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**The Thames Tideway Tunnel [“TTT”]**

**An Exercise in “Enron-Economics”**

1. **Step 1:** Government, - any EU government, - identifies the need for investment in infrastructure assets [the “Project”]. Government “specifies” the Project as being “for the public good”, notwithstanding that the cost-benefit, Value for Money assessment may neither support, nor justify, the investment.
2. **Step 2:** the Government sets up a “special purpose”, single activity company called “IP” to undertake the Project.

The Project comprises investment in transportation infrastructure by IP, carrying material from a fixed ‘Point A’ to a fixed ‘Point B’. Said material is to be supplied to IP at Point ‘A’ by an independent company, “TW”, against an indeterminate schedule, - in the event, perhaps, even never, - and then IP is to deliver the same material back to TW at ‘Point B’.

There are conceivably no other suppliers than TW for the material for IP at Point A, and no other customer for the material transported to Point B by IP than TW.

Notwithstanding the inherent inter-dependence of IP and TW, Government insists that the two companies are completely “independent” of each other.

Project costs are estimated as £2.8bn [€3.4bn], with construction over 7 years.

With financing costs, IP will need to raise around £4bn. [€4.8bn], of which 25% will be equity from investors, and £3bn. [€3.6bn.] debt from banks or bonds. As the borrower, the debt will appear “on’ IP’s balance sheet”.

- 3 **Step 3:** the Government awards a licence, - a franchise, a concession, or a “Public-Private Partnership [PPP]”, - to IP to deliver the service. Competitive bidding takes place for the IP private investors or concession.
- 4 **Step 4:** IP is instructed by Government what to build, and the consultant, who originally designed the Project for TW, is awarded a £ multi-million contract to be IP’s Project Manager without any apparent need for competitive bidding.

Contractors for building the Project are, however, sought through a competitive bidding process. Sadly, there are only 2 companies with host country domicile out of the 17 pre-qualified for the works.

- 5 **Step 5:** Government then directs, supported by statute, that the costs of IP's Project have to be paid for by TW customers, notwithstanding that TW customers have no interface with IP, nor receive a service from IP. After all, both TW and IP are "independent companies"!
- 6 **Step 6:** as IP is physically unable to collect their fees due from TW customers itself (as in Step 5), Government demands, by statute, that TW customers must pay TW the fees due to IP, for TW to pass these on to IP. Government's claim that both TW and IP are "independent" is thereby sustained? Further, TW absolves itself from any financial liability in this matter!!

[NB: in fact, under its own licence from Government, TW should have made the infrastructure investment that IP is undertaking in the first place, but TW has been unable to do so due to financial weakness and arguably financial mismanagement. Hence, the "Enron" structure so adopted. Furthermore, under this "Enron" structure, IP is only accountable to the Regulator and Government, - both Government agencies, - and no-one else, not even TW (or IP) customers or the Stock Exchange.

An additional bonus for IP is that all of the customers in TW's marketplace will have to pay IP fees, notwithstanding that only 20% of TW customers will actually benefit, - and then indirectly, - from IP's services.

- 7 **Step 7:** as the 7 year construction period is considered too long for IP to sustain, Government demands that all TW customers pay IP's fees from the start of construction, irrespective of the fact that customers will not receive any benefit for another 7 years!, i.e. TW customers are being asked to carry some of IP's construction risks.

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- 8 Of course, "TW" is Thames Water, and "IP" is the Infrastructure Provider, "specified" by HM Government in June 2014 to undertake the Thames Tideway Tunnel project, "TTT", ("the Project").
- 9 The net result of the above is that HM Government is being able to deliver investment in infrastructure assets for a UK monopolistic public service with seemingly no impact on HM Government's balance sheet.
- 10 Hey presto! Magic!! IP is Enron re-incarnate! Many hard-pressed governments in the EU will "be over the moon"! They can set up a multitude of "special-purpose private companies" to invest in public service assets, leverage up the company with debt, make their populations pay for such investment by statute, and the debt so raised to pay for the assets will be deemed "off balance sheet" for the host government!!

"Stuff Eurostat", who monitor government accounts in Brussels, ..... "and the IMF, too!!".

However, such authorities might consider otherwise. They may not accept this “smoke and mirrors” structure for IP and TTT as “off balance sheet” for HM Government.

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- 11 The answer lies in the requirements and interpretation of ESA 95, with which all EU Member States must comply in drawing up their national accounts. In particular Chapters VI.4 and VI.5 relate to “public infrastructure financed and exploited by corporations” and “public-private partnerships” [“PPP”] respectively in the ESA 95 Manual.
- 12 Under ESA 95, which is administered by Eurostat, the assessment as to whether such transactions are “on” or “off” balance sheet is measured against the transfer of risk to the private party. In particular, the focus is on:-
- construction risk;
  - availability risk; and
  - demand risk.
- 13 **Construction Risk:** a 7 year construction period is very long by any standard. Fixed price contracts are just not available for such periods. Hence, the contracts for IP will be awarded on some form of cost-plus basis and be exposed to cost inflation.

Secondly, under ESA 95, construction risk is interpreted as significant additional costs, delays, and external events triggering payments to third parties, etc., which result in government providing compensation.

HM Government has agreed to provide the TTT IP with compensation: (a) when there are large cost over-runs; (b) if the Government terminates IP’s licence; (c) if IP cannot raise the funding needed; (d) if insurance cover becomes unavailable; and (e) if an event arises such that IP’s insurance cannot meet the claims made.

In addition, by statute TW’s customers will have to pay IP during the construction period, whatever happens! The amounts remain undisclosed, but could amount to around £100-150mn per annum, i.e. up to 5% of debt outstanding, for each year during the 2015 - 2023 construction period.

Hence, under the above support package, it can be argued that much of the construction risk is assumed by Government, and Government, in turn, pass this on to IP customers, via TW, by statute. Further, IP debt (£3bn) could well be interpreted as not a contingent liability, but as “on” balance sheet for HM Government, at least for the construction period.

- 14 **Availability Risk:** the details of the commercial and operating contracts for TTT are to date undisclosed. However, the “Availability” measure for a project, where the asset may never be called upon to be “Available”, - particularly, as the demand for TTT is completely unpredictable, - raises some unique questions. Indeed, some may argue that such “Availability” measure is quite meaningless in the circumstances.

There is also another scenario that could easily arise. Should there be a downpour and TW passes effluent to TTT IP, but TTT is “un-Available”, (a) clearly IP should receive no fees from TW customers and, possibly, even should be forced to reimburse TW customers; and (b) who pays compensation payments or fines due as a result of TW putting effluent/CSOs into the Thames?? Are not such events those exceptional circumstances for which HM Government have indicated that they would provide compensation?

On this criterion, therefore, Eurostat may not accept as TTT IP debt as being “off” balance sheet for HM Government during the operations period.

- 15 **Demand risk:** the demand for TTT is in “the lap of the gods”. There may, or may not, be downpours. Secondly, as to whether TTT is used following such events is up to TW supplying “material”, i.e. CSO effluent, to IP at Point A. TTT may never even be called into use at all!

Indeed, if the Government finally implement Schedule 3 (SUDs) of the Flood & Water Management Act 2010, which was to be introduced early 2014, then the use of TTT could be minimal, and even then, according to some experts, totally redundant after 10-12 years from completion.

Yet TW customers are to pay for the “service” to be provided by IP, whatever the demand and, possibly, indefinitely!!

Under current TW/DEFRA proposals, however, IP assumes no demand risk, this risk being transferred, by statute from IP to TW customers, who have to pay! Hence, under this criterion, IP’s debt should be classified as “on” HM Government’s balance sheet.

I expect that this was not HM Treasury’s intention, albeit that DEFRA seem to be in the vanguard of the TTT project.

### **Conclusion:**

The proposed structure for TTT IP is flawed and seems designed to circumvent EU Regulations. Sadly, one has the impression that DEFRA, TW and their advisors, with a passive HM Treasury as observer, have tried to be too clever and to obfuscate the real risks and obligations for the TTT project.

In 2002-3, Network Rail(NR)’s £20bn. debt was deemed as “off” balance sheet for HM Government by the Office of National Statistics (ONS) and Eurostat. NR’s debt was considered a “contingent liability”, i.e. not a liability today, but could be in the future!! Whitehall and HM Treasury were delighted. Many in the City thought otherwise.

Twelve years on, and HM Treasury have indicated that NR’s debt, which now stands at a mere £30bn, will be brought back on to the UK Government’s balance sheet in Oct 2014. That lesson should be learnt, as for Enron!

TTT should not be assigned a similar fate, ..... and TW customers should not have to foot the bill for a significant infrastructure investment, which will have limited, if any, use and in no way represents Value for Money.