April 2021

Consultation on amending Tideway's project licence

Ofwat

Contents

1. About this document

The document sets out our proposed amendments to the conditions that attach to the project licence of Bazalgette Tunnel Limited (trading as **Tideway**). The proposed amendments are required to give effect to: 1) an alternative sharing rate between Tideway and Thames Water's customers for Covid-19 impacted costs on the Thames Tideway Tunnel project; and 2) a different depreciation rate for Covid-19 impacted costs. In addition we are consulting on potentially accepting an amendment to a regulatory milestone date to take into account the delay caused to the project by Covid-19, although this amendment is only likely to be introduced later, once the extent of delay (if any) is known.

The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013[1] (**the SIP Regulations**) apply, modified or otherwise, the Water Industry Act 1991 (**the Act**) to the regulation of infrastructure providers.

Under section 17IA of the Act (as applied by the SIP Regulations), we are able to modify the conditions of an infrastructure provider's licence if it agrees to the changes we are proposing to make. Tideway has provided its indicative consent to the changes proposed in this document.

This document constitutes a Notice under section 17IA (3) of the Act (as applied by the SIP Regulations). Accordingly, it sets out the proposed licence modifications and their effect and sets out our reasons for proposing these modifications. It also invites comment on these proposals. Comments must be received by Ofwat by **7 May 2021**.

2. Background

The Thames Tideway Tunnel (**TTT**) once constructed, will be a 25 km (16 mile) tunnel running mostly under the tidal section of the River Thames through central London. Its purpose is to capture and convey almost all the combined raw sewage and rainwater discharges that currently overflow into the river.

Tideway is the infrastructure provider appointed to deliver the project. It operates under a project licence (**licence**) issued by Ofwat and its sole function is the construction, delivery and maintenance of the tunnel.

Covid-19 has impacted the Tideway project far more extensively than for any other water or sewerage company, leading to delays in construction and a consequent increase in costs for Tideway. With the outbreak of Covid-19 in March 2020, construction on all sites across the project ceased, except where necessary for safety reasons or to protect specialist equipment. From mid-May sites began to restart work on a phased basis, in line with Construction Leadership Council and public health guidance, after a series of detailed safety reviews had been carried out and Tideway and its contractors implemented measures to protect its workers and the wider community. The measures included social distancing and personal travel plans. Since then, work has re-commenced on all construction sites but at a reduced rate of efficiency and at additional cost because of the Covid-19 restrictions in place.

Under its licence, Tideway bears 40% of any overspend and customers bear 60% of that overspend. Tideway estimates that its additional expenditure as a result of Covid-19 will be in the order of £200m (including the costs of delay). Absent a licence amendment, Tideway will bear 40% of this amount.

At the start of the Covid-19 pandemic, Tideway approached Ofwat asking that the additional costs incurred as a result of Covid-19 be borne by customers. It argued that the impact of the pandemic was very extensive for the business and it was not a risk envisaged at the time of licence award and that the costs of it should not be borne by its shareholders. For the reasons set out below, Ofwat recognised that Covid-19 had had and will have a much more significant impact on Tideway than on other companies in the sector, but considered that Tideway should not be wholly insulated from additional costs and must bear a proportion of those costs.

In line with this principle, Ofwat provisionally agreed to a different sharing rate between Tideway and customers in respect of early Covid-19 costs. Ofwat also provisionally agreed that Covid-19 expenditure should depreciate at a different rate from the rate that would otherwise apply to an asset with an expected life of about 120 years. This was to support Tideway's financial resilience in funding additional Covid-19 expenditure. We have also provisionally agreed to amend a regulatory date to take into account delay solely caused by Covid-19.

These proposed licence amendments on which we are consulting are to give effect to these provisional decisions.

We set out below how Tideway has been impacted by Covid-19. We then describe the proposed amendments and their effect.

3. How Tideway has been impacted by Covid-19

The Thames Tideway Tunnel is being constructed on a number of brownfield sites throughout central London. It makes use of specialist tunnelling and construction plant including four large tunnelling machines and two smaller tunnelling machines and specialist shaft excavation plant including the first electric shaft walling machine in the world.

By comparison with typical large water and wastewater projects, the Tideway project is of a scale significantly higher both in terms of cost and complexity. The average UK water and wastewater capital project is the in range £100k to £2m. Large projects are rare and typically in the range £20m to £200m. In comparison, the Tideway project is estimated to cost in excess of £4bn, with tunnels bigger in diameter than Crossrail and the Channel tunnel.

The three main drive sites, which are all brownfield, face significant operational constraints. They are at least half the size of a typical "efficient" tunneling site because of the central London location. By way of illustration, the drive sites are 10 times smaller than the HS2 tunneling sites for smaller diameter tunnels. The connection shafts are sited at existing combined sewer overflow sites along the Thames river bank, often in a combination of public open space, main transport routes and at times partly or wholly built out into the river, again constraining site size.

Social distancing measures in such constrained worksites significantly impact the ability of Tideway to operate at full capacity. In addition, the tunnel is being built through the middle of central London. Prior to the pandemic, most workers travelled to sites using public transport. Although Tideway took steps to facilitate alternative travel plans to reduce the number of staff using public transport, this factor also prevented sites operating at full capacity.

Tideway engages three Main Works Contractors (**MWCs**) on modified target cost NEC3 contracts.[1] NEC3 contracts are widely used across the construction industry, particularly in tunnelling.

At the start of the pandemic, about 95% of Tideway's operations shut down. Tideway's concern was to retain specialist expertise, protect specialist equipment and avoid the consequences of long term demobilisation of the project. It also wanted to be able to commence construction as soon as possible once restrictions started lifting. It sought to mitigate these risks through a number of measures.

Firstly it agreed to underwrite the costs of the MWCs and their supply chain for the period from mid-March to end of April 2020. Secondly, for the period from 1 May to 24 July 2020, Tideway adopted what it called an 'emerging cost approach', whereby it did not distinguish between Covid-19 costs and productive costs. In return, the MWCs agreed to a lower fee for that period. This allowed Tideway and the MWCs to mobilise as quickly as conditions allowed to restart work on individual sites.

On 24 July 2020, the emerging cost period ended and from 25 July 2020 the conditions of the NEC3 contracts in place prior to the emerging cost period were reinstated. This meant that the MWCs were no longer protected from operating conditions impacting performance and the risk of performance was once more subject to the cost sharing arrangement in the contracts.

As indicated above, the Tideway sites are relatively small for construction sites and this has caused challenges and required major changes in construction operations to accommodate the social distancing and other safety precautions required for Covid-19 both on the surface and in the more constrained underground spaces. Tideway's cost and schedule performance has continued

[1]The NEC3 is part of a suite of engineering and construction contracts. NEC stands for 'New Engineering Contract.

to be impacted by Covid-19 operating conditions, which has predominantly resulted in construction activities taking longer to complete and increased delay cost. Tideway estimates that whilst social distancing constraints remain in place it will continue to operate at a reduced efficiency.

We recognise the continued impact of delay due to Covid-19 after 24th July on Tideway but such costs are more difficult to estimate.

4. The modifications proposed and our reasons for proposing them

4.1 Alternative sharing rates

Ofwat said that it would only agree alternative sharing arrangements if Tideway could demonstrate to our satisfaction that it has been able to differentiate Covid-19 impacted costs from other costs and that Tideway has acted efficiently and effectively with respect to those costs. We also said that Tideway's shareholders would have to bear a proportion of any Covid-19 costs.

In the early months of the pandemic, Tideway put in place a methodology for differentiating Covid-19 costs from other costs and put in place an assurance process for verifying those costs. Ofwat considered the methodology and the assurance process to be robust and agreed that Tideway had acted appropriately to protect its supply chain, and accordingly Ofwat provisionally agreed that instead of customers bearing 60% of those costs, customers should bear 85% of those costs. This was in respect of the period from mid-March 2020 to 24 July 2020.

The proposed licence drafting will set out this alternative customer sharing rate for that initial period and will provide that Ofwat may, in its sole discretion, agree alternative sharing rates for periods after 24 July 2020. This flexibility is considered necessary to enable Ofwat to set alternative rates for the period after 24 July 2020 once better evidence becomes available on Covid-impacted costs for that period. However, we expect all companies to be managing the impact of Covid-19 in a way that mitigates costs as the regulatory framework is not designed to insulate companies from all unexpected costs incurred. We have therefore indicated to Tideway that the bar for agreeing alternative sharing rates will be higher as time goes on.

The drafting provides that Ofwat may determine "the proportion of Covid Expenditure to be borne by the Infrastructure Provider, such proportion not to be less than 15 percent and not to exceed 40 percent" and to determine the period in respect of which that proportion will apply.

This flexibility will also enable us to take into account, amongst other things, the impact of further waves of Covid-19 and associated additional construction costs related to Covid-19 that may arise in the medium to long term.

4.2 Accelerated depreciation

In order to support Tideway's financial resilience in funding additional Covid-19 expenditure, Ofwat has provisionally agreed that the proportion of Covid-19 expenditure that is borne by customers should depreciate at a faster rate from the rate that would otherwise apply to an asset with an expected life of about 120 years. The licence drafting provides that all expenditure which Ofwat has determined to be Covid-19 expenditure in the period from the start of the pandemic up until 30 September 2021, will depreciate over 18 years, commencing from 1 April 2022. 18 years was considered appropriate as this reflects the normal depreciation period for the wastewater assets of Thames Water.

Absent this amendment, all depreciation on the TTT assets will be determined at the First Periodic Review, which will take place after the tunnel is constructed and has been accepted for use. Unless the project is delayed, this is likely to be in 2030. The drafting ensures that when depreciation is agreed at the First Periodic Review, there will be no double counting with regard to the different depreciation rate for agreed Covid-19 expenditure.

To give effect to the 18-year depreciation period, amendments are required to both Appendix 1 of Tideway's licence and to Condition B. This is because Appendix 1 will cease to have effect after the First Periodic Review (i.e. 1 April 2030 unless there is a material delay to the project). After the First Periodic Review, Tideway's costs and revenues will be determined by a price review, with the normal wastewater wholesale price review cycle applying. In setting prices for Tideway, the 18-year run-off on Covid-19 impacted costs will continue to apply to those costs, unless agreed otherwise by Ofwat and Tideway.

We continue to expect that, after taking into account the impact of accelerated depreciation and alternative sharing rates in respect of Covid-19 impacted costs of around £1, customer bill impact will remain within the original £20-25 range in 2014-15 prices.

4.3 Project delay

Tideway estimates that the project will be delayed by about 6 months as a direct result of Covid-19. If we accept that any delay is due solely to Covid-19, it would require a further licence amendment. The amendment would be to change one of the regulatory milestone dates included in the licence by the length of delay caused by Covid-19. This decision has not yet been taken, however, as it is dependent on Ofwat being satisfied that Tideway can adequately differentiate delay caused by Covid-19 from other causes of delay. If we are so satisfied, we are minded to amend the licence to extend the Planned System Acceptance Date by the length of any delay caused by Covid-19. The Planned System Acceptance Date is set in the licence as a fixed date, namely 28 February 2027.

This change is considered necessary because if there is a delay to the project such that acceptance of the completed asset is not achieved by the Planned System Acceptance Date, Tideway will incur a penalty for the delay. Currently, the weighted average cost of capital (**WACC**) that applies to the project was set in the competitive bidding process (the **Bid WACC**). If the project is delayed beyond 28 February 2027, the Bid WACC will decrease by 1% from that date.

5. Next steps

We will consider all representations received before finalising the amendments giving effect to the alternative sharing rate and the accelerated depreciation. If made, we anticipate these amendments coming into effect in about June 2021.

Although we are consulting on the proposal to also amend the Planned System Acceptance Date to reflect delay caused by Covid-19, this amendment is only likely to be introduced later, once the extent of delay (if any) is known. Our decision in that regard will depend on whether Tideway has been able to satisfy us that it can differentiate delay caused by Covid-19 from other causes of delay. If the period of delay is substantially more than the 6 months indicative period set out above, we are likely to conduct a further consultation on that issue before making a final decision on whether or not to make the licence change.

5.1 Where to send submissions

If you wish to make representations on this proposal please submit your representations by email to richard.barton@ofwat.gov.uk

Representations must be received by Ofwat on or before **7 May 2021**. Further information about how to make representations or objections, including information on the treatment of confidential information, can be obtained from Ofwat at the above address or at http://www.ofwat.gov.uk/foi/

Ofwat will only use the information you have provided for the purpose of this consultation. We will retain your information in accordance with Ofwat's retention schedule and will not share with third parties unless we have a legal obligation to do so. For further information please see Ofwat's Privacy Policy in our Publication Scheme.

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