

T. Martin Blaiklock
Consultant
Infrastructure & Energy Project Finance

182 Broom Road,
Teddington,
Middlesex TW11 9PQ, UK

Tel: (44)-208-255-3851
E-mail: tmblaiklock@me.com

July 31st, 2015

Consultation : Thames Tideway Tunnel [“TTT”]:
Infrastructure Provider (“IP”) Licence

I wish to contribute some comment to the above Consultation.

Preface:

1. TTT is a unique infrastructure project. It is a private venture, albeit sponsored by Government. It is costly (i.e. £4.2bn. at 2011 prices), and is to take 7 years to build. Also, being a long, up to 65m deep and 7m, diameter tunnel under a Capital City, it carries significant construction and completion risks.
2. Corporately, TTT is also unique. One third of TTT is to be built by Thames Water (“TW”), - under whose licence from OFWAT, TTT should normally have been built in the first place, - and two-thirds by a new private utility, “IP”. Hence, the interdependency for overall project completion and operation between TW and IP, notwithstanding Regulation 5 (1) of the SIP Regulations, which states that the incumbent Undertaker, - TW in this case, - is prohibited from undertaking the project [ref. DCO, Jun 2014].
3. To add to this complexity, IP has only one supplier (of untreated water) and one customer, that being TW in both cases.
4. Finally, customers to IP, - in other words, TW customers, - will have to pay for the costs of IP as soon as construction starts, not when any service is delivered 7 years later. [Indeed, many such IP customers, unbeknownst to them, are probably already paying TW for their part in TTT]. Further, such IP charges, for which there is mandatory payment by customers under The Water Industry Act 1991, are collected by TW on behalf of IP. [Follow all that??!!]
5. Such an artificial, byzantine structure, described by ambitious investment bankers as “innovative” and a Model for future infrastructure investment, is a charade and doomed to failure. In effect, it is based on the “RAB” (Regulatory Asset Base) Model, where the completion risk is passed to the customers and not left with those best able to control it, i.e. the project sponsors.
6. The RAB Model may work well for small capital investments made by existing operational utilities, - which IP is not, - but it is a flawed Model when applied to a new large infrastructure asset, as is TTT. It mis-allocates project risks such as to defeat the original principles of privatisation.

TTT Historical Context: a TW customer perspective

7. In 2005/6, TTT was recommended as the best solution, within the technologies available at the time, by an Expert Group, comprising TW, OFWAT (the Regulator), Greater London Authority and Government, and led by Prof. Binnie, an acknowledged UK expert in water and flood management, to solve the issue of CSO's (Combined Sewer Outflows) into The Thames Tideway in Inner London and to meet the EU Urban Waster Water Treatment Directive (UWWTD). As the project was in London, it was naturally the responsibility of TW under its licence to build TTT. It failed to do so.
8. In due course, TW's inaction over TTT raised the prospect that the EU Court of Justice would fine the UK Government accordingly, unless action was taken. TW, meanwhile, was increasingly financially weaker than in 2005/6, viz. [Balance Sheet values]:-

<u>Year</u>	<u>2005</u>	<u>2012</u>	<u>2015</u>
Shareholder funds [£mn]	1,661	1,401	1,439
Long-term debt [£mn]	1,661	8,050	10,020

9. In 2006/7, TW, then owned by the German utility, RWE, was sold to a consortium of Private Equity-type investment funds, domiciled and controlled by Macquarie Bank, Australia, in Luxemburg.
10. Over the period 2005-2015, TW has paid over £2.6bn to shareholders as dividends and £340mn in UK corporation tax. Today, over half its £10bn of long-term debt is raised via a Cayman Islands company.
11. By 2010-12, it was clear that TW could not fund TTT from its own resources, unless it strengthened its balance sheet by issuing more capital. TW turned to Government for help, and in 2012 Government specified the project as a "SIP", a Specified Infrastructure Project, giving TTT special status nationally.
12. It was then that the proposed byzantine project structure for implementing TTT was devised. Hence, this request for OFWAT's Licence 3 years later.
13. Other than an update on the cost-benefit analysis of the original 2005/6 TTT proposal in 2011, no serious, independent analysis has been undertaken by TW or Government since then as to whether TTT is the best option in 2015 terms.
14. Indeed, the only recent and authoritative evidence has been provided by Prof. Binnie (July 2015), which demonstrates that TTT is arguably not needed. With the investment that TW itself has made in recent years on upgrading Sewage Treatment Plants (STPs) and the construction of the Lee Tunnel (open late 2015), the Tideway is much improved and has not breached the Tideway-specific standard for dissolved oxygen quality since the end of 2013 (when the upgrades were completed), thereby complying with EU Regulations.

15. Prof Binnie adds, nevertheless, that further, easier and cheaper measures should be taken by TW, such as sewer separation; real-time control of the sewer/interceptor connections; the use of dispersed detention tanks; the installation of floating booms to collect rubbish; and the widespread adoption of “SuDS” (Sustainable Drainage Systems) throughout London, to preserve the quality of The Tideway.

16. Prof. Binnie’s analysis and recommendations have been brushed aside consistently by Government and TW, - and, now seemingly, by OFWAT, - over the last 3 years, demonstrating a complete lack of objectivity by the Authorities in this matter. History may be less kind to the Authorities.

This Consultation Process:

17. The proposed IP Licence is for the construction of a project, which will deliver a service to TW customers in 7-8 years time. It is not a licence to an undertaker to deliver a service tomorrow from existing assets.

18. Further, TW / IP customers have, by law, to pay for the service, 7-8 years in advance of receiving any benefit. By any standards, this is a highly unusual imposition to place on captive customers.

19. However, as the success of IP as a service provider is dependent on project completion, the Licence, *per se*, is insufficient for TW customers to determine whether IP should be issued with the authority (*i.e.* is “fit and proper”) to implement the investment. Additional documents and information are required for examination before a judgement can be reached.

20. In particular, TW customers should have available to them the following:-

- a) The technical specification of IP’s project and its TW interfaces;
- b) IP’s estimated costs of the project, with its major contract values;
- c) TW’s costs spent to date in developing TTT and the preparatory works;
- d) IP’s proposed construction contractual structure: after all, customers will be carrying completion risk;
- e) IP’s “Alliancing Agreement” with TW;
- f) IP’s “Revenue Agreement” (between TW and IP);
- g) IP’s “Direct Agreement” with Government;
- h) IP’s “Project Management Contract” with CH2MHill; and
- i) IP’s “Tax Change” exemption agreement with HMRC.

21. All the above impact the payments to be made by TW customers for IP. Such documents need to be made available for any reasonable TW customer to decide and approve whether they support the issuance by OFWAT of a Licence to IP.

22. Furthermore, the draft Licence, as attached to the Consultation, is a double-annotated, ‘pdf’ copy, which is well nigh incomprehensible. As someone, who is professionally quite conversant with public service concession agreements, this draft ranks with the worst.

23. The payment clauses, in particular, - 40pp of double annotated text, - need a lawyer-accountant to decipher. How practical and “fair” is that? The complexity of such clauses exposes TW customers to unnecessary risk.

24. The circumstances and timetable for this Consultation for a Licence to a new, monopoly public service provider, which, if approved, could impact customer bills by £70-80 per annum, have been:-

- a) the Consultation was issued July 17th, 2015 for responses by August 14th;
- b) the Licence, as shown in the draft attached to the Consultation, is to be “made”, i.e. assumedly signed, August 21st, effective August 24th, i.e. only 5 working days after closure of submissions under the Consultation;
- c) School holidays started July 11 and finish August 31st;
- d) Parliament is in Recess from July 25th until early September; and
- e) according to Appendix 1, if the IP Licence is not issued by Sept 15, 2015, TW customer have to start paying for IP anyway.

25. Given such timetable, this Consultation can be viewed as “unfair”, since:-

- a) most, possibly all, TW customers have not been informed by TW (or Government) that their bills are to rise by £70-80 per year to pay for TTT [For one, I have received no notification, and I have yet to meet anyone who has].;
- b) many TW customers are away on holiday whilst this Consultation proceeds;
- c) there will be no opportunity in Parliament to raise any queries with respect to this IP licence, which represents a private sector, monopoly public service for 12-14 million customers; and
- d) the documentation under this Consultation is incomplete [ref. para. 20].

In the context of OFWAT’s obligation under Sec 17FA (2) of the Modified Act (ref. p. 6 of this Consultation) to consult, it could be viewed as an abuse of this Statutory Regulation for OFWAT to adhere to such timetable. Indeed, the timetable adopted by OFWAT suggests that they intend to issue IP with a Licence irrespective of the outcomes of this Consultation.

26. In this context, OFWAT’s attention is drawn to the UK Supreme Court Judgement, Oct 2014, ref. UKSC56, Moseley v. Haringey Council, with respect to a flawed consultation process adopted by the Council on that occasion, which the Court found later to be unlawful. Similarities exist between the events that arose on that occasion and this TTT/IP Consultation.

Should such a Judgement be applied to the IP Licence Consultation, then the issue of a Licence to IP could be deemed “unlawful”, which could exempt TW customers paying for TTT.

27. To quote from that Judgement:-

- a) "*... fairness will require that interested persons be consulted not only upon the preferred option but also upon arguable yet discarded alternative options.*"
- b) "*a decision-maker may properly decide to present his preferred options in the consultation document, provided it is clear what the other options are.*"
- c) "*consulting about a proposal does inevitably involve inviting and considering views about possible alternatives.*"

28. In this Consultation, apart from the proposal by OFWAT to issue a Licence to IP, there has been no consideration of alternatives:-

- a) either to award a Licence to a third party, e.g. TW or someone else; or
- b) not to award a Licence to IP and to provide TW customers with an alternative and equal service, i.e. abandon the plans for TTT and follow the advice and recommendations of experts such as Prof. Binnie.

29. Overall, therefore, this Consultation can be deemed "unfair". It is also being undertaken with indecent haste. Given the underlying complexity of IP's business case, this process represents high and unacceptable risk for TW customers.

Conflicts of Interest:

30. It is inevitable that Conflicts of Interest can arise with any major infrastructure project, and TTT is no exception. However, any such Conflicts need to be exposed and accepted, or not, when dealing with public services, not hidden.

31. It is for that reason that recently the UNECE published (Jun 2015) its draft "Charter on Zero Tolerance to Corruption in PPP (Public-Private Partnership) Procurement", which apply to privately-owned, public service concessions, which generically TW is and IP will be.

32. Conflicts can arise when the primary interest of a party to a transaction becomes unduly influenced by a secondary, or shared interest. Further, when the possibility of such an issue arises, it is incumbent on the conflicted, particularly within the process of public works or contracts, for that party to disclose possible or potential conflicts at the outset.

33. The structure adopted for TTT is littered with such conflicts. There are undisclosed conflicts between:-

- a) TW and IP, albeit the Government proclaim them as "independent" under SIP Regulations. [NB. the proposed 3 Exec. Directors of "independent" IP, notwithstanding their skills and experience, are: (a) ex-TW; (b) ex-UBS (TW's Financial Advisor); and (c) ex-CH2MHill (TW's Technical Advisor).];

- b) TW and Government: viz. with the sponsoring Ministry, DEFRA, the Environment Agency and HM Treasury;
- c) TW, IP and its Financial Advisor, UBS; and
- d) TW and its Technical Advisor/Project Manager, CH2MHill, who also advises The Environment Agency on River Thames/Tideway flood issues and is to be Project Manager for IP.

34. OFWAT (the Regulator), and CCWater are not exempt from such conflicts either. OFWAT's Financial Advisor for TTT has also advised the "Ultimate Controller" of TW in Luxemburg, the Macquarie Group, plus OFWAT themselves for PR14 (which included tariffs for TTT and half the UK's water utilities, etc.0;

35. None of the above, potentially compromising, conflicts have to date been disclosed publicly, or to TW customers. Yet, international norms and procurement guidelines, particularly for public service contracts, require transparency, integrity and probity. Such norms can be found in the EU Directives EU/2014/23 and EU/2014/25 on the procurement of public services, along with the UNECE Guidelines mentioned above.

36. With such multiple potential conflicts of interest within the structure of this TTT transaction, the opportunity is enhanced for possible irregularities.

37. Some independent scrutiny is demanded. Given, the status of the parties involved with TTT, such scrutiny can really only be imposed by Parliament, with NAO as a monitor to the proceedings.

The Tender Process for IP:

38. The bidding process underpinning TTT is highly irregular. The major construction contracts were "competitively" bid and evaluated on a "conventional" basis by TW, the supplier and customer for the TTT project, under the authority passed to them by the Sec of State. There appears to have been no independent oversight.

39. Once evaluated, these contracts are to be handed over to IP to implement and manage, - and, also, TW have provided, with their advisors, the personnel to do so! Bids for the ownership and financing of TTT were undertaken separately, orchestrated by TW, i.e. the ultimate beneficiary.

40. In the Reasons Notice" of the Specification for The Thames Tideway Tunnel Project (June 2014), the Sec. of State stated (ref. Para 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 fair market price and both OFWAT and investors will recognise this as an appropriate WACC."

41. TW and the new IP, as "water undertakers", are required to comply with UK's Utilities Contract Regulations 2006, Schedule 1, in respect of the tendering and award of major contracts, and comply with norms as found in the EU Directives EU/2014/23 and EU/2014/25).

42. In addition, HM Treasury's Guide on Procurement for complex investments in infrastructure assets, e.g. PFI, PPP, etc., [HM Treasury / OGC: "Competitive Dialogue in 2008"], state:-

- a. [ref. para 5.2.5]: "*The number (of bidders) invited to participate in the dialogue needs to be sufficient to ensure genuine competition and must be a minimum of three provided that there are that many suitably qualified candidates*"; and
- b. [ref. para 5.2.6]: "*where there is an inadequate bidder response, the Contracting Authority must consider if the procurement should proceed or not (cf. Single Bidder Situations: Box 5.7)*".

43. Box 5.7 (p.27) further states that:

- a. "*Market failure or lack of competition occurs when there is only a single (or no) bidder for a project, or perhaps where there are two or more bidders but only one is considered to be credible. In the absence of competitive tension a bidder is not appropriately incentivised to offer its best price, terms and conditions. Consequently value for money will be difficult to achieve unless other steps can be taken to secure it. The Contracting Authority should carry out a thorough review before deciding on the way forward. If it concludes that it is not possible to take appropriate additional action to secure value for money, the procurement should be halted at that point*".

44. Given that:-

- a there were only two bidders in the final tender for the IP Licence;
- a in the absence of "competition, questions have not been raised as to whether TTT is Value for Money or even needed; and
- a a change of Bid Specifications took place after bids were received (ref. p. 7 of this Consultation),

it is recommended that, in the light of such irregularities with respect to normal UK and EU procurement procedures, the negotiations for IP be halted, and these matters be open to public and Parliamentary scrutiny. Otherwise such bids will be open to legal challenge.

45. It appears that the two IP bidders were evaluated against their quotation for the WACC (Weighted Average Cost of Capital) for IP. Such a criterion used for evaluating bids is unique in my experience (viz. 40 years in private sector infrastructure finance globally).

46. WACC is an accounting/economic measure, dependent on assumptions for the debt-equity ratio and the costs of debt and equity. Such assumptions are highly subjective and subject to change as markets change. It is a flawed measure to use in assessing the financial, as opposed to accounting or economic, capacity of a bidder to finance, build and operate a major infrastructure project, such as TTT.

47. WACC has been used to assist tariff setting for on-going utilities, but not for new major projects, such as TTT. The uncertainty and variance of WACC going forward are highly unreliable. Furthermore, the experience of using WACC in the setting of water tariffs for the E & W water companies since privatisation in 1989-90 has increasingly placed these companies at financial risk by aggressive owners, viz. the figures on p. 1 of this Response for TW. At privatisation, TW was well into Investment Grade, a status required under its Licence; today, it is only one or two 'notches' above junk status.

48. UBS, TW's Financial Advisor, claim the innovative nature of this structure and measure as a model for future infrastructure investment.

I say, the funding of a major tunnel project under the UK's Capital City should not be a laboratory for a financial experiment, as it represents an unacceptable public risk.

Financial Structure & Funding:

49. The Consultation is deficient in describing the funding structure and funding. It is expected that the sources will include:-

- a) equity made up from 60/40 = shareholder loans / pure equity;
- b) reportedly, a £1bn EIB loan facility; and
- c) a £1bn Revolving Credit Facility from commercial banks (Bk of Tokyo-Mitsubishi; RBC; Lloyds; SMBC; Credit Agricole; and Bco. Santander).

50. It is assumed that IP intends to re-finance the Revolving Credit with institutional debt later in construction or on project completion.

51. As the above funding is probably inadequate to complete TTT, no standby funding seems to have been put in place, as it should.

52. Further, the proportions of debt to equity under this structure are not disclosed, so an assessment of financial risk is impossible.

53. Such a funding structure is deeply flawed. It is also, effectively, only part-committed. This breaches a key principle of project financing, viz. to have all the long-term funds committed at the outset.

54. Market conditions change. In 5-10 years time, it may not be possible to re-finance the Revolving Credit, so IP will have to pay up, or bailed out by Government or customers. This is a significant risk for TW customers and taxpayers in general.

Note: such a debacle has arisen in the UK before with the Channel Tunnel Rail Link 20 years ago. Following licence award, the owners were unable to raise the institutional debt, as had been planned. Government had to step in. Who was the Financial Advisor responsible for the structure? UBS, the same as for TW, IP and TTT!!

55. The introduction of sub-debt / shareholder loans into the structure for a monopoly UK public service utility is a UK tax evasion mechanism. The application of interest due on shareholder loans, which are often at elevated interest rates, as a cost to reduce tax liabilities, is, in effect, extracting dividends pre-tax. It should be outlawed, not least as IP is a public service utility supposedly with owners of probity.

[Note: it has been noted that both Macquarie, - the Ultimate Controller of TW, - and UBS were both on the list of companies seeking tax evasion advice from PwC in Luxemburg. Furthermore, PwC is Financial Advisor to OFWAT for TTT.].

56. All the banks reported as supporting the Revolving Credit Facility are signatories to The Equator Principles, which apply globally to project debt greater than US 10mn equivalent. However, it is regretful that the TTT proposals to do not comply with these Principles, e.g. reference EXHIBIT II, item b) in The Principles, which requires consideration of: "feasible environmentally and socially preferable alternatives".

Neither TW or DEFRA have undertaken such 'consideration' for 7-10 years, and, in the light of Prof. Binnie's recent studies and other expert opinion, alternatives to TTT do carry merit of consideration.

57. The impact of non-compliance with The Principles could be serious:

- a) the application of such Principles are getting stricter as time moves forward;
- b) without compliance, syndication of a non-compliant loan will be well nigh impossible; and
- c) even if the named banks subscribe to IP financing today, 3 years on they may not due to the stricter application of The Principles, with the result that IP/TTT on-going funding would collapse.

Hence, non-compliance raises serious risks for IP, TTT and TW customers.

[Note: neither UBS nor Macquarie are signatories to the Principles].

58. The names of the shareholders are provided under the Consultation, but their financial status is absent. Indeed, some of the shareholder companies are paper-thin or obscure (i.e. not financials not published) and of no apparent financial substance, e.g. Amber, Dalmore, DIF. Only Allianz and Swiss Life have substance/corporate financial resources, but their support and responsibilities to TTT are not disclosed. **This is very unsatisfactory.**

59. Similarly, the Consultation provides no cv's of the proposed IP Directors' experience in financing and operating a civil engineering project of this magnitude, notwithstanding their expertise in other spheres. The only project experience lies with the implanted TW-sponsored Exec. Directors. **Again, this is very unsatisfactory.**

Comment on the Draft Licence:

60. The payment and adjustment clauses for Allowed Revenues (i.e. what IP/TW customers can be charged) under Appendix 1 of the Draft Licence (note: 40 pp. long!) are a tangle, reminiscent of the payment clauses for the London Underground PPP, which ended as a financial disaster.
 [NB. The London Underground PPP had the same Financial Advisor as OFWAT has for TTT.]

Particular note should be taken of the following issues in the draft Licence:-

61. The Allowed Revenue adjustments, based upon UK RPI-type and construction indices, are, in effect, also inflating, or increasing, IP overhead and/or contractor profits (ref App. 1, Art 3). That is unfair to TW customers.

If one assumes that contractor profit is, say, 15%, then only 85% of his costs should be increased by the index, or, alternatively, the index reduced by 15%. Compensation for inflation can never be exact, but it is essential that, at all times, pressure should be placed on the contractor throughout construction to control and minimise costs. The proposed mechanism fails to do that.

62. The "Charging Year seems to start when Licence is awarded. It should start when Licence is awarded and all financing and construction contracts are effective.

63. It seems that under the Licence (Item 1.4?) the IP Licencee receives protection against future tax changes or interpretations of tax law. **Many taxpayers, not just TW customers, will be outraged by this concession.**

- a. has HMRC / HM Treasury sanctioned this?
- b. has OFWAT authority to include this in its Licence?
- c. such concession sets an unfortunate precedent;
- d. why should IP receive this concession and not TW, other water companies, and TW customers? and
- e. does not such concession represent EU State-Aid?

If the investors do not trust the stability of UK tax law, they should go elsewhere!

64. On the other hand, a change of law, which impacts on the ability of IP/TW's part of TTT to undertake its normal services to customers, may justify compensation or adjustment, but only to the extent that costs of operations might increase (or decrease) as a result of such change.
65. "Appropriate Discount Rate"; this definition in the Licence is based upon comparisons with precedents, for which there are none, i.e. it's a nonsense.
66. There seems no third party mechanism for Dispute Resolution.
67. Many of the adjustments are based upon the WACC bid ("BWACC"), which, in reality in terms of cost to IP, may change over the construction and operational period, not least by IP owners increasing the debt level in the company (which, in turn, reduces their WACC and increases their profits at TW/IP customer expense). This is flawed.

Procurement Waiver:

68. OFWAT seeks a waiver as to the transfer to IP of the construction contracts tendered by, evaluated and "awarded" by TW in advance of IP's Licence award.
69. Firstly, this does not seem to be in compliance with EU Regulation EU/2014/25, which is understood to be enshrined in UK Law in Sept 2015, outlaws such a process;
70. Secondly, no value to such contracts has been disclosed. However, if they cover the 3 main construction contracts, systems integration, etc., the overall value is probably £3-4bn, well in excess of any waiver being acceptable.
71. These contracts have been designed, tendered and awarded by entities, TW and CH2MHill, who are also indirect beneficiaries of said contracts. This is contrary to normal procurement procedures and there has been no oversight of the process.

CONCLUSION:

The Consultation asked:-

- ***are the proposed shareholders of IP “fit and proper” entities to hold IP’s Licence?***
- ***are the proposed IP shareholders of such substance as to comply with Condition K? and***
- ***is it acceptable for OFWAT to issue a waiver in respect of the procurement of certain construction contracts for IP?***

The answer to all three questions is a resounding, “NO”.

Further, there is little credible evidence to challenge that conclusion.

Sir Ian Byatt, Chairman of OFWAT, 1989-2000, has been quoted as describing TTT as “a lemon”. I can but agree! There are so many flaws and faults in the deal, that it should be halted now.

That may be costly to TW/DEFRA and OFWAT in the short-term, but TW customers will receive best value for money that way in the circumstances.

If it had been justified to build TTT in the first place, it would have been better for Government to take financial responsibility from the outset, or TW to strengthen its balance sheet and fund the project itself.

However, neither of these options applies today. Prof. Binnie’s latest evidence indicates TTT is not needed, totally undermining Government’s claim that TTT represents Value for Money. Other cheaper, lower risk options are available and just as effective to sustain water quality in The Tideway.

Had these options been fairly, openly and/or independently assessed in compliance with regulations, the evidence indicates that they would be far more effective in providing greater benefits to the public and UK economy.

CC.: CCWater; EIB; EU Court of Auditors; NAO, MP’s.