Ofgem's SPV Model

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1. Introduction

This paper offers a perspective on the SPV model for onshore transmission investments. It draws especially on the lessons that have emerged from the work that First Economics has carried out recently in the water industry when looking at Ofwat's parallel proposals for 'direct procurement', including discussions that we have had with regulators, companies, investors and customer representatives.

The paper is structured into three main parts:

- section 2 picks out the distinguishing features of the SPV model;
- section 3 identifies some of the factors that ought to be captured in any regulatory impact assessment that Ofgem might work up before deciding on the appropriate approach to future projects; and
- section 4 makes some concluding observations.

2. The SPV Model vs the CATO Model

The current interest in onshore transmission SPVs is part of Ofgem's broader response to the obstacles that there at the present time to proceeding with the preferred CATO model. In keeping with the presumption that it is better for the market to reveal the efficient cost of new investments rather than for a regulator to fix the costs that customers must pay via a determination, Ofgem's August 2017 SPV proposals would, if implemented, require the licensed National Grid Electricity Transmission (NGET) business to obtain major new transmission infrastructure from third parties, starting with the Hinkley Seabank project in 2018.

The SPV model differs from the CATO model in two main ways:

- first, the SPV model is a form of corporate out-sourcing in which NGET would be procuring the construction, financing and operation of a new asset that NGET is responsible for delivering from an outside provider. The CATO model, by contrast, would have taken responsibility for a new part of the national transmission network away from NGET and passed that responsibility in full to a new entity to take over on a stand-alone basis; and
- second, the SPV model is underpinned by a contractual arrangement in which the obligations that the third party has to NGET and vice versa are written into legally enforceable agreements. In the CATO model the new asset owner would be a transmission licensee and, as such, would be regulated by Ofgem in accordance with the regulator's statutory duties using the toolkit laid out in the Electricity Act.

These two things mean that the SPV model and the CATO model have a very different character. Stepping right back, the SPV model can perhaps be thought of as being akin to a corporate PFI arrangement, whereas the CATO model is first and foremost a way of creating a new class of regulated company. Even if the two structures stem from the same thought process – i.e. the view that there should be contestability for large projects, where feasible – the distinction between a contractual approach and a regulated approach to new investments is not a trivial one and potentially produces different kinds of benefits and costs for end consumers.

3. Cost-benefit Analysis for the SPV Model

This can be seen more clearly if we start to work through the factors that we would expect to feature in a future cost-benefit analysis or regulatory impact assessment.

3.1 Benefits

The key advantage that the SPV model could have over the status quo option of own-delivery by NGET is the potential for greater cost efficiency.

When faced with a choice between obtaining multiple quotes from suppliers via a competitive process or negotiating the price of a new investment with a monopoly supplier, it would seem obvious that customers would have a preference for the competitive process. The experience that there has been over the last ten years in offshore transmission appears to validate this preference: successive competitions have been won by a range of new entrant companies and at prices that appear to be significantly lower than Ofgem could have obtained via a normal regulatory determination.[1]

The choice between the SPV model and own-delivery is not just a choice between competition and regulatory determination, however. Unlike the OFTO (and CATO) model, the SPV model requires there to be a transfer of an investment out of a regulated, licensed business and into a separate entity in order to open up that investment to competition. It would be wrong to assume that the pricing of the investment will be the same in these two settings, other than to the extent that competition can be harnessed to drive costs down. Rather, there needs to be a recognition that the pricing of core regulated infrastructure is often different from the pricing of infrastructure that is delivered via other means.

This is a message that has emerged very clearly from investors' early reaction to Ofwat's proposals for direct procurement in the water industry. As KPMG put it in a recent report to Ofwat:[2]

> Generally investors considered that it would be difficult to beat the cost of capital of a regulated water company except, potentially, on a marginal cost basis (i.e. reflecting a marginal cost of finance where new debt in the DPC is financed at current market rates compared to an appointed water company that receives a weighted average cost of capital reflecting both embedded and new debt).

In our own interactions with potential investors, instincts in this area were based principally on the distinction that they make between investing in a regulated revenue stream and investing in a set of payments that are promised by a company. In the former case, investors feel that they have, in effect, a direct lien on a captive customer base, whereas in the latter case, investors see a less certain set of cashflows where payment is conditional on what is happening with the other cashflows that the company is responsible for managing. This translates into differences in perceptions of risk and, potentially, a different cost of capital.

While there may be ways of reducing perceptions of risk, it necessarily follows that it cannot be taken for granted that the SPV model will result in lower final costs. There are clearly two offsetting factors to consider: the potentially higher cost of financing assets outside of a

[1] Note, that the low cost of capital implied by recent OFTO transactions is partly a function of the 'late build' model, in which OFTOs take on built assets from developers after construction, and partly a function of a bespoke risk allocation. Care must be taken when comparing an OFTO cost of capital, to, say, the RIIO cost of capital.

[2] KPMG (2017), Direct procurement for customers.

conventional regulated structure; and the potential reduction in costs that comes from having a competitive process. In order to proceed with the SPV model, Ofgem would need to be clear that the net position is positive after both of these factors are taken into account.

3.2 Costs

Ofgem also ought to recognise that the transfer of assets out of a licensed business and into a separate corporate entity could also present other disadvantages for customers, as follows.

Relationship between Ofgem and asset owner

When assets are owned and managed by a licensed business, Ofgem as economic regulator has a direct relationship with the company that is controlling what are likely to be important parts of the country's transmission network. It can use this relationship to impose restrictions and obligations on the company for the benefit of customers. For example, all current transmission licences contain provisions which require the licensee to:

- ring-fence its electricity transmission business from other, unrelated activities;
- maintain a minimum investment-grade credit rating;
- submit annual accounts and other information to Ofgem; and
- cooperate with other industry parties.

If assets are in the hands of SPVs, Ofgem will not have the same direct relationship with the asset owner/manager and cannot directly impose regulatory rules on the SPV company. Ofgem will presumably want to consider if it should impose requirements on NGET to insert certain Ofgem-designed conditions into the contracts that it lets (e.g. to replicate the standard terms that appear in transmission licensees). However, this may not fully replicate the controls that Ofgem is able to exert over a licensed entity. As one example, one of the great strengths of the Electricity Act regulatory framework is that it enables Ofgem to update companies' licence conditions as circumstances change; it is not clear how NGET could write a contract that requires another party to adhere to restrictions or obligations that Ofgem has not yet thought of.

Enforcement

Similar observations can be made about the processes that would kick in if end customers are unhappy with the transmission network's performance.

In the conventional model, Ofgem has a wide range of powers available to it if needs to remedy poor performance on the part of a transmission company, including: the right to require a recovery plan; licence enforcement proceedings; the ability to levy financial penalties; and, in extremis, powers to strip a firm of its licence and transfer the licence to a new company. None of these Electricity Act powers would apply in a situation where the owner and manager of a transmission asset is not a licensed business in its own right.

It is not clear how easy it would be to insert a similar set of sanctions into a contract, not least because investors may worry about the risks that they face if such powers are wielded by a company rather than by a regulator that is guided by a set of statutory duties. The SPV model could therefore be said to create holes in the enforcement framework that protects the interests of customers. Moreover, even if these holes could be plugged by contractual means, Ofgem would in any case need to rely on NGET to use its contractual remedies, thus effectively delegating a responsibility to protect customer interests that Parliament has said should really be discharged by the economic regulator.

Special administration

Another example of the downside that there could be for customers when part of the transmission network is owned by an unlicensed entity arises in the event of insolvency. Parliament has previously decided that essential infrastructure should not be governed by normal Insolvency Act proceedings but should instead come under a framework of special administration, in which priority is given to continuity of service over the interests of creditors. An SPV would not be covered by special administration rules, potentially leaving users of the SPV's assets with less protection against financial distress and service disruption.

Contract horizon end date

One clear disadvantage that we can see that there could be for customers in a contract-based structure lies in the difficulty that there will be in writing and letting a single contract for the natural life of the built assets. A new transmission connection would normally be expected to have an asset life of 40 years, however it is unlikely that it will be possible for any company to secure finance for this length of time and, hence, there may be an unwillingness on the part of potential contractual partners to enter into a full 40-year term.

Ofgem indicated in its recent consultation document that it may be appropriate for NGET to let contracts for only a 25-year period. Ofgem also suggested that the payments that NGET makes over this period should pay in full for the SPV's construction, financing and operational costs so as to avoid a situation in which NGET has to pay any sort of residual cost or termination payment. From a customer's perspective, this is not ideal. Normally, customers would want the cost of an asset to be depreciated over the life of the asset, so that there is a matching of the charges that customers pay to the benefits that customers take from use of the asset. Ofgem is proposing, in effect, a front-loading of charges, in which early customers will have to pay more and later customers will pay nothing. This is a form of inter-generational transfer, which would normally be said to have adverse consequences for economic efficiency and equity.

Contracting issues more generally

A final observation we would make is that designing a contract that will govern the construction, financing and operation of an asset in an appropriate way over a 25-year period will not be straight-forward. Contracts are not nearly as flexible as licences, and the onus will be on Ofgem and NGET to think ahead and write down now in legal terms the responsibilities that the parties will have in future states of the world.

Two points, in particular, are worth emphasising:

- the risk allocation between NGET, its SPV partner and customers will need to be made clear upfront, probably for the full life of the asset, in order to make the SPV an investable proposition; and
- there will need to be a recognition on all sides that the nature of a contract-based structure is that it will be costly to customers to subsequently depart from that initial risk allocation during the life of the contract.

4. Conclusion

Given the context that we have just laid out, our overall perspective on the SPV model is very similar to the perspective that we have given on Ofwat's direct procurement framework: while we could be wholeheartedly supportive of recent efforts to award new licences for major projects via

competitions, we are not at all sure that the case has been made for what we think amounts to the insertion of a web of corporate PFIs into the regulated utility industries.

As a minimum, Ofgem could have been clearer in its August 2017 consultation that the cost-benefit analysis for SPVs is likely to be different from the cost-benefit analysis for CATOs or OFTOs.

On the benefit side, we do not think there should be a presumption that an SPV's financing costs, even if established via a competitive process, will always beat the cost of capital that investors see in a conventional regulated structure. This is an area that requires additional analysis, including in relation to the pricing benefits that Ofgem may be able to obtain if it is able to shape the contracts that are to to be let so that they appear to give the SPV something that it more akin to a regulated revenue stream rather than just a contractual revenue entitlement.

On the cost side, we have identified a number of downsides that would seem to come from taking essential infrastructure outside of the direct reach of the industry's economic regulator. Again, there may be steps that Ofgem can take to ameliorate some of these effects, although our sense is that it will not be possible to completely recreate the protections that customers would have if projects were to remain fully regulated. There is therefore likely to be a cost side in the SPV ledger, which needs to be properly understood before Ofgem can confidently say it is in a position to conclude that SPVs will benefit customers.

We would hope that Ofgem will feel able to offer this kind of more balanced analysis of benefits and costs when it publishes its consultation conclusions later this year. There are a number of parties that Ofgem can talk to that have experience of both regulated and contract-based investments in infrastructure and who may have useful perspectives to offer. We have also found it helpful to talk to the regulators and companies in the regulated industries that have had experience with PFI contracts over a number of years (e.g. the Water Industry Commission for Scotland and Scottish Water, and the NI Utility Regulator and NI Water).

For the avoidance of doubt, the purpose of this paper is very definitely not to say that making large projects contestable is a fundamentally bad idea. We did not write a paper like this in response to Ofgem's CATO proposals and we agree with the view expressed by other industry stakeholders that it is unfortunate that Parliament is not currently in a position to extend the framework for competitive licence awards onshore. Our observation would simply be that Ofgem's SPV ideas are new and different from anything that has come before and should be evaluated in much greater detail before a decision is taken to require NGET to take forward this new way of procuring transmission infrastructure.

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