Deloitte.

Scottish Futures Trust

Energy Efficiency Measures

Part A - Commercial and Accounting impacts Overview

22 January 2013

Contents

1. Basis of Report

1.1 Background

This Report considers at a high-level the range of outline commercial structures for implementing energy efficiency measures across the public sector in Scotland, and their resulting accounting and budgetary impacts. Deloitte has advised Scottish Futures Trust ("SFT") in accordance with our contract dated 21 November 2012.

1.2 Purpose of this report

The report examines the potential accounting and budgetary treatment implications of a range of outline commercial structures based on current International Financial Reporting Standards ("IFRS"), as applied in the public sector, and budgeting guidance as set out by HM Treasury ("HMT"). It does not constitute an accounting opinion.

This report should be read in conjunction with the report entitled "Scottish Futures Trust Energy Efficiency Measures Part B - Technical Guidance on Commercial and Accounting Impacts" dated 22 January 2013 ("Part B", the "Detailed Guidance"). The Detailed Guidance sets out the accounting standards and budgeting rules more fully as they would apply to energy efficiency structures. This report constitutes the high-level executive summary of the Detailed Guidance.

1.3 Limitations of our report

This report assumes that the accounting and budgeting treatments will be based on the high-level commercial structures set out in Section 6 of the Detailed Guidance. Any variations to the structures may result in a different analysis of the accounting and budgeting consequences of the structure. Note that commercial structures in this report are summarised from the full detail set out in the Detailed Guidance.

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, nor the detailed contractual terms which may be agreed between parties on implementing these structures.

This report has been written in general terms, based on hypothetical situations 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 herein. This is normal practice when carrying out such limited scope procedures, but contrasts significantly with, for example, an audit.

1.4 Accounting considerations

The following specific limitations of scope apply both to this report and to the Detailed Guidance:

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 reports.

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.

2. Introduction

2.1 Objectives of this report

SFT is considering the potential for implementing various structures for energy efficiency measures across Scotland, particularly where initial capital funding for projects can be raised through private finance, rather than utilising public sector Capital Budgets.

Some energy efficiency contracting structures may utilise Capital Budgets, whereas others will utilise Resource Budgets. In addition, some schemes may be ‘spend-to-save’ in nature so will be intended to result in a reduced budgetary requirement over time. This report is primarily focused on the use of Resource Budgets to fund energy efficiency improvements to the public sector estate.

Increasingly, energy efficiency represents a potential opportunity for the public sector to:

- Reduce budgetary pressure by releasing funding for use elsewhere;
- Generate cost savings;
- Decrease the impact of future energy price increases;
- Accelerate the transition to a net energy generation position;
- Decrease the impact of carbon taxes;
- Stimulate growth and jobs;
- Generate new revenue streams; and
- Reduce carbon emissions.

However, with increasing pressure on capital budgets and the scale of investment required in energy efficiency measures, delivering these benefits can be challenging.

This report sets out a range of potential shortlisted commercial structures; the types of property and public sector body for which they should be considered; and compares them against a series of objectives identified by SFT.

These objectives include:

- Not scoring to Central Government Capital Budgets;
- Leveraging external finance;
- Reducing carbon consumption; and
- Dovetailing with other property strategies.

This report is written from the perspective of the Scottish public sector broadly; for example (but not limited to):

- Central government departments including the NHS;
- Non-Departmental Public Bodies;
- Agencies; and,
- Local government.

These are referred to collectively hereafter as the Procuring Government Entity (“PGE”).

However, it must be noted that the specific objectives of each type of organisation each PGE may be different and, as such, each organisation should necessarily weigh up these outline commercial structures and their accounting and budgeting implications against their specific objectives. For example, a local government authority may decide that a commercial structure that does not result in a financial accounting liability, which affects borrowing limits and covenants, is a specific objective.

2.2 Structure of this report

Section 3 of this report outlines the three commercial structures that SFT considered to best meet the above objectives and are analysed in terms of:

- What measures can be delivered under each structure;
- How the structure may be considered off capital budgets; and
- The advantages and disadvantages of each structure.

Section 4 provides an overview of the applicable Accounting and Budgetary standards to provide insight into the key characteristics of each high-level commercial structure which means that they are likely to be off budget and to what extent these characteristics can be flexed.

The potential next steps that could be taken in developing these commercial structures are summarised in Section 5.

3. Analysis of outline commercial structures and potential measures

3.1 Identification of assessed commercial structures

While a number of commercial structures exist, the following three commercial structures were identified against SFT's objectives for more detailed analysis:

- Service concession arrangement;
- Service concession arrangement with the PGE taking on an equity stake; and
- Executory contract - this is an accounting term which is defined in Section 6.1 of the Detailed Technical Guidance paper dated 22 January 2013. In summary, an executory contract is one where the provider is paid as services are delivered.

As explained in Sections 3.2 to 3.4, depending on the precise nature of the contractual and commercial arrangements (which are considered in the accounting and budgetary treatment), these structures have the potential to score to Resource Budgets rather than Capital Budgets.

3.2 Service Concession

A service concession is an arrangement where the PGE specifies both the energy efficiency services and the provision of these dedicated assets.

The contractor, possibly through a Special Purpose Vehicle (the "SPV"), provides services to the PGE on the basis of 'dedicated assets' i.e. these assets will be dedicated for the use of the public sector customer and the contractor. The works may be funded through debt and equity raised by the contractor, including third-party finance.

Depending upon the specifics of the payment mechanism, there may be an element of payment related to (i) making the dedicated assets available for use by the PGE; and (ii) the delivery of energy efficiency savings.

More detail of the definitions and scope of a service concession with a public sector equity stake is provided in Section 6.2 of the Detailed Guidance report dated 22 January 2013.

What measures could be deliverable?

Examples of measures which could be deliverable under a service concession arrangement include:

- Insulation works integral to the building such as solid wall insulation or cavity wall insulation;
- Contractor manages existing building controls to reduce energy consumption;
- Contractor simply runs the building more efficiently;
- "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.

How may this structure be considered off Capital Budgets?

A service concession may be considered "on balance sheet" for accounting purposes, but may be off capital budgets i.e. the accounting and budgeting treatment may differ as explained below and within Section 4.

Service concessions will be accounted for under International Financial Reporting Interpretations Committee Interpretation 12 of Service Concession Arrangements ("IFRIC 12"), accounting guidance which specifies that the assets underlying an arrangement will be accounted for on the balance sheet of the PGE, with a corresponding liability for payments to be made to the contractor for services over the life of the contract.

However, in the case of a service concession, budgeting treatment is considered separately under European System of Accounts ("ESA 95") rules, which may not result in the same conclusion as the accounting treatment. For accounting purposes, a service concession is most usually considered to be on balance sheet for the PGE, but depending on the allocation of risk as assessed under the ESA 95 tests may still be considered off capital budgets.

In summary, by transferring "construction risk" and one or both of "availability" and "demand" risk related to the assets underlying the project, the arrangements would not score to capital budgets.

The accounting and budgeting assessments are not straightforward but the trigger points at which they would be considered a service concession type arrangement, or would score to capital budgets are considered in detail in Section 4.3 to 4.5 below.

Note that where an arrangement falls out of scope of IFRIC 12, for example because it is for "dedicated assets" for the sole use of the PGE but the PGE did not control the asset at the end of its useful life, there may arise circumstances where that arrangement would be classified as a lease. This is explained in Section 4. When an arrangement is classified as a lease, the accounting and budgeting will be the same, and the capital element of any finance lease will necessarily score to capital budgets.

What are the advantages of a service concession (with ESA 95 budgeting risks transferred)?

- The PGE can specify the type of measures;
- More measures can be implemented than compared to an executory contract (see Section 3.4 below), in particular those integral to the building;
- There is scope to integrate energy efficiency measures with wider asset management strategies such as asset replacement, maintenance, lifecycle and building facilities management; and
- Does not score to capital budgets (subject to the ESA 95 budgeting assessment).

What are the disadvantages of a service concession (with ESA 95 budgeting risks transferred)?

- If the PGE is specifying the measures they may limit innovation by bidders;
- Results in a balance sheet liability (albeit with a corresponding balance sheet asset); and
- PGE will require headroom for the liability against any covenants or similar (e.g. Prudential Borrowing).

3.3 Service Concession with public sector equity stake

This is materially the same as the arrangement for a Service Concession above, but with the PGE also taking a stake of the equity in the SPV, in addition to the private sector. This may be desirable if the PGE wishes to retain some upside risk that savings may be higher than expected. More detail of the definitions and scope of a service concession with a public sector equity stake is provided in section 6.3 of the Detailed Guidance report dated 22 January 2013.

Deliverable measures would potentially be the same as in a service concession with no equity stake, and as described in Section 3.2.

How may this structure be considered off capital budgets?

If the PGE enters into a service concession with the SPV which would otherwise result in an 'off capital budget' treatment, any ownership stake in the SPV may have an impact on this budgetary treatment as it may limit the amount of risk transferred.

The implication of an off capital budget treatment is that the risks and rewards relating to the service concession assets are transferred to the SPV and therefore 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. Thus, as an equity holder in the SPV, the PGE is exposed to some of the risk it transfers to the SPV which weakens the overall risk transfer.

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

What are the advantages of retaining an equity stake?

- The PGE may retain some upside risk if savings are higher than expected when agreeing payment structures with the SPV;
- The public sector would have an increased degree of influence over the running of the SPV; and
- It may still not score to capital budgets subject to the ESA 95 budgeting assessment, though this treatment would become more complex.

What are the disadvantages of retaining an equity stake?

- The budgetary treatment becomes more complex and therefore less certain as the PGE retains additional risk in the project;
- Depending on the degree of control and influence, the PGE's balance sheet may be grossed up through consolidating the SPV (i.e. the accounting disclosure in the event of consolidation would be to accumulate both the assets and liabilities of the SPV into the accounts of the PGE); and
- The PGE retains some downside risk that savings may not be as high. Thus, if the PGE's payments to the SPV are related to the delivery of savings and these savings are not delivered the PGE will pay less to the SPV. However, as an equity holder in the SPV the PGE then fails to realise its expected equity return.

3.4 Executory Contract

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 i.e. on the realisation of energy savings. More detail of the definitions and scope of an executory contract is provided in Section 6.1 of the Detailed Guidance report dated 22 January 2013.

What measures would be deliverable?

It would be up to the energy service provider 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 energy consumption reduction targets for the service provider. Potentially, the procurement of such a service could require bidders to bid a guaranteed reduction in energy use as well as a fee per unit saved in order to encourage maximum energy savings. Any specification of measures during procurement would likely indicate that the arrangement was a Service Concession rather than an Executory contract.

It is likely that the PGE would have to agree levels of access to buildings with the service provider, allowing them to restrict access to certain parts of the building or to certain times.

Where the private sector contractor would be paid upon the delivery of a service only (i.e. when they reduce energy use) and the private sector contractor is at risk for the performance of any kit they utilise, this would be an indication that the contract is an executory contract.

Examples of measures which could be implemented using this structure include:

- Contractor manages existing building controls to reduce energy consumption;
- Contractor simply runs the building more efficiently;
- "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, provided not for the sole use of the PGE (see Section 3.5).

It is unlikely that measures which are integral to a building such as cavity wall or solid wall insulation could be implemented under this structure as they would likely be deemed "dedicated assets", implying that the contract would be considered a service concession (see Section 3.2).

While some public sector organisations are more used to accounting for long-term contracts as service concessions, the length of the contract is not overly relevant to determining the correct accounting treatment, rather, the balance of risk transfer as described above is the most relevant consideration, noting of course that risk transfer around underlying assets and the length of the contract are not unrelated.

How would this structure be considered off Capital Budgets?

An executory contract would not score to capital budgets. However, in order for an energy services contract to be considered an executory contract, the PGE would have to specify that a contractor reduces the PGE's energy usage by agreed percentages and is paid based on the delivery of efficiency savings with no specification of any measures or underlying assets.

As explained further in the examples in Section 4, in circumstances where assets are seen to be dedicated assets for the use of the PGE, this could indicate that under accounting and budgetary standards the contract is a service concession, despite the payment stream being based upon efficiency savings. For example, if the contractor installs wall cladding or other immovable long-term kit, this could imply that the PGE is paying for the kit over the term of the arrangement which could be said to be underlying dedicated assets. As a result, this would need to be considered on a case-by-case basis.

What are the advantages of a executory contract?

- Provides the option to transfer key risks 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; and
- May stimulate innovation as the private sector (through a bidding process) would be free to suggest newer ways of providing energy efficiency measures.

What are the disadvantages of a executory contract?

- It would need the private sector contractor to take the risk of achieving agreed savings, which may not be commercially acceptable in certain situations;
- The more risk that the private sector accepts the higher the contract prices are likely to be;
- PGE loses ability to specify types of measures they wish to see implemented;
- There would need to be consensus with the PGE's finance function and external auditors to ensure the arrangements are agreed to be executory contracts; and
- The contract may artificially limit the (carbon) saving potential due to the need to exclude measures integrated into the building and therefore may not necessarily provide an optimal solution to achieve the full technical potential and/or medium to long term payback of measures.

3.5 Energy efficiency measures

Potential measures that could be delivered under a set of contractual arrangements and can be accounted for as either a service concession or an executory contract are detailed in Table A1 below. These measures are not exhaustive, but provide an indication of the accounting types for the measures deliverable under each structure.

The table includes an indicative Red, Amber Green rating (RAG):

- Red indicates that the measures are unlikely to be deliverable under that type of arrangement;
- Green indicates that the measures are likely to be deliverable under that type of arrangement; and
- Amber indicates that further consideration would be required on the factors set out in the box.

The Table also provides specific comments on how measures may need to be specified to meet the requirements of executory contracts.

Table A1: Measures available under either a Service Concession or an Executory Contract

Measure	Service Concession (inc with public sector equity stake)	Executory Contract
Insulation works integral to the building such as solid wall insulation or cavity wall insulation		Items delivered as full building measures may be considered to be for the delivery of "dedicated assets" and considered service concessions
Contractor manages existing building controls to reduce energy consumption		
Contractor simply runs the building more efficiently		
"Moveable" energy efficiency works such as new heating, cooling or lighting systems		Could be delivered as executory contract if the PGE has no control over the types of measures installed and only specifies the levels of energy savings required
Localised clean energy generation technology such as ground or air source renewable heat, biomass heating or solar PV		Could be delivered as executory contract if the PGE has no control over the types of measures installed and only specifies the levels of energy savings required

4. Accounting and Budgeting overview

4.1 Introduction

In this section a summary description of the main considerations in relation to the accounting and budgeting treatment for a number of potential commercial arrangements is provided through a series of Q&A references.

Q4 (i) What is the distinction between accounting and budgeting?

There are two main methods of reporting which are relevant to the 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 (“arrangement(s)”) which may be entered into to deliver energy efficiency measures.

Q4 (ii) What are the different accounting and budgeting treatments that an arrangement for energy efficiency measures may result in?

Table A2 summarises the accounting and budgetary treatment of various outline commercial structures. Note that the table below and Sections 4.2 onward consider lease accounting in addition to service concessions and executory contracts. These are not considered in the shortlist of options as finance leases score to capital budgets, but are set out here as changes to outline commercial structures can result in that arrangement being classified as a lease.

Table A2: Relevant Accounting and Budgetary Rules

Potential Commercial Arrangements	Accounting (Resource Accounts)	Budgeting (Departmental Budgets)
Executory contract	Account for expenditure as and when it is incurred. There are no long term liabilities or assets. The accounts may include a disclosure note of the commitments to make payments over the life of the arrangement.	The budgeting will follow the accounting. Expenditure will be recognised as and when incurred on *resource budgets.*
Operating lease[1]	Account for expenditure as and when it is incurred. There are no long term liabilities or assets. The accounts will include a disclosure note of the commitments to make lease payments over the life of the arrangement.	The budgeting will follow the accounting. Expenditure will be recognised as and when incurred on *resource budgets.*
Finance lease	Recognise a liability to pay for the asset over the life of the contract. This will be based on the net present value of the guaranteed minimum lease payments for the asset. Recognise an asset for the items that are being installed by the contractor. Initially this will equal the liability being recognised and it will then be treated in line with other assets of that class.	The budgeting will follow the accounting. The capital expenditure to repay the debt will be recognised on *capital budgets* and the subsequent depreciation (and embedded finance charges) will score to *resource budgets.*
Service concession	Recognise a liability to pay for that asset over the life of the contract. This will be based on the net present value of the guaranteed asset related payments. Recognise an asset for the items that are being installed by the contractor. Initially this will equal the liability being recognised and it will then be treated in line with other assets of that class.	Budgeting treatment is assessed separately and does not necessarily follow the accounting treatment. The budgeting treatment will depend upon the risk transfer from the public sector to the private sector contractor. If sufficient risk is transferred, the payments will be classified as scoring to *resource budgets (similar to operating lease treatment).* If insufficient risk is transferred the initial capital expenditure will be recognised on *capital budgets* and the subsequent depreciation, service charges (and embedded finance charges) will score to *resource budgets* (similar to finance lease treatment).

The accounting and budgetary considerations for the four arrangements identified above are assessed in Sections 4.3-4.6.

[1] Note, under current IASB proposals, the operating lease classification may cease to exist in its current form. In essence this would require an asset and liability equal to the entities share of the asset to be recognised on the entities balance sheet as if it were a finance lease.

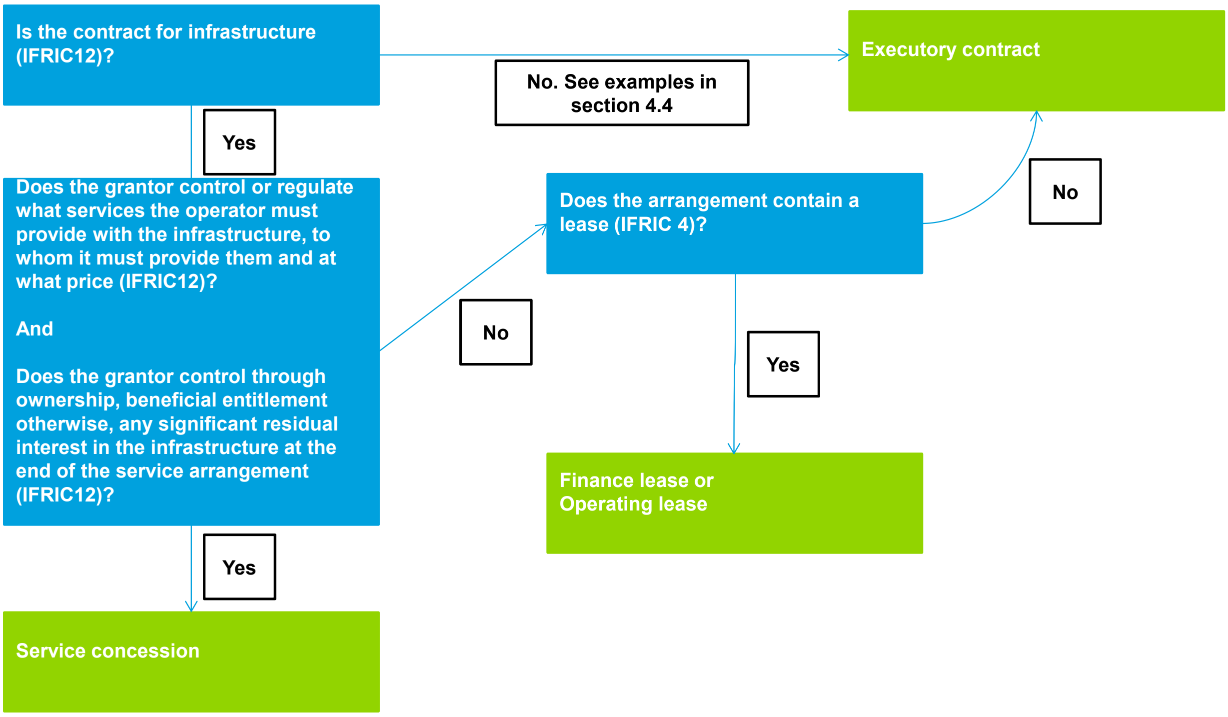
4.3 Accounting and budgetary framework

The questions below set out the accounting and budgeting treatments which would follow for all but the Service Concession arrangement. The budgeting issues for a Service Concession are set out in Section 4.5.

Q4(iii) What are the standards that need to be considered when accounting for an energy efficiency arrangement?

The standards which may be relevant when considering the accounting implications of an energy efficiency arrangement include IFRIC 12, IFRIC 4 "Determining whether an arrangement contains a lease" ("IFRIC 4") and IAS 17 "Leases" ("IAS 17"). The decision tree shown below indicates the key questions which need to be determined in order to identify the appropriate accounting treatment:

Diagram A1: Accounting Treatment Decision Tree



4.4 Is the contract a Service Concession or an Executory Contract ?

The following paragraphs provide a high-level overview of the accounting guidance and provides indicative examples of how the nature of an energy efficiency contract may influence the accounting treatment. Note that the accounting standards themselves are discussed in the Detailed Guidance dated 22 January 2013.

Q4 (iv) What is the initial consideration for treating a project as an executory contract as opposed to a service concession?

The accounting guidance that deals with service concessions is contained within IFRIC 12. A service concession under IFRIC 12 is commonly understood to mean an arrangement ***which is for the provision of infrastructure assets, and associated services***, either directly to the public, or to the public sector to enable the provision of public services.

Any arrangement that is for the provision of both infrastructure assets and associated services, is likely to fall under the initial considerations of IFRIC 12 and could need to be assessed against the subsequent criteria.

If however, the arrangement does not involve the provision of assets (though any private sector contractor may utilise some assets to perform their duties), then the arrangement would be an executory contract.

Table A3: Indicative examples –Applicability of IFRIC 12

Examples of arrangements which are likely to fall outside the scope of IFRIC 12 and therefore may be an Executory Contract	**An arrangement whereby the PGE only sets out that a contractor reduces the PGE's energy usage by agreed percentages and is paid based on delivery of efficiency with no specification of any assets**. Where the private sector contractor would be paid upon the delivery of a service only (i.e. when they reduce energy bills) and the private sector contractor is at risk for the performance of any kit they utilise, this would be an indication that the contract is an executory contract. Further examples: • Arrangement where a contractor manages existing building controls to reduce energy consumption; and • Arrangement where a contractor simply runs the building more efficiently.
Examples that are harder to conclude on definitively.	Possible examples, where further analysis of the payment mechanism and risk sharing would be required: • Under the same terms as above, if the contractor installs wall cladding or other immovable long term kit, this could indicate that the PGE is paying for the kit over the term of the arrangement, and could be said to be underlying infrastructure assets.
Examples of arrangement which would be considered infrastructure (i.e. fall within the scope of IFRIC 12) and therefore not an Executory Contract	**An arrangement where the PGE tenders for a boiler and maintenance of that boiler for the life of the contract** is likely to be indicative of a service concession or lease, and not be considered an executory contract. There are clearly infrastructure assets underlying the arrangement which is dedicated to the contract and the arrangement is not for services only.

If the arrangement contains a lease the accounting will be for either an operating or finance lease which is described further in Section 4.5. The budgeting treatment for a lease will follow the accounting treatment.

Q4 (v) Would it be possible for an arrangement that is considered to provide infrastructure under IFRIC 12 to still be considered a executory contract?

Yes. Based on the continuing IFRIC 12 assessment, an arrangement may pass the initial IFRIC 12 tests but subsequently fall outside of scope on the "controls" based tests below. In this case it is likely to be considered as either a finance lease; an operating lease; or an executory contract.

Q4 (vi) Once an arrangement is within the scope of IFRIC 12, what are the tests to ascertain if it is a service concession?

There are 2 tests:

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?**

The interpretation of the guidance is that in most scenarios the PGE will, through any process of awarding a contract, control what services will be provided and that the contract will also stipulate a price. In practice, it is very unusual to see an arrangement where a PGE enters into any arrangement without determining the price or the service required.

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

If the contract states that the ownership of assets will remain with the PGE upon termination of the contract, then this would firmly indicate a service concession arrangement. Similarly, if the arrangement was for the majority of the useful life of the underlying infrastructure assets, then under the guidance it would be considered that the PGE would have consumed the entire asset and would also indicate a service concession.

On the other hand, where the private sector contractor takes away the asset at the end of the arrangement and is able to utilise this asset elsewhere, it would appear that the public sector does not have a significant residual interest in the asset.

In addition, it is worth noting that the right of first refusal over the assets is considered to constitute control. Hence, if the contract stipulates that the PGE can buy the assets this would constitute control.

Table A4: Indicative examples – IFRIC 12 Tests – Is this a service concession?

Examples of arrangements which would not be considered a service concession	• An arrangement which included the temporary installation and maintenance of equipment with a useful life of 10 years for a one year contract. The equipment is then removed and used elsewhere by the private sector. • Installing and providing heat through a community heat pump which has a life of 20 years over a period of five years which would be used to provide heat to other entities in addition to the PGE. The equipment would continue to be used by the private sector beyond the five-year contract.
Examples that are harder to conclude on definitively	• A set of arrangements that does not definitively meet or is excluded from the criteria set out above requires further consideration, on a case by case basis. • It is usual for many arrangements to fall within this area and therefore a more detailed assessment of the project against the accounting standards is necessary.
Examples of arrangement which would be considered a service concession	• **An arrangement where the PGE tenders for a boiler and maintenance of that boiler for 10 years (where the useful economic life of the boiler is 10 years).**

If the accounting treatment results in the arrangement being classified as an executory contract, then the budgeting will follow the accounting, and expenditure will be recognised as and when incurred on *resource budgets*.

If the accounting treatment results in the arrangement being classified as a service concession the budgeting treatment is assessed separately and does not necessarily follow the accounting treatment.

The budgeting treatment will depend on the risk transfer from the public sector to the private sector contractor. If sufficient risk is transferred, the payments will be classified as scoring to *resource budgets (similar to the accounting treatment of operating leases).*

If insufficient risk is transferred the initial capital expenditure will be recognised on *capital budgets* and the subsequent depreciation, service charges (and embedded finance charges) will score to *resource budgets (similar to the accounting treatment of finance leases).*

Section 4.6 sets out full detail on how to undertake the budgeting assessment for a service concession.

4.5 Potential treatment as a lease

Q4 (vii) Could the arrangement be classified as a lease?

Yes. As per the decision tree in Diagram A1, the next stage if an arrangement is not considered to be a service concession on the basis of the controls tests detailed above, is to apply IFRIC 4. IFRIC 4 states that in determining whether an arrangement should be viewed as a lease, the following criteria are to be considered.

a) Is the fulfilment of the arrangement dependent on the use of a specific asset or assets (the asset)?

For example, a simple provision of telephone handsets or internet router boxes as a means of providing telephone and network asset, would be considered under IFRIC 4 which would generally not view this as an implicit identification of specific assets. This is due to the assets being generally substitutable and the Supplier being able to replace and change out assets without consent required from the PGE.

b) Does the arrangement convey a right to use the asset?

This is considered when the following criteria are met:

- The PGE 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;
- The PGE 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,
- 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 PGE 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.

Under most arrangements where the PGE was the sole user, this last point would apply. However, if the arrangement was for a community measure such as a community ground source heat pump, it would appear that the PGE does not control the asset, subject to the understanding that it is *not* remote that one or more parties other than the PGE will take more than an insignificant amount of the output of that heat pump.

Table A5: Indicative examples – arrangements which may or may not be classified as a lease

Examples of arrangements which would not be considered a lease	• Arrangements that do not depend upon specific assets as there are no identifiable assets. • Arrangements where the assets are non-specific such that the private sector can substitute assets as in the example of the IT contract above.
Examples that are harder to conclude on definitively	• A set of arrangements that does not definitively meet or is excluded from the criteria set out above requires further consideration, on a case by case basis. • It is usual for many arrangements to fall within this area and therefore a

	more detailed assessment of the project against the accounting standards is necessary.
Examples of arrangement which would be considered a lease	• **Any assets installed in PGE premises where the significant output is consumed by the PGE. Note the more specialised and dedicated they are, the more likely the conclusion under IFRIC 4 that there is a lease.**

4.6 Budgeting treatment for service concessions

Q4 (viii) When do the additional tests for budgeting treatment apply?

As set out in Q4(vi),Test (b), for executory contracts and leases, the budgeting treatment follows the accounting treatment.

However, in the case of a service concession, budgeting treatment is considered separately under ESA 95, which may not result in the same conclusion as the accounting treatment. For accounting purposes a service concession is most usually considered to be on balance sheet for the PGE, but depending on the allocation of risk as assessed under the ESA 95 tests may still be considered off capital budgets.

Q4 (ix) What are the ESA 95 tests?

- In order for a project to be off capital budget under the ESA 95 tests, there needs to be clear evidence that most of the risk is transferred to the private sector contractor;
- Where construction risk and one or both of demand and availability risk are transferred, this would indicate that the project does not score to capital budgets; and
- There is often a level of sharing of availability and demand risks between the PGE and the private sector contractor. Accordingly, the payment mechanism must often be closely scrutinised to ensure sufficient risk is transferred to obtain an off capital budget treatment.

Construction risk transfer considerations include:

- An arrangement where the private sector contractor bears the risks associated with constructing any infrastructure assets, for example where cost overruns are borne by the private sector contractor; and
- Note that any milestone payments made by the PGE during construction would indicate that less risk is transferred to the private sector contractor. Furthermore where any more than 50% of construction costs are paid out by milestones, this would by default indicate that not enough risk is transferred for the arrangement to be considered to be off capital budgets.

Availability risk transfer considerations include:

- An arrangement where the private sector contractor is at risk for making the infrastructure assets available. For example, if the arrangement is the provision of a boiler payment mechanism is such that the private sector contractor would only be paid when the boiler is working as specified, meeting performance service levels; and
- In practice this may also take the form of the private sector contractor receiving an availability deduction for when the boiler was unavailable.

Demand risk transfer considerations include:

- An arrangement where the private sector contractor bears the risk of fluctuations in demand;
- In the example of a boiler, if the PGE were to vacate the building, demand would be nil. If this meant that the private sector contractor did not receive any payment this would indicate the private sector bears all of the demand risk; and
- In practice full demand transfer is unlikely to be commercially acceptable so there will likely be a minimum level of payment, and an element of sharing of this risk.

5. Next Steps

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

5.1 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.

5.2 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.

5.3 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.

5.3.1 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.

5.4 Identify market appetite

Part B of 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.

5.5 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.

Appendix 1: Glossary

Term/acronym	Meaning
Detailed Guidance or Part B	The report entitled "Scottish Futures Trust Energy Efficiency Measures Commercial and Accounting impacts – Detailed Guidance" 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 services dependent on dedicated assets 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

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