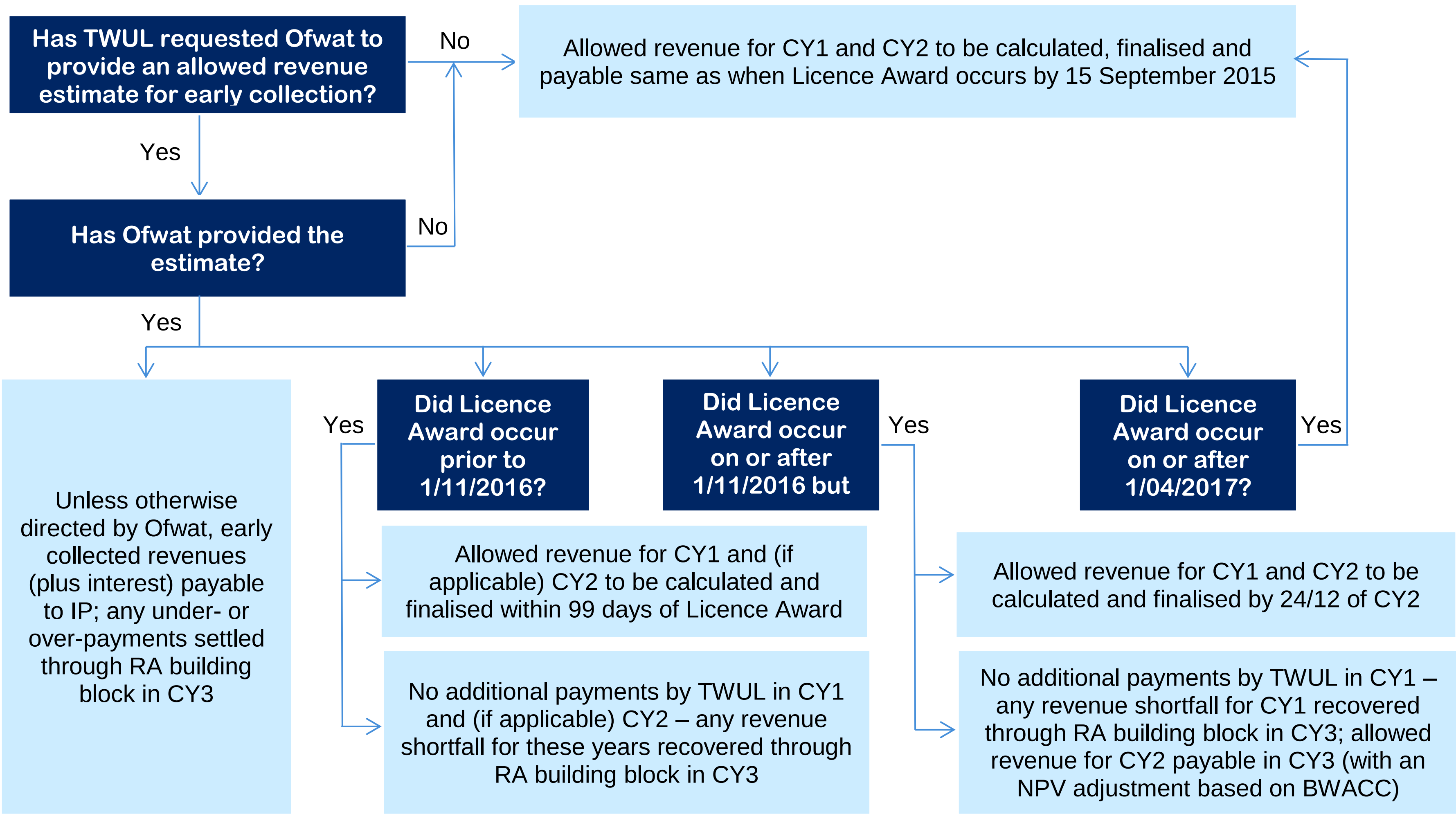
Addendum C: Illustration of allowed revenue calculation and payment in first and second Charging Years

This addendum illustrates the timing of calculation and payment of allowed revenue in respect of the first and second Charging Years pursuant to Appendix 1 to the Project Licence.

Licence Award occurs by 15 September 2015



Licence Award does not occur by 15 September 2015



Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.

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