18 April 2016

To: Vice-President Jyrki Katainen
Rue de la loi 200
1049 Brussels
Belgium

Copy: Members of the Commissions part of the 'Energy Union' project team

Object: Reviewing accounting rules and/or debt treatment for energy efficiency investments will help close the energy efficiency financing gap in Europe

Mr Vice-President,

Long-standing analysis by the IEA indicates that to meet the well below 2°C goal, two-thirds of the EU's low carbon energy infrastructure investment to 2040 will need to be in energy efficiency[1]. Yet current levels of investment are quite modest. Just in buildings it estimated that €60-100bn[2] needs to be invested annually to achieve Europe's 2020 energy efficiency targets, with current investments at less than half this level[3][4]. The task is significant.

Interpretation of accounting rules is one of the key reasons by the Energy Efficiency Financial Institutions Group (EEFIG) that energy efficiency remains an area of significant under-investment. The EU's current interpretation of International Financial Reporting Standards (IFRS), recently confirmed by EUROSTAT[5], make it difficult for many Member States and their local authorities to develop investment programmes with the private sector. This is because these investments, despite being delivered and financed wholly or in part by private sector partners, require capital budget to cover their cost and as a result are recorded as being on balance sheet and counted towards public sector debt.

The rules are therefore a disincentive to governments to develop energy efficiency investment programmes – and promote the continued focus on grant-funded schemes. This leaves private sector public-private financing options under-exploited and the energy services company (ESCO) as well as Energy Performance Contracting (EPC) market under-developed.

As an example, while buildings are responsible for the largest share of European final energy consumption (40%[6]) and represent the greatest potential to save energy, current investments to improve energy efficiency are at less than half the level needed to meet Europe's 2020 energy

[1] IEA (2014). World Energy Investment Outlook.

[2] COM (2012). Consultation Paper: "Financial Support for Energy Efficiency in Buildings"; and EURIMA. (2012). Financing Mechanisms for Europe's Buildings Renovation.

[3] DIW (2013). Financing of Energy Efficiency: Influences on European Public Banks' Actions and Ways Forward.

[4] BPIE Estimates based upon 2011's "Europe's Buildings under the Microscope: A country-by-country review of the energy performance of Europe's buildings".

[5] See Eurostat (2015). Guidance Note on the Impact of Energy Performance Contracts on Government Accounts and note this applies to government-led investment in buildings (not industry).

[6] Enerdata (2012). Energy Efficiency Trends in Buildings in the EU.

efficiency targets. The annual funding gap is between €30bn-50bn[7]. Other opportunities – notably in industry, which accounted for 25% of the EU's energy consumption in 2012 – are also significantly underexploited. **As such there is a strong case for reviewing current accounting treatment for energy efficiency investment.**

In light of this information, we ask you to review the current accounting treatment for energy efficiency investments. We believe there is a strong case for updating how the rules are interpreted and applied. We suggest here four different updated approaches that, if implemented, could materially improve the investment conditions for energy efficiency. They are alternative approaches that can be considered either alone or in various combinations, depending on what is considered politically viable.

1. Revising Eurostat's view of what is considered an "asset"

Consider a different interpretation of the term "asset" in relation energy efficiency investments – revising it from relating to the value of the entire building to the value of the building's elements and installations on which energy efficiency investment has been made. This would reflect better the scope of energy efficiency investments performed on public buildings and enable energy efficiency investment to be classified as a public-private partnership (PPP).

2. Recognition of cash savings from energy efficiency investments in the 'scoring' of investments

Consider an amendment to the interpretation of IFRS rules and recognise cash savings from energy efficiency investment programmes and EPCs in the 'scoring' of investments. This would have the effect of EPCs being prioritised and scored higher in the approvals process compared to other standard infrastructure projects (in the case of governments) and other investments (in the case of businesses). This approach would significantly unlock the potential of the ESCO market to grow to serve both governmental and industry investment needs.

3. Reinterpreting debt rules

3a. Creating an off balance sheet classification for energy efficiency

In recognition of the productive nature of energy efficiency investment in both the short and long term, consider a new off balance sheet EUROSTAT classification of 'productive debt'. (This applies only to government-led energy efficiency investment programmes but will positively impact all Member States.)

3b. Clarifying that flexibility will be granted under the Stability and Growth Pact structural reform clause to fund major energy efficiency investment as part of a structural reform programme

Clarifying that governments will be eligible for flexible treatment under the Stability and Growth Pact to borrow to invest in major energy efficiency programmes. This would be justified on the basis that improving energy productivity through energy efficiency investment amounts to a structural reform that both drives sustainable growth and creates a more efficient economy.

Further background and detail on the arguments for doing this is set out in the attached Annex.

[7] COM (2012) Consultation Paper: "Financial Support for Energy Efficiency in Buildings"; and EURIMA. (2012). Financing Mechanisms for Europe's Buildings Renovation. DIW (2013). Financing of Energy Efficiency: Influences on European Public Banks' Actions and Ways Forward

We would welcome a discussion in how these ideas could be taken forward.

Yours sincerely,

Annex

The opportunity

Upcoming revisions to the Energy Efficiency Directive and Energy Performance in Building Directive, including implementation of the Heating and Cooling Strategy offer an opportunity to close the energy efficiency and demand side flexibility financing gap.

The issue

Long-standing analysis by the IEA indicates that to meet the well below 2°C goal, two-thirds of the EU's low carbon energy infrastructure investment to 2040 will need to be in energy efficiency[8]. Yet current levels of investment are quite modest. Just in buildings it estimated that €60-100bn[9] needs to be invested annually to achieve Europe's 2020 energy efficiency targets, with current investments at less than half this level[10][11]. The task is significant. Buildings are responsible for the largest share of European final energy consumption (40%[12]) and they represent the greatest potential to save energy - as 75% of buildings standing in the EU were built during periods with no, or minimal, energy-related building codes[13]. Other opportunities exist more widely in the economy – notably also in industry, which accounted for 25% of the EU's energy consumption in 2012. Looking out to 2040, the IEA estimates an average of $200bn (€178bn) needs to be invested annually across the EU to deliver the scale of energy efficiency investment needed to keep the it on track to the well below 2°C goal. This equates to the need for an at least eightfold increase in energy efficiency investment compared to 2013 levels[14].

In 2015 the final report of the Energy Efficiency Financial Institutions group (EEFIG) note that 'accounting risk' was a disincentive both to companies and to governments with respect to developing energy efficiency investment programmes with private sector providers and that interpretations of EUROSTAT rules on public debt and deficit should not prejudice investment in energy efficiency in public buildings[15]. Between November 2015 and January 2016, EU survey was undertaken by the European Association of Energy Service Companies (eu.esco) and the European Federation of Intelligent Energy Efficiency Services (EFIEES) to assess the impact specifically of Eurostat rules on public debt and deficit on EPCs offered by private EPC providers to public sector in Europe[16]. They have found that Eurostat rules represent a regulatory obstacle to contracting and investing in energy efficiency in the public sector in several EU Member States.

[8] IEA (2014). World Energy Investment Outlook.

[9] COM (2012). Consultation Paper: "Financial Support for Energy Efficiency in Buildings"; and EURIMA. (2012). Financing Mechanisms for Europe's Buildings Renovation.

[10] DIW. (2013). Financing of Energy Efficiency: Influences on European Public Banks' Actions and Ways Forward.

[11] BPIE Estimates based upon 2011's "Europe's Buildings under the Microscope: A country-by-country review of the energy performance of Europe's buildings".

[12] Enerdata (2012). Energy Efficiency Trends in Buildings in the EU.

[13] COM (2012). Consultation Paper: "Financial Support for Energy Efficiency in Buildings".

[14] IEA (2014). Special Report: World Energy Investment Outlook.

[15] EEFIG (2015). Energy Efficiency – The first fuel for the EU Economy.

[16] EU.EUSCO (2016). Results of EU survey on Eurostat guidance note "The impact of Energy Performance Contracts on government accounts"

The arguments for revisiting accounting treatment for energy efficiency investment

- The very significant and ongoing level of under-investment.
- The non-level playing field for energy efficiency compared to other infrastructure investments funded by via public-private partnerships. This constitutes a failure to apply the Efficiency First principle.
- The failure of current rules to take into account the productive nature of these investments – including the energy savings made from the first day the assets are operational[17].
- The failure to take into account the fact that for investments made as EPCs, the majority of risks (and therefore liabilities) lie with the private sector and that EPCs can offer an energy savings guarantee.

Policy opportunity

The Energy Union Strategy recognizes this gap – and sets out the need for a fundamental rethinking of how energy efficiency is delivered in Europe[18]. Implementation of the Heating and Cooling Strategy is an opportunity to start to do that. The Commission's focus on closing the financing gap, notably in buildings, through promoting the use of energy service companies, energy performance and public procurement contracts is the right one. But to enable this approach to achieve its potential, the rules around how these investments – but also more widely in other public infrastructure and in industry - are accounted for need to be reviewed with urgency.

Suggested updated approaches

Quickest 'fix'

Option 1. Revising Eurostat's view of what is considered an "asset": The "50% rule" (established by the Manual on Government Debt and Deficit and confirmed by the guidance note by Eurostat from 7 August 2015) states that a contract is not viewed as a PPP unless the value of capital expenditure for improving energy efficiency reaches at least 50% of the value of the building after the energy efficiency renovation has taken place. This is simply not realistic: meeting the 50% rule as it currently stands is difficult even in cases of investment in so called deep renovations. This means EPCs fail to qualify as PPPs, despite EPCs being structured so that ESCOs take the majority of the risk. A more realistic and practical approach would be to redefine the term "asset" so that is refers to a specific building's elements and installations on which energy efficiency investment has been undertaken, instead of the building as a whole.

Reinterpreting debt rules

Option 2. Recognition of cash savings from energy efficiency investments in the 'scoring' of investments (applies to government and private sector-led investment across the economy[19]):

[17] Where EPCs are used, the contracts offer guaranteed energy savings that generates cash savings that cover the cost of the investment, unlike other forms of public spending.

[18] See European Commission (2015), A Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy.

[19] This would have a positive impact across the economy – in buildings, other public infrastructure, industrial efficiency improvements.

Adjustment to the interpretation of IFRS rules to allow for applications for capital budget to cover EPCs to be considered in the context of the initial capital budget required net of the future savings to governments or businesses going forward. This would have the effect of EPCs being prioritised through being scored higher in the approvals process compared to other standard infrastructure projects (in the case of governments) and other investments (in the case of businesses). Requiring this calculation to be undertaken would also mitigate the risk of misuse of EPCs by public and private entities[20].

Option 3a. Creating an off balance sheet classification for energy efficiency in recognition of the productive nature of energy efficiency debt (applies to Government-driven investment[21]): Adjustments to Eurostat rules on how energy efficiency investment programmes (whether financed by public sector or by ESCOs) are scored in government accounts would remove the need for governments to find capital budget to cover the cost of investment - which takes funding away from essential social infrastructure such as hospitals and schools. While these are also important they do not deliver an immediate return on investment as they are not 'invest-to-save' projects. This key difference does argue for a differentiation between these different asset classes. It also argues for a differentiated treatment under the Stability and Growth Pact, as set out below.

Option 3b. Clarifying that flexibility will be granted under the Stability and Growth Pact to fund major energy efficiency investment as part of a structural reform programme. Flexible treatment could be granted on the basis that major energy efficiency investment programmes are designed to improve productivity and therefore constitute a structural reform that both drives sustainable growth and creates a more efficient economy. This would then merit a temporary exemption for government borrowing to finance energy efficiency programmes from the Medium-Term Budgetary Objective (Stability and Growth Pact). This position would need to be agreed and formalised by the Economic and Financial Committee, as it has been done with the European Fund for Strategic Investments (EFSI)[22].

To create accountability and transparency in how the reinterpreted rules are applied (by ensuring that the EPCs are really focused on energy efficiency improvements), the European Commission could also facilitate the development of standardised operational guidelines, contracts[23] and procurement processes.

Development of standardised operational guidelines, contracts and procurement processes accelerate government and also business investment in energy efficiency services and products: Set up an Energy Efficiency Financial institutions-style process with providers, financiers and

[20] The transparency of this approach would mitigate against the risk that the procuring entities remove from their balance sheet assets for which they assume full risks (thus helping to ensure the spirit of the IFRS rules is implemented.

[21] In buildings but also other public infrastructure including street-lighting, municipal facilities such as water treatment etc.

[22] Economic and Financial Committee (2015). A Commonly Agreed Position on Flexibility within the Stability and Growth Pact.

[23] Standardised guidelines to the implementation of EPC are indeed an important tool to streamline the use of this type of contracts. Still, EPC cover not only a financial aspect, but also a concrete set of measures that define how service operators will deliver energy savings they guarantee during the period of investment and operations of infrastructures covered. Hence what is needed is less a standardized EPC contract than a standardized language and guidelines that guarantee that all stakeholders can agree on the most optimal outcome of a given contract.

government procuring entities that would benefit from this initiative, in terms of reduced transaction costs. Issues to discuss should include how to deliver: a clear definition of EPCs, a shorter more structured procurement process, contract templates and so on. It would also promote market integrity and therefore growth as it would ensure all parties better understand an agreed upon set of guidelines, procurement processes that are commercially acceptable in the market. This would help mitigate any risk associated with off-balance sheet treatment.