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Reasons for amending Tideway's project licence

Ofwat

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1. About this document

On 8 April 2021 and 13 December 2021 we consulted on proposed amendments to the conditions that attach to the project licence of Bazalgette Tunnel Limited (**Tideway**). Initially, the amendments were solely to deal with the impact of Covid on Tideway. Subsequently, we agreed to also amend the way a financing mechanism in the project licence works (the Financing Cost Adjustment Mechanism (FCAM)).

We received two responses to the first consultation and one response to the second consultation. Having considered the responses we have now made the amendments. The purpose of this document is to set out our reasons for doing so.

2. Overview of the amendments made

In the first consultation, we set out proposed amendments to give effect to: 1) an alternative sharing rate between Tideway and Thames Water's customers for Covid impacted costs on the Thames Tideway Tunnel project; 2) a different depreciation rate for Covid impacted costs; and 3) a different regulatory date to take into account project delay caused solely by Covid.

Subsequent to that first consultation, Tideway asked us to consider a further amendment which would change the way the FCAM was applied. The primary reason for this subsequent request was that Tideway considered that the operation of the FCAM would result in outcomes not in line with expectations. It believed that extraordinary macro-economic circumstances were introducing extreme revenue impacts which would affect the project's financial resilience. Tideway stated that without amendment, the FCAM was forecast to remove about 25% of its revenue for every year from 2024/25 until 2031/32 (when the FCAM will expire).

Given this request we issued a further consultation in December 2021. In this second consultation we said that we were considering the requests from Tideway for licence changes in the round and we proposed still applying alternative incentive sharing rates for Covid impacted costs but not to apply a different depreciation rate for Covid expenditure. Instead, we proposed amending how the FCAM operated. In summary, the proposals we consulted on in December 2021 were to give effect to:

1) an alternative cost sharing incentive rate of 85% borne by customers for Covid costs incurred prior to 24 July 2020;

2) an alternative cost sharing incentive rate for Covid costs incurred between 25 July 2020 and 30 June 2021 of 80% borne by customers and 20% by Tideway;

3) a change in how the FCAM operated; and

4) a change to a regulatory date set out in the licence, to take into account project delay caused solely by Covid. We still propose amending the Planned System Acceptance Date to reflect delay caused by Covid. However, that change has not yet been made. We will only make that change when we are satisfied that Tideway can distinguish with evidence, any delay caused by Covid from other causes of delay.

3. Replies to the consultation

We received one supportive response to this second consultation and we have now made the amendments set out in 1 – 3 above.

In response to the first consultation, we received two submissions: one from a water company and one from the Consumer Council for Water (CCWater). The response from the water company was supportive of the proposals. The response from CCWater asked a number of questions about the proposals. In particular, CCWater was concerned about the impact on customer bills. We responded in writing to CCWater's queries.

In response to the second consultation we received one submission which was from CCWater. It was supportive of the proposals and believed we had struck an appropriate balance between customer and investor interests in the revised proposals. On the FCAM, CCW recognised that the large benefit customers were deriving from the FCAM was not envisioned at licence award and that the economic climate has changed. They agreed that leaving the FCAM as it was could potentially impact Tideway's cash flows and affect the achievability of project completion within the envisaged timelines. They also agreed with the proposal to freeze the application of the FCAM at 31 March 2021 meaning that customers retain around 62% of current and future benefits. They thought this would provide certainty and limit further exposure to interest rate volatility and said their research shows that customers prefer stability of bills.

4. Background and reasons for the modifications

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.

Covid 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.

Revised sharing rate mid-March to 24 July 2020

With the outbreak of Covid 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 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.

In the early months of the pandemic, Tideway put in place a methodology for differentiating Covid 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.

In considering what would be a reasonable alternative sharing rate, we sought expert advice on potential counterfactuals – ie what would have been the likely cost to the project (and customers) had Tideway adopted an alternative approach in the period from March 2020 to 24 July 2020.

We concluded that in closing all sites other than for essential work and in continuing to pay its supply chain, Tideway had acted reasonably in that in almost all scenarios relating to the counterfactuals considered, the cost to Tideway (and customers) would have been higher, to substantially higher, than the costs actually incurred by Tideway for the period March to 24 July 2020.

Whilst individual costs and assumptions are open to challenge, on balance we concluded that the approach adopted by Tideway for dealing with Covid related costs in the period from March to 24 July 2020 was reasonable, enabling it to maintain control of progress and costs during the most challenging period of the pandemic and was consequently the best option for customers. Accordingly, Ofwat has decided that instead of customers bearing 60% of Covid related costs, customers should bear 85% of those costs.

Customer sharing rate 25 July to 30 June 2021

From 25 July 2020 onwards, the 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 restrictions in place.

Although Tideway has managed the situation well, and there are no obvious areas we can 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 were up and running with adapted ways of working and in this period, the impact of Covid 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 were different.

Given this, on balance, we decided that a sharing rate slightly lower than that for the period to 24 July 2020 was warranted and decided to apply an 80% sharing rate for this later period.

Information from Tideway indicates that by 30 June 2021, the vast majority of Covid impacted costs had been incurred, with minimal ongoing impact from Covid.

Ofwat therefore decided that the alternative sharing rate of 80% would end on 30 June 2021 and we informed Tideway that we did not envisage making any future adjustments for Covid.

The Financial Cost Adjustment Mechanism

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.

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. 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 deciding whether or not to change the FCAM we 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.

[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 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 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.

Although there were a number of other options we considered for the reform of the FCAM, the most straightforward was 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 if the mechanism is frozen at March 2022, customers would retain 90% of the current and forecast future benefits. Of these options, we decided 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.

The effect of the amendment will be that the FCAM will in future, rather than being calculated in accordance with inputs which change each year it will be based on inputs as at year end March 2021. 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.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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