

CONFIDENTIAL



SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

NBN
15 October 1986

Nigel

I am growing increasingly worried that our efforts towards improving the energy efficiency of the public sector, and the growth of an important new service industry, are being hampered by a Treasury ruling on the subject of Contract Energy Management.

Over £500 million is currently being wasted every year in the public sector because of the inefficient use of energy. We are being criticised by our own backbenchers for allowing this to continue. At a time when we are encouraging all organisations to make better use of their energy, it is unacceptable that the worst culprits should be in our own backyard and that the public sector should be wasting money which could be put to good use in hospital care, education etc.

Contract Energy Management (described in the Annex to this letter) is a way of bringing private sector expertise to bear on the recovery of that waste, without any increase in public spending - the private sector bears all the risks: the public sector cannot lose. It is absurd that we should be erecting artificial barriers to the development of this exciting new service.

Contract Energy Management is developing fast in the private sector and some progress has already been made among local authorities - for instance, savings of 40% have been realised in a scheme in Surrey which is being monitored by the Energy Efficiency Office (described in the Annex to this letter). Surrey are extending it to six further sites. Yet this success is not being taken up widely in the public sector, largely because of Treasury insistence that Contract Energy Management be classified as financial leasing, and so count against capital expenditure limits. Of course, I accept there is a financial element to the transactions concerned, but the Treasury's obsession with this to the exclusion of the other important aspects of the transaction is highly damaging. Bob Reid of Shell, for instance, has written to me to express his concern. A Shell subsidiary, Emstar, one of our foremost Contract Energy Management companies, are finding it very difficult to obtain work in Government buildings because of the Treasury ruling. I believe that Lorne UMC Limited - the company involved in the Surrey Contract - has written to you about the problem in the local authority sector.

CONFIDENTIAL



What is needed is a clear green light from the Treasury enabling Contract Energy Management schemes to go ahead. I believe this should be quite possible even within the existing rules, fairly interpreted. My economists have prepared a paper (enclosed) analysing the arguments. I hope you will look into this as a matter of urgency. We have to ensure that the present waste does not continue.

The issues raised by this do of course have very considerable implications for areas other than energy where significant work could be put out to the private sector. I am therefore copying this letter and enclosures to the Prime Minister, George Younger, Norman Fowler, Nicholas Ridley, Malcolm Rifkind, Paul Channon, Kenneth Baker, John Moore and Sir Robert Armstrong.

A handwritten signature in dark ink, consisting of a large, stylized 'P' followed by a smaller, more fluid signature.

PETER WALKER

1. One of the barriers to improving energy efficiency in the public sector is that many public sector organisations lack the necessary in-house resources to tackle their energy problems themselves. An effective way of overcoming this - which is already used by a growing number of private sector organisations - is Contract Energy Management (CEM).
2. CEM is a relatively new high-tech industry that is well established in both the public and private sector in the USA, and is now beginning to grow in the UK and throughout Europe. It involves the provision of a complete energy management service by the CEM company, including an energy survey and the provision and management of any necessary energy saving equipment, in return for a share of the subsequent savings in the client's energy bill.
3. Contracts are structured so that the client is guaranteed a saving right from the start and the arrangements for sharing further savings encourage both parties to press for continued efficiency throughout the life of the contract - usually from 5-10 years. The CEM company is involved in training and motivating staff and at the end of the contract ownership of any equipment normally falls to the client along with all subsequent savings.

North East Surrey College of Technology

4. A pilot scheme in the public sector is being carried out by Surrey County Council. The North East Surrey College of Technology was chosen for the initial contract. Five companies were invited to tender for the project but only one bid was received (from UMC). This was mainly because of the costs involved in complying with the detailed tender specifications that Surrey produced.
5. UMC's proposal involved the replacement of the college's oil fired boilers with gas fired units, installing a new gas main to the college and installing a computerised energy management system and automatic light switching. Payments were structured so that Surrey received an immediate 3% saving on their base year (1985) energy bill. The next 24% of savings went to UMC and any further savings were to be split 50/50. The contract is for seven years. At the end of this period the new hardware becomes Surrey's property and all subsequent savings go to them.
6. To date the contract has worked successfully and the energy bill has been reduced from £130,000 pa to £80,000 pa.



THE TREATMENT OF CONTRACT MANAGEMENT IN PUBLIC SECTOR
CONTROL PROCEDURES

Introduction

1/ The public sector is a large user of energy. It spends £3.5bn annually on energy as a final user (i.e. apart from the conversion of primary energy into secondary energy in power stations etc.). The potential for economic energy savings in this sector is £650m annually.

Estimated Economic Potential For Energy Savings In Public Sector

per annum.

Health Service	c £100m
Central Government	c £150m
Nationalised Industries	c £250m
Local Authorities	c £150m
Total	c £650m

The public sector is said by energy efficiency experts to be some way behind the private sector in improving the economic efficiency of its energy use. For this reason, it is seen as a market with great potential. For such potential to continue to remain unexploited some 13 years after the original oil price increases is a clear reflection on the capability of these public bodies in the field of energy management and their efficiency over the whole of this period.

2/ There are many reasons for the poor performance of the public sector. Some of these are institutional or organisational (as mentioned in the Rayner Report); some reflect the lack of sufficient incentives to efficiency in this sector; and some are the result of the absence of energy specialists in these public bodies, perhaps because - in contrast to the position in specialist energy companies or consultancy firms - no clear career progression can



be foreseen. But over and above this, one suspects that many public sector managers and officials are reluctant to divert their efforts from what they see as their main-line activities to devising and evaluating energy efficiency schemes. This is particularly germane given that energy may represent less than 5% of total costs and the options to be considered require the acquisition of a body of what, for them, is new and specialist knowledge. For them today's unavoidable problems may be too pressing.

Contract Energy Management - What it is

3/ A solution to these problems, in many cases, can be found in contract energy management, using private sector expert energy specialists and managers. Contract Energy Management (CEM) or energy performance contracting, is a useful way of enabling organisations, lacking sufficient in-house energy expertise and specialist managers, to have the benefit of such services. There are a variety of contracts on offer involving the supply of specialist advice, management and energy-saving equipment. These range from companies who, in the main, supply heat or steam from their own equipment to the client's premises, to companies who provide a 'complete CEM package'.

4/ This paper is mainly concerned with complete CEM contracts. These normally provide for the contractor to supply a complete energy management service, to finance and undertake energy saving feasibility studies, and for the technical design and installation of new energy efficiency equipment on the customers' premises. The contractor is then responsible for operating and maintaining the equipment throughout the period of the contract, usually from 5-10 years, in return for a proportion of the savings that ensue. The clients staff are trained and motivated. As a result, the client is able to benefit from the latest technology without having to recruit energy specialists, weigh up the relevant merits of each type of plant, or reach a decision on which type to purchase. The contractor recovers his costs through savings in the energy bill, a proportion of which are shared by the client, - both parties are thereby encouraged to make further energy savings. The contracts are usually structured so that the contractor



guarantees an initial saving of say, 2-3% though this can be more. Savings beyond this, upto a given percentage, then go to the contractor to cover his staff and other operating costs the capital cost of the new equipment, and interest charges etc. Any further savings are then split in an agreed proportion between client and contractor.

5/ CEM is not a purely British phenomenon; In USA the use of CEM has grown rapidly from a turnover of less than \$5 million in 1981, to \$250 million in 1984 and some \$400 million last year. In part, this growth may have happened because the US Government, in pursuit of similar economic efficiency objectives, has positively encouraged the involvement of contract management companies in the public sector, particularly by devising and approving the use of model contracts and pilot projects.

6/ The contrast with the UK is stark. Here, even after a public body has decided to explore a CEM scheme, it is difficult to get CEM companies - of which there are eight in Britain - to put in bids. The heavy initial costs (associated with meeting the tendering specifications and the delays arising from the procedures) are said to be reasons. Moreover in a situation in which specialist energy technicians and managers are scarce, CEM companies usually are able to consider only one or two potential public sector possibilities at a time. (The private sector makes its decisions more quickly in order to achieve the earliest possible benefit from the energy savings). A corollary of this is that the public body may find it difficult to obtain more than one tender.

7/ A major impediment to the use of CEM in the public sector - and one which affects the willingness of these public bodies to pursue the CEM route - is H.M. Treasury's current interpretation of how such CEM schemes are to be viewed in relation to the 'Ryrie Rules', which set the criteria against which schemes involving private finance for nationalised industry investment, have to be considered.



Issues To Be Considered

8/ In view of the size of the potential economies which could be realised by CEM schemes, HMT's treatment of contract management needs to be considered carefully to establish whether it is consistent with Government policy generally, and more specifically:-

- (i) whether HM Treasury's guidelines with regard to the treatment of contract management are consistent with the Government's economic efficiency aims for the public sector and for the economy generally, or whether it frustrates, or constrains, the attainment of those aims;
- (ii) whether HMT's treatment of contract management as if it were leasing is sustainable;
- (iii) whether the HMT guidelines conform with their doctrinal interpretations in other areas e.g. in treatment of contracting out opportunities

Present Treatment In Public Sector

9/ Contract Management payments by the public sector are without doubt a form of public expenditure but an important issue is whether for HMT control purposes the capital value of the assets in CEM schemes should be scored as public expenditure in the year the contracts are signed. The NEDC working party chaired by Sir William Ryrle devised criteria under which private capital might be introduced. These criteria were endorsed by NEDC in October 1981:-

- (i) decisions to provide funds for investment should be taken under conditions of fair competition with private sector borrowers; any links with the rest of the public sector, Government guarantees or commitments, or monopoly power should not result in the schemes offering investors a degree of security significantly greater than that available on private sector projects;



- (ii) such projects should yield benefits of improved efficiency and profit from the additional investment commensurate with the cost of raising risk capital from financial markets.

10/ The Department of Energy recognises the Treasury's understandable concern to protect the Government's Medium Term Financial Strategy against efforts to circumvent the agreed expenditure limits on public sector programmes. It also recognises and endorses the view of H.M. Treasury, as stated at a recent NEDC committee relating to private sector involvement in public sector capital projects, viz,

"It is an important general objective of Government policy to enlarge the area in which free enterprise and a competitive market can function. The best way of achieving this is full privatisation. Where this is not appropriate, many of the advantages can be gained by contracting out. But private finance may, however, be welcome provided it leads to greater efficiency after taking account of any extra financing cost."



11/ The difficulty, in practice, has been that when a detailed interpretation of these criteria in cases of CEM schemes has been required, HMT has been so unyielding in its defence of the MTFS policy that it has appeared to be prejudiced against all private sector CEM initiatives, regardless of their merit. The Ryrrie rules have been invoked and the least favourable interpretation has been placed on the cases considered. As a result, HMT has been widely criticised - not the least by the Commons Energy Select Committee - for this negative approach to the considerable opportunities for using the capability of the private sector to undertake economically-attractive energy saving projects in the public sector.

H.M. Treasury Stated Position On CEM

12/ H.M. Treasury's position on contract energy management schemes, as stated in their Memorandum 35 to the Select Committee on Energy (6th September 1985), is that:-

"The public expenditure implications of a contract between a public sector body and an energy management company will depend on the details of the contract. In general, where the length of a contract is comparable with the lifetime of the capital assets involved and the assets are used solely on behalf of the public sector body concerned, the contract will normally be treated - for public expenditure purposes - on a par with financial leases." However HMT added that "more complicated contracts would need to be considered individually". "Broadly, speaking, though, for nationalised industries and local authorities, the capital value of an asset acquired as a financial lease is scored as public expenditure in the year in which the lease is signed. The effect is equivalent to purchase of the asset. For central government, the capital value is not scored as public expenditure, but all leasing deals have to be agreed with the Treasury. Any such proposal would normally need to be accompanied by an appraisal of financing costs."



13/ NIP(85)10 (para. 34) states "Leasing is a form of borrowing" and "for EFL purposes, finance and long term property leases must be capitalised". However, an exception exists for leases which it can be demonstrated are entered into "solely for operational reasons" "By operational is meant a clearly defined operational need of a temporary nature which cannot appropriately be met by the purchase of an asset. Such leases are usually short in relation to the life of the asset involved". NIP(85)10 accepts that "it is not possible to lay down hard and fast rules distinguishing between operational and other leasing".

14/ The reasons for HMT's leasing guidelines are stated to be (i) because leasing has a cost, (ii) because the cost of borrowing by the government is usually less than the commercial lessor's cost of borrowing and reflected in lease rentals, (iii) only part of the benefit of the tax foregone by the Exchequer will be passed back to the nationalised industry and (iv) large volumes of leasing can have repercussions on money supply. Hence leasing by nationalised industries is not encouraged.

15/ At no time have the reasons for the HMT's treatment of CEM agreements (as opposed to those against financial leasing) been clearly stated and adequately discussed. Generally, CEM agreements are treated by HMT "as on a par with financial leases", the reasons for this are unclear. Given the size of the potential public sector energy savings this is highly unsatisfactory and exposes Ministers to criticism. A full consideration of the issues concerning CEM schemes is therefore essential.

Categories of CEM Schemes

16/ Contract energy management is a term which covers a wide range of different types of project. It may help therefore to attempt to categorise these into three groups:-

- A. Projects which effectively remain in the public sector and continue to be managed in the public sector at public sector risk, although nominally funded by private lenders, e.g. through financial leases.



B. Projects which, although forming an integral part of programmes planned and controlled by Government - central or local - are nonetheless capable of being privatised, i.e. the responsibility, the management and the associated risks are genuinely transferred to the private sector.

C. Projects which arise from public sector activity, are economically attractive, but which without private sector involvement, and risk finance, would not otherwise be undertaken as components of established public sector programmes.

Each of these needs to be considered on its merits against the criteria.

17/ The Treasury rightly regards private sector funding of Type A projects as devices to circumvent the proper limits on public expenditure. There is no issue about this.

18/ For Type B projects, H.M. Treasury appear to have established two criteria for the acceptance of private sector involvement:

- selection of the private sector undertaker should be based on fair arm's length competition, and the risks and responsibilities must genuinely be transferred to the private sector;
- the saving of resource costs from the greater efficiency of undertaking the work in the private sector, must outweigh the additional cost of private risk capital.
(However, a significant new factor seems to have been recognised in the case of Dartford Bridge - the economic value to the taxpayer of transferring risk to private lenders.)

The Treasury accepts that when such projects are genuinely transferred to the private sector they do not score against the PSBR. (In another context, the Dartford Third Crossing, forming part of the roads programme, appears to be a topical example.) However, it would appear that H.M. Treasury have not, as a general rule, conceded that the public expenditure designated for the programme,



of which the project is a part, should remain unaltered, i.e. additionality in such cases is not automatic.

19/ Type C projects would appear to be precisely the type of project - additional to established programmes - which the Ryrie rules were tailored to permit. As for Type B projects, the basis for selection must be fair arm's length competition. There also must be a genuine transfer of responsibility of risk to the private sector. The test for the risks is less stringent and the comparison with the alternative of public sector financing is not relevant in this case. The essential point is that the project should be economically sound, i.e. the efficiency gain and the consequent profit should be commensurate with the cost of private financing.

20/ Nevertheless, the Treasury have consistently rejected energy saving projects under risk-bearing management contracts on the grounds that they are effectively circumventions of public expenditure controls on programmed activity (i.e. Type A projects). Their argument has been:-

- (a) if the energy saving projects are as economically attractive as is claimed, they should be incorporated in the public expenditure programmes for the health service, the education service, defence etc;
- (b) energy management contracts are tantamount to financial leases and therefore equivalent to the purchase of the capital assets in question; accordingly the equivalent capital cost should score against the PSBR and fall within the expenditure limits established for the programme;
- (c) moreover, such lease financing is necessarily expensive; it would be best for the expertise of energy consultants to be hired directly without the associated provision of expensive risk capital.



21/ Argument (a) above, whilst intellectually neat, is splendidly blinkered. The fact is that the real world is populated by human beings who do not necessarily act rationally - at least when they are not using their own financial resources. Paragraph 2 above has shown a variety of reasons why economically optimal allocation of resources in the public sector may not take place. These factors cannot be corrected overnight, and until the public sector world is put to rights, the energy economies will not be realised. This then is another case where the best is the enemy of the good. Since HM Treasury is not averse to adopting pragmatic solutions to problems which conflict with intellectual purity in other areas, why then should this argument be seen as an important one? (Here one recalls the replacement of the intellectually respectable test rate of discount criteria applied to NI investment programmes, which in the face of the pragmatic argument that these were not universally applied was replaced with the rather more dubious required rate of return concept.).

22/ The Argument (a) also begs the question of whether the same or equivalent project could be carried out as part of public expenditure. It also ignores the economies resulting from the division of labour, the current scarcity of energy engineering specialists and the fact that most bodies cannot offer them ^{career} prospects - even if they were prepared to enter the sector. (see also para 28 below).

CEM and Financial Leases - The Essential Differences

23/ The Treasury's presumption that contract management schemes as a class are 'on a par with financial leases' (argument (b) above) seems to ignore the essential differences between CEM & Financial Leases. The fact is that complete CEM schemes are wholly different. First, because the motivation for leasing agreements is quite different from that for complete contract energy management schemes. Second, because the nature of a complete CEM agreement is different in kind in terms of what is traded. Third, because complete CEM does not involve 'the extra costs' associated by HMT with financial leases.



24/ The motivation for financial leasing (i.e. category A projects) ^{centres} upon the fact that the private sector has tax allowances available that cannot be exploited either because of insufficient profit in the public sector (as with some nationalised industries), or because the part of the public sector concerned is non-profit making and hence not taxable. There would therefore be some advantage to the public sector organisation, in the absence of the HM Treasury's ruling regarding the capital value of the asset acquired as public expenditure, in financial leasing arrangements, since leasing would provide, in the year of asset acquisition, a way to avoid public expenditure controls on its operation, - though at the expense of higher current expenditure later. In contrast the motivation for CEM schemes is quite distinct. It arises from a need to exploit the advantages of a division of labour (through the use of specialist energy managers and engineers). This is a fundamental economic principle to which the Government subscribes. Moreover forms of Contract Management have been widely used over many decades for many activities in both the public and private sectors. Like all trading transactions, its continued existence emanates from a perception by the parties concerned that each is better off with such contracts than without them. Normally, this perception of benefit will be seen as a material one with a measurable improvement in terms of the objectives and aims of each participant, usually - though not always - in the form of expected higher profits over the period of the contract.

25/ The nature of contract management agreements are quite different in kind from those in leasing agreements. CEM is about trading energy services; leasing is about hiring physical assets. Leasing, unlike CEM, does not involve a detailed energy survey, specialised management, shared savings or the eventual handing over of the equipment to the lessee, nor does it involve the training of staff. It provides no incentive to efficiency and responsibility for the decision about the type of hardware to be leased lies with the client rather than the contractor, as in complete CEM schemes. With complete CEM it is the contractor who bears all the risk both technical and financial. He decides what assets are to be purchased. In the case of CEM schemes, the management



and the risk-taking are outside the public sector. Moreover CEM s provide a different type of management, a more highly-specialised, and appropriately qualified, executive often with computerised back-up analysis and control equipment. CEM in the public sector is, therefore, not a contrived device to obviate a public sector control system. It provides the very means by which improved economic efficiency is achieved. Further, being dissimilar from leasing, it has some characteristics more in common with, say,

contracts to British Telecom to provide a service involving the installation of their equipment in, say, an Inland Revenue or HM Customs building - or perhaps HM Treasury itself - or a contract with Initial Services PLC for a period of years to provide towels to a government department in towelling machines owned by themselves. There are also similarities between contract energy management schemes and contracts with an outside caterer to provide canteen facilities in a government department, local authority contracted out refuse collection and contracts with assets used in certain private sector service premises within the precincts of a main line railway terminus, to the extent that the services provided are, or were formerly, commonly associated with railway travel e.g. Thomas Cook's, travel insurance, catering hotel services etc.

26/ The 'extra cost of leasing, (as in (c) of paragraph 20 above) is central to HMT's attitude. It features in each of (i), (ii) and (iii) in para 14 above. That there are extra costs with leasing is not disputed. That there are 'extra costs' from contract management is disputed.

27/ First, informed observers hold the view that despite 13 years of high energy prices little progress towards economic efficiency in the public sector's energy use has been achieved and that the potential for worthwhile running cost savings is substantial.



28/ Second, to 'unlock' these savings requires specialised experience, know how and control mechanisms which monitor energy use. The public sector has under-invested in energy systems because it does not have the specialist expertise to unlock this potential. For some public sector organisations large enough to justify in-house expertise in energy management, there may well be a good case for them to hire directly the expertise of energy consultants without the associated provision of what HMT see as 'expensive risk capital'. For example, the local authority in Tyne and Wear routinely allocate some £6 million of capital expenditure to energy-saving projects. Their planners and the architects' department have energy management expertise, and the backing of the local politicians to identify projects offering attractive energy savings, and to manage the design and installation of the requisite systems. However, as in the private sector, there are many organisations in the public sector which do not have such expertise. Nor are they equipped to make the best use of an energy consultant, as distinct from an energy management contractor motivated by having his own money at risk. Selecting the best consultant is the first problem. Above all, they would be looking for expertise and project management capability. It certainly isn't a matter of selecting the lowest-quoted rates for the service. Many hospital managers, for instance, may see considerable benefits in putting CEM companies into competition with one another to offer the best energy savings package. Significantly, a large and growing number of private sector companies reach just this conclusion. They recognise that energy management is not part of their core business, and it is not worth acquiring in-house expertise even if they could, given the necessarily limited career prospects; for them it could be far better to use the up-to-date skills of specialist CEM companies with competition ensuring that they get the best buy. Generally, however it is clear that important current cost savings are therefore being foregone that are significantly greater than those that would be achievable if the LA or NI invested in the new plant itself without the benefit of such expertise. In this respect, leasing is quite dissimilar from CEM. The former does involve an extra cost to the public sector; the latter does not. This is because, without



CEM, many new energy systems would not be commissioned and because, even in the case of energy systems that were commissioned (despite the disadvantage) the benefits to be expected without CEM would be substantially less. To this extent, there is no extra cost involved in CEM. In short, CEM contracts are financed by sharing savings that otherwise would not take place. Without the existence of 'extra costs of financial leases' the HMT's logic for CEM's treatment disappears.

29/ The issue about whether the private sector is being 'over compensated' for its risk-bearing is irrelevant provided a) the tendering is competitive and at arm's length or/and (b) savings occur to the public sector on projects which otherwise would not have been carried out.

30/ One may also look at the issue in a slightly different way: Leasing is usually undesirable because the cost of borrowing from a leasing company is higher than the cost of the Government borrowing direct from the markets. Hence the present value of future public expenditure will usually be increased by leasing: reduced expenditure in the first year will be more than counterbalanced by increased expenditure after the first year. Thus, special measures are required to discourage leasing, or at least enable it to be fairly compared with simple borrowing. Such measures should not apply to CEM since it leads to reduced public expenditure in every year. There appear to be two economic reasons for this: (i) Failure of the markets for energy saving and using assets. Public sector energy users do not have full information about this complex market and thus are not aware of the potential for energy saving. While they might employ consultants to give expert advice, they are not able to assess whether the employment of consultants would itself save money and so, being risk averse, prefer not to employ consultants. CEM does not involve risk for the public sector managers. (ii) The financial markets are not able to distinguish between investment (e.g. in energy saving) that saves money in future years and many other types of investment (hospitals, roads, etc.) that require increased current expenditure in future years. The



appropriate response to market expectations about the future public expenditure position (and hence about the money supply, interest rates and inflation) is different in two cases. It is desirable therefore to distinguish between capital expenditure that saves costs and expenditure that incurs costs in future. CEM is a way of doing this.

31/ For all these reasons complete CEM schemes should not be treated in the same way as financial leases. The issue of whether CEM activities could be financed more cheaply through PSBR is irrelevant since it does not arise; it is most unlikely that the schemes will go ahead without the enthusiasm, initiative and expertise of CEM companies; hence complete CEM is not a form of back door public financing. Rather it is akin to using an outside computer bureau but with the computer facilities and their staff in one's premises. There is a strong argument to classify complete energy management contracts in category C. It is clear that, whatever their merits, economically-attractive energy saving projects at present are not being incorporated in public sector programmes. Without private sector initiative and private risk capital, they will not be undertaken. There are very real efficiency gains and economic benefits which are more than commensurate with the cost of private risk capital, i.e. they comply with the Ryrie rules.

32/ Even when it might be argued that the project does or should form part of a public sector programme, the nature of energy management contracts is such that the responsibility and risk is genuinely transferred to the private sector. In other words, such arrangements are not devices to circumvent proper public expenditure limits (category A). They represent the full transfer of responsibility and risk to the private sector (category B). Given this it can readily be demonstrated that the saving of resource costs from the greater efficiency achieved under energy management contracts is more than sufficient to outweigh the cost of private finance, particularly when the value of transferring risk is taken into account.



33/ Quite apart from this, the concept of what does or should form part of a public sector programme represents a somewhat dated approach to the full range of policy opportunities. This Government has never drawn any clear and immutable doctrinaire line between the public and private sectors in the way the 'Ryrie Rules' - now over 5 years old - imply. The approach has been an entirely pragmatic one with the 'general objective of Government policy to enlarge the area in which free enterprise and a competitive market can function. Recent pronouncements by Ministers concerning future privatisation schemes clearly indicate that there is no 'ring fence' around the public sector and that quite novel forms of privatisation may take place if 'roadblocks' are not set up. Current HMT interpretations, in contrast, by leaning over backwards to see the worst possible interpretation of every project, do cause questions to be asked concerning whether protection of the MTFS is the only consideration the HMT has in mind - or whether a preconceived conception of where the public/private sector dividing line is and should be is an implicit part of its reasoning - or of the reasoning of those who interpret the guidelines.

34/ It has been demonstrated above that (i) complete CEM contracts are wholly different in character from normal financial leases for projects that continue to be managed in the public sector at public sector risk; (ii) under complete CEM contracts, the responsibility, the management and the associated risks are genuinely transferred to the private sector in a form of privatisation; (iii) for these reasons, complete CEM projects awarded to private sector contractors on the basis of competition, satisfy the conditions under the scope of the 'Ryrie Rules', and that

- (a) In most cases, the CEM project in question can be regarded as a genuine addition to established public sector programmes; without private sector initiative and private risk capital, the project would not be undertaken. Thus Ryrie requires simply that the project should be economically sound, (i.e. the efficiency gain and the consequent profit should be commensurate with the cost of private financing). Manifestly, complete CEM contracts



- (b) In a few cases, however, the CEM project may truly be seen as forming part of an established public sector programme. In this case, a CEM contract would still comply with Treasury rules provided the efficiency gains and risk transfer savings are commensurate with the cost of private risk capital, though this does not follow automatically. Some public sector organisations e.g. NCB, CEGB, SSEB, B.S.C., BRB. etc have the expertise directly to manage energy saving projects but, as in the private sector, there are many organisations which do not have the in-house capability, and would benefit substantially from the specialist skills of a CEM contractor working under the stimulus of providing risk capital to be rewarded from part of the efficiency gain.

35 John Banham of the Audit Commission in his article in the latest edition of "ENERGY MANAGEMENT FOCUS" clearly agrees with this Department's interpretation:-

"The current view is that where a contract makes it clear that the fees payable relate to the service and not the capital equipment, the payments do not count against capital expenditure limits."

A Rational and Workable System For CEM Contracts

36/ It is, of course, essential for HM Treasury to satisfy themselves that there are control systems in existence in each part of the public sector which contain sufficient safeguards to prevent contracts being entered into as a device to avoid or alleviate the impact of public expenditure controls. To this end, valid tests by which departments and other overseeing authorities may scrutinise the purposes of contract management schemes are required.



37/ These tests not only need to be consistent with government objectives but also to be interpreted in ways consistent with those objectives. This may not always have happened. Moreover, to the extent that current HMT interpretations of the guidelines militate against the achievement of £650 million per annum of savings, there is a sense in which the HMT is 'cutting off its nose to spite its face', with macro policies preventing micro-economic efficiency.

38/ This paper has shown that H.M. Treasury's rules may not need to be changed to accommodate certain CEM schemes; but they do need to be interpreted as originally intended and without any rigid or dated pre-conceptions about the dividing line between public & private sectors. Beyond this, there may, however, be a case for a more drastic revision to reflect recent policy thinking.

39/ But whatever the solution, if the full economic benefit of energy savings is to be achieved, it would be of little practical value if the agreed outcome was that each and every project had to be judged by HM Treasury on its merits to receive their approval. This would be the kiss of death and most certainly frustrate endeavours to 'unlock' the economic potential for public sector energy savings. For this reason, some form of general approval for categories of CEM projects is required, under which they would not be regarded as on a par with financial leases, with the result that the capital value of any assets required would not be scored against public expenditure in the year of the contract.

40/ There are a number of ways in which this could be done. One possible way would be to devise a set of guidelines for category approval which were designed to ensure that the contract was a complete energy management one, involving private sector management, risk, expertise and asset ownership throughout the contract period, thereby manifesting it was not a device to avoid public expenditure. (Acceptable model contracts could in some cases be appropriate with a check list of items). The guidelines would have to have regard to whether:-



- (i) the contract has been arrived at in a fair arms' length competitive situation;
- (ii) other ways of achieving the same savings had been properly explored;

41/ Only in the case of CEM schemes falling outside these guidelines would it be necessary to seek an H.M. Treasury view.

42/ An agreed procedure along these lines would enable CEM to play its full part in unlocking the £650 million p.a. or so public sector economic potential for energy savings, would meet outside criticism, and would provide a boost to a new service industry in a growth sector both at home and abroad. It could also have important employment implications, and through these, savings on the PSBR. Such a procedure could reconcile the aims of both HMT control and those of improved economic efficiency throughout the public sector.

E. H. M. PRICE

EcS 10 October 1986