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Thames Tideway Tunnel, UK

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The successful investors in the new £4.2 billion ($6.5 billion) Thames Tideway Tunnel sewer in London have 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.

For this unique project the private sector has had to finance over £3 billion in capital costs for a construction period of more than seven years.

Procurement

The new 'super sewer' is being constructed to deal with London's overloaded Victorian sewerage system. 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.

The project was deemed too costly for Thames Water to undertake alone. The utility has however taken on £1.4 billion of preparatory works, including the construction of the £700 million Lee Tunnel which will carry sewage on to the Beckton treatment plant.

The Flood Water & Management Act entered effect in 2013 which has allowed the utility to tender new infrastructure to a third party financier. And so Thames Water tendered for an independent infrastructure provider (IP), with its own license from regulator Ofwat, to undertake the rest of the work.

Thames Water launched an invitation to negotiate in October 2014 and preferred bidder selection was in mid-July 2015, before the Ofwat license award and financial close occurred on 24 August.

Linklaters partner Charlotte Morgan said: "Delivering a £4 billion complex procurement (including three rounds of competitive bidding) in under a year sets a new benchmark compared to traditional project procurement."

The Bazalgette consortium of Amber Infrastructure-managed fund INPP, Allianz Capital Partners, Dalmore Capital, DIF and Swiss Life won the competition, beating another consortium comprising Borealis, USS, Innisfree and InfraCapital.

Early investor returns

Thames Water's advisers – UBS, KPMG and Linklaters – marketed an entirely new structure for infrastructure delivery which they needed to make as bankable as possible.

Bazalgette will commit £1.275 billion in equity to the IP vehicle Bazalgette Tunnel Limited, which will be drawn down until early 2018. Regulated revenue streams therefore start immediately during construction.

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DIF partner Allard Ruijs said: "The equity is invested in the early years of the construction phase realizing a stable income for our investors secured by a transparent and established regulatory framework."

Regulated revenue streams

Thames Water customer bills will 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).

However unlike for a normal utility, the IP will have its own revenue structure for construction and testing up to 2030. Bidders' success depended upon their bid WACC (BWACC).

To 2030 the IP's revenues will be based on BWACC x RAB, giving the IP clarity on future revenue streams. As construction advances, the RAB rises. After 2030 the IP is subject to Ofwat's five-yearly WACC determinations.

In the final round the last two bidders' BWACCs were too close to call. Thames Water called for an additional bid and lender sources say both groups responded by trimming equity distributions, with Bazalgette submitting the best offer.

Due to regulatory adaptations and government support, Bazalgette's BWACC of 2.497% is lower than the 3.7% set by the regulator for the water industry. Customers should have to pay at most £20-£25 more on their water bills in the mid-2020s to cover the costs, 70% under initial estimates of £70-£80.

Revolving debt

The sponsors had to raise debt to draw over more than seven years. An adviser on the deal, partner David Wyles at Herbert Smith Freehills, said: "There was an inherent tension between needing certainty of committed funding and the time-cost of committed money."

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. Moody's rating is Baa1. The equal lenders are:

- Credit Agricole
- Lloyds
- MUFG
- RBC
- Santander
- SMBC

Periodic public bond issuances at terms and timings of favourable market conditions will repay the debt. A banker on the deal explained that the bidders had to show they could finance costs up to a certain threshold. But by issuing notes, debt will effectively be unlimited.

Government support package

PwC and Ashurst advised the Department for Environment, Food and Rural Affair. Its support covers five areas of risk the private sector could not bear:

- Supplemental insurance for claims beyond a commercial policy
- Market disruption facility, if debt markets are effectively closed
- Compensation for government cancellation
- Contingency funding above agreed "threshold outturn", a figure above which the IP may pay or government will

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inject equity
- “Special administration offer agreement”, whereby government offers to purchase IP shares or discontinue the project if the IP is in special administration for 18 months

Peter Hall, partner at Ofwat’s adviser Norton Rose Fulbright, said: “A major challenge we overcame with Ofwat was ensuring that the contractual arrangements between the IP, Thames Water and builders fit with the legislative and regulatory frameworks.”

Construction contractors for the west, central and east lots have 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.

Likewise unique adjustments to the IP’s license include a mechanism for the IP to share cost digressions with Thames Water customers.

A transferable hybrid?

Regulated sectors could potentially look to this hybrid structure for major greenfield projects. “Reservoirs for example aren’t cheap,” commented Hall.

Linklaters’ Morgan said: "Given the exceptional value for customers the IP competition created, other regulators will want to examine applying the delivery model in rail, transmission and airport development." She added the offshore transmission operator hybrid model is similarly a successful regime for a new asset class.

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