CHESHIRE EAST COUNCIL

REPORT TO: CABINET

Date of Meeting:	20th September 2010
Report of:	David Wharton
Subject/Title:	Energy Procurement
Portfolio Holder:	Cllr Peter Mason

1.0 Report Summary

1.1 Cheshire East and Cheshire West & Chester collectively spend approx £12m per annum on energy (gas and electricity), approx £6m each annually. There are currently a number of joint contracts that were inherited from Cheshire County Council. These contracts are not due for renewal until 30/6/2011. However, we now need to decide the most appropriate method of procurement.

1.2 Traditionally many councils have utilised an energy third party organisation. However, the Office of Government and Commerce (OGC) Pan Government Energy Project (PGEP) recommends that one of the smartest ways for public sector organisations to buy energy is to use recommended frameworks through a Central Purchasing Body (CPB) that have aggregated volumes, can offer flexible purchasing and enable best practice risk management. It is no longer feasible or advisable for Councils to conduct individual energy tender exercises or utilise third party organisations whom are not deemed to be a ‘contracting authority’ under the UK Contract Procurement Regulations. Over 80% of local authorities are now using one of the OGC’s recommended solutions.

1.3 Procurement leads from Cheshire West and Chester and Cheshire East have collaborated and worked closely to review the procurement of energy and to determine the most appropriate procurement route and Energy partner going forward. An options appraisal of the OGC’s recommended panel of Central Purchasing Bodies has identified West Mercia Supplies (WMS) as the most appropriate purchasing body (See Section 10.7).

1.4 There has been internal stakeholder engagement and communication with an energy/officer working group in order to identify operational issues and recommend decisions impacting on all related budget holders.

1.5 It is preferable that contracts are entered into in September/October 2010 in order to allow for our volumes of energy to be included in the residual load that WMS will be going to market with sometime in

October/November 2010 and agreeing reference prices shortly after. There is a great deal of work involved in the transfer and implementation of a new provider in checking consumption figures and site data which will take many months once the contract has been signed.

1.6 An early forward purchase gives flexibility and the ability to secure competitive rates. To provide some context, Gas prices have increased by 40% since March 2010 and are still rising in a market currently with low demand.

1.7 More recently it has come to light that not all of the third party organisations are in fact trading as legal ‘central purchasing bodies’ (CPB’s), as they are private energy management companies. It is therefore considered that many local authorities are using these companies illegally so it is more imperative than ever that we move away from our current third party provider as soon as practicable.

1.8 The recommendations conclude that a contract for energy in its entirety is awarded using the WMS (West Mercia Supplies, Shrewsbury) framework which is one of the OGC’s recommended, flexible, risk managed solutions. WMS are a ‘not for profit’ public sector organisation.

2.0 Decision Requested

2.1 The decisions requested are:

i) Agreement to the use of the Procurement Method recommended i.e. a ‘fully flexible’ procurement.
ii) Agreement to appoint West Mercia Supplies (WMS) as the preferred provider.

3.0 Reasons for Recommendations

3.1 The reasons for the recommendations are that the council needs to secure energy and enter into energy contracts for the next few years as the current contracts are coming to an end (30/06/11). As well as needing to secure energy prices early, there is a great deal of work to do in order to transfer the requirements to a new provider. If a contract is not secured, there would be a significant cost to the council in paying ‘deemed rates’ and/or higher rates should there be a significant delay in entering into a new contract.

3.2 There is significant pressure on local authorities to ensure they aggregate their volumes and buy flexibly to secure best prices and the OGC’s framework of accredited public sector buying organisations is able to accommodate these requirements and they are also fully EU compliant.

3.3 The CPB's are able to apply the right knowledge, skills and experience and can buy energy on the authority's behalf, and who will aggregate volumes from other public sector organisations.

3.4 From the review undertaken, it is recommended that WMS offer the most appropriate energy solution for Cheshire East Council.

4.0 Wards Affected

4.1 All

5.0 Local Ward Members

5.1 All

6.0 Policy Implications including - Climate change
- Health

6.1 There are 'Green Energy' policy implications and decisions to be made. Cheshire East could, if desirable, determine a percentage and/or chose dedicated buildings associated with green energy procurement.

6.2 There is currently no accreditation and no longer any carbon reduction programme benefits associated with the purchase of green energy. There has therefore been a downturn in councils buying green energy as it is more expensive and there are no benefits as such other than making a statement of the councils' 'green' commitment.

6.3 Costs for green energy are currently £0.62p per kwh with brown energy costing £0.47p per kwh. The premium for procuring green energy is therefore £0.15p kwh.

6.4 If the Council wanted to purchase all green energy - based on current volumes and current costs, the extra cost would be approx **£55,538 pa.**

6.5 If the Council wanted to purchase a % of green energy - for example Half Hourly Establishments (>100kwh) the extra cost would be approx **£29,553 pa.**

6.6 Internal officers within the energy management team and the climate change steering group have been consulted regarding this issue along with John Nicholson (Strategic Director of Places) and Cllrs Menlove and Mason. All are in agreement that there are insufficient resources available to purchase green energy at this time.

7.0 Financial Implications (Authorised by the Borough Treasurer)

7.1 The Street Lighting and Asset Management budgets will be affected by the procurement of Energy. Also, individual Schools and various establishments' that have opted to use the Councils energy contract will see an impact on their budgets.

7.2 It has been agreed that schools will be communicated with shortly in order to gain their commitment of energy volumes to the new contract. Schools will be asked to inform the council by a specific date should they wish to opt out of the contract as, due to the trading element, schools opting out of the contract may have an adverse affect on the Council's position.

8.0 Legal Implications (Authorised by the Borough Solicitor)

8.1 If the Council purchases through WMS it will be deemed to have complied with the Public Contracts Regulations 2006 (the Regulations) to the extent that WMS has itself complied with Regulations. In order to ascertain the legality of the creation of the framework we look at the notice that was published in the Official Journal of the Economic Union (the OJEU Notice) at the start of the procurement. We have identified certain risks:

1 The existing electricity framework is for a total of five years. There is an original term of three years with two possible extensions of one year each. According to the Regulations frameworks cannot be let for more than 4 years except in 'exceptional circumstances'. The reason given in the OJEU Notice is 'to meet the commercial needs of the supply sector'. This may possibly be argued not to be an exceptional circumstance.

The notice in OJEU for the future framework indicates that the next framework will be in place from 1 October 2012. In the event that the framework was challenged for going beyond 4 years the courts could restrict the existing framework to four years and this could result in WMS being without a supply source for one year from 1 October 2011 to 30 September 2012.

No price range has been indicated in the OJEU notice in respect of the current framework and this is contrary to the guidance issued by EU Commission.

2 The Council will be purchasing on behalf of schools. Legal has seen a draft of the contract under which the Council would be purchasing electricity, however, during the presentation given by WMS at Westfields, it was made clear that the contract terms would be mainly 'take it or leave it', except for minor adjustments. It was further clarified that the contract would envisage a definite amount of energy during the term of the contract to enable WMS to place future orders. In case the demand is substantially reduced and WMS is left with excess energy, any ensuing loss would be the responsibility of the Council. Legal is approaching through Procurement to balance out this condition

There may possibly be some protocol asking the school to procure energy through the Council but the schools converting to Academies may be free to make their own independent energy procurement decisions. Thus, if they decide to change their energy source and demand with WMS is reduced; the eventual liability and consequential financial burden would vest in the Council. This risk could be mitigated by the Council entering into contracts with schools before signing the energy procurement contract and ensuring that the schools indemnify the Council in the event of a school changing its electricity source.

9.0 Risk Management

9.1 In utilising the OGC's framework of providers, prices can be controlled and monitored as volumes will be aggregated, purchased flexibly and risk managed to reduce exposure to higher energy prices.

9.2 Energy prices/budgets can be determined as the council will agree on capped 12 month (or period to be agreed) prices so if costs increase, the council/users will not automatically receive the increases and will be able to budget sufficiently.

9.3 If energy costs fall, prices will be monitored and controlled by the chosen energy provider along with OGC and WMS will be able to unlock/unset (e.g. sell back to the market) tranches of energy in order to sell and buy back the volumes of energy at a lower rate e.g. they will seek to capture trading gains from the weakening of energy prices as they occur.

9.4 In order to mitigate pricing risks for all parties, there is a proportion of utility costs that can be hedged/unhedged and it is these costs that need to be managed within a controlled framework that not only takes cognisance of the providers risk/governance strategy, but also the risk parameter of Cheshire East Council.

9.5 This hedging results from an agreed assignment of 'Capital at Risk' (CAR). Effectively, this means, an amount of money over and above the cost per unit that the council is to pay in order to allow the consortia/provider to trade our portfolio of gas/electricity to obtain the most competitive rates. The CAR fee has been identified as 5%.

9.6 Trading will provide for trading gains which will be monitored within year and formally calculated at the end of each financial year based on volumes. Gains will be split 50/50% between Cheshire East and the consortia.

9.7 Whilst the gain share of 50% could be perceived as low, it is important to remember that the opportunity to receive 50% of any trading gains has not been available in previous contracts. This provides added value over and above the ability to secure competitive market prices and the 50% gain share that WMS receive is part of their overall management/fee structure which pays for their energy expertise including bureau services/site works/dedicated web pages for schools to monitor their meter readings for instance.

9.8 The preferred provider has also given the option of them putting up with the CAR fee in return for a larger gain share e.g. 60/40%, but it is unlikely this option would benefit the council as much as paying the CAR fee and reaping 50% trading gains.

9.9 There are a number of options and decisions for the Council to agree on to capture the trading gains and re-distribute internally e.g. either centrally or service specific and/or to reduce costs of the management fee for the contract. An initial meeting has been held with internal service dept colleagues including finance and audit and there will be further internal discussions with finance/audit as to determine the best methods of paying the fee and re-distributing trading gains.

9.10 A future risk management option is also currently being investigated by OGC and its accredited energy providers e.g. buying energy directly from generators. This could help reduce long-term price risk, increase security of supply, and potentially stimulate additional sources of renewable energy. This initiative would not be available if the council does not use an OGC recommended solution.

10.0 Background and Options

10.1 Cheshire East and Cheshire West & Chester collectively spend approx £12m per annum on energy (gas and electricity). There are currently a number of joint contracts.

10.2 The current CE Electricity and Gas supply agreements are due to expire 30th June 2011. Both contracts are based on a fixed price model arranged in 2008, resulting in the Council being locked in to prices. The procurement was carried out by a private sector energy management organisation, UX-online. The Energy cost for CE in 2009/10 was around £6m.

10.3 Generally price of energy is determined by the day on which it is purchased. Traditionally it is purchased in same way as future stocks and shares. There are two main options:

- A one off tender where all the volume is bought on one day at one price for a period of between 12-36 months. This relies on picking the right day to tender. This option gives certainty of price but does not manage risk as the Council may be locked into a vastly inflated price for a prolonged period of time. This is our current method.

- Aggregate volume with a consortium and have the volume bought over the 6 months period preceding the start of the contract. This also gives certainty of price but allows a far greater management of risk. These consortia also manage day-to-day administration, which means they take on the responsibility of buying the energy and managing it.

10.4 Historically Cheshire East Council and many other public sector bodies have used a third party intermediatary (TPI) to act as their energy consultant. It has come to light that, in the main, these private commercial organisations are not deemed to be an appropriate 'contracting authority' under Regulation 3 of the UK Public Contract Regulation and therefore they are not fully EU compliant for local authorities to use in order to procure energy.

10.5 <u>OGC Pan Government Energy Project (PGEP)</u>

The Pan Government Energy Project (PGEP) recommends that all public sector organisations adopt aggregated, flexible and risk managed energy procurement. The project sponsored and chaired by the Ministry of Defence, has developed best practise recommendation for energy procurement, in consultation with customers and public sector buying organisations. The aims of the project are to review public sector energy usage and procurement and to deliver increased value for money through both cost and carbon savings; and to encourage a managed approach to energy procurement.

The energy market is extremely volatile. Prices can vary significantly on a daily basis with dramatic rises and falls over a 12 month period. Moves of plus or minus 20% in a single month are possible. Such market conditions make it difficult to manage budgets and control cost, therefore increasing the importance of adopting a best practise approach to energy procurement.

The three characteristics of best practise energy procurement identified by the project are:

1. Flexible procurement:
   - all costs that make up the delivered price of the energy are fully transparent
   - purchasing on the wholesale market allows the removal of certain costs e.g. purchasing is conducted in real time so there is no additional premium for keeping a price open to cover the risk of wholesale price movement whilst a decision is made
   - flexible purchasing allows adoption of a risk management strategy

2. Aggregation:
   - Larger portfolio's are more attractive to suppliers, and reduce supplier margins by as much as 3%

- Provides the minimum volumes that are required to trade on the wholesale market
- There is the potential to increase risk managed options

3. Risk Management:
   - Given the volatility in the market, it is crucial that any energy procurement is carried out in accordance with a defined risk managed strategy. Effective risk strategies are developed through knowledge and understanding of the energy markets, statistical analysis and an understanding of the customers need for budget certainty.

Flexible procurement can also extend to what is known as 'fully flexible' which provides for an element of trading e.g. where the energy prices increase, volumes of energy can be locked out/secured to ensure customers are protected from significant cost spikes. If however, the market starts to fall, the CPB can selectively unset (sell back volume) their position ready to re-purchase them at lower prices.

Both of the options of flexible and fully flexible provide access to the wholesale markets. However, the key differences between them are identified in the table below:

Delayed tranche (flexible) – Summary	**Fully flexible - Summary**
• Still some lack of budget certainty. • Often not purchasing more than12 months ahead as cannot change purchasing decision. • Prices based on a view of the market • Customer has to accept any price risk or limit involvement in price falls • Risk of reconciliation charges to customers if prices increase	• Budget certainty during each financial year, through a capped price mechanism • Positions locked/held (prices secured) out as prices increase • Ability to sell back to market when prices fall (unsetting tranches of volumes) • Ability to reduce prices to customers to reflect market falls • Offers price protection if prices increase • Offers lower prices if prices fall • Ability to purchase years in advance with minimal risk as position can be unset (sell back)

OGC have confirmed that there is now over 80% of public sector bodies using one of the recommended solutions.

10.6 <u>OGC's Accredited solutions – Options Appraisal</u>

Following discussions regarding CE and CW&C requirements, the following CPBs were specifically recommended for CE and CW&C to review:

- West Mercia Supplies (WMS)
- Yorkshire Purchasing Organisation (YPO)
- Eastern Shires Purchasing Organisation (ESPO)

The OGC do not advise that LAs benchmark and evaluate all CPB solutions as they have all been evaluated already and all offer value for money. It is the additional customer service elements and risk strategies which the authority should consider in order to best meet with their individual requirements.

All of the recommended CPBs have been through a stringent assessment to ensure that they can offer this type of contract. The assessments are conducted by PGEP representatives against criteria approved by the whole PGEP (refer also appendix 1).

The assessments are not comparative; it is a misconception that energy prices can be benchmarked to provide a league table based on which CPB is delivering the best price. Each PBO works to a risk strategy and looking at this, along with services provided, will help to select the most suitable.

Energy pricing is dependent on when the client instructs the consortium to start purchasing.

Research into the various CPB solutions identified that the main difference between these organisations is their business model and services offered to customers in respect of billing, energy management and information. These additional services are extremely important to Cheshire East as they will facilitate the adoption of the contract by schools and allow the Council to implement more energy efficient strategies.

WMS are well suited for our geographical area. Many of the other consortia prefer not to do business out of their area in respect of 'energy'. The other 2 consortia listed above, ESPO, YPO, unfortunately at this time cannot provide the full bureau services that CE and CW&C require. We could do a separate tender exercise for the bureau services with other organisations but this is far from ideal due to our time constraints and feasible issues with different providers talking to each other.

10.7 The WMS Solution

From the CPBs listed above, and the information and research undertaken, it is felt that the consortia/solution that best matches the Council's requirements e.g. full bureau services, access to real time market rates, geographically suited is West Mercia Supplies (WMS).

The on-costs/management fee is £50,000 per annum which includes the full energy consultancy provision e.g. bureau services/site work support etc as explained below. This fee can be built into the individual site bills. This fee is infact the only influencable spend. The difference therefore against an annual joint spend of £12m (£6m for CE) is insignificant but this annual spend can be influenced more so by choosing the right flexible solution.

The administrative costs have been reviewed although it is important to note that these costs merely represent the on-cost of procuring and managing the energy; they do not reflect the price paid for the energy as this will depend on the day / days on which the energy is purchased and the chosen flexible solution.

Their on-costs (management fee) are reasonable whilst offering the most holistic and comprehensive service, which also include the following benefits:

- Capped prices (maximum price paid) for the financial year.
- No reconciliation or surcharges due to market increases
- Ability to reduce prices if market price falls – (with WMS fully flexible offering) e.g. 50/50% profit sharing. (At the end of each year, there will be 50% of any trading gains recoverable by the council from WMS, so this in effect is further reducing the cost of energy and the annual management fee).
- A tailored approach to billing which includes important site information i.e. price, CO_2 consumption a well as readings and meter details. This is not offered by others.
- Full support is offered for site works, WMS will organise new meters, pipe work, etc. and ensure new installations move onto the contract at the discounted price, not out of contract prices. This is unique to WMS.
- Management information will be adapted to allow the Council to carry out independent analysis of the contract to assess performance, provide key performance indicators and data for the Carbon Reduction Commitment.
- WMS will also provide a web page for sites, specifically schools, to allow manual meter reads to be entered to present estimated bills. This will also provide useful consumption and emission data to each individual school.
- Many of the above benefits are exclusively offered by WMS.

WMS also offer a unique business model of energy purchasing that allows possible cashable gains at the end of each financial year. Should the Council choose WMS as its preferred consortia, it will have the option of exploring this model. Whilst other recommended solutions have the ability to provide 'flexible' trading options, WMS are currently the only consortia providing this solution.

The OGC are currently encouraging other CPBs to operate fully flexible contracts so that they can take advantage of market conditions and have greater opportunity to save public money.

Other CPBs are trialling 'fully flexible' solutions, however, WMS is the only CPB actively using 'sell back' in their strategy. Fully flexible contracts require a lot of market analysis, resource to transact multiple trades and a robust risk management strategy. CPBs conducting fully flexible procurement will also require their full member approval. WMS have very supportive members and they have taken a gradual journey into fully flexible trading since 2006. They have a dedicated, professional team of people to manage this solution in line with their Governance, Accountability, Risk and Reporting Strategy.

Previously the council has had to accept the tendered price on a certain day/year and hope that the cost is competitive. No previous contracts or any of other available accredited solutions have had a pricing mechanism where the council could mitigate its ongoing energy cost throughout the life of the contract in order to ensure best value is obtained.

The past performance of the WMS energy purchasing team provides confidence that they have the skills to improve significantly upon market prices as demonstrated below. OGC also monitor the performance of the recommended solutions and conduct independent compliance review meetings.

The graph below shows the winter 2009/10 price and demonstrates the dangers of entering into fixed price contracts.

The graph also shows WMS's performance against the market average. The winter 2009/10 gas price achieved by WMS is 37p/therm. This is (40%) below the market average for the purchasing window available.

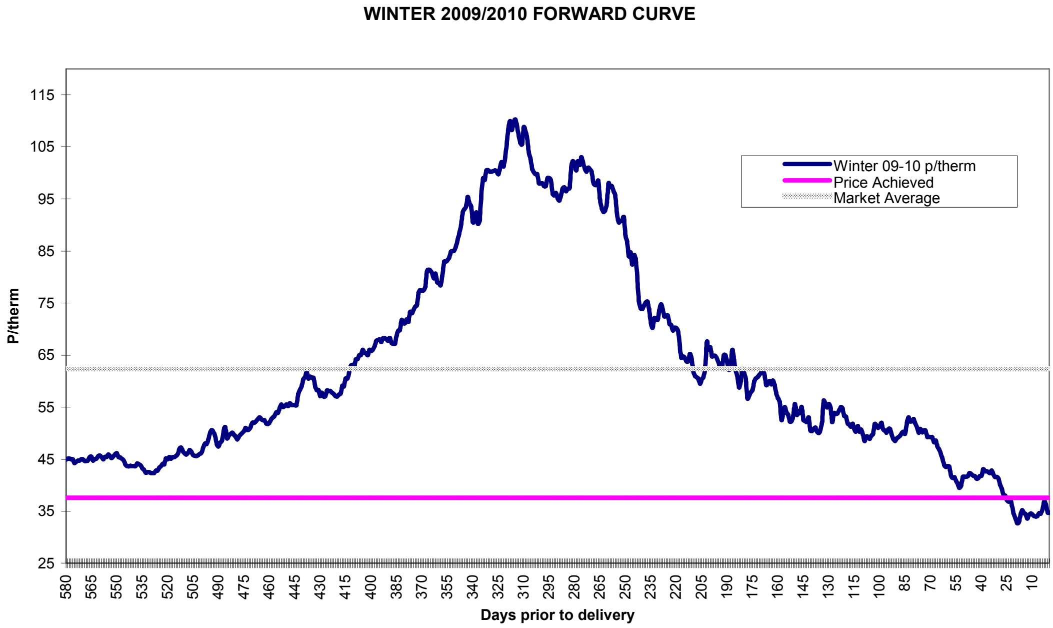
WMS currently have six local authorities and a number of other non profit making organisations on their portfolio. The total aggregated energy portfolio is currently as follows:

Volume:
Electricity: 250 GWh
Gas: 390 GWh

This equates to a combined energy turnovers of approx £31 million per annum.

The local authorities currently utilising WMS services for energy are:

- Shropshire Council
- Worcestershire County Council (some districts also)
- Herefordshire Council
- Telford & Wrekin Council
- Gloucestershire County Council
- Swindon Borough Council



Gloucestershire County Council (with an annual value of approx £7 million) joined the WMS fully flexible contract in October 09 and have reportedly made savings of up to £1 million in the first 6 months of operation. They have indicated they receive a more than satisfactory level of service from WMS and in particular, the schools have expressed their satisfaction in being able to speak to someone over the phone to resolve queries rather than getting an automated call centre.

Swindon Borough Council (with an annual value of approx £5 million) have also been utilising WMS services since October 09. They have also indicated that they have received an acceptable level of service and said that the transfer of sites were fairly smoothly transferred over, and that they are obtaining competitive rates and have a good team of people on hand at WMS to help resolve any issues. They are currently in the process of calculating savings and could only give an estimate figure of approx £150k, not including gain share at this stage.

Comparison of costs from previous costs to new costs under the WMS arrangement is very complex as it depends on what the authority in question was paying currently on their fixed price contract and dependant upon when they entered into contracts with WMS along with their pricing/rebate structure.

To estimate savings for Cheshire East is very difficult, however, a straight comparison of CE spend/gains which could have been made for the financial year 2009/10 if using the WMS contract (based on the original fixed price against current WMS prices) show a combined Electricity/Gas approx gain share of £300,000.

The management fee and CAR costs are not taken into account in the above estimations as the method of recouping these costs is still to be agreed.

All costs are transparent including energy price, pass through costs and management fee. Trading gains made from capturing falls in the energy market are also transparent. The management fee is a fixed annual fee for the duration of the contract, dependant on portfolio size and volumes. This fee can be included in the unit cost should the authority wish.

Currently the management costs with UX on-line are hidden within the cost for electricity so they are not very transparent and the costs for electricity/gas are fixed at the market rate from the day of originally tendering.

Normally a minimum of a three year contract is required to optimise purchasing decisions, and due to the issues with supply transfers.

10.8 Recommendation

It is important to note that this recommendation complies with the best practice guidance and recommendations from OGC who advise that improved prices can be achieved through adopting flexible, aggregated, risk managed energy procurement.

The OGC have an internal report including a flagging system which is submitted monthly which identifies and highlights all those authorities currently not using a recommended solution.

If a public sector body was to use a/another solution e.g. a commercial organisation or do their own tendering procedure, this would be going against the government recommendations.

Cheshire East is currently being flagged as 'amber' and it has been noted by the OGC Commercial Delivery manager that all endeavours are being made to move towards a compliant, recommended solution so they hope to flag us as green as soon as we have agreement to enter into a compliant solution.

West Mercia Supplies (WMS) are able to offer the full holistic service along with a unique commercial business model which will deliver the best market rates, which in turn will give confidence to Cheshire East Council and its stakeholders that it is securing value for money.

Upon the information researched and discussed above, it is recommended that a contract be awarded using WMS consortia as the preferred consortia which is one of the recommended OGC (PGEP) solutions.

The typical recommended contract sign-up period is an initial contract period of 3 years with a 12 month option to extend. In the future, with the use of Power Purchase Agreements, councils could sign up their volumes for much longer.

11.0 Overview of Year One and Term One Issues

11.1 The contract will be managed by Procurement, Energy Management and key internal stakeholders. Prices and CAR will be monitored in line with the agreed risk strategy.

12.0 Access to Information

The background papers relating to this report can be inspected by contacting the report writer:

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Appendix 1 - P AN GOV E R NMEN T E N E RGY P ROJ E C T

Best Practice Energy Procurement Criteria

For Public Sector Contracting Authorities only

1. Organisations will be assessed against whether they:

a. Use a contract/framework with the ability to deliver wholesale energy sourced independently from the supply agreement, including where appropriate Renewable Obligation Certificates and Levy Exempt Certificates (electricity only).

b. Use a contract/framework or contracting authority with transparent pricing mechanisms (i.e. those which allow visibility of raw energy price, all regulated charges, suppliers' margin, administration charges, and other supplier charges such as renewable energy premiums and ROC prices etc).

c. Use a contract/framework with the ability to fix volumes over a series of purchases in the wholesale market.

d. Apply a documented (robust) risk management strategy that supports the purchasing strategy, and meet recommended robust governance arrangements.

e. Use recommended tools and techniques for managing risk.

f. Apply the agreed savings methodology and sound performance measurement.

g. Ensure that the contract is OJEU compliant, meets the best practice criteria as agreed by the CCB and is enabled for other public sector users where appropriate.

h. Deliver quarterly management information as required for reporting.

i. Ensure that all contracts will be for volumes of >500GWh electricity, or > 150GWh for contracts covering 5 or more separate customer organisations. Ensure that gas volumes will be >20 Million therms, or >10 million therms for contracts covering 5 or more customer organisations.

j. Ensure that OJEU / Procurement has been approved through a process agreed by the CCB to ensure it is a collaborative arrangement and consistent with the overall category strategy.