

# Severn Tidal Power Legal Review – Part II

## Smaller Schemes

The **first option** postulated for the smaller schemes is that the Private Sector own, finance, construct and operate the asset for its entire useful life under the terms of a licence.

Traditionally, in the UK electricity generation market (and in overly simplistic terms), what this has meant is that government agrees to grant licences to generate and the private sector will independently source relevant sites to purchase and will undertake all relevant design, planning and licensing work at their own risk (together with any relevant environmental works) in order to design, build, finance and operate a power plant, also at their own risk, in accordance with the terms of the licence and planning approval.

To reflect the ownership of offshore sites, in the offshore wind sector the same arrangement has been implemented save that, rather than purchase land at will, leases have been granted (after auction) by the Crown Estate.

With respect to Severn Tidal Power, the market feedback you have received would suggest that the market will, if left to itself, decide **not** to take the risks and incur the investment associated with any of the schemes currently under consideration in preference to other generation opportunities within the UK market or elsewhere without receiving positive encouragement/support/subsidy from government and it is clear, therefore, that the traditional "market led" approach will not be available to government if it wishes to ensure that one or more of the preferred schemes for Severn Tidal Power is to be brought to fruition.

For the Shoots Barrage, Beachley Barrage and Welsh Grounds Lagoon the support which the market feel they would require is:

- (a) government support with/lead the development of compensatory measures;
- (b) government support with regard to design and planning issues; and
- (c) potential revenue support with a preference for an extension of the RO mechanism and/or introducing a premium Feed in Tariff (**FIT**) or fixed FIT.

The **second option** put forward by you is that the private sector finances, constructs and operates one (or more) of the three schemes under the terms of a concession for say 25-35 years, after which time it reverts to government ownership. Government may then let a further concession to operate the asset or may, instead, privatise it at that stage. It is anticipated, as a result of the market feedback, that the private sector will again need support in terms of:

- (a) government to lead on the compensatory measures work; and
- (b) planning risk may also need to be shared or bid costs underwritten in the event of failure to achieve planning.

For this option you are once again asking us to assume that the RO mechanism will be used for revenue support (it would need to be extended for a Severn Scheme) or alternatively a premium or fixed FIT (or hybrid of availability payment combined with an electricity payment) may be preferred.

Government wishes to know how, if it accepts that support such as that outlined above is to be given, it can:

- (a) bring forward a preferred scheme to market; and
- (b) evaluate the bids for that scheme under either or both of the options.

### **How may government bring a proposed scheme to market?**

#### **Background**

The various consultation documents relating to Seven Tidal Power make it clear that when the government made a Call for Proposals in 2008, ten proposals were forthcoming, three of which are those now listed by you above (i.e. Shoots Barrage, Beachley Barrage and Welsh Grounds Lagoon).

We assume that each of the schemes identified is site-specific (hence the reason why the schemes are named after the particular site). We understand, however, that the design postulated in response to the Call for Proposals is not final and that various elements of the design remain open to various optional design arrangements which may be undertaken by various competing designers and that the designs themselves will dictate the actual land take required around the general Site(s) identified.

#### **Certainty – risk versus reward**

If DECC wishes to encourage private sector bidders into a competition to build the necessary power station and attendant infrastructure and to undertake the relevant planning, habitat and other associated works it will have to:

- (a) give sufficient certainty that the project(s) will go ahead;
- (b) be able to offer prospective bidders a limit or a means to calculate a limit on the amount they will be required to spend on the development/design of the project; and/or
- (c) guarantee or ensure sufficient certainty that the required return on the eventual capital employed will be available.

If any of the above remain too uncertain, government faces the prospect that insufficient interest will be shown in the competition and/or the prospect that those that do in fact bid will place such a high risk premium on their bids that the scheme(s) become unaffordable. The skill with any competition in a new industry or where highly complex and "one-off" technology is to be utilised is to get the balance right and to provide carefully measured and highly targeted support at levels that offer true value for money.

#### **One competition or many?**

We assume that, in an ideal world, government would wish to request tenders for the project to design, build, operate and manage the plant and all attendant planning and habitat issues in one competition (the **Total Project Approach**). However, to launch such a competition at a time when numerous designs are capable of being utilised, at a time when the compensatory habitats requirements are unknown and the planning process/land take etc are all uncertain, we would anticipate that a high proportion of bid cost reimbursement will need to be offered by government to obtain sufficient bidders to encourage sensible and meaningful competition.

Further, if the Total Project Approach is adopted at a time of such high uncertainty, government must expect that the amount of contingency built into the pricing of the bids for the project will be exceedingly high and could well affect affordability.

One way of achieving the levels of certainty required would be for government to lead the design, planning and land acquisition process (probably with the assistance of a private sector manager, the management contract for which could be let by way of a competition). However, we understand that such an option is not attractive to government and that a different approach which passes some of the risks associated with these issues to the private sector, whilst giving the private sector the comfort it has identified in the public consultation, is the key here.

The competition should, therefore be structured such that the parts of it that can be "fixed" should be so "fixed" prior to letting the contract while the later parts could, perhaps, be dealt with by means of a framework arrangement or other set of parameters to ensure that proper competitions are run at a later date to ensure value for money at all stages of the project.

Which parts can, therefore, sensibly be "fixed" prior to launching the main competition for the project?

## **Phased project letting**

### **Design**

The first phase of the competition could call for designs to be produced and procured to a level that requires a reasonable but not overly excessive level of investment to enable government to be able to assess the viability of the design and to enable future tenderers (phase 2) to take a view on the viability of obtaining planning and to price their construction and O&M costs.

If greater certainty as to the acceptability of the designs from a planning perspective or as to likely construction costs is required then we would anticipate that the initial planning consultations etc could also form part of this contract, but that a higher level of bid cost reimbursement will need to be offered by government to encourage sufficient interest in the project to make a competition worthwhile. It is difficult to believe (and the market consultation seems to support the view) that bidders will wish to make a substantial investment in a bespoke design that is unlikely to have any applications outside of this particular project with no certainty that their design will be taken forward.

The Design Contract(s) awarded by government would be transferred to the winning bidder of a phase 2 competition so that the co-operation of the Designer in the planning and ongoing process is available to that winning bidder and in order to try to maximise risk transfer relating to the design.

Of course, if a Total Project Approach is adopted, rather than this phased approach then tenderers will be more able to take design risk as part of the risk allocation of the project, but the quid pro quo for this is that government will have less say over the individual parts of the project and the identity of the major contractors etc. It will, as outlined above, also mean that additional contingencies are put into the bid at an early stage and that reimbursable bid costs could potentially rise to unacceptable levels.

By fixing a design prior to launching the major (phase 2) bid, government will have taken a large degree of uncertainty out of the process and should be able to attract a higher number of bidders for the project as a result.

### **Setting the RO/FIT Level?**

Government will also have to make a decision as to whether it will, prior to launching the main (phase 2) competition, put in place the necessary amendments to the RO and/or Energy Act (as appropriate) to set a revenue support structure that will be available to the bidders during the operational phase of the project (i.e. when the plant is producing electricity). This will include obtaining all relevant state aid clearances if the FIT route is adopted. Depending on the structure of the FIT to be adopted some or all of primary legislation, secondary legislation, amendments to supply licence obligations and amendments to generation licence obligations may be required. For example, we consider that:

- for a FIT using a central purchasing agency there would need to be introduced primary and secondary legislation provisions and supply licence obligations similar to those used to support NFFO contracts post NETA;
- for a FIT with a structure similar to that for small scale low carbon generation in s41–43 the Energy Act 2008, primary and secondary legislation and amendments to supply licence obligations would also be required (however, at this stage, we would note that the scale of generation from a Severn Tidal project may make this an inappropriate structure for a Severn Tidal project); and
- for a regulated FIT, in addition to primary and secondary legislation and potentially changes to supply licence obligations, there would also need to be amendments to the structure of the generation licence or a form of additional licence to provide for the appropriate regulated rate of return, since this is not currently a feature for generation licences. In this regard, there are provisions in distribution and transmission licences which could be drawn upon as a precedent.

By setting this part of the remuneration structure ahead of the competition the government is taking out of the equation the ability of the bidders to bid for the type of RO or level of FIT it requires but it will give bidders the opportunity to calculate their anticipated market return and to work from this to establish the levels of grants, subsidies and direct payments required from government etc. to "plug" any funding shortfall(s) in the delivery of the chosen scheme.

One option may be to set up the RO scheme in a manner that itself permits the Secretary of State to amend the regime and grant further ROs if required once the competition has been completed. If, however, the FIT route is chosen, it is difficult to see how government could make bidding for the appropriate level of FIT a selection criteria when it is not in control of whether it will be able to provide the requested support at the end of the day (i.e. is unable to ensure that EU state aid clearance will be given at the requisite level bid by the winning bidder).

## **How might the government wish to structure the competition for phase 2?**

### ***Private led scheme – sale of company***

If government wishes to use the existing licensing regime and private led approach, we would anticipate that it would need to select the site and scheme in broad terms (Phase 1).

Government would then set up an SPV company and grant a licence to generate to that company. It would be that company that would be the beneficiary of the RO/FIT regime and the Design Contract referred to above. That company would then enter into a contract (the **Project Contract**) whereby it would undertake to the Secretary of State to design, build and operate the plant and attendant infrastructure, and undertake the relevant planning and habitats work etc.

Government would launch a competition to seek purchasers of the SPV company. Part of the competition would be the agreement and negotiation of the relevant Project Contract referred to above (i.e. the agreeing of a detailed risk allocation between the government and the bidder) which would be executed by the SPV company immediately prior to the sale of that SPV company to the preferred bidder.

### ***Disadvantages of this Structure***

The proposed private led process outlined above contemplates a sale of a licensed company with no reversion of the licence or the constructed assets to government at any time in the future. Giving a once and for all "shot" at fixing and pricing the relevant risks. In this structure, any mispricing of risks such that the

SPV company earns profits well in excess of those originally anticipated could be an embarrassment for government in the future and the mechanisms for rectifying this (e.g. taxing the relevant company on its "super profits") are generally felt to be politically unattractive options that may potentially diminish interest in future major infrastructure developments in the UK. Alternatively, if the payment regime is too thin to cover the relevant risk and additional unexpected costs that are not covered by government are too high, then the SPV company may find that it is dis-incentivised to manage the plant and/or the processes required to procure the plant and may find the "walk-away" option (even with all of its reputational and monetary consequences) preferable.

## **A better approach?**

### ***Limited life concession letting***

For the reasons outlined above, we consider that government should consider the limited life concession approach (the second option put forward by you) for the three smaller schemes outlined above (and, indeed for the Cardiff and Weston Scheme – see below) as being an approach more likely to obtain private sector involvement in the projects rather than the sale of company ("private led") approach outlined above. In such a scheme, the government could let a concession (Project Agreement) to a winning bidder to design, build and operate the plant. The advantage of this Concession Agreement approach over and above an outright sale of the company is that it will potentially allow the rights and obligations between the parties to be shared in a far more granular manner than is available under a Sales Agreement where a much more "one-time" involvement is envisaged. For example, the manner in which changes to the anticipated project may be financed etc can be dealt with in the agreement and rather than requiring a one-off payment up front by government to reimburse costs that may be added over the years (e.g. as a result of planning conditions, etc) government could instead pay more over time as the increased operating or management costs are actually incurred by the company as a result of such impositions.

### **How could the project contract deal with the relevant issues whilst ensuring sufficient (but not excessive) government support as identified in the public consultation?**

If government were to offer a contract for the continuing design, construction and operation of the projects then, as outlined above, the key areas in which the private sector would feel unable to accept all of the risk of the project (once an approved design is selected) would be the planning and land acquisition process, together with the Habitats regime. Before deciding how the risks associated with these various items may be allocated it is perhaps worth outlining in brief the planning and land acquisition process that one would be required to go through, and which would include many of the Habitats requirements.

### ***What then is involved in attempting to obtain planning?***

We are of the view that the schemes proposed will in all likelihood fall within the new NSIP regime for planning. The newly formed Independent Planning Commission (**IPC**) has jurisdiction to grant development consent relating to England and Wales (s.240(3) of the Planning Act 2008).

The new system of determining development consents by the IPC changes the nature of public participation in the consideration of a NSIP by substituting rights to cross-examine and call evidence, with new rights to be consulted at an earlier stage. The quid pro quo of this change is that developers will in future have to engage in a far more complex, rigid and defined consultation exercise at the pre-application stage of the planning process. This will lead to a significant increase in the amount of pre-application preparation – not least in terms of design. At the pre-application stage, the design must be sufficiently flexible to make the consultation exercise worthwhile, but sufficiently certain, to allow the consultation exercise to have an effective anchor concept. Accordingly, the pre-selection of the design will need to be made, bearing in mind that the designer will be required to remain in place for the duration of the planning process and sufficiently incentivised to work with a preferred bidder to finalise planning requirements.

The IPC will not accept applications unless they are content that the pre-application consultation exercise has been satisfactorily undertaken. In a case such as this, it is also highly likely that they will expect an Environmental Impact Assessment to accompany the application. The design will (probably) have to be moulded and finalised to reflect the consultation exercise prior to the submission of the application and one assumes that a fair level of agreement on the Compensatory Habitats (as to which see below) will also be required to be reached as part of this consultation process.

Just to give a flavour of the expectations of applicants at the pre-application stage, hard copies of all of the various guidance notes and regulations on the NSIP applications process run to nearly two lever arch files.

When the IPC accepts the application, there is a second publicity phase, this time on the project in its proposed final form. A meeting is then held to determine the procedure to be used for the examination of the project, followed by the examination itself and thereafter the issue of the decision. All of this is expected to take about a year, from application to decision. So that means a year, plus the pre-application consultation. Most practitioners would regard that as optimistic, even if there are no challenges by way of Judicial Review at any of the various stages of the process.

Whilst the new procedures are generally welcomed by developers, the response of third party objectors aggrieved not only by the substance of the project, but also by the differences in the approach to public participation, poses a current, unwelcome uncertainty. There is a real possibility that the timing of a project could be substantially extended should a third party make an application for Judicial Review.

An order granting planning consent may also include provisions authorising the compulsory acquisition of an interest in Crown Land only if it is an interest which is for the time being held other than by or on behalf of the Crown and the appropriate Crown Authority consents to the acquisition (s.135 and 226 of the Planning Act 2008). The Crown Estates own the seabed 12 nautical miles beyond the mean low water mark. Crown land cannot be acquired without the consent of the Crown. Some of the shoreline in and around the Severn Estuary is, we are informed, owned by private landowners such as the Duke of Beaufort. . Accordingly, it is highly likely that, as part of the development consent received, the relevant land purchase (or at least lease), together with the pricing arrangements will be settled with the Crown and the other landowners , at the same time as the planning is achieved. The level of private landowner interest differs for each of the short-listed options.

## **Land and Planning:**

### **Planning**

In order to transfer planning and land risks to the Private sector to the extent possible, the Project Contract should provide that the winning bidder will have to undertake all work necessary to ensure that Planning permission is granted. No doubt the Secretary of State will agree to offer such assistance as it is able to do. As outlined above, the process involved in obtaining planning is, notwithstanding the new regime, a lengthy and uncertain process. The government could run the competition to let the design, build and operation of the project by requiring bidders to outline the processes they will put in place to achieve a successful planning outcome and indicating the level of monetary support they will require from government during the planning process. A "banding" approach to sharing the risk of unknown costs could be adopted whereby government agrees to pay additional costs incurred in excess of £X but up to £Y with a sharing mechanism for expenditures in excess of this and with the top slice taken by the winning bidder.

We assume that, if planning permission is not forthcoming at the end of the process (and the end point itself will have to be identified (i.e. how many appeals tribunals etc will be required to be gone through etc.)) government would (in order to obtain sufficient bidders at the outset) have to agree to reimburse the preferred tenderer for all (or a substantial portion) of its costs of relevant design and planning work.

The contract will also have to deal with how the winning bidder is to be recompensed for any increased costs of design, construction or operation that arise as a result of planning conditions imposed that were not budgeted for up front. Again, a portion of these may be capable of being borne by the winning bidder and picked up in later electricity sales proceeds etc. However, certain payments may also need to be made by government by way of fees, grants, indemnities etc. on an "as incurred" basis in order to maintain the investment criteria of the winning bidder.

## **Land**

The Project Contract would also require the winning bidder to purchase all requisite land required to complete the construction of the power plant and the attendant grid connection and on-land works. The competition would require the bidders to specify what assistance they would require from government to undertake this task. We assume that they will be prepared to accept an investment of up to £X but would like assurance that all sums expended by them over this level will be reimbursed by government. In order to ensure that the bidders remain "honest" in their attempts to purchase the relevant land and obtain competitive prices, government could agree to pay amounts over £X but up to £Y, leaving any remaining pricing risk with the private sector. Nuisance and other claims could be dealt with in the same manner.

One assumes that if the winning bidder is unable for any reason to purchase the whole of the land required it will wish to receive compensation from the government for amounts expended to that date on the project. Accordingly, the Project Contract will have to deal with the manner in which government can insist upon (and pay for) design refinements that may be required to fit the required design on so much of the land as is able to be purchased and/or how to identify when the required land is actually so unlikely to be capable of being purchased that it has effectively frustrated the project and will enable the winning bidder to abandon the project with full compensation for amounts expended by the winning bidder to that date.

## **Compensatory Measures:**

Government would also wish to ensure that the private sector bidder was responsible for dealing with the relevant parties in agreeing the method, approach, and works etc. required to deal with the Compensatory Measures and agree with all relevant interested parties – harbour authorities, statutory undertakers, government departments and agencies and regulators, etc. – the manner in which issues affecting them will be resolved. Many of these issues would be wrapped into the planning process and dealt with as part of the Environmental Impact Assessment delivered as part of that process.

Given the uncertainty around these measures at the time of the competition, the Project Contract would, we anticipate, require the winning bidder to undertake and manage these measures and the competition run by government would require the bidders to outline the manner in which this process would be managed, the level of support and subsidy they would require the government to pay in respect of this process and the manner for implementing and paying for the implementation of the Compensatory Measures agreed. Again, we would anticipate a level of investment by the winning bidder with additional sums payable by government and a mechanism for pricing/completing the relevant works once identified and agreed. Any ongoing operational/maintenance costs in excess of those anticipated in the original bid would, once again, have to be borne by/shared with government. Additional land may be required to be purchased to introduce compensatory habitats etc. Accordingly, the issues raised in the **Land** section will be equally relevant here.

It is also extremely unlikely that an all-in quote for the cost of the compensatory habitats works packages will produce any meaningful response if bid at a very early stage in the process. Bidders should be asked to bid on either the basis that they will run a competition for the Habitat works agreed upon or will provide a "pull-down menu" with scheduled prices etc. that may be used if they undertake the various works packages themselves.

## **Construction**

Depending upon the extent of the design work undertaken at the time when bids are called for, Government could either request fixed-price bids for the undertaking of the construction of the plant and grid connections etc. in the usual and "classic" project financing mode. However, given the uncertainties at the time of bidding, the length of time that will undoubtedly elapse prior to construction commencement and/or the amendments that may be required to be input as a result of the planning process, government may feel that it is better to set out in the Project Agreement the framework against which and the manner in which the preferred bidder will put out the relevant works packages (when fully worked up) to tender – and the manner in which it may, itself participate in that tender (e.g. as a co-tenderer/rights to match/other). An alternative would be to have a "pull-down menu" as discussed above or to have a reference bid against which all bidders bid and which, as the works packages evolve is revised on a completely open-book basis.

## **Operation**

The O&M arrangements could be put out to tender at the same time as the construction requirements and on a similar basis to that outlined above. One assumes that the operation of the power station will only materially alter if the design is radically revised from a technical perspective rather than from an aesthetic one. Accordingly, a fixed price with a variations mechanism to deal with amendments to design through the process, may be capable of being included within the Project Contract that is put out to tender.

## **Payment mechanism**

The payment mechanism under the Project Contract (on the assumption that a fixed-term concession competition is adopted) could take a number of forms:

- (a) DECC have asked us to assume that in one scenario the concessionaire is to take an element<sup>1</sup> of electricity market price risk by having the benefit of an extended RO scheme and/or a premium or fixed FIT regime to recover project costs and to provide it with a return.

On this basis, the additional compensation required to be paid to the concessionaire in order to deal with the risks it will not or cannot accept can be dealt with by either:

- (i) being paid over time on a straight-line basis;
- (ii) being paid over time on a cost-plus basis "as incurred";
- (iii) being paid on a "back-ended" or "Major Milestone" basis (i.e. requiring the concessionaire to arrange interim financing for these items);
- (iv) being paid upfront by way of grant, indemnity or other payment.

On the basis of market feedback those matters for which additional compensation is likely to be required include matters relating to Compensatory Measures for affected habitats; design and planning/land acquisition. However, the exact extent of assistance required will eventually, of course, be finally established by the competition itself.

- (b) Utilising the RO/FIT regime as the primary payment method (as outlined in (a) above), the payment mechanism could, to the extent that bidders require amounts over and above the RO/FIT to make the project economic over the period, be reimbursed through a payment mechanism based upon "Availability" of the plant. For example if the planning permission granted imposes additional operational expenditure upon the project then this can be paid for over time using the availability mechanism but only for so long as the plant is actually fully available. If this mechanism is

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<sup>1</sup> The degree of exposure will of course depend on the banding in the RO allocated to the scheme and the quantum of the premium FIT. These aspects are therefore a key part of any competition.

introduced then additional provisions dealing with deductions for under performance will also need to be included within the Concession Agreement.

- (c) Note that, if required, and in order to attract a wider universe of potential investors into these schemes, government may wish to utilise the availability payment structure alone rather than to extend the RO and/or introduce a premium or fixed FIT. If government decides to implement this form of payment mechanism in order to remove wholesale electricity price risk from the concessionaire, this may well reduce anticipated debt and equity financing costs and/or increase the universe of potential investors in the scheme (see our earlier paper for more detail on this (relevant section attached at appendix 2)). If this were to be introduced then a different set of arrangements would be required to get the power produced by the scheme to market. Under this arrangement, the government could run further competitions for people to bid to manage the available power over various periods. This competition could be run by government as a separate exercise or the Concession Agreement could impose an obligation upon the Concessionaire itself to run such competitions.

The availability based payment mechanics in the concession would provide for the agreed risk allocation in relation to the incurrence of the costs of mitigating imbalance charges in the event of unexpected unavailability. The payments received from the electricity marketer would defray the payment obligation of government under the concession (either directly if payments are received directly by the Concessionaire or indirectly if they are received by government) with any balance outstanding being made up (if required) by way of a market levy.

### **What steps would be needed to bring these electricity trader Scheme(s) to market?**

We would anticipate that the steps for the competition to select a marketer would broadly follow those outlined above in relation to the phase 2 project. Additional documentation will also be required to set out the terms of the competition for and the rights and obligations of the electricity marketer, in particular in relation to:

- (a) the basis upon which the capacity/power generated by the scheme is to be auctioned;
- (b) how the marketer is to be remunerated and incentivised; and
- (c) the length of its appointment.

It should be noted that there is no reason why this has to be for the same period as the concession agreement even where the concessionaire is the initial appointee.

Different periods could be auctioned into the market on the basis that the highest bidder in financial terms wins.

### **Termination provisions**

As well as those issues listed above that would be included in the Project Agreement, a limited-time Project Agreement would also typically include provisions dealing with:

- (a) the ability of government to terminate the Project Agreement for poor performance;
- (b) if required, the ability for the government to terminate at will (with suitable compensation attached);
- (c) the required maintenance regime – particularly at the back end of the concession (hand-back provisions/rights of inspection/reserve requirements) to ensure that government does not receive back a poorly maintained asset at the end of the concession period; and

- (d) refinancing or other unexpected or excessive profits and the manner of sharing any "up-side" with government etc.

Thought will also need to be given to the manner in which government will structure the length of the concession itself. With such a protracted timetable to agreeing design, planning, habitats etc., thought should be given as to whether to structure the concession so that it is for a fixed period after completion of the asset, whether to grant a concession for a longer fixed period and to give no long-stop date for completion (on the basis that the fixed term will, in any event give the winning bidder the incentive to complete) or whether to grant the concession on the basis that it lasts for as long as is necessary to reimburse the winning bidder for its bid and works costs etc. and to earn an agreed return on its capital employed.

### **What are the steps involved in the competition outlined above?**

1. DECC publish an OJEU Notice requesting expressions of interest and outlining the technical requirements of the prospective bidders, i.e. specifying whether the bidders are required to have formed the necessary JV/Consortia companies and if so what skill-sets these should include (Design capability/technical expertise/Net Worth/Construction expertise/Electricity marketing expertise, etc.). DECC would then evaluate those expressing interest in the project and will produce a short list of those that qualify. At this stage one would generally wish to have sufficient interest that one would be able to select around three to six Bidders to take to the next round.
2. Consultative tender documents are issued to qualifying bidders. These documents would contain broad outlines of preferred risk allocations and seek views from the bidders as to the manner in which they wish to see matters amended to encourage them to make more competitive bids.

The documents would provide clear guidance as to the manner in which government wishes the risks etc. to be allocated but would also seek innovation from the private sector as to the manner in which these risks can be managed or mitigated more effectively and/or any other mechanisms that may result in greater value for money and/or more certainty of out-turn cost.

A clear evaluation process would need to be worked out (and although it is not necessary to publish this it may be helpful to do so in this instance to encourage required behaviours as part of the consultation).

A first draft of the Project Contract together with a draft of the licence would be issued and mark-ups/suggestions requested, it being made clear that the level of acceptance of the risk allocation envisaged would be one of the final evaluation criteria.

Meetings would be had with each tenderer to try to understand the reasons for their amendments/requirements and to try to understand the manner in which the documentation could be amended to provide better value for money.

3. The outcome of the above consultation process would be that initial tender documentation would be issued incorporating those ideas arising out of the consultation as government felt were helpful and bidders would put in their initial bids outlining their expected requirements as to support and subsidy from the government in order to undertake the project. From these bids the government would look to shortlist bidders (no more than two or three) to take through to the final stage of this procedure.
4. The shortlisted two or three bidders would be taken through the competitive dialogue procedure (whereby each bidder negotiates and agrees with government its final Project Contract) and submits its bid (together with that contract). If the two/three bids remain materially different as to design solutions proposed, then amendments required to documentation that are design-specific will have to be recorded carefully to minimise the likelihood of disgruntled losing bidders taking (or succeeding in) action at a later date complaining of unfair treatment. Typically the competitive dialogue process

has been disliked by bidders as it is a very protracted and expensive method of agreeing projects which involves a high degree of interaction and involvement without the certainty of being awarded the contract. We would anticipate that bidders may well, in a project such as this one, require a high proportion of bid cost reimbursement to encourage them to stay the course.

5. Shortlisted bidders are asked to enter final bids on the relevant documentation produced by government following the competitive dialogue process.
6. Required bids may either (at government's option) be fully financed or government could run the competition on the basis that it will evaluate the bids on a technical and cost basis with an assumed cost of finance being the same for each bidder. They will then work with the winning bidder to complete the financing once the bidder is appointed. The danger with this approach is that financiers may, themselves, seek to re-open certain of the risk positions agreed between the parties. However, in times of constrained liquidity in the debt markets this option has been used successfully and we assume that your financial adviser will advise nearer the time as to the best method of procuring the competition from a finance market perspective. One issue that governments often forget is that even if risk positions are re-opened by the lenders then this does not necessarily mean that the equity investors need benefit from the revised allocation. Government can instead support the lenders if certain risk positions occur which the equity have agreed to bear.
7. If fully financed bids are required then this will also be part of the evaluation criteria – i.e. cost and deliverability, etc.
8. Once final bids are submitted and government has selected the winning bidder the losing bidders must be formally told of their position and be given the opportunity to meet with government to discuss reasons for losing.
9. The chosen party then moves ahead with the closing arrangements. We assume that a condition precedent to the actual signing of the Project Agreement will be that government approves all of the sub-contracts to be entered into by the winning bidder to design, construct and manage the process. Accordingly, although no major amendments may be made to the Project Agreement post preferred bidder, the process of finalising all relevant contracts post selection is often rather lengthy.
10. Contracts are awarded and commercial close is reached.
11. The finance is completed if this method is chosen.
12. Finance documents are executed and financial close is reached.

#### **What contract documents would be required?**

The Contract documents required to complete this process would include:

- (a) Setting up a **Corporate Structure** for the winning bidder project company (i.e. the constitutional documents and, if relevant, shareholders' agreement).
- (b) The **Project Contract** that the winning bidder would execute containing the relevant undertakings to design, build, finance and operate the scheme and the compensatory habitats etc. as set out above. If the Sales approach is adopted then this contract would be executed immediately prior to the sale of the company and be its primary asset.

- (c) If the sale of company method of competition is adopted, a **Sale Agreement** – containing an agreement to transfer relevant rights/assets (under the Hybrid Bill (if adopted) and either the relevant contracts or the agreed number of shares [100%] in the SPV company<sup>2</sup>) to the winning bidder.
- (d) **Generation licence.** The terms of the generation licence would need to be known as part of the tender so that any risks inherent therein could be considered in the tenders.

Relevant subcontracts required will include:

- (a) Design Contract(s)
- (b) Construction Contracts
- (c) O&M Agreements
- (d) Habitats Management Contracts
- (e) Habitats Works Contracts
- (f) finance documents
- (g) security arrangements
- (h) direct agreements and collateral warranties etc
- (i) all associated bonding and guarantees etc.

#### **How will government evaluate the bids?**

We assume that government will wish to ask for and evaluate bids on the basis that bidders outline the level of support (monetary and otherwise) that they wish to receive from government to bring their bid to fruition and agree that costs (including delay costs) over and above the level bid by them will be borne by them (or shared with government on an agreed basis).

On the assumption that all bids are equally credible (i.e. deliverable) and that the government is satisfied with the management regime to be implemented by each bidder, the bid requesting the lowest "subsidy" on these issues and agreeing to take the highest risk would presumably be adjudged the winner of the bid.

To judge the level of likely legal spend for government, parallels should perhaps be drawn with Eurostar, Dartford Crossing, London Underground and Crossrail.

We would anticipate that legal spend for the competition through to contract award will be in the region of £2-5 million.

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<sup>2</sup> The rights/assets to be transferred will depend upon how the earlier works/service arrangements have been contracted for.

## **Hybrid Bill option**

As an alternative to the utilisation of the new planning regime, government may also wish to consider, in light of the number of rights and interests that one is attempting to deal with, (i.e. compensatory measures; compulsory purchase powers; planning issues; port and harbour measures, introduction of a premium or fixed rate FIT for large-scale generation for the first time and/or extension of the RO scheme etc.) whether to adopt a **Hybrid Bill** approach to delivering the project. It may be that the simplest and most deliverable method of attracting bidders for the relevant scheme(s) is to introduce a Hybrid Bill in respect of such schemes. Under such a Hybrid Bill, the Secretary of State would be granted the rights to:

- (a) design, build, finance and operate the government selected site/design; and
- (b) transfer such rights on terms and subject to such conditions as he sees fit to one or more other persons (e.g. Private Sector entity of an entity which is part owned by the private and public sectors) to take forward.

Where the persons referred to in paragraph (b) above are companies owned in whole or in part by government, sell and otherwise deal with the shares (and associated rights) in such companies on such terms and subject to such conditions as he sees fit.

Utilising a Hybrid Bill process will:

- allow government to start a meaningful consultation and competition process at an earlier stage;
- act as a focal point for the effort which assists in efficient implementation;
- give the private sector a greater sense of government commitment which will facilitate engagement;
- allow parliament to assess all relevant issues within the context of a single bill;
- add certainty to a presently uncertain planning process;
- simplify to the maximum extent possible any tender process; and
- assist in allowing repeated review of the correct timing and manner of commencement of a tender process which enables the maximum number of meaningful bids to be introduced and encourage competition that will drive value for money to government.

## **Summary background information in relation to Hybrid Bills**

Hybrid Bills have been successfully utilised in connection with a number of recent UK infrastructure projects that government has put to market in recent years e.g. Channel Tunnel; Dartford Crossing; Crossrail and others.

Hybrid Bills are, by their nature, rather cumbersome pieces of legislation that effectively override existing legislative provisions and/or set out a framework for agreeing how relevant legislative requirements may be met and providing for further Statutory Orders (or secondary legislation) to be passed at a later date as the relevant schemes progress further. However, given the number of issues that the private sector have requested government to take the lead on and the cumbersome and uncertain process involved in the new IPC planning process together with the required Habitats processes, we believe that the Hybrid Bill may be a

very valuable tool in government's armoury for running competitive tenders such as that envisaged for the Severn Tidal Power Schemes.

We set out in **Appendix 1** the manner in which the Environmental, Design, Planning and other issues can be dealt with as part of the Hybrid Bill process if required and the manner in which this approach therefore assists in obtaining flexibility as to the correct time to launch and the manner in which to launch a competition which will remove a number of the uncertainties requiring risk premia to be added by private sector bidders.

## **Cardiff-Weston or Bridgewater Bay Lagoon**

Finally, you have asked us to answer the same questions as for the two options above in relation to a scheme for the Cardiff-Weston or Bridgewater Bay Lagoon under which the private sector would finance, construct and operate the asset under the terms of a concession for 25-35 years, after which time it would revert to government ownership. Government may then grant a concession to operate the asset or privatise it.

We understand that:

- (a) the scale of investment for this scheme is likely to include the government accepting the support outlined previously in this memorandum but, in addition, is likely to require government capital to be invested in the project vehicle; and/or a government underpinning of private sector capital until completion; and/or a government shareholding in the structure.
- (b) It is likely that the revenue support for the scheme would take the form of a Fixed FIT or availability payment because of the scale of off-take risk involved.

### **How may government bring a proposed scheme to market?**

The manner in which this sort of project may be procured and brought forward to market is identical to that outlined above. A FIT payment structure raises identical issues to the availability payment structure discussed above, save that if the level of FIT introduced at the outset of the competition is insufficient then the Project Agreement will contain far higher levels of other government subsidy to deal with cost and time over-runs and/or the shareholding of the government may have to be utilised to "equalise" the difference between the FIT payment and the private sector expected return. The need for primary legislation and EU state-aid clearances makes this option far less flexible than the availability payment option and we assume that with a project this large and complex, a combination of the two (along the lines postulated in the Payment section above) would provide the greatest flexibility and hence comfort as to value for money for government.

Where government capital support and/or shareholding is required, the following issues will also need to be addressed in detail and included in the tender and evaluation process:

- (a) the terms of the government investment in the delivery vehicle (quantum; voting power; ability to control under certain circumstances/issues upon which a positive vote is required/issues upon which a veto is given/items over which government has no say/management control/board composition/level of day-to-day involvement/ability to create springing rights in relation to dividends/votes etc.; the level at which distribution sharing begins/ends); and
- (b) the level of underpinning until completion that government wishes to provide (and on what terms).

### **How will government evaluate the bids?**

The considerations in relation to evaluation are also similar to those outlined above.

Additional criteria for the selection of the preferred bidder on the running of this form of competition will also presumably include an assessment of which bidder requires the least underpinning/investment by government and who is prepared to accept the level of government intervention at shareholder level that the government has decided, pre-procurement, that it wishes to retain.

**Allen & Overy LLP**

**January 2010**

## APPENDIX 1

### Examples of how the Hybrid Bill may deal with the relevant issues arising in a more cohesive and holistic manner?

#### **Environmental – Habitats directive etc.**

When any Bill which authorises the carrying-out of works is submitted for approval it is required to be accompanied by an Environmental Statement containing the information referred to in Part II of Schedule 4 to the Town and Country Planning (Environmental Impact Assessment) (England and Wales) Regulations 1999 (SI 1999 No. 293) and sufficient information to assess the environmental impact of the works.

The Commission guidance on compensatory measures recommends close co-ordination and co-operation between the assessment authorities, the proponent of the compensatory programme and the national Natura 2000 authorities (i.e., in England and Wales, The Joint Nature Conservation Committee (JNCC), Natural England (NE) and the Countryside Council for Wales (CCW)). It also recommends public information and/or consultation stages. We would anticipate that an appropriate Hybrid Bill process itself will be sufficient to discharge these recommendations.

#### **Consultation**

During the parliamentary process for a Hybrid Bill, public and private persons would therefore be given the opportunity to make representations and objections to the provisions of the bill. We would anticipate that the Environmental Statement referred to above would be a document of key interest in such representations and objections.

We assume that, in an effort to minimise the number of objections/amendments required, prior to starting the Hybrid Bill process, DECC would therefore wish to have consulted with the relevant environmental bodies and agreed a way forward on the Compensatory Measures etc. that are to be agreed as part of the process.

This consultation and, if possible, framework agreement with the relevant agencies will, again, take a considerable period to complete. It may be that, if such a framework agreement or environmental management agreement is to be reached during the passage of the Hybrid Bill, that the agreement could be signed with a "Severn Power Company" set up and owned by government that will be the person (or one of the persons) to whom rights under the Hybrid Bill would be transferred by the Secretary of State (see paragraph 1(B) (Recommended procurement method – the Hybrid Bill) above).

#### **Early consultees (i.e. prior to the start of the formal parliamentary process)**

We believe that the following entities should be included as early consultees (i.e. prior to the start of the formal parliamentary process) for the reasons given below:

- (a) NE and the CCW are each given formal advisory or assistance roles or the right to make representations to any competent authority on matters connected with the discharge of their functions under the Habitats Regulations.
- (b) We would also recommend that JNCC is an early consultee. Whilst the JNCC has an advisory role, this does not specifically include giving advice or making representations on compensatory measures. However, it is responsible for the UK-wide (and international) responsibilities and functions of NE, CCW and the equivalent bodies in Northern Ireland and Scotland). As such, it is very likely that it would be consulted by the SoS in practice.

- (c) We would also expect the Environment Agency to be fully consulted and engaged in the site selection and design for the scheme and the design of any compensatory works. Indeed, this agency could, perhaps, be used as the focal point through which all relevant environmental issues could be channelled.
- (d) Member States are obliged under the Habitats Directive to inform the Commission of compensatory measures taken, although not to consult them in advance about the design of those measures. However, in cases in which Member States have sought the Commission's opinion about imperative reasons of overriding public interest in connection with priority sites and species, the Commission has often commented on proposed compensatory measures as well, or even made its opinion conditional on certain compensatory measures being implemented.
- (e) Relevant Harbour and Port Authorities and statutory authorities (including NGC). Highway Authority requirements and all other statutory utilities/authorities/consents etc. as their rights and obligations will also be affected/dealt with in the bill.
- (f) OFGEM. OFGEM will be most interested in the effect of the Hybrid Bill on the wholesale electricity market, and its input into the revenue support provisions in the Hybrid Bill will be vital.
- (g) Market participants. Receiving detailed comments at an early stage from prospective participants will maximise the chances of success for the delivery of the scheme on government's preferred terms.

### **Interim contracting**

In order to progress the scheme prior to the Hybrid Bill completing its parliamentary process, consultants and advisers will need to be retained and commence work<sup>3</sup>. The benefit of the work of some of these consultants/advisers may be required by one or more of the entities which will deliver the scheme. The best example of this is design-related work.

Design and other works and services contracted by the Secretary of State could either be contracted in a "Severn Power Company" (see above) or could be contracted directly by the Secretary of State on the basis that all such Contracts and arrangements entered into are capable of assignment to persons delivering the scheme and/or recognise that the ownership of the contracting party may change. Provisions in the Hybrid Bill to this effect would obviate the need to deal with this in multiple contracts with consultants and advisers.

### **The Competition**

Once the Hybrid Bill is passed into law (or earlier if there is sufficient certainty to run an efficient competition which the private sector will fully engage in), the formal competition to find the relevant private sector entities to (as appropriate):

- (a) become the transferee from the Secretary of State to undertake to complete the works and operate the scheme; or
- (b) purchase shares in the "Severn Power Company" (the entity which would undertake to complete the works and operate the scheme),

can commence.

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<sup>3</sup> As noted below, it may be that greater certainty can be introduced into the competition process if the Secretary of State (or the "Severn Power Company") also enters into the construction and financing arrangements. Similar considerations would apply to such contracts.

At this stage, the prospective entities should have sufficient clarity on the amount of compensatory measures to be undertaken, the planning process and acceptability of the design etc. as well as the regime via which they will receive their income (i.e. RO or FIT etc).

## APPENDIX 2

Suggested "Mixed Payment" arrangement for Severn Power.

1. Government procures design, build and O&M provider under concession for (25/35 [or more]) years.
2. Note: Sale of power will need to be dealt with either in the Project Contract or consider a structure whereby government enters into a separately-procured contract with a power trader (**Variant Project Structure**).
3. Public Contracts Regulations 2006 would need to be followed.
4. Government may wish to introduce an additional levy on the electricity market to recoup differences between the availability price paid to the SPV company and the fixed price paid to it by the trader. We anticipate that the risk transfer achievable under the Project Contract (although similar in many respects to the Public Private Partnership initiative) will be far less than for standard accommodation PPPs, hence we have "badged" this structure in a different manner to avoid perceived PPP disadvantages.
5. Under the Variant Project Structure, bids would be sought for traders to pay a fixed price to government in return for the power generated by the SPV company. This fixed price would enable the government to recoup its availability charge paid to the SPV company.
6. Note: Project Contract to provide for the SPV company to transfer power and rights attaching to that power (e.g. ROCs etc.) to any relevant trader nominated by government.
7. The advantage of procuring the Project Contract without exposing the SPV company investors to electricity market risk will be that the universe of bidders is potentially enlarged (i.e. construction contractors and infrastructure funds may be attracted by the availability nature of the payments).
8. The electricity trader contract competition would ensure highest pricing and can be structured as one or a number of long or short-term contracts depending upon government's view of the best price available.
9. The issue of future "super profits" may be dealt with either by limiting the length of the trading contract(s) or by limiting returns/claw-backs within the contract etc.
10. The government will also be able to reserve for itself the right to charge a general electricity levy across the market to compensate it for the difference between the availability price paid and the amounts paid to it under the trading contract, if desired.
11. The structure could also envisage:
  - (i) O&M contractor sub-contracting to trader;
  - (ii) O&M contractor having ownership of JV interests with others in the trader.
12. Such structures may lead to more opaque market dealings which may not be acceptable to the existing electricity market without appropriate disclosure and/or may limit the electricity market "shelter" afforded to investors in the SPV company.
13. It would also be possible to combine this structure with a FIT and/or levy. Under this variant, the Project Contract would provide that government would procure payment of the "availability" stream (i.e. the FIT) from suppliers directly to the concession company.

