Ref. Ares(2020)114367 - 09/01/2020

EUROPEAN COMMISSION
EUROSTAT

Directorate D: Government finance statistics (GFS)
Unit D-3: Excessive deficit procedure (EDP) 2

Luxembourg,
ESTAT.D.3/LA/JJ/ OL/AR/at

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Subject: **Request for ex-ante advice on the Scottish Government's Energy Performance Contract**

Reference: Your letter on 17 January 2019 and included documents – Case 2018-27
Your e-mail on 11 December 2019
Your e-mail dated 12 December 2019, including the amended model agreement for EPCs
Your e-mail dated 3 January 2020

Dear Mr. Wales,

Thank you for the documents and the additional information provided including the updated framework agreement on Scottish EPCs. After having examined the arguments in the documents and our subsequent discussions, Eurostat is now in a position to express a view on this matter.

1. THE CLASSIFICATION ISSUE

The issue is to analyse the statistical classification of the model EPC agreement under the Scottish DBFM EPC[1]. This analysis is based on the provided model agreement and additional discussions between the ONS and Eurostat.

Documents provided

The ONS provided to Eurostat a copy of the following confidential documents:

- the EPC model agreement between the Scottish government (the authority) and the contractor in its initial version received on 17 January 2019and as amended on 12 December 2019;
- the provisional classification decision made by the ONS for such EPC arrangements;
- two classification documents considered by the ESCC (ONS);
- several explanatory documents on the EPC model agreement.

The Eurostat analysis is based on these documents, which can be amended by negotiation of the parties. Therefore, any amendments of the current model agreement should be analysed, case by case, to assess the statistical treatment of each particular EPC contract.

2. DESCRIPTION OF THE CASE

The model DBFM EPC is designed for the realisation of capital investments in one or several measures (e.g. construction works, equipment etc.) to improve energy efficiency through reducing energy consumption of existing infrastructure. The list of eligible assets corresponds to those mentioned in the EPC Guide[2]. The DBFM EPC will involve initial capital investment in one or a series of measures (e.g. construction works, provision of equipment) designed to improve energy efficiency through reducing the energy consumption of existing infrastructure (including combined heat and power). However, in addition, the DBFM EPC may include capital investment in:

- ancillary equipment and assets that facilitate the delivery of the services provided under the DBFM EPC (e.g. equipment for monitoring energy consumption); and/or

- assets that produce energy (e.g. photovoltaics) for consumption in existing facilities and/or sale to third parties.

However, the capital expenditure on such ancillary assets will be less than 50% of the total capital expenditure on the assets constructed and/or installed under the DBFM EPC.

In most cases, the project should be delivered to government (the authority) through private sector companies. The financing is presumed to be made available to the partner by financial institutions/investors.

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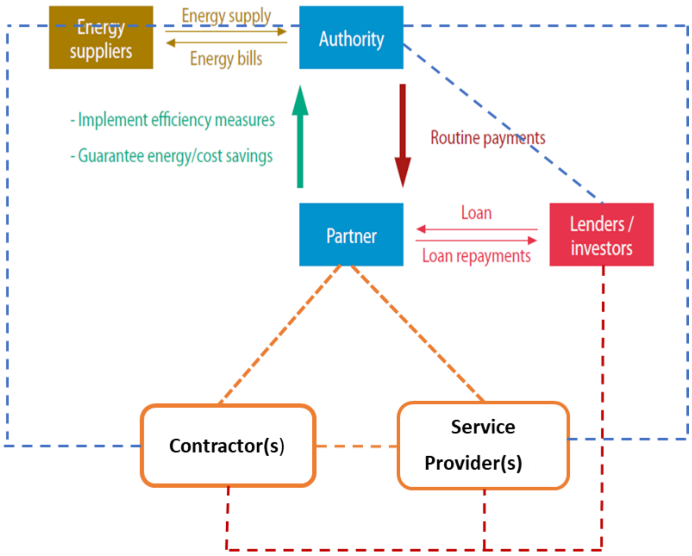
[1] DBFM = Design, Build, Finance and Maintain – EPC = Energy Performance Contract

[2] Guide to Statistical Treatment of Energy Performance Contracts (EPCs), published jointly by the EIB and Eurostat in May 2018 (EPC Guide)



The contract will be awarded through a tender procedure. Following the Scottish government submission, the capital investment will be realised by a partner. Following the Scottish government's policy proposal, the partner will be one of the twelve companies on the Scottish EPC framework none of which is controlled by government. Although the policy proposal does not exclude that the EPC contract might be delivered through a Special Purpose Vehicle, this SPV should not be controlled by government. Following the policy proposal, the Scottish government should have no equity share in or provide, in general, no financing to the partner, whether one of the twelve companies mentioned above or a SPV.

The contract will expire at least 8 years after the starting date of the operational services, but the duration will be specified for each individual contract.

The partner will be responsible for the design, the construction, installation and the maintenance of the EPC assets, based on the project specifications set in the tender documents.

The capital investment will procure the right to the partner to receive service payments, which government will finance through the reduced energy bill payable to the energy suppliers. The service payments will be lower or equal to the expected savings of energy costs, the latter being guaranteed by the partner.

3. METHODOLOGICAL ANALYSIS

Classification proposal of the Economic Statistics Classification Committee (ESCC)

The ESCC has reached an indicative and provisional advice on the classification of EPC assets, which under the current framework agreement might be classified off-balance sheet. The ONS advice has been issued as confidential.

Applicable accounting rules

Eurostat carried out its analysis based on the Guide to Statistical Treatment of Energy Performance Contracts (EPCs), published jointly by the EIB and Eurostat in May 2018

(EPC Guide), which is relevant for the analysis. The guide completes comprehensively the general rules specified in ESA 2010 and the Manual on Government Deficit and Debt in force.

Analysis

Before analysing the specific features of the EPC contract, it is necessary to understand whether the EPC contract is signed between government (the authority) and a private partner. The model agreement does not clearly exclude the possibility that the partner will be a Special Purpose Vehicle. However, in its submission of the case to the ONS, the Scottish government states that there should be no shareholding of government and the partner will always be a private entity. In this case, the contracting partner will be classified in the private sector (S.11). As long as there is no shareholding by the authority, there will be no dividend payments.

3.1. EPC or PPP

The definition of an EPC requires that the authority is for statistical purposes classified inside government. Whereas, the partner has to be an entity, classified for statistical purposes, outside the general government sector. The submitted EPC documents state that the authority will be either Scottish ministers or in the general government sector classified units belonging to Scottish ministers. Whereas the partner will always be a unit classified outside general government. This should also apply in the rare cases where the EPC contract will be delivered through a Special Purpose Vehicle.

If the partner is remunerated on the basis of energy consumption and/or cost savings associated with the existing infrastructure, then (if having the other features of an EPC discussed in the following sections) the arrangement will be considered as an EPC.

The features described in the model agreement will therefore qualify as an EPC agreement (EPC Guide chapter 2).

3.2. Eligible assets

The provided list of eligible EPC assets includes removable and un-removable assets as described in the EPC Guide.

3.3. The partner’s responsibilities

The partner is responsible for the design, the construction, installation and the maintenance of the EPC assets, based on the project specifications set in the tender documents and under the close supervision of the authority.

The partner has therefore the responsibility to design, build and install the EPC assets at its own risk. For realising the project, the partner will have access to all relevant places to execute its work. Any insufficient execution of the work will have to be fixed by the partner at its own expense. The authority will take no risk for increased costs by taking it over or sharing it with the partner. In the same time, any cost savings in the construction phase will not lead to any savings sharing between the authority and the partner. The completion will have to be documented and tested in detail following clear rules and measurements, before any service payment will occur. This applies also for any phased completion. However, the framework agreement includes provisions that each individual contract might specify the rules of the authority’s approval of the project design.

Any maintenance is specified in the relevant maintenance documents and is the sole responsibility of the partner, who has to carry it out under the control of the authority. The partner has to address on its own costs any incompleteness of the maintenance. Although amendments to the maintenance procedures might be introduced by the partner, but will be subject to an approval procedure, which should make sure that there is no additional risk devolved to the authority. No maintenance fund has to be established, putting the authority at risk. The model agreement does not include any third party guarantee on the performance to be delivered.

According to the model agreement, the service level specification will have to be fixed for each project as those specifications are related to each individual project.

Any additional savings due to the maintenance performance are attributable to the partner. Correspondingly, any additional cost has to be borne by the partner.

The here discussed provisions developed in the model agreement will have no influence on the statistical treatment of the EPC arrangement (EPC guide theme 3).

3.4. Energy performance – guaranteed savings

The capital investment will procure the right to the partner to receive service payments, which government will finance through the reduced energy bill payable to the energy suppliers. The service payments will be lower or equal to the expected savings of energy costs, the latter being guaranteed by the partner. A thorough independent control mechanism is put in place to monitor the energy savings realised through the capital investment. The performance is regularly monitored and verified at least once a year, through a clearly established procedure based on objective criteria.

Energy savings are to be met by the partner and a penalty mechanism is in place to ensure that the payment obligations of the authority are clearly linked to the energy performance delivered.

The general provisions set in the framework agreement comply with the rules set in the EPC Guide (theme 4) and would therefore not lead to the classification of the EPC arrangement on the authority’s balance sheet.

3.5. Payment mechanism

Operational payments will start on completion of the construction/installation of the EPC asset(s) certified by an independent tester. No interim payments or payments linked to existing infrastructure are included in the model agreement. The payments can be subject to revaluation based on an independent and recognised index.

The operational payments, due monthly, will include deductions for:

(a) shortfalls in the delivery of energy savings. There will be no cap on the deduction for the delivery of the energy performance (EPC Guide 5.6.3), calculated as a multiplier based on the difference between the agreed energy savings and the actually delivered energy savings,

(b) failures to deliver the agreed level of additional services, such as maintenance of heating boilers, LED lighting or related monthly service reporting. The model agreement includes a project related cap on availability deductions. The cap is anticipated to be between 50% and 100% of the payments related to the availability of such additional services (EPC Guide theme 5.5.8).

The monthly payment can be positive, zero or negative (in the latter case, a payment is due from the private partner to the authority). The authority will recover all deduction due to any shortfall in the previous year in the following year.

Monthly operational payments might from time to time include possible pass-through costs to be borne by the authority. The calculation method is clearly set out in the framework agreement.

Any energy savings in excess of the guaranteed energy savings are shared between the private partner and the authority, whereas the private partner receives ⅔ of the excess savings with no cap.

The payment mechanism follows the rules set in the EPC Guide (theme 5) and allows recording the EPC assets on the private partner's balance sheet.

3.6. Compensation, relief and force majeure events

The model agreement specifies the handling of delay, relief and force majeure events.

Delay events

The model agreement defines delay events as events due to (a) an authority change, (b) a breach of the agreement by the authority, (c) the execution of work executed by the authority and being part of the agreement, (d) the opening-up of any works realised if these works could be reasonably considered as defect, (e) force majeure and (f) relief events.

In such events, the completion date can be revised in favour of the partner under the condition that the partner has taken all reasonable measures to eliminate or to mitigate the event. The partner will not be relieved from its liabilities nor will such an event give it any extension right if the partner is responsible for such an event.

Compensation will be due only for events (b) to (d), but only if the partner has not contributed to create such an event. The amount of compensation has to be agreed between the authority and the partner. The partner has to take all action to minimise the compensation amount. Any amount due to any failure of the partner or recoverable from third parties will reduce the compensation amount. Any compensation should not leave the partner in a better or worse situation compared to the situation before such event. Any dispute will be settled under the dispute resolution procedure.

Relief events

Relief events are clearly defined and exclude any event, which is under the control of or can be influenced by the partner. These events can only be in relation to the design, construction and testing process; the right to access of the authority's representatives; programme and dates of completion; pre-testing and completion as well as delay events. The partner has to take any reasonable action to mitigate the effects of such an event. No relief event gives the contractor the right to any compensation.

Force majeure

Force majeure events are detailed in the model agreement and are all totally out of the control of the parties. The parties have to take any action possible to mitigate the effects of such events and none of the parties will be relieved from liability when due to a failure to do so. The parties shall endeavour to agree the changes to the agreement, which may be equitable with regard to the event. The authority will be entitled to make any deduction of the payments due during the period of this event.

A force majeure event can result in the early termination of the agreement.

These provisions of the model agreement will have no influence on the statistical treatment of the EPC contract (EPC Guide theme 6).

3.7. Changes to the contract – changes in law

Both parties can introduce changes to the contract. If the authority introduces such changes, the private partner has to provide an estimate of the additional costs, which, if accepted by the authority, would lead to an adjustment of the annual payment.

The authority that can either accept, amend or reject the change proposal, shall evaluate any change, introduced by the private partner. If accepted, the authority might also accept the changes to the annual payment schedule.

In addition, provisions of the framework agreement allow changes to the maintenance or the financial agreement in place. If the change is recognised as justified, there might be introduced adjustments to the annual payment, as long as the private partner will not be in a better or worse position than before.

The provisions included in the framework agreement as described will have no influence on the statistical treatment of the EPC assets (EPC Guide theme 7).

The authority bears no risk of changes in law and the private partner has no right of any compensation. However, any unforeseeable change will be discussed and assessed between the parties and any dispute might be referred to dispute resolutions. These provisions will have no influence on the statistical treatment of the EPC assets (EPC Guide theme 8).

Warranties given by the two partners are linked to typical commercial warranties. Any indemnity is only due by either party if there is a breach of the obligations or due to negligence by one party. The indemnity events will not lead to the classification of the EPC on the authority's balance sheet (EPC Guide theme 10).

3.8. Default of one party, early termination of the contract

Authority default and voluntary termination

Authority defaults are clearly defined and are limited to:

- the breach of any obligation on land interest as long as this breach has a material adverse effect on the partner;
- the non-payment of any sum due;

- a breach under the clause of the assignment of the contract to a third party, which is not a part of the Scottish minsters or for any other assignment without the prior written consent by the partner;
- and specifically for projects related to the NHS, any introduction of any adverse law or any adverse law proposal.

Following an authority event of default, the private partner has the right to terminate the agreement, after giving notice and requesting the remedy of the default.

The compensation payment to be made by the authority to the partner is stated in detail:

– redundancy payments,

– either the open market value (if available) or all amounts of annual payments following the base case less the aggregate of all capital expenditure and operating costs, all amounts to be discounted back to the termination date,

– the market value of all other assets and rights less any attached liabilities linked but not attached to the agreement,

less

– all third party rights, excluding rights under subcontracts or other claims against third parties whether determined or not (if not assigned to the authority),

– amounts, which the authority is entitled to set off.

Any dispute will be solved following the dispute resolution clause.

Partner's default

The partner defaults are extensively described and include the breach of obligations, insolvency, failure to achieve the completion date in the long run, breach of safety and health requirements, any change in control or the assignment of the contract to a third party, which is not bilaterally agreed. Any default provision include the possibility of remedy in order to reduce any material adverse effect. In the case of no remedy by the private partner, the authority has the right to early termination of the agreement.

- *Retendering procedure*

The authority can choose to retender the agreement only if there is a liquid market, defined as at least two willing capable parties to enter the agreement. During the tendering procedure, the authority has the right to elect to withdraw the retendering procedure, but only before having received any compliant tender.

The compensation due is the sum of any service payments between the termination date and the compensation date plus the highest compliant tender price less the tender cost.

If under the retendering procedure no compliant tender has been received the tender procedure is still valid and the highest compliant tender price will be zero. If the highest compliant tender price is zero or negative, the compensation will be zero or the outgoing partner will have to compensate the authority for this amount.

The model agreement does not specify in detail all the documents to be provided for the retendering procedure. In particular, the specification of any remediation costs resulting from the partner's underperformance are not specifically mentioned (see EPC Guide 12.1.1 – Eurostat's comments). However, this should be included in the provisions in which the authority has to make available all qualification criteria and other requirements as well as the terms of the retendering procedure.

The authority shall use any reasonable endeavours to complete the tender process as soon as practicable.

- *No retendering procedure*

If the authority elects the no retendering procedure, the estimated fair value will be determined by the sum of:

– all forecast payment amounts shall be calculated in nominal terms plus any recognised indexation but discounted to the termination date,

– less all costs reasonably forecast and discounted, including any rectification costs, less any insurance payments due and less any amounts payable by the authority in respect of capital expenditures not yet paid.

Force majeure

In the event of force majeure and the absence of any agreement between the parties within 6 months, both parties have the right to terminate the agreement.

- any redundancy payments and subcontractor losses,
- the market value of all other assets and rights less any attached liabilities linked but not attached to the agreement,
- plus, up to the termination date, the aggregate of capital costs and operating costs, such expenditure being no greater than in the base case less the total annual payments,
- all third party rights, excluding rights under subcontracts or other claims against third parties whether determined or not (if not assigned to the authority),
- amounts, which the authority is entitled to set off.

The assets will be transferred to the authority.

Termination for corrupt gifts and fraud

The rules applying to corruption and fraud are stipulated in the model agreement. In such a situation, the authority has the right, subject to any remedy, if applicable, to terminate the agreement without paying any compensation. The assets will be transferred to the authority.

The provisions set in the model agreement would have no impact on the statistical treatment of the EPC contract (EPC Guide theme 12).

3.9. Insurance

The framework agreement includes the provision that insurance premiums will be passed through to the authority included in the annual payment. This provision as well as the fact that the authority will bear the risk of premium movements has a **high influence** on the statistical treatment of the EPC contract (EPC guide theme 9.3). All other provisions on insurance will have no influence on the statistical treatment of the EPC contract.

3.10. Financial agreements

In principle, the authority should not provide any financing or at least the financing should be below 10%. Furthermore, the authority will not be liable for any savings shortfall (see section 3.2).

The partner is free to enter in any financing agreement (included in the tender documents). He shall be entitled to amend the financing documentation or enter into a refinancing agreement, with the limitation that such amendment or refinancing will not increase any authority liability, without the prior written consent of the authority. Any refinancing (less any refinancing cost) will entitle the authority to a maximum of 30 % of any refinancing gain. The authority has the choice to receive such gain sharing either by a lump payment, a reduction of the annual payments or by a mix of both payment mechanisms.

Any change in interest costs are included in the adjustment mechanism for the annual payments.

In principle, the authority will not enter into any financing or only for limited amounts (less than 10%) of the EPC assets and therefore this has no influence on the statistical treatment of the EPC contract (EPC guide theme 14).

3.11. Government influence

In general, the model agreement excludes any equity share (and the subsequent rights of the authority to receive dividends) of the authority in the private partner. In this case, there will be no influence on the statistical treatment of the EPC contract (EPC guide theme 15.1). Some specific projects might require an authority equity participation, which, in general following the Scottish government policy submission, will be limited to the threshold to avoid the reclassification of the EPC contract on the authority's balance sheet. Nevertheless, each project in such a situation has to be assessed together with all other elements against the guidance of the EPC Guide.

The transfer or assignment of the contract to a third party or the change of control of the private partner has to be approved by the authority. The change of control of a publicly listed company or the transfer of the shares following the enforcement of any grant or security already approved by the authority shall be disregarded from the authority approval during the lifetime of the contract. These provisions in the framework agreement exclude any financing rules, which are discussed under section 3.10. Therefore, the provisions included in the framework agreement have no influence on the statistical treatment of the EPC contract (EPC guide theme 13.2).

The step-in rights for the authority distinguish whether the project delivers poor performance or not. Poor performance is defined in detail in the model agreement.

(1) If the project is delivered with no poor performance, the partner has the right to receive the full amount of the annual payment (as long as the private partner delivers all assistance necessary to the authority during the step-in period) plus an indemnity for all directly incurred losses.

(2) If the project is delivered with poor performance, the partner has still the right to receive the annual payment for the relevant period, after deduction due to poor performance, less any step-in costs incurred by the authority.

This will have no influence on the statistical treatment of the EPC contract (EPC guide theme 15.3).

The framework agreement does not include any provision of any cap on the private partner's revenues or profits. Therefore, this has no influence on the statistical treatment of the EPC contract (EPC guide theme 15.4).

4. EUROSTAT'S VIEW

Statistical treatment of the EPC contract

For the classification of the EPC contract off-balance sheet of the authority, the analysis should conclude that the private partner bears simultaneously most of the risks and most of the rewards. Considering the EPC framework agreement, the analysis shows that most of the risks and rewards are either borne by the private partner or shared by the authority and the partner. Therefore, most of the provisions would have no influence on the statistical classification of the EPC assets on the authority's balance sheet.

Nevertheless, one element needs to be considered further. The provision, that insurance costs are passed directly through to the authority, leads to the situation that the authority will bear the insurance risk for the full amount, which has a high influence on the statistical treatment of the EPC contract.

The EPC guide states that if there are no more provisions than one of high importance, and not more than four moderate importance included in the agreement, the EPC should not to be considered as being on government balance sheet. The information provided leads to the conclusion that there will be one high influence on the statistical treatment. Therefore, the EPC should be recorded on the balance sheet of the private partner.

Limitation

However, the model agreement, as it stands, does not include any financing provisions. In addition, it will be subject to amendments related to the specification of each individual project. Therefore, any amendment related to project specific features or amendments in general, which have an impact in particular, but not limited to, on:

– the sector classification of the partner;
– the financing of the partner by the authority;
– the sharing of risks and rewards between the partner and the authority

should be carefully assessed against the EPC Guide in order to classify the particular EPC project accordingly.

5. PROCEDURE

This view of Eurostat is based on the information provided by the UK authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC.

Eurostat is therefore publishing all official methodological advice (ex-ante and ex-post) given to Member States on its website.

Yours sincerely,

(e-Signed)

Luca Ascoli
Director