



Cabinet
10 December 2018

Report from the Chief Finance Officer

Approval to proceed with the South Kilburn District Energy Network

Wards Affected:	Kilburn
Key or Non-Key Decision:	Key
Open or Part/Fully Exempt: <small>(If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)</small>	Open
No. of Appendices:	One <ul style="list-style-type: none"> • Appendix 1 – South Kilburn Energy Network Background
Background Papers:	N/A
Contact Officer(s): <small>(Name, Title, Contact Details)</small>	Catherine Arotsky Senior Energy and Sustainability Manager, Resources Email: Catherine.arotsky@brent.gov.uk Tel: 020 8937 2942

1.0 Purpose of the Report

1.1 To agree the most practical proposal for the delivery of the Council's obligations in respect of the South Kilburn District Energy Network (the SK DEN).

2.0 Recommendations

That Cabinet:

2.1 Approve the procurement a suitable partner to manage and operate the South Kilburn District Energy Network, on the basis of the Council forming a company with this partner for the reasons set out in the report.

2.2 Delegate to the Chief Finance Officer, in consultation with the Deputy Leader (as lead Member for Finance) authority to agree relevant pre-tender considerations for the procurement of a suitable partner and thereafter evaluate tenders on the basis of such pre-tender considerations.

2.3 Delegate to the Chief Finance Officer, in consultation with the Deputy Leader (as lead Member for Finance) authority to select a partner, to agree partnership terms, enter into a partnership agreement and take all steps

necessary to establish a company with the partner to manage and operate the South Kilburn District Energy Network.

- 2.4 Note that in the event that a suitable partner cannot be procured or it is not possible to agree partnership terms, the backstop arrangement is that the service will, at least initially, be managed and operated in house.

3.0 Detail

- 3.1 The regeneration of South Kilburn is a fifteen year programme that is approximately half way through. It aims to transform the area into a sustainable and mixed neighbourhood and create a real sense of place and belonging. This report outlines the proposal for the South Kilburn District Energy Network (the SK DEN). Appendix 1 contains further detailed technical background to the South Kilburn District Energy Network project.

- 3.2 In summary, as part of the original terms for the regeneration of South Kilburn, the GLA required that a district heat network was installed in accordance with the London Plan. In simple terms a district heat network is a communal heating scheme, where heat is generated centrally and residents receive their heat from that central facility, rather than having the option to contract with British Gas or another similar national supplier. It should be noted that developments of the scale of those in South Kilburn would usually, as a minimum, use communal heating, whereby there are central boilers for each block, rather than the proposal which allows for central boilers for numerous developments. In order to finance the heat network, contributions have been collected and will continue to be collected via Section 106 agreements.

- 3.3 Accordingly, the construction of the facility has been included within the contracts let in South Kilburn. The Energy Centre is in the basement of Gloucester & Durham which is currently in construction. The contract with Telford Homes (who are constructing Gloucester & Durham) requires that the Council confirm by January 2019 whether they will supply heat to Gloucester & Durham. The Energy Centre is contractually required to be handed to the Council (or their contractor) for fit out in December 2019 with (if agreed) a requirement to supply heat to the first phase of Gloucester & Durham by May 2020

- 3.4 The point at issue is not therefore whether the council should undertake this project, but only how best to undertake it. However, the question of why do it is an important one. As outlined, it is a requirement from the GLA, and it is understood that not installing a District Heat Network at South Kilburn will have a significant negative impact on our relationship with GLA for future developments. It is outlined in the London Plan, that district heat networks offer significant opportunities for reducing local and national emissions as a district heat network can optimise the heat generating equipment. Looking to the future, having a district heat network, offers a single point of change where new technologies offer reduced emissions and more efficient systems, so instead of having to change 260 boilers in a block of flats, it would be 2 boilers which could be changed for heat pumps or some other technology yet to be invented. This is one of many areas which the Council will have an opportunity to influence where they stay involved in the project. The techno-

economic model outlines the predicted carbon savings against a business as usual scenario illustrated in

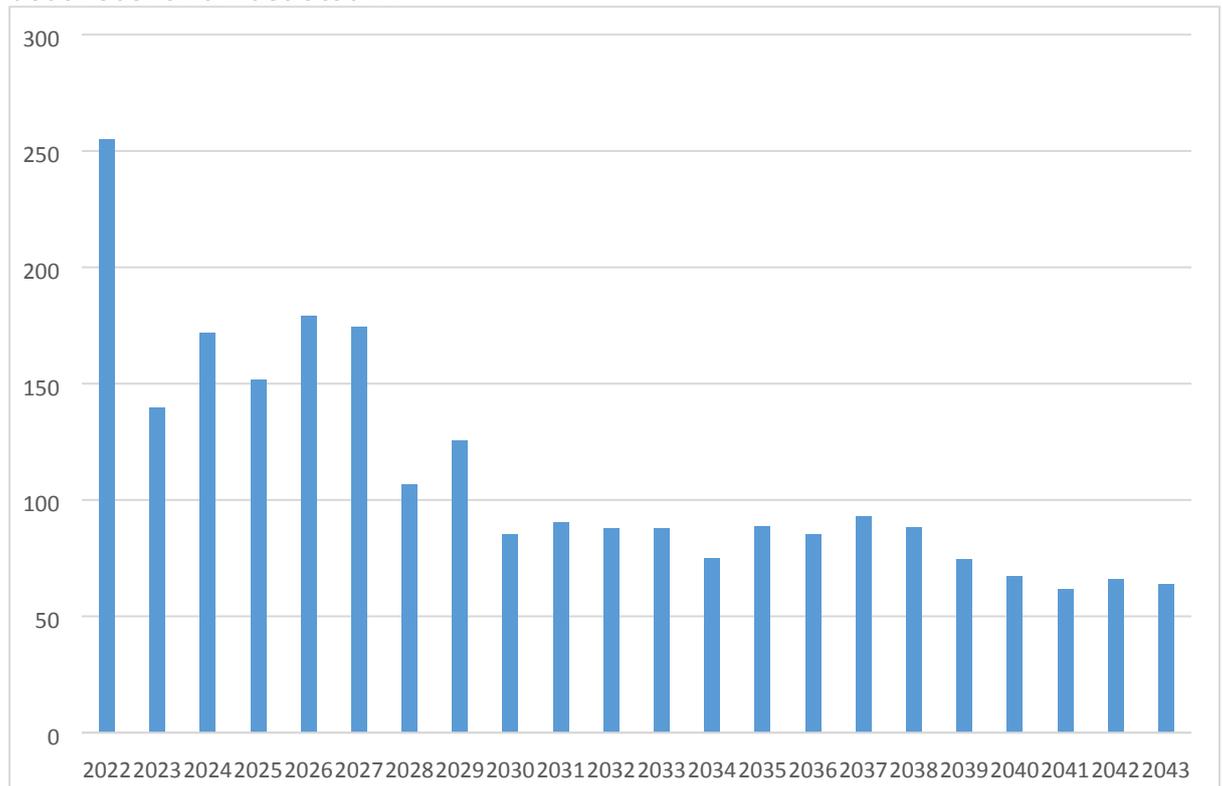


Figure 1.

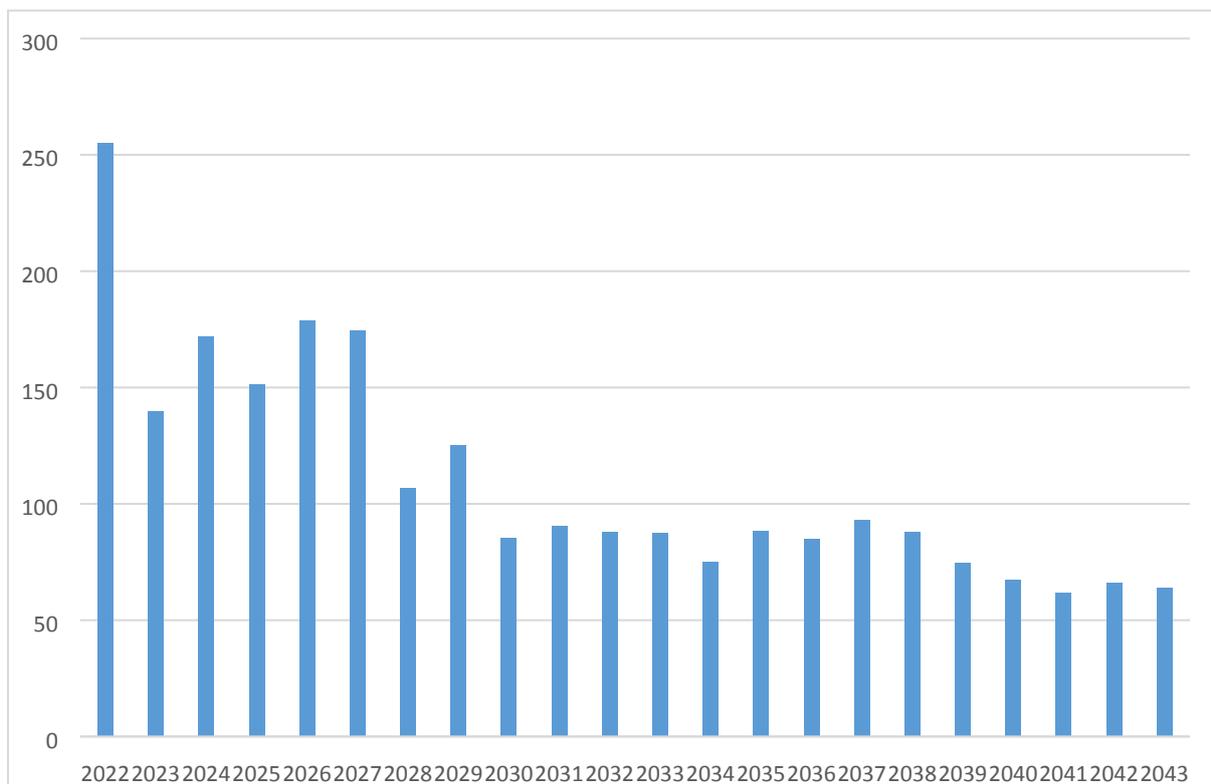


Figure 1: Graph of Carbon Savings against a Business as Usual Scenario

3.5 After a review of the options, as set out below, it is proposed that a partner will offer the most appropriate route to delivering the District Energy Network at South Kilburn. However, there are important arguments for and against each

of the main options, and setting up a new company (which is, narrowly, the recommended option) would be a complex undertaking.

- 3.6 As set out below, simply seeking to let a contract to manage and operate the centre has been tried before and failed to attract attention from the market. In fact, the previous procurement was on the basis of “design, build, manage and operate” which would ordinarily have been considered more attractive to the market. Letting a contract, if bidders could be found, to manage and operate a facility that someone else had designed and built is problematic and likely to lead to complicated issues in, for example, assigning liability for defects.
- 3.7 A partner avoids some of these issues, because from the point of view of the market the council would clearly be retaining a share of the latent defects risk and hence retaining an ongoing stake in the operation of the facility. Soft market testing tends to support this view, with three contractors responding positively to initial discussions.
- 3.8 There is also the potential for the company to become a profitable enterprise in its own right. Some councils – Enfield, Nottingham City and Bristol for example – have successfully set up such enterprises through commercial structures including similar partnering arrangements, so the potential clearly exists.
- 3.9 That said, each of the examples cited above operate at greater scale than the SK DEN, and hence the opportunity for any surpluses in the short-term is limited or should be regarded with considerable caution. However, the facility has been specified such that it can be expanded in scale relatively easily, using GLA and s106 funding. The physical facility is sufficiently large to heat more than just Gloucester & Durham, and so a partnering option offers the best chance of attracting a partner willing to invest in making the scheme work on the basis of possible future expansion and hence profit.
- 3.10 A partner offers opportunities for the Council to work with a specialist partner to ensure that the residents of South Kilburn are offered a competitive price for heat. It also offers opportunities for meeting objectives in terms of reductions in emissions and commissioning innovative solutions and in helping to minimise the risk of fuel poverty. Again, the concern is that a conventional procurement route will not attract such a partner, leaving the council alone to develop a project outside of its core competencies.
- 3.11 However, setting up a company with a partner organisation is of course complex, and there are no guarantees that a suitable partner can be found under this approach. A clear risk is that the council invests considerable time and effort in the necessary due diligence steps without achieving anything. Even if a company is established it adds to the complexity of the council’s operations, although perhaps this risk should not be overstated since the council already operates a wide range of partnerships with public and private sector bodies, and a single, relatively small, company of this type could be argued not to add greatly to this.
- 3.12 There are two main alternative approaches.
- 3.13 The Council could put the project back out to market for an Energy Services Company to operate. The council has put this proposal to market twice and

both times it has failed to attract any bids. As set out above, seeking to procure this on a simple “manage and operate” basis is arguably even less likely to be successful. In order to maximise the prospects of success of this route it is likely that all of the Section 106 money would have to be provided to the company, but there would be no opportunity for the Council to receive any income from the project or influence the price of heat to the residents.

- 3.14 If this approach did work it would result in the simplest solution for the council, but probably not the most financially attractive. There is also the risk that the council would have less control over future pricing than where they are a partner within the district energy company. This could therefore become an issue for residents in future years, as the contractor would seek presumably to maximise the price charged per unit in order to maximise their own profits.
- 3.15 On the basis that this approach is probably the least likely to work as intended (as there is little reason to expect the procurement to be successful except perhaps at a poor price) and will most restrict the council’s ability to control future prices for residents it is not recommended. A variant of this approach would be to procure a contractor via a council owned company. However, this does not significantly alter the balance of risks or likelihood of a successful procurement and so has not been considered further.
- 3.16 The other alternative would be for the council simply to operate the facility itself (either directly or via one of its companies). This is the fall-back position, in any event, as if the council accepts its existing obligations to deliver the service then if one of the market-based solutions above is adopted and is not successful then the council will have to operate the facility itself.
- 3.17 This approach is not without merit. It is simple, and offers more certainty over delivery, so that the focus can be on making the proposal work well rather than on procurement and complex corporate structures. It also gives the council maximum flexibility over the future pricing for residents, although the converse of this is that possible public pressure not to increase prices would then translate into extra net cost for the council.
- 3.18 The main difficulty is that the council lacks experience and capacity in managing such a facility. There is an energy team, which consists of just two people. They have some, but by no means all, of the relevant expertise in the sector, but certainly not the capacity to manage such a facility. Under this option the team would therefore need to be expanded, and the council would also need to invest in its IT facilities to develop billing systems and so on, whereas a private sector partner could easily simply paste in its existing billing system.
- 3.19 On balance, therefore, this is not the preferred option, although as noted above it is not without merit and is in any event the fall-back position.
- 3.20 A partnering arrangement is therefore, on balance, the recommended option in terms of ensuring best value to South Kilburn’s residents whilst also giving the better chance of achieving financial and sustainability objectives.
- 3.21 Assuming that the recommended approach is adopted it is important to note some key risks and how they will be mitigated, but in the context of noting that all of these risks are present to some extent regardless of the approach

adopted. A key risk is that the Council agrees in January 2019 to supply heat to Gloucester & Durham but then does not complete the contracts for the partnered district energy company in time to provide heat by May 2020. The mitigation for this risk is to ring fence the cost of interim boilers for Gloucester & Durham. This risk is further mitigated, as Telford Homes are procuring their own boilers as they require heat for commissioning before May 2020 and, as noted above, in house delivery remains available as a fall-back option.

- 3.22 As with any project of this nature there are a number of other risks which are managed through normal project management disciplines. Construction risk and delay are the key issues being managed here, but as these risks are largely the same regardless of the option chosen they are not very material to the immediate decision on commercial structures that is now requested.
- 3.23 Given the need to provide heat by May 2020, the procurement of a suitable partner and the negotiation of partnership arrangements need to be progressed with the minimum of delay. Officers are currently seeking advice from the GLA's DEEP Programme that will feed in to setting pre-tender considerations and therefore it is recommended to delegate to the Chief Finance Officer in consultation with the Deputy Leader (as Lead Member for Finance) authority to set pre-tender considerations. Again to minimise delay, delegated authority to the Chief Finance Officer in consultation with the Deputy Leader is recommended in order to conduct the procurement, select a partner, to agree partnership terms, enter into a partnership agreement and take all steps necessary to establish a company with the partner to manage and operate the SK DEN.

4.0 Financial Implications

- 4.1 As indicated in the report the district energy network project has undertaken soft market testing with potential contractors. A final detailed business plan has not yet been developed and this will very much depend on the expertise and vision of the selected delivery partner. Each party consulted so far has offered quite different options in terms of their opinions as to how best to manage such a network.
- 4.2 The estimated costs of the scheme, when it is constructed and fully operational, could be up to £10m, depending on the final solution. This is being financed solely by S106 contributions and the scheme is not reliant on any subsidy from the Council for the initial construction nor for any ongoing running costs. However, if the District Energy Network is not constructed for any reason there is a risk that these sums would need to be returned to developers.
- 4.3 As the capital costs to build the network will be 100% funded from external contributions it is not unreasonable to expect an ongoing income stream once operational, but it would not be prudent to budget for it at this early stage, especially as there is little certainty on costs. The final makeup of the scheme including any distribution of potential surpluses will be determined in conjunction with the chosen delivery partner.
- 4.4 The analysis has been undertaken based on a core network feeding:
- Gloucester & Durham
 - Hereford & Exeter
 - Peel

- Granville New Homes
- Carlton & Granville Centre.

Plus, an updated model to include the latest data from the above and Neville Winterleys Carlton.

- 4.5 There are many assumptions which will require further investigation. In particular, an assumption has been made as to the price of heat, however, the price of heat is set by the heat supplier and would be based on an analysis of costs and in accordance with the Heat Trust guidance. The current analysis is based on supply of bulk heat (i.e. one customer per building), however, the soft market testing suggested that ultimately all contractors in this market would at least want the opportunity to sell directly to households. It should also be noted, that there are a number of fixed costs irrelevant of the size of the network. Feedback from one of the potential partners indicated that they would set a heat price based on the total likely customers, which would mean that until those customers are connected, the heat network may not make a profit.
- 4.6 The contract for Gloucester & Durham has a requirement for the Council to confirm by January 2019 whether they will supply heat for the development on first occupation (May 2020). If the Council confirm that they will provide heat to Gloucester & Durham, the Council will receive an additional £400k capital receipt to the South Kilburn programme. It is also worth noting that there are simple technical options for meeting the Gloucester & Durham heat requirements even if the Energy Centre is not fully operational by the longstop date of May 2020.

5.0 Legal Implications

- 5.1 The procurement of a partner to manage and operate the SK DEN and the estimated value of this arrangement is such that the procurement will be subject to EU Procurement Regulations. It will also be classed as a High Value Contract under the Council's Contract Standing Orders and Financial Regulations.
- 5.2 For High Value Contracts, the Cabinet must approve pre-tender considerations (Standing Order 89) and the inviting of tenders (Standing Order 88). Whilst Recommendation 2.1 seeks authority to invite tenders, for the reasons detailed in paragraph 3.23, Recommendation 2.2 seeks delegated authority to the Chief Finance Officer in consultation Lead Member to approve pre-tender considerations.
- 5.3 Delegations to the Chief Finance Officer in consultation Lead Member are also sought to select the preferred partner, negotiate and enter into a partnership agreement and thereafter take all necessary steps leading to the formation of company with the partner. The justification for such delegations is to ensure the project can be progressed with the minimum of delay given the need to provide heat by May 2020.

6.0 Equality Implications

- 6.1 The project offers an opportunity to reduce fuel poverty by providing cost effective heat to vulnerable customers. Otherwise there are no equality implications.

7.0 Consultation with Ward Members and Stakeholders

7.1 Not specifically on the commercial structures, which are the subject of this report, but the South Kilburn project generally has been consulted upon extensively with ward members and the local community.

8.0 Human Resources/Property Implications (if appropriate)

8.1 Not applicable

Report sign off:

CONRAD HALL

Chief Finance Officer