Recommendation 78: Include the supply of basic energy as an exemption under FAR 5.202.

Problem

The price of natural gas and electricity (i.e., basic energy) moves on a *spot market*, which means the price fluctuates so much that it is traded in 1-minute intervals.[1] The majority of basic energy bought in government as a commodity is awarded within 3 hours of receiving price proposals, otherwise offerors have the right to withdraw their price.[2] These practices are customary in the marketplace due to the by-the-minute-interval at which basic energy is traded. FAR 5.303 does not offer an exception precluding this fluctuating commodity *from announcement of contract awards* (also known as *public announcement*), as it does for other commodities with price instability (i.e., FAR 5.202, Exceptions Perishable Subsistence Supplies), for which a delay in award is unreasonable. The requirement at FAR 5.303, Announcement of Contract Awards, triggers an unnecessary contract award delay from the time the government has received offers, to the time it is authorized to notify the potential awardee, thus resulting in either: (a) overinflated prices to cover an unnecessary risk factor of price volatility; or (b) during exchanges with industry, offerors reported that any delay award notification for basic energy is so far out of customary commercial practices, it dissuades the firm from doing business with the government.

Background

At least 15 government agencies that procure basic energy are affected by the FAR requirement according to a Federal Business Opportunities (FBO) search for the purchase of electricity or natural gas as a commodity.[3] There is a distinct difference in the FAR from buying power (i.e., electricity, utilities) as a service, as opposed to a *supply* or *commodity* (these two terms are interchangeable). Many of the requests for proposal advertised on FBO used the classification code *S –Utility and housekeeping services*, because there is no commodity classification code available for basic energy as a supply.[4] A *classification* disconnect exists between government agencies procuring basic energy as a *supply*, and those procuring power as a *service*. This distinction becomes important because the FAR provides an exception at 5.202 (b)(5) which precludes an agency from the announcement requirements (including those required at FAR 5.303) if the proposed contract action is for utility services and only one source is available. According to FAR Part 41, Utility Services, "the acquisition of natural or manufactured gas when purchased as a commodity does not apply." Therefore, agencies procuring basic energy as a supply are not exempt.

> *The term 'price volatility' is used to describe price fluctuations of a commodity; it is measured by the day-to-day percentage difference in the price of the commodity. The degree of variation, not the level of prices, defines a volatile market. Since price is a function of supply and demand, it follows that volatility is a*

[1] "What is Price Volatility," U.S. Energy Information Administration, accessed October 14, 2018, https://www.eia.gov/naturalgas/weekly/archivenew_ngwu/2003/10_23/Volatility%2010-22-03.htm. U.S. Energy Information Administration cites the term *basic energy* as a supply of natural gas, electricity, heating oil.
[2] DLA Energy, briefing to Section 809 Panel, October 2018.
[3] "Agencies," FedBizOpps.Gov, Federal Business Opportunities, accessed October 14, 2018. https://www.fbo.gov/index?s=agency&mode=list&tab=list.
[4] "Home," FedBizOpps.Gov, Federal Business Opportunities, accessed October 14, 2018. https://www.fbo.gov/index?s=main&mode=list&tab=list.

> *result of the underlying supply and demand characteristics of the market. Therefore, high levels of volatility reflect extraordinary characteristics of supply and/or demand. Volatility provides a measure of price uncertainty in markets. When volatility rises, firms may delay investment and other decisions or increase their risk management activities. The costs associated with such activities tend to increase the costs of supplying and consuming gas.*[5]

Basic energy today is a commodity. As a wholesale commodity, this product is bought and sold on the New York Mercantile Exchange (NYMEX) where pricing is calculated in 5-minute increments with over 400 thousand contracts traded daily.[6] "Currently, electricity products can be traded at more than two dozen hubs and delivery points in North America, and natural gas products can be traded at more than 120 hubs."[7] Trades occur every minute and prices fluctuate with each trade because power-plants must maintain or change their output to meet demand at least every 5 minutes.[8] This spot market operation is indicative of real-time price transactions so as to not have a generation shortfall on the overall system.[9]

Only the requirements at FAR 5.303, Announcement of Contract Awards, are problematic because they cause an unnecessary delay in award notification for a commodity with major price fluctuations. The requirements in FAR 5.2, Synopsis of Proposed Contract Actions, do not inhibit commercial practices, nor do these requirements prevent timely award. Adding an exemption category under FAR 5.202, Exceptions, which specifically exempts the agency from the requirements in FAR 5.303 if the contracting officer determines the proposed contract action for the supply of basic energy (i.e., natural gas, electricity, heating oil, or similar basic energy commodities subject to price volatility) would address the problem.

Discussion

"Prices of basic energy are generally more volatile than prices of other commodities."[10] When purchasing basic energy as commodities, the current contract award announcement process adversely affects the government's ability to engage the dynamic marketplace in a manner consistent with commercial practice. The requirement under FAR 5.303, Announcement of Contract Awards, requires the contracting officer to make award information available (if more than $4 million) in "sufficient time for the agency concerned to announce it by 5 p.m. Washington D.C. time. Agencies shall not release information on awards before the public release time of 5 p.m. Washington D.C. time." There are two major problems with the latter FAR requirement regarding the award of basic energy:

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[5] "What is Price Volatility," U.S. Energy Information Administration, accessed October 14, 2018, https://www.eia.gov/naturalgas/weekly/archivenew_ngwu/2003/10_23/Volatility%2010-22-03.htm.

[6] "New York Mercantile Exchange—NYMEX," Investopedia, accessed October 14, 2018. https://www.investopedia.com/terms/n/nymex.asp.

[7] "Wholesale Electricity and Natural Gas Market Data," U.S. Energy Information Administration, accessed October 14, 2018, https://www.eia.gov/electricity/wholesale/.

[8] Ibid. Richard J. Campbell, *Electricity Markets – Recent Issues in Market Structure and Energy Trading*, *R43093*, Congressional Research Service, 37, accessed October 11, 2018. https://fas.org/sgp/crs/misc/R43093.pdf.

[9] Ibid.

[10] "What is Price Volatility," U.S. Energy Information Administration, accessed October 14, 2018, https://www.eia.gov/naturalgas/weekly/archivenew_ngwu/2003/10_23/Volatility%2010-22-03.htm.

- If the local agency had the capacity to notify the public through its media directorate after 5 p.m. Eastern time on the day of award, then the award notification for basic energy would still disrupt the commercial practices of an instantaneous price evaluation and award notification within 3 hours of receiving firm price offers.

- Agency supplements (e.g., DFARS, AFARS) all require either 2 or 3 business days. For example, Army contracting officers must submit the information for contract award no later than noon 3 business days' notice prior to the date of proposed award.[11] If the Army were to receive final price offers for the supply of basic energy on a Thursday at 2 p.m., it could not notify offerors of the award until the following Tuesday. This practice is unreasonable in the basic energy market and dissuades vendors from doing business with the government, particularly small businesses.[12]

The scale at which the government buys basic energy is huge, consistently resulting in awards more than $4 million dollars. "The Federal government consumed roughly 57.4 million megawatt-hours of electricity to operate all of its U.S. facilities in fiscal year 2007 (the latest information available), making it the single largest U.S. electricity consumer."[13] "Electricity prices vary by region across the United States based on supply and demand factors which are largely influenced by the cost of fuels (i.e., natural gas), power generation technologies and infrastructure, and trends in weather."[14] The price of electricity is codependent on the price of natural gas because electricity is most often generated using either coal or natural gas.[15]

If not otherwise mitigated, any award notification delay when purchasing basic energy as a commodity exposes the supplier to significant price risk, resulting in higher offered prices to the government.

Conclusions

Basic energy in the commercial market place is dependent on the trading practices of the NYMEX, where pricing is done on a 1-minute increment basis and contracts are leveraged based on supply-and-demand variations on a 5-minute basis. The immediacy to secure contract pricing is paramount to the government receiving the best priced offer. Equally important, the government should closely adhere to commercial practices to maintain a healthy pool of vendors willing to do business with the government.

The proposed FAR change to add an exemption under FAR 5.202 excludes the announcement of a contract award in accordance with FAR 5.303 for basic energy. This proposed change would mitigate price inflation and reinforce commercial business practices. It would allow the government to take full advantage of the dynamic marketplace and align with the commercial practice by awarding basic energy contracts almost immediately after receipt of a price offer. This exception is anticipated to

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[11] "A quick reference of the AFARS," Department of the Army, accessed October 14, 2018, http://farsite.hill.af.mil/vmafara.htm.
[12] DLA Energy, briefing to Section 809 Panel, October 2018.
[13] Anthony Andrews, *Federal Agency Authority to Contract for Electric Power and Renewable Energy Supply, R41960,* Congressional Research Service, accessed October 14, 2018, http://nationalaglawcenter.org/wp-content/uploads/assets/crs/R41960.pdf.
[14] Richard J. Campbell, *Electricity Markets – Recent Issues in Market Structure and Energy Trading*, *R43093*, Congressional Research Service, 37, accessed October 11, 2018. https://fas.org/sgp/crs/misc/R43093.pdf.
[15] "Wholesale Electricity and Natural Gas Market Data," U.S. Energy Information Administration, accessed October 14, 2018, https://www.eia.gov/electricity/wholesale/.

increase the number of participating offerors, enhance competition, and facilitate participation of small businesses.

Implementation

Legislative Branch

- There are no statutory changes required for this recommendation.

Executive Branch

- Modify FAR 5.202, Exceptions, to create and insert paragraph (b) and reorder the remaining sequential paragraph (c).

Implications for Other Agencies

- There are no cross-agency implications for this recommendation.