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A new model: Thames Tideway Tunnel

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WHAT WE SAID THEN: *"The new Thames Tideway Tunnel sewer in London has achieved construction phase stable returns for investors and a cost of capital well below the industry average at 2.497%, all under a bespoke regulatory regime."*

When all the usual options are blocked off, it forces you to get creative. And so it was for Thames Water and its planned super sewer.

A number of procurement models for major infrastructure projects now seem discredited in the UK. They are either seen as undesirable by politicians or the public (too much private sector profit), or seen as unworkable by the industry (not enough private sector profit).

This created a challenge for Thames Water when it came to funding a new £4.2 billion sewage network underneath central London. The Thames Tideway Tunnel will divert around 39 million tonnes of untreated sewage from overflowing into the River Thames. Thames Water has designed a tunnel that would run 25km from Acton in the west to Abbey Mills Pumping Station in the east, 65m below ground with a 7m diameter. It has an expected life-cycle of 120-year.

Although it agreed to invest £1.4 billion on preparatory works and construction of the Lee Tunnel, Thames Water was unable to bear the full costs itself. So, it set about designing a completely novel way to deliver a major project.

The introduction of the Flood Water & Management Act in 2013 allowed the utility to tender new infrastructure to a third-party financier.

Thames Water tendered for an independent infrastructure provider (IP), with its own license from regulator Ofwat, to undertake the rest of the work.

The Bazalgette consortium, comprising Amber Infrastructure-managed fund INPP, Allianz Capital Partner, Dalmore Capital, DIF and Swiss Life, won the competition to be the IP in July 2015. Bazalgette will commit £1.275 billion in equity to the IP vehicle Bazalgette Tunnel Limited, which was due to be drawn down until early 2018.

Regulated revenue streams therefore start immediately during construction.

Thames Water customer bills repay debt and provide equity returns through an additional bill charge on behalf of the IP.

Ofwat regulates utilities' customer charges every five years – with a calculation of weighted average cost of capital (WACC) multiplied by regulated asset base (RAB).

Bidders' success depended upon their bid WACC (BWACC).

However unlike for a normal utility, the IP will have its own revenue structure for construction and testing up to 2030 based on BWACC x RAB. After 2030 the IP is subject to Ofwat's five-yearly WACC determinations.

The sponsors had to raise debt to draw over more than seven years. Once equity is absorbed the senior debt will be drawn. RBC and Evercore put together a £1 billion 10-year revolving debt facility with a margin of 85bp over Libor, and commitment fee at 35% of that.

Periodic public bond issuances at terms and timings of favourable market conditions will repay the debt. Bazalgette has already issued several bonds since reaching financial close, including a £250 million green bond in November 2017.

Construction contractors for the west, central and east lots had target cost contracts, rather than turnkey. Overall their contracts have a total value of roughly £1.77 billion. Overruns or upside on those contracts are shared between the IP and contractors. Tunnelling is due to begin in 2018 and continue until 2021.

All works are scheduled to be complete by 2023.

Not only is the project's structure genuinely innovative, but the tunnel itself will be a major feat of engineering.

A question mark hanging over the development is how strong public support for it will be moving forward. The increase in water utility bills to repay the capital cost will be introduced gradually, and there is surely a risk of a public backlash once those bills start rising.

Until then, everyone one involved in the deal can continue to marvel at how clever they all are.

Thames Tideway Tunnel

Financial close: August 2015

Size: £4.2 billion

Sponsors: Bazalgette Tunnel Limited (INPP; Allianz Capital Partner; Dalmore Capital; DIF; Swiss Life)

Commercial lenders: RBC; Credit Agricole; Lloyds; MUFG; Santander; SMBC

Awarding Authorities: Thames Water; Department for Environment, Food and Rural Affairs (UK); Ofwat

Advisers: UBS; RBC; Evercore Partners; KPMG; PwC; Ernst & Young; Clifford Chance; Freshfields Bruckhaus Deringer; Hogan Lovells; Ashurst; Linklaters; Herbert Smith Freehills; Norton Rose Fulbright; Sharpe Pritchard; Berwin Leighton Paisner; Arcadis