



Title of meeting: Cabinet

Date of meeting: 22nd March 2022

Subject: Portsmouth City Council - Gas Contract

Report by: James Hill - Director for Housing, Neighbourhood and Building Services

Author: Andrew Waggott, Head of Energy Services

Wards affected: All

Key decision: No

Full Council decision: No

1. Purpose of report

- 1.1 The Leader of the Council has requested that officers review Portsmouth City Council's gas contract that it holds with Gazprom Energy, in order to determine whether the contract can be terminated sooner than the contract end date.
- 1.2 This paper sets out the background, recommendations, key considerations and financial and legal risk of early termination of this contract.

2. Recommendations

It is recommended that the Cabinet:

- 2.1 Consider the content of the report and the option available to terminate the contract with Gazprom in compliance with the contract conditions referencing termination.
- 2.2 Determine if they wish to exercise the option to terminate the contract with Gazprom in compliance with the contract conditions referencing termination; and if so;
- 2.3 Instructs officers to serve notice to terminate the Gazprom contract effective from the 30 June 2022 to end the contract on the 30 September 2022
- 2.4 Delegates authority to the Director of Housing, Neighbourhoods and Building Services (in consultation with the Section 151 Officer and the City Solicitor) the



authority to terminate the contract with Gazprom in compliance with the contract conditions referencing termination.

- 2.5 Delegates authority to the Director of Housing, Neighbourhoods and Building Services (in consultation with the Section 151 Officer and the City Solicitor) to commence a procurement exercise to confirm a new supplier from the 1st October 2022; focussing on sourcing routes that allow for the lawful exclusion of Gazprom from bidding for the contract
- 2.6 Asks officers to continue to work with external partners from government, the Local Government Association (LGA), brokers and peer authorities to highlight issues and suggest remedies to the situation that this and other councils find themselves in with regards to Gazprom contracts
- 2.7 Request a paper be put to Cabinet at the next available meeting in the new municipal year to provide an update and to detail the total known costs of exiting the Gazprom contract ahead of its full term; reflecting market conditions and the costs which will only be clear at the point of formal termination
- 2.8 Note that the events in Ukraine and the conditions of the gas commodity market remain extremely fluid and note the availability of the Chief Executive's emergency powers to be used, should matters change materially in coming weeks
- 2.9 Following the full council meeting on the 15th March 2022, and the discussion on this matter arising from an emergency Members' question. The Leader is asked to write to the energy broker to ask that they waive their fees associated with this contract termination, or that they consider donating the fee to an appropriate charity supporting the crisis in the Ukraine

3. Background

3.1 Gazprom Energy

- 3.1.1 Gazprom Energy is the trading arm in the UK, Germany, France and the Netherlands of the Russian-listed parent company and is headquartered in Manchester. Gazprom is the largest energy supplier, by volume, to industrial and commercial companies in the UK, supplying around 22% of all gas to over 30,000 clients, including a number of local authorities and other public bodies^[1].
- 3.1.2 Since the commencement of the war in Ukraine, Gazprom's close links to the Russian state has led many local authorities (see section 3.3) and other organisations to cite their intention to end their supply agreements with them,

¹ <https://www.gazprom-energy.co.uk/blog/gazprom-energy-ranked-as-largest-non-domestic-gas-supplier-in-the-uk/#:~:text=Gazprom%20Energy%20ranked%20as%20largest%20non%2Ddomestic%20gas%20supplier%20in%20the%20UK&text=We%27re%20pleased%20to%20announce,Q2%202020%20market%20share%20report.>

although to date the Council is not aware of any public sector bodies who have formally terminated their agreements.

3.1.3 The UK's gas supply is largely comprised of domestic North Sea gas, imported Norwegian and liquified natural gas from the Middle East and the USA. Less than 5% of UK gas originates from Russia. However, gas is traded globally and the threat of reduced flows into Europe brought about by the war in Ukraine has sent huge shocks through the market; with wholesale gas over the past month, trading at as much as 1,200% higher than the same time last year.

3.2 The PCC-Gazprom Contract

3.2.1 The council entered into a 3-year supply contract with Gazprom Energy, commencing on the 1st October 2021 (end date 30th Sept 2024). Gazprom Energy won the contract via the council's third party intermediary (energy broker) through a competitive tender process. This contract is to supply 100% of the natural gas to council-operated buildings including communal heating in social housing properties, schools and tenanted buildings.

3.2.2 This is a flexible contract, allowing the Council to work with their brokers to make forward buying decisions. At the time of entering the contract, the Council estimated their spend on gas to be £1.8 million per annum or £5.4 million across the three-year term of the contract. Since this time, gas prices have risen in an unprecedented way, with huge volatility, particularly since the invasion of Ukraine.

3.2.3 Enquiries have been made as to the contractual arrangements to terminate the contract supply contract with Gazprom. The following information has been reviewed by the energy services team and in-house legal colleagues (see legal comments within this report), who have confirmed that the council can exit from the contract on the 12-month anniversary (i.e. 30th September 2022), subject to providing written confirmation before 30th June.

3.2.4 The council will be liable for a termination payment which will include (but will not be limited to) Gazprom's fees at approximately £45,000 per annum which would suggest the total cost brought about by this element of the charges would be circa £90,000 in total. This figure is unquantifiable as set out in further detail within the legal section of this report. In addition to any termination fee incurred as a result of service of notice an additional one-off fee of £16,875 would be payable to the broker.

3.2.5 Of larger financial concern is that the council has secured 50% of its gas for the October 2022 - March 2023 period. Since the time that this volume of gas was secured, prices have risen considerably, and to re-secure this gas will cost significantly more based on current market conditions. Should notice to terminate be served, it is at Gazprom's discretion as to if and when to sell back this gas to the market, however there is no detail in the contract as to when this trade would be made. Gas prices are extremely volatile at the current time, with the cost of the commodity, at times in the past month, almost double the previous historic high.

- 3.2.6 In informal discussions with Gazprom, they have indicated that the decision about when and at what price to sell off the forward-purchased gas is entirely and solely at their discretion. It is not known what percentage profit Gazprom would realise on these trades. It is also possible that, given the current political climate, if Gazprom were to try to sell the Council's forward-secured gas, that they might not find a buyer.
- 3.2.7 The 50% volume of gas that the Council has forward secured for the winter period 2022-23 was locked in at £997,111. In the worst-case scenario (i.e. no buyer was found for this gas) then the Council would be liable for this cost.
- 3.2.8 Gas is a global commodity, the price of which is subject to daily market conditions. As previously discussed, gas prices have been subject to historic volatility since the beginning of the war in Ukraine. At the time of writing, the 14th March 2022, to resecure the 50% winter 2022-23 volume would cost £ £1,301,965 (an increase of £304,853).
- 3.2.9 These costs are worked up on the basis of serving notice to terminate in accordance with the contract, which can be actioned from now until the 30th June. Serving notice would mean the council's gas would continue to be supplied by Gazprom until the 30th September 2022.
- 3.2.10 If a decision were taken to breach the contract conditions, effectively ending our supply contract immediately, then a more detailed analysis of the financial, legal, procurement and contractual implications would need to be undertaken urgently to understand the potential impact of this. In this eventuality, the Council understands that Gazprom would not release the supplies to a new supplier without the Council settling in full, any breach of contract fees determined by Gazprom and payment for any future secured volumes of gas.

3.3 Working with Peers

- 3.1.1 Council officers are working with the LGA and have participated in a forum at which councils discussed their contracts collaboratively and fed back to government officials.
- 3.3.2 The Cabinet Office are working on a Procurement Policy Notice (PPN) with other departments of central government. The note is due to be issued shortly and will provide guidance to public sector bodies. However, it was clear from the latest LGA organised call that responsibility and risk for decision making will remain with the public sector body concerned. The note will likely take the form of guidance rather than providing mandated direction.
- 3.3.3 The Leader of the Council has sent a response to the Secretary of State for the Department of Levelling Up, Housing and Communities (DLUHC) to request that support be given to ensure that the Council can leave the Gazprom contract without significant costs being incurred.

3.4 Re-Procuring the Gas Contract

- 3.4.1 It is essential that the gas contract be urgently reprocured as a parallel activity with serving notice to terminate with Gazprom. It is essential that the council has a supplier in place through whom they are able to hedge future purchases of gas, as without one they are exposed to an extremely volatile market.
- 3.4.2 The Council's brokers anticipate, using their electronic dynamic purchasing system (DPS), that a compliant procurement exercise can be undertaken in 6-8 weeks. Once in place, trades and hedges beyond October 2022 can be undertaken to insulate the Council from some market volatility.
- 3.4.3 The Council's broker, at time of writing, has not been able to de-list Gazprom as a supplier on their DPS. There is no legitimate way of excluding Gazprom from taking part in these tenders, so it cannot be ensured that they will not win a re-procured contract with the Council. This is an issue being faced by many of the established energy brokers.
- 3.4.4 At present, it is difficult to see how Gazprom can be legitimately suspended from any public procurement exercise. It is an issue faced by a number of the local authorities that the Council has been liaising with through the LGA. Some are actually in the position of entering into a brand-new contract with Gazprom on the 1st April 2022, with no legal way of proceeding.
- 3.4.5 For gas supply contracts the established market norm is for bid evaluation to be focused almost solely upon price which is reflected in the established framework agreement and dynamic purchasing system protocols which typically restrict assessment of non-commercial elements to no more than 30% of the evaluation weightings.
- 3.4.6 The PPN may provide further guidance on how evaluation mechanisms could be legally applied which may deter Gazprom from bidding but is unlikely to go as far as providing a means of lawful exclusion. In any procurement exercise that Gazprom cannot be lawfully excluded from they are likely to be highly competitive as they are likely to have surplus supplies which they may offer at significant discount.
- 3.4.7 If the council's broker is unable to lawfully exclude Gazprom from their own dynamic purchasing system and no legislation is passed which would prevent Gazprom taking part in future procurement processes the council's best option would be to investigate using a framework agreement which Gazprom are not party to and, unlike a dynamic purchasing system, is closed for further applications at the point it is legally established.

4. Reasons for recommendations



- 4.1 The recommendations enable PCC to exit from the Gazprom contract using the contractual mechanism. The delegations enable the relevant officers to proceed with the termination.
- 4.2 Given the conflict in Ukraine, there is an understandable desire to end the Gazprom contract in the shortest period of time possible, however it is important to ensure that in doing so, the Council does not allow Gazprom to achieve significantly higher profits than they would by seeing out the contract terms and conditions.
- 4.3 It is important to note that increased costs will be felt across all service areas, including schools, social housing, social care, tenanted buildings and leisure facilities.
- 4.4 It is important that the Council is not exposed to an un-hedged position for longer than absolutely necessary. Securing a new supplier will allow for a smooth take-over of the gas supplies when Gazprom ceases their supply to the Council's properties.
- 4.5 It is important to ensure that Gazprom are not in a position to win any future tenders of the Council's gas portfolio. At present, there does not seem a way of legally ensuring this, without either a) finding a framework without Gazprom on it or b) central government taking regulatory or legislative action to prevent Gazprom from trading.
- 4.6 At least thirty local authorities hold contracts with Gazprom, some with similar terms and structures to the Council's. There is value in working collectively to overcome issues and share learning on issues of energy buying, financial risk, legal and procurement.
- 4.7 The LGA has been successful in securing external legal advice regarding the Gazprom contracts, which may play an important role in determining the Council's course of action.
- 4.8 Central government action may ultimately prove to be the only way of securing a secure legal route out of the contract without paying large penalties: either through sanctions, suspension of the licence or a relevant statutory instrument.
- 4.9 The total cost the council may be liable for as a result of termination will only become apparent following issuing of the termination notice and legal cost negotiation commences. The costs contained within this paper are best estimates based on discussions with brokers, peers and Gazprom themselves. As previously noted, the gas commodity market is currently very volatile, and the full cost will only be known once new volumes of gas are secured by an alternative supplier for the inter 2022-23 period.
- 4.10 Given the current volatility in gas prices and trading conditions brought about by the war in Ukraine, it would be prudent to allow officers to make agile decisions, to the

financial and legal advantage of the Council, whilst not reneging on the commitment to terminate the contract with Gazprom.

- 4.11 Such a change in conditions could arise from a change in central government's stance on sanctions, the removal of Gazprom licence to supply energy or Gazprom entering administration.

5. Integrated impact assessment

- 5.1 See Appendix A of this report.

6. Legal implications

- 6.1 The Council entered into a contract with Gazprom Energy for the supply of gas from 1 October 2021 due to expire on 30 September 2024 the contract was awarded via the Council's broker through a competitive tender process.
- 6.2 Upon review of the contract, it has been confirmed that the Council can exit the existing contract on the 12-month anniversary (30 September 2022), subject to providing written confirmation before 30 June 2022.
- 6.3 If the Council elects to terminate early, in accordance with the contract terms, then the Council will have to pay a "*termination payment*", outlined in section 3.2.3 and 3.2.4 of this paper. Legal cannot comment or assess the quantum of such *termination payment* at this stage, as there are too many unknown factors. Negotiations as to costs will begin with the contractor via legal upon issuing of the notice.
- 6.4 If a decision is made to terminate the contract outside of its terms (prior to 30 September 2022) this would result in a breach of contract/wrongful termination and would result in liability for damages allowing Gazprom an entitlement to damages for breach of contract based on common law principles and will not be regulated or limited by the contract. Legal cannot comment or assess the potential quantum at this stage (due to this being based on common law statute) but it is highly likely to exceed the termination payment liability under the break clause.
- 6.5 Any procurement of an alternative gas supplier must be done in compliance with the Public Contract Regulations 2015 (PCRs 2015), most significantly Regulation 18 relating to the principles of equal treatment, transparency and proportionality. The PCRs 2015 would therefore prevent the exclusion of bidders based on nationality, such as Russia. In any event many Russian linked companies trade through UK incorporated group or subsidiary companies, as is the case with Gazprom Energy.
- 6.6 If the procurement of a new supplier is via a framework agreement then in order to ensure the Council is meeting its obligations under the PCRs 2015, awards of contracts must comply with the terms of the framework agreement in question.



- 6.7 Section 17 of the Local Government Act 1988 (LGA 1988) relates to '*exclusion of non-commercial considerations*', meaning that there are restrictions on what can be considered when dealing with public supply or works contracts.
- 6.8 Section 17(4)(c)(ii) of the LGA 1988 states that that one of the functions regulated by the section is "*in relation to a subsisting public supply or works contract with the authority - the termination of the contract*" - this is of relevance as it shows that terminating a contract, such as is the case here, is expressly one of the functions regulated by the section.
- 6.9 Section 17(5)(e) of the LGA 1988 states that one of the non-commercial matter(s) that cannot be considered by local authorities is "*the country or territory of origin of supplies to, or the location in any country or territory of the business activities or interests of, contractors*". It seems apparent that the contract with Gazprom and their relationship with Russia would fall within this category of non-commercial matters'.
- 6.10 As a result of section 17 there are limited ways to legally exclude Gazprom from the procurement process for UK public sector contracts without risk of challenge, this is unlikely to change unless legislation is passed to alter this position and remove the existing legislative barriers.
- 6.11 The Council has a duty of Best Value under section 3 of the Local Government Act 1999, which states the Council must "*make arrangements to secure continuous improvement in the way in which its functions are exercised, having regard to a combination of economy, efficiency and effectiveness.*" Cabinet is reminded that consideration must be given to this duty when reaching a decision on the recommendations in the report.
- 6.12 Currently the Russia (Sanctions) (EU Exit) (Amendment) Regulations 2022 do not reflect commercial relationships already entered into by Authorities and there is currently no specific trade restriction on purchasing gas from a Russian source. Continued investigation should be undertaken to monitor any further amendments and sanctions that could be of relevance.

7. Director of Finance's comments

- 7.1 The invasion of the Ukraine happened 10 days after the Councils budget was agreed on the 14th February 2022 and as a consequence there is no contingency built into the current budget to cover the impact of terminating the agreement with Gazprom. The Council would need to identify a funding source should they choose to terminate this contract. The exact scale of the financial impact of this decision as stated in the report is as yet unknown and neither is the remedial action to cover the financial impact.

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Signed by: James Hill - Director of Housing, Neighbourhood and Building Services

Appendices:

Appendix A - integrated impact assessment

Background list of documents: Section 100D of the Local Government Act 1972

The following documents disclose facts or matters, which have been relied upon to a material extent by the author in preparing this report:

Title of document	Location
N/A	

The recommendation(s) set out above were approved/ approved as amended/ deferred/ rejected by on

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Signed by: