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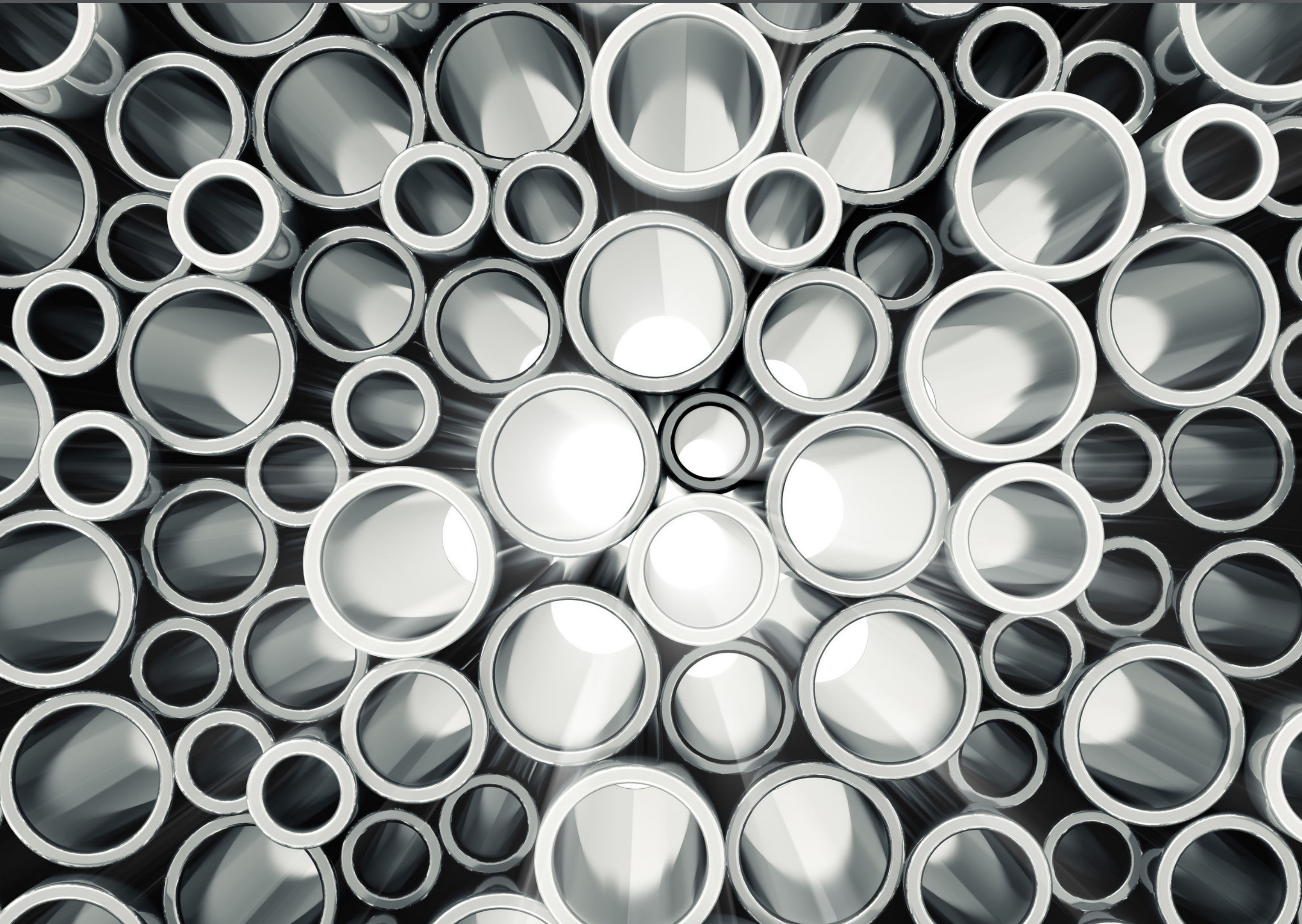
THE SPV MODEL AND DPC

How do they compare?



*Both the water industry and the energy industry are carrying out their periodic price reviews and are seeking to introduce more competition into sectors which comprise a series of regulated monopolies. Ofwat, as the water regulator, are introducing Direct Procurement for Customers (***DPC***) and Ofgem, as the energy regulator, have the Special Purpose Vehicle (***SPV***) model as one option for increasing competition in onshore electricity transmission assets. Each regulator seems to be looking to the other for inspiration – indeed, for once Ofwat seems to be in the lead with Ofgem keeping a close eye on developments, given that the water price review (***PR19***) is a year ahead of the energy ones (***RIIO-2***).*

OFWAT: DIRECT PROCUREMENT FOR CUSTOMERS (DPC)

DPC is a new model under PR19 designed to allow larger water infrastructure projects to secure competitive financing. Water companies have recently submitted their business plans to Ofwat for AMP7, including consideration of whether DPC would be appropriate for relevant projects. Under DPC a water company runs a competitive tender to appoint a third party (known as a competitively appointed provider, or CAP), to design, build, finance, operate and maintain new infrastructure.

If this model sounds familiar it is because it is based on the OFTO model in the energy industry, where infrastructure connecting offshore wind farms to the mainland is owned and operated by a separate company following a competitive process. For background on OFTOs, see our article, The state of the OFTO market.

There are two models of DPC: the contracting model, where the incumbent water company retains the licence for the network and contracts out its obligations to construct and operate a particular asset to a contractor; and the utility model, where the contractor obtains its own licence – the Thames Tideway Tunnel being an example of this in practice.

The DPC contracting model is untested, and in the discussions surrounding PR19, there have been concerns as to the extent of residual liability for the incumbent water company if the contractor defaulted on its contractual obligations, given that the water company remains accountable to Ofwat as the licence holder.

The Thames Tideway Tunnel is a successful example of the DPC utility model, with the contractor having its own licence, backed up by various Government support mechanisms which are unlikely to be replicated in future projects, unless they are similarly high profile.

OFGEM: SPV MODEL

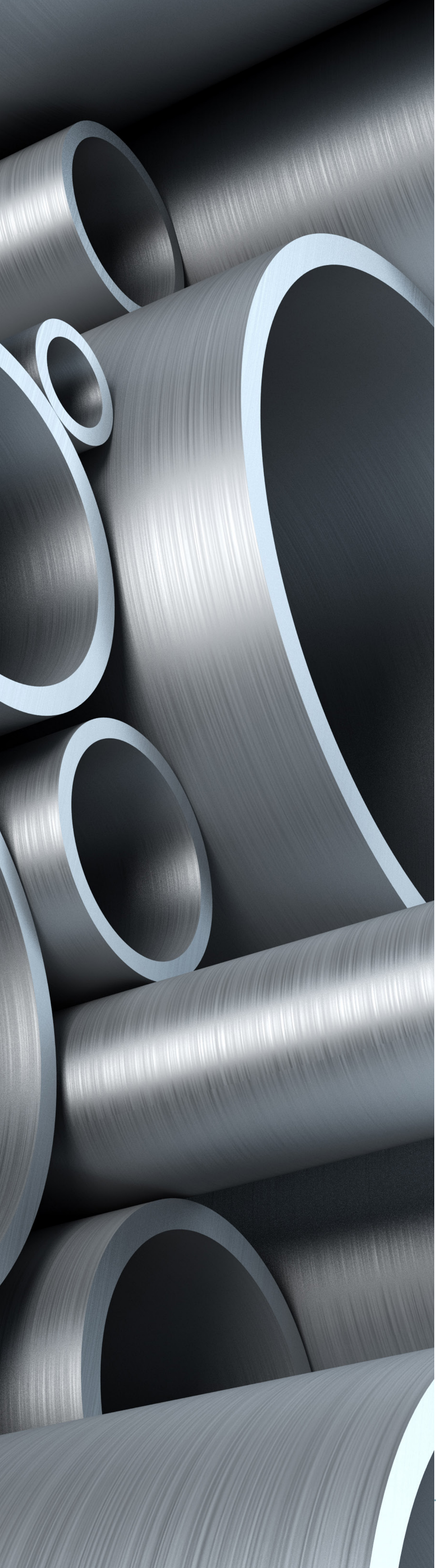
But here's where it gets circular. In parallel with Ofwat's DPC, Ofgem are developing new models for competition in onshore transmission (new electricity transmission assets that will connect large generation projects to the grid, for example Hinkley-Seabank which will connect the new Hinkley Point C nuclear power station). Originally they hoped to bring in a Competitively Appointed Transmission Owner (**CATO**) model, but this requires primary legislation and Brexit has put that on hold for the time being. So in the meantime they have developed two alternative models: the SPV model and the Competition Proxy model (**CPM**).

Ofgem have recently issued an update and impact assessment on implementing their CPM and SPV models for future projects; and are consulting on the commercial and regulatory framework for the SPV model. In the latter consultation, they said they will continue to monitor developments in DPC for potential learning to apply to the SPV model, given there are some similarities between the two. Yet both the DPC and the SPV model are based on the OFTO model which emanated from Ofgem. The main difference is that under the OFTO model, the contractor has to have their own licence, whereas under the SPV model and the contracting model of DPC, the incumbent utility company retains the licence responsibility.

COMPARING THE MODELS

It is worth comparing how the contracting model of DPC (for water) and the SPV model (for electricity) will work. We summarise the main points in the table below. Water companies have to put forward projects to be considered for DPC, whereas Ofgem will assess each project (under the current price control period) that falls within the “new, separable and high value” criteria, and decide whether and under which model to put out to competition. It therefore seems Ofgem want to be more involved in running procurements than Ofwat.

AREA	OFWAT DPC MODEL	OFGEM SPV MODEL
Eligible projects	Technically discrete projects which are most likely to deliver the greatest value for customers. Suggested threshold of £100m totex.	New, separable and high value (£100m or above) (see draft guidance on criteria)
Who decides on model	Water company in their PR19 business plan. Must show that the costs and benefits of putting the project out to DPC outweigh those of building and operating it in-house.	Ofgem, for existing SWW projects. Approach for future projects under RIIO-2 to be decided.
Who runs the competition	Water company, following Ofwat procurement principles (see Table 9.1 of Appendix 9 of PR19 methodology)	Transmission owner (TO), with Ofgem approval and oversight, following Ofgem procurement principles (see section 5 of the SPV Model consultation)
Can associated companies bid?	No	Yes, if robust conflict mitigation measures can be put in place
Contract principles	Set out in Table 9.2 of Appendix 9 of PR19 methodology	Set out in section 2, Table 2 of the SPV Model consultation. More detail in accompanying Agilia report
Length of contract	15-25 years	25 years
Are assets fully depreciated over contract term?	No. Assets are depreciated over their useful lives (probably longer than contract term)	Yes
At what stage can projects be tendered?	Any stage	Late stage (after planning) for RIIO-1 projects; early models considered for RIIO-2
When does revenue start?	After construction period	Normally after commissioning, but may start to be paid earlier if long/complex construction project
Who remains ultimate licence responsibility for project?	Water company	TO



KEY DIFFERENCES

So the key differences between the water and energy models are:

- Water companies have to put forward projects to be considered for DPC, whereas Ofgem will assess each electricity transmission project (under the current price control period) that falls within the “new, separable and high value” criteria, and decide whether, and using which model, to put it out to competition.
- Ofwat’s approach seems to be less prescriptive than Ofgem’s. Ofgem seem to want to keep close control over the procurement process, which requires Ofgem’s approval at key stages. The content of the Direct Agreement between the TO and the bidder under the SPV model is also more prescriptive than Ofwat’s DPC contract principles.
- Associated companies cannot bid for a DPC, but may be able to bid for an SPV project, if appropriate conflict mitigation measures can be put in place. Ofgem however have not ruled out following the same approach as Ofwat and simply banning associated companies from bidding.
- The length of a DPC project is not fixed (Ofwat suggest 15-25 years but the water company and the bidder can decide during the procurement); but an SPV model project has a fixed 25-year revenue stream.
- Linked to this, the two regimes treat depreciation differently. Water assets may not fully depreciate over the term of the DPC, so there needs to be provisions around valuation on handback. TO assets will depreciate fully over the 25-year term.

COMMENT

Ofwat have now given their initial assessment of the water companies' PR19 business plans and were disappointed with most companies' responses to the opportunities from direct procurement. The threshold assessment of £100 million totex was well applied, but then numerous projects over that threshold were then rejected for DPC either for technical reasons (e.g. inadequate separation from other assets) or lower comparable value for money for customers, without giving sufficient evidence or convincing reasons.

Ofwat have asked those companies for more information on why those schemes were rejected for DPC and given them some detailed actions, including a set of standard assumptions for NPV analysis so that the water companies can compare the value for money of using DPC for a scheme instead of carrying it out in-house. The revised information must be submitted by 1 April.

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