

WEST DUNBARTONSHIRE COUNCIL**Report by Strategic Lead for Regeneration****Council: 24 June 2020**

Subject: Establishment of the Energy Supply Company (ESCo) for the West Dunbartonshire District Heating Network

1. Purpose

1.1 The report proposes the establishment of a Limited Liability Partnership as the Energy Services Company (ESCo) which will be responsible for the commercial operation and ongoing management of the Heat network. In addition, the report highlights the requirement for a further capital spend in the necessary infrastructure works of £1.058m and for a £1.0m working capital facility which will enable the ESCo to begin operations.

2. Recommendations

2.1 It is recommended that Council:

- Approve the establishment of “West Dunbartonshire Energy” as a Limited Liability Partnership (LLP) with Clydebank Property Company (CPC) as the other partner as described in the report;
- Agree the management structure of West Dunbartonshire Energy identified in Paragraphs 4.4 - 4.15 of this report;
- Agree that the Administration and Opposition groups be requested to nominate Members to the Strategic Management Board in accordance with the proposal in Paragraph 4.12 of this report;
- Agree to provide a further £1.058m capital funding to the project to enable the completion of the Energy Centre;
- Agree that the Council provides the ESCo with up to £1.0m working capital and allow the project to begin operations with appropriate funds through Council’s approved Treasury Strategy through temporary investment in the company; and
- Note that any future expansion plans that require capital financial support from the Council will be subject of future reports to Council.

3. Background

3.1 At the meeting of Council on the 23rd November 2016, Council approved the establishment of a District Heating Network at Queens Quay, Clydebank subject to funding and also subject to the project establishing that it would, as

a minimum, cover its costs whilst providing low carbon energy for decades to come.

- 3.2** Additionally Council approved the establishment of an Energy Supply Company (ESCO) to be wholly owned between the Council and a wholly owned nominee of the Council. It was noted that the likely legal form for the ESCo was a Limited Liability Partnership because of its perceived advantages in terms of the retention and application of any surpluses.
- 3.3** As has been subsequently reported, the Council was successful in obtaining Scottish Government Funding in the form of Low Carbon Infrastructure Transition Programme (LCITP) funding and has now largely built out the network.
- 3.4** Together with £6.1m from Scottish Government, the Council will have invested £14.358m in this project, if the recommendations are approved in the delivery of the necessary physical infrastructure to deliver low carbon /low cost heat as outlined in previous reports.
- 3.5** As noted in previous reports the management of the District Heat Network will be undertaken by the ESCo which will be responsible for the day to day management of the Energy Centre Operator and Network Operator contractors (both currently awarded to Vital Energi Utilities Limited) to ensure that the system operates within optimal parameters and that the supply of heat is maintained to customers.
- 3.6** It is envisaged that the proposed ESCo will require to perform the following primary roles:
- Commercial management of the District Heating business;
 - Approval of tariff structure, pricing and heat sale;
 - Performance monitoring of the Energy Centre Operator and Network Operator;
 - Procurement of metering and billing arrangements;
 - Customer relations;
 - Network development;
 - Regulatory compliance; and
 - Negotiation of terms for new customers.
- 3.7** At present the UK heat market is unregulated although this is under review. Accordingly, it is proposed that the ESCo operates under a voluntary quasi regulatory framework such as the Heat Trust Rules. This has already been agreed in terms of the arrangement with the Wheatley Group for heat offtake.
- 3.8** As a requirement of LCITP funding the governance structure will include community representation. This is incorporated into the proposals for the management structure of the ESCo. Discussions will take place between the ESCo and the Council Communities Team to identify a suitable representative to be invited onto the Strategic Board of the ESCo.

4. Main Issues

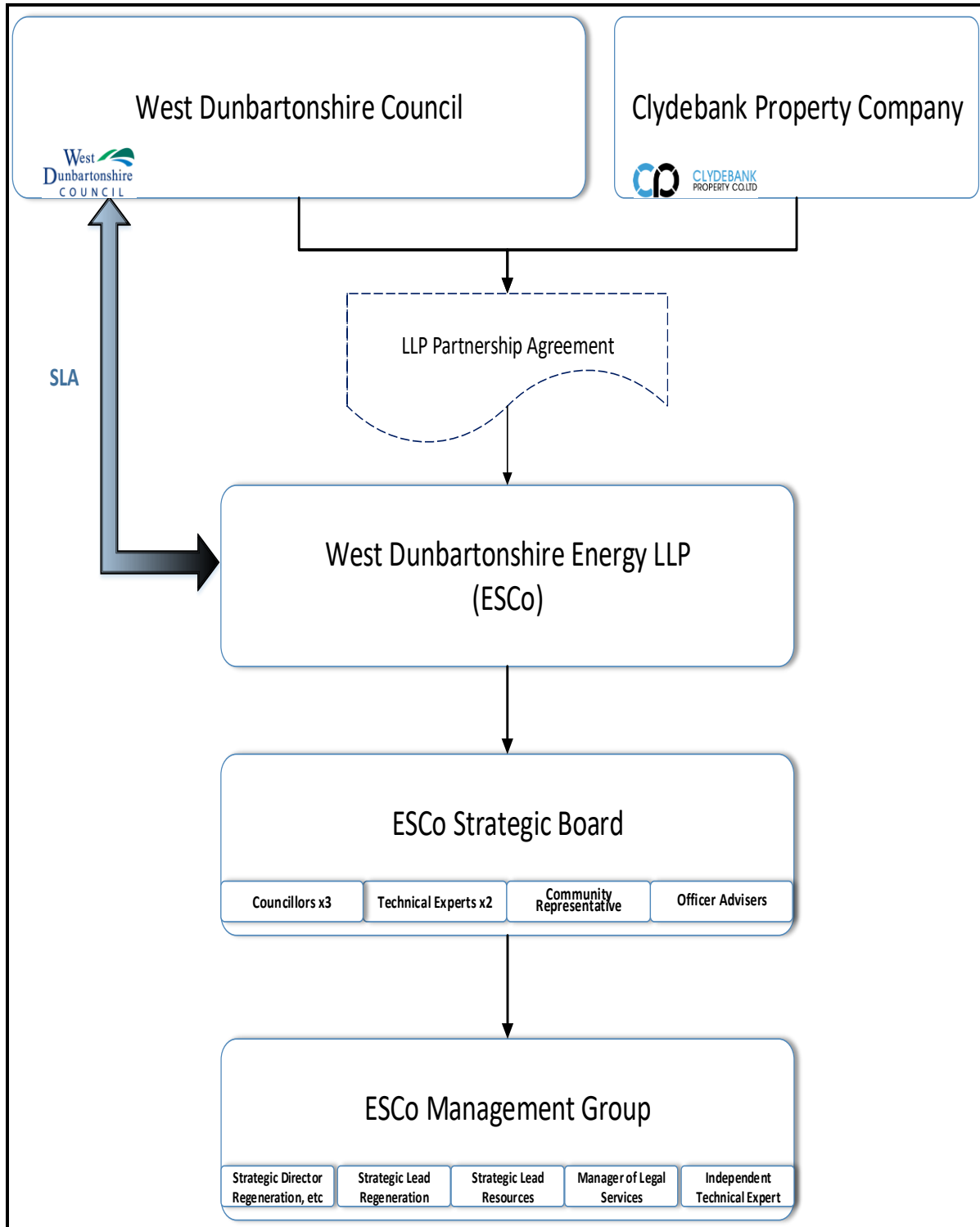
- 4.1** To date the priority has been to deliver the physical infrastructure necessary to allow the heat network to operate successfully. It is anticipated that all works will be completed by October 2020 at which point the system will be commissioned and become operational.
- 4.2** The Council has now established the final capital costs of the creation of the District Heating Network infrastructure, and revised assumptions around the cost of energy and the savings District Heating will be able to deliver in both carbon tax and energy tariffs, it can be demonstrated that the District Heating Network will, on its current projections (and under a range of scenarios), be on course to repay the Council's capital spend within 30 years.
- 4.3** The formation of a dedicated Energy Services Company (ESCo) was an integral part of the original District Heating Network Business Case and the project has now reached a stage where this entity can be properly established. It is proposed that ESCo will operate as an external organisation within the Council's ownership with its own Strategic Governance and Operational Management structure.
- 4.4** The proposed corporate structure for the ESCo has been considered at length and following finance, tax and legal advice, the following conclusions were reached:
- a) Trading entity - to provide customer confidence this should be Council owned and backed.
 - b) Governance - the governance requirements should meet the objectives defined during the LCITP bid, namely:
 - Composition - The ESCo should primarily comprise Council representation with specialist advisory provision.
 - Responsibility - The ESCo will require to ensure that the Energy Centre Operator and Network Operator achieve Key performance metrics
 - Transparency - Whilst Operating as a business and thus having to consider its commercial interests and confidentiality, the ESCo should strive for transparency and openness in its dealings with heat consumers
 - Community - Appropriate representation should be sought from community bodies having an interest in the successful operation of the District Heating Network.
 - c) The most appropriate corporate structure would be an LLP (Limited Liability Partnership) to provide a tax efficiency.

- d) Management of the ESCo will be provided by Council Officers supported by specialist advisers.
- 4.5** Subject to Companies House approval, it is proposed that the new entity would be called West Dunbartonshire Energy LLP.
- 4.6** As an LLP cannot be solely owned by one party, it is proposed that the minority share in the partnership be held by the Clydebank Property Company Limited – itself wholly owned by the Council.
- 4.7** It is proposed that the relevant rights as owner and participant in any profits etc. would initially be in the ratio of 99.9 to 0.1 with the Council owning a 99.9% interest in the LLP and thereby any surplus, and Clydebank Property Company owning the remaining 0.1%.
- 4.8** The Council would enter into a Service Level Agreement with the ESCo to cover the delivery of services to the ESCo by Council officers as the Council has with other arms length bodies.
- 4.9** The Council and Clydebank Property Company Limited would enter into an LLP Partnership Agreement to constitute the ESCo. This document would regulate the relationship between the partners and also contain the overarching rules for the operation of the LLP in much the same way that a Memorandum and Articles of Association regulate a Limited Company at a high level.
- 4.10** As the principal partner, the Council, will largely remain liable for the performance of the LLP's responsibilities and it is this covenant that has, to date, proven attractive to parties wishing to take heat from the District Heating Network.
- 4.11** All major investment decisions involving additional capital sums or amendments to the fundamental principles underlying the finance model would be taken at Partnership level (following appropriate decision making at Council / CPC level). Additionally, the Partners would meet at least annually formally to deal with Statutory Business.
- 4.12** The next level of management would be the ESCo Strategic Board. It is proposed that this Board would comprise 3 Elected Members and a Community Representative and would be supported by 2 Technical Experts and Council Officer Advisers. The Board will set strategic objectives within the boundary of the Business Plan and would provide scrutiny and performance monitoring for the ESCo management Group. The Board will be likely to meet twice a year – once to approve the Budget and annual accounts and once to monitor performance and spend against targets. Additional meetings to address extraordinary events would be scheduled as required, for example large scale extension of the network to other consumers outwith Queens Quay. Members may wish to note that where multiple nominations

have been invited to boards and organisations they have tended to follow, so far as possible, the makeup of the Council.

- 4.13** Day to day decision making for the ESCo and oversight of the officers managing the Energy Centre Operator and Network Operator contracts will be provided through the ESCo Management Group comprising the Strategic Director of Regeneration, Environment & Growth, The Strategic Lead – Regeneration, the Strategic Lead – Resources, the Manager of Legal Services and an external Independent Expert.
- 4.14** The necessary oversight of the Energy Centre Operator and the Network Operator will be undertaken by existing Council Officers with appropriate skill sets.
- 4.15** The ownership and management structure for the LLP will be in accordance with Figure 1 below.

Figure 1



4.16 Vital Energi Utilities Limited will provide necessary technical and expertise both in the delivery and operation of the Energy centre and in the maintenance of the Network, connection of new customers and the ongoing supply of heat. These contracts would be by the Council to the ESCo once

established with the Council retaining appropriate rights to allow it to assume direct control.

- 4.17** Using the financial modelling information gathered at the outset of the project, the original financial model has been updated to reflect the current position. A business plan is being developed for the ESCo to demonstrate its economic viability.
- 4.18** The projected capital costs as agreed at the October 2019 Council meeting was £19.4m which was calculated to cover the known project costs to completion at that time and as noted above this is projected to now be £20.458m.
- 4.19** The additional spend required since October 2019 can be attributed to the following areas;
- Muir Construction Claim for Delay - £233,000;
 - Water Ingress Insurance Claim - £146,000;
 - Site Enabling Works - £160,000;
 - Vital Energi Delay Claims in commencing works - £151,000;
 - Gaps in Scope - £168,000; and
 - Contingency - £200,000.
- 4.20** Council was made aware at the October 2019 meeting that officers were considering challenging certain claims made by Contractors of CRL. In conjunction with our advisors Turner and Townsend, we have identified a number of areas of costs incurred, including those identified above, that we are seeking further information and clarity from our development partners CRL. The Council will actively pursue all potential claims following receipt of final certificates from CRL in line with the processes within the Development Agreements. The outcome of these claims may reduce the final cost.
- 4.21** The projected costs to completion including a contingency of £200,000 are £20.458m against a current available budget of £19.4m. A further £1.058m is therefore required to conclude the contract including the contingency amount which will only be used if required. Costs will be mitigated at every opportunity and will be monitored closely as the fit out program draws to a close and the project nears completion.
- 4.22** As with most new businesses the ESCo will require some working capital in order to get up and running and, based on the financial modelling it is anticipated that the ESCo will require funds initially of up to £1.0m for this purpose. It is recommended that this would be provided by the Council via the Council's approved Treasury Strategy through a temporary investment in the company at the appropriate competitive interest rate.
- 4.23** As the ESCo expands its customer base as new housing is developed on the site etc. there will be further capital spend required to fund the costs of connection to the network. It is currently anticipated that such future costs will

be initially funded as capital spend by the Council and recovered through the ongoing lease payments by the ESCo. As these options are developed this will be considered by the ESCo Board and any such further capital spend would be sought through an appropriate report to Council.

- 4.24** It should be noted that the revised Financial model takes into account the need for additional Capital funds of £1.058m to complete the build element of the project and the need for a £1.0m working capital advance and remains in a cash positive position over the life of the project and the Council will see any capital spend paid back in 30 years.

5. People Implications

- 5.1** It is proposed that the continued monitoring of the Network Operator as part of the ESCo will be carried out by the Energy & Compliance Team within Corporate Asset Management. These duties will be predominately be carried out by the Energy, Compliance and Sustainability Team and be absorbed into the existing remit of the team.

6. Financial and Procurement Implications

- 6.1** It is estimated that the final capital cost of the build out of the project will be £20.458m. This sum comprises the infrastructure (the Energy Centre, the Pump Chamber and the Core Pipe Network) as well as the equipment situated within these structures, with all works under the build stage being completed by October 2020.

- 6.2** As advised above, the ESCo will also require initial working capital funding in it's early operation as customers start to come on-stream over time of £1.0m to permit operations to commence. It is recommended that this is provided from the Council in the form of investment up to this level as required by the ESCo under the Council's agreed Treasury Strategy.

- 6.3** The District Heating Network assets have been funded by the Council and grant from Scottish Government through the LCITP fund. It is proposed that the ESCo will be responsible for the commercial management of these assets through a lease under which the net revenues would be used to pay the Council payment which would be sufficient to recover the Council's capital spend together with interest.

- 6.4** In order to demonstrate the financial viability of the proposed ESCo and the capital spend made by the Council a revised finance model has been developed from the original finance model. The finance model looks at the detailed costs associated with the running and maintenance of the ESCo and projected income streams. The key elements includes:

- **Income from Heat Sales**

It is expected that the heat sales and revenue will be realised following connection of the heat network to each heat customer. The first heat

sales are expected to begin in October 2020. It is proposed that the heat sales will be based upon the heat charges tariff set out in the signed Customer Supply Agreements with each connected customer. The charges will be made up of:

- a) Variable charge which will multiply the metered consumption of heat recorded via a heat meter by the agreed heat rate (p/kWh); and
- b) Standing charge which will be charged monthly (£/month) and will cover the cost of plant operation and performance.

In terms of heat sales to social housing tenants on commencement of West Dunbartonshire Energy, the ESCo will benchmark pricing against the average cost of the lowest 5 suppliers of energy in Clydebank. The overall charge will take account of usage and lifecycle maintenance costs.

- **The Renewable Heat Incentive (RHI)**

The renewable heat incentive is a Government incentive paid to all registered renewable generation plant. This RHI payment will be claimed by the ESCo and it will receive a quarterly revenue equating to the amount of heat generated by the renewable heat source technology, the water source heat pump, and the RHI tariff applicable to it. The RHI payment is expected to be £29m over 20 years.

- **Connection Charges**

The third revenue stream to the ESCo will come from the connection charges. These are the charges that will be levied against all the customers connecting to the heat Network. The level of the connection charge will depend upon each customer and will largely equate to the avoided cost for building and installing their own heating plant and equipment. The connection charge is a one-off charge for the connection to the heat network.

- **Utility supply costs for input energy**

The electrical load for the heat pumps is significant and therefore the business is sensitive to fluctuations in the price of electricity. The use of heat storage will allow heat generation out with peak times and overnight when differential tariffs are available and lower night time electricity costs incentivise off peak use. The gas boilers primarily provide system resilience but could be used to support heat supply during peak times.

- **Operating and maintenance costs for Energy Centre and Heat Network**

The plant and equipment responsible for abstracting water from the River Clyde, producing heat and distributing heat to homes and businesses is complex and requires to be operated and maintained efficiently and effectively. The initial "Operate and Maintain" contract will be awarded to Vital Energi Utilities Limited, following the original tender

process but will be retendered at regular intervals during the life of the project.

- **Lifecycle replacement**

Provision has been made for future replacement of plant when it reaches the end of its useful life. The moving parts and motors in the heat pumps and throughout the network will be repaired and replaced as required under the maintenance regime.

- **Business rates and Insurance**

Annual allowances for Non-Domestic Rates and for Network Equipment and Buildings Insurance have been made. No account has yet been included for specific concessions or allowances that District Heat Networks may be entitled to claim under Non-Domestic Rates relief provisions. Annual insurance premiums for the network should be reviewed regularly to assess cost/risk relationship and to capture potential savings.

6.5 It is expected that revenue will build over the lifetime of the project which will enable the ESCo to make further investment in network expansion as commercial opportunities become apparent. The potential to add a connection to serve the Golden Jubilee Hospital is actively being assessed with the potential of further support from LCITP. Feasibility work is presently being carried out in order to assess the commercial impact on the ESCo's income streams and the benefits such a connection could bring to the hospital and the surrounding Dalmuir area. Any further proposed capital investment may require further Council spend to expand the asset in which case, will be subject to a future report to Council by the ESCo.

7. Risk Analysis

7.1 In relation to the ongoing operation of the District Heat Network business the following risks have been identified and summarised as follows.

- The Council continues to be at risk funding the build and implementation of the District Heating Network and will also be at additional risk in covering the commitments made by the ESCo to customers in guaranteeing access to Heat. The demand side from the local market and income generation potential indicates that the risk of the Council underwriting the costs and commitments of the ESCo is low and the financial model has been subject to significant scenario planning to seek to ensure the risk to the Council is minimised;
- Increasing energy costs for the ESCo could have a negative effect on the financial costs of running the network. Projected costs of electricity is indexed using the U.K. Department of Business, Energy and Industrial Strategy guidance on valuing energy use and greenhouse gas emissions and has been tested under a range of scenarios. In addition, under such

circumstances it is likely that the ESCo will also be able to increase charging tariffs;

- Covid-19 impact, whilst not critical to the overall financial model, creates a risk of a slowdown in the housing market and uptake of heat from new houses. It is anticipated that this will be a timing issue and the financial model indicates that such delays can be accommodated; and
- Insufficient demand – the base load of the network is heavily supported by public sector presence on Queens Quay and the expectation is that all new house development will be connected to the network.

7.2 The heat tariffs in all cases will be calculated with reference to a “business as usual” counterfactual where the cost for District Heating heat supply are referenced to the existing (gas fired) equivalent, taking into account full lifecycle costs and, where appropriate, carbon taxes. After 2025, new build housing installations of domestic gas fired boilers will be banned and therefore a new counterfactual approach will need to be developed. However, this is unlikely to have an adverse impact on revenues.

7.3 After 20 years of operation Renewable Heat Incentive (RHI), which only relates to heat supplied by water source heat pumps, will cease which may then require a future modification in the primary generation of heat supply. This will be subject to ongoing review as the deadline approaches and as new technology and approaches to generating green heat are developed.

8. Equalities Impact Assessment (EIA)

8.1 Following an initial screening there are no potential negative impacts identified in terms of equality and the proposed establishment of the ESCo does not change that position.

9. Environmental Sustainability

9.1 The district heat network at Queens Quay will make a valuable contribution to achieving Carbon reduction targets in West Dunbartonshire.

9.2 Connection of existing and new Council buildings including the proposed 1,200 planned homes would in the absence of the District Heating Network be provided by traditional gas fired boilers. The centralisation of generative capacity and the use of water source heat pumps as the primary source of heat being distributed in the network will represent potential carbon savings. The District Heating Network at Queens Quay only is expected to remove over 4,000 tonnes of carbon from the environment each year over the next 40 years.

9.3 The creation of the proposed ESCo will ensure that the primary aims and objectives for the heat network (carbon reduction and addressing fuel poverty) will be remain under the control of the Council.

9.4 Once established trading surpluses generated by the District Heat Network can be reinvested in network expansion to further share the benefits within the district and/or returned to owners.

9.5 As a Demonstrator project the District Heat Network at Queens Quay will provide an exemplar for other local authorities and, through an active dissemination strategy, allow acquired project knowledge to be shared widely to assist in achieving a net carbon zero target in Scotland.

10. Consultation

10.1 Regeneration, Corporate Asset Management, Legal, Finance and the Corporate Procurement Unit were consulted in the preparation of this report.

11. Strategic Assessment

11.1 At its meeting on 25 October 2017, the Council agreed that its five main strategic priorities for 2017 - 2022 are as follows:

- A Strong local economy and improved employment opportunities.
- Supported individuals, families and carers living independently and with dignity.
- Meaningful community engagement with active empowered and informed citizens who feel safe and engaged.
- Open, accountable and accessible local government.
- Efficient and effective frontline services that improve the everyday lives of residents.

This project delivers on the first, third fourth and fifth of these priorities.

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Date: 13 June 2020

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Appendix: None

Background Papers: Report to IRED Committee, 21 November 2018 entitled "Regeneration Fund Update"

Report to IRED Committee, 17 January 2018 entitled
“Regeneration Fund - Queens Quay District Heating
Network, Energy Centre land purchase”

Report to IRED Committee, 16 August 2017 entitled,
“Regeneration Fund- Project Proposals for Dumbarton
Waterfront Pathway and Balloch Village Square Projects”

Report to IRED Committee, 21 June 2017 entitled,
“Regeneration Fund Update”

Report to Council, 23 November 2016 entitled,
“District Heat Network for Queens Quay and Clydebank”

Report to IRED Committee, 14 September 2016 entitled,
“Regeneration Fund”

Report to IRED Committee, 16 March 2016 entitled,
“Regeneration Fund”

Equalities Impact Assessment Initial Screening Nov 2016

Wards Affected:

Clydebank Waterfront
Clydebank Central

