Deloitte.

Scottish Futures Trust

Energy Efficiency Measures

Part B - Technical Guidance on Commercial and Accounting impacts

22 January 2013

Contents

1. Basis of Report

This report, “Scottish Futures Trust - Energy Efficiency Measures Part B - Technical Guidance on Commercial and Accounting impacts” dated 22 January 2013, (“Part B”, the “Detailed Guidance”), contains the detailed technical guidance for the projects Scottish Futures Trust (“SFT”) is considering. It should be read in conjunction with “Scottish Futures Trust - Energy Efficiency Measures Part A - Commercial and Accounting impacts Overview”, dated 22 January 2013 (“Part A”), which is a summary of the underlying detail at a higher, more user friendly level.

1.1 Background

Deloitte has been appointed by SFT to assist it in considering at a high-level the potential commercial and accounting structures for implementing energy efficiency measures across the public sector in Scotland. The work we have carried out is in accordance with our contract dated 21 November 2012.

1.2 Purpose of this report

This report does not constitute an accounting opinion. Rather, it examines the theoretical accounting and budgetary treatments likely to apply to the potential commercial structures being considered. It is based on current IFRS accounting standards for the public sector and budgeting guidance as set out by HM Treasury (“HMT”).

1.3 Limitations of our report

This report assumes that the accounting and budgeting treatments will be based on the high-level commercial structuresas set out in Section 6. Any variations to the structures may result in a different analysis of the accounting and budgeting consequences of the structures.

This report should not be taken to supplant any other enquiries and procedures that may be necessary to satisfy your requirements in implementing any of the potential structures. In particular, we have not considered the economic merits or value for money considerations of any of the structures.

This report has been written in general terms and therefore cannot be relied on to cover specific situations; application of the principles set out will depend upon the particular circumstances involved and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this report.

The procedures we performed did not constitute a review or an audit of any kind. We did not subject the information contained in our report or given to us by SFT to checking or verification procedures except to the extent expressly stated above. This is normal practice when carrying out such limited scope procedures, but contrasts significantly with, for example, an audit. The procedures we performed were not designed to and are not likely to reveal fraud.

1.4 Accounting considerations

The following specific limitations of scope apply to Section 6 “Commercial Structures and their Accounting and Budgetary implications”:

Our advice is based on IFRS and HMT budgeting guidance as at the date of the report. You should be aware that the requirements of IFRS and budgeting rules may change over time and that it is your responsibility to take account of the impact of any such changes. We also note that the Office of National Statistics (“ONS”) has the final decision on the National Accounts treatment for any proposed commercial structure. We will not be under any obligation to update or otherwise alter our advice subsequent to the date of our final opinion.

We have not considered the accounting impact on any theoretical Special Purpose Vehicles ("SPVs") which may be set up for the implementation of any of the structures, as the contractual and finance structure are as yet undetermined.

1.5 Use of our report

This report has been prepared solely for the exclusive use of SFT and solely for the purpose of assisting SFT in the consideration of the potential commercial structures for implementing energy efficiency measures and the likely accounting and budgeting treatments.

We have granted our consent to SFT publishing this report to provide generic background only and accept no duty of care or liability to any party reading the content. We note that the generic guidance set out herein may not be appropriate to specific transactions which will need to be assessed on their own merits. Any specific transactions will need to undertake a detailed assessment of the appropriate accounting and budgeting treatments based on individual project specifics.

1.6 Information used in the production of this report

Our work has drawn on available IFRS, Financial Reporting Manual ("FReM"), and budgeting guidance as set out in the HMT issued technical guidance for government departments and other public sector bodies, on how to apply the tests contained within the Manual for Government Deficit and Debt ("MGDD").

The process of identifying and shortlisting relevant commercial models was performed through a series of workshops with SFT as set out in Appendix 4 – Scope of work.

1.7 Glossary of terms

Where names or phrases are capitalised, they are either titles of sections within this report (in which case this will be clearly indicated in the context) or they are specific terms which have been defined in the Appendix 3 "Glossary of Terms".

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2. Objectives

This section reviews the specific objectives of SFT which are then used in Section 5 to shortlist various commercial structures for further analysis of their accounting and budgetary impact.

2.1 Leveraging External Finance

A primary objective for SFT is to examine the potential to fund energy efficiency measures through private finance.

This is due to pressure on central government capital budgets and a desire to transfer an element of risk to the private sector. In some cases, such as through relevant contract terms in service concession arrangements or through energy services contracts, the majority of risk can be transferred to the private sector.

2.2 Accounting and Budgetary Impact

In commissioning this work, a primary objective of SFT was to better understand the factors which would influence the budgetary classification of investment in energy efficiency measures as either resource expenditure or capital expenditure. As explained in further detail in Section 3, there are two methods of reporting which are relevant to public sector in the UK. These are:

- Resource accounts which refer to the Financial Accounts prepared by entities; and,
- Departmental budgets[1] which include:
  - Resource budgets - current expenditure such as pay or procurement and including depreciation, which is the current cost associated with the ownership of assets; and
  - Capital budgets - for new investment and net policy lending.

The objective of SFT is to set out the high-level contractual structure, payment mechanism and risk allocation such that any energy efficiency measures do not result in an upfront utilisation of capital budgets, but rather are paid for over time out of resource budgets.

Under resource budgets, energy efficiency measures would therefore be paid for over the life of the project, as they delivery energy efficiency savings. Ideally, projects would result in a net reduction in spending as the payment for efficiency measures may be offset by savings in energy bills.

2.3 Carbon Reduction

The measures will need to reduce carbon consumption throughout the Scottish public sector estate. This will be over a wide range of buildings across both local and central government.

In 2009, Scotland set itself the world's most ambitious greenhouse gas reduction targets after the Scottish parliament voted to cut the nation's CO2 emissions by 42% by 2020. This is greater than the 34% set across the UK at the same time. Energy efficiency measures will play a material role in delivering these carbon reduction targets.

2.4 Dovetailing other property strategies

SFT expects that energy efficiency measures would be set such that they are consistent with the wider Scottish Government property strategies and policies.

Similarly, any structures introduced to deliver these measures will necessarily be consistent with these strategies. In particular, we note that the rationalisation of the Scottish Government estate, and possible integration of contracts for energy efficiency management and wider facilities management are important considerations.

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[1] Note that in the context of local authorities departmental budgets apply to the sponsoring government department

2.5 Other Considerations

There are a range of other considerations which a Procuring Government Entity ("PGE") must consider when deciding the type of Energy Efficiency contract it wishes to enter. These are summarised within Section 7 and include factors such as value for money, affordability, market appetite and capacity. These are outside the scope of this report.

3. Possible sources of finance

There are a number of possible sources of finance for an energy efficiency investment into the Scottish public sector estate. These are summarised in the paragraphs below with a brief commentary as to their applicability to the alternative commercial structures.

3.1 External financing

Private Finance

This category would include corporate banks, debt funds, institutional investors, vendor finance, asset finance, project finance and equity/venture capital funds.

Private finance remains a viable option for raising funding for energy efficiency measures. These could be structured as either service concessions, PPP type whole building schemes, energy services contracts, leases, or any other specific measure that relied on private sector funding to deliver assets and/or services to the PGE.

Based on the contractual arrangements and payment mechanisms for these, the external finance raised could be classified as being “off capital budgets”, in contrast to internal government funding which is likely to be classified as being “on capital budgets”.

UK Green Investment Bank plc

Following state aid approval on 17 October 2012 the Government has set up the UK Green Investment Bank plc (GIB). Its mission is to provide financial solutions to accelerate private sector investment in the green economy. The GIB is capitalised with £3 billion, and has been set up with a view to addressing market failures affecting green infrastructure projects in order to stimulate a step up in private investment.

3.2 Public sector financing options

Capital Budgets

There is currently pressure on available Capital Budgets across the public sector, which results in there being limited availability to fund energy efficiency measures.

PWLB (Public Works Loan Board)

This source of finance is available for Local Government across Scotland. However, funds raised through the PWLB, while being low cost, will score to prudential borrowing limits. Moreover, any assets purchased using these borrowings will likely score to Capital Budgets.

SPRUCE (JESSICA)

The £50m Scottish Partnership for Regeneration in Urban Centres (SPRUCE) Fund is a JESSICA (Joint European Support for Sustainable Investment in City Areas) UDF (Urban Development Fund) that is a source of funding for regeneration and energy efficiency projects within targeted areas of Scotland. Borrowing by local authorities through this scheme would score against Prudential Borrowing Limits and the asset would be likely to be capitalised within the financial accounts and score against capital budgets.

SPRUCE funding is available to private sector borrowers working on municipal projects. In these instances, the accounting and budgetary implications would depend upon the specifics of the agreement entered into by the Contractor and the PGE.

European Energy Efficiency Fund

The European Energy Efficiency Fund (EEEF) is a public-private partnership dedicated to mitigating climate change through energy efficiency measures and the use of renewable energy in the member states of the European Union.

It focuses on financing energy efficiency, small-scale renewable energy and clean urban transport projects targeting municipal, local and regional authorities and public and private entities acting on behalf of those authorities.

These may be more focused in Local Government for Scotland.

As with SPRUCE funding, EEEF is available to private sector borrowers working on municipal projects. In these instances, the accounting and budgetary implications would reflect the specifics of the agreement entered into by the Contractor and the PGE.

European Local ENergy Assistance (ELENA) Fund

This is an European Investment Bank ("EIB") fund which supports the EU's climate and energy policy objectives. It is a joint EIB-European Commission initiative that helps local and regional authorities to prepare energy efficiency or renewable energy projects. It attempts to mobilise more than EUR 1.6bn in investments over the next few years, rather than funding the works directly. As with EEEF, this is set up toward funding local projects.

Central Energy Efficiency Fund (CEEF)

The Scottish Government's Central Energy Efficiency Fund (CEEF) is a key vehicle for delivering energy efficiency and small-scale renewable energy measures across the public sector in Scotland. The scheme applies to all Scottish local authorities and health boards as well as Scottish Water.

Established in 2004, CEEF is a £20m revolving loan fund to assist the public sector in making the initial capital investment to achieve energy savings. £15 million of the fund was allocated to the 32 local authorities in Scotland, £4 million to the NHS trusts and £1 million to Scottish Water. To be eligible for CEEF funding, projects must use specific energy saving technologies and must meet a five year payback period for energy efficiency projects or seven and a half-year payback period for renewable projects.

4. Accounting and budgeting principles

4.1 Overview

What is the distinction between accounting and budgeting?

There are two main methods of reporting which are relevant to public sector in the UK. These are:

- Resource accounts which refer to the Financial accounts prepared by entities; and
- Departmental budgets. Departments prepare budgets covering both resource (i.e. revenue) and capital elements. These are:
  - Resource – current expenditure such as pay or procurement and including depreciation, which is the current cost associated with the ownership of assets; and
  - Capital – for new investment and net policy lending.

In addition, there is a reporting mechanism known as the National Accounts. This is a set of economic indicators used to measure overall outturn. Widely reported indicators include items such as Gross Domestic Product (GDP) and Public Sector Net Debt (PSND). National Accounts are not considered extensively here as their relevance to Government Departments and Local Authorities is most normally linked to the other two methods noted above.

4.2 Different types of arrangement

This section considers the application of the accounting and budgetary principles to outline commercial arrangements which may be entered into to deliver energy efficiency measures.

What are the different accounting and budgeting treatments that an arrangement for energy efficiency measures may result in?

The table below summarises the accounting and budgetary standards applicable to the treatment of various outline commercial structures.

	Resource Accounts	Budgets	Dual reporting
Service concession	IFRIC 12	ESA 95	Possibly
Operating Lease	IFRIC 4 / IAS 17	IFRIC4 / IAS 17	No
Finance lease	IFRIC 4 / IAS 17	IFRIC4 / IAS 17	No
Executory Contract	Accruals Concept	Accruals Concept	No

4.3 Background to departmental budgetary and fiscal policy frameworks

The departmental budgeting system is the process by which the total level of public expenditure allocated to individual departments is managed and controlled. It has two stated aims as set out in Paragraph 1.1 of the CBG:

- Support the achievement of macro-economic stability by ensuring that public expenditure is controlled in support of the Government's fiscal framework.
- Provide good incentives for departments to manage spending well so as to provide high quality public services that offer value for money to the taxpayer.

The Government's fiscal policy framework governs levels of taxation, public spending, borrowing and debt and its definitions and measurements are drawn with reference to key balances and aggregates derived from the National Accounts. The National Accounts are a system of economic statistics that are prepared by the Office for National Statistics ("ONS") under the standards set out in the European System of Accounts 1995 ("ESA 95") and supporting documents.

National Accounts vs. resource accounts (financial accounts)

While the National Accounts have many similarities to departmental resource accounts prepared under HMT's Financial Reporting Manual ("FReM"), there are important differences. Specific issues include the treatment of provisions, definitions of capital spending and, from 1 April 2009, the treatment of service concessions.

Budgetary framework vs. resource accounts (financial accounts)

The policies that underlie the departmental budgetary system are set out in the CBG. In the main, they follow the resource accounting principles set out in the FReM. However, as set out in Paragraph 1.1 of the CBG, budgets need to protect the fiscal position as measured with reference to ESA 95. It is the differences between the treatment of transactions in the FReM based financial statements and the treatment in the National Accounts that guides some of the more detailed budgeting rules.

Budgetary framework vs. National Accounts

Accordingly, the budgetary totals that are allocated at Spending Reviews are set primarily with reference to the National Accounts concepts of expenditure. This means that when considering the impact of the Project on the departmental budgets it is necessary to understand the treatment of service concessions within the National Accounts.

4.4 Resource accounts - Treatment of service concessions

Under IFRS as it is applied in the public sector, the balance sheet classification of assets that underlie a service concession are determined based on the control criteria set out within the International Financial Reporting Interpretations Committee's Interpretation 12 ("IFRIC 12") (refer to Appendix 1 for an IFRIC 12 based decision tree). In summary, where the public sector controls or regulates the services to be provided; to whom they are provided; and at what price and also controls any significant residual interest in the assets, the project will be within the scope of IFRIC 12 and the public sector will be expected to record the underlying assets on their balance sheet. As this is the case in most service concessions, it is expected that most of the underlying assets will be recognised on the individual procuring PGE's accounts.

In a letter to HMT dated 5 October 2007, the ONS confirmed that the control based approach required under IFRIC 12 is not consistent with the risk and reward based approach required under ESA 95 and the MGDD guidance. The effect of this is that the ONS no longer relies on the determination in the financial statements when compiling the National Accounts.

4.5 Resource accounts - Treatment of leases

In the event that the project falls out of the scope of IFRIC 12, the FReM requires consideration of IFRIC 4 to determine if the arrangement contains a lease.

IFRIC 4 states that in determining whether the following criteria are met, the substance of control by the PGE of assets results in a lease arrangement:

- Fulfilment of the arrangement is dependent on the use of a specific asset or assets.
- The arrangement conveys a right to use the asset.

Accordingly, we consider each requirement in turn in the sections to follow.

4.5.1 Is the arrangement dependent on the use of a specific asset or assets?

Specific assets may be explicitly identified within the contractual arrangement; however, identification of assets does not necessarily lead to a lease arrangement. This will depend if the supply of service is dependent upon the use of the specific asset. Where the specific asset identified may be substituted with another asset to provide the service, then the fulfilment of the contract is not likely to be dependent upon the specified asset, and therefore, the contract will not contain a lease.

In addition, IFRIC 4 states that specific assets may be implicitly identified within the contractual arrangement, in cases when the supplier owns or leases only one asset through which the service must be delivered and they could not feasibly use an alternative asset to perform the contract obligations.

For example, a simple provision of telephone handsets or internet router boxes as a means of providing telephone and network assets. IFRIC 4 would generally not view this as an implicit identification of specific

assets. This would be due to the assets being generally (i) substitutable; and (ii) the supplier would be able to replace and change out the assets without consent required from the PGE.

4.5.2 Does the arrangement convey the right to use the asset?

Under IFRIC 4, for an asset to be controlled by the Public Sector, it must meet one of the following requirements:

a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset;

b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset; and

c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.

4.5.3 IAS 17 Leases

IAS 17 draws a distinction between two types of leases, finance and operating, of which the accounting implications of each will differ. IAS 17 designates a finance lease as one that substantively transfers the risks and rewards of ownership of an asset to the lessee. In contrast, an operating lease will not transfer substantively the risks and rewards of ownership to the lessee.

In order to determine whether the risks and rewards have transferred, IAS 17 states the following indicators would normally lead to a lease being classified as a finance lease:

a) The lease transfers ownership of the asset to the lessee by the end of the lease term;

b) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

c) The lease term is for the major part of the economic life of the asset even if title is not transferred;

d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

e) The leased assets are of such a specialised nature that only the lessee can use them without major modifications.

Additionally, IAS 17 states the following could individually or in combination lead to a lease being classified as a finance lease:

f) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

g) Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

h) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

4.6 Budgets - Treatment of service concessions

4.6.1 ESA 95 guidance

Specific guidance has been developed by Eurostat, the EU statistical PGE with responsibility for the application of ESA 95 across the EU. This guidance deals with private to public sector arrangements where the private sector provides services to the public sector 'on the basis of dedicated assets' and is contained

within the Manual for Government Deficit and Debt ("MGDD"). Economic ownership for these purposes is defined with reference to exposure to the risks and rewards associated with the assets.

The MGDD requires that the assets underlying a contract to provide services on the basis of dedicated assets should only be considered to be on the private sector balance sheet for National Accounts purposes (hence not on the public sector balance sheet for National Accounts purposes) if there is strong evidence that the private sector is bearing most of the risk attached to the asset in question (see Step 2 in Appendix 2).

The MGDD identifies three categories of risk that should be assessed when making the balance sheet determination for the purposes of the National Accounts:

- Construction risk;
- Demand risk; and
- Availability risk.

The following tests are then applied:

- if the public sector carries construction risk the assets are viewed as being on the public sector balance sheet for the purposes of the National Accounts; and
- where the private sector holds construction risk and one or both of demand risk and availability risk, then MGDD states that this is representative that the private sector 'is bearing most of the risk attached to the asset in question'. Accordingly, the assets are not considered to be on the public sector balance sheet for the purposes of National Accounts.

In borderline cases it may not be possible to draw a conclusion on the basis of the tests set out above. In such cases, the MGDD requires that further factors be taken into account, including the final allocation of the assets (i.e. the residual value risk).

Where the public sector predominantly finances the construction of the assets during the construction phase there is a presumption that the assets are public sector assets, as the public sector is deemed to be acting as the final purchaser of the assets.

These tests are summarised in the flow chart at Appendix 2.

4.6.2 Specific HMT-issued guidance for budgeting for service concessions

As a result of the ONS no longer using the financial accounting determination when preparing the National Accounts (as set out in section 4.4), HMT issued technical guidance for government departments and other public sector bodies, on how to apply the tests contained within the MGDD[2]. The guidance sets out that dual reporting will be required where the results of an analysis under IFRIC 12 are different to the results under an analysis performed for the purposes of National Accounts.

HMT- issued technical guidance confirms that the budgeting treatment for the sponsoring department now follows the treatment in the National Accounts in a letter entitled "Consolidated budgeting guidance for 2009-10 (IFRS updated)" and dated 28 April 2009. Accordingly, the impact on the departmental resource and capital budgets is no longer based on the IFRIC 12 determination but rather on an application of the MGDD balance sheet classification tests. The effect of this is a decoupling of the budgetary and accounting treatment, such that public sector managers will no longer be able to rely on the information gathered as part of the preparation of their financial statements when considering the affordability of a service concession, and will instead need to perform and document a separate MGDD-based analysis.

4.7 Budgets - Treatment of leases

The MGDD guidance sets out that the accounting treatment for leases will be applied in the treatment of budgets as well. As such, any structure that is considered an operating lease under IAS 17 will be similarly considered for budgeting and therefore score to Resource budgets. However, unlike the dual reporting for Service Concessions falling within IFRIC 12, a finance lease under IAS 17 will be considered to score to capital budgets.

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[2] http://www.hm-treasury.gov.uk/d/tech guidance nataccounts for pfi.pdf

5. Commercial Structures identified

5.1 Overview

There is a range of possible commercial structures that could be used to provide energy efficiency measures. A number of these are considered further below. These would likely be considered under the accounting and budgeting principles set out in Section 6 of this report.

The long list in this section is based upon commercial structures currently used by the public sector to procure services (for energy efficiency or otherwise), and structures relating to specific energy efficiency measures such as heat off-take agreements or Managed Energy Services Arrangements ("MESA").

Table 6.1: Structures identified – pros, cons and possibilities

1. Energy Performance Contract (EPC)

Overview	This is a structure under which the public sector will procure services for energy efficiency from a contractor. Payments will be made to the contractor based on the reduction of energy consumption. *Note that for the analysis in this report, the consideration of EPCs and Energy Service Contract ("ESCO") are on the basis that the PGE would not specify measures that would be delivered.*
Pros	Transfers all the risk of a project to the private sector. Would not appear on the balance sheet of the PGE's accounts and therefore the PGE would not be encumbered with a liability (and corresponding asset). Would not score to Capital Budgets. May stimulate innovation as the private sector (through a bidding process) would be free to suggest newer ways of providing energy efficiency measures.
Constraints	May be difficult as it would need the private sector contractor to take all risk of achieving agreed savings, which may not be commercially acceptable. The more risk that the private sector takes on the higher contract prices are likely to be. PGE loses ability to specify types of measures they wish to see implemented. Would need consensus with internal finance function and external auditors to ensure these arrangements are agreed to be classified as executory contracts. For the avoidance of doubt, an executory contract is a defined accounting principle suggesting the procurer only pays for services as they are delivered.
Possible measures	Insulation works integral to the building such as solid wall insulation or cavity wall insulation; "Moveable" energy efficiency works such as new heating, cooling or lighting systems; Localised clean energy generation technology such as ground or air source renewable heat, biomass heating or solar PV.
Possible property types	Likely to be parts of buildings as access to parts of a building can be restricted as seen fit. Would be applicable to existing buildings as well as new builds.
Contract length	Typically these arrangements are short term and for less than 5 years.
Funding	Private sector bears risk of funding and constructing assets.

2. Managed Energy Services Agreement (covering all utilities including water)

Overview	Under this structure a contractor will pay the building owner's on-going utility bill directly and charges the building owner a fee equal to or lower than the building's historical energy rates adjusted for key occupancy and weather-related variables that are agreed upon prior to finalising the agreement. In this way, the investment fund becomes an intermediary between the building owner and the local utility and generates revenue by capturing the differential between the building's old energy costs and its decreasing energy costs as the building is made more efficient over time.
Pros	Likely to be off public sector capital budgets. Some risk transferred to private sector.
Constraints	Limited control over the types of measures introduced. Price may be higher than some other structures given that the private sector bears much of the risk. Lack of any upside that the private sector would make in reducing energy costs.
Possible measures	Insulation works integral to the building such as solid wall insulation or cavity wall insulation; "Moveable" energy efficiency works such as new heating, cooling or lighting systems; and Localised clean energy generation technology such as ground or air source renewable heat, biomass heating or solar PV.
Possible property types	Likely to be parts of buildings as access to parts of a building can be restricted as seen fit, but could be the whole building as well.
Contract length	Typically these arrangements are short term and for less than 5 years.
Funding	Private sector bears risk of funding and constructing assets.

3. Service concession

Overview	The public sector, though a contract specifies both the energy efficiency services and the assets used to provide those services. This is a step removed from an ESCO or MESA as the public sector has far more control over the types of measures installed. The contractor, possibly through a Special Purpose Vehicle (the "SPV") provides services to the public sector 'on the basis of dedicated assets'. i.e. these assets will be dedicated for the use of the public sector customer and the contractor. For example, the PGE may specify that they would require a boiler or ground source heat pump. The works would be funded through debt and equity raised by the contractor and, possibly including third party finance. Depending on the specifics of the payment mechanism, there may be an element of payment for the contractor making the dedicated assets available for use by the PGE, and an element based on energy efficiency gains/usage.
Pros	Likely off capital balance sheets (but see below re Resource Accounts). Funding is raised by the private sector.
Constraints	Likely to be recorded as on balance sheet for the purposes of Resource Accounts under IFRS.
Possible measures	Insulation works integral to the building such as solid wall insulation or cavity wall insulation; "Moveable" energy efficiency works such as new heating, cooling or lighting systems; Localised clean energy generation technology such as ground or air source renewable heat, biomass heating or solar PV.
Possible property types	Could be both whole building and part building measures and as such would be applicable across much of the SG estate.
Contract length	Service concession arrangements can range from short term contracts of less than 5 years to longer term contracts up to 25-30 years or more.
Funding	External finance raised by the SPV.

4. Heat off take agreement

Overview	This is a contract/agreement to purchase heat from a renewable heat source such as a ground source heat pump or biomass boiler. Typically long term.
Pros	The owner-operator of the renewable heat equipment may receive RHI subsidies.
Constraints	If the PGE were to take on the role of the owner/operator it would likely result the project being classified as being on balance sheet.
Measure most suited for the delivery of	Localised clean heat generation technology such as ground or air source renewable heat or biomass heating.
Property types applicable to	Likely to be whole building given the nature of the assets to be installed and so are more suited to SG or Local Government owned and occupied building,
Contract length	Typically these arrangements are based on the life of the corresponding asset.
Funding	External finance raised by the energy efficiency / heating provider.

5. Clean energy pre purchase agreement

Overview	This is a contract/agreement to purchase clean energy from a renewable source such as solar PV.
Pros	The owner-operator of the solar PV equipment may receive FIT subsidies.
Constraints	If the PGE were to take on the role of the owner/operator it would likely result in the project being classified as being on balance sheet.
Possible measures	Localised clean electricity generation technology such as solar PV.
Possible property types	Likely to be whole building given the nature of the assets to be installed and so are more suited to SG or Local Government owned and occupied building.
Contract length	Typically these are longer term arrangements
Funding	External finance raised by the energy efficiency / heating provider.

6. Leasing

Overview	The public sector will lease specific assets to implement energy efficiency measures. Payments will be made to the lessor over the life of those assets.
Pros	The public sector will have a great deal of control over the measures implemented.
Constraints	Depending on the type of lease and the payment mechanisms, this could be considered a finance lease and therefore score to capital budgets.
Possible measures	Insulation works integral to the building such as solid wall insulation or cavity wall insulation; "Moveable" energy efficiency works such as new heating, cooling or lighting systems; Localised clean energy generation technology such as ground or air source renewable heat, biomass heating or solar PV.
Possible property types	Could be both whole building and part building measures and as such would be applicable across much of the Scottish government estate.
Contract length	Leasing arrangements can range from short term contracts of less than 5 years to longer term contracts up to 25-30 years.
Funding	External finance raised by the lessor.

5.2 Shortlisting of potential options

There are a number of measures considered above. Each of these were considered against the objectives in Section 2 in order to shortlist potential options.

An EPC and a MESA are both variations of an "executory contract" whereby the PGE will make payments based on agreed outputs or deliverables. As such, on a high-level the accounting for each would appear similar. As such, a broad category for executory contract has been considered in the shortlisted arrangements in Section 6.

Service concession arrangements are often used to deliver large scale infrastructure projects such as schools, hospitals and roads, but are also used to deliver projects such as IT delivery. This could be considered similar in some aspects (as explained in Section 6) to energy efficiency measures and so has been shortlisted here.

A further option has been identified here whereby the PGE would take an equity stake in the SPV delivering a service concession. This would allow the PGE to share in any upside risk of the savings delivered by the SPV being higher than expected, but would also be at risk for any downside.

Finance leases, while they would leverage external finance, would necessarily score to capital budgets based on the available HMT guidance. As such this option has not been shortlisted. Operating leases would however not score to capital budgets, though these will have the same characteristics as an executory contract, which is discussed further.

Note that the distinction between an executory contract, lease (finance or operating) and a service concession is not necessarily linear and depends on a variety of factors. The technical accounting guidance underpinning these factors are set out in Section 6.

Heat offtake agreements and clean energy pre-purchase agreements could be considered executory contracts if they were structured as such, or equally be considered a service concession.

The extent to which each of these measures address the identified objectives is summarised below:

Table 6.2: Mapping measures to objectives

	External finance	Off capital budgets	Carbon reduction	Dovetail with other property strategies	Shortlisted?
EPC	Yes	Yes	Yes	Yes	Yes
MESA	Yes	Yes	Yes	Yes	No – similar to an EPC in that it is an executory contract. As a result, has not been considered further.
Service concession	Yes	Yes	Yes	Yes – whole building long term measures	Yes
Heat offtake agreements	Yes	No	Yes	No – this is a more specific measure	No
Clean energy pre-purchase agreement	Yes	No	Yes	No – this is a more specific measure	No
Finance leases	Yes	No	Yes	Maybe	No

Based on the discussion above, the three structures shortlisted by SFT are:

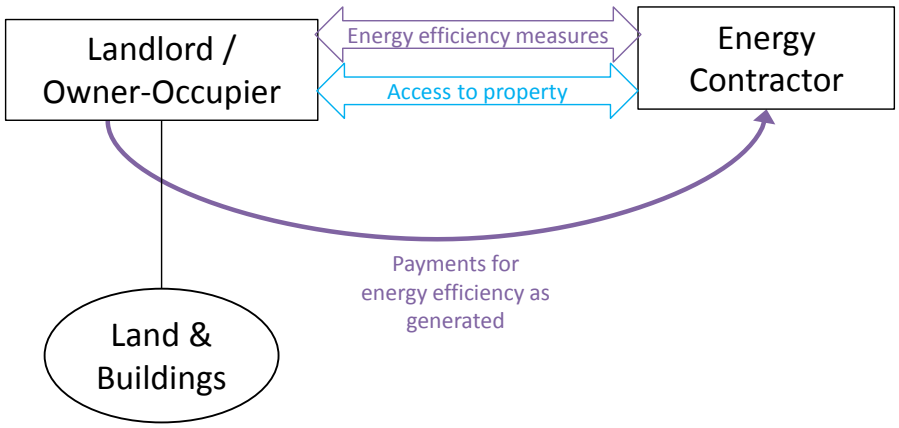
- Energy performance contract (EPC) as a form of executory contract;
- Service concession; and
- Service concession including equity stake by the public sector.

These shortlisted structures are considered further in Section 6.

6. Commercial Structures and their Accounting and Budgetary implications

6.1 Executory Contract and variations (these include EPCs as defined in Section 5)

6.1.1 Definition



An executory contract provides a long-term investment and delivery structure for energy efficiency projects. The key elements of this structure are:

- The PGE will give a contractor access to its buildings or specified parts of its buildings to provide energy efficiency measures;
- The PGE will make payments to the contractor for providing these measures as and when they are generated;
- It would be up to the energy contractor to determine which measures to install in the building. The PGE would likely have little control over the specific type of measure introduced under this structure, but could set target energy consumption reduction targets for the energy contractor. For example, the contractor may have the independence to install as appropriate a new boiler, ground source heat pump, wall cladding or any other measure as appropriate given the access given to it by the PGE; and
- The contractor will be responsible for the functioning of any measures it may install and will receive payments only to the extent that they deliver the energy efficiency measures that they have been contracted to provide.

6.1.2 Accounting implications

This section reviews the accounting implications of the terms described above and examines (i) whether the arrangement would be characterised as a service concession for the provision of infrastructure, and (ii) whether the assets that underlie the project are controlled by the PGE within the meaning of IFRIC 12 and the HMT Guidance. IFRIC 12 contains an amendment to IFRIC 4 'Determining Whether a Transaction Contains a Lease', which makes clear that where an arrangement could fall to be accounted for either as a lease or a service concession, then the provisions in IFRIC 12 should apply.

Step 1: Is the contract a service concession for the provision of infrastructure?

The HMT guidance defines a service concession arrangement as one which *"contractually obliges the private sector operator to provide the services related to the infrastructure to the public on behalf of the grantor".*

(a) Is the contract a service concession?

Possibly. This will depend on whether it is genuinely a service only contract with no public sector control over the type and residual value of asset or residual assets, and where the operator takes the entire risk over the project.

Under the terms of described above, any contract will be for the provision of services only. There is likely to be a form of assets that the private sector contractor will require in order to provide those services, but subject to the contract terms being sufficiently broad and allowing the private sector sufficient control over the assets that they utilise, this may not fall within the category of a service concession.

Note that this could be a finely balanced argument, which will require consensus from the auditors of the relevant PGE.

We could conclude therefore that the given sufficiently broad contract terms an arrangement of this type is simply a contract for services, with no dedicated assets provided given that the contractor has the ability to utilise whatever assets are required to provide a dedicated level of service.

Therefore, this would be considered an executory contract whereby the PGE accounts for payments as and when they consume the service provided and a liability to pay arises. In this case, if the contractor provides a given level of efficiency gains, the PGE will pay an amount agreed for those efficiency gains.

As such, an executory contract will be considered an expense in resource accounts subject to the control test above.

6.1.3 Budgetary implications

The analysis uses the steps set out in the flow chart replicated from HMT's draft for consultation "Technical Guidance on the Application of the Standards used in the production of National Accounts to PFI and Similar Transactions" ("HMT Technical Guidance") dated 2 September 2009 *(www.hm_treasury.gov.uk/psr_bac_classification_papers.htm)* in Appendix 2 to comment on the potential National Accounts determination of the Project.

Step 1: Is the project within scope?

There are two stages to consider:

Stage 1(a). Is the project a contract for services that depends on the provision of dedicated assets?

It depends. While, the project would simply be for the provision of energy efficiency, with no specification of any dedicated assets, this would depend on (i) there being no public sector control over type or residual value of the asset; (ii) whether the operator takes the entire risk; and (iii) any assets will be designed to the specification of the private sector to deliver those services.

Stage 1(b). Is the public sector procuring authority, the end-user or another third party the main purchaser of the services provided by the provision of the dedicated assets?

The public sector procuring authority is the end-user of the services based on the provision of dedicated assets.

However, having determined that the project does not require dedicated assets, it can be concluded that an executory contract as defined here is outside the scope of the MGDD guidance.

It should also be noted that this assessment is in line with the general conclusion reached in the HMT Techincal Guidance, which states that:

"for practical purposes...where a procuring authority is required to consider the provisions of IFRIC 12 'Service Concession Arrangements'...it will be necessary to consider the guidance contained within this paper in order to make the balance sheet determination for the purpose of the National Accounts."

Such a project is likely to be outside of the scope of IFRIC 12 above and is accordingly also outside the scope of MGDD and budgeting rules for PFI and similar transactions.

As such, an executory contract would be considered an expense in resource budgets.

6.1.4 Further considerations

The three key benefits of an executory contract to a PGE are:

- Guaranteed energy performance improvements;
- Up front capital funding provided by third parties; and
- Using operational savings to reduce capital budget requirements for maintenance and refurbishment.

Because each executory contract can be separate, the framework is flexible enough to accommodate the PGE's own strategy, drivers and funding availability. This means the benefits can be tailored to each type of Public Sector entity individually (i.e. *Local Government, Central Government, NHS*).

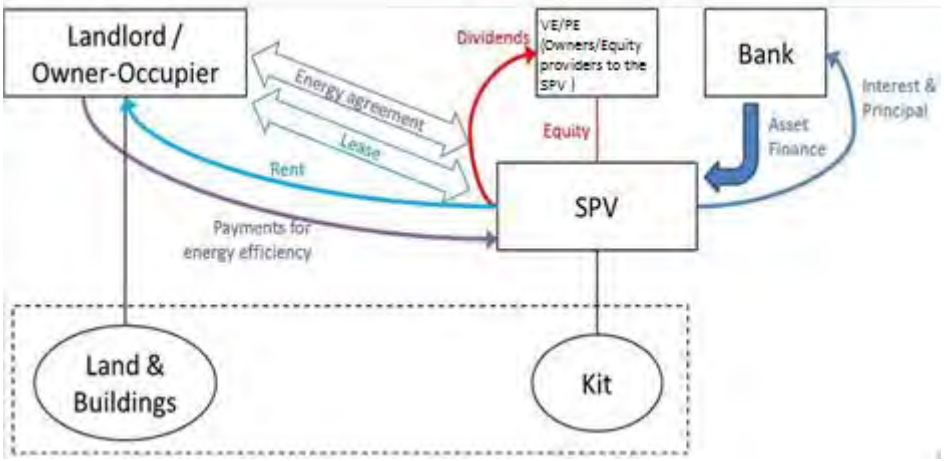
However, the public sector loses the ability to control, in any detail, the type of measure that is introduced. Moreover, the public sector does not gain from any upside that the contractor makes as its payments for efficiency are set.

6.1.5 Consideration against objectives

Objective	Executory contract
Leveraging private finance	Funding for the measures that will be put in place will be made directly by the contractor, funded through debt, equity or government subsidy. Since the contractor will own the assets that it uses to provide the services, any subsidies that are forthcoming from Government will be made to the contractor. In practice, this will likely result in the price of the contract to the public sector being lower as the contractor's margin will take into account any subsidy received.
Not on Capital Budgets	The payments are made to the contractor as and when energy efficiencies are consumed (i.e. savings are realised). As such, this will be an executory contract and not score to either resource accounts or capital budgets as capital. However, at the end of any accounting period, the public sector may have to account for monies owed or receivable from the contractor as appropriate for payments either not yet made, or made in advance of when the service delivers.
Reduce carbon consumption	Under the terms of the contract, the PGE will be making payments for specified levels of energy efficiencies and reduced carbon. However, the structure is such that much if not all of the risk of providing those gains rests with the contractor.
Dovetailing other property strategies	An executory contract could be considered together with a Facilities Management contract, given that both would likely be for the provision of services relating to a designated building. This would result in both the FM and Energy management works being performed concurrently and reduce disruption and ongoing maintenance.

6.2 Service Concession

6.2.1 Definition



Note: Venture Capital/ Private Equity refers to Owners/Equity providers to the SPV

The key elements of this structure are:

- The PGE specifies both the energy efficiency services and the specific assets to provide those services;
- The Contractor, through a Special Purpose Vehicle (the “SPV”) provides services to the public sector 'on the basis of dedicated assets’ i.e. these assets will be dedicated for the use of the PGE and the contractor;
- For example, the PGE may specify that they would require a boiler or ground source heat pump;
- The SPV will be funded through debt and equity raised by the contractor and third parties; and
- Depending on the specifics of the payment mechanism, there will be an element of payment for the SPV making the dedicated assets available for use by the PGE, and an element based on energy efficiency gains/usage.

This will differ from the executory contract structure in that the PGE has far more control over the energy efficiency measures that are implemented.

In this structure the landlord or owner occupier does not take a stake in the SPV and therefore does not directly benefit from the dividend payments that the SPV will make to its equity holders.

6.2.2 Accounting implications

This section of the report sets out the analysis of the terms described above and examines (i) how it can be characterised as a service concession for the provision of infrastructure and (ii) whether the assets that underlie the Project are controlled by the PGE within the meaning of IFRIC 12 and the HMT Guidance. IFRIC 12 contains an amendment to IFRIC 4, which makes clear that where an arrangement could fall to be accounted for either as a lease or a service concession, then the provisions in IFRIC 12 should apply.

Step 1: Is the contract a service concession for the provision of infrastructure?

The HMT guidance defines a service concession arrangement as one which *"contractually obliges the private sector operator to provide the services related to the infrastructure to the public on behalf of the grantor".*

(a) Is the contract a service concession?

Yes, under the terms described above, a contract which is for the provision of services related to a network of infrastructure to the public sector in order to enable the provision of public services, could be classified as a service concession.

(b) Do the assets comprise 'infrastructure'?

The HMT guidance does not define infrastructure assets but identifies their key characteristics and provides some examples. The characteristics are as follows:

- Part of a system or network;
- Specialised in nature and do not have alternative uses;
- Immovable; and
- May be subject to constraints on disposal.

The assets that underlie the Project would be considered infrastructure if some or all of the following factors were incorporated into the contract:

- They will form part of a network providing energy efficiency (note that a GSHP, boiler or even wall cladding could be considered a network for energy efficiency measures);
- The measures specified would be specialised to requirements set out by the PGE;
- Many measures such as wall cladding, windows, Ground Source Heat Pump, pipes, boilers would be considered immovable; and
- Upon termination of the service contract the assets are to pass back to (or remain with) the public sector.

One of the characteristics described above is “immovable”. This may relate to all the assets being considered here, depending on the types of measures. However, the wording used in the HMT guidance to describe the features of infrastructure assets states “*assets usually display some or all of the following characteristics*” and accordingly, it is not necessary for all the features to be present for the assets to be considered infrastructure.

We conclude therefore that such a contract could be a service concession for the provision of services related to the infrastructure on behalf of the PGE. As such, we continue the assessment to determine whether the assets are controlled by the PGE within the meaning of the guidance.

Step 2: Is the asset controlled by the PGE?

In order for the asset to be considered as controlled, both the criteria in IFRIC 12 need to be satisfied.

(a) Does the grantor control or regulate what services the operator must provide with the infrastructure, to whom it must provide them and at what price?

Yes, the contract/procurement process would necessarily stipulate what services must be delivered, to whom, and at a price agreed by the contractor through the acceptance of tender.

This criterion would be met.

(b) Does the grantor control through ownership, beneficial entitlement otherwise, any significant residual interest in the infrastructure at the end of the service arrangement?

Yes, the contract/procurement process would often state that the ownership of assets will remain with the PGE upon termination of the contract.

As such, the procuring public sector entity would be deemed to control the assets for the majority of their useful life during the project and so this criterion would be met.

As a result, IFRIC 12 would apply, and the underlying assets would be recognised on the balance sheet of the PGE.

The corresponding entry would be a liability to make payments to the SPV over the life of the contract, , akin to a lease liability.

As such, the PGE would account for this structure at the outset of the contract with an asset valued at the fair value of the various energy saving measures installed and an equal and opposite liability for the payments to be made to the SPV. Over the life of the project, the PGE would depreciate the assets in line with their policy for other assets in the same class, and repay (and recognise interest expenditure) on the liability.

6.2.3 Budgetary implications

As set out in Section 4, the treatment of service concessions for budgets may not be the same as the treatment for resource accounts, as the test applied for budgetary treatment is ESA 95 as set out in the MGDD.

The analysis uses the steps set out in the flow chart replicated from HMT Technical Guidance in Appendix 2 to comment on the potential National Accounts determination of the Project.

Step 1: Is the project within scope?

There are two stages to consider:

Stage 1(a). Is the project a contract for services that depends on the provision of dedicated assets?

Yes, the Project would be for the provision of the design, supply, installation, commissioning, maintenance, support and management of energy efficiency infrastructure. The infrastructure will be designed to the specifications of the PGE through the procurement process and will be dedicated assets.

Stage 1(b). Is the public sector procuring authority, the end-user or another third party the main purchaser of the services provided by the provision of the dedicated assets?

Having determined that the project can be considered a contract for services based on the provision of dedicated assets, it is necessary to consider who is purchasing the services being provided.

The PGE is the end-user of the services based on the provision of dedicated assets.

It should also be noted that this assessment is in line with the general conclusion reached in the HMT Technical Guidance, which states that:

"for practical purposes...where a procuring authority is required to consider the provisions of IFRIC 12 'Service Concession Arrangements'...it will be necessary to consider the guidance contained within this paper in order to make the balance sheet determination for the purpose of the National Accounts."

Such a project would likely be within scope of IFRIC 12 above and is accordingly within scope of MGDD and budgeting rules for PFI and similar transactions.

Step 2: Having determined the transaction is within scope, is there strong evidence that the private sector is bearing most of the risk attached to the dedicated assets in question?

As this report considers indicative structures, we address the risk distribution for a treatment that would likely be considered off capital budgets and assess what factors would cause this to change.

Construction risk

Construction risk covers the risks associated with delivering the asset in working condition. The key aspects of construction risk include:

- Penalties for late delivery;
- Exposure to cost overruns and changes in relevant prices;
- Failure to meet specified standards;
- Initial design risk; and
- Exposure to external factors such as environmental risks.

The expectation is that the efficiency measures will be delivered on a price model based upon usage. The determined prices will spread the total cost of the project over the period of the contract. This spreading of costs over the contract period causes the private sector to be at risk of fluctuations in costs over the period of the contract. This would represent a significant risk being borne by the private sector, as should their cost estimates prove inaccurate, cost overruns and changes in material prices may fail to be covered by the fixed revenues associated with delivery of the contract.

Note that if the public sector procuring entity were to make milestone payments during the course of construction, the HMT guidance suggests that "some or all" of the construction risk would be retained by the

public sector. The level of milestones which would tip the risk balance toward the public sector is judgemental, but available guidance and precedent suggest that this is circa 30% of the total capital costs, and certainly no more than 49%.

Accordingly, the terms should be set out such that the contractor bears construction risk.

Availability risk

Through the contract terms, availability risk should rest with the contractor, such that at any time the dedicated asset is not available for use (through downtime or malfunction), the contractor would not be paid. Note that where a cap on availability deductions exists, the significance of the cap may render the availability risk as shared between both parties.

The terms of the contract should be set out such that the contractor bears availability risk.

Demand risk

Finally, demand risk is likely to be shared. While reductions in tenancy in a building may mean that payments to a contractor are lower, a contractor is unlikely to wish to take the risk that the PGE no longer requires the building (and therefore would make no payments).

The terms of the contract should be set out such that the contractor bears an element of demand risk.

Overall

Even with a shared demand risk, given the overall structure of the payment mechanism, it is likely that the overall contract terms will be set up to mean that the concession does transfer "significant risk" to the contractor. This would result in the assets in the service concession not scoring to capital budgets. Payments made to the contractor would instead be reflected in the resource budgets of the PGE.

6.2.4 Further considerations

In this structure the landlord or owner occupier does not take a stake in the SPV and therefore does not directly benefit from any upside, made by the SPV. The public sector is likely to enter into this structure if:

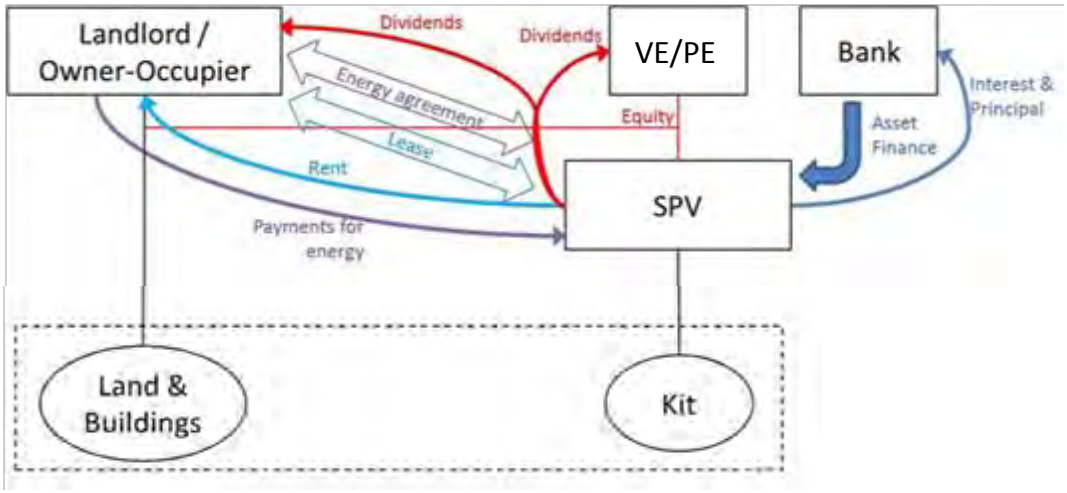
- It can achieve free/reduced cost heating; and/or
- It has to include renewables as part of its energy mix as a condition of planning consents.

6.2.5 Consideration against objectives

Objective	Service Concession
Leveraging private finance	The SPV will be funded by private finance (as both debt and equity).
Not on Capital Budgets	While this will score to the balance sheet of the public sector under IFRS, the contract can be structured such that budgeting risk allocation tests result in no score to capital budgets.
Reduce carbon consumption	The public sector will have far greater control over the measures to be implemented. As a result, this would mean that the public sector can implement more aggressive measures for carbon reduction. The public sector would also share an element of risk with the contractor, unlike in an executory contract and as such this arrangement may result in lower costs over the life of the concession for the savings achieved.
Dovetailing other property strategies	The public sector could extend a service concession for both energy efficiency measures and FM. It is likely that this would be a component of a full estate strategy however, while a service concession could be extended for individual specific situations.

6.3 Service Concession including equity stake

6.3.1 Definition



Note: Venture Capital/Private Equity refers to Owners/Equity providers to the SPV

- The PGE specifies both the energy efficiency services and these rely on dedicated assets used to provide those services;
- The contractor, through a SPV provides services to the public sector 'on the basis of dedicated assets' i.e. these assets will be dedicated for the use of the PGE and the contractor;
- For example, the PGE may specify that they would require a boiler or ground source heat pump;
- The SPV will be funded through debt and equity raised by the contractor, third parties and also an equity provided by the PGE; and
- Depending on the specifics of the payment mechanism, there will be an element of payment for the SPV making the dedicated assets available for use by the PGE, and an element based on energy efficiency gains/usage.

This structure is a service concession as described in Section 6.2 but in this instance the PGE does have an equity stake in the SPV and therefore does derive through dividends some benefit from the dividend payments that the SPV will make to its equity holders.

Depending on the equity stake, this may also result in the PGE having to account for their stake in the SPV either as an investment, or through consolidating on a line-by-line basis, each of the SPVs assets and liabilities.

6.3.2 Accounting implications

The analysis of this structure in terms of the application of IFRIC 12 would be the same as in Section 6.2.1 above.

As a result, IFRIC 12 would apply and the underlying assets would be recognised on the balance sheet of the PGE.

The existence of an equity stake in the SPV by the PGE would have an impact upon the accounting.

Equity accounting /Consolidation

An equity stake of over 20% would, under IAS 27, indicate a significant influence by the PGE over the SPV, and would therefore be considered to be an **associate** of the PGE. Moreover, if (as defined below), the PGE also has joint control over the SPV, it would be considered a **joint venture**.

IAS 27 sets out that:

"If an entity holds directly or indirectly (e.g. through subsidiaries) 20 per cent or more of the voting power of the investee it is presumed that the entity has significant influence unless it can be clearly demonstrated that this is not the case" (IAS28:3)

*"**Significant influence** is the power to participate in the financial and operating policy decisions of the investee but is not control or **joint control** of those policies" (IAS28:3)*

"The existence of significant influence by an entity is usually evidenced in one or more of the following ways:

1 representation on the board of directors or equivalent governing body of the investee;

2 participation in policymaking processes including participation in decisions about dividends or other distributions;

3 material transactions between the entity and its investee;

4 interchange of managerial personnel; or

5 provision of essential technical information

"Joint control is the contractually agreed sharing of control of an arrangement which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control." (IAS28:3)

The PGE can elect to account for its stake in the associate or joint venture under the Equity method. Under this method:

".. On initial recognition the investment in an associate or a joint venture is recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the investee's profit or loss is recognised in the investor's profit or loss." (IAS28:10)

Note that, despite the level of the stake in the SPV, IFRS "Consolidated Financial Statements", sets out that if the PGE directly ***controls*** the activities of the SPV, the assets and liabilities would be consolidated on a line by line basis into its consolidated financial statements.

The tests for the point at which control is said to exist (and consolidated accounts are required) are set out in IFRS 10.

*"An investor **controls** an investee [33] when it is exposed or has rights to [33] variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee" (IFRS 10:6)*

*"Thus an investor **controls** an investee if, and only if, the investor has all the following:*

1 power over the investee

2 exposure or rights to variable returns from its involvement with the investee; and

3 the ability to use its power over the investee to affect the amount of the investor's returns" (IFRS10: 7)

"An investor with the current ability to direct the relevant activities (activities of the investee that significantly affect the investee's returns) has power even if its rights to direct have yet to be exercised Evidence that the investor has been directing relevant activities can help determine whether the investor has power but such evidence is not in itself conclusive in determining whether the investor has power over an investee" (IFRS10: 12)

This is particularly important when considering the setup of the contractual terms. An SPV that exists solely for the purposes of delivering the energy efficiency measures to the PGE may be considered to be controlled by the PGE (i.e. the SPVs "relevant activities" as defined above would be solely the provision of the contract and as such would be reliant on the PGE for the value of its returns).

The accounting disclosure in the event of consolidation would be to recognise both the assets and liabilities of the SPV into the accounts of the PGE. This would have the effect of grossing up both the assets and liabilities of the PGE. Note that while the PGE would recognise a liability to repay the SPV, the SPV would equally recognise a financial asset to receive payments from the PGE. Moreover, the SPV would also show liabilities for the debt required to fund the building of the assets. The PGE would therefore have to recognise the full value of this financial asset and the related debt on their balance sheet. The net impact on the balance sheet is nil as assets are offset by equal and opposite liabilities. However, this may result in the PGE breaching any covenants they may have as a result of the gross liabilities (admittedly offset by gross assets) being recognised on its balance sheet.

6.3.2 Budgets

If the PGE enters into a service concession with the SPV which results in an 'off balance sheet' treatment for budgeting purposes, any ownership stake in the SPV may have an impact on this treatment.

The implication of an off balance sheet budgetary treatment is that the risks and rewards relating to the service concession assets are transferred to the SPV and hence are not held by the PGE. However, the presumption of risk allocation is undermined where the PGE has a share of the SPV's equity. The PGE is not able to allocate risk away from the public sector into an organisation in which the public sector has a stake.

There are no hard and fast rules to what percentage of equity is permissible in this instance since every case is judged on its own merits and other factors outside of the equity stake in the SPV, will be relevant within the meaning of ESA 95. However, typically, anything less than 25% equity may support the case for the successful allocation of risk away from the PGE.

Office of National Statistics

The analysis regarding the treatment of any project for National Accounts purposes draws on the rules set out in the MGDD and the specific guidance issued in the HMT Technical Guidance. It is imperative to note that the ONS is the sole agency in the UK for determining the treatment of an entity or a transaction in the National Accounts. Accordingly, any comments we provide on the potential treatment of a project in the National Accounts are subject to the impact of any future judgement by ONS.

6.3.3 Further considerations

In this structure the landlord, or owner occupier, takes a stake in the SPV and therefore shares from any upside. The public sector is likely to enter into this structure if:

- It can achieve free/reduced cost heating;
- It wants to share in the upside of any additional savings realised;
- It has to include renewables as part of its energy mix as a condition of planning consents; and/or
- The equity or debt providers require them to stand behind the structure to reduce counterparty risk in the SPV.

6.3.4 Consideration against objectives

Objective	Service Concession including equity stake
Leveraging private finance	The SPV will be funded by private finance (as both debt and equity). There will be a level of equity invested by the public sector as well, but given the objective of keeping this off capital budgets, this will not be significant, and the majority of funding will be private.
Not on Capital Budgets	While this will score to the balance sheet of the public sector under IFRS, the budgeting risk allocation tests would indicate that this would not score to Capital Budgets, in the absence of an equity stake. However, any equity stake by the public sector in the SPV has the potential to undermine this as risk is transferred back to the PGE. We would recommend that HMT, and if possible ONS, be consulted to understand their current interpretation of the guidance when fine tuning this structure.
Reduce carbon consumption	The public sector will have far greater control over the measures to be implemented. As a result, this would mean that the public sector can implement more aggressive measures for carbon reduction. The public sector would also share an element of risk with the contractor, unlike in an executory contract and as such this arrangement may result in lower costs over the life of the concession for the savings achieved.
Dovetailing other property strategies	The public sector could extend a service concession for both energy efficiency measures and FM. This is likely to be a full building strategy however, while a service concession could be extended for individual specific situations.

7. Other considerations and next steps

7.1 Other Considerations

This report considers each of the structures against the objectives set out by SFT. It does not consider all possible issues to be taken into consideration before making a decision to proceed with one of these structures. For example, we have not considered:

- Tax implications such as enhanced capital allowances or VAT;
- Legal or contractual matters;
- Public sector procurement routes;
- The economics of installation of particular measures on particular properties; or
- Value for money considerations.

7.2 Next Steps

This section sets out potential considerations which would be relevant to implementing any energy efficiency measures.

7.2.1 Build consensus across stakeholders on the accounting treatment

The accounting and budgeting treatment set out earlier within this report is based upon the application of the FReM, Local Government Code and HMT guidance on the treatment of service concessions. While the accounting guidance is very prescriptive under IFRS, the budgeting guidance is less so.

Budgeting treatment for service concessions is ultimately predicated upon the determination of a project by the Office of National Statistics. This is on the basis of judgement on the transfer of risks of a project between public and private sectors. As such, it is difficult to set out with certainty the budgeting treatment without a set fact pattern and contractual payment mechanism.

As a result it is important, especially for projects which have not previously been attempted, to obtain both from your auditors (for a Resource Accounting perspective) and HMT and ONS (from a budgetary perspective), a view on the treatment of each structure before it is implemented.

7.2.2 Feedback from across the Scottish Public Sector

Efficiency measures and their usefulness across government will need to be tested at various levels and across sectors in Scotland (i.e. Scottish Government, NDPBs, Agencies, Local Authorities).

Feedback on the measures and sources of funding suggested in this report will be useful in fine-tuning the approach to energy efficiency structures in Scotland.

7.2.3 Value for Money considerations

Any potential investment by a public sector entity must meet value for money requirements. Therefore before any particular commercial structure is implemented a value for money case should be developed. This will include consideration of the level of risk transfer and maximisation of the benefits arising from carbon savings and energy efficiency savings.

7.2.4 Affordability

The affordability implications of the proposed structures would also require consideration by the PGE. There is an expectation that the energy efficiency measures should be self-funding from energy savings but this assumption needs to be tested and where possible, the level of potential savings quantified.

7.2.5 Identify market appetite

This report sets out a number of potential commercial structures and sources of finance. In this regard, it will be important to test the appetite and capacity in the market, for the proposed commercial structures, the proposed risk transfer and their willingness to fund these.

7.2.6 Procurement considerations

The PGE will also need to make decisions on the procurement approach (e.g. single tender, framework). The PGE will ideally consider their capacity to develop and execute a potential commercial structure as well as affordability and value for money. There are opportunities to collaborate in the development of standardised contracts across the Scottish public sector for the preferred commercial structures.

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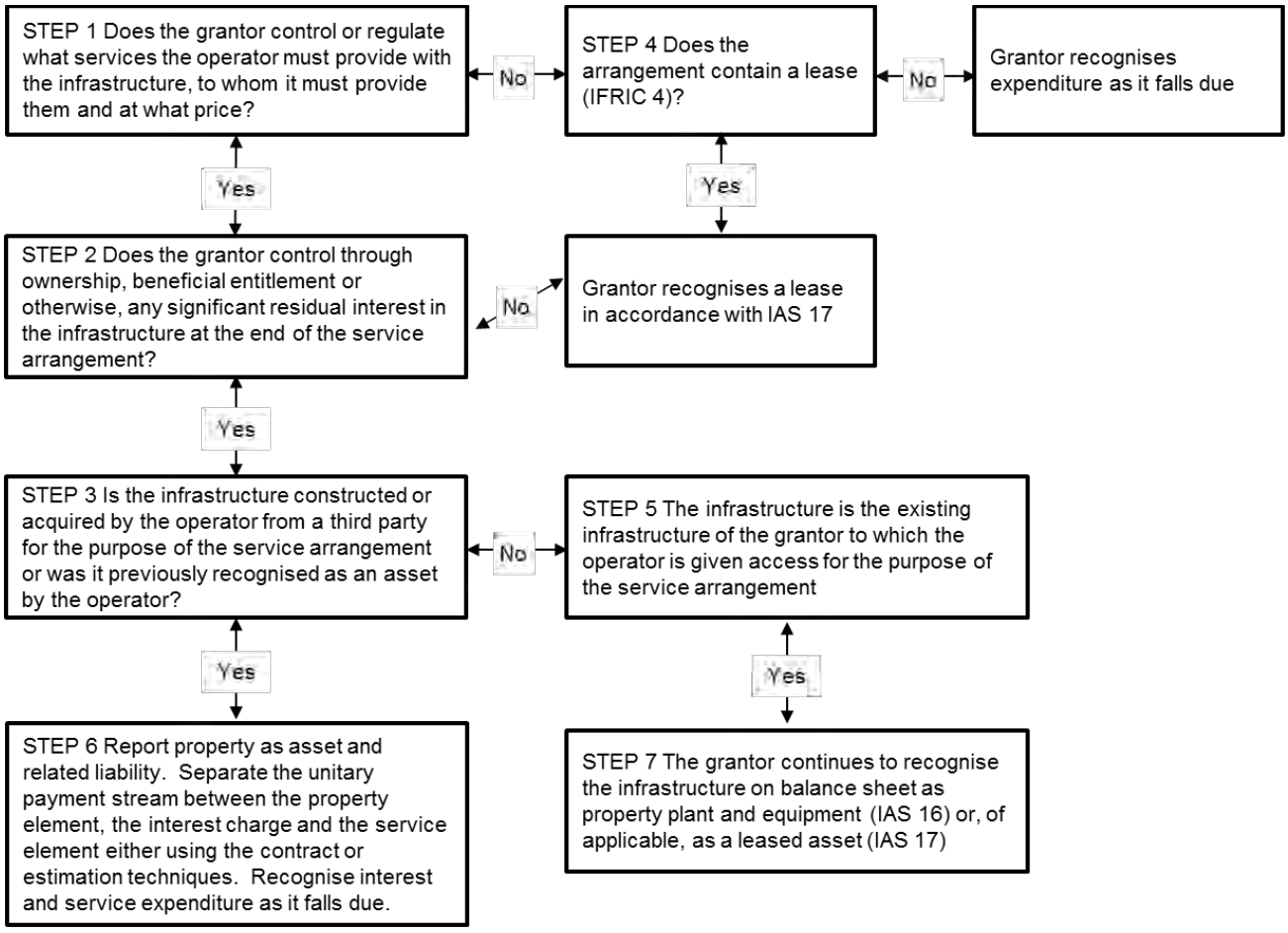
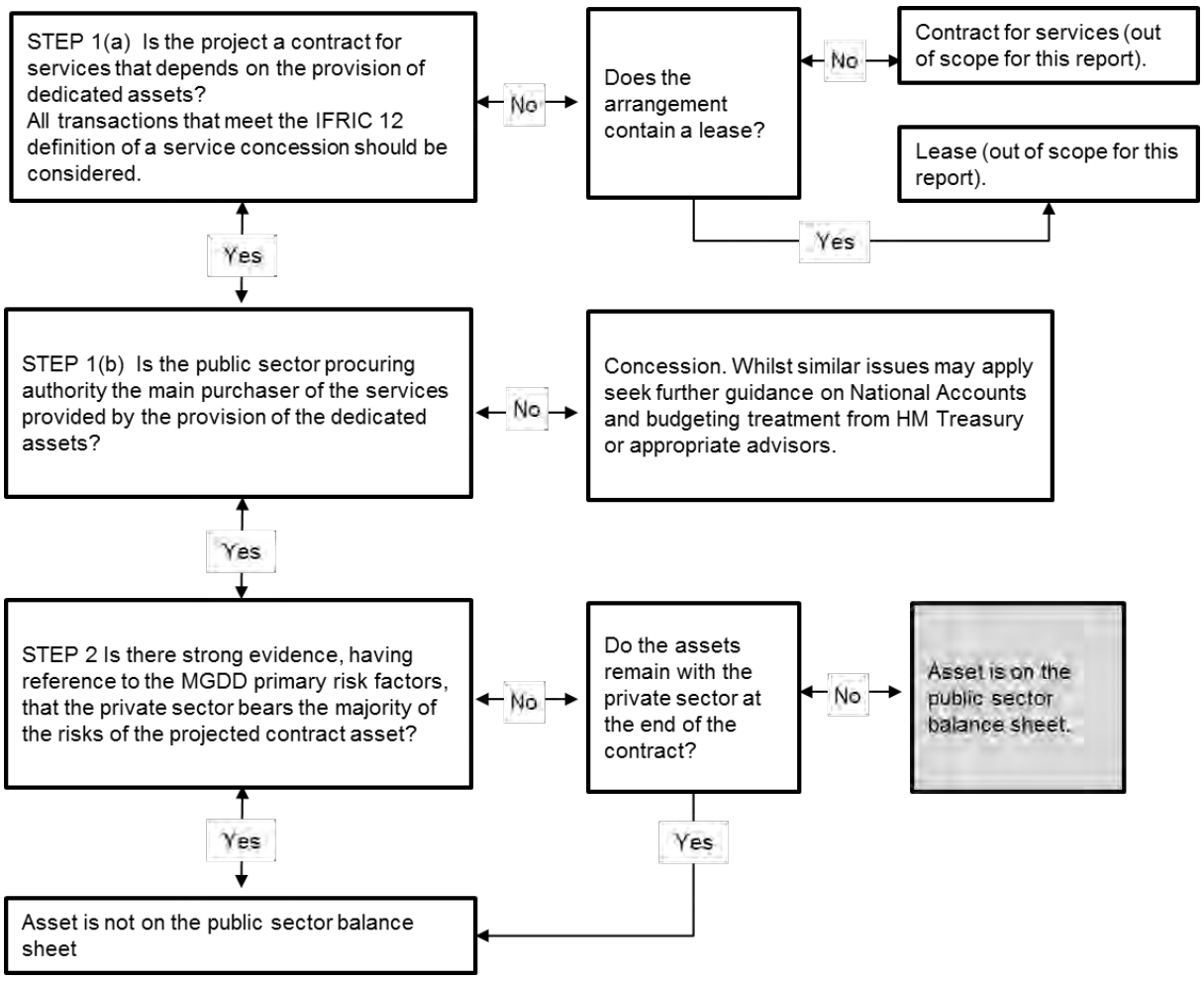
Appendix 1: IFRIC 12 based decision tree (relevant to financial accounting)



Source: Replicated from HMT's draft for consultation guidance 'Technical Guidance on the Application of the Standards used in the production of Nationalstructure, to whom it must provide Accounts to PFI and Similar Transactions'.

Appendix 2: ESA 95 flow chart (relevant to National Accounts and Budgetary Treatment)



Appendix 3: Glossary of Terms

Term/acronym	Meaning
Part A	The summary report entitled “Scottish Futures Trust Energy Efficiency Measures Part A Commercial and Accounting impacts Overview” dated 22 January 2013
SFT	Scottish Futures Trust
NDPB	Non Departmental Public Body
IFRS	International Financial Reporting Standards
MGDD	Manual on Government Deficit and Debt
HMT	HM Treasury
Service Concession	Arrangement through which the public sector specifies both services and the assets used to provide those services. In this document, the arrangements will be for the provision of energy efficiency services.
HMT Technical Guidance	Technical Guidance on the Application of the Standards used in the production of National Accounts to PFI and Similar Transactions
CBG	HMT issued Consolidated Budgetary Guidance
Contractor	Private sector operator providing either a service or a set of assets and related services to the public sector under defined contract terms
PGE	Procuring government entity. A public sector body that enters into a contract with a private sector operator to receive energy efficiency services and/or assets and related services.
ESCO	Energy Service Contract
Capital Budgets	Budgets for new investment and net policy lending
Resource Budgets	Budgets for current expenditure such as pay or procurement and including depreciation, which is the current cost associated with the ownership of assets.
RHI	Renewable Heat Incentive
PV	Photo Voltaic
FIT	Feed in Tariff
Executory Contract	Defined accounting principle suggesting the procurer only pays for services as they are delivered
SPV	Special Purpose Vehicle
PSND (description)	Public Sector Net Debt – Economic Indicator representing the total debt across the Public Sector
IASB (description)	International Accounting Standards Board – Independent accounting standard setting body of IFRSs
Finance Lease	A lease that transfers the majority of the risks and rewards to the Lessee.
Operating Lease	A lease that is not a finance lease.
ESA 95	European System of Accounts 1995 – system of national accounts and regional accounts used by members of the EU.
IFRIC 12	International Financial Reporting Interpretations Committee Interpretation 12 – Service Concession Arrangements

Appendix 4: Scope of work

1.1. Analysis and assessment of the funding/financing and commercial delivery structures as named in the proposal, as well as any relevant alternative or variant structures, identifying options to be considered in detail and drawing on practical examples where appropriate. This analysis will include, but will not be limited to:

- Description of the structures' key characteristics;
- Identification of the key risks and benefits;
- Applicability to energy efficiency improvements including examples of successful delivery; and
- Recommendation for structures to be assessed in more detail as part of the commission.

1.2. Identification, description and assessment of current, relevant accounting and budgeting treatment guidance for Scottish Government public sector accounting in relation to energy efficiency improvements to buildings, which should include, but not be limited to:

- Review of applicable and relevant accounting and budgeting treatment and guidance;
- Any potential future considerations (e.g. treatment of leasing); and
- Identification of the key issues to be considered in relation to the relevant commercial structures and of any issues that may be specific to particular types of improvement measures and assets.

1.3. A more detailed assessment of the implication of these accounting and budgeting treatment requirements in relation to specific commercial and delivery structures, identifying how best to optimise these commercial structures to minimise the impact on public sector capital budgets, which should include but will not be limited to:

1.3.1. An assessment of the impact of:

- alternative asset ownership, operations and maintenance;
- contract duration;
- payment mechanism and sharing of cost savings and risk;
- product guarantees; and
- specification of services.

1.3.2. Identification of issues and solutions to address any specific improvement measure considerations (e.g. boilers, lighting, insulation etc); and

1.3.3. Identification of any potential barriers to implementation and identification of actions to address these.

1.4. An analysis of the Local Authority issues in relation to the findings of paragraph 3.3 above in relation to accounting and budgeting treatment, and identification of potential variations that may need to be taken into consideration.

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