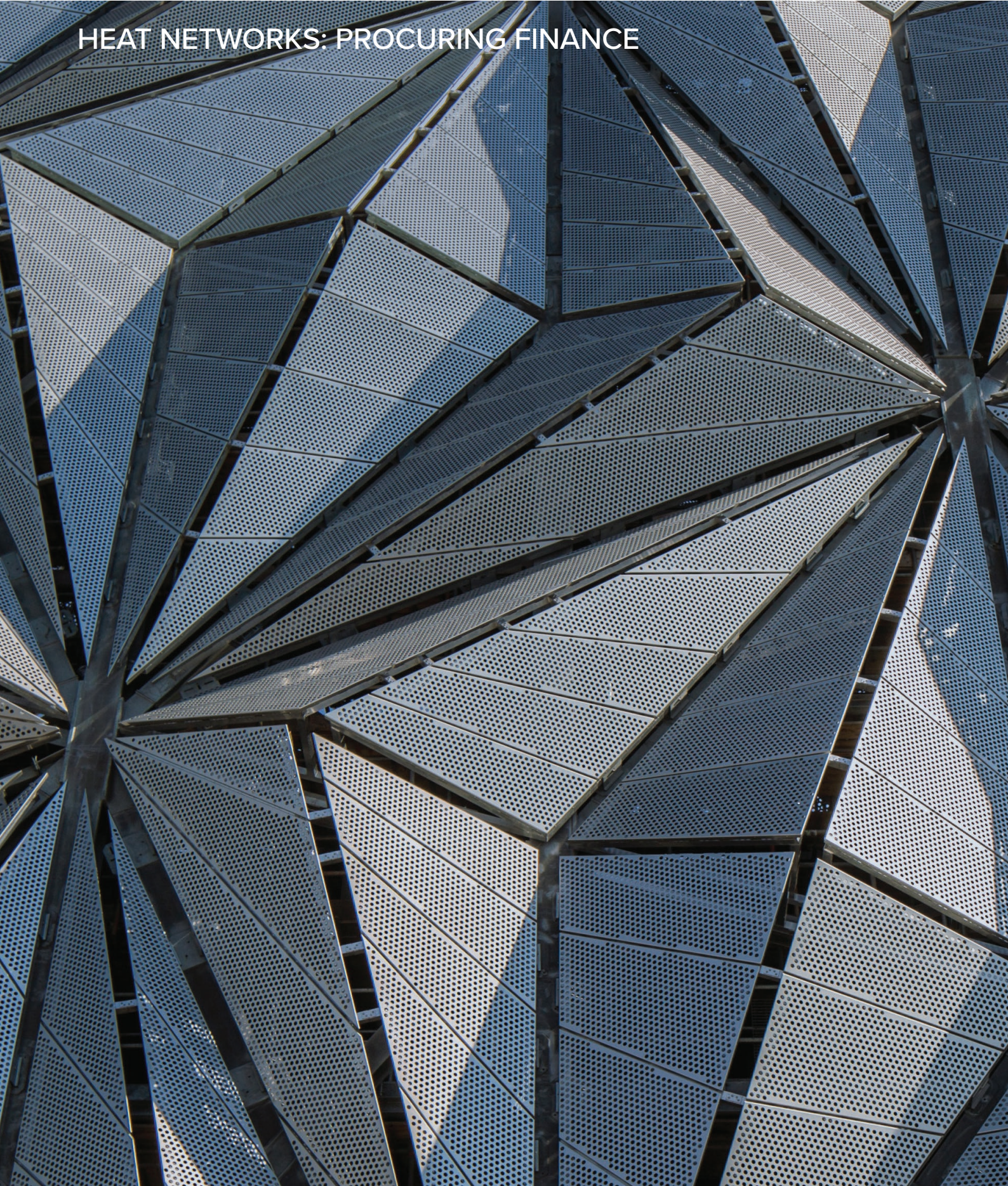


HEAT NETWORKS: PROCURING FINANCE



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GLOSSARY

BEIS – Department for Business, Energy and Industrial Strategy.

CCR – the Concession Contracts Regulations 2016.

Commercialisation Stage – the stage at which the Sponsors engage with the market to procure or secure the works and services needed for the project and agree final Energy Supply Contracts with Offtakers.

Development Agreement – an agreement among the Sponsors of a project under which they collaborate to develop the project. This is usually superseded by a Shareholders' Agreement once an SPV is incorporated.

Development Stage – the stage of the project where the sponsors plan the project scope, undertake in-principle discussions with Offtakers and assess the viability of a project (including heat mapping, energy master planning, feasibility and detailed project development).

DPD Guidance – the BEIS Detailed Project Development Guidance which covers commercial structures, State aid considerations, Heads of Terms for some key contracts and financial modelling guidance.

Energy Supply Contract – an agreement for the supply of energy (heat, cooling and/or electricity) to an Offtaker.

GBER – the General Block Exemption Regulation.

Heat Network – the distribution of thermal energy in the form of steam, hot water or chilled liquids from a central source of production through a network to multiple buildings or sites for use of space or process heating, cooling or hot water.

ITN – Invitation to negotiate.

ITPD – Invitation to participate in dialogue.

ITT – Invitation to tender.

MEIP – the Market Economy Investor Principle.

NPI – Non Public Investor. An investor, or potential investor, in a Heat Network project which is not a public body. This can include investors that are also involved in the operation of the Heat Network or third party investors.

Offtaker – a consumer of energy under an Energy Supply Contract.

OJEU – the Official Journal of the European Union <https://www.oj.eu.eu/>.

PCR – the Public Contracts Regulations 2015 <http://www.legislation.gov.uk/ukxi/2015/102/contents/made>

Senior Debt – debt which ranks ahead of (ie is entitled to be repaid before) other debt.

Sponsor(s) – the party or parties responsible for shaping the project (and running any procurement exercise). In the context of this Guidance, a Local Authority and, where relevant, an NPI. The term “Promoters” is sometimes used (although not in this Guidance) to refer to the same parties.

State aid – broadly speaking, financial aid from a public body which favours a selected business and has the potential to distort competition and/or affect trade between EU Member States.

SPV or Special Purpose Vehicle – in the context of this Guidance, a private company limited by shares which is established specifically for the purpose of a project and which carries on no activities other than the project.

Teckal – an exemption from the requirement to undertake a procurement in accordance with the PCR/UCR now codified in Regulation 12 of PCR and Regulation 28 of UCR.

UCR – the Utilities Contracts Regulations 2016 <http://www.legislation.gov.uk/ukxi/2016/274/contents/made>

EXECUTIVE SUMMARY

This Guidance addresses the question: “Does private sector investment in a Heat Network need to be procured”?

It is designed to help a Local Authority which may recognise the potential benefits of engaging with a non-public investor (NPI) to deliver a Heat Network, but wants to better understand:

- at what stage the Local Authority can engage with the NPI;
- what role the NPI could play in developing the Heat Network project;
- what the procurement law and State aid implications are of involving the NPI; and
- what alternatives there are for delivering the project in a way which meets the Local Authority’s objectives, complies with legal requirements and supports investment from non-public sources.

Similarly, NPIs considering investment in a Heat Network project with a Local Authority may want to better understand the procurement law and State aid considerations which are relevant to the structuring of the project, and how these influence the Local Authority’s approach to delivery.

This Guidance:

- provides points for consideration to help Local Authorities and NPIs collaborate in the most effective way. It does not advocate a course of action or constitute legal advice and all parties must seek appropriate legal, financial and commercial advice for any project in which they are involved. Specifically, it does not comment on legal capacity (vires), or regulatory requirements (such as Electricity Act licensing), although these will be factors to take into account when structuring a Heat Network project.
- has been developed with Local Authorities in mind, but many of the issues identified will also be relevant to other public bodies involved in the development of a Heat Network.
- sits alongside other guidance commissioned by BEIS Heat Networks Delivery Unit and should be read in conjunction with them. This includes:
 - the [Detailed Project Delivery \(DPD\) Guidance](#); and
 - Financing Heat Networks in the UK.
- considers Heat Networks supplying multiple buildings, but some of the commercial arrangements in the Illustrative Scenarios may also be relevant to communal heating of multi-occupancy blocks.
- deals with the law in England and Wales but similar principles are likely to apply in Scotland and Northern Ireland.

July 2018

1. INTRODUCTION

The background of the page is a dynamic, abstract composition of flowing, curved lines in shades of orange, red, and yellow, set against a dark, almost black background. The lines create a sense of movement and energy, resembling light trails or fluid motion.

1. INTRODUCTION

1.1 Structure of this Guidance

1.1.1 This Guidance is arranged as follows:

- (a) this Section (Introduction) provides the context for the Guidance, explains how to use it and describes a typical timeline for a Heat Network project;
- (b) [Section 2](#) looks at the Development Stage (pre-procurement) of a Heat Network project, including whether, and how, a Local Authority should engage with an NPI;
- (c) [Section 3](#) considers the Commercialisation Stage including whether, and how, the PCR, UCR and CCR apply to the procurement of different aspects of the project;
- (d) [Section 4](#) discusses issues generally relevant to the structuring of a Heat Network project; and
- (e) [Section 5](#) reviews seven Illustrative Scenarios to highlight the public procurement considerations for each structure.

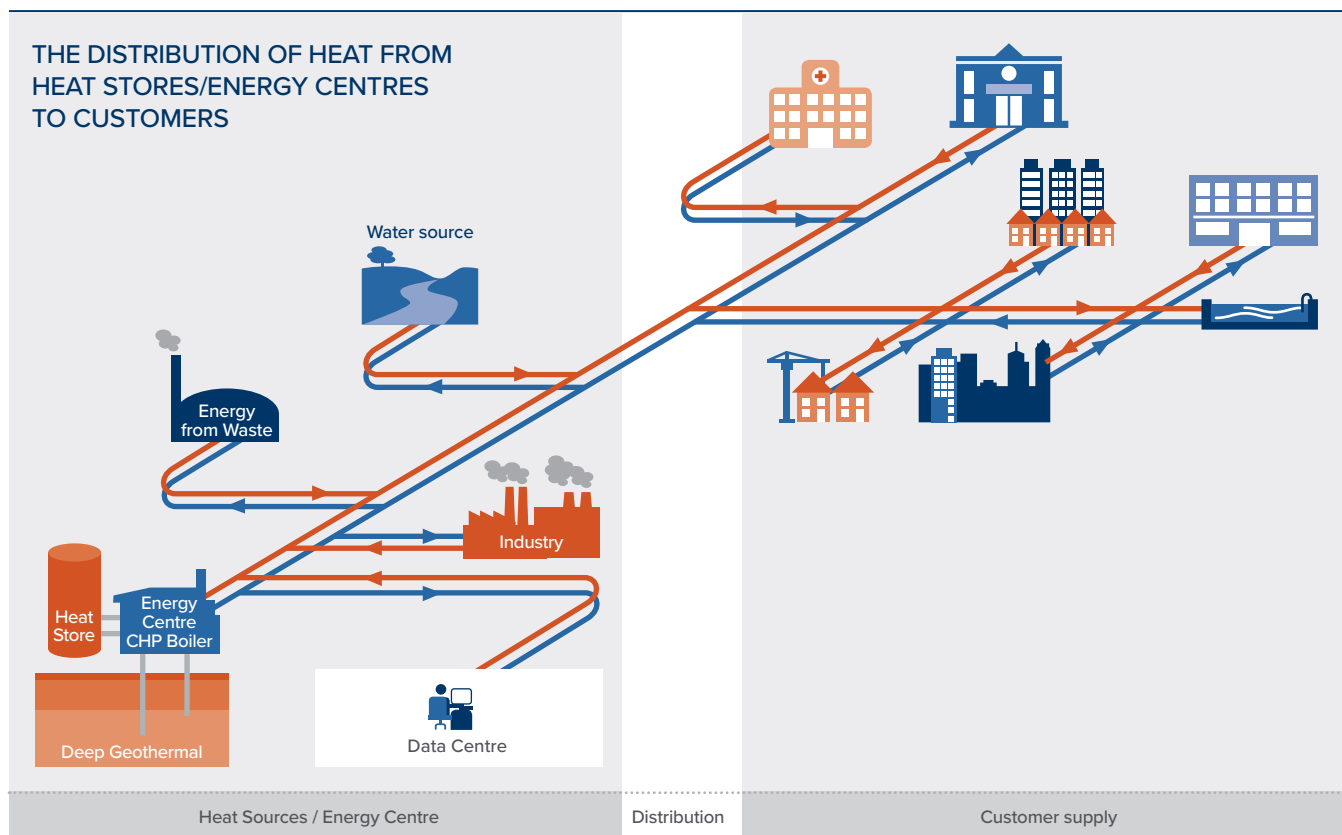
1.1.2 Heat Network projects vary enormously. For example:

- (a) many are newly built, although some may involve the refurbishment and upgrade of existing networks;
- (b) some are for the provision of energy to new developments, but others involve supplying existing buildings;
- (c) some schemes are developed by one or more public sector body for the purpose of efficient self-supply, others are developed by private sector companies, or by public-private joint ventures, to supply a customer base which can be any mix of public and private sector;
- (d) some schemes are integrated (encompassing generation, distribution and supply) others may involve only some of these elements; and
- (e) many, though not all, schemes will be developed with a view to possible expansion and/or inter-connection with other networks in the future.

1.1.3 In addition to this variety, there are also transactions to restructure, inter-connect and/or refinance existing Heat Network projects.

1.1.4 This Guidance does not address all of the possible scenarios. It deals with the most common issues and themes in Heat Network projects, which will not all be relevant to every project.

1. INTRODUCTION



1.2 How to use this Guidance

1.2.1 This Guidance uses decision trees to help you navigate your way to the most relevant issues for your project. By answering a few general, high-level, questions you will be directed to the material most likely to be relevant to your circumstances. It may not always be possible to answer a question with certainty, in which case go with the answer you think is most likely. If circumstances change, or you would like to understand the implications of the alternative, just re-work the decision tree.

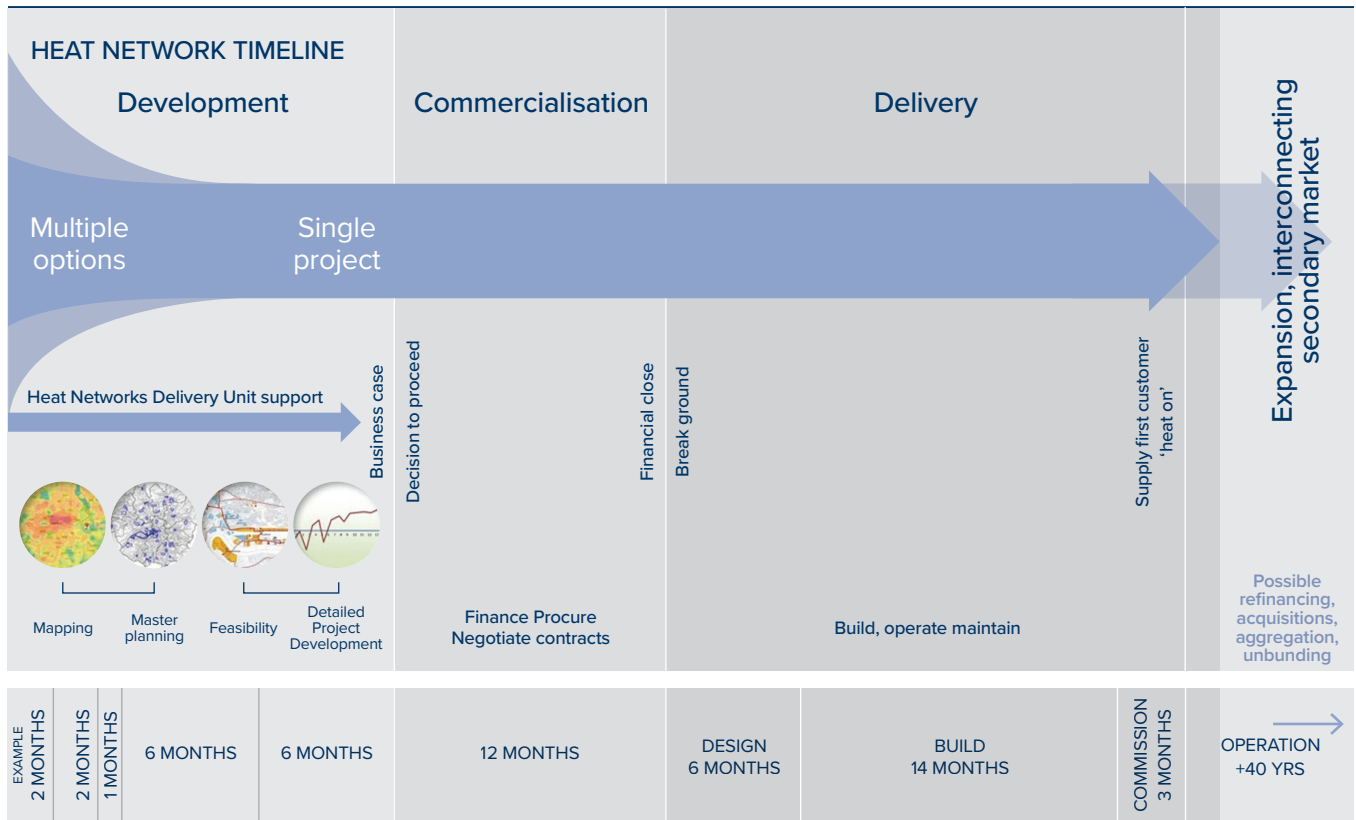
Development Stage Decision Tree

1.2.2 [Section 2](#) considers the circumstances where it may make sense to engage with an NPI at the Development Stage of a Heat Network project. The Development Stage Decision Tree will give you a quick indicative answer and cross refer you to the material elsewhere in the Guidance which covers the issues you need to consider.

Structure Decision Tree

1.2.3 [Section 3](#) deals with the Commercialisation Stage of a Heat Network project and considers the public procurement issues which can influence the choice of project structure. The Structure Decision Tree will guide you to the Illustrative Scenario(s) - there may be more than one – which is/are most relevant to your circumstances, along with the corresponding material elsewhere in this Guidance.

1. INTRODUCTION



1.3 Illustrative scenarios

1.3.1 The Illustrative Scenarios in [Section 5](#) are no more than that – illustrative – and you may not find any that perfectly fit your particular project. However, by using the Structure Decision Tree you will be directed to the material in this Guidance which is likely to be relevant to your project.

1.4 Typical project timeline

1.4.1 Many of the issues addressed by this Guidance are influenced by the stage the project has reached and cannot be considered without a context. This Guidance therefore assumes a typical project timeline, as described above.

1.4.2 As with any infrastructure project, there are several stages in the timeline to deliver a Heat Network. This Guidance uses the following terminology.

Development stage

1.4.3 In this first stage the Sponsors of the project plan its scope, undertake in-principle discussions with energy Offtakers (and potentially energy suppliers) and assess the viability of the project from a technical, commercial and financial perspective.

1.4.4 At this stage, no capital expenditure is incurred, although there will be material service-related costs which will need to be procured and funded. This will include as a minimum:

- (a) Mapping and master-planning, typically carried out by technical consultants, to assess: potential heat loads, possible energy centre locations, high level network routing and indicative project costs, income and returns;

1. INTRODUCTION

- (b) Techno-economic feasibility studies, typically carried out by technical consultants to assess one or several of the opportunities identified as part of the mapping and master-planning work carried out. This will involve stakeholder engagement for existing loads & potential future loads, technology options appraisal, energy centre location & associated stakeholder engagement, utilities capacity consideration & engagement, RIBA 2 design work for energy centre layout, route mapping and project cash flow modelling;
- (c) Outline business case preparation (often to HMT Green Book standards particularly for projects with capex in excess of £5m) covering, in addition to techno-economic assessments; legal, financial & contractual structuring options appraisal for the preferred technical solution, commercial negotiations with identified potential offtakers, easement / wayleave agreements if needed, energy centre site location negotiations, state aid assessment, procurement strategy and RIBA 3 technical design work depending on the procurement strategy adopted to name a few of the key activities (see [DPD guidance](#)).

Who are the “Sponsors” of a project?

The Sponsors of a project are the parties who are the driving force behind the project. In this Guidance the Local Authority is the Sponsor together with, for some Illustrative Scenarios, the NPI.

- 1.4.5 This stage ends with a decision about whether Development Stage evidence indicates that the scheme is likely to be viable and, therefore, whether to proceed to the next (commercialisation) stage.

Commercialisation Stage

- 1.4.6 In this stage the Sponsors engage with the market to procure the works and services they need to implement the project.
- 1.4.7 This is likely to involve competitive procurement exercises, either because public procurement law requires it or for commercial reasons (to secure best value, which they are duty bound to do).
- 1.4.8 The Commercialisation Stage involves limited capital expenditure, but the service-related costs are likely to be significant.
- 1.4.9 This stage primarily involves the implementation of the procurement strategy that would have been developed as part of the development of the Outline Business Case. Additionally it involves developing, and where appropriate negotiating, the terms of the contracts needed to deliver the project and will yield much more precise costings than were possible at the Development Stage. More formal agreements with NPIs may also be entered into at this stage to secure the necessary sources of finance. [See further paragraph 2.6](#).
- 1.4.10 On the basis of tender responses for the design and build of the network, the Sponsors will decide whether or not to proceed with the scheme and, if they do, they will select the contractors who are to provide the works and services and enter into the required contracts.
- 1.4.11 The Commercialisation Stage ends with financial close/Final Business Case approval, at which point the parties providing the funding required to meet the capital expenditure (which will typically include some or all of the Sponsors, and may include third parties) will commit that finance.

Delivery

- 1.4.12 Following financial close, the project is designed, built, operated and maintained in accordance with the transaction documents.

Refinancing and Exit

- 1.4.13 At some stage during the project’s life the investors may seek to refinance the project, to take advantage of improved financing terms (generally and/or because the project has moved into a lower-risk phase) and/or exit the project by selling their stake.
- 1.4.14 For further guidance on refinancing see Financing Heat Networks in the UK.

2. DEVELOPMENT STAGE



2. DEVELOPMENT STAGE

2.1 Potential benefits of early collaboration with an NPI

- 2.1.1 The Development Stage includes activities like identifying the scope and extent of the Heat Network, securing commitments in-principle from potential Offtakers, developing indicative capital structures for the Heat Network and shaping the best structure for any procurement required to implement it.
- 2.1.2 You may have decided in principle to develop a project but either lack the necessary resources (human and/or financial), or want to draw on additional specialist expertise, to ensure that the project is structured in a way which will attract investment from NPIs.
- 2.1.3 An NPI may have the capability and appetite to provide you with support across a range of Development Stage activities.
- 2.1.4 This Section considers when, and on what basis, a collaboration between a Local Authority and an NPI is feasible.

2.2 Public Sector Schemes

- 2.2.1 Of course it is possible to develop and deliver a Heat Network without collaborating with an NPI and, in some cases, this will be the preferred approach. A simple structure might involve a loan from the Public Works Loan Board and be structured along the lines illustrated in Scenario G (see [Illustrative Scenario G](#) in Section 5).
- 2.2.2 This does, however, place the greatest demand on your capital resources, and in many cases may not be the most efficient or effective way for you to achieve your objectives or provide the best flexibility for future exit or indeed expansion or inter-connection with other networks. In many cases, there will be alternatives which may bring different advantages.

2.3 Types of Investor

- 2.3.1 NPI is a general term. In practice, there are different kinds of potential investor, with different business models, appetite for risk and expertise. The key characteristics of a particular Heat Network project (e.g. location, scale, and principal actors), as well as the way it is structured, will influence the kind of investors it will attract. A Local Authority developing a Heat Network project should consider these issues early on to make sure, if you choose to engage with one or more NPIs, that you are talking to the right people. BEIS maintains a list of investors interested in Heat Networks at <https://www.gov.uk/guidance/heat-networks-overview>.
- 2.3.2 For example, providers of senior debt finance are likely to have a relatively limited appetite for risk because, being lenders, they do not share any upside (they are only ever entitled to repayment of the principal amount of the loan plus interest and fees). This contrasts with equity investors whose dividend payments and share value will reflect how well the project is performing (see below). Senior lenders to projects may also only be interested in relatively large investments because of the high transaction costs (the cost associated with setting up the loan, including the due diligence to assess credit worthiness). Schemes which do not involve long-term, stable revenue commitments from large Offtakers or which are simply too small scale are unlikely to appeal to them. However, Senior Debt is likely to be cheaper than other sources of finance (eg equity), precisely because it gets paid first and therefore is exposed to less risk.
- 2.3.3 Equity investors, on the other hand, may have a greater appetite for schemes whose business case is less certain (because of the upside the project can offer) and may be willing to take on smaller scale projects (e.g. £1m to £5m of capital expenditure). They are also likely to be more proactive and fleet of foot. That said, they will expect a return on investment which reflects the risk they take, making equity a more expensive form of finance than Senior Debt.

2. DEVELOPMENT STAGE

- 2.3.4 Between these two extremes there is a whole range of other forms of finance, each occupying a different position on the scale of risk vs. reward. The terminology can be obscure, but the principles are consistent. Different appetite for risk = different expectation of reward.
- 2.3.5 It is important that if considering NPIs as a possible funding option you seek to understand early on the risk and reward appetite of different investors. The investor type will have a significant bearing on the role the NPI will play in the project and, as a consequence, the nature of the engagement with the NPI and at what point you should engage with it.
- 2.3.6 For further guidance on funding Heat Network projects see [Financing Heat Networks in the UK](#).

2.4 When is a procurement of the NPI required?

- 2.4.1 All Local Authorities must comply with public procurement law. So, does a proposed engagement with an NPI to develop a Heat Network project trigger the need for a procurement exercise? It is very likely to, at some stage, and this Section considers the key decisions which lead to the requirement to run a procurement process.¹
- 2.4.2 Where the engagement involves no payments to the NPI, and there is no written contract in respect of the collaboration, no public procurement will be required because no services will have been purchased by the Local Authority.
- 2.4.3 However, an informal arrangement like this may not be acceptable to some NPIs and they may require a written agreement to regulate the collaboration during the Development Stage of the project (referred to in this Guidance as a Development Agreement).
- 2.4.4 Where a Development Agreement is proposed you should consider whether this requires a public procurement ([see paragraph 2.6](#)).

2.5 Development Phase Decision Tree

- 2.5.1 If you are considering whether to engage with an NPI at the Development Stage of a Heat Network project (ie the phase which assesses whether or not a Heat Network is viable and, if so, the nature, extent and commercial structure for the project) you may find the decision tree below a helpful guide.
- 2.5.2 Two fundamental questions are likely to determine whether Development Stage engagement is feasible or not:
- (a) is the project “investable” without an anchor public sector Offtaker (e.g. a hospital or a leisure centre)?; and
 - (b) is a funding competition (to provide the finance required for project capital expenditure) required?
- and these are reflected in the Development Tree that follows.
- 2.5.2 However, for any particular project, other factors may also be relevant so the Development Stage Decision Tree is necessarily indicative only and you should take specific legal advice.

¹ The PCR and UCR permit pre-market consultation and prior involvement of tenderers but impose certain constraints. See in particular Regulations 40 and 41 PCR and 58 and 59 UCR.

2. DEVELOPMENT STAGE

Is the project “investable” without an anchor public sector Offtaker?

2.5.3 For projects where the investment case relies on a public sector offtaker, who will enter into an Energy Supply Contract, the NPI is unlikely to want to commit material time and resources to developing it if that offtaker, and the associated future revenue, is not certain.

If, for example, the public sector Offtaker ran an independent procurement for its Energy Supply Contract, there would be no guarantee that it would be awarded to the vehicle established by the Local Authority and the NPI (referred to in this Guidance as the SPV – [see paragraph 4.3](#)). Therefore, procurement of the investment by the NPI in the SPV will need to happen as part of the same procurement as the award of the Construction Contracts (see [paragraph 4.9](#) for a description of possible contracting structures) and award of the Energy Supply Contract by the public sector Offtaker, at the Commercialisation Stage.

This is because:

- (a) the NPI’s investment relies on the public sector Offtaker taking heat from the Heat Network and the NPI won’t actually provide funding (other than for limited development costs) until the Energy Supply Contract is awarded; and
- (b) the public sector Offtaker cannot simply award the Energy Supply Contract to the SPV, it must instead follow the procurement rules and (generally) run a competition to identify the most economically advantageous supplier².

2.5.4 If the investment case does not rely on the supply of energy to a public sector Offtaker, or the proportion of energy to be supplied to public sector Offtakers is so low that the project is still viable without them, then engaging with an NPI at the Development Stage is more likely to be feasible. This is because the decision by the NPI to invest in the project does not depend on the award by a public sector Offtaker of an Energy Supply Contract to the SPV, so those elements can be progressed independently of each other. A joint procurement of all elements is not required (see paragraph 2.5.3 for details of when a unified procurement is likely to be needed).

2.5.5 Even where the conditions in paragraph 2.5.4 are satisfied (meaning that a public procurement for engagement with an NPI may not be required) if a procurement exercise for delivery of the Heat Network is necessary or desirable (e.g. procurement of the Construction Contracts) ([see Section 3](#)) and the NPI intends to bid for this element of the project as well as being an investor, a Local Authority should be cautious about engaging with the NPI at the Development Stage because that is likely to make it more difficult to run a fair and compliant procurement exercise, and to demonstrate compliance with procurement regulations³.

Is a funding competition required for the project capital expenditure?

2.5.6 The second key question is whether a competitive procurement for the project capital expenditure is required for commercial reasons.

2.5.7 Even if the project is investable with no public sector Energy Supply Contract you may want to run a competition to secure investment for the project capital expenditure to make sure that it achieves the best possible funding terms.

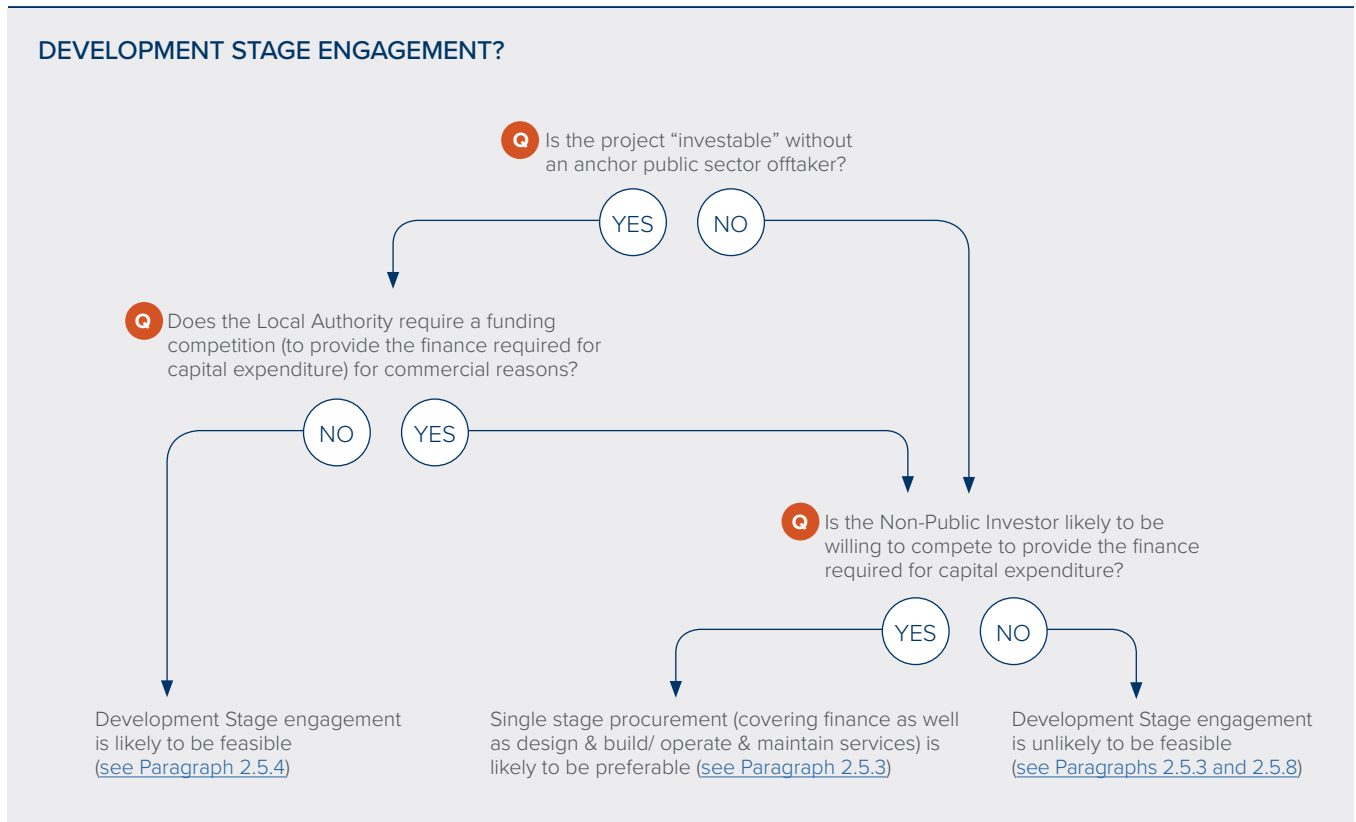
2.5.8 If the NPI intends to bid in the funding competition, it may not be advisable to engage with it at the Development Stage because that is also likely to make it more difficult to run a fair and effective competition⁴. If other potential funders perceive themselves to be at a disadvantage, they may decide not to participate – to the Local Authority’s disadvantage.

² If the structure involves the public sector Offtaker awarding the Energy Supply Contract to an identified SPV (as anticipated in the Illustrative Scenarios), this is a direct award (i.e. uncompleted) and to be compliant the procurement process must involve a competition to identify the investor who offers the most economically advantageous tender, (except where there is an exemption) since the SPV is simply a structuring vehicle.

³ The PCR and UCR permit pre-market consultation and prior involvement of tenderers but impose certain constraints e.g. this would normally involve engagement with the wider market, rather than with a single entity only. See in particular Regulations 40 and 41 PCR and 58 and 59 UCR.

⁴ The PCR does permit pre-market consultation and prior involvement of tenderers but impose certain constraints e.g. this would normally involve engagement with the wider market, rather than with a single entity only. See in particular Regulations 40 and 41 PCR and 58 and 59 UCR.

2. DEVELOPMENT STAGE



2.6 Development Agreements

2.6.1 Entering into a Development Agreement does not require a public procurement if no works, services or supplies are purchased by the Local Authority under the Development Agreement. This rules out any conditional payments by the Local Authority to the NPI for any services provided, e.g. payment of development fees if the Local Authority does or does not proceed with the Heat Network project.

When must a Development Agreement be publicly procured	
<p>Likely to require procurement</p> <p>If it involves:</p> <ul style="list-style-type: none"> • Exclusivity commitments • Reimbursement by Local Authority • Transfer of land or other valuable assets 	<p>Unlikely to require procurement</p> <ul style="list-style-type: none"> • If it involves collaboration without commitment • If each party is responsible for its own costs (see further paragraph 2.6.2 below)

2.6.2 A typical Development Agreement might involve each of the Local Authority and the NPI committing to fund defined Development Stage activities (set out in an agreed plan) in specified proportions according to an agreed budget. All costs are “at risk” and neither party is responsible for reimbursing the other except, possibly, in circumstances of clear default or fraud. Costs incurred under the Development Agreement constitute “development costs” and are often recoverable from the SPV (importantly not the Local Authority) at financial close, but only if the project reaches that stage. This sort of arrangement does not require a public procurement.

2. DEVELOPMENT STAGE

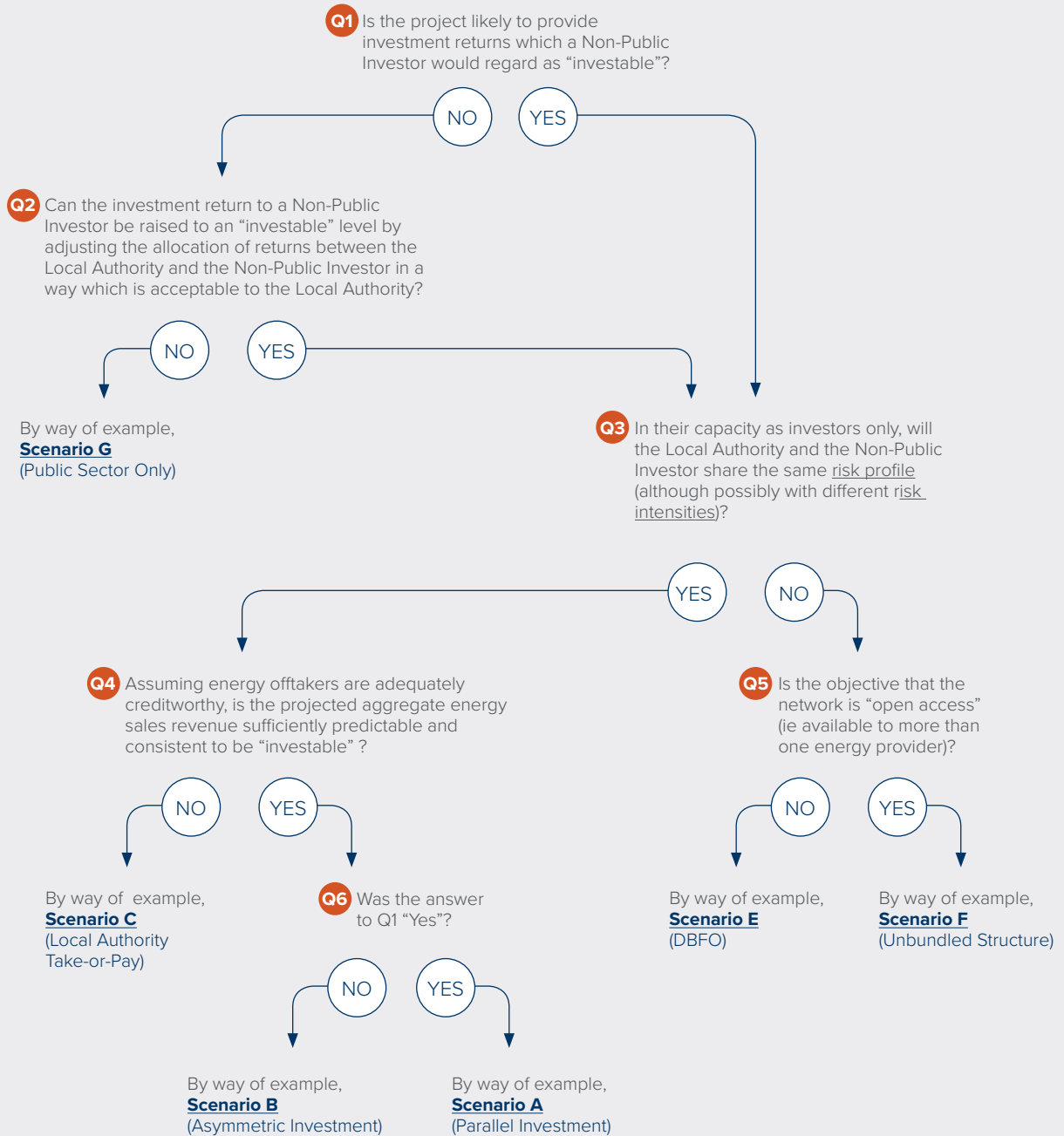
2.6.3 It will also be important to make sure that the terms of any Development Agreement do not result in unlawful State aid ([see paragraph 4.11](#)). For example, if the Development Agreement requires the Local Authority to reimburse the NPI for its development costs in specified circumstances, as well as potentially amounting to a purchase of services by the Local Authority (see paragraph 2.6.1 above), it might also amount to unlawful State aid because the reimbursement mechanism confers a benefit on the NPI from State resources.

2.7 Structure Decision Tree

- 2.7.1 Before the Sponsors of a project can proceed to the Commercialisation Stage, they must develop and settle on the commercial and contractual structure for the project, which will then be reflected in the design and content of the procurement materials.
- 2.7.2 The structure which best suits an individual project will depend on the unique characteristics and circumstances of that project and must be developed with those in mind. This Guidance does not make any recommendations about structures, but the decision tree below may be helpful to guide you to the Illustrative Scenarios which deal with the issues most relevant to your project.
- 2.7.3 If there is potential for multiple investible Heat Networks which can be scoped with a reasonable degree of certainty at an early stage, a Local Authority may consider a strategic partnership with the NPI under which individual projects are implemented using the most appropriate structure. See Illustrative [Scenario D](#) in Section 5.

2. DEVELOPMENT STAGE

STRUCTURE DECISION TREE



3. COMMERCIALISATION STAGE

The background of the slide is a deep blue color. Overlaid on this are several thin, black, parallel lines that create a perspective effect, suggesting a grid or a series of parallel paths receding into the distance. In the upper right quadrant, there are several bright, circular light spots that are out of focus, creating a bokeh effect. These spots vary in size and intensity, with some appearing as bright yellow and others as a more muted orange. The overall aesthetic is clean, modern, and technical.

3. COMMERCIALISATION STAGE

3.1 Application of PCR and UCR to Heat Networks

When is a public procurement required?

- 3.1.1 The Commercialisation Stage covers all activities from the point at which the scheme is deemed viable on the basis of work done at the Development Stage, and a decision is made to proceed to commercialisation, until financial close.
- 3.1.2 It includes developing, and where appropriate negotiating, the terms of the contracts needed to deliver the project and will yield much more precise costings than were possible at the Development Stage. Having received firm prices from the market, the Sponsors will decide whether or not to proceed with the scheme and, if they do, they will enter into the required contracts with the selected contractors, investors, utilities and offtakers.
- 3.1.3 It is also possible for Local Authorities to use the CCR to procure a Heat Network. The CCR provides an alternative procurement route which is generally regarded as providing contracting authorities/utilities with greater flexibility about how the procurement is undertaken. However, the CCR may only be used where the following conditions are met:
- the contracting authority/utility must entrust the execution of works or provision and management of services to the concessionaire under a written contract;
 - the consideration for the contract must consist either solely in the right to exploit the works/services or in that right together with payment;
 - the contract must transfer to the concessionaire demand or supply risk (or both); and
 - the concessionaire must be exposed to the vagaries of the market (i.e. potential loss must not be merely nominal or negligible).⁵
- 3.1.4 Public procurement law requires contracting authorities (which includes Local Authorities) to advertise their requirements for works, services and supplies above a certain value ([see https://www.ojec.com/thresholds.aspx for the current thresholds](https://www.ojec.com/thresholds.aspx)), and to run fair and transparent tender processes, subject to some exceptions. For most of their activities, the relevant procurement law applying to Local Authorities in England and Wales is the PCR.
- 3.1.5 This Guidance addresses both the PCR and UCR because, depending on what capacity you (or the relevant SPV) are acting in (contracting authority or utility) either or both of the PCR and UCR will apply.
- 3.1.6 If a Local Authority itself engages in:
- (a) the provision or operation of a fixed network which provides, or will provide, a service to the public in connection with the production, transport or distribution of heat; or
 - (b) the supply of gas or heat to such networks
- then, in relation to those activities, the relevant procurement law is the UCR on the basis that the Local Authority is deemed to be a “utility”. The principle of advertising and running fair and transparent tender processes applies equally under UCR and PCR. The specific procedures required are largely the same under both regulations, although generally speaking the UCR is less onerous.

⁵ Regulation 3 of the CCR: Given the level of risk transfer which must occur the CCR are only likely to be applicable where the contractor is granted a right to develop and exploit a Heat Network (i.e. it is taking risk in relation to the exploitation of such right) rather than where a contractor is paid to design, build, maintain or operate a Heat Network as in the latter scenario the contractor is paid based on its deliver of works/services. Likewise the CCR are unlikely to be applicable to Energy Supply Contracts where payment is based on the energy supplied. On this basis the CCR are only likely to be applicable to the appointment of a development partner under Scenarios E and F. Given the much more limited application of the CCR this Guidance focuses on the application of the PCR and UCR. However, Local Authorities should seek legal advice regarding the application of the CCR as applicable.

3. COMMERCIALISATION STAGE

Establishing an SPV

3.1.7 Simply setting up an SPV with an NPI will not in itself engage the procurement rules. Subscription for shares by a Local Authority does not involve the purchase of works, services or supplies. However, the SPV will be being incorporated for a purpose and the context of the incorporation will have a bearing on whether the procurement rules are relevant. The question will be: is incorporation of the SPV part of a wider arrangement which involves the purchase of works, services or supplies which are covered by the PCR, UCR or CCR?

Examples of contracts which may need to be procured according to PCR or UCR

3.1.8 The Illustrative Scenarios used in this Guidance include a number of situations in which a procurement process under the PCR, UCR or CCR may be required in order to develop a Heat Network. For example:

- (a) a Local Authority entering into a Development Agreement with an NPI on an exclusive basis or where the Local Authority commits to pay the NPI (conditionally or otherwise) for services;
- (b) where the SPV is required to comply with the UCR and/or PCR for its procurement of a Construction Contractor as described in [paragraph 4.9](#);
- (c) procurement by a Local Authority of an NPI and a Construction Contractor in a single procurement as described in [paragraph 2.5.3](#);
- (d) award by a public sector Offtaker of an Energy Supply Contract to the SPV ([see paragraphs 3.1.14 and 3.1.15](#)); and
- (e) joint procurement by a Local Authority and public sector Offtaker of an NPI, a Construction Contractor and an Energy Supply Contract between the SPV and public sector Offtaker in a single procurement as described in [paragraph 2.5.3](#).

Contracts exempt from the public procurement rules

3.1.9 Specific types of contract falling outside the scope of the PCR, UCR and/or CCR include:

- (a) in-house arrangements (a public body supplying itself) and shared service providers (e.g. the Teckal exemption described in [paragraph 3.4](#));
- (b) renewals, extensions and changes of an existing contract where that change is not material;
- (c) excluded classes of contract, including loan contracts;
- (d) works contracts that are subsidised up to 50% by a contracting authority; and
- (e) contracts awarded by Heat Network utilities for the supply of energy or fuels for the production of energy.

What is a contracting authority?

3.1.10 The UCR, PCR and CCR apply to “contracting authorities”. This is defined as ‘the State, regional or local authorities, bodies governed by public law or associations formed by one or more such authorities or one or more such bodies governed by public law...’ (Regulation 2(1) of PCR, Regulation 4(1) of UCR and Regulation 4 of CCR).

3.1.11 “Bodies governed by public law” have the following characteristics:

- (a) they are established for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character;
- (b) they have legal personality; and
- (c) they:
 - (i) are financed, for the most part, by the State, regional or local authorities, or by other bodies governed by public law;
 - (ii) are subject to management supervision by those authorities or bodies; or
 - (iii) have an administrative, managerial or supervisory board, more than half of whose members are appointed by the State, regional or local authorities, or by other bodies governed by public law.

3.1.12 The PCR and CCR therefore apply to Local Authorities. It is also possible for the UCR to apply to Local Authorities in specific circumstances.

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3.113 The PCR and the CCR may also be relevant to the SPV because, depending on its structure, governance and ownership (see paragraph 3.118), it may be a contracting authority in its own right.

Energy Supply Contracts

3.114 The energy requirements of a contracting authority (including a Local Authority) are within the scope of public procurement law. In particular, energy from a Heat Network is within that scope.

3.115 Therefore where a contracting authority purchases heat and/or electricity it is likely that it must do so in accordance with the applicable procurement rules

SPV as a Utility

3.116 Depending on, amongst other things, the extent of your interest in the SPV and whether it operates on the basis of a special or exclusive right, (for example a licence or permission granted other than through a procurement process) it is possible that the SPV will be subject to the UCR. The UCR regulates the provision or operation of fixed networks intended to provide a service to the public in connection with the production, transport or distribution of heat, or the supply of heat to such networks.

3.117 If the SPV is a utility it must, amongst other things, procure works, supplies and services (eg for the design, construction, maintenance and operation of the Heat Network) in accordance with the UCR and the structure for the relevant project must be developed accordingly.

PCR or UCR?

3.118 If the SPV is owned or controlled by one or more public bodies, then it may be both a utility and a contracting authority to which the PCR applies. If the purpose of the procurement falls principally within the UCR (ie relates to the provision or operation of fixed networks intended to provide a service to the public in connection with the production, transport or distribution of heat, or the supply of heat to such networks), then those regulations will prevail over the PCR. For further guidance on this see the DPD Guidance. Where the contract to be procured satisfies both the CCR and also either the PCR or UCR contracting authorities should consult Regulations 20 and 22 of the CCR, and seek appropriate legal advice, in order to determine which set of regulations applies.

3.119 The procurement regime may therefore also apply to the award of contracts between SPVs, where the project structure involves more than one. See, for example, illustrative [Scenario F](#) and [Scenario G](#).

3.2 Procurement Options for Projects with Public Sector Offtakers

3.2.1 From a public procurement perspective, projects which do not depend on public sector Offtakers are, not surprisingly, more straightforward than those which do.

3.2.2 If the SPV has a viable business case without any public sector anchor Offtaker ([see paragraph 2.5.4](#)), the SPV may be established and financed first (without the need for an award of an Energy Supply Contract by a public sector Offtaker). If the SPV is classified as a utility under UCR (see paragraph 3.116), it will have to procure the Construction Contractor in accordance with UCR. If, subsequently, a public sector Offtaker wishes to connect to the SPV's Heat Network, the public sector Offtaker will generally have to run a competitive procurement exercise for the award of an Energy Supply Contract which the SPV can bid for and may or may not be successful.

3.2.3 However, if the SPV's business case depends on one or more public sector anchor Offtakers, the scope of the project may need to include the award by the anchor Offtaker(s) of an Energy Supply Contract to the SPV. In our view this means a single, unified competitive procurement exercise is likely to be needed, involving the financing of the SPV (therefore effectively selecting who will be the supplier under the Energy Supply Contracts), the selection of a Construction Contractor and also the award of the Energy Supply Contract to the SPV by the public sector Offtaker ([see paragraph 2.5.3](#)).

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3.3 Timetable implications of a public procurement

- 3.3.1 To deliver a Heat Network the Sponsors and/or the SPV will need to appoint a number of contractors e.g. D&B Contractor and O&M Contractor (alternative contractual arrangements are discussed in [paragraph 4.9](#)). If the SPV is subject to the UCR and/or PCR it will have to procure these contracts in accordance with the applicable regulations. Certain contracts may be exempt from this requirement – [see paragraph 3.1.9](#).
- 3.3.2 Each of the UCR and PCR prescribe a number of different procedures which may be used to implement the procurement, including the open procedure, restricted procedure, competitive dialogue and competitive procedure with negotiation. The UCR is generally regarded as providing greater procedural flexibility than the PCR, however the facts of each particular case will determine which regulations apply. For further guidance on public procurement options see the DPD Guidance.
- 3.3.3 The choice of procedure allowed under UCR or PCR (as the case may be) will be determined by the nature of works, supplies and/or services being procured and the extent to which negotiations with bidders is likely to be required.
- 3.3.4 The open procedure and restricted procedure should only be used for the procurement of works/services/ supplies which are not complex and where no negotiation or substantive engagement with bidders will be required. Competitive dialogue and the competitive procedure with negotiation should be used for procurements which are complex and/or where negotiation is required.
- 3.3.5 Each of the procedures specifies minimum time limits and procedural requirements which must be adhered to when undertaking a procurement. A summary of the minimum time limits is noted below:

What are the Minimum Time Periods under PCR?

Procedure	Standard timescales	Minimum timescales if Local Authority issues and accepts electronic tenders
Competitive procedure with negotiation	Minimum time period to allow for Selection Questionnaire responses: 30 days from date Contract Notice sent to OJEU	As per standard timescales.
	Minimum time period for ITN responses: 30 days from date ITN sent to candidates	25 days from date ITN sent to candidates
Competitive dialogue	Minimum time period to allow for Selection Questionnaire responses: 30 days from date Contract Notice sent to OJEU	As per standard timescales.
	Minimum time period for ITPD responses: No minimum. Timescale determined by CA	As per standard timescales.
Open	35 days from date Contract Notice sent to OJEU	30 days from date Contract Notice sent to OJEU
Restricted	PQQ stage: 30 days from date Contract Notice sent to OJEU	As per standard timescales.
	ITT stage: 30 days from date ITT sent to candidates	25 days from date ITT sent to candidates

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What are the Minimum Time Periods under UCR?

Procedure	Standard timescales	Minimum timescales if local authority issues and accepts electronic tenders
Negotiated procedure with prior notice	Minimum time period to allow for Selection Questionnaire responses: 30 days from date Contract Notice sent to OJEU	As per standard timescales.
	Minimum time period for ITN responses: 10 days from date ITN sent to candidates	As per standard timescales.
Competitive dialogue	Minimum time period to allow for Selection Questionnaire responses: days from date Contract Notice sent to OJEU	As per standard timescales.
	Minimum time period for ITPD responses: No minimum.	As per standard timescales.
Open	35 days from date Contract Notice sent to OJEU	30 days from date Contract Notice sent to OJEU
Restricted	PQQ stage: 30 days from date Contract Notice sent to OJEU	As per standard timescales.
	ITT stage: 10 days from date ITT sent to candidates	As per standard timescales.

What are the Minimum Time Periods under CCR?

The CCR takes more of a principles based approach to procurement than the PCR and UCR and does not prescribe that specific procedures are used. It does however require that contracting authorities comply with the minimum time limits set out below:

Standard timescales	Minimum timescales if local authority issues and accepts electronic tenders
The minimum time limit for the receipt of applications (whether or not including tenders for the concession contract) shall be 30 days from the date on which the concession notice was sent for publication.	NA
Where the concession contract award procedure takes place in successive stages the minimum time limit for the receipt of initial tenders shall be 22 days from the date on which the invitation to tender is sent.	The time limit for receipt of tenders may be reduced by 5 days.

3.3.6 Note that these are minimum time limits. You should ensure that enough time is given to bidders taking into account the complexity of the procurement and the time required for preparing tenders and engaging in dialogue (where relevant).

3.4 Teckal Exemption (Regulation 12 of the PCR and 28 of the UCR)

3.4.1 Generally speaking, any public body wishing to procure energy (acting as an Offtaker) must undertake a procurement in accordance with the PCR or UCR (as appropriate).

3.4.2 There is an exemption from these rules where the public body is purchasing from an ‘in-house’ legal entity, providing the conditions described below are met. For further examples of exemptions [see paragraph 3.1.9](#).

When does the Teckal exemption apply?

3.4.3 Three tests must all be satisfied in order for the exemption to apply, namely:

- the “Control” test: the procuring body⁶ must exercise control over the supplier in a way which is similar to the control the procuring body has over its own departments (control in these circumstances amounts to a decisive influence over strategic objectives and significant decisions of the controlled legal person);
- the “Activities” test: more than 80% of the activities of the supplier must mainly relate to its relationship with the procuring body; and
- the supplier must have no private sector shareholders.

⁶ See paragraph 3.4.6 regarding multiple procuring bodies.

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3.4.4 Therefore, due to the requirement in paragraph 3.4.3(c) for projects which involve co-investment by an NPI in the SPV (e.g. all Illustrative Scenarios other than Illustrative Scenario G) the Teckal exemption is not applicable. Accordingly, the public body wishing to procure energy will probably need to participate in a unified one-stage procurement. [See paragraph 2.5.3.](#)

How does Teckal apply where there are multiple procuring bodies?

3.4.6 Where the supplier (e.g. the SPV) is established by multiple procuring bodies:

- (a) the “Control” test (see paragraph 3.4.3(a)) is assessed by looking at the collective control which the procuring bodies have, and the board of the supplier must be composed of representatives from all procuring bodies;
- (b) the “Control” test will be satisfied only if the supplier does not pursue any interests which are contrary to those of the procuring bodies;
- (c) the supplier must have no private sector shareholders; and
- (d) the “Activities” test (see paragraph 3.4.3(b)) is assessed by looking at the activities of the supplier with the procuring bodies taken together.

3.4.7 Where there are multiple procuring bodies, the stake each procuring body holds in the supplier need not be equal, since the “Control” test is assessed by looking at the collective control which the procuring bodies have. Provided the procuring bodies collectively have control, and the board of the supplier is composed of representatives from all procuring bodies, the percentage of the shareholding (or equivalent) of each procuring body does not matter.

3.4.8 For the “Activities” test, the application of the 80% threshold is subject to some interpretation. A procuring body can use an average total turnover measure, or an appropriate alternative activity-based measure such as costs incurred. If this threshold is exceeded, contracts made between the supplier and the procuring body(ies) will no longer benefit from the exemption and so could be challenged as direct awards.

Can suppliers make a margin where the Teckal exemption is used?

3.4.9 The supplier is not prevented by the Teckal structure from making a margin or return on its investment, whether that comes from sales to its procuring body(ies) or the marginal third party sales. This is only subject to the “Activities” test threshold (see paragraph 3.4.3(b)).

Implications of using the Teckal exemption

3.4.10 If developing a Heat Network project which satisfies the Teckal requirements (including no co-investment by an NPI) you should, however, always consider the following factors before implementing the project relying on the Teckal exemption.

3.4.11 If the SPV were to cease to be a Teckal company, the public sector Offtakers (previously procuring bodies for Teckal purposes) which awarded Energy Supply Contracts to the SPV relying on it would have to end the contract and undertake a new procurement exercise for the Energy Supply Contracts.

3.4.12 Use of the Teckal exemption may constrain the future development of the Heat Network (i.e. the physical expansion of the network). Because more than 80% of the SPV’s activities must mainly relate to its relationship with its controlling procuring body(ies), the level of activity the SPV can undertake with others is constrained (ie it is likely to restrict expansion of the private sector customer base). Although new public sector Offtakers can become controlling procuring bodies (e.g. by acquiring an interest in the SPV which satisfies the requirements of Regulation 12 of the PCR and 28 of the UCR prior to awarding the Energy Supply Contract), because no NPI may co-invest in the SPV, any future expansion by the SPV will have to be funded by public sector bodies. On the other hand, expansions implemented using other legal entities are likely to be very complicated.

3.4.13 There will be a cap on the level of supplies to private sector Offtakers that the SPV can make. The level of activities undertaken by the SPV with parties other than controlling procuring bodies must remain below 20% and this position will need to be kept under review.

4. GENERAL ISSUES



4. GENERAL ISSUES

Overarching Considerations

- 4.1.1 Section 5 of this Guidance considers seven Illustrative Scenarios for Heat Networks and explains the factors which indicate why, taking into account the characteristics of a particular project, one structure may have advantages over others.
- 4.1.2 This Section addresses a number of overarching considerations which are likely to be relevant, to some extent, to all Heat Network projects. The significance of these considerations for each Illustrative Scenario is dealt with in [Section 5](#).

4.2 When is investment made into a Heat Network project and who provides the funding?

- 4.2.1 A typical Heat Network project requires investment at various stages in its lifecycle. The scale of the funding required, how it is used and who provides it all vary depending on the nature of the project and what stage it has reached.

Development Stage Funding

- 4.2.2 During the Development Stage ([see Section 2](#) for a description of this stage) funding will be required for the Development Stage activities, but not for capital expenditure. This means the funding will be relatively modest (depending on the complexity of the scheme) and is likely to be funded by the Sponsors.
- 4.2.3 Development Stage funding is a risky investment because, at this stage, there is material uncertainty about whether the project will proceed at all. Third party funding (ie other than by the Sponsors) is unlikely. Whilst NPIs may be interested in understanding the project at this stage and may be willing to enter into a Development Agreement ([see paragraph 2.6](#)), it may be challenging to negotiate funding for consultancy work for technical, financial or legal advice.
- 4.2.4 If there is more than one Sponsor, and no SPV has at this stage been incorporated, funding is likely to be provided according to an agreement between the Sponsors, sometimes called a Development Agreement. Services provided by third parties (eg external advisers) will have to be procured by and provided to one or more of the Sponsors because no SPV exists but this should be on terms which allow the benefit of the services to be transferred to the SPV if and when it is incorporated.
- 4.2.5 If an SPV has been incorporated at this stage, funding is likely to be provided by the Sponsors according to the Shareholders' Agreement which regulates the SPV, or according to an associated Subscription Agreement.
- 4.2.6 If you have not engaged with an NPI at the Development Stage ([see paragraph 2.5](#)), Development Stage funding will be provided entirely by you (the Local Authority). If an NPI has been engaged, then funding may be provided by both you and the NPI in whatever proportions have been agreed in the Development Agreement or SPV Shareholders' Agreement.

Commercialisation Stage Funding

- 4.2.7 If the project proceeds to the Commercialisation Stage, further funding will be needed for Commercialisation Stage costs. These are likely to be substantial amounts, although there will still be limited capital expenditure at this stage.
- 4.2.8 In most cases (and in each of the Illustrative Scenarios), the SPV will have been incorporated at this stage because it will be the, or one of the, parties doing the procuring. The funding required at this stage is therefore likely to be provided by the Sponsors (if more than one) according to the Shareholders' Agreement which regulates the SPV, or according to an associated Subscription Agreement. The SPV may be a utility for the purposes of procurement law (see [paragraphs 3.1.16 and 3.1.17](#)).

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- 4.2.9 Commercialisation Stage funding is also a risky investment because, even at this stage, there is some uncertainty about whether the project will proceed. It is probably less risky than Development Stage funding but the amounts are likely to be greater. Third party funding (ie other than from the Sponsors) is unlikely.
- 4.2.10 If you have not engaged with an NPI at the Development Stage, Commercialisation Stage funding will be provided entirely by you (the Local Authority). If an NPI has been engaged, then funding may be provided by both you and the NPI in whatever proportions have been agreed in the Development Agreement or SPV Shareholders' Agreement.
- 4.2.11 See [paragraph 4.4](#) for further guidance on alternative ways to structure funding provided by the Sponsors.

Financial close

- 4.2.12 The funding committed at financial close is primarily intended to finance the remaining aspects of the design and construction of the Heat Network infrastructure and, typically, to reimburse development costs (ie the costs of getting the project to financial close). These are largely capital costs and are likely to be substantially greater than the costs incurred at the Development Stage and the Commercialisation Stage.
- 4.2.13 Financial close funding is exposed to the risks in the project (e.g. construction risk, technology risk and demand risk), but not to the risk that the project may not proceed. There are likely to be several types of funding (for example, equity in the form of share capital, shareholder loans and senior loans), each with its own characteristics and risk profile. Third party funding (ie not from the Sponsors) is possible at this stage.

4.3 When should an SPV be used?

- 4.3.1 In many cases it will be beneficial for a company to be established specifically as a vehicle for investment and whose only activities relate to the Heat Network (or ownership of companies which relate to the Heat Network) – a so-called “special purpose company” or “special purpose vehicle”, referred to in this Guidance as an SPV. This is not always the case, however. Some Heat Network projects are implemented using companies with a wider remit including, for example, renewable generation and energy efficiency.
- 4.3.2 This Guidance assumes that an SPV will be used.
- 4.3.3 The use of an SPV leads to a number of important subsidiary issues, including governance and decision making arrangements for the SPV, its funding structure and exit considerations. These are discussed in [paragraph 4.4](#) and [paragraph 4.7](#).

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4.4 Options for structuring an SPV

- 4.4.1 English company law provides a lot of flexibility to structure SPVs in a way which provides each equity investor (shareholders) with rights and obligations which reflect the nature and extent of its participation in the Heat Network project.
- 4.4.2 Key considerations include:
- (a) the scope of the SPV's operations;
 - (b) the voting influence each investor will have over decisions by the SPV:
 - (i) made at board level; and
 - (ii) made at shareholder level (and, in particular, Reserved Matters);
 - (c) obligation and entitlement to provide funding to the SPV to finance its activities (which may vary, depending on the stage of the project). In addition to the initial funding required, there may be a need for subsequent, additional, funding;
 - (d) return on investment;
 - (e) transfer/disposal of interests and rights of pre-emption; and
 - (f) winding up and dissolution.
- 4.4.3 Detailed discussion of these issues is beyond the scope of this Guidance. However, in the context of developing the structure for any Heat Network project you should take appropriate legal advice.

Decision making

- 4.4.4 For joint venture companies, influence in decision making is often proportionate to shareholding, but not always. Various mechanisms can be included in the company's constitutional documents to protect a minority shareholder's position and otherwise regulate how the joint venture's business is conducted.
- 4.4.5 These include:
- (a) board quorum requirements (which can require all relevant interests to be represented before a decision is made);
 - (b) weighted voting rights, which can give a shareholder a greater influence in decision making than its shareholding would typically have; and
 - (c) acts or decisions of the joint venture company for which a positive vote of the shareholders must be obtained (**Reserved Matters**).
- 4.4.6 You should always take legal advice about decision making (and other control mechanisms) in the context of each project.

Different classes of share capital

- 4.4.7 For some Heat Network projects it may be appropriate for the Local Authority and the NPI to have different rights and entitlements. For example, one investor might have the right to receive a specified amount as a preferred dividend before any remaining amount was distributed to the other investor or to both investors proportionately.
- 4.4.8 Different classes of share, with different rights, is one way to achieve this. The nature of these rights is essentially a blank canvas – they can be crafted to achieve whatever commercial outcome is required (subject to complying with company law).
- 4.4.9 It is important to recognise that the SPV's revenues, and the risks to which it is exposed, do not change because there is more than one class of share. Accordingly, all shareholders, whatever class of share they hold, remain exposed to the same risks but they share those risks in a different way if there is more than one class of share.

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Shareholder loans: Different lending terms

4.4.10 As well as subscribing for shares, the Sponsors may also choose to provide loans to the SPV. Another mechanism which results in different positions for the Local Authority and the NPI is for them to provide loans to the SPV on different terms. For example, one loan may be subordinated (ie repayment of one loan ranks ahead of repayment of the other) or there may be differences between:

- (a) interest and fee structures;
- (b) the tenor (ie period during which any part the loan is outstanding);
- (c) the events which trigger early repayment (Events of Default); and/or
- (d) security for repayment.

4.4.11 Even more than shares, loan terms can be tailored to suit the circumstances.

4.4.12 Note that, despite the fact that loans will rank ahead of equity, unless the loans are guaranteed (which would be unusual) because the borrower is an SPV with no assets other than the Heat Network, the lenders will be exposed to the performance of the Heat Network, because that is the SPV's only source of revenue.

4.4.13 Loans from shareholders are generally on "soft" terms meaning that, if the SPV cannot make a payment due, this is not an event of default instead the unpaid amount is capitalised and will be paid from future cash flows if/when circumstances allow.

The use of both equity and debt

4.4.14 It is common for an investor to provide both share capital and shareholder loans.

4.4.15 Shares give the investor a stake in the SPV (eg influence in decision making) and no entitlement to a return unless and until a dividend is declared. In contrast, shareholder loans do not provide any right to influence what the SPV does (other than through covenants in the loan documents, for example) but the lender is entitled to be repaid the principal amount of the loan and interest in accordance with the loan terms.

4.4.16 Shareholder loans are likely to be more flexible than equity investments (for example, repayment of the principal amount of a loan is not subject to the rules about returning capital to shareholders), and the tax treatment of dividends and interest payments is different.

4.4.17 For further guidance on funding for Heat Networks see Financing Heat Networks in the UK.

Third party debt financing vs. Equity financing

Equity involves raising capital by issuing shares in the SPV in return for the investment. Often this will be accompanied with shareholder loans; however this is beyond the scope of this Guidance. For further guidance see Financing Heat Networks in the UK. Third party debt involves borrowing money from a lender and paying it back, usually over a defined period, and usually with interest. Each mechanism has its advantages and disadvantages, and very often a combination of the two will be used.

Advantages of equity financing

- Investor accepts project risk because there is no commitment from the SPV to pay the investor unless and until it makes a profit and a dividend is declared. If the SPV's business fails, the investor loses its investment.
- As well as the investment itself, the investor may bring skills, expertise and contacts.

Advantages of debt financing

- Subject to the terms of the loan, the SPV retains control over the project.
- Once the loan principal (plus interest) is repaid, there are no further obligations to the lender, who has no entitlement to share in any profits the SPV makes.
- Loan terms are flexible and a matter for the lender and SPV to negotiate and agree. Few restrictions imposed by law.

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Disadvantages of equity financing	Disadvantages of debt financing
<ul style="list-style-type: none"> • The investor will acquire a degree of ownership and control of the SPV which typically corresponds to its investment. • Payment of distributions, and the return of equity capital, is subject to statutory control and can be less flexible than debt finance. • Reflecting the risk profile, equity is generally “more expensive” than debt (ie the investment return an equity investor will expect is likely to be more than the cost of debt finance). 	<ul style="list-style-type: none"> • Failure to repay the loan in accordance with its terms can lead to default and enforcement against the SPV. • Generally lenders are more risk-averse than equity investors. Subject to the terms of the loan, certain actions by the SPV may require their consent and their interests as lenders may not be aligned with the SPV’s (constraining the SPV’s ability to act).

4.5 Use of more than one SPV

- 4.5.1 As noted in paragraph 4.4.9, different classes of share (or for that matter, different shareholder loan terms) do not change the underlying risks to which the investment is exposed. The borrower is an SPV whose only revenues are derived from the Heat Network.
- 4.5.2 By structuring a project to have more than one SPV (for example unbundling generation and distribution from customer supply) it is possible to split project risks up and, if you and the NPI have different interests in the SPVs, you can be exposed to different risks (and, through different classes of share and/or different shareholder loan terms, to different risk profiles as described above).
- 4.5.3 [Illustrative Scenario E](#) and [Scenario F](#) provide examples of this approach.

4.6 The SPV’s status as a public or non-public body

- 4.6.1 Depending on the nature, and extent, of the interests which you and the NPI respectively have in the SPV, it may be classified as either a public body or a non-public body for public accounting purposes. For further guidance on this see section 1.2.3 of Eurostat’s Manual for Government Deficit and Debt (2016 edition): <http://ec.europa.eu/eurostat/web/products-manuals-and-guidelines/-/KS-GQ-16-001>.

4.7 Exit

- 4.7.1 Before committing to an investment NPIs will need to be comfortable with the mechanisms which will enable them to “realise” it (ie dispose of it for value). Typically, this will be by selling the shares and associated interests they hold in the project (like their shareholder debt) to another investor or, together with all other shareholders, selling the SPV. Other mechanisms include causing the SPV to sell its business (including the Heat Network) or, to the extent that the NPI’s interest is a loan, by refinancing.
- 4.7.2 You should explore these issues with the NPI from the start to ensure that their plans are aligned. Appropriate provisions will need to be included in any Shareholders’ Agreement and the SPV’s articles, and you should take the necessary legal advice.

4. GENERAL ISSUES

4.8 Potential Future Expansion and/or Interconnection

- 4.8.1 Understandably, when a Heat Network project is first put together the focus tends to be on structuring it to deliver the immediate requirements. Opportunities for improving economic performance by, for example, connecting additional heat load may be assessed as part of an upside business case (ie making optimistic assumptions about uncertain outcomes) but are unlikely to be factored into the base case.
- 4.8.2 However, it is also very important to consider, right from the start, the potential for the network to expand and/or interconnect with other networks over time. Other than in exceptional circumstances (for example a geographically isolated network servicing a major localised demand), it is likely to be in everyone's interests (investors, energy suppliers, energy Offtakers and consumers in general) for individual schemes – wherever technically and economically feasible – to be designed to be capable of being expanded together with other networks to form clusters and for clusters to be able to join together to form the district-wide networks. Larger networks can bring a number of advantages, including increased efficiency and access to a wider range of heat sources.
- 4.8.3 If an individual scheme is developed without due regard to potential future expansion or interconnection, decisions made at the outset may constrain, or even prevent, the potential for future expansion or interconnection.
- 4.8.4 For example, if a scheme to supply predominantly public sector Offtakers is developed relying on Regulation 28 of the UCRs (the “Teckal” exemption – [see paragraph 3.4](#) for further comment on this), this may avoid the need to run a competitive procurement exercise. However, because the expansion or interconnection of the network with another network may undermine the basis for the exemption, future expansion or interconnection may be prevented or require complex legal structuring later. Taking into account possible future expansion or interconnection, it might be preferable to structure the delivery of the initial scheme differently, both economically and from the perspective of wider public benefit.
- 4.8.5 Expansion can also mean expansion of the business rather than physical expansion of the original scheme. An SPV which owns and operates one Heat Network might acquire additional, separate, network assets from a third party or acquire the shares in another company which owns another network, consolidating the business but without physically connecting the assets.
- 4.8.6 Decisions about whether to expand the network, connect the network to another or expand the business through acquisition will be decisions for the network owner – in most cases, the SPV. The governance arrangements for the SPV (specifically the Shareholders' Agreement and Articles of Association) will regulate how those decision are made. Each shareholder, and its appointed directors, will have an influence determined by those documents. If the shareholders, or directors, cannot agree that is likely to lead to no expansion, connection or acquisition.
- 4.8.7 It is therefore very important for a Local Authority entering into a relationship with an NPI to explore these issues from the start to ensure that longer-term objectives are, in principle, aligned. This will be relevant to defining the scope of the SPV's business in, for example, the Shareholders' Agreement.
- 4.8.8 Having considered the potential scope for expansion you should take care to ensure that the procurement documentation (e.g. the OJEU Notice and ITT) and contracts (e.g. Construction Contracts) are drafted taking this into account. A deficiency in the description of the scope of the project in the procurement materials could constrain the ability to later expand the network without having to run another competitive procurement exercise.

4. GENERAL ISSUES

4.9 Options for Construction Contracts

- 4.9.1 Heat Network projects generally involve design and construction, and subsequent operation and maintenance, of the physical infrastructure as well as customer-facing activities such as metering and billing. The nature and extent of that infrastructure will vary from one project to another and there will be many project-specific issues to be considered which are beyond the scope of this Guidance.
- 4.9.2 This Guidance assumes that the SPV will be the entity which will appoint the relevant contractors, and will do so by means of a competitive procurement exercise.
- 4.9.3 However, two fundamental structural questions are: (1) should the design and build contractor (**D&B Contractor**) and operation and maintenance contractor (**O&M Contractor**) be procured separately or, alternatively, should a single contractor (who will deliver the design, build, operation and maintenance of the Heat Network (**DBOM Contractor**)) be used and (2) what form of contract should be used?

Separate or single contract(s)

- 4.9.4 A number of factors will influence this choice and you should seek appropriate advice (including legal advice) for each project. However, there are a few general considerations:
- First, separate procurements of the D&B Contractor and O&M Contractor may allow for more vigorous competition for the relevant contracts, with the commercial advantages that brings for the project. This is because smaller or more specialist contractors, who would not be able to perform all of the required services, would be in a position to bid. If the project structure involves a single DBOM Contract, contractors of this kind would need to form a joint venture or act as sub-contractors to a main contractor in order to participate. Each of these is possible, of course, and happens regularly, but the more complex or bespoke these arrangements are, the more valuable the opportunity presented by the project must be to justify the time and expense needed to implement them.
 - Having separate D&B and O&M Contracts may also have the advantage that the contracts are simpler and on more standard terms than a consolidated DBOM Contract. This could influence which procurement procedure is used, which may have implications for the overall project timeline. If the contracts are relatively straightforward, and will not need negotiation, the SPV may be able to use the restricted procedure or open procedure. On the other hand, if the contracts are more complex and will need negotiation, this will push towards use of either competitive dialogue or the competitive procedure with negotiation ([see paragraph 3.3](#)). For further information on public procurement see the DPD Guidance.
 - Separating the D&B and O&M Contracts does, however, create an interface risk which will need to be managed. Simply put, the D&B Contractor and the O&M Contractor may separately try to avoid responsibility for any mis-match between their respective responsibilities and/or the cost of rectifying it. The SPV, as the common element between the two contracts, will be responsible for managing this risk, and the SPV's capability to manage the risk should be a consideration when considering this approach. A single DBOM contract largely eliminates this risk for the SPV, which will have recourse to a single point of responsibility. This structure incentivises the relevant contractor (together with any subcontractors) to carefully consider the maintenance and operational aspects of the Heat Network at the time it is designed and built, which minimises the risk of problems arising later.

Form of Contract

- 4.9.5 If a single contractor is to be used for both D&B and O&M elements, then typically a DBOM Contract would be used to appoint the contractor. There might be separate sub-contracts sitting underneath that, dealing with the design and build of the Heat Network and its operation, respectively. Often these sub-contracts will be a pass down of the DBOM Contract although, in relation to the design and build element, industry standard construction contracts (for example NEC) are sometimes used. If the latter approach is adopted, care must be taken to ensure all of the relevant risks are passed onto the sub-contractor.

4. GENERAL ISSUES

- 4.9.6 If the D&B element is to be procured separately from the O&M element, a variety of different contract forms can be used. In the context of Heat Networks projects these are often referred to as EPC Contracts. The contractor will be responsible for all of the design, construction, commissioning and completion of the Heat Network and provide a single point of responsibility. There are standard form construction contracts in the market which can be used, such as NEC. Most standard forms will need to be tailored for use in a specific context, but provide a helpful starting point and contractors are generally familiar with them. Bespoke contracts are also used, often based on Local Authority project agreements, suitably adapted. Other methods of procuring contractor(s) can also be used, for example: alliancing, construction management or procuring each part of the works under separate contracts. Note that not all of these will deliver a single point of responsibility for design, construction, commissioning and completion, which is generally desirable.
- 4.9.7 The optimum contracting structure is likely to be driven by project-specific considerations. You should get expert legal advice on this conventional and commonly occurring issue.
- 4.9.8 In this Guidance, we refer to all of these arrangements generally as “Construction Contracts”. Separate legal advice should be obtained regarding the appropriate contract to use in the circumstances.

4.10 Energy Supply Contract Terms

- 4.10.1 The commercial terms of Energy Supply Contracts will be influenced by market conditions at the time they are entered into, and detailed consideration is beyond the scope of this Guidance. However the following features may have an influence on the choice of structure for a project.
- 4.10.2 A key feature for many projects is the term of Energy Supply Contracts and the Offtaker’s rights to terminate early. From the perspective of the SPV’s business model (and the interests of those who depend on it, including the Sponsors and lenders to the SPV) the longer term the Energy Supply Contracts, the more robust and investable the business will be.
- 4.10.3 Energy consumers, on the other hand, are typically used to contracting for supplies of energy on shorter term contracts and/or on terms which allow them to switch supplier relatively easily and without material cost.
- 4.10.4 For schemes which rely on a small number of key Offtakers (for example a university or hospital) long term offtake commitments (say 15 years+) may be essential if the project is to be investable. For schemes with a large and diversified portfolio of Offtakers the term of each Energy Supply Contract may be less of an issue.
- 4.10.5 Offtake risk is mitigated, to some extent, by the physical infrastructure. Connection to a heat supply network involves different equipment (plant) from that required for other methods of space heating. Once a Heat Network connection is in place, switching to an alternative method of space heating may require significant time and expense.
- 4.10.6 The same issue is, in some schemes, also addressed by including a commitment in leases (and other land interests) not to use other methods of space heating except in specified circumstances. The legal issues surrounding this are beyond the scope of this Guidance, but where this feature is present you should take appropriate legal advice.

Different pricing models for different classes of customer

- 4.10.7 Another issue to be aware of is pricing for customers. At the date of this Guidance, Heat Networks, and the supply of energy using them, is much less regulated than other energy supply sectors. However, it is prudent, when developing Heat Network pricing models, to have regard to the approach taken in gas and electricity supply, particularly in relation to pricing for domestic consumers.
- 4.10.8 Recognising the current light touch regulatory regime⁷ (which is under increasing scrutiny as the Heat Network market grows in significance), Local Authorities sometimes seek to achieve a degree of influence over supply terms, and particularly pricing and service standards, in order to safeguard the interests of consumers.

⁷ Essentially limited to the Heat Network Metering and Billing Regulations 2014.

4. GENERAL ISSUES

4.10.9 Where appropriate, this influence can be achieved in a number of ways, for example by negotiating a Governance Agreement (or similar) as part of the overall project structure. Such an agreement would include an agreed process by which supply terms can be amended over time, with appropriate involvement by a range of interested parties. This sort of mechanism is an alternative to, and in many cases may be more effective than, achieving influence through control mechanisms in the SPV's Shareholders' Agreement.

4.10.10 It is common for energy pricing models to distinguish between classes or categories of customer and for a range of products (each with its own characteristics, designed to appeal to a particular class or category of customer) to be offered. Generally, within a class or category the terms offered to all customers are the same.

State aid compliance (Energy Supply Contracts)

4.10.11 Consideration must be given to whether Energy Supply Contracts with public sector Offtakers could constitute State aid flowing from the public sector customer to the NPI or the SPV.

4.10.12 As described in paragraph 4.11, State aid involves the transfer of State resources to an undertaking. It is therefore possible for the terms of an Energy Supply Contract between a public sector customer and the SPV to involve such a transfer, if the commitments the public Offtaker makes are out of step with terms which would be acceptable to other market participants.

4.10.13 The most obvious example is, perhaps, pricing which is manifestly higher than elsewhere in the market. Unless there is a legitimate commercial justification for the pricing, it may amount to unlawful State aid. Other arrangements might also involve State aid, for example a take-or-pay commitment which is particularly favourable to the SPV and for which there is no legitimate commercial justification.

4.10.14 Be aware, also, that State aid can also operate in the opposite direction. If an SPV is funded by a public body and supplies energy to a non-public Offtaker at below market price, that could involve a transfer of State resources and so constitute State aid. You should seek appropriate legal advice regarding State aid compliance.

4.11 State aid

What does State aid look like?

4.11.1 State aid is concerned, in essence, with the 'transfer of resource' from the State to undertakings (broadly meaning entities engaged in economic activities).

4.11.2 In the context of a Local Authority engaging with an NPI in respect of a Heat Network project, the transfer of resource could, for example, take the form of the NPI benefitting from a reduction in risk, or an increase in return, which is not commercially justified. As a broad rule of thumb, if there is any doubt about whether another undertaking (ie investor in the relevant market), standing in the shoes of the Local Authority, would agree to reduce the NPI's risk or increase the NPI's return, then the arrangement may involve State aid.

4.11.3 It is essential that State aid compliance is considered (and appropriate legal advice sought) at the start of the project, and that it is kept under review throughout until financial close. Robust State aid solutions are easier to design and implement when they form an integral part of the overall project structuring.

4.11.4 Legal advice will be needed to identify whether State aid is present and, if it is an inherent part of the project, whether/how the aid can be provided in a compliant way ([see paragraph 4.11.10](#)). If unlawful State aid is given various sanctions can be imposed (including recovery of the aid).

What is the test for State aid?

4.11.5 State aid has four fundamental characteristics which must all be present in order for State aid to arise. They are:

- (a) it is granted through State resources;
- (b) it favours certain undertakings, or the production of certain goods;
- (c) it distorts, or threatens to distort, competition; and
- (d) it affects trade between Member States.

4. GENERAL ISSUES

What constitutes a grant of State resources?

4.11.6 The grant of State resources requires a depletion of the State's resources, compared with the position if the aid had not been granted. If the State will receive value proportionate with the cost to its resources, that will not be aid because, first, the State's resources will not be depleted (it will receive goods, works or services of value equivalent to the cost) and, second, because the recipient undertaking will not receive favourable treatment (it will have had to provide goods, works or services of value equivalent to the value it receive). In the context of Heat Networks if, for example, you invest alongside an NPI and you both receive the same return on your investment proportionate to your stake, this is unlikely to involve State aid. On the other hand, if the NPI invests on more favourable terms, the risk of State aid is greater.

When is 'favour' shown to an undertaking?

4.11.7 To 'favour' an undertaking requires an advantage to be given, something over and above what the market would provide. In the context of investment in Heat Networks, if you invest on the same terms as a commercial entity (ie a typical market participant) this would not involve State aid (see paragraph 4.11.11 regarding Market Economy Investor Principle). In contrast, if you make an investment which no commercial entity would make, then State aid is more likely to be an issue.

What is an 'undertaking'?

4.11.8 An undertaking is any entity which is engaged in economic activities, operating in a market where there is or could be competition. Most NPIs are therefore likely to be undertakings for State aid purposes.

When is trade between Member States affected?

4.11.9 For so long as the UK remains a Member State of the European Union, this characteristic is likely to be present. This is because the works, services and supplies required to implement a Heat Network project in the UK are open to competition by undertakings from all Member States of the European Union. The position after the UK has exited the EU is currently uncertain.

How to demonstrate State aid compliance

4.11.10 There are a number of ways to comply with State aid rules:

- (a) no aid present: Market Economy Investor Principle;
- (b) aid present:
 - (i) utilise the General Block Exemption Regulations (**GBER**) for permitted aid;
 - (ii) utilise de minimis regulations; or
 - (iii) apply to the European Commission for approval.

4.11.11 If a public body invests in an enterprise on terms and in conditions which would be acceptable to a private investor operating under normal market economy conditions, the investment is likely to be not State aid. This is the essence of the "market economy investor principle" (**MEIP**).

4.11.12 The clearest possible way to demonstrate that the arrangements satisfy MEIP is for a private investor to actually invest on the same terms as the Local Authority. If this is not possible, the MEIP may still be satisfied, but demonstrating compliance may be less straightforward. Undertaking commercial and financial analysis of the investment to assess whether they are terms which would be accepted by other market investors and conducting a funding competition for the required non-public investment may be helpful. You should take appropriate legal advice.

4.11.13 If a project has features which might amount to State aid and the MEIP cannot be satisfied, an alternative way to demonstrate compliance is for the terms of the investment by the Local Authority to comply with Article 46 of the GBER. Article 46 specifically authorises investment aid for energy efficient district heating and cooling. Provided the project has the features stipulated in Article 46, the arrangements will automatically constitute authorised aid and will be exempt from any requirement to seek permission from them to the European Commission (although there is still an obligation to notify within 21 days of the aid being awarded).

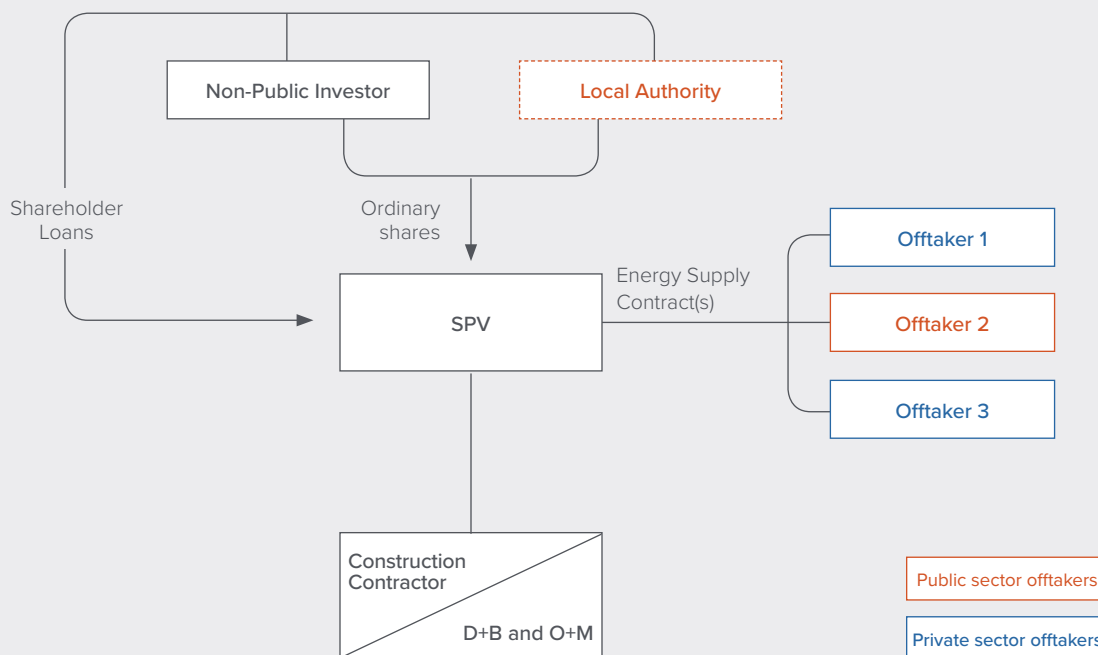


5. ILLUSTRATIVE SCENARIOS

5. ILLUSTRATIVE SCENARIOS

- 5.1 This Section describes seven Illustrative Scenarios and some of the public procurement and State aid considerations relevant to them.

- 5.2 None of the Illustrative Scenarios may fit your particular project, but by considering those which have similar characteristics (there may be more than one), you should be directed to the materials in this Guidance which are most relevant to your circumstances.

SCENARIO A: PARALLEL INVESTMENT**A. SCENARIO A – PARALLEL INVESTMENT:**

Local Authority and NPI invest on the same terms (could be different amounts) for both equity and shareholder loans

A.1 Description

- A.1.1** As explained in paragraph 4.2 of Section 4, each of the Illustrative Scenarios in this Guidance assumes the use of an SPV. In Scenario A the SPV is jointly owned and controlled by the Local Authority and the NPI.
- A.1.2** The funding required by the SPV is provided by each of the Local Authority and the NPI both subscribing for equity (ordinary shares) and providing shareholder loans to the SPV on the same terms.
- A.1.3** The return on investment is provided through repayment of the shareholder loans and dividends, both funded by the net revenues of the SPV. As with all of the Illustrative Scenarios, these revenues will have to be robust enough to drive a level of return on investment which is at, or above, the NPI's target return on investment or else the NPI will not invest.
- A.1.4** This Scenario is called "Parallel Investment" because the Local Authority and NPI's investments in the SPV are on the same terms for both equity and shareholder loans (not necessarily equal amounts). This means that the two investors are exposed to exactly the same risks and will benefit or suffer to the same extent, proportionate to their respective investments.

A. SCENARIO A – PARALLEL INVESTMENT

- A.1.5 There will be a Shareholders' Agreement which regulates, amongst other things, decision making in the SPV. Voting influence is often proportionate to shareholding, but not always. The Shareholders' Agreement will also determine which decisions are to be made by the board of directors (usually this is most day-to-day decisions) and which are to be made by the shareholders (usually exceptional things like, for example, a decision about whether to interconnect the Heat Network with another).
- A.1.6 The balance of influence in the SPV will determine whether it is under public or non-public control. It is important to recognise that the Local Authority does not have to control all aspects of the SPV's decision making in order for the Local Authority to control decision making by the SPV on a particular topic. It may be possible for the Local Authority to exert sufficient control through other means including, for example, commitments in a Governance Agreement to which the SPV is a party, mechanisms in any Energy Supply Contract between the SPV and the Local Authority, "Reserved Matters" in the Shareholders' Agreement or controls in the SPV's shareholder loan with the Local Authority.

A.2 Construction Contractors

- A.2.1 The Heat Network is designed, built and then operated and maintained under one or more agreements between the SPV and Construction Contractors which is/are not connected to the NPI. [See paragraph 4.9 of Section 4](#) for comment on the risks and benefits of using a single DBOM versus splitting out the contracts.
- A.2.2 These works and services can be procured in a number of different ways. A key factor influencing the appropriate procurement route is whether the NPI partner will also be providing any of these services. These options, and associated public procurement issues, are discussed in Section 3.

A.3 Energy Supply Contracts

- A.3.1 The SPV derives revenue primarily through the supply of energy (heat and possibly electricity, depending on project scope) under Energy Supply Contracts with various Offtakers.
- A.3.2 This Scenario envisages a range of Energy Supply Contracts, some with private sector Offtakers and some with public sector Offtakers, as indicated by the red and blue edging around the respective Offtakers in the diagram (the dashed red edging around the Local Authority indicates that it too may be an Offtaker).
- A.3.3 Public sector Offtakers (including the Local Authority if relevant) must run a competitive procurement to award Energy Supply Contracts. The SPV may bid into this procurement exercise. [See paragraph 3.2 of Section 3](#) for guidance on the options to achieve this.
- A.3.4 The SPV can, without running a competition, enter into Energy Supply Contracts with private sector Offtakers (there may however be requirements for the Offtaker to undertake a formal procurement).
- A.3.5 Paragraph 4.10 of Section 4 considers public procurement issues which influence the terms of Energy Supply Contracts.

A. SCENARIO A – PARALLEL INVESTMENT

A.4 State aid

Investment in the SPV

A.4.1 State aid from the Local Authority to the NPI: In this Scenario, both the Local Authority and the NPI invest in the SPV on the same terms (although not necessarily in the same proportions). Consequently, it is unlikely that the NPI would be viewed as being in receipt of State aid from the Local Authority ([see paragraph 4.11.7 of Section 4](#) for further comment on this).

Energy Supply Contracts

A.4.2 Detailed consideration of competition law is beyond the scope of this Guidance. However, if the SPV is to supply energy to different customers on different terms, you should seek appropriate legal advice about whether this gives rise to any issues from a competition law perspective. Depending on the characteristics of the project, the SPV may be considered to be in a dominant position.

A.4.3 State aid from the public sector Offtaker to the NPI/SPV: Care must also be taken to ensure that the terms of any Energy Supply Contract with a public sector Offtaker comply with State aid rules. If the terms offered are competitive with the relevant terms for the supply of competing energy services (e.g. gas-fired space heating), or they are improved for the Offtaker, then State aid is less likely to be an issue. You should take appropriate legal advice, however, in relevant cases.

A.4.4 If the SPV enters into Energy Supply Contracts with a private sector Offtaker you should ensure that they are not on terms which are materially better for the Offtaker than terms available from other suppliers. There is a natural commercial incentive on the SPV (and Local Authority) to avoid offering supply terms which are unnecessarily attractive for the Offtaker, so this is unlikely to be an issue but you should take appropriate legal advice in relevant cases. [See paragraphs 4.10.11 to 4.10.14 of Section 4](#) for further guidance.

Construction Contractors

A.4.5 State aid issues are unlikely to affect the basis on which the Construction Contractors is/are engaged if, as will almost always be the case, they are appointed following a competitive procurement exercise in accordance with the applicable regulations (usually the UCR). [See section 3 for further guidance.](#)

A.5 Expansion of the Heat Network

A.5.1 Scenario A supports future expansion of the Heat Network.

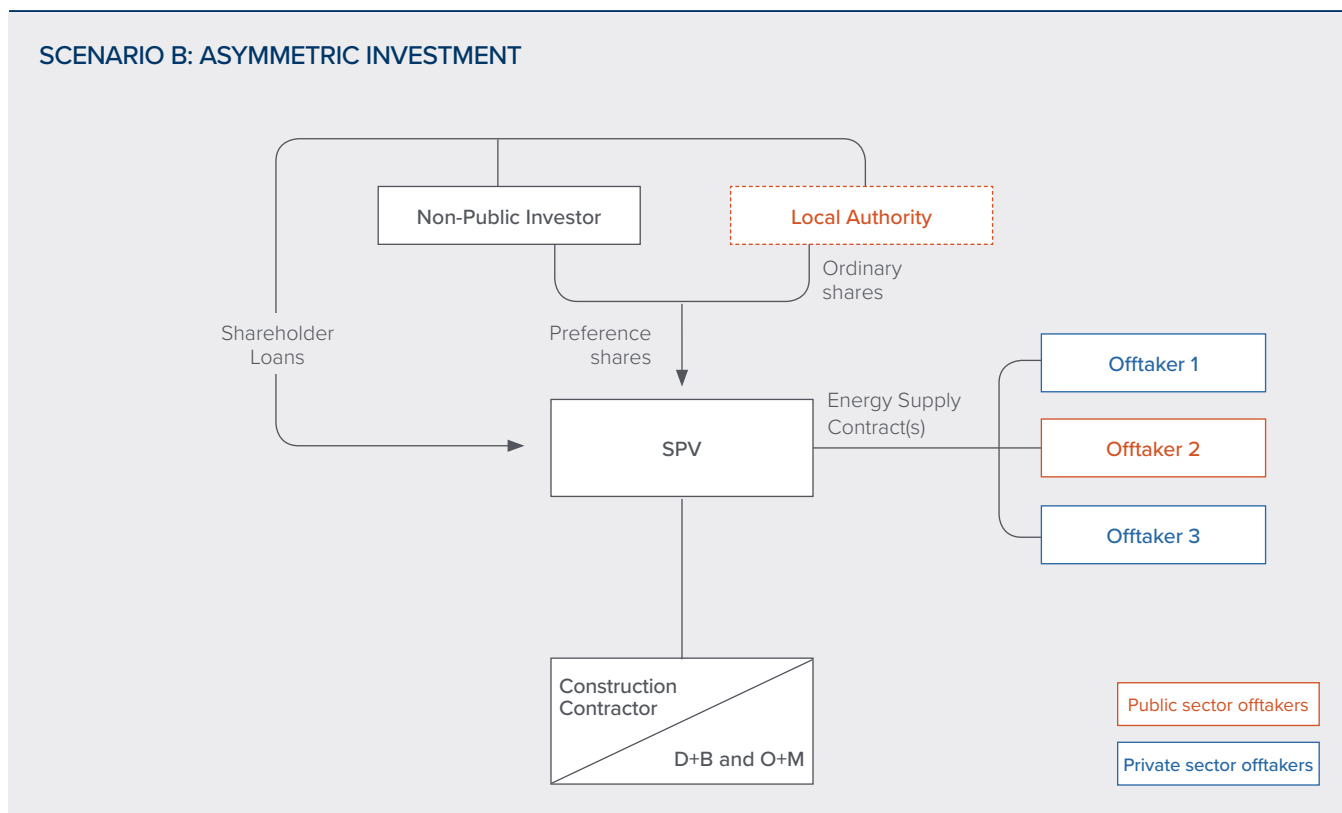
A.5.2 There is no restriction on the amount of non-public sector supply the SPV can undertake.

A.5.3 Unless additional public sector Offtakers are covered by the terms of the original procurement, to secure new public sector customers the SPV will have to compete in, and win, procurement exercises run by the relevant public bodies for the award of an Energy Supply Contract.

A.5.4 Inter-connection of the SPV's Heat Network with one or more networks owned by third parties should be possible, provided those other networks have not been procured relying on an exemption from the public procurement rules ([see paragraph 3.4 of Section 3](#) for further comment on this).

A.5.5 A further possibility for expansion under this Scenario is that the SPV's business can be expanded by it acquiring other network-owning SPVs or their Heat Network assets, as long as those SPVs do not supply to public bodies which rely on an exemption from public procurement rules.

A.5.6 Note that expansion as described in paragraph A.5.5 may have procurement law consequences where the SPV is subject to the UCR and/or PCR. If the SPV acquires another SPV's Heat Network assets this may need to be undertaken in accordance with the applicable public procurement regime. However, where the acquisition is structured as a purchase of shares, the UCR and/or PCR are unlikely to apply.



B. SCENARIO B – ASYMMETRIC INVESTMENT:

Local Authority and NPI invest on different terms (could also be different amounts) for both equity and shareholder loans

B.1 Description

- B.1.1** In Scenario B the SPV is jointly owned and controlled by the Local Authority and the NPI. The contractual structures of Scenarios A and B are identical.
- B.1.2** The funding the SPV requires is provided by each of the Local Authority and the NPI. However, unlike Scenario A, in Scenario B the commercial arrangements are slightly different and the Local Authority and the NPI subscribe for equity or provide shareholder loans to the SPV on different terms.
- B.1.3** By way of example, one of the parties (in Scenario B this is the NPI) might subscribe for Preference Shares which entitle it to a dividend which is payable before any dividend on the Ordinary Shares. Another mechanism would be to adjust the terms of the shareholder loans so that the NPI shareholder loan was repaid before the Local Authority's shareholder loan and/or the rates of interest payable on the shareholder loans were different.
[See paragraph 4.4 of Section 4](#) for further information.

B. SCENARIO B: ASYMMETRIC INVESTMENT

- B.1.4** As for scenario A, the return on investment is provided through repayment of the respective shareholder loans and through dividends declared on the shares, both funded by the net revenues of the SPV. However, because the investment terms are asymmetric, the two investors do not share the same risk and reward profile. In Scenario B the Local Authority is taking more risk because the NPI receives preferential payments. This approach increases the likelihood of achieving the NPI's target return on investment, which could be higher than for the Local Authority, so the commercial arrangement might be more likely to secure their investment.
- B.1.5** The risks to which the SPV is exposed are not different from Scenario A, but because the Local Authority and the NPI hold different shares and/or shareholder loans, the Local Authority and the NPI have different risk profiles. This asymmetric risk position must be acceptable to both investors. In particular, the Local Authority must be satisfied that its investment is justifiable despite being on different terms to the NPI's investment, for example on grounds of wider public benefit.
- B.1.6** As for Scenario A there will be a Shareholders' Agreement which regulates, amongst other things, decision making in the SPV. Voting influence may be proportionate to shareholding, but not necessarily. As for scenario A, the Shareholders' Agreement will also determine which decisions are to be made by the board of directors (usually this is most day-to-day decisions) and which are to be made by the shareholders (usually exceptional things like, for example, a decision about whether to expand or interconnect the Heat Network with another).
- B.1.7** The balance of influence in the SPV will determine whether it is under public or non-public control. It is important to recognise that the Local Authority does not have to control all aspects of the SPV's decision making in order to safeguard its wider interests. To the extent that the Local Authority does not control decision making by the SPV on a particular topic, it may be possible for the Local Authority to exert appropriate control through other means including, for example, commitments in an governance agreement to which the SPV is a party, mechanisms in any Energy Supply Contract between the SPV and the Local Authority, "Reserved Matters" in the Shareholders' Agreement or controls in the SPV's shareholder loan with the Local Authority.

How to achieve asymmetric investment

An asymmetric investment is when two or more investors have different risk and reward profiles. Where asymmetry makes sense commercially it can be achieved in a number of ways, for example:

- by creating different classes of share in the SPV (e.g. preference shares and ordinary shares) with different rights and/or entitlements
- by creating different loan terms (e.g. senior debt vs. subordinated loans).
- by giving different rights/entitlements to individual shareholders (or classes of shareholder) in a Shareholders' Agreement and/or in the SPV's Articles of Association (e.g. shareholder's right to participate in dividends).

B.2 Construction Contractors

- B.2.1** The Heat Network is designed, built and then operated and maintained under one or more agreements between the SPV and Construction Contractors (which are not connected to the NPI). [See paragraph 4.9 of Section 4](#) for comment on the risks and benefits of using a single DBOM versus splitting out the contracts.
- B.2.2** These works and services can be procured in a number of different ways. A key factor influencing the appropriate procurement route is whether the NPI partner will also be providing any of these services (FDBOM). These options, and associated public procurement issues, are discussed in [Section 3](#).

B. SCENARIO B: ASYMMETRIC INVESTMENT

B.3 Energy Supply Contracts

- B.3.1 The SPV derives revenue through the supply of energy (heat and possibly electricity, depending on project scope) under Energy Supply Contracts with various Offtakers.
- B.3.2 Scenario B envisages a range of Energy Supply Contracts, some with private sector Offtakers and some with public sector Offtakers, as indicated by the red and blue edging around the respective Offtakers in the diagram (the dashed red edging around the Local Authority indicates that it too may be an Offtaker).
- B.3.3 Public sector offtakers (including the Local Authority if relevant) must run a competitive procurement to award Energy Supply Contracts. The SPV may bid into this procurement exercise. [See paragraph 3.2 of Section 3](#) for guidance on the options to achieve this.
- B.3.4 The SPV can, without running a competition, enter into Energy Supply Contracts with private sector Offtakers (there may however be requirement for the Offtaker to undertake a formal procurement).
- B.3.5 [Paragraph 4.10 of Section 4](#) considers public procurement issues which influence the terms of Energy Supply Contracts.

B.4 State aid

Investment in the SPV

- B.4.1 State aid from the Local Authority to the NPI: In this Scenario, because the Local Authority and the NPI invest in the SPV on different terms there is an increased potential for State aid being present. The effect of the asymmetric investment could be to transfer State resources (ie from the Local Authority) to an undertaking (ie to the SPV or, indirectly, to the NPI).
- B.4.2 This will require careful consideration and appropriate legal advice should be obtained. [See paragraph 4.11 of Section 4](#) for further details regarding State aid.

Energy Supply Contracts

- B.4.3 Detailed consideration of competition law is beyond the scope of this Guidance. However, if the SPV is to supply energy to different customers on different terms, you should seek appropriate legal and financial advice about whether this gives rise to any issues from a competition law perspective. Depending on the characteristics of the project, the SPV may be considered to be in a dominant position.
- B.4.4 State aid from the public sector Offtaker to the NPI/SPV: Care must also be taken to with the terms of any Energy Supply Contract with a public sector Offtaker. If the terms are competitive with the relevant terms for the supply of competing energy services (e.g. gas-fired space heating), or they are improved for the Offtaker, then State aid is less likely to be an issue. You should seek appropriate legal advice, however, in relevant cases.
- B.4.5 If the SPV enters into Energy Supply Contracts with private sector Offtakers you should ensure that they are not on terms which are materially better for the Offtaker than terms available from other suppliers. There is a natural commercial incentive on the SPV (and Local Authority) to avoid offering supply terms which are unnecessarily attractive for the Offtaker, so this is unlikely to be an issue but you should take appropriate legal advice in relevant cases. [See paragraphs 4.10.11 to 4.10.14 of Section 4](#) for further guidance.

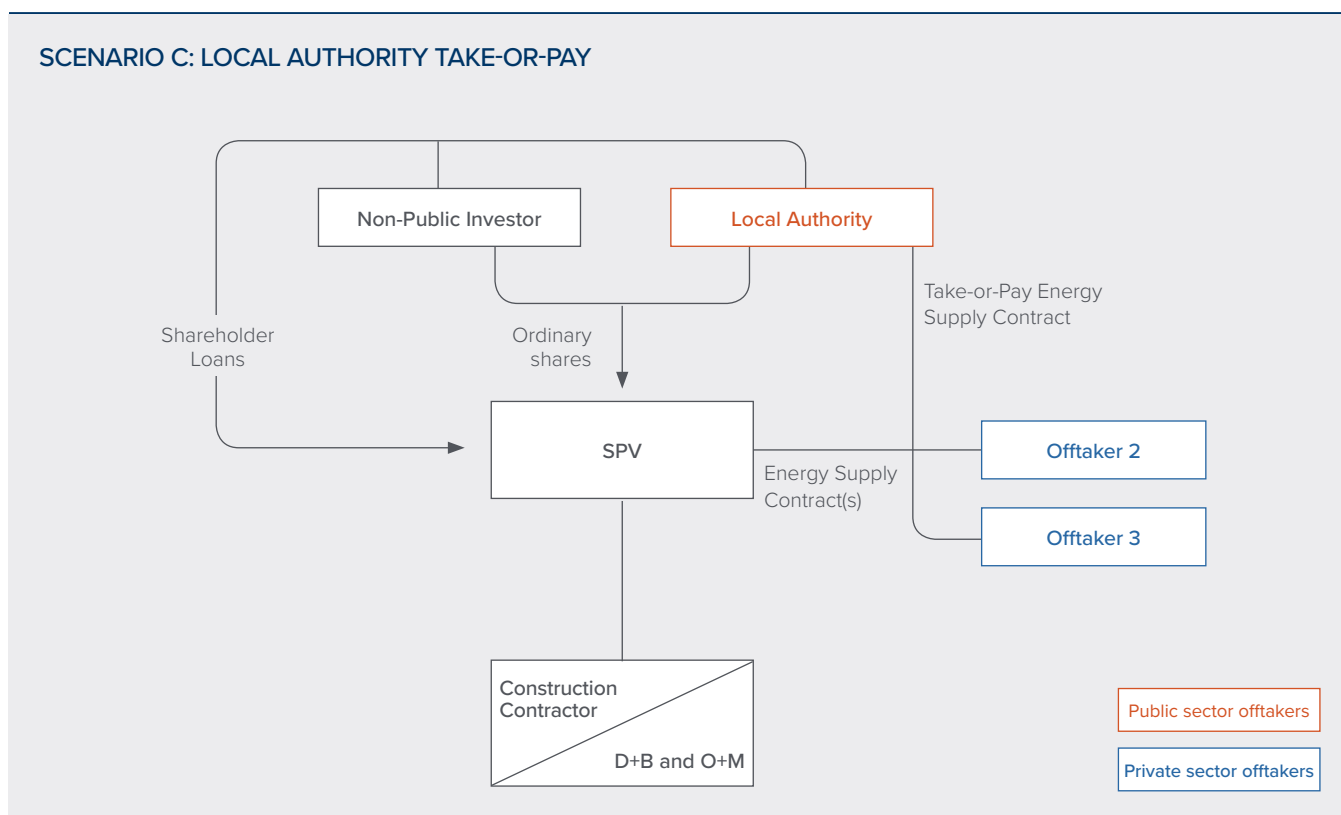
Construction Contractors

- B.4.6 State aid issues are unlikely to affect the basis on which the Construction Contractors are engaged if, as will almost always be the case, they are appointed following a competitive procurement exercise in accordance with the applicable regulations (usually the UCR).

B. SCENARIO B: ASYMMETRIC INVESTMENT

B.5 Expansion of the Heat Network

- B.5.1 Scenario B supports future expansion of the Heat Network.
- B.5.2 There is no restriction on the amount of non-public sector supply the SPV can undertake.
- B.5.3 Unless additional public sector Offtakers are covered by the terms of the original procurement, secure new public sector customers, the SPV will have to compete in, and win, procurement exercises run by the relevant public bodies for the award of an Energy Supply Contract.
- B.5.4 Inter-connection of the SPV's Heat Network with one or more networks owned by third parties should be possible, provided those other networks have not been procured relying on an exemption from the public procurement rules ([see paragraph 3.4 of Section 3](#) for further comment on this).
- B.5.5 A further possibility for expansion under this Scenario is that the SPV's business can be expanded by it acquiring other network-owning SPVs or their Heat Network assets, as long as those SPVs do not supply to public bodies which rely on a Teckal exemption from public procurement rules.
- B.5.6 Note that expansion as described in paragraph B.5.5 may have procurement law consequences where the SPV is subject to the UCR and/or PCR. If the SPV acquires another SPV's Heat Network assets this may need to be undertaken in accordance with the applicable public procurement regime. However, where the acquisition is structured as a purchase of shares, the UCR and/or PCR are unlikely to apply.



C. SCENARIO C – LOCAL AUTHORITY TAKE-OR-PAY:

Local Authority, as offtaker, provides a take-or-pay commitment to the SPV

C.1 Description

- C.1.1 In Scenario C the SPV is jointly owned and controlled by the Local Authority and the NPI. The contractual structures of Scenarios A and C are identical, other than the Local Authority's take-or-pay commitment.
- C.1.2 The funding the SPV requires is provided by each of the Local Authority and the NPI both subscribing for equity (ordinary shares) and providing shareholder loans to the SPV on the same terms. This means that the two investors are exposed to exactly the same risks and will benefit or suffer to the same extent, proportionate to their respective investments.
- C.1.3 The return on investment is provided through repayment of the shareholder loans and dividends, both funded by the net revenues of the SPV. As with all of the Illustrative Scenarios, these revenues will have to be robust enough to drive a level of return on investment which is at, or above, the NPI's target return on investment or else the NPI will not invest.
- C.1.4 This Scenario is called "Local Authority Take-or-Pay" because, in its capacity as an energy Offtaker, the Local Authority commits to either take and pay for a minimum amount of energy in each period of the Energy Supply Contract or, if it does not take the minimum quantity to pay an amount (referred to here as the **Take or Pay Amount**) to the SPV which ensures that the SPV's revenue in the relevant period is at least a minimum amount. If the Local Authority does the latter, it will typically be entitled to take energy in subsequent periods after having taken (and paid for) the specified minimum quantity, without further payment (up to the outstanding balance of the Take or Pay Amount).

C. SCENARIO C: LOCAL AUTHORITY TAKE-OR-PAY

- C.1.5 As for Scenario A, there will be a Shareholders' Agreement which regulates, amongst other things, decision making in the SPV. Voting influence is often proportionate to shareholding, but not always. The Shareholders' Agreement will also determine which decisions are to be made by the board of directors (usually this is most day-to-day decisions) and which are to be made by the shareholders (usually exceptional things like, for example, a decision about whether to interconnect the Heat Network with another).
- C.1.6 The balance of influence in the SPV will determine whether it is under public or non-public control. It is important to recognise that the Local Authority does not have to control all aspects of the SPV's decision making in order to safeguard its wider interests (for example, to influence heat pricing for domestic customers). To the extent that the Local Authority does not control decision making by the SPV on a particular topic, it may be possible for the Local Authority to exert appropriate control by other means including, for example, commitments in a governance agreement to which the SPV is a party, mechanisms in any Energy Supply Contract between the SPV and the Local Authority, "Reserved Matters" in the Shareholders' Agreement or controls in the SPV's shareholder loan with the Local Authority.
- C.1.7 See also Financing Heat Networks in the UK for comment on related accounting issues (including SPV balance sheet treatment).

C.2 Construction Contractors

- C.2.1 The Heat Network is designed, built and then operated and maintained under one or more agreements between the SPV and a DBOM Contractor (or D&B Contractor and O&M Contractor) which is/are not connected to the NPI. [See paragraph 4.9 of Section 4](#) for comment on the risks and benefits of using a single DBOM versus splitting out the contracts.
- C.2.2 These works and services can be procured in a number of different ways. A key factor influencing the appropriate procurement route is whether the NPI partner will also be providing any of these services (FDBOM). These options, and associated public procurement issues, are discussed in Section 3.

C.3 Energy Supply Contracts

- C.3.1 The SPV derives revenue through the supply of energy (heat and possibly electricity, depending on project scope) under Energy Supply Contracts with various Offtakers.
- C.3.2 This Scenario envisages a range of Energy Supply Contracts, some with private sector Offtakers and some with public sector Offtakers, as indicated by the red and blue edging around the respective Offtakers in the diagram (the dashed red edging around the Local Authority indicates that it too may be an Offtaker).
- C.3.3 However, in this Scenario the Energy Supply Agreement with the Local Authority plays a particularly important role, since it includes the Take-or-Pay commitment. That decreases the risk of fluctuations in the SPV's revenues, increasing their stability and predictability. This feature may be necessary to make the SPV's business case investable.
- C.3.4 If the Local Authority has a relatively predictable and constant energy demand, and the Take-or-Pay threshold is set at a comfortably low level, the arrangement may in practice involve little additional risk for the Local Authority.
- C.3.5 Public sector Offtakers (including the Local Authority if relevant) must run a competitive procurement to award Energy Supply Contracts. The SPV may bid into this procurement exercise. See paragraph 3.2 of Section 3 for guidance on the options to achieve this.
- C.3.6 The SPV can, without running a competition, enter into Energy Supply Contracts with private sector Offtakers (there may however be requirements for the Offtaker to undertake a formal procurement).
- C.3.7 [Paragraph 4.10 of Section 4](#) considers public procurement issues which influence the terms of Energy Supply Contracts.

C. SCENARIO C: LOCAL AUTHORITY TAKE-OR-PAY

C.4 State aid

Investment in the SPV

C.4.1 State aid from the Local Authority to the NPI: In this Scenario, both the Local Authority and the NPI invest in the SPV on the same terms (although not necessarily in the same proportions). Consequently, it is unlikely that the NPI would be viewed as being in receipt of State aid from the Local Authority (see [paragraph 4.11.7 of Section 4](#) for further comment on this).

Energy Supply Contracts

- C.4.2 Detailed consideration of competition law is beyond the scope of this Guidance. However, if the SPV is to supply energy to different customers on different terms, you should seek appropriate legal and financial advice about whether this gives rise to any issues from a competition law perspective. Depending on the characteristics of the project, the SPV may be considered to be in a dominant position.
- C.4.3 State aid from the public sector Offtaker to the NPI/SPV: The Take-or-Pay commitment in the Local Authority's Energy Supply Contract requires careful consideration from a State aid perspective. It must be commercially justifiable, for example on the basis that the per-unit energy cost is less than it would be without the Take-or-Pay commitment.
- C.4.4 As for other Scenarios, unless energy costs for the Local Authority are competitive with, or better than, terms for the supply of competing energy services (e.g. gas-fired space heating), State aid may be an issue, and appropriate legal advice should be sought in relevant cases.
- C.4.5 If the SPV enters into Energy Supply Contracts with a private sector Offtaker you should ensure that they are not on terms which are materially better for the Offtaker than terms available from other suppliers. There is a natural commercial incentive on the SPV (and Local Authority) to avoid offering supply terms which are unnecessarily attractive for the Offtaker, so this is unlikely to be an issue but you should take appropriate legal advice in relevant cases. [See paragraphs 4.10.11 to 4.10.14 of Section 4](#) for further guidance.

DBOM Contractor or D&B/O&M Contractors

C.4.6 State aid issues are unlikely to affect the basis on which the DBOM Contractor or D&B and O&M Contractors are engaged if, as will almost always be the case, they are appointed following a competitive procurement exercise in accordance with the applicable regulations (usually the UCR).

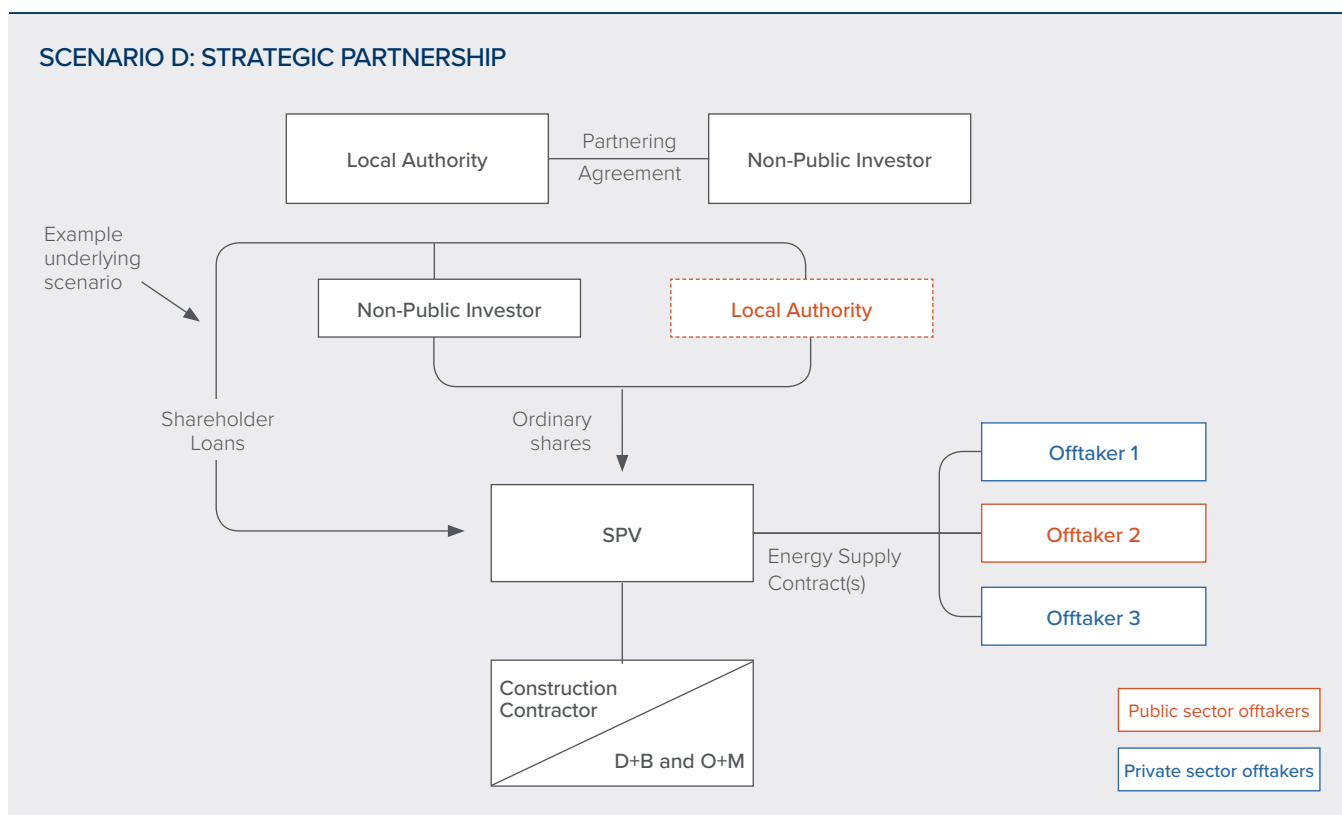
C. SCENARIO C: LOCAL AUTHORITY TAKE-OR-PAY

C.5 Expansion of the Heat Network

- C.5.1 Scenario C supports future expansion of the Heat Network.
- C.5.2 There is no restriction on the amount of non-public sector supply the SPV can undertake.
- C.5.3 Unless additional public sector Offtakers are covered by the terms of the original procurement, to secure new public sector customers the SPV will have to compete in, and win, procurement exercises run by the relevant public bodies for the award of an Energy Supply Contract.
- C.5.4 Inter-connection of the SPV's Heat Network with one or more networks owned by third parties should be possible, provided those other networks have not been procured relying on an exemption from the public procurement rules ([see paragraph 3.4 of Section 3](#) for further comment on this).
- C.5.5 A further possibility for expansion under this Scenario is that the SPV's business can be expanded by it acquiring other network-owning SPVs or their Heat Network assets, as long as those SPVs do not supply to public bodies which rely on a Teckal exemption from public procurement rules.
- C.5.6 Note that expansion as described in paragraph C.5.5 may have procurement law consequences where the SPV is subject to the UCR and/or PCR. If the SPV acquires another SPV's Heat Network assets, this may need to be undertaken in accordance with the applicable public procurement regime. However, where the acquisition is structured as a purchase of shares, the UCR and/or PCR are unlikely to apply.

C.6 A practical consideration

- C.6.1 An important practical consideration for The Local Authority in this Scenario is that it has a particularly stark conflict of interest between its role as a Take-or-Pay Offtaker and its role as an investor in the SPV. Although there is always a conflict of interest in projects where a Local Authority is both an investor and an energy Offtaker, in this Scenario it is particularly acute because the Take-or-Pay mechanism in the Energy Supply Contract transfers demand risk from the SPV to the Local Authority.
- C.6.2 In a structure like this, the Local Authority would need to ensure that this potential conflict was managed effectively by, for example, having different individuals/teams within the Local Authority responsible for the representing the two different interests.



D. SCENARIO D – STRATEGIC PARTNERSHIP: Over-arching framework between Local Authority and NPI

D.1 Description

- D.1.1 Scenario D involves a strategic partnership between the Local Authority and NPI under which together they pursue multiple individual Heat Network projects.
- D.1.2 The diagram above illustrates the Parallel Investment structure (Scenario A) merely by way of example. In practice, various structures, including those described elsewhere in this Guidance, could be implemented under the framework of a strategic partnership.
- D.1.3 The strategic partnership is a long-term commitment between the Local Authority and the NPI to collaborate, probably on an exclusive basis, according to the terms of a Partnering Agreement.
- D.1.4 The Partnering Agreement includes criteria for identifying specific projects for development (for example a particular type of project or projects in a specified geographical area). The Local Authority and the NPI each commit to pursue opportunities which satisfy those criteria, on and subject to the provisions of the Partnering Agreement.
- D.1.5 The Local Authority and NPI will implement each specific project using one or more SPVs. The most appropriate structure to use for each project will depend on the circumstances.

D. SCENARIO D: STRATEGIC PARTNERSHIP

D.1.6 Project-specific SPVs may be incorporated for each project, or the same SPVs may be used across more than one project. Project-specific SPVs ring fence risks and are likely to be required where the allocation of risks or sources of funding differ from one project to another.

D.1.7 If risk allocation is consistent across projects and the funding sources are the same, then using the same SPV may have the advantage of diversifying risk and making cash flows more stable and allows for a portfolio of assets to be sold or refinanced more easily.

D.2 Procurement risk

D.2.1 If, as is likely, the partnering arrangement involves an exclusive commitment, a competitive procurement process will be required to select the strategic partner.

D.2.2 To enable the Local Authority to select the most economically advantageous tender robustly, the procurement may include a sample Heat Network project in respect of which bidders are required to provide detailed proposals.

D.2.3 Although frameworks under which works, services or supplies are “called off” are permitted by public procurement law and are widely used, Local Authorities must take particular care, and take appropriate legal advice, when using them in the context of Heat Networks. The more precise the definition of the framework, the less susceptible to challenge individual projects implemented under it will be.

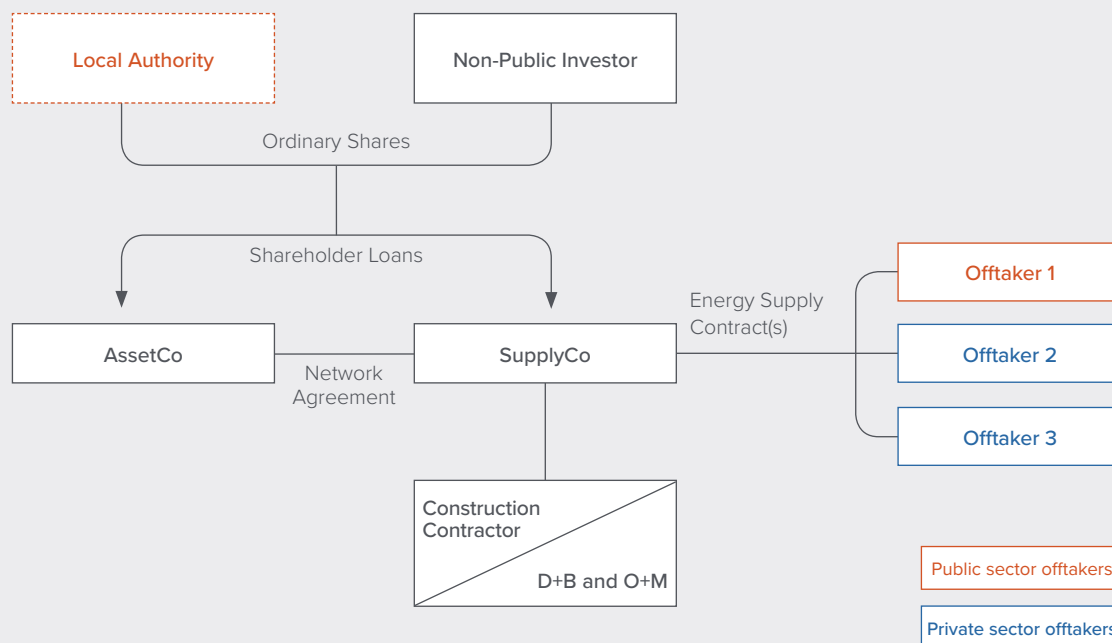
D.2.4 If every project implemented under the framework is a “carbon copy” of the reference project used to identify the most economically advantageous tender in the original procurement exercise, and the original procurement clearly related to multiple potential projects, then the risk of a successful challenge is likely to be low.

D.2.5 If the framework is used to implement a project whose characteristics are materially different from the scope of the original procurement, there is a greater risk of successful challenge on the basis that the criteria used to select the strategic partner are not relevant to the project in question.

What does exclusivity look like

In the context of a Local Authority–NPI collaboration, exclusivity arrangements could include:

- the Local Authority–NPI exclusive relationship extending to all heat network projects in a specified geographical area within a specified time period (e.g. for 10 years);
- the NPI’s exclusivity relates only to Heat Network projects that satisfy specified criteria (e.g. projects above a capital expenditure threshold);
- the NPI having a right of first refusal for a specified period of time;
- a commitment from the NPI to invest not less than a specified sum over a given period of time, or a commitment to meet carbon/air quality targets within a specified period or risk losing exclusivity.

SCENARIO E: INFRASTRUCTURE-OPERATION SPLIT**E. SCENARIO E – INFRASTRUCTURE–OPERATION SPLIT:**

Two separate SPVs are established, one is the owner and funder of the Heat Network (AssetCo) and the other the operator and customer-facing business (SupplyCo)

E.1 Description

- E.1.1 Scenario E involves two SPVs: one is the owner and funder of the Heat Network (AssetCo) and the other the operator and customer-facing business (SupplyCo).
- E.1.2 Ultimately AssetCo funds the capital costs of the Heat Network and owns the infrastructure.
- E.1.3 SupplyCo is responsible for designing and building the Heat Network, which is owned by AssetCo, but operated, maintained and used by SupplyCo to supply energy to Offtakers, all in accordance with the Network Agreement.
- E.1.4 Under the Network Agreement:
- SupplyCo commits to design and build the Heat Network in accordance with AssetCo’s requirements on a lump sum, turn-key basis;
 - AssetCo agrees to finance the cost of the Heat Network by making a series of stage payments to SupplyCo, reflecting “value in the ground”;
 - on completion of commissioning and testing of the Heat Network (possibly in phases), AssetCo makes the Heat Network available to SupplyCo on an exclusive basis for an agreed period (typically from practical completion until the end of the operational life of the relevant infrastructure) for the purposes of supplying energy to Offtakers in accordance with the Network Agreement;

E. SCENARIO E: INFRASTRUCTURE-OPERATION SPLIT

- (d) in consideration for the rights granted to it, SupplyCo pays AssetCo a fee. Through these fees AssetCo recovers, over the term of the Network Agreement, the capital cost it invested in the Heat Network plus AssetCo's investment return;
- (e) SupplyCo is responsible for operating the Heat Network and maintaining it in accordance with the Network Agreement; and
- (f) SupplyCo supplies energy to its Offtakers through Energy Supply Contracts, the form of which (including performance standards) is regulated by the Network Agreement.

Split risk

- E.1.5** A key distinction between Scenario E and Scenarios A, B, C and D is that this Scenario separates design, build, operation and maintenance risk (including cost overruns and delays), which sit with SupplyCo, from ownership, which sits with AssetCo.
- E.1.6** AssetCo is a relatively low-risk infrastructure-owning business. Its capital requirements are fixed (subject to any expansion of the Heat Network) and, once the Heat Network is operational, AssetCo's revenues should be predictable in the long-term. That said, those revenues are also likely to be capped because there is likely to be a maximum fee payable by SupplyCo under the Network Agreement.
- E.1.7** By contrast, SupplyCo is a customer-facing trading entity that manages the majority of the risks in the project. There may be opportunity to grow SupplyCo's gross revenue (for example by connecting further Offtakers) and to manage on-going costs, thereby improving profitability. SupplyCo is a more dynamic, but higher risk, business than AssetCo.
- E.1.8** The extent to which the Local Authority and NPI are exposed to these two different risk profiles will be determined by their respective shareholdings in the two SPVs. This kind of structure is therefore appropriate where the Local Authority and the NPI have different appetites for types of risk.
- E.1.9** NPIs who are interested in the customer relationships, and whose focus is the effective and efficient operation of energy infrastructure, are likely to be interested in a controlling interest in SupplyCo. NPIs who are interested in strategic infrastructure assets with long operational life and which yield stable, long-term revenues are likely to be interested in AssetCo. Some NPIs may be interested in both. NPI participation in each of AssetCo and SupplyCo, and the Local Authority's corresponding participation, can be adjusted according to circumstances.
- E.1.10** For each SPV there will be a Shareholders' Agreement which regulates, amongst other things, decision making in that SPV. The types of decision to be made in each SPV will reflect the risks to which that SPV is subject and, hence, the structure of the project.
- E.1.11** Voting influence is often proportionate to shareholding, but not always. The Shareholders' Agreement for the relevant SPV will also determine which decisions are to be made by the board of directors (usually this is most day-to-day decisions) and which are to be made by the shareholders (usually exceptional things like, for example, a decision about whether to interconnect the Heat Network with another).
- E.1.12** The balance of influence in each SPV will determine whether it is under public or non-public control. It is important to recognise that the Local Authority does not have to control all aspects of an SPV's decision making in order to safeguard its wider interests. To the extent that the Local Authority does not control decision making by an SPV on a particular topic, it may be possible for the Local Authority to exert appropriate control by other means including, for example, commitments in a binding agreement to which the SPV is a party, "Reserved Matters" in the Shareholders' Agreement or controls in the SPV's shareholder loan with the Local Authority.

Alternative Split

- Design & Build risk could, alternatively, be allocated to AssetCo rather than SupplyCo.
- This might eliminate a layer of cost (because AssetCo deals with the D&B Contractor direct) but it would also create an additional interface for AssetCo, increasing its risk profile.
- The choice will depend on circumstances.

E. SCENARIO E: INFRASTRUCTURE-OPERATION SPLIT

E.2 DBOM Contractor or D&B/O&M Contractors

- E.2.1 The Heat Network is designed, built and then operated and maintained under one or more agreements between SupplyCo and a DBOM Contractor or D&B Contractor and O&M Contractor. [See paragraph 4.9 of Section 4](#) for comment on the risks and benefits of using a single DBOM versus splitting out the contracts.
- E.2.2 The necessary works and services can be procured in a number of different ways. These options, and associated public procurement issues, are discussed in Section 3.

E.3 Energy Supply Contracts

- E.3.1 SupplyCo derives revenue through the supply of energy (heat and possibly electricity, depending on project scope) under Energy Supply Contracts with various Offtakers.
- E.3.2 Scenario E envisages a range of Energy Supply Contracts, some with private sector Offtakers and some with public sector Offtakers, as indicated by the red and blue edging around the respective Offtakers in the diagram.
- E.3.3 Energy Supply Contracts with public sector Offtakers (including the Local Authority if relevant) must be awarded through a competitive procurement exercise. [See paragraph 3.2 of Section 3](#) for guidance on the options to achieve this.
- E.3.4 Without running a competition, Energy Supply Contracts with private sector Offtakers can be entered into (there may however be a requirement for the Offtaker to undertake a formal procurement).
- E.3.5 Paragraph 4.10 of Section 4 considers public procurement issues which influence the terms of Energy Supply Contracts.

E.4 Network Agreement

- E.4.1 In this scenario there would normally be a simultaneous procurement of the DBOM, or separate D&B and O&M contracts, and investment by the NPI ([see paragraph 2.5.3 of Section 2](#)) together with, if relevant, any anchor public sector Energy Supply Contracts. As the Network Agreement is a key component of this Scenario it will need to be developed as part of that procurement exercise.

E.5 State aid

Investment in the SPV

- E.5.1 State aid from the Local Authority to the NPI: In this Scenario, because the two SPVs have different risk profiles and the Local Authority and the NPI(s) are likely to hold differing interests in each of AssetCo and SupplyCo, there is an increased potential for State aid. The effect of the split of risk and differing levels of investment could be to transfer State resources (ie from the Local Authority) to an undertaking (ie to an SPV or, indirectly, to the NPI(s)).
- E.5.2 This will require careful consideration and appropriate legal advice should be obtained. Further detail regarding State aid is set out in paragraph 4.11 of Section 4.

Energy Supply Contracts

- E.5.3 Detailed consideration of competition law is beyond the scope of this Guidance. However, if SupplyCo is to supply energy to different customers on different terms, you should seek appropriate legal advice about whether this gives rise to any issues from a competition law perspective. Depending on the characteristics of the project, SupplyCo may be considered to be in a dominant position.

E. SCENARIO E: INFRASTRUCTURE-OPERATION SPLIT

- E.5.4 State aid from the public sector offtaker to the NPI/SPV: Care must also be taken to ensure that the terms of any Energy Supply Contract with a public sector Offtaker are State aid compliant. If the terms offered are competitive with the relevant terms for the supply of competing energy services (e.g. gas-fired space heating), or they are improved for the Offtaker, then State aid is less likely to be an issue. You should take appropriate legal advice, however, in relevant cases.
- E.5.5 If the SPV enters into Energy Supply Contracts with a private sector Offtakers you should ensure that they are not on terms which are materially better for the Offtaker than terms available from other suppliers. There is a natural commercial incentive on the SPV (and Local Authority) to avoid offering supply terms which are unnecessarily attractive for the Offtaker, so this is unlikely to be an issue but you should take appropriate legal advice in relevant cases. [See paragraphs 4.10.11 to 4.10.14 of Section 4](#) for further guidance.

DBOM Contractor or D&B/O&M Contractors

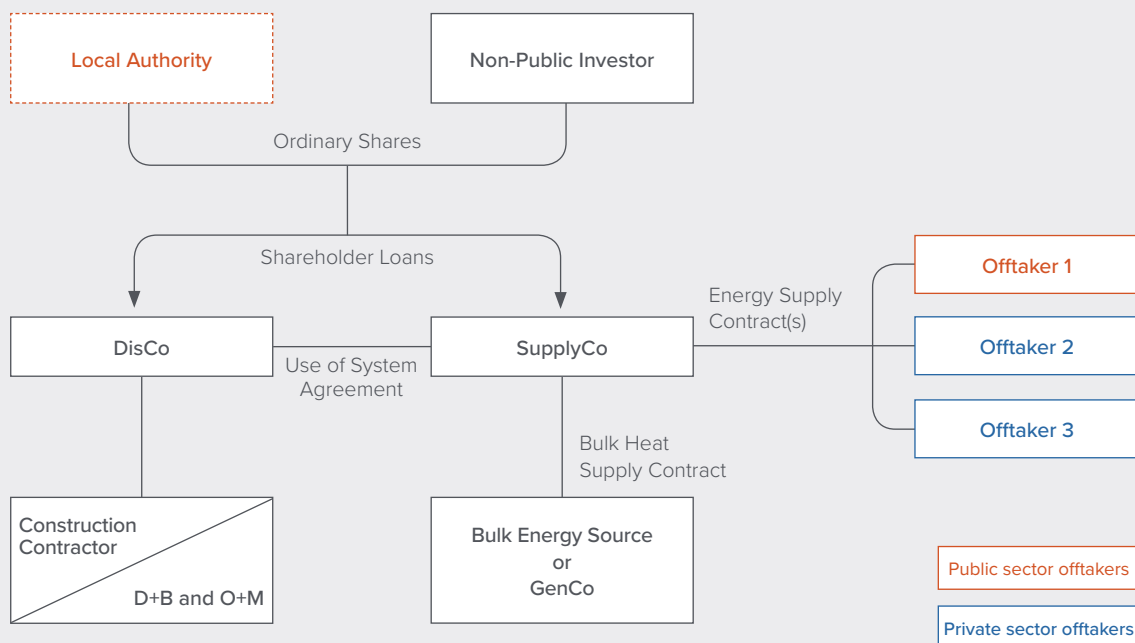
- E.5.6 State aid issues are unlikely to affect the basis on which the DBOM Contractor or D&B and O&M Contractors are engaged if, as will almost always be the case, they are appointed following a competitive procurement exercise in accordance with the applicable regulations (usually the UCR). [See paragraph 4.9.2 of Section 4](#).

Network Agreement

- E.5.7 Care must also be taken to ensure that the terms of the Network Agreement are State aid compliant. For further details regarding State aid [see paragraph 4.11 of Section 4](#).

E.6 Expansion of the Heat Network

- E.6.1 Scenario E supports future expansion of the Heat Network.
- E.6.2 There is no restriction on the amount of non-public supply SupplyCo can undertake.
- E.6.3 Unless additional public sector Offtakers are covered by the terms of the original procurement, SupplyCo will have to compete in, and win, procurement exercises run by the relevant public bodies for the award of an Energy Supply Contract.
- E.6.4 Inter-connection of AssetCo's network with one or more networks owned by third parties is, in principle, possible provided that those networks do not supply to public bodies which rely on an exemption from public procurement rules.
- E.6.5 Decisions about expansions to the Heat Network or inter-connection with other networks would be made principally by AssetCo (as the owner of the Heat Network). However, any expansion or inter-connection is likely to affect SupplyCo's interests under the Network Agreement, which is likely to contain provisions which have a bearing on any such proposal. If the arrangement involves changes to the Network Agreement, the UCRs may apply.
- E.6.6 The scope of the business can, in principle, be expanded by the AssetCo is acquiring other network-owning SPVs (providing those SPVs do not supply to public bodies which rely on an exemption from public procurement rules) but if the arrangement involves changes to the Network Agreement the UCRs may apply.
- E.6.7 A further possibility for expansion under this Scenario is that AssetCo's business can be expanded by it acquiring other network-owning SPVs, as long as those SPVs do not supply to public bodies which rely on an exemption from public procurement rules.
- E.6.8 Note that expansion, as described in paragraph E.6.7, may have procurement law consequences where the SPV is subject to the UCR and/or PCR. If AssetCo acquires another SPV's Heat Network assets, this may need to be undertaken in accordance with the applicable public procurement regime. However, where the acquisition is structured as a purchase of shares, the UCR and/or PCR are unlikely to apply.

SCENARIO F: UNBUNDLED STRUCTURE**F. SCENARIO F – UNBUNDLED STRUCTURE:**

Generation and distribution of heat separated from customer supply

F.1 Description

- F.1.1** Scenario F is similar in some respects to structures in place for gas and electricity utilities where generation, distribution and customer supply are separated or ‘unbundled’. This contrasts with most Heat Networks currently which are ‘vertically integrated’ i.e. the same entity is responsible for generation, distribution and supply.
- F.1.2** This Scenario involves two SPVs: one is the owner, funder and operator of the Heat Network (DisCo) and the other is customer-facing supply business (SupplyCo). The DisCo – SupplyCo relationship need not be exclusive (in other words, there may be more than one SupplyCo).
- F.1.3** DisCo funds the capital cost of designing and building the Heat Network and owns the infrastructure. In this Scenario the Heat Network does not include the generating plant, which is owned and operated by a third party (a Bulk Energy Source or GenCo). DisCo engages a DBOM Contractor, or separate D&B and O&M Contractors, to undertake the necessary works.
- F.1.4** Once the Heat Network is operational, DisCo grants SupplyCo the right to use it to supply energy to SupplyCo’s Offtakers, in accordance with a Use of System Agreement. DisCo may grant similar rights to others.

F. SCENARIO F: UNBUNDLED STRUCTURE

F.1.5 In this Scenario:

- (a) DisCo provides services to SupplyCo using the Heat Network. These services include making energy available for offtake by SupplyCo's Offtakers and, possibly, supplying that energy;
- (b) SupplyCo may be responsible for sourcing the energy it supplies to its Offtakers, either from DisCo or from third parties (for example, a bulk energy source like an Energy from Waste plant or from a generating SPV (GenCo));
- (c) SupplyCo pays DisCo charges for providing the relevant services. DisCo recovers its capital investment in the network, plus its return, through the fees received from all SupplyCos using the network;
- (d) DisCo is responsible for operating the Heat Network and maintaining it in a way which allows it to provide the services under the Use of System Agreement(s); and
- (e) SupplyCo supplies energy to its Offtakers under Energy Supply Contracts.

Split risk

- F.1.6 As for Scenario E, a key distinction between Scenario F and Scenarios A, B, C and D is that this Scenario separates key risks between DisCo, SupplyCo and GenCo (if relevant). However, the nature of the respective businesses and the allocation of risks among them is very different to Scenario E.
- F.1.7 DisCo is an infrastructure-owning business but it is also responsible for the operation and maintenance of the Heat Network. Its capital requirements are fixed (subject to any expansion of the Heat Network). However, in this Scenario DisCo's network is not dedicated to supporting only one supply business, DisCo provides services potentially to multiple SupplyCos and its revenues depend on the throughput of energy in the Heat Network. Depending on the pattern of offtakes, these revenues may be more or less predictable in the long-term. The limiting factors on DisCo's revenues are the physical capacity of the Heat Network and the prices it charges SupplyCo (and other users) for the services it provides.
- F.1.8 SupplyCo(s) is a customer-facing trading entity which requires relatively little capital investment. Its revenues are a function of the number of Offtakers it has, their aggregate demand and the prices it charges for energy.
- F.1.9 The extent to which the Local Authority and the NPI are respectively exposed to the two different risk profiles will be determined by their shareholdings in the two SPVs. One or both may also have an interest in GenCo. This kind of structure is therefore appropriate where the Local Authority and the NPI have different appetites for types of risk.
- F.1.10 NPIs who are interested in customer relationships are likely to be interested in a controlling interest in SupplyCo. NPIs who are interested in strategic infrastructure assets with long operational life and which yield stable, long-term revenues are likely to be interested in DisCo. NPIs may also be interested in GenCo, either alone or alongside an interest in DisCo, SupplyCo or both. NPI participation in each of DisCo, GenCo and SupplyCo, and the Local Authority's corresponding participation, can be adjusted according to circumstances.
- F.1.11 For each SPV there will be a Shareholders' Agreement which regulates, amongst other things, decision making in that SPV. The types of decision to be made in each SPV will reflect the risks to which that SPV is subject and, hence, the structure of the project.
- F.1.12 Voting influence is often proportionate to shareholding, but not always. The Shareholders' Agreement for the relevant SPV will also determine which decisions are to be made the board of directors (usually this is most day-to-day decisions) and which are to be made by the shareholders (usually exceptional things like, for example, a decision about whether to interconnect the Heat Network with another).
- F.1.13 The balance of influence in each SPV will determine whether it is under public or non-public control. It is important to recognise that the local Authority does not have to control all aspects of an SPV's decision making in order to safeguard its wider interests. To the extent that the Local Authority does not control decision making by an SPV on a particular topic, it may be possible for the Local Authority to exert appropriate control by other means including, for example, commitments in a binding agreement to which the SPV is a party, "Reserved Matters" in the Shareholders' Agreement or controls in the SPV's shareholder loan with the Local Authority.

F. SCENARIO F: UNBUNDLED STRUCTURE

F.2 DBOM Contractor or D&B/O&M Contractors

- F.2.1 The Heat Network is designed, built and then operated and maintained under one or more agreements between DisCo and a DBOM Contractor (or D&B Contractor and O&M Contractor). [See paragraph 4.9 of Section 4](#) for comment on the risks and benefits of using a single DBOM versus splitting out the contracts.
- F.2.2 The necessary works and services can be procured in a number of different ways. These options, and associated public procurement issues, are discussed in [Section 3](#).

F.3 Energy Supply Contracts

- F.3.1 SupplyCo derives revenue through the supply of energy (heat and possibly electricity, depending on project scope) under Energy Supply Contracts with various Offtakers.
- F.3.2 Scenario F envisages a range of Energy Supply Contracts, some with private sector Offtakers and some with public sector Offtakers, as indicated by the red and blue edging around the respective Offtakers in the diagram.
- F.3.3 Energy Supply Contracts with public sector Offtakers (including the Local Authority if relevant) must be awarded through a competitive procurement exercise. [See paragraph 3.2 of Section 3](#) for guidance on the options to achieve this.
- F.3.4 Without running a competition, Energy Supply Contracts with private sector Offtakers can be entered into (there may however be requirement for the Offtaker to undertake a formal procurement).
- F.3.5 [Paragraph 4.10 of Section 4](#) considers public procurement issues which influence the terms of Energy Supply Contracts.

F.4 Use of System Agreement

- F.4.1 In this Scenario DisCo provides a service to SupplyCo(s) under the Use of System Agreement. Although SupplyCo will be a utility, it may be entitled to award the Use of System Agreement without running a competitive procurement.⁸
- F.4.2 Care must be taken to ensure that the terms of the Use of System Agreement are State aid compliant. For further details regarding State aid [see paragraph 4.11 of Section 4](#).

F.5 State aid

Investment in the SPVs

- F.5.1 In this Scenario, because each SPV has a different risk profile and the Local Authority and the NPI(s) are likely to hold differing interest in each of DisCo, GenCo and SupplyCo, there is an increased potential for unlawful State aid. The effect of the split of risk and differing levels of investment could be to transfer State resources (ie from the Local Authority) to an undertaking (ie to an SPV or, indirectly, to the NPI(s)).
- F.5.2 This will require careful consideration and appropriate legal advice should be obtained. Further details regarding State aid considerations are set out at [paragraph 4.11 of Section 4](#).

Energy Supply Contracts

- F.5.3 Detailed consideration of competition law is beyond the scope of this Guidance. However, if SupplyCo is to supply energy to different customers on different terms, you should seek appropriate legal and financial advice about whether this gives rise to any issues from a competition law perspective. Depending on the characteristics of the project, SupplyCo may be considered to be in a dominant position.

⁸ For instance, see Regulations 23(b) and 50(1)(c) of the UCR and Regulation 32(2)(b)

F. SCENARIO F: UNBUNDLED STRUCTURE

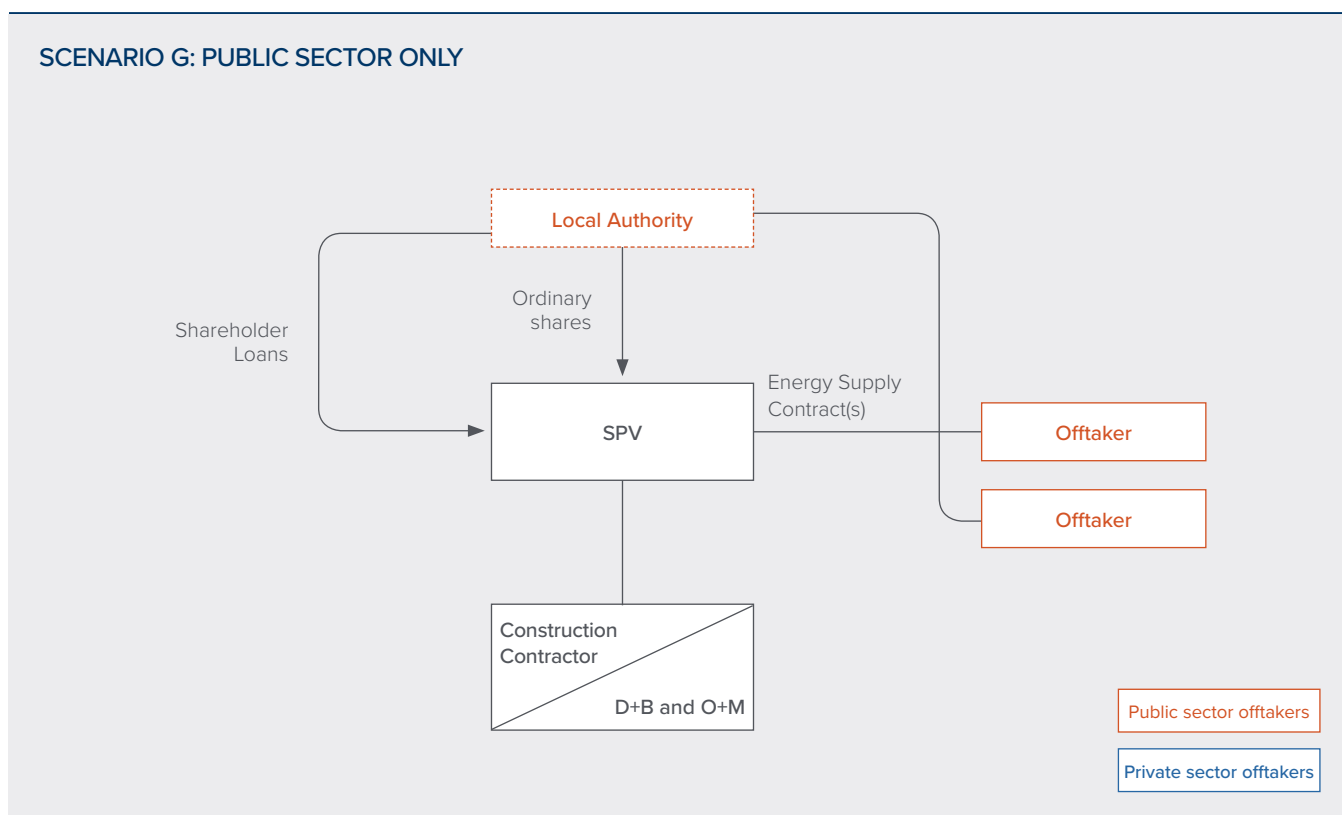
- F.5.4 Care must also be taken to ensure that the terms of any Energy Supply Contract with a public sector Offtaker are State aid compliant. If they are competitive with, or better for the Offtaker than, terms for the supply of competing energy services (e.g. gas-fired space heating), this is unlikely to be an issue, but appropriate legal advice should be sought in relevant cases.
- F.5.5 If the SPV enters into Energy Supply Contracts with a private sector Offtaker you should ensure that they are not on terms which are materially better for the Offtaker than terms available from other suppliers. There is a natural commercial incentive on the SPV (and Local Authority) to do this, so this is unlikely to be an issue but appropriate legal advice should be sought in relevant cases. [See paragraphs 4.10.11 to 4.10.14 of Section 4](#) for further guidance.

DBOM Contractor or D&B/O&M Contractors

- F.5.6 State aid issues are unlikely to affect the basis on which the DBOM Contractor or D&B and O&M Contractors are engaged if, as will almost always be the case, they are appointed following a competitive procurement exercise in accordance with the applicable regulations (usually the UCR). [See paragraph 4.9.2 of Section 4](#).

F.6 Expansion of the Heat Network

- F.6.1 Scenario F supports future expansion of the Heat Network.
- F.6.2 There is no restriction on the amount of non-public supply SupplyCo can undertake.
- F.6.3 Unless additional public sector Offtakers are covered by the terms of the original procurement, SupplyCo will have to compete in, and win, procurement exercises run by the relevant public bodies for the award of an Energy Supply Contract.
- F.6.4 Inter-connection of DisCo's network with one or more networks owned by third parties is, in principle, possible provided that those networks do not supply to public bodies which rely on an exemption from public procurement rules.
- F.6.5 Decisions about expansions to the Heat Network or inter-connection with other networks would be made principally by DisCo (as the owner of the Heat Network). Provided expansion or inter-connection does not affect SupplyCo's interests under the Use of System Agreement DisCo will be free to proceed as it sees fit.
- F.6.6 The scope of the network business can, in principle, be expanded by DisCo acquiring other network-owning SPVs (providing those SPVs do not supply to public bodies which rely on an exemption from public procurement rules).
- F.6.7 A further possibility for expansion under this Scenario is that DisCo's business can be expanded by it acquiring other network-owning SPVs, as long as those SPVs do not supply to public bodies which rely on an exemption from public procurement rules.
- F.6.8 Note that expansion as described in paragraph F.6.7 may have procurement law consequences where DisCo is subject to the UCR and/or PCR. If DisCo acquires another SPV's Heat Network assets this may need to be undertaken in accordance with the applicable public procurement regime. However, where the acquisition is structured as a purchase of shares, the UCR and/or PCR are unlikely to apply.



G. SCENARIO G – PUBLIC SECTOR ONLY:

Public sector funded SPV supplying only public sector clients, utilising Teckal regulations

G.1 Description

- G.1.1 In this Scenario the Heat Network is developed entirely by, and for the benefit of, public bodies.
- G.1.2 Consequently, all resources (human and financial) must be provided by the public sector Sponsors. At the Development and Commercialisation Stages, depending on the level of in-house resource, this may have implications for the rate at which the project proceeds. In the operational phase, this means the Local Authority must have an enduring in-house operational capability or outsource its requirements.
- G.1.3 Because the Heat Network is intended to be profitable an SPV is used ([see paragraph 4.2 of Section 4](#) for guidance on this point).
- G.1.4 The funding required by the SPV is provided by the Local Authority subscribing for equity (ordinary shares) and providing shareholder loans to the SPV.
- G.1.5 The return on investment is provided through repayment of the shareholder loan and dividends, both funded by the net revenues of the SPV. As long as the return on investment exceeds the cost of the loan, the project is likely to be viable.
- G.1.6 For this Scenario there is no need for a Shareholders' Agreement because the Local Authority is the only investor. If two or more public bodies co-invest a Shareholders' Agreement would be required (to regulate, amongst other things, decision making in the SPV).

G. SCENARIO G: PUBLIC SECTOR ONLY

G.1.7 If the Local Authority is not the only Offtaker, there may be a commercial tension between the Local Authority's interests as investor and the terms of Energy Supply Contracts (including with the Local Authority as Offtaker) which should be recognised early on. It may be appropriate for the Local Authority to put different teams in place to represent the different interests.

G.2 DBOM Contractor or D&B/O&M Contractors

G.2.1 The Heat Network is designed, built and then operated and maintained under one or more agreements between the SPV and a DBOM Contractor or D&B Contractor and O&M Contractor. [See paragraph 4.9 of Section 4](#) for comment on the risks and benefits of using a single DBOM versus splitting out the contracts.

G.2.2 These works and services can be procured in a number of different ways. These options, and associated public procurement issues, are discussed in [Section 3](#).

G.3 Energy Supply Contracts

G.3.1 The SPV derives revenue through the supply of energy (heat and possibly electricity, depending on project scope) under Energy Supply Contracts with various Offtakers.

G.3.2 This Scenario has only public sector customers and as such has several Energy Supply Contracts with a number of public sector Offtakers, as indicated by the red edging around the Offtakers in the diagram (the dashed red edging around the Local Authority indicates that it too may be an Offtaker).

G.3.3 The public sector Offtakers can award Energy Supply Contracts to the SPV directly without a competitive procurement exercise provided the requirements of the Teckal exemption are satisfied. [See paragraph 3.4 of Section 3](#) for further guidance.

G.3.4 The SPV can supply energy to private sector Offtakers (not illustrated in the diagram) provided that this accounts for less than 20% of the SPV's revenue.

G.4 State aid

G.4.1 Although this Scenario involves only public sector bodies, State aid should still be considered in the context of the Energy Supply Contract terms and other contractual relationships with the SPV since, despite being publicly-owned, it may be participating in a competitive market (i.e. the provision of energy services).

G.4.2 If the SPV enters into Energy Supply Contracts with a private sector Offtakers (representing in aggregate less than 20% of the SPV's revenue) you should ensure that they are not on terms which are materially better for the Offtaker than terms available from other suppliers. There is a natural commercial incentive on the SPV (and Local Authority) to do this, so this is unlikely to be an issue but appropriate legal advice should be sought in relevant cases.

G. SCENARIO G: PUBLIC SECTOR ONLY

G.5 Expansion of the Heat Network

- G.5.1 Scenario G might constrain future expansion of the Heat Network.
- G.5.2 Private sector expansion is effectively constrained unless public sector expansion keeps step as, due to Teckal, less than 20% of the SPV's revenues may be derived from supply to private sector Offtakers.
- G.5.3 There is no restriction on the amount of public sector supply the SPV can undertake provided:
- (a) the requirements of the Teckal exemption are satisfied; or
 - (b) the additional public sector Offtakers are covered by the terms of the original procurement; or
 - (c) the SPV competes in, and wins, procurement exercises for supply of energy run by additional public bodies.
- G.5.4 Inter-connection of the SPV's Heat Network with one or more networks owned by third parties is unlikely to be possible, unless those other networks are also public networks and the requirements of the Teckal exemption continue to be satisfied following inter-connection.
- G.5.5 A further possibility for expansion under this Scenario is that the SPV's business can be expanded by it acquiring other network-owning SPVs, as long as those SPVs do not supply to public bodies which rely on an exemption from public procurement rules.
- G.5.6 Note that expansion as described in paragraph G.5.5 may have procurement law consequences where the SPV is subject to the UCR and/or PCR. If the SPV acquires another SPV's Heat Network assets this may need to be undertaken in accordance with the applicable public procurement regime. However, where the acquisition is structured as a purchase of shares, the UCR and/or PCR are unlikely to apply.

ABOUT US



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Energy and natural resources is one of our eleven key sectors and we have a dedicated team that has been involved with Heat Networks in the UK for over 10 years. We act for a number of government departments, local authorities, NHS trusts and universities and have the expertise to build strong relationships and deliver an excellent service to clients across a full spectrum of issues. The firm has been ranked in Legal Week's Best Legal Adviser report for six years running (2018) was also ranked 14th in the FT's 2018 Top 50 Innovative Law Firms report.

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This guidance is intended to constitute generic guidance to those local authorities on the extent to which public sector procurement issues may arise in the event project finance is sourced from third parties in relation to Heat Network schemes. However, this guidance does not provide advice, or recommend any approach or decisions, specific to any particular project or circumstance, and local authorities must obtain their own professional advice in relation to any specific project, decisions or contracts. This guidance may not under any circumstance be relied on by any persons or organisations, and any such persons or organisations who rely on it do so at their own risk. BEIS excludes, to the fullest extent permitted by law, any liability where this guidance is relied on by persons or organisations.

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