



ANNEX 6: PROCUREMENT STRATEGY

Electricity North West Limited
Registered Office:
304 Bridgewater Place,
Birchwood Park,
Warrington,
Cheshire.
WA3 6XG.
Registered no: 2366949 (England)

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1. Executive Summary

The long term nature of operating an electricity distribution business lends itself to arranging procurement on a strategic sourcing basis, with a dedicated in-house team providing the continuity required by this approach and ensuring legal, market and service knowledge retention,

The key categories adopted within Electricity North West are:

Electrical Equipment

Long term framework agreements are put in place to guarantee formalised contractual coverage on over 85% of this expenditure Category. Detailed knowledge of the forward capital programme has been used to develop a Volume Banded Pricing Matrix. This mechanism enables suppliers to price volumes in a risk-free way, guaranteeing the optimum commercial offer. For key items where there is commonality of technical specification, we collaborate with other DNOs to consolidate volumes via the Selectus consortium. The greater economies of scale facilitated through this strategy have delivered significant savings.

Construction

A critical success factor in this category is the creation of an effective contracting strategy and formation of productive and mutually beneficial relationships with suppliers. For Electricity North West this is facilitated by placing a range of long term framework contracts to cover the main Secondary Networks works including Underground Networks, Overhead Lines, Substation Works and Minor Civils activities.

Whilst Tier 2 suppliers are used to execute the long term frameworks, Tier 3 suppliers have been proactively developed on some of the project specific challenges. This has delivered significant additional savings by reducing management charges and main contractor margins. The adoption of a more flexible approach to payment terms has been an important enabler in this initiative.

In the case of Grid and Primary projects, the works are of a more concentrated nature and a greater financial value. This type of activity lends itself to Project Specific Tendering in order to realise the additional commercial benefits that are available from suppliers' economies of scale.

The size of some of the Grid and Primary projects, coupled with the general construction market downturn, has allowed new potential suppliers to be introduced into areas of the UK market which were previously specialist areas with very few market players.

Business Services

One of the key areas of focus within the Business Services category is the reduction of back office transaction processing time. Tools, Equipment, PPE and Travel are all being transferred to Electronic Catalogue ordering to reduce administration and to provide improved management information.

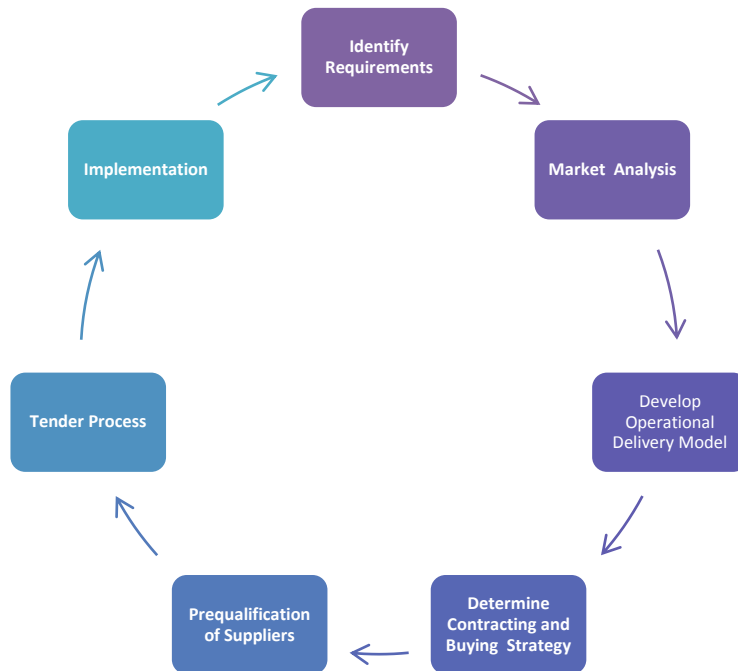
In the logistics area, a trial has been carried out involving the daily delivery of materials direct to site with the aim of reducing non-productive time for cable jointers and linesmen. Following the success of this trial, the resulting methodology has now been encompassed within the scope of works for the recently awarded Logistics Service Provider contract.

2. Category Approach

2.1 Overview of our procurement strategy

The long term nature of operating an electricity distribution business lends itself to arranging Procurement on a Strategic Sourcing basis, with a dedicated in-house team providing the continuity required by this approach and ensuring knowledge retention. By applying this strategic approach throughout an entire organisation the results are significantly greater than traditional, transactional based purchasing negotiations.

The Procurement process flowchart for an individual market initiative is illustrated in the diagram below.



Sourcing is initiated and closed out through the Achilles Vendor Database. For materials contracts, stock levels are managed by the Logistics service provider to match supply with business demand.

A Category Management structure underpins all procurement within Electricity North West. Typically, Senior and Junior Buyers work in pairs, taking full responsibility for a key area of expenditure.

This degree of specialisation facilitates the development of detailed product knowledge and market awareness and allows the Buying team to develop highly effective stakeholder relationships and a true understanding of future requirements. The development of a long term Category Plan ensures that each team is able to maintain the focus on Strategic initiatives as well as responding to the daily challenges of stakeholder and supplier demands.

Guiding principles have been developed for each category which ensure that each individual tender initiative is aligned to long term business objectives.

The close collaboration with suppliers encouraged by the Category approach enables wider business benefits to be unlocked through supplier innovation.

The key categories adopted within Electricity North West are listed below with the key features being documented in the following sections, further described below:

- Electrical Equipment
- Construction
- Business Services

2.2 Electrical Equipment Category

2.2.1 Delivery

Years of market consolidation and supplier closure, coupled with high barriers to entry for potential new entrants, have resulted in a relatively narrow field of suppliers competing in the various markets for Electricity Distribution Equipment in the UK. This combines with the ever-present risk of product quality issues and periodic operational bans to make supply chain continuity the top priority for this category to ensure minimal risk to customer services.

As a matter of course, a minimum of two suppliers are sought for the majority of strategic items, including all transformer, switchgear and cable types across the full voltage range. Long term framework agreements are put in place to guarantee formalised contractual coverage on over 85% of Category expenditure.

A formal Business Continuity Management process is used to establish the key areas of exposure across the product portfolio. In cases where only one contracted supplier is available, a formalised supplier health monitoring regime is initiated with the aim of triggering an early warning of potential issues. In parallel, the Buying team proactively work to establish alternative sources of supplier or to establish contingency solutions. Where this is not possible, levels of stock are set at increased levels to reduce service level risks.

In the case of non-core ancillary items a move to longer framework periods has been initiated with the aim of reducing costs associated with tendering, redesign, supplier transition and training.

2.2.2 Commercial Approach

In this category it is more difficult to influence price purely through competition, due to the consolidated nature of the supplier base. Buyer power is further restricted by the relatively low volumes available to Electricity North West as a single DNO. Furthermore, non-European suppliers tend to enter the European market only for larger projects such as 132kV switchgear renewals. These factors tend to combine to result in a “market price” for many products.

Notwithstanding these challenges, a number of initiatives have been implemented to enhance our commercial position in this category.

Whilst the traditional utility approach has been to enter in to contracts with no guarantee of volumes, Electricity North West have utilised the strong business knowledge engendered by the Category Management approach in order to amend this methodology. The detailed knowledge of the forward capital programme has been used to develop a Volume Banded Pricing Matrix which is utilised when going to market for key strategic items. This obtains supplier prices based on ranges of overall product volumes as well as the traditional “no-guarantee” price. By requesting all suppliers to price on this basis the Buyer gains an

informed view of how the market values the opportunity. This enables the Buyer to run various scenarios and to determine the optimum award strategy from a commercial and delivery risk perspective. Contract Prices are then set for the framework duration, based on the agreed volumes. In the event of lower, or higher, volumes being delivered, the rates will revert to the pricing appropriate to the delivered volumes as detailed in the matrix. This mechanism enables suppliers to price volumes in a risk-free way, guaranteeing the optimum commercial offer. The underlying principle is to build enough flexibility into the process to let the market decide the optimum solution, rather than narrowing down options by attempting to second-guess the market.

For key items where there is commonality of technical specification, we collaborate with other DNOs to consolidate volumes via the Selectus consortium. The greater economies of scale facilitated through this strategy have delivered additional savings in the case of cable purchase.

A number of key strategic items within this category feature a direct link to commodity price levels for metals and oil, with particular examples including cables, transformers and overhead conductor. Our strategic approach is to determine any key commodity issues in advance of going to market and to then specify the parameters to be included in a Contract Price Adjustment (CPA) formula. This builds in sufficient uniformity to enable all supplier returns to be compared on an equal footing. CPA formulae are always based on routinely published data which is available in the public domain.

Open ended Price Review clauses are avoided in supply contracts in order to mitigate the risk of uncontrolled price escalation. Prices are either fixed or, alternatively, linked to a publicly available index. Where possible, prices are fixed in Sterling, eliminating currency risk during the contract period. Award criteria are typically focused on Price, Technical Compliance, Delivery, Experience and Contract Management.

2.2.3 Innovation

Due to the low level of competitive forces within this category, the area with the greatest potential for positive impact is innovation. Whilst change is typically evolutionary rather than revolutionary due to the nature and age of the electricity supply industry, the long term benefit of cumulative marginal improvements should not be underestimated. The Procurement team play a key role in promoting and supporting new initiatives with examples including:

- Network Automation
- Innovation Funding Initiative projects
- Low Carbon Network Fund projects
- Standardised Design Solutions
- Containerised Substations

2.3 Construction Category

2.3.1 Delivery

This Category represents the largest single area of external expenditure for Electricity North West and constitutes a major part of the Capital Programme.

Whilst, historically, delivery has been through larger, management contractors, the current regulatory period marked a move to typically smaller suppliers with directly employed workforces possessing the required skill sets enabling greater control over delivery by

removing a layer of management that was not adding significant value to the overall offering.

A critical success factor in this category is the forming of productive and mutually beneficial relationships with suppliers. This is facilitated by placing a range of long term framework contracts to cover the main Secondary Networks areas including Underground Networks, Overhead Line, Substation Works and Minor Civils activities.

Formal periodic reviews enable progress to be closely monitored and timely resolution of issues. Where activities are of a more specialist nature, bespoke frameworks have been put in place to ensure that appropriately qualified and experienced suppliers are engaged.

2.3.2 Commercial Approach

The general downturn in the wider construction market coupled with the appeal of the continuity of work available within utility markets has resulted in a situation where the Construction category offers the greatest opportunity for commercial benefits. At present the market is highly competitive with relatively low entry barriers to suppliers from related fields. As base costs are largely labour related, there is significant scope for suppliers to offer attractive rates in order to secure work. Whilst this benefit is proactively sought and secured, it is also important to realise that the situation is now showing signs of reversing as the wider construction market recovers.

The majority of secondary networks activities are carried out using framework agreements that have been competitively tendered based on a range of activities spread across a wide geographical area.

In the case of Grid and Primary projects, the works are of a more concentrated nature and are of a greater financial value. This type of activity lends itself to Project Specific Tendering in order to realise the additional commercial benefits that are available due to the greater economies of scale. This strategy has been widely adopted on 33kV and 132kV cable laying and 132kV overhead line refurbishment projects. The key to success in this area is to establish long term visibility of the forward programme, enabling strategic and tactical decisions to be made with respect to which projects are suitable for tendering, including potential grouping strategies to generate further scale economies.

In the secondary networks arena, initiatives have been introduced to separate out suitable programmes from the secondary networks frameworks, enabling optimum pricing levels to be established from suitably qualified and incentivised suppliers. Examples of such opportunities include regional cut-out change programmes and groupings of 11kV Overhead Line Refurbishment projects.

Whilst Tier 2 suppliers are used to execute the long term frameworks, Tier 3 suppliers have been proactively developed on some of the project specific challenges. This has delivered significant additional savings by reducing management charges and main contractor margins. The adoption of a more flexible approach to payment terms has been an important enabler in this initiative.

An important principle underpinning the approach in this category is to maintain flexibility on the award of packages in order to enable the market to determine the optimum commercial option. The Bredbury 132kV switchgear replacement project is a particular example in which the tender has incorporated pricing options for both turnkey and package awards in order to avoid eliminating the optimum commercial option.

Award criteria are largely price based to maximise commercial benefit, with technical competency being the predominant selection criterion at the pre-qualification stage.

2.3.3 Innovation

The size of some of the Grid and Primary projects, coupled with the general construction market downturn has allowed new potential suppliers to be introduced into areas of the UK market which were previously specialist areas with very few market players. An example of this, delivering significant commercial benefits, was the award of a 132kV overhead line refurbishment project to an Irish contractor, Powerteam. Once introduced to the Electricity North West area, Powerteam were able to propose an alternative catenary system on a subsequent project, introducing competition to a type of project that had previously been a sole source situation.

After carrying out detailed root cause analysis of construction variations on G&P projects, the tender process was redesigned, moving the responsibility for Ground Conditions to the contractor – with very little cost but significant benefit in terms of minimisation of future variations.

2.4 Business Services Category

2.4.1 Delivery

This is the most diverse Procurement category, covering all indirect spend areas including Consultancy, Fleet, Field Support, Office Support, IT and Telecom, Facilities Management and Logistics.

With the exception of the more specialist technical consultancy areas, these sub-categories tend to be characterised by large numbers of available suppliers, leading to reasonably high levels of competition. A further aspect of the category is that supplier relationships tend to be particularly important as service scope often continues to evolve during a contract period. Driven largely by these two factors, typical delivery strategy is to award relatively long framework contracts to a single supplier. Award criteria will cover a wide range of delivery criteria as well as price.

Procurement strategy is to use outsourcing to facilitate peak lopping and to perform specialist tasks. Where a core activity with a steady requirement is being carried out by external suppliers, initiatives are put in place to bring the activities in-house. Examples include Transaction Processing, with attention having focused on Quantity Surveying and currently on Civil Design. This move encourages knowledge retention as well as cost control.

2.4.2 Commercial Approach

Within any business it is common for the Business Services category to feature a lower rate of framework compliance with expenditure spilling out across a wide range of ad-hoc suppliers due partly to the diverse range of services.

A key element of strategy within this category is to carry out monthly spend monitoring to assess framework coverage within each expenditure area. Exceptions are analysed and addressed either through stakeholder education, or initiating new frameworks, where appropriate, to ensure that business is conducted on clear commercial terms.

Increased control of purchasing presents a further opportunity for commercial improvement. All new frameworks feature provision of detailed management information designed to facilitate identification of variances in demand on an individual or regional basis for subsequent action. In parallel with this process, a review of all routine spend areas, such as Tools, Personal Protective Equipment and Stationery, is being carried out with a clear aim to seek HSE Compliance, control and visibility whilst reducing expenditure.

The Selectus purchasing consortium is utilised to maximise buying power in areas of specification commonality. An excellent example is in framework contracts for purchase of commercial vehicles and company cars, where Electricity North West combine volumes with Northern Power Grid, Scottish Power, United Utilities, Scottish Water and Northumbrian Water to secure best value from vehicle manufacturers.

2.4.3 Innovation

One of the key areas of focus within the Business Services category is the reduction of back office transaction processing time for Electricity North West. Tools, Equipment, PPE and Travel are all being transferred to Electronic Catalogue ordering, to reduce administration and to provide improved management information. The adoption of electronic ordering also makes it easy to implement and control product rationalisation through the use of approved lists.

Management Information is used to great effect in the fuel category where weekly information is circulated regarding cheapest pump prices for each geographical area, followed by exception reports featuring examples of operatives not following this guidance.

In the logistics area, a trial has been carried out involving the daily delivery of materials direct to site with the aim of reducing non-productive time for cable jointers and linesmen. Following the success of this trial, the resulting methodology has now been encompassed within the scope of works for the recently awarded Logistics Service Provider contract.

3. Performance Initiatives

A number of generic initiatives have been implemented across all of the Procurement categories targeting improved performance and uniformity of process.

A structured Governance process ensures alignment through a hierarchy of levels starting with an overarching Procurement Strategy and passing through Category Plans, Monthly Category Reviews and individual Tender Strategies. Stakeholder communication is a particular strength utilising weekly updates of all on-going tenders, regular category newsletters and Project Specific briefing slides.

Staff training has been a major drive, with all Buyers being put through the Achilles Academy modular course to ensure that the whole team have a common level of proficiency with regard to the EU Procurement legislation. Further training programmes include Contract Structure and Numerical Analysis with the aim being to establish standardisation of approach.

Process rationalisation has been focussed on implementing a uniform standard for Tender Files, facilitating easy handover between Buyers if required. Now that filing has been standardised this has improved efficiency through the elimination of paper records.

4. Sustainable Procurement

Typically, suppliers for larger contracts and regular requirements are sourced from the Achilles Vendor Database. This mitigates supply chain risk by ensuring that potential suppliers have appropriate controls in place with regard to Quality, Health & Safety, and Corporate and Social Responsibility, including Environmental Considerations and Carbon Footprint.

Supply chain analysis has been carried out at product level, mapping the potential for non-compliance with Environmental and Social standards, against the business criticality of that product group. This process facilitates the establishment of priorities for action across the categories, enabling the incorporation of product-specific sustainability considerations within the tender process. Examples include:

- the reuse of packaging across the Electrical Equipment category,
- use of timber from sustainable sources for wood poles,
- assessment of suppliers' approach to labour standards and welfare on the workwear tender, and
- the agreement of Primary Transformer manufacturers to utilise reprocessed insulating oil from the Electricity North West network when supplying new units.

Whole life costing is routinely utilised within the tender assessment process for electrical equipment, encouraging a wider perspective on costs including sustainability aspects.

Robustness of the Electricity North West supply chain is proactively managed via a programme of monthly Business Continuity Management meetings. These establish a Red / Amber / Green rating for each product area, based on the number of contracted suppliers, level of expenditure, criticality of product and level of supplier performance. Action plans are in place within each category to address areas where contractual coverage or supplier performance can be improved. In addition, a process of financial monitoring is in place for all key suppliers in order to provide an early warning of potential issues.

Supplier diversity is encouraged, including the provision of opportunities for SMEs and the stimulation of local economic growth, within the bounds of the EU Procurement Legislation. Strategies for working with SMEs include agreeing shorter payment terms where appropriate, assisting in the development of operational staff and identification of growth opportunities for existing suppliers. In 2012, 505 North West based suppliers formed a significant proportion of the total supplier base of 1250, receiving £52m of orders from a total of £200m. Furthermore, many of the suppliers whose head offices are outside of the region still deliver services through North West based staff, creating local employment opportunities.

5. Relationship to Delivery Strategy

The delivery model strategy has been targeted to support our proposals for the RIIO-ED1 period. In particular the developments we have put in place over recent years have provided a firm and robust platform on which to build further improvements in customer service, robust delivery capacity and improving delivery efficiency.

The strategy has focussed on key areas of customer service and sought to achieve significant improvements through delivery of investment and improved field delivery performance. Where customer service is of primary importance we have focussed our own

direct workforce on the activity, providing improved speed of service and direct control of reactive works. This will in particular provide improved performance in the resolution of supply interruptions.

The volumes of work required for the RIIO-ED1 period have been identified across all aspects of delivery and the resources required for delivery of the identified volumes have been reviewed. The most appropriate vehicle for delivery, direct labour or contractor, has then been reviewed bearing in mind service levels, volumes of work and costs, and the optimum model at this time confirmed and is to be implemented through the run up to RIIO-ED1, if not already in place. This model is being co-ordinated with the workforce renewal programme to deliver an optimised resource structure. The intention is to successfully combine the benefits of having both a direct labour organisation and contractor resource whilst minimising any associated drawbacks with these same models. In so doing we are applying the most appropriate delivery method to activities line-by-line to achieve a robust and efficient delivery model.

In addressing the RIIO-ED1 programme of work we have sought to achieve high levels of efficiency in the delivery programme. Our preparation work has included actively seeking to identify upper quartile levels of efficiency across the whole span of delivery requirements. We have then sought to achieve upper quartile cost performance from a total cost perspective across the breadth of our RIIO-ED1 proposals. The level of detail considered has been set out at individual fault types and individual Ofgem defined capital programme unit rates and their sub categories. This has been a fundamental review of the programme and has resulted in the building of a focussed and clear delivery structure. This has required some modifications to our operational structure, some of which have already been implemented and further changes are planned as we move towards and into RIIO-ED1. These changes have facilitated a very competitive proposal to be submitted from a delivery cost perspective and continual focus on output delivery, cost performance and monitoring from our delivery team.

In reviewing our contractor delivery structure moving into DPCR5 we moved away from large partnering style contractor contracts, which were shared with United Utilities. We reviewed the works we require and moved to Tier 2 delivery contractors who had the capability to deliver the works largely with their own resources within their areas of business expertise. This movement resulted in a small increase in the number of contractors being employed in delivery; however it has further reduced the levels of contractor margin and the associated overhead costs incurred.

The change also further reduced the management chain between with the contractor field force, improving the speed of management control in place. The contract structure was designed to reflect best practice available in the market with key frameworks for excavation and lay, overhead line and civil works being put in place. Major projects have been procured separately from the market and have continued to provide additional efficient delivery resource to the business. We may look to implement a Rising Lateral Mains framework contract in due course, following clarity of volumes and programmes of work, if we consider this will offer commercial or service level benefits.

This innovative and simple structure has been very successful in delivering reduced contractor costs and in providing resource to the business. We therefore have proposed to continue this delivery structure into RIIO-ED1. To continue to develop our capability and efficiency we are seeking to further improve the delivery options by improving the efficiency of the overall work force, both the direct labour and the contractor resource, their co-ordination and focus through further improvements.

The contracting strategy and structure is shown on the graphic below, including the transition from major framework suppliers to elemental activity frameworks. We have indicated where existing contractors are in place and where this arrangement may be extended or replaced by other contractors where we consider improved service or lower costs may be obtainable. The graphic also indicates where we will seek to tender contracts for future works within RIIO – ED1. These replacement processes are intended to be staggered through the programme period to allow the Procurement Team resources to address them individually, minimising team resource levels needed and allowing team focus on the services being sought.

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Programme Manager	United Utilities			Electricity North West														
Contractor Delivery Manager	Framework Contractors			Electricity North West														
Excavate and Lay Works		Contract 1	Contract 1		Extension of existing or replacement contractor		Tender Contract Award Process											
			Contract 2	Contract 2	Extension or Replacement of existing Contractor	Tender Contract Award Process												
				Contract 3	Extension or Replacement of existing Contractor	Tender Contract Award Process												
			Direct Labour Delivery															
Overhead Line Works			Contract 1		Extension of existing or replacement contractor		Tender Contract Award Process											
			Contract 2	Contract 2	Extension or replacement of existing contractor	Tender Contract Award Process												
				Contract 3	Extension or replacement of existing contractor	Tender Contract Award Process												
			Direct Labour Delivery															
Plant Works			Contract 1		Extension of existing or replacement contractor		Tender Contract Award Process											
				Contract 2		Extension of existing or replacement of contractor	Tender Contract Award Process											
			Direct Labour Delivery															
Civil Works			Contract 1		Extension of existing or replacement contractor		Tender Contract Award Process											
Generator Works			Contract 1		Extension of existing or replacement contractor		Tender Contract Award Process											
			Direct Labour Delivery															

In calculating detailed activity unit cost rates we have considered the volumes and selected the best programme delivery methods. ‘Bottom up’ detailed pricing of relevant activities has been undertaken and includes consideration of all the following cost elements:

- Study of typical site requirements.
- Value management review of activity
- Review of specific material required.

In the detailed calculation we have then included for the following aspects of direct costs:

- Labour costs
- Contractor Delivery costs
- Electrical Material costs
- Electrical Plant costs
- Construction Materials costs
- Operational activity costs

We have not allowed the introduction of permitting arrangements and other costs associated with recent or impending implementation of the Traffic Management Act to affect contractor rates.

Where suppliers or contractors are the selected delivery resource we have sought to ensure we are using market tested supplier and contractor costs within our calculations. Across the breadth of our proposals our Procurement teams have worked, over recent years and in the preparation of our RIIO-ED1 plan, to ensure all major spend areas are competitively tendered on a regular basis and in line with European Procurement legislation. For network related activities, covering both construction activities and materials, over 95% of expenditure is procured through long term, market tested frameworks or project-specific tendering. The following table documents the higher value contracts, illustrating that our current contractual terms provide coverage into the RIIO-ED1 period. These costs are included within our proposals at the market rates established.

Category	Contract	Annual Value (£m)	2013	2014	RIIO ED1							
					2015	2016	2017	2018	2019	2020	2021	2022
Construction	XD5 Constuction Frameworks	60.0	4	5	E	E	E	E	E	1	2	3
	Project Tendering	28.0	Individually Tendered									
Electrical Equipment	Cable (LV, 11 & 33kV)	12.0	3	E	E	1	2	3	E	E	1	2
	11kV Switchgear	3.3	1	2	3	E	E	1	2	3	E	E
	Cable (132kV)	2.0	1	2	3	E	E	1	2	3	E	E
	HV Automation Contracts	2.0	1	2	3	E	E	1	2	3	E	E
	Distribution Transformers	1.9	3	E	E	1	2	3	E	E	1	1
	Primary Transformers	1.7	2	3	E	E	1	2	3	E	E	1

Key: Current contractual coverage
 Forthcoming framework period

Examples in which our procurement approach has generated clear commercial advantages include the following:

Bredbury 132kV Switchgear Renewal – Market stimulation to encourage new entrants, together with optimisation of work packaging options has generated a commercial benefit £4m (30%) when compared to the traditional sourcing route.

Distribution Switchgear – Use of volume banded pricing together with optimisation of product allocation within a dual sourced contract delivered annual savings of £200k (14%), as well as enhancing supply chain resilience.