



Climate Alliance thoughts on

'Accounting rules creating barriers for Energy Performance Contracts'

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Purpose

This paper outlines how the European accounting rules create barriers on implementing energy efficiency investments in the building sector. It explains the growing obstacle of the debt consolidation of Energy Performance Contracts (EPC), and provides some suggestions for joint action. Climate Alliance seeks support from its Executive Board and national coordinators to bring this topic on their national agendas and to put pressure for European Commission to take further action.

What is at stake?

In short, the problem is a discrepancy between the European energy policy objectives and the European System of National and Regional Accounts (hereafter referred as ESA10). Energy efficiency is constantly brought up at the European level as the outstanding solution for cutting CO₂ emissions, creating jobs and economic development and at the same time removing dependency on fossil fuels. The Energy Efficiency Directive defines a 3% annual renovation rate target for publicly owned buildings since 2014 (art.5, EED¹) and the national minimum performance requirements are defined in the 'Energy performance of buildings directive (art 4, EPBD). Both major EE directives ask the public sector "to lead by example", to provide "best practice cases", to test and apply "new renovation techniques and financing models to seize the opportunity". Renovated public buildings should be the frontrunners in quality, number and ambition via deep-renovations. This will prepare the market-uptake for wider deployment of refurbishment programs, as foreseen in the long-term renovation roadmaps (Art. 4, EED).

At the same time, the EUROSTAT guidance note of 07/08/15, "The Impact of Energy Performance Contracts on Government Accounts", poses a major barrier for EPC in the public sector. The EUROSTAT note, following the ESA10 rules, wanted to clarify to whom the *gross fixed capital formation* (meaning the actual investment in energy saving measures) have to be attributed to: the public building owner (EPC client) or the Energy Service Company (ESCO = EPC supplier). In a nutshell, the consequence is that the energy saving investment is treated by default as 'government expenditure', which increases the debt level. In other words, the EUROSTAT note makes it impossible to implement an EPC contract 'off-balance'.

¹ Since 9 July 2015 is the exemplary role of public buildings further strengthened by reducing the requirement of the total useful floor area from 5000 m² to 250 m² for both the energy performance certificates (Art. 12, EPBD) and the 3 % rate of renovations in public buildings (Art.5, EED)

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Why is this balance neutrality so important? Since the creation of the Euro (Maastricht treaty, 1992, the Stability and Growth Pact, 1998), a system emerged for multilateral budgetary surveillance via a package of rules to monitor and coordinate fiscal and economic policies to enforce the deficits and debt limits². In countries with a debt ratio above 100% of GDP (BE, CY, PT, IE, IT, GR) or close to 100% (FR, ES) balance sheet debt restrictions prohibit public authorities from refurbishing buildings which will deliver net economic benefits to the owner and respective Member States.

As a result, local and regional authorities will not get permission from financial supervisory bodies for their investments if these are interpreted as public debt. Until now, the only way to overcome that was via exemption rulings, which does neither provide more accountancy clarity, or long-term solutions. Highly indebted municipalities will not get exemptions to report these investments differently in comparison to other capital gross formations and this is blocking completely the take-up of cost-effective energy efficiency measures in the public sphere. The higher administrative budget (for getting permission from legal and financial departments within the public authorities) will reduce the profitability of an EPC directly, making it less cost- and time efficient. Therefore, in the case of energy efficiency investments, the Stability Pact undermines its own goals, i.e. budgetary relief and less unnecessary public spending. In addition, it obstructs realizing requirements of the EED and EPBD.

Several stakeholders started to highlight concerns on the negative impact of the EUROSTAT guidance note on the market development, including the Energy Efficiency Financial Institutions Group ([EEFIG report](#)), stating: *“Interpretations of EUROSTAT rules on public debt and deficit should not prejudice investment in energy efficiency in public buildings³”*. Also the European Investments Bank experiences the consequence for the successful [ELENA facility](#), which aims to maximize investments in sustainable energy via technical assistance provided to local and regional authorities. The IEE project *“EESI 2020”*, under coordination of the Berlin Energy Agency, promotes EPC schemes in nine European regions and has voiced serious concerns on the Eurostat note in a dedicated event together with [Fedarene](#) and in recent [publications](#). Climate Alliance coordinates [CITYinvest](#), a Horizon2020 project on innovative financing for energy efficiency, which implements wide-scale refurbishment programs in three pilot regions (Liège (BE), Rhodope (BG) and Murcia (ES). In two of the three regions, Liège and Murcia, the

² The EU Treaty defines an excessive budget deficit as one greater than 3 % of GDP. Public debt is considered excessive under the Treaty if it exceeds 60 % of GDP without diminishing at an adequate rate (defined as a decrease of the excess debt by 5 % per year on average over three years).

³ Furthermore, EEFIG suggests that an “over conservative” approach to fully accounting all the debt associated with EE investments on-balance sheet and neglecting to value the associated risk-adjusted asset created by that investment – the energy savings – even if guaranteed by a third party under contract (or insured) is inappropriate and blocks the flow of investment into energy efficiency. EEFIG recommends that Ministries of Finance of EU Member States require further analysis into the most appropriate accounting treatment for on and off balance sheet financing for energy efficiency projects (EEFIG, 2015, p.73).



debt deconsolidation problem creates a significant threat to achieve the project's targets.

The European energy efficiency targets should not be thwarted by the accounting rules which aim to limit public debt but in fact block energy efficiency investment. These investments could deliver - not only energy and CO2 savings needed for reaching the 2030 targets - but also financial relief for public building owners involved.

What are the pieces of the puzzle to move forward?

First some words on the false solutions, to de-mystify the communication. The EUROSTAT guidance note 'provides two exemptions':

- The criteria of a public-private partnership (PPP), which can be classified off-balance sheet when the project covers a "capital expenditure in the already existing assets equal to 50% of the asset's value", which is almost never applicable to a building refurbishment project.
- The operating lease exemption, where the EPC is interpreted as a service contract and there is no capital expenditure: the energy equipment is seen separately from the building and the public entity does not own these assets, nor has a wish to acquire it at the end of the contract. Non-removable assets cannot go under this definition, as they are more substantial measures in the building envelope (renovating walls and roofs, thermal bridges, double/triple glazing etc.) Refurbishment measures, broader than the 'low-hanging fruits' such as LED relighting, do not comply with this. Furthermore, in the coming years the operating lease option will also most likely become on-balance sheet, even for removable assets, thus this will not create a long-term solution.

The main convincing argument is the fact that the public authority pays to the ESCO the up-front investment back in terms of difference in the energy bills. This is a basic rule for an EPC contract: the guaranteed savings result in a certain level of lower energy consumption and these cost savings pays back the service provider, the ESCO. If this remuneration would be classified as 'operating costs', then it would no longer appear on the public authority's balance sheet. In fact, the investment would be paid back from the similar budget as the costs of energy. This makes absolute sense and would balance both the costs and the benefits of the EPC project under the same budget category.

The rationale of doing this makes the case clear for a new treatment for cost-savings investments. This could lower the competition between EE investments and other capital expenditures that simply need to be paid back (like infrastructure such as roads and rails), without any guaranteed cost relief resulting from it.

Our proposals

To improve this situation, different efforts need to take place simultaneously. Starting now, the European Commission needs to acknowledge this issue as of EU's importance, because the achievement of the energy efficiency targets are depending on it. This will be triggered by all levels of governance – local, regional, national – understanding of the EPC



contracts involved, their benefits, risks, and procurement processes and asking for changing parts of the European accounting system.

Secondly, the Member States should, motivated by the Energy Efficiency Directive, Art. 20, set up National Energy Efficiency Funds (fully public, or public-private) to ensure affordable up-front financing. The fund can be sourced from central budgets, public banks, energy user charges' (incl. EE Obligations, EED Art.7), ESIF budget, ETS auction revenues, etc. Local and regional authorities would then have a secured credit line for their EE projects, even though it remains for now on the balance sheet. In the medium to long-term these EE funds also will de-risk the perception of EE projects (making private capital more affordable) and bring more stable investment environment, which increases the confidence in the EE sector and its market-uptake. EPC remains on the balance sheet, but its upfront investment is at least safeguarded. It is, however, not the lack of potential funding, which is the blocking barrier, but the debt consolidation in the public accounts.

The more structural solutions will be build on the new definitions of EE investments in EAS10, being treated as operating costs instead of capital expenditure, in fact as assets instead of one-time costs. Perhaps more tangible impacts of EE investments should bring this political debate on good decision making further: tackling energy poverty, creating jobs and Juncker's Investment Plans priorities⁴, reducing energy dependency and achieving the EU 2030 targets. These impacts are all heavyweights on the EU agenda and many evidence on the 'energy efficiency first' principle is already acknowledged across the EU institutions.

The Energy Union and the EED/EPBD revisions, together with the Paris Climate Agreement, provides the momentum to start tackling the blocking barriers for the EU to move forward in a global leader position for climate and energy matters.

Conclusion

The public accounting hurdles prevent public authorities to make good quality and long-term decision for energy efficiency measures in the building stock. Energy performance contracting acts as a key innovative business model with the capacity to scale-up the market and reach the requirements set by the energy efficiency directives.



⁴ If the EU chooses to tap into the cost-effective potential of energy savings, it would drive €714bn of investments and create or maintain 11 million jobs. This means more than twice the aimed potential of the current Juncker Investment Plan



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ABOUT [Climate Alliance](#)

"Climate Alliance of European Cities with the Indigenous Rainforest Peoples" is the largest city network committed to climate protection and preservation of the tropical rainforests. Since 1990, Climate Alliance has supported a total of now almost 1,700 members from 24 European countries in attainment of their voluntary commitments to reduce CO2 emissions by ten percent every five years and to halve per capita emissions by 2030 at the latest (base year 1990).