December 2021

Consultation on amending Tideway's project licence

Ofwat

Contents

1. About this document

In April 2021 we consulted on proposed amendments to the conditions that attach to the project licence of Bazalgette Tunnel Limited (**Tideway**). The proposed amendments we consulted on were required to give effect to:

1) an alternative sharing rate between Tideway and Thames Water Utilities Limited's (**Thames Water**) customers for Covid-19 impacted costs on the Thames Tideway Tunnel project;
2) a different depreciation rate for Covid-19 expenditure from the rate that would otherwise apply to an asset with an expected life of about 120 years; and
3) a different regulatory date to take into account project delay caused solely by Covid-19.

Subsequent to the above consultation, Tideway asked us to consider a further licence amendment, namely, to change how the Financing Cost Adjustment Mechanism (FCAM) operated. The primary reason for this subsequent request was that Tideway considered that the operation of the FCAM would result in outcomes that are not in line with expectations. It believes that extraordinary macro-economic circumstances are introducing extreme revenue impacts which would affect the project's financial resilience. Tideway state that the existing FCAM is forecast to remove a significant part of its revenue amounting to ca. 25% of its revenue from 2024/25.

We have provisionally agreed to amend how the FCAM is calculated and applied in the future. We have, however, taken a decision in the round and in the context of our previous decisions on the impact of Covid-19. In particular we are no longer proposing to provide a different depreciation rate for Covid-19 expenditure. This change would have increased cashflow for Tideway (and increased customers' bills although they would still remain within the original £20-25 cost range), but we no longer consider this is necessary given the proposed changes to the FCAM.

It is proposed that the FCAM calculation should, in future, be based on the same inputs as are applied when calculating Tideway's revenue charge for 2022/23 so that past customer benefits accrued are preserved. There will be no further incremental effects arising from future changes to the inputs into the FCAM (whether favourable or unfavourable for customers).

In our April consultation, we proposed an alternative sharing rate for Covid-19 expenditure incurred up until 24 July 2020 whereby customers will bear 85% of that expenditure and Tideway will bear 15%. In the consultation, we also said that Ofwat should have discretion to agree further alternative sharing rates for Covid-19 expenditure beyond 24 July 2020 but did not specify what those alternative sharing rates would be. We now propose an alternative sharing rate for Covid-19 expenditure for the period from 25 July 2020 to 30 June 2021 whereby customers will bear 80% of that expenditure and Tideway will bear 20%.

This document focuses on the changes to the FCAM but also provides a recap and update on our position with respect to the impact of Covid-19 on the project.

We still propose amending the Planned System Acceptance Date to reflect delay caused by Covid-19. However, that change will be made subsequent to the changes proposed above. In our previous consultation we said Tideway's indicative assessment of the delay caused by Covid-19 was six months and our decision to amend the date would depend on whether Tideway is able to satisfy us that it can differentiate delay caused by Covid-19 from other causes of delay. We also said that if the period of delay is substantially more than the 6-months indicative period, we are likely to conduct a further consultation before making a final decision on whether or not to amend the Planned System Acceptance Date. That remains our position, although on the basis of current information we do not expect to need a further consultation.

The Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (**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.

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, store 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.

The impact of Covid-19 on Tideway

Covid-19 has impacted the TTT 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 across the project was paused, except where necessary for safety reasons or to protect specialist equipment. For the period from late March to end of April 2020, about 95% of Tideway's operations were paused. In response, Tideway agreed to underwrite the costs of the main works contractors and their supply chain in order 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.

From mid-May 2020 sites began to resume more normal activities in line with Government restrictions and Construction Leadership Council guidance. This was done on a phased basis 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. From May 2020 until 24 July 2020, Tideway adopted what it called an 'emerging cost approach', whereby it did not distinguish between Covid-19 costs and productive costs based on amended commercial arrangements with the main works contractors. This allowed Tideway and the main works contractors to mobilise as quickly as conditions allowed to resume more normal activities on individual sites.

From 25 July 2020 onwards, these extraordinary measures ceased, and the main works contractors returned to the conditions set out in their contracts. Work returned to more normal levels on all construction sites but at a reduced level of efficiency and at additional cost because of the Covid-19 restrictions in place.

Since 30 June 2021 Tideway has reported that the impact of Covid-19 on cost has been negligible and we assume that there will be no further impact on the project in the future beyond that date.

Tideway's request for licence amendments to deal with Covid-19 impacts

Under its licence, Tideway bears 40% of any overspend and customers bear 60% of that overspend. At the time, Tideway estimated that its additional expenditure as a result of Covid-19 would be in the order of £220m (although this figure was subsequently adjusted down by Tideway as new information became available. Ofwat has assessed the impact to be about £184m which is close to Tideway's latest estimate including the costs of delay). Absent a licence amendment, Tideway would 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 should all 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. Ofwat recognised that Covid-19 had had 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.

In April 2021, we consulted on the licence amendments necessary to give effect to this provisional decision.

The previous consultation in April 2021

In the previous consultation Ofwat provisionally proposed an alternative customer sharing rate of 85% for the period mid-March 2020 until 24 July 2020. The proposed licence drafting also proposed that Ofwat could, in its sole discretion, agree alternative customer sharing rates for periods after 24 July 2020. This flexibility was considered necessary to enable Ofwat to set alternative rates once better evidence became available to Ofwat on Covid-19 impacted costs for any subsequent periods. In particular, we said that Tideway would have to demonstrate to our satisfaction that it has been able to differentiate Covid-19 impacted costs from other costs and that Tideway had 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.

The previous consultation also set out Ofwat's rationale for provisionally agreeing that all Covid-19 expenditure should depreciate at a faster rate than the rate that would otherwise apply to an asset with an expected life of about 120 years. We proposed that Covid-19 expenditure in the period from the start of the pandemic up until 30 September 2021, would 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.

3. The Financing Cost Adjustment Mechanism (FCAM)

Subsequent to the April 2021 consultation, Tideway requested that Ofwat amend the calculation and application of the FCAM. As set out in section 1, Tideway believe that the operation of the FCAM is resulting in outcomes that are not in line with expectations. It considers that extraordinary macro-economic circumstances are introducing extreme revenue impacts which would affect the project's financial resilience now and in the future. It forecasts that the FCAM could potentially remove a significant part of its revenue (ca. 25%) from 2024/25, equating to around £380m of its revenue in total.

We set out below the purpose of the FCAM and how it currently operates and then consider whether it should be amended and if so, the rationale for any change.

The purpose of the FCAM

Unlike under 5-year price controls, whereby the Weighted Average Cost of Capital (WACC) is re-determined reflecting current market conditions, the WACC bid by Tideway's shareholders in 2015 is fixed for the expected construction and testing period of nearly 15-years at 2.497% real. The consequence of fixing the WACC for a long period is that investors are exposed to a different level of risk, including longer term volatility in interest rates which will directly impact returns achieved. As part of the bidding process, investors could have sought to hedge interest rates or could have priced a risk premium into the WACC to offset such interest rate risk, and customers would have borne the cost of both these options, whether or not the perceived interest rate risk occurred.

To reduce the need to price in hypothetical interest rate risk – and provide an environment to moderate the WACC ultimately bid - the FCAM was designed to cap the financial impact borne by Tideway as a result of increasing real interest rates following licence award, and to transfer the risk above such a cap to Thames Water's customers. The mechanism also provided a symmetrical means by which customers could benefit from declining interest rates after licence award (although this was not thought to be the direction interest rates would take at the time).

The impact of the first 0.5% either above or below the 1.30% reference rate is borne in full by Tideway, with the next 0.5% being shared equally by Tideway and Thames Water's customers. The impact of any movements over and above 1.0% in either direction is fully borne by or to the benefit of customers. Annual increments for the FCAM are calculated for each financial year which are then fixed going forward. The total of these annual increments is reflected in customers' bills with a two-year time lag.

4. The rationale for amending the FCAM

When the FCAM was agreed at licence award in 2015, interest rates were increasing and were expected to continue increasing. However, we have seen large, unexpected falls in rates attributed to macro-economic and other factors, including Covid-19. The fall in market interest rates (as published by IHS Markitt ("iBoxx™")) alongside increasing spot implied inflation (as published by the Bank of England) has resulted in lower actual real interest rates for the purposes of calculating and applying the FCAM. For example, the applicable published iBoxx™ yield[1] has fallen 225 basis points (bps) since March 2016.

The low interest rate environment has benefited customers, through reductions in Tideway's revenues but has reduced available cashflows to fund completion of the project. The real annual average yield for the year to March 2021 was -0.88% – a difference of 218bp from the reference rate of 1.3% as at March 2015 in the FCAM.

Tideway forecasts that customer benefits from the FCAM would be substantial. Tideway has, of course, been able to raise debt at cheaper prices than anticipated at licence award which will offset to some extent the revenue impacts of the FCAM. However, Tideway believe that the FCAM does not act in a fair way since the impact could equate to sharing ca.120% of Tideway's projected debt outperformance i.e. customers would have recovered all outperformance and 20% more.

In considering whether to agree to change the FCAM we have considered our general statutory duties (including our duty to ensure that companies can finance their functions) as well as:

- whether such changes support the project and are in the wider interests of customers, or whether the option of doing nothing is in the interests of customers, and

- the principle that, in general, Ofwat considers that financial decisions are a matter for shareholders and management, rather than for Ofwat.

Tideway's funding decisions were taken in full knowledge as to the operation of the FCAM. This includes the development and use of deferred drawdown bonds after licence award. This awareness is further demonstrated by Tideway who have said that it stress tested the FCAM against a range of expected outcomes although not against the extreme outcomes seen.

However, we acknowledge that there has been an unprecedented change in interest rates since the project began and we recognise the scale of actual and potential consequences of the decrease in interest rates on the company. We did not expect the FCAM mechanism to transfer 120% of the benefits of lower interest rates to customers. In addition, we need to consider the impact on

[1] The applicable index yield is the iBoxx BBB UK non-financials with 10+ year maturity deflated by reference to the spot implied inflation rate for 10-year maturity published by the Bank of England for the same date.

Tideway's ability to finance the completion of the TTT, along with the risk that the completion of the TTT could be further delayed if Tideway considers it necessary to reschedule activities to control its net debt (and hence the FCAM impact). Neither of these consequences would benefit customers.

Tideway's initial suggestion considered a hypothetical retrospective amendment to the FCAM, out of which the customer benefit – from the lower interest rate environment – should be ca. £75m, with any remaining financing benefit staying with Tideway. Tideway viewed this would provide a fairer outcome based on their expectations as to how the FCAM should have operated. We did not consider that this suggestion – where customers would retain just £75m (or about 20%) of the benefits – was a reasonable one, especially as it would have resulted in the benefit customers had already accrued under the mechanism being in part removed. We determined as a principle that customers should retain the benefits the FCAM has already accrued to date up to the last financial year (to 31 March 2021).

There are a number of other options we could consider for the reform of the FCAM. The most straightforward is to freeze the application of the FCAM at a particular date so that there are no further future increments added or subtracted. If the mechanism is frozen at March 2020 customers would have retained 37% of the current and forecast future benefits – this was Tideway's revised preferred position. If the mechanism is frozen at March 2021, customers would retain 62% of the current and forecast future benefits, and at March 2022, customers would retain 90% of the current and forecast future benefits. Of these options, we consider that freezing the mechanism at March 2021 offers the best balance between Tideway and customers. It retains all of the benefits accrued to the last financial year for customers but makes no assumption about future benefits or disbenefits. This is Ofwat's preferred option and is the one we are consulting on in this paper.

Although Tideway has forecast a profile of future interest and inflation rates in arriving at its revenue impact estimate, this is subject to considerable uncertainty. However, this is just a forecast and the impact on Tideway if no changes are made to the FCAM, could be more or less than that. Freezing the impact means that customers (and Tideway) will no longer be exposed to risk in relation to the FCAM.

On the basis of our preferred option the FCAM would in future, rather than being calculated in accordance with inputs which change each year, be based on inputs as at year end March 2021, which will be used in calculating Tideway's revenue charge for 2022/23. Under this change the FCAM benefit to customers accrued would be preserved and is projected to deliver future benefits to customers of ca. £18m per annum from 2022/23 to 2031/32 (after which the FCAM ends). This means a total benefit to customers, including benefits delivered since licence award, of ca.£192m. This represents about two-thirds of Tideway's projected debt cost savings.

However, we have also looked at the changes that were previously proposed to deal with the impacts of Covid-19 and whether customers now need to bear all of these, particularly the acceleration of depreciation charges for Covid-19 expenditure. This is considered in section 5 below.

5. Different depreciation rates are no longer required

In discussions with Tideway, we said we would consider proposed changes to the FCAM in the round with the other licence changes proposed to deal with the impact of Covid-19. After consideration Tideway suggested that if Ofwat agreed changes to the FCAM, accelerated depreciation of Covid-19 costs could be dropped.

The original need for accelerated depreciation of Covid-19 costs, was to increase the cash flow for Tideway and improve the level of liquidity in the company over the medium term. Making the changes to the FCAM proposed in this consultation would also achieve this and so the need for accelerated depreciation, which would result in additional cost to customers in the short to medium term, is no longer considered necessary.

The impact of not amending the licence to include an alternative depreciation rate for Covid-19 costs, is to reduce the theoretical cost customers would have borne by about ca. £167m in total or ca. £9.25m per annum for 18-years commencing from 2022/23.

6. Alternative sharing rate from 24 July 2020.

Ofwat previously provisionally agreed to increase the incentive cost sharing rate for costs incurred as a result of Covid-19 from the standard 60% to 85% for the period from the start of the Covid-19 pandemic up to 24 July 2020. It was agreed that we would look at an alternative cost sharing rate for the period post 25 July 2020 once we were satisfied that there was sufficient evidence from Tideway that it had a sufficiently robust methodology for distinguishing Covid-19 costs from other costs for this period. We indicated to Tideway that the bar for agreeing alternative sharing rates after 24 July 2020 would be higher than for the previous period.

Whilst the main works contractors returned to the conditions set out in their contracts on 25 July 2020, Covid-19 impacts continued to have an impact on productivity. Having considered Tideway's and its contractors' ability to manage the impact of Covid-19 disruption from 25 July 2020 to the end of June 2021, noting that disruption has reduced through the period, we see no reason to differentiate between any parts of that period. The movement from 'the emerging costs' approach with amended commercial arrangements, back to the conditions of their contracts from 25 July onwards has given all parties the incentive to manage their own affairs.

Although Tideway has managed the situation well, and there are no obvious areas we could point to that could have been significantly improved, the period to 24 July 2020 was unprecedented, with work paused and exceptional efforts made to secure labour/plant in the face of an initially uncertain period. Post 24 July 2020, all sites have been up and running with adapted ways of working and in this period, the impact of Covid-19 should have been managed along with all other risks held by the project. In addition, the amended commercial arrangements with main works contractors in the first period because of the special arrangements up to 24 July 2020 were not in place after that date and so the incentives are different.

Given this, on balance, we have decided that a sharing rate slightly lower than that for the period to 24 July 2020 is warranted and consider that 80% is more appropriate.

The current information from Tideway indicates that by 30 June 2021, the vast majority of Covid-19 cost impact had been incurred and that broadly the current impact of Covid-19 is now minimal. Consequently, we do not envisage making further adjustments in the future.

7. The modifications proposed

As set out above, we are proposing a package of measures to limit the impact of external macro-economic events which would have significant revenue impacts for Tideway and could impact the project's financial resilience. The licence modifications required to do this are set out in summary form below.

1. That future benefits derived by customers pursuant to the FCAM will be frozen by basing inputs for future calculations of the FCAM on inputs determined for the purposes of calculating Tideway's 2022/23 IP Revenue Charge. This will mean that for 2023/24 and each subsequent Charging Year, the Financing Cost Adjustment will be zero and so the Financing Cost Adjustment Building Block for Charging Year 2023/24 and each subsequent Charging Year will be equal to the Financing Cost Adjustment Building Block for Charging Year 2022/23.

2. We are no longer proposing a licence change to allow Covid-19 expenditure to be depreciated over 18 years.

3. We previously proposed an alternative cost sharing incentive rate of 85% borne by customers for Covid costs incurred prior to 24 July 2021. That is still our proposal but in addition, we are proposing a cost sharing incentive rate for Covid-19 costs incurred between 25 July 2020 and 30 June 2021 of 80% borne by customers and 20% by Tideway.

It is difficult to precisely estimate the aggregate impact on customers of these proposed changes. The amended FCAM will reduce Tideway's revenue (and customers' bills) by about £18m per year for each year from 2022/23 onwards until 2031/32 after which the FCAM will expire. Changes in future interest rates (after March 2021) will no longer have an impact on Tideway's revenues arising from the FCAM. Tideway's expectation of interest rates after March 2021 would have further reduced revenues but it is difficult to predict future rates and hence the impact on customers' bills. In addition, removing the accelerated depreciation (which was due to commence in 2022/23) will reduce Tideway's revenue by about £9.25m per year. The additional Covid-19 expenditure of £184m is estimated to add ca.£5m per year to customers' bills. The increase in the sharing rate for Covid-19 expenditure, along with the incentive cost sharing rate for non-Covid-19 costs, will not impact Tideway's revenues until after the Post Construction Review which is expected to be undertaken in 2028.

The main impact of these changes is to increase certainty for Tideway and customers but the immediate bill impact from 2022/23 is a reduction arising from removal of the £9.25m per year depreciation charge offset by the impact of the additional Covid-19 expenditure of ca. £5m. We estimate this to be a net impact of a ca. £0.70 per annum reduction in the average bill.

8. Next steps

We will consider all representations received before finalising these proposed amendments. If made, we anticipate these amendments coming into effect in about February/March 2022.

8.1 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 no later than 17.00 hours on 17 January 2022. 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/

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