

REASONS NOTICE

SPECIFICATION OF THE THAMES TIDEWAY TUNNEL PROJECT

This reasons notice is given in accordance with section 195A of the Water Industry Act 1991 (as is given effect with modifications by the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013¹ (“the SIP Regulations”)) and sets out the Secretary of State’s reasons for the giving of a notice under regulation 4(1) of the SIP Regulations specifying the Thames Tideway Tunnel Project as an infrastructure project.

The Secretary of State has, before exercising the power, prepared a draft of this reasons notice and consulted as required by regulation 4(4) of the SIP Regulations.

In accordance with section 195A(3) of the Act, a copy of this Reasons Notice has been served on Thames Water Utilities Limited (“TWUL”).

BACKGROUND

The legislative framework

1. The Flood and Water Management Act 2010 amended the Water Industry Act 1991 (“the Act”) by inserting a new Part 2A, which conferred powers on the Secretary of State to make regulations about the provision of infrastructure for the use of water undertakers or sewerage undertakers.
2. Pursuant to the above powers, the SIP Regulations were made on 27 June 2013 and came into force on 28 June 2013. Regulation 4(1) of the SIP Regulations allows the Secretary of State (or the Water Services Regulation Authority (“Ofwat”)) to specify an infrastructure project as a “specified infrastructure project”. An infrastructure project is a project or part of a project in connection with designing, constructing, owning or operating infrastructure². It is a project which an incumbent water or sewerage undertaker must ordinarily undertake to fulfil its statutory duties under section 37 (general duty to maintain water supply system etc.) or section 94 (general duty to provide sewerage system) of the Act.
3. Regulation 4(3) of the SIP Regulations provides that the Secretary of State may only exercise the power to specify an infrastructure project if he is of the opinion that:-
 - a) the infrastructure project is of a size or complexity that threatens the incumbent undertaker’s ability to provide services for its customers (referred to in the rest of this notice as the ‘Size or Complexity’ condition); and

¹ S.I. 2013/1582

² See section 36A of the Act, which was inserted by the Flood and Water Management Act 2010.

b) specifying the infrastructure project is likely to result in better value for money than would be the case if the infrastructure project were not specified, including taking into account:

- (i) the charges fixed or likely to be fixed under Chapter 1 of Part 5 of the Act (financial provisions, charges); and
- (ii) the powers of the Secretary of State under section 154B of the Act (financial assistance for major works).

4. The condition in (b) above is referred to in the rest of this notice as the “Value for Money condition” or “VfM condition”.
5. Once specified, the incumbent undertaker is prohibited from undertaking that infrastructure project, although the Secretary of State or Ofwat may permit or require it to undertake certain preparatory work³. The incumbent undertaker is also required to put the specified infrastructure project (including the financing) out to tender⁴. Once the project has been put out to tender, the Secretary of State or Ofwat has the power to designate by notice as an “infrastructure provider” (“IP”) a company which appears to be wholly or partly responsible for the specified infrastructure project⁵. The IP may then be licensed and regulated under a modified version of the regulatory regime set out in the Act⁶.
6. Regulation 4(9) of the SIP Regulations requires Ofwat to publish guidance to be followed by it in determining whether to issue, vary or revoke a specification notice. This guidance was published in draft as part of a consultation undertaken by Ofwat in October 2013. It is generic in nature and has been designed to apply to infrastructure projects generally. In deciding whether to exercise the power to specify this Project, the Secretary of State has had regard to this draft guidance.

The Thames Tideway Tunnel Project

Project Description

7. The sewerage system in central London is a combined sewer system in which both surface water runoff and foul sewage enter the same drainage system and are conveyed to sewage treatment works for treatment. It is estimated that on average 39 million tonnes per year of untreated sewage and surface water have been overflowing into the Thames Tideway (the River Thames and the River Lee) from these combined sewers as a result of their capacity being exceeded because of rain. While the system was designed to overflow into the River Thames during heavy rainfall, it currently

³ See regulation 5(1) and (3) of the SIP Regulations

⁴ See regulation 6(1) of the SIP Regulations.

⁵ See regulation 8(1) of the SIP Regulations

⁶ See Schedule 1 of the SIP Regulations, which applies and modifies the Act in relation to specified infrastructure projects..

overflows even during modest rainfall, due to an increased population, higher water use per capita and increased development, leading to greater runoff of surface water.

8. The Court of Justice of the European Union, in its judgment of 18 October 2012 (Case C-301/10 *Commission v United Kingdom*⁷), found the UK to be in breach of its obligations under the Urban Waste Water Treatment Directive (Directive 91/271/EEC, the “UWWTD”). In particular, the level of sewage discharge into the River Thames was unacceptable.
9. Current improvements to the main sewage treatment works and the construction of the Lee Tunnel are expected to reduce the current annual volume of overflows to 18 million tonnes, but this level remains unacceptable and is not compliant with the UWWTD.
10. A variety of solutions have been investigated over the past ten years, with the conclusion that a full-length Tunnel is the preferred solution. Government’s support for the Tunnel as a solution was originally set out in March 2007, when Defra published its *Regulatory impact assessment – sewage collection and treatment for London*. This publication drew on the conclusions of the independent 2005 Thames Tideway Strategic Study (“TTSS”), which described the problem with combined sewage outflows into the Thames and assessed a number of options for delivering improvements; the Tunnel was central to the option recommended by the TTSS. Government commitment to the Tunnel was reiterated in Ministerial Statements in 2010 and 2011; in the November 2011 Defra publication *Creating a River Thames fit for our future: A strategic and economic case for the Thames Tunnel*; and in Defra’s *National Policy Statement for waste water* published in February 2012. Reviews in 2012 and 2013 found that the evidence supporting the case for the Tunnel, and hence the case itself, was still valid.
11. The Thames Tideway Tunnel Project is planned to have a minimum capacity of 1.24m cubic metres (tonnes) and to extend for approximately 25 km along the length of the River Thames between Acton and Abbey Mills. It will sit between 20m and 70m below the surface and have a diameter of approximately 7m. Along its course it will intercept 34 of the Combined Sewer Outflows (CSOs) which currently connect the existing sewerage network to the river. The interception of the CSOs allows for overflow of surface water and sewage to be diverted from the river to treatment and subsequently discharged as treated water.
12. As the undertaker for the area, the responsibility for compliance with the Urban Waste Water Treatment (England and Wales) Regulations 1994 (S.I. 1994/2841) (which implement the UWWTD) lies with TWUL⁸. If the Thames Tideway Tunnel Project is specified under the SIP Regulations as described above, TWUL will be prohibited from

⁷ <http://www.bailii.org/eu/cases/EUECJ/2012/C30110.html>

⁸ The duties in the Urban Waste Water Treatment (England and Wales) Regulations 1994 supplement the duties imposed on sewerage undertakers under section 94 of the Act and need to be read alongside the duties imposed on the Secretary of State and Ofwat under section 2 of the Act, including the duty to secure that undertakers are able to finance the proper carrying out of their functions.

undertaking the works necessary to achieve compliance. Instead, it will be required to put those works out to tender.

Project Costs

13. The Thames Tideway Tunnel Project is a project whose current estimated cost is £4.2 billion at 2011 prices and at a 'P80' level, i.e. where it is estimated that there is an 80% chance the final cost of the Project will be £4.2 billion or less. That project cost, in accordance with normal practice, excludes financing costs and taxation costs.

The extent of the works included in the specification notice

14. The Secretary of State has specified the design, construction, operation and ownership of the Thames Tideway Tunnel. However there are some elements which have a risk profile that is similar to TWUL's existing business and are likely to be best delivered by TWUL. These elements will amount to approximately £1.4bn of expenditure on the project (at P80 and at 2011 prices, excluding financing costs) and TWUL will continue to undertake them subject to any changes arising from the detailed design work that is yet to be undertaken.

15. This leaves £2.8bn of expenditure (on the same P80 2011 prices basis) to be undertaken potentially by an IP. In practical terms, this £2.8bn represents the higher-risk tasks of building the main Tunnel and the connection shafts to the Combined Sewer Outflows, but generally not the work inside TWUL's existing infrastructure, or other works that are preparatory to the main Tunnel works. The precise arrangements in relation to these works vary on a site by site basis to take into account the requirements of each particular site.

16. For the rest of this notice, the works requiring £4.2bn worth of expenditure to deliver the Thames Tideway Tunnel are referred to as the 'Project'; this is the infrastructure project specified in the specification notice. A separate Preparatory Works Notice given under regulation 5(3) of the SIP Regulations (and also subject to consultation) will require or permit TWUL to undertake the £1.4bn of works referred to above. The remaining £2.8bn of work described above and the operation of the Thames Tideway Tunnel will be delivered by a new regulated company following the tendering exercise required by regulation 6(1) of the SIP Regulations and its designation as the IP under regulation 8(1).

17. Including the whole £4.2bn of expenditure within the scope of the Project is a practical step intended to contribute to the efficiency of the interface between TWUL and the IP because the exact boundaries between the IP and TWUL are liable to change as the contractors refine the design. This construct allows sufficient flexibility to ensure that the party that is best able to carry out particular works is enabled to do so.

Outcome of consultation

18. In accordance with regulation 4(4)(a) of the SIP Regulations, the Secretary of State has consulted the following persons:

- i. TWUL;
- ii. Ofwat;
- iii. Mayor of London;
- iv. Local authorities in London, through which the Tunnel is expected to pass;
- v. London MPs with a known interest;
- vi. EFRA Committee MPs;
- vii. Water and Sewerage companies in England; and
- viii. Consumer Council for Water.

19. The consultation papers were made available on the Department's website and members of the public were given the opportunity to comment. The consultation ran in parallel with the consultation for preparatory works notice between 4th December 2013 and 6th January 2014 and a summary of the responses can be found at **Annex A**.

20. Only minor changes have been made to the original draft Reasons Notice as a result of the consultation. These changes seek to clarify particular points; they do not change the substance of the reasoning.

CONSIDERATION OF EXTENT TO WHICH THE CONDITIONS OF THE SIP REGULATIONS ARE MET FOR THE PROJECT

Size or complexity – TWUL and the Thames Tideway Tunnel

21. In approaching the Size or Complexity condition, the Secretary of State has discounted the ability of the incumbent undertaker, subject to price review control by Ofwat, to pass on the costs of the Project to customers. He has also discounted the availability of financial support being made available under section 154B of the Act. Otherwise, in the Secretary of State's opinion, there would be no project which would threaten the incumbent undertaker's ability to provide services for its customers and the condition in regulation 4(3)(a) would be rendered ineffective.

22. Whether the Size or Complexity condition is satisfied in any particular circumstances is a matter of fact and degree. A variety of risks may affect whether an incumbent undertaker will have the ability to provide services to its customers if it undertakes an infrastructure project. The Secretary of State has identified the following risks as being particularly relevant to the Project:

- scale risk, arising from the size of the Project in the context of the whole of the incumbent undertaker's business;
- construction risk, arising from the nature of the Project's construction works in the context of the works usually undertaken by the incumbent undertaker;
- management risk, arising from the type and scale of management resource necessary to manage the Project in the context of the management resources necessary to manage the rest of the incumbent undertaker's business; and

- regulatory risk, arising from the duration of the Project in the context of the usual duration of capital works in the incumbent undertaker's business.

Scale risk

23. TWUL's investment programme for 2010-2015 was £5.5bn, leading to a Regulated Capital Value for TWUL at the end of this period of £11bn, funded approximately 75% by debt and 25% by equity. The largest single project was the Lee Tunnel at £635m, or 12% of the overall capital expenditure in that period. The Lee Tunnel amounts to 6% of TWUL's total RCV. If it were to fail, it is likely that TWUL's balance sheet could accommodate the failure.
24. The Project would, by contrast, form 30% of RCV, with peak annual expenditure of £500-£900m. Such a concentration of risk in a single project would increase the risk profile of TWUL by comparison with the normal profile in an undertaker, with a portfolio of projects that are significantly smaller than the Project and which would spread the risk.

Construction risk

25. The capital programmes of water and sewerage companies ("WASCs") typically involve assets of lesser scale than the Project, and with limited and well understood technical risks. While the evidence of tunnel works being delivered on time and to cost is mixed, and tunnelling techniques have improved over the years, underground construction carries higher risks than construction above ground. This is partly due to the consequences to above-ground structures if things go wrong and partly due to the difficulty of assessing all of the geological risks before tunnelling starts.
26. The Project is approximately 25km long, passes through central London and goes under a large number of both underground and above-ground assets, the disruption of which would entail significant costs. This means that its construction risk profile is higher than TWUL's normal construction works, and is higher - both in total and per km of construction - than the Lee Tunnel, whose course takes it under fewer valuable assets. This risk is concentrated in the £2.8bn of work that is proposed for the IP.

Management Risk

27. The size of the Project is also likely to lead to increased management risk, as the size and rapidity of expansion of capital expenditure would put significant stress on TWUL's management and governance. TWUL would have to seek increased management capacity and its governance structures would need to ensure it gave sufficient attention to the project. Given the very different nature of a construction project from its normal business, these requirements would pose an increased risk to TWUL's ability to manage its business to a satisfactory standard.

Regulatory risk

28. Typical capital works in the sector can usually be completed within any one five year Price Review period. However, the duration of construction of the Project will extend beyond a single regulatory period. This would mean that unless adaptations to the regulatory regime were made, TWUL would need to commit to a substantial proportion of the investment without knowing what return it could expect.

Risk Summary

29. The Secretary of State considers that if the Project were to be undertaken within TWUL, the foregoing factors would increase the company's risk profile to the extent that it would threaten its ability to provide services to its customers.

30. To illustrate this, it is helpful to consider the likely consequence for TWUL's credit rating should it undertake the Project. It is likely that TWUL's rating would be downgraded, with a significant risk that it could lose its investment grade rating in the absence of mitigating action.

31. It is also likely that this downgrade would take place at the time TWUL was trying to access the markets for the large quantities of capital required to build the Project. Without remedial action to restore TWUL to investment grade, those capital markets would almost certainly be closed to TWUL. The market for sub-investment grade debt would be unlikely to meet the need.

32. In this situation, it is likely that TWUL would breach an appointment condition (such as the requirement to use reasonable endeavours to ensure that it maintains an investment grade credit rating) or statutory duty, which could, in turn, lead to its being placed in special administration. The reasonable possibility that undertaking the Project within an established WaSC could lead to special administration illustrates one threat to TWUL's continued ability to provide services to its customers.

Possible Mitigants

33. The Secretary of State has also considered whether there are any mitigants to lessen the threat to TWUL's ability to provide services to its customers. Two possible remedies are:

- a) *Changes to Ofwat's regulatory regime.* For the purposes of the Size or Complexity condition, the Secretary of State has considered the possibility that Ofwat could make reasonable and proportionate modifications to the regulatory regime governing TWUL (by way of changes being made to TWUL's conditions of appointment) as a potential means of mitigating the threat to TWUL's ability to provide services to its customers. For example, to ensure that the Project was funded over the period of its construction rather than just for the next five years, as is the case for the rest of the sector. The Secretary of State accepts that such regulatory change would serve to reduce some of the regulatory risk associated with the Project. However, even if regulatory modifications could, as a matter of law, form part of the analysis in determining whether the Size or Complexity condition is satisfied (as to which the Secretary of State has formed no concluded view), he

does not consider that it would address the other significant risks identified above and is of the view that the size and complexity of this Project would still threaten TWUL's ability to provide services to its customers.

- b) *Injections of equity.* The Secretary of State has also considered whether, in the event of a TWUL credit rating downgrade to sub-investment grade, it might be possible for TWUL to deliver the Project by raising sufficient new equity to restore its credit rating. In this situation, however, TWUL would no longer have the risk profile of a typical utility: it is likely that some existing investors might wish to withdraw their equity; and new investors would need to be found both to replace those investors that left and to put in the additional equity for the Project. In the absence of Government support, TWUL would be likely to face very considerable difficulties in raising sufficient equity. Even if it could do so, the higher risk profile of TWUL would lead to higher costs of equity and the cost implications for customers would be significant.

Size or Complexity - conclusion

34. The scale and risk profile of the Project make it likely that if it were undertaken by TWUL without Government intervention, TWUL would have its credit rating downgraded, probably to sub-investment grade, and would be unlikely to be able to raise sufficient finance to remedy this and meet its licence conditions at a cost that would be acceptable to customers. The analysis is not materially affected by the proposal to enable up to £1.4bn of the Project to be undertaken by TWUL through a Preparatory Works Notice.
35. The Secretary of State has therefore concluded that the Project is of a size or complexity that threatens TWUL's ability to provide services to its customers and so meets the Size or Complexity condition set out in the Regulations.

Value for Money (VfM) Condition

36. The VfM condition, set out above, requires the Secretary of State to compare the likely VfM of the Project delivered within TWUL with the likely VfM of the Project delivered by an IP. It requires the Secretary of State to take into account the likely costs to customers and the likely costs to taxpayers.
37. It is assumed that the construction costs of the Thames Tideway Tunnel itself would be the same under either scenario. It is also assumed that Government support would be available to the Project under either scenario.
38. The potential implications for the taxpayer if the UK were subject to fines due to non-compliance with the UWWTD have not been considered in this analysis, as it is assumed that it would be possible to deliver the Project under either scenario, albeit at different costs.
39. The wider VfM case for proceeding with the Project is not considered, as it is set out elsewhere (see the references above).

VfM – Customer charges

40. As the Project costs would be the same whether or not the Project was specified, the main considerations from a customer perspective are:
- the cost of financing the Project (which is not included within the Project costs);
 - any impact on cost of financing for other TWUL investments and its provision of other services; and
 - any differential in management and transaction costs between the two scenarios.
41. Ofwat determines the Weighted Average Cost of Capital (WACC) for the water industry for a five year period at each Price Review. The WACC must allow investors an appropriate rate for the risks they face while delivering value for money for customers. To achieve this Ofwat uses a variety of techniques and tools to determine a competitive market price derived from looking at market comparators for similar projects.
42. In the case of the Project, the sector WACC is unlikely to be appropriate because the risk profile of the Project differs significantly from typical investments in the sector. Therefore a separate WACC would need to be determined and applied to the Project.
43. If delivered through an IP, the SIP Regulations require the project and its financing to be put out to competitive tender. Provided that there are sufficient bidders to achieve competitive tension, it can be reasonably assumed that the resulting financing costs will represent the fair market price and both Ofwat and investors will recognise this as an appropriate WACC. Ring-fencing the risks in an IP will assist this price disclosure role by giving investors greater clarity on the risks they are exposed to.
44. If the Project is delivered through TWUL, Ofwat will need to determine an appropriate WACC to apply across the whole of TWUL's business, reflecting the risk of the whole business. It will be based among other things on a blend of the risk of the Project and the risks of TWUL's normal business. Determining this WACC will be difficult, as Ofwat has no comparators for equivalent projects through which to determine a fair WACC. However, assuming Ofwat can determine a fair WACC, this blended WACC will reflect a higher risk than just the sum of the Project risks and normal TWUL risks. This is because the Project increases the risk profile of TWUL as a whole as described earlier.
45. As a result, specifying the Project is expected to deliver lower customer charges than would be the case if it was delivered through TWUL, as the cost of financing the project will not be linked to the cost of financing TWUL's wider investments.

Management & transaction costs

46. There will be costs associated with establishing an IP, e.g. Senior Management, Finance and Treasury, HR, IT and general overheads. However, it is likely TWUL will also have to expand its capacity in these areas. Analysis suggests that while there could be some additional management costs for the IP option over and above the

TWUL option, these are insignificant compared to the other costs considered above and therefore will not affect the VfM assessment.

47. There will also be transaction costs associated with the Project. Most of these costs are likely to be not dissimilar between the two scenarios (e.g. development costs, costs of procuring main contractors etc.). But the costs of procuring the IP as required under the Act will be additional, as there will be no similar process associated with delivery inside TWUL. These costs are likely to be of the order of tens of millions of pounds which would not have a significant impact on customer bills.

Exclusion from this analysis of costs arising in the event of TWUL needing to inject additional equity

48. The Size or Complexity section above refers to additional costs that would arise if TWUL were required to raise additional equity in order to deliver the Project itself without Government support (see para 33(b) above). However, in this Value for Money assessment, the Secretary of State has assumed that Government support would be available under either scenario and that this support would enable TWUL or the IP to maintain an investment grade credit rating. These costs are therefore omitted from the Value for Money analysis.

Possible Mitigants

49. The above analysis assumes that delivery within TWUL would see the Project delivered as if it were any other capital project delivered by TWUL. If the Project were to be delivered within TWUL, the greater the degree of structural or regulatory ring-fencing of the Project from the rest of TWUL's business, the less the differential is likely to be in terms of costs of capital.

Taxpayer support

50. The project will be funded by charges on TWUL customers, not from general taxation. In November 2011 the Government said:

"The Government believes that the private sector can and should finance this project but accepts that there are some risks that are not likely to be borne by the private sector at an acceptable cost. It is willing in principle to provide contingent financial support for exceptional project risks where this offers best value for money for customers and taxpayers. However, I will want to be assured that when offering this contingent support, taxpayers' interests remain a top priority and that the taxpayer is appropriately protected by measures that minimise the likelihood and impact of these exceptional risks".

51. Any Government support to the Project would be provided under section 154B of the Act (*financial assistance for major works*). This allows the Secretary of State to give financial assistance in connection with the construction of sewerage infrastructure which involves exceptionally large or complex works.

52. Taxpayers may also be at risk if either TWUL or an IP is placed in Special Administration and the special administrator seeks financial assistance from the Government under section 153 of the Act (*Government financial assistance where special administration orders made*). This gives the Secretary of State the power, with the consent of the Treasury, to give grants or loans to a company in special administration for the purpose of facilitating the achievement of the purposes of the special administration order.
53. The assumption for this analysis is that the sorts of Project risks that require contingent Government support in an IP are not likely to be materially different within TWUL given the stress the Project will place on TWUL's balance sheet.
54. However the consequences for the taxpayer of any support under section 154B are likely to be easier to manage if the Project is specified. This is because there would be a clear separation between the Project and TWUL, meaning that any Government support could be limited to the Project. If the Project were to be delivered by TWUL, there are a number of steps that could be taken to limit the scope of any Government support to the Project rather than the wider TWUL business. But the assessment is that the risk to the taxpayer would nevertheless be greater in this scenario than if the Project were specified.

Possible Mitigants

55. As with the financing costs, the greater the degree of structural or regulatory ring-fencing of the Project from the rest of TWUL's business, the less the differential in value for money between the two scenarios, i.e. by ensuring that taxpayer support was limited to the greatest extent possible to the Project. However, it is unlikely that the ring-fencing would be complete and the IP approach is likely to remain better value for money.

Value for Money – Conclusion

56. It is likely that delivery of the Project through an IP would lead to better value for money for customers than if the Project were delivered through TWUL. The main reason for this is that if the Project were delivered through TWUL, the Project's higher than usual risks would affect the entirety of TWUL's business and so would increase the cost of financing for all of TWUL's investments. This risk is concentrated in the works associated with the £2.8bn of costs proposed for the IP and the analysis is not materially affected by the proposal to enable up to £1.4bn of the Project to be undertaken by TWUL through a Preparatory Works Notice.
57. It is also likely that delivery of the Project through either scenario would require the Taxpayer to take on similar contingent liabilities. But the consequences of those risks materialising would be likely to be greater if the Project were delivered through TWUL with the taxpayer exposed to greater costs.
58. At this stage there remains considerable uncertainty both in absolute terms and in timing over the tax consequences of specifying the Project. These will be dependent on

the details of the financing proposals from a potential IP, the interaction with TWUL and the regulatory treatment by Ofwat of the tax liabilities. However it is considered that the scale and nature of the likely tax consequences are unlikely to affect the value for money for customers and taxpayers sufficiently to alter the case for specifying the Project.

59. The Secretary of State has therefore concluded that specifying the Project is likely to result in better value for money than would be the case if the Project were not specified, including taking into account:

- (i) the charges fixed or likely to be fixed under Chapter 1 of Part 5 of the Act (financial provisions, charges); and
- (ii) the powers of the Secretary of State under section 154B of the Act (financial assistance for major works).

OVERALL CONCLUSION

60. Accordingly, for the above reasons and having regard to all other relevant considerations, the Secretary of State is of the opinion that:

a) the Project is of a size or complexity that threatens the ability of Thames Water Utility Ltd to provide services for its customers; and

b) specifying the Project is likely to result in better value for money than would be the case if it were not specified, including taking into account:

(i) the charges fixed or likely to be fixed under Chapter 1 of Part 5 of the Act (financial provisions, charges); and

(ii) the powers of the Secretary of State under section 154B of the Act (financial assistance for major works).

A handwritten signature in cursive script, reading "Rupert de Manley". The signature is written in black ink on a white background. The name "Rupert" is written in a large, flowing script, followed by "de" in a smaller script, and "Manley" in a large, flowing script. The signature is enclosed in a thin black rectangular border.

Parliamentary Under Secretary of State for Natural Environment and Science

For and on behalf of
the Secretary of State for Environment, Food and Rural Affairs

4 June 2014

ANNEX A

Reasons Notice

Specification of the Thames Tideway Tunnel Project

www.gov.uk/defra



Department
for Environment
Food & Rural Affairs

**Consultations on (A) Draft Reasons for
Specifying the Thames Tideway Tunnel as a
Specified Infrastructure Project and (B) Draft
Reasons for Issuing a Preparatory Work
Notice**

Summary of responses and next steps

April 2014



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This document/publication is also available on our website at:

www.gov.uk/government/consultations/thames-tideway-tunnel-draft-reasons-for-specifying-the-project-as-a-specified-infrastructure-project-and-issuing-a-preparatory-work-notice

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Background

1. The purpose of these two consultations was to seek views on both the draft reasons for specifying the proposed Thames Tideway Tunnel as a Specified Infrastructure Project under the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013, referred to as the “SIP Regulations”, and the draft reasons for issuing a preparatory work notice for Thames Water Utilities Ltd, referred to as “Thames Water”. Both consultations were run in parallel.

2. By specifying the Thames Tideway Tunnel as an infrastructure project under the SIP Regulations, Thames Water would be required to tender competitively for a new independent company to finance and deliver the Project rather than undertaking the Project itself. The Regulator, Ofwat, would then consider designating the successful bidder as the ‘Infrastructure Provider’ for the project and granting it a Project Licence. This competitive tendering process should ultimately help to ensure that best value for money for customers is achieved and costs minimised. Although Thames Water would be prohibited from carrying out the specified infrastructure project, the Secretary of State may permit or require Thames Water to undertake certain preparatory work in relation to the project by issuing a preparatory work notice. The draft reasons for issuing such a notice were the subject of the second consultation.

3. The consultation ran for four weeks between 4 December 2013 and 6 January 2014, and was issued to 324 contacts by email, including:

- Ofwat;
- Mayor of London;
- Greater London Assembly members
- London local authorities;
- London MPs with an interest;
- MPs in the Thames Water region;
- EFRA Committee MPs;
- English Water and Sewerage companies; and
- The Consumer Council for Water.

4. The consultation documents were placed on the Defra consultation website and it was open to members of the public to submit their views and comments.

Summary of replies

5. Defra received 20 replies to the public consultations; the types of respondents break down as follows:

Replies to Public Consultation		
Organisation Type	Number of Respondents	% (rounded)
Individuals	5	25
MPs/Lords	4	20
Water & Sewerage Companies	1	5
Non-Governmental Organisations	1	5
Public Bodies	5	25
Local Authorities	3	15
Local Community Groups	1	5
<i>Total</i>	<i>20</i>	<i>100</i>

6. The public consultations invited comments on the draft reasons for specifying the proposed Thames Tideway Tunnel as a Specified Infrastructure Project, and the draft reasons for issuing a Preparatory Work Notice for Thames Water Utilities Ltd to carry out certain preparatory works related to the Tunnel project. A summary of the main points raised by respondents, and the Government's response, is detailed below.

7. A full list of respondents to the consultation is attached at Annex 1.

Main points

8. The 20 respondents provided views and comments on the draft reasons notices as well as a range of other issues related to the proposed Thames Tideway Tunnel project. Although some of the points raised were not strictly relevant to this consultation exercise, for the sake of completeness they have been included in the summary below:-

- **Supportive of the Thames Tideway Tunnel project**
 - Regard must be had to securing the best value for the taxpayer.
 - Strategic support for the Thames Tideway Tunnel by Mayor of London/GLA in Policy 5.14 of London Plan.

- The Tunnel should be delivered in the most cost-effective way, with as little disruption as possible and taking as little land as possible.
- **Supportive of draft reasons for specification and/or preparatory works notices**
 - Specification could ultimately minimise the risks of the project and help ensure better value for money for customers through a competitive bidding process for delivery of the project, than if delivered by Thames Water.
 - Taken together, the draft specification reasons and the draft preparatory work reasons strongly underpin the case for specification of the TTT project and for the issue of the related preparatory work notice.
 - Thames Water expressed support for the use of the SIP Regulations regime to implement the TTT project. They are fully supportive of both the specification of the TTT Project and the use of a preparatory works notice. Thames Water also broadly endorses the draft reasons for both notices, although clarification was sought on particular points summarised below:-
 - Clarification was sought on whether the Secretary of State would be required to have regard to Ofwat's guidance in respect of raising or revoking a specified infrastructure notice;
 - Clarification needed at paragraph 12 of the draft specification reasons and paragraph 13 of the draft preparatory work reasons that Thames Water only has responsibility for compliance with the Urban Waste Water Treatment Regulations 1994 to the extent that Ofwat has ensured it can finance its functions;
 - Clarification needed at paragraph 14 of the draft specification reasons and paragraph 18 of the draft preparatory work reasons that the Thames Water expenditure stated could change if the draft preparatory work notice changes in regard to the extent of works needed, and at paragraph 15 of the draft specification reasons and paragraph 16 of the draft preparatory work reasons that Infrastructure Provider construction works will on some occasions have to be inside Thames Water's existing infrastructure;
 - Consideration should be given to extending the second bullet point in paragraph 38 of the draft specification reasons to refer to the impact on the cost of financing not only for other Thames Water investments, but for Thames Water's provision of services to its customers.

- Putting the main part of the investment and construction of the Tunnel out to competitive tender is a good discipline for helping to achieve value for money, as it will reflect current market rates.
 - The Infrastructure Provider should retain the risk associated with the main Tunnel delivery; should circumstances lead to the need for a government/taxpayer intervention, this separation of interests would ensure that the project, rather than Thames Water, was the recipient of any financial support.
 - Appropriate measures should be put in place to ensure preparatory works costs are properly attributed and are no more than necessary. These costs should be separate from Thames Water's other sewerage investment plans to ensure transparency and accountability.
- **Neutral on the Thames Tideway Tunnel project and draft reasons for notices, but with concerns about practical effects of the notices**
 - The more complex the relationship between Thames Water, the IP, contractors and sub-contractors the more difficult it will be to hold contractors to account for undue impact or to get problems resolved effectively. There should be a clear construction site management regime and public communications system in place for each site, with ultimate responsibility resting with Thames Water's Chief Executive.
 - More clarity needed about how site-specific details of preparatory works will be consulted upon (by Thames water and the contractors), notified and otherwise managed.
 - Needs to be clarity about the relationship between an Infrastructure Provider and other public bodies regarding protection of their assets (such as rail infrastructure), services and ability to discharge their duties during construction works activities and operation.
 - The Secretary of State should have regard to ensuring that construction risk is fully funded by the Infrastructure Provider with appropriate safeguards to ensure that the Infrastructure Provider can meet all liabilities associated with potential impact on other bodies' undertakings and that they will be effectively indemnified against any impacts consequent on carrying out works for the project.
 - Strategy for the transition of the project from Thames Water to an Infrastructure Provider should involve consultation with relevant local authorities, so they can build a good relationship with the Infrastructure

Provider from the start and have clear points of contact about who is responsible for different aspects of the project.

- The issue of a preparatory work notice should not supersede the planning process, as some of the proposed preparatory works may require separate planning permission in their own right.

- **Opposed to the Thames Tideway Tunnel project**

- Thames Water's debt level nearly 80%, little or no corporation tax paid, and dividend payments of £2 billion in last 6 years have restricted its ability to invest in large infrastructure projects because of the adverse impact on its credit rating potentially leading to insolvency; Government support would not be value for money.
- Thames Water is failing to fulfil its main statutory obligations under s.37 and s.94 of Water Industry Act 1991 by not developing and maintaining an economic and efficient water supply and public sewerage system, and by not putting aside money to do so. This has contributed to the UK breaching Urban Waste Water Treatment, Water Framework, and Floods Directives, as well as other air quality, biodiversity and national carbon target requirements. Specifying the Thames Tideway Tunnel project as a Specified Infrastructure Project would perpetuate this.
- Makes no sense to drain rainwater into a new expensive tunnel when a better, cheaper Blue-Green Infrastructure solution exists to stop rainwater entering the sewers in the first place (and also help solve flooding and drought problems).
- If the risk associated with building the Thames Tideway Tunnel to Thames Water as a company is so great that a separate special-purpose company is needed, then it should not be built at all.

- **Opposed to specification of the Thames Tideway Tunnel project, and draft reasons**

- Proposed procedure for assessing whether to specify a project is weak and lacks objectivity and transparency – will result in endless argument and conflict; failures in other public service sectors, e.g. Private Finance Initiative (PFI) projects, should not be repeated:
 - Cost & size – specification should not be for relatively small deals, to avoid undue Government and Regulator administration burdens; minimum £100 million recommended.

- Complexity & risks – should not be used as criteria for specification as these will be the same whether the project is specified or not. Utilities' licences are assumed to have approved them as competent to undertake all activities.
 - Value for money – a flawed concept as it is a subjective rather than objective judgement; depends on assumptions of current value of estimated future economic and financial costs and benefits brought back to today's value using an assumed discount rate ('cost of money'). Different parties have different views about what these assumptions should be.
 - Previous infrastructure and PFI projects have failed financially because flawed Green Book methodology has been used to assess future costs and benefits. English water and sewerage companies as private companies and Ofwat are not constrained by the Green Book in considering cost of capital, etc., but its use has led to 'cost of money' errors in five-year plans.
 - Specified project won't necessarily secure more competitive financing; whether undertaken by special-purpose company or regular undertaker, developers and managers should seek most competitive financing package anyway.
 - Quite possible that specified special-purpose company with no proven track record would command more costly financing than an established utility company.
 - Suggested alternative Gateway process for assessing whether to specify an infrastructure project as a Specified Infrastructure Project.
 - Variations of the specification notice should not be allowed (except in cases of force majeure) and revocation should be automatic and irreversible if the project is not implemented in 2 years.
- Specification leading to an Infrastructure Provider option would place financial interests of Thames Water shareholders above those of its customers and the taxpayer, and almost certainly contravene Regulation 4(3)(b) of the SIP Regulations. Too little consideration has been given to the split of debt to equity in Thames Water's investment programme.
 - The Thames Tideway Tunnel as proposed by Thames Water is neither necessary nor desirable and therefore the Secretary of State should not specify it as a Specified Infrastructure Project.

- **Opposed to preparatory works by Thames Water, and draft reasons**
 - Land comprising the foreshore of the King Edward Memorial Park would be acquired. Parks are in very short supply in central London, and the Wapping area in particular. The loss of another green space, even for just three or four years, would have a detrimental effect on the area.

- **Other Thames Tideway Tunnel-related issues**
 - Carnwath Road should not be used as a main tunnel construction site because of likely adverse impact on the local community around it, and that another more suitable alternative site should be found.
 - The land for the TTT construction site at Carnwath Road should not be subject to compulsory purchase.
 - Not satisfied that adequate assessment of the socio-economic impact of the use of the Carnwath Road site has been carried out by Thames Water, and there appears to be no clear justification for the site selection of Carnwath Road over Barn Elms.
 - Speculative action by Thames Water seeking to charge customers for the project is unfair when there is no guarantee that Thames Water will be delivering it.
 - Shareholders should inject fresh capital into Thames Water to rebalance the debt: equity ratio and enable it to build the Tunnel itself and avoid a credit rating downgrade with the higher associated costs that would involve.
 - The Thames Tideway Tunnel project as proposed by Thames Water is not environmentally sound. Much better results could be achieved by a combination of measures, in particular retrospective separation of foul and surface water, SuDS, use of storm tanks and better sewer management – no official study has been done comparing such combination with the tunnel.
 - A combination of alternative projects could be financed in conventional ways and produce environmental benefits earlier than a large tunnel; nor would it involve ‘difficult to insure’ risks that could be involved in tunnelling under the Thames.
 - Inclusion of the Thames Tideway Tunnel project in the Waste Water National Policy Statement is anomalous and indicates Ministerial decision to adopt it as the solution to non-compliance with the Urban Waste Water Treatment Directive was taken a long time ago and without proper consideration of alternative solutions.

- Thames Tideway Tunnel project does not meet the Urban Waste Water Treatment Directive qualification that any solution to ensure compliance should be in accordance with the best technical knowledge not entailing excessive cost (BTKNEEC).
- Concerns about the scale of the proposed increase in customer bills, and the effect it will have on Thames Water's lower-income customers at a time when there is already enormous pressure on household budgets and incomes.

Government response

9. We have noted the range of views and comments received from respondents on the draft reasons for specification of the Thames Tideway Tunnel project and for certain preparatory works related to the project to be carried out by Thames Water. Other comments relating to the merits of the Thames Tideway Tunnel project itself were also received and noted, although these are considered to be outside the scope of the consultations. The purpose of these consultations was not to review the merits of a tunnel or of Thames Water's application for a Development Consent Order, but to consider the question of whether the Thames Tideway Tunnel project should be delivered by an Infrastructure Provider. In the case of the draft specification notice, this involved looking at whether the size or complexity of the project would threaten Thames Water's ability to provide services to its customers and whether the proposed Infrastructure Provider delivery model would offer better value for money than if the project was carried out by Thames Water. In the case of the draft preparatory works notice, the consultation was directed at whether Thames Water should be required or permitted to carry out the preparatory works specified in that notice in relation to the Thames Tideway Tunnel project.

10. The case for a tunnel has already been addressed in the Government's Waste Water National Policy Statement, which was debated and approved by Parliament in March 2012. The Government supports a tunnel-based solution as the most cost-effective, timely and comprehensive response to the problem of significant sewage pollution in the River Thames, and to comply with the judgment of the Court of Justice of the European Union in October 2012 that the UK was in breach of the Urban Waste Water Treatment Directive in respect of London. A range of alternative solutions over the last decade or so, including the use of green infrastructure and sustainable drainage systems (SuDS) either on their own or in combination with various smaller tunnel options, were assessed as being unable to meet the environmental standards for the Thames Tideway or to reduce the number of Combined Sewer Overflow spills to a level that would achieve compliance with the Urban Waste Water Treatment Directive.

11. The concept of 'Best Technical Knowledge Not Entailing Excessive Cost' (BTKNEEC) allows compliance with the Urban Waste Water Treatment Directive without imposing unachievable obligations that Member States might only be able to fulfil at disproportionate cost, or not at all. The Directive does not specifically define what might constitute excessive cost, and this will vary on a case by case basis. However, the principle that all waste water must be collected and treated in normal circumstances must not be undermined by Member States' invoking disproportionate costs as a reason for not complying other than exceptionally. The judgment of the Court of Justice of the European Union of October 2012 against the UK confirmed this point.

12. With respect to Thames Water's application for a Development Consent Order ("DCO") to build and operate the Thames Tideway Tunnel, this was submitted to the Planning Inspectorate in February 2013 and is currently being examined by the Planning Inspectorate. A final decision is expected to be taken by Ministers in autumn 2014. It should be noted that this is a Thames Water project, and because of the quasi-judicial role of the Secretaries of State for Environment, Food and Rural Affairs, and Communities and Local Government in deciding the DCO application, the Government has played no part in formulating the detail of the DCO application and cannot comment on site-specific matters or the route of the Tunnel.

13. It should also be noted that prior to submitting the DCO application, Thames Water conducted two three-month public consultations on the proposed route of the Tunnel in 2011 and 2012, which provided opportunities for local communities' concerns to be raised and detailed consideration of the proposed construction sites. There were also some further site-specific consultations after the two main consultations. As part of its DCO application, Thames Water also submitted an Environmental Statement describing the aspects of the environment (including impacts on people) that are likely to be significantly affected by the project, and including measures envisaged for avoiding or mitigating significant adverse effects.

14. Several respondents commented on Thames Water's tax and shareholder dividend arrangements. The Government does not comment on the tax affairs of individual companies. However, HM Revenue and Customs' approach is to treat everyone even-handedly in line with tax law and their Litigation and Settlement Strategy, and to ensure consistent outcomes so that companies pay the tax they owe and receive the reliefs to which they are entitled; including any claims to capital allowances which may be due on infrastructure projects. Ofwat as the Regulator also seeks to ensure that any reliefs claimed by companies are taken into account as part of its Price Review process

15. Some respondents proposed that shareholders, not customers, should pay for the Tunnel. Investment in the water sector is funded through a mixture of equity (i.e. shareholders) and debt raised on the capital markets. The income from customer bills is used to repay debt and provide a return to shareholders. If there was no income from

customer bills, it would not be possible to attract investment or repay debt. Therefore this is not a viable option for financing the Thames Tideway Tunnel.

16. It is the level of risk in the Tunnel, including that arising from its scale, which is likely to make the Tunnel difficult to finance and deliver at an acceptable price without some contingent financial support from government, as described in a Written Ministerial Statement in November 2011 and which is currently under discussion. This challenge is not related to Thames Water's capital structure (e.g. its level of debt or "gearing") but to the risk profile of the Thames Tideway Tunnel project.

17. An alternative approach to specification proposed in response to this consultation was a "gateway" model that among other things would remove "complexity" as a criterion for specification, and "value for money" in Regulation 4(3)(b) as a measure for specification, along with recommending that specified infrastructure projects should be regulated by Ofwat. However, both the concepts of complexity and value for money form part of the conditions for specifying a large or complex project in the SIP Regulations, which also provide for Ofwat to regulate such projects through a Project Licence granted to an independent Infrastructure Provider. The SIP Regulations also include specific provision for the variation and revocation of a specification and/or a preparatory works notice. In addition, value for money in the context of specifying a project is considered to be about cost-effectiveness, i.e. procuring its financing at lowest cost through competition and the separation from a water company's day-to-day business of the provision of infrastructure of a different risk profile. The Government therefore has no plans to change the criteria for specifying a large or complex project, as detailed in the SIP Regulations.

18. Section 94 of the Water Industry Act 1991 sets out the duty of every sewerage undertaker: to ensure its area is effectually drained. To this end the undertaker must provide an appropriate system of sewers and must also ensure that it complies with its duties under the Urban Waste Water Treatment Regulations 1994. However, these duties must be read alongside the wide-ranging duties imposed on the Secretary of State and Ofwat under section 2 of that Act, which requires them to exercise and perform their statutory powers in the manner they consider best calculated to secure that the functions of a sewerage undertaker are properly carried out. This duty includes ensuring that such undertakers are able, by securing reasonable returns on their capital, to finance the proper carrying out of their functions.

19. A specification notice would require Thames Water to put the infrastructure project as specified out to tender, and place a prohibition on Thames Water from undertaking the project. The sole purpose of the preparatory works notice would be to release Thames Water from this prohibition so that it can carry out certain preparatory works in relation to the project. The preparatory works notice would not override highway powers or confer consent under other statutory regimes such as planning permission.

20. The issuing of specification and preparatory works notices would not materially affect the relationship between the body delivering the Tunnel and other bodies. Whether the body delivering the Tunnel is Thames Water or an IP or any other vehicle, it will need to agree a series of Asset Protection Agreements between them, covering their services and ability to discharge their duties during construction works activities, and ensuring proper allocation of liabilities and indemnities.

21. Similarly, the requirement or otherwise for any further planning clearances will not be dependent on the existence or otherwise of an Infrastructure Provider. Matters such as construction site management regimes and public communications systems will be determined by Thames Water and any Infrastructure Provider as appropriate as part of preparations for construction in due course.

Next steps

22. In the light of the responses to the two consultations, the Secretary of State is considering whether to issue a Notice under the 2013 SIP Regulations to specify the Thames Tideway Tunnel project as a Specified Infrastructure project, and a Notice under the SIP Regulations requiring or permitting (as the case may be) Thames Water to carry out certain preparatory works in relation to the Thames Tideway Tunnel project. A decision is expected in the summer.

23. Should the Secretary of State decide to issue the above two Notices, the reasons for exercising those powers will also be published as soon as reasonably practicable afterwards.

Annex 1: list of respondents

London (Royal) Borough of Kensington & Chelsea

London Borough of Hammersmith & Fulham

City of London Corporation

Mayor of London/Greater London Authority

Angela Watkinson MP

Greg Hands MP

Simon Hughes MP

Lord Berkeley

Thames Water Utilities Ltd

Marine Management Organisation

Transport for London

Network Rail

Consumer Council for Water

Thamesbank

Carnwath Road Coalition

5 individual citizens