

SCOTTISH FUTURES TRUST

GUIDANCE

on

**Powers of Scottish public bodies to generate/procure heat and electricity supplies,
to supply heat and electricity to third parties, and the constraints on those powers**

Version 1.1

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TABLE OF CONTENTS

Introduction	1
1 Local Authorities	4
2 Universities	13
3 Colleges of Further Education	18
4 NHS Boards	23
5 Central Government and its Agencies (and the Scottish Court Service)	26
6 Registered Social Landlords	31
7 Scottish Water	37
8 Public procurement	41
9 State aid	50
10 Competition law	52

Appendices

Appendix 1: legislation referred to in the Local Authorities section.

Appendix 2: legislation referred to in the Universities section.

Appendix 3: legislation referred to in the Colleges of Further Education section.

Appendix 4: legislation referred to in the NHS Boards section.

Appendix 5: legislation referred to in the Central government and its agencies (and the Scottish Court Service) section.

Appendix 6: legislation referred to in the Registered Social Landlords section.

Appendix 7: legislation referred to in the Scottish Water section.

Appendix 8: legislation and case law referred to in the public procurement section.

Version history

Version	Date	Notes
1	May 2014	Full guidance
1.1	November 2014	Section 1 amended

Introduction

This Guidance sets out the powers of Scottish public bodies to generate or procure heat and electricity supplies, and their powers to supply heat and electricity to third parties.

The Guidance also considers the constraints on these powers. Constraints operate at two levels. Some are legal, such as lack of power or restrictions on the exercise of power. Others are better categorised as administrative, for example, inability to carry on a particular activity unless certain consents are obtained, or unless an administrative framework is complied with.

The Guidance reviews relevant ancillary powers: these include powers to borrow, to establish companies, partnerships or joint ventures or to participate in these, and to trade or carry on an activity with a view to making profit.

The public bodies which are considered are local authorities, universities, colleges of further education, NHS boards, central government and its agencies (and the Scottish Court Service), registered social landlords and Scottish Water.

The majority of public bodies in Scotland are therefore covered. Because each is different in terms of statutory functions and powers, it has not been possible to cover non-departmental public bodies in this Guidance.

Within the section for each public body, the issues considered are addressed in the same order:

- analysis of powers to generate or procure heat and electricity supplies;
- constraints on the generation or procurement of heat and electricity supplies;
- analysis of powers to supply heat and electricity to third parties (whether in the public or the private sector); and
- constraints on the supply of heat and electricity to third parties (whether in the public or the private sector).

There are three separate sections which raise issues that are common to all public bodies. The first of these addresses the key issue of public procurement and its application to projects involving the generation or supply of heat and/or electricity.

The second separate section considers State aid. This section provides background to considerations that are relevant and to potentially relevant exemptions.

The final separate section addresses competition law. It is a pointer to issues which should be borne in mind.

There is also a common issue relating to the deliberate "oversizing" of energy-generating plant or the related network in order to accommodate anticipated expansion. This issue does not merit a separate section, and is instead addressed at paragraphs 1.41 to 1.45 of the Guidance at the end of the section on local authorities.

There may be many reasons for a Scottish public body to generate or procure heat and electricity supplies itself and indeed to supply heat and electricity to third parties. One reason may involve the climate change duties which are placed on Scottish public bodies by Part 4 of the Climate Change (Scotland) Act 2009. In particular, section 44(1) of that Act provides that a public body must, in exercising its functions, act: (a) in the way best calculated to contribute to the delivery of the targets set in or under Part 1 of the Act; (b) in the way best calculated to help deliver any programme laid before the Scottish Parliament under section 53 (climate change adaptation); and (c) in a way that it considers is most sustainable. Section 45 requires the Scottish Ministers to give guidance in relation to these climate change duties and Scottish public bodies must have regard to it. The guidance is available at <http://www.scotland.gov.uk/Resource/Doc/340746/0113071.pdf>. It is just worth noting that the section 44 duties do not add to the functions (or powers) of Scottish public bodies: what they do is to require Scottish public bodies to act in accordance with the duties when exercising the functions (and powers) that they do have. Part 4 of the 2009 Act is reproduced as part of Appendix 1.

There is an electricity-related issue which should also be mentioned. The current Scottish Procurement national Framework Agreement for the supply of electricity to the Scottish public sector runs from 1 April 2013 to 31 March 2016, with an option to extend to 31 March 2019. Within the Framework Agreement conditions, there is provision which is designed to address situations where a public body is generating electricity which exceeds the needs of the premises on which that electricity is generated, but which does not exceed the overall electricity consumption requirements of that public body across all of its premises. In such a case, the Framework supplier is obliged to consider and offer terms for the purchase from the public body of that excess generation, which can then be used to supply the public body's other premises, in effect, self-supply. In light of the overall economies of scale secured via the Framework Agreement (which covers the entire Scottish public sector) it is expected that the price which would be paid by the Framework supplier for the excess generation will be better than that which could be secured on the open market by the public body acting alone. There are obvious cost benefits to projects if the price obtained for electricity generated for self-supply purposes can be maximised. We understand that Scottish Procurement will be happy to discuss and further advise on this scenario with any Scottish public sector body for whom it may be relevant.

In most of the sections of the Guidance references are made to relevant legislation or case law. That legislation and case law is reproduced in the Appendices, the numbering of which corresponds to the principal sections of the Guidance. Within the Appendices, the legislation or cases are referred to in the order in which they are referred to in the corresponding section of the Guidance. Where the same legislative provision is referred to more than once in an individual section of the Guidance, it is set out in the relevant Appendix only when first referred to. Only references to specific sections, paragraphs, articles or schedules of legislation or regulations are reproduced; thus, entire Acts, Regulations or EU Directives are not reproduced. We are grateful to Westlaw UK for permission to reproduce this material.

With the exception of a small number of references to known future changes, the law in this Guidance is stated as at 30 April 2014. The legislation reproduced in the Appendices is considered to represent the relevant provisions in force as at 30 April 2014, but may be subject to future change and should be specifically checked for any such change.

This Guidance is intended to provide general information on the powers of Scottish public bodies and the constraints on these powers, in relation to the subject matter of generating or procuring heat and electricity supplies and supplying heat and electricity to third parties. It does not constitute, and may not be relied upon by any person as, legal advice or guidance in respect of any particular project or projects. Legal advice should be taken, as appropriate, with reference to the individual circumstances of projects.

1 Local Authorities

Power to generate or procure heat and electricity supplies

1.1 Section 170A of the Local Government (Scotland) Act 1973 confers a discretionary function on a local authority to produce and supply heat and electricity. In particular, per sub-section (1), a local authority may

- "(a) produce heat or electricity or both;
- (b) establish and operate such generating stations and other installations as the authority think fit for the purpose of producing heat or electricity or both;
- (c) buy or otherwise acquire heat;
- (d) use, sell or otherwise dispose of heat produced or acquired, or electricity produced, by the authority by virtue of this section;
- (e) without prejudice to the generality of the preceding paragraph, enter into and carry out agreements for the supply by the authority, to premises within or outside the authority's area, of such heat as is mentioned in the preceding paragraphs and steam produced from and air and water heated by such heat."

1.2 As regards heat, therefore, a local authority has the power to produce heat, to buy or otherwise acquire heat and to use, sell or otherwise dispose of such heat and to enter into agreements to supply premises within or outside the authority's area of such heat.

1.3 As regards electricity, a local authority has power to produce electricity and to use, sell or otherwise dispose of electricity that it has produced. Section 170A(1) does not confer a power to buy electricity (but see further at paragraph 1.12) nor, therefore, to sell electricity except where that electricity has been produced by the local authority.

1.4 Section 170A(1) is subject to section 170A(3). The effect of that sub-section is to limit the power of a local authority to sell electricity to circumstances: (a) where it is produced from waste; or (b) where it is produced in association with heat; or (c) as may be specified in regulations. Regulation 2 of the Sale of Electricity by Local Authorities (Scotland) Regulations 2010, made under section 170A(3), provides that electricity may be sold by a local authority where it is produced from the following renewable sources, namely:

wind, solar, aerothermal, geothermal, hydrothermal and ocean energy, hydropower, biomass, landfill gas, sewage treatment plant gas, and biogases.

1.5 Sections 170A and 170B make further provision in relation to the provision and regulation of heat infrastructure which may be provided by a local authority. These provisions are discussed in

paragraphs 1.6 to 1.9. There are no equivalent provisions in either section 170A or 170B in relation to the provision of electricity infrastructure. On that issue, see further at paragraph 1.13.

- 1.6 Section 170A(4) provides that a local authority may construct, lay and maintain pipes and associated works for the purpose of conveying heat produced or acquired by it and may contribute towards the cost incurred by another person in providing or maintaining pipes or associated works connected with pipes provided by the authority.
- 1.7 Section 170A(5) provides that a local authority may break open roads for the purpose of laying pipes and associated works. The particular powers to do this are those set out in Parts I and II of Schedule 3 to the Water (Scotland) Act 1980, to be read as if references to Scottish Water were references to the local authority.
- 1.8 Section 170B(1) permits a local authority which supplies or proposes to supply heat, hot air, hot water or steam in pursuance of section 170A to make byelaws with respect to the works and apparatus to be provided or used by persons other than the authority in connection with the supply and for preventing waste and unauthorised use of the supply and unauthorised interference with works and apparatus used by the authority or any other person in connection with the supply. These byelaws may also provide that a contravention is an offence punishable on summary conviction with a fine not to exceed level 3 on the standard scale (currently £1,000).
- 1.9 Section 170B(2) provides a power of entry to premises by authorised officers of a local authority where a supply of heat is being provided by that authority. That power is exercisable for various purposes, including installing and reading a meter and considering whether there has been a contravention of any byelaws made. The power is a modified version of the power of entry available to Scottish Water under section 38 of the Water (Scotland) Act 1980.
- 1.10 While sections 170A and 170B confer discretionary functions on a local authority and do not therefore require to be linked to other local authority functions, in practice a local authority will be seeking to discharge other functions through the use of sections 170A and 170B. The authority may be acting in implement of the duties under Part 4 of the Climate Change (Scotland) Act 2009 (see in particular section 44 - duty to act in the way best calculated to contribute to the climate change targets set out in Part 1 of the 2009 Act) and related guidance on that duty under section 45, it may be motivated by duties around the provision of education (school facilities: see section 17 of the Education (Scotland) Act 1980), or housing (tenanted properties: see section 2 of the Housing (Scotland) Act 1987), or powers relating to economic development (see section 20 of the Local Government in Scotland Act 2003), or the provision of leisure and other related facilities (see section 14 of the Local Government and Planning (Scotland) Act 1982), or the provision of the authority's own offices (see section 79 of the 1973 Act). The discharge of any of these functions or duties, or a combination of them, may drive the desire to produce, acquire or sell heat and electricity, but these functions or duties do not themselves authorise that activity.
- 1.11 A local authority also has an ancillary power, under section 69 of the Local Government (Scotland) Act 1973, to do anything which is calculated to facilitate, or is conducive or incidental to, the

discharge of any of its functions. This power is relevant in respect of the particular means which an authority may adopt to take forward an energy scheme (such as the establishment of, or participation in, a company). However, it need not be relied upon in relation to the primary production of heat or electricity by the authority itself, or indeed the purchase or acquisition of heat by the authority.

- 1.12 The section 69 power is also applicable in circumstances where a local authority is simply seeking to manage its energy needs, for example through a contract for the supply to the authority of electricity or gas. Section 170A does not specifically authorise the purchase or acquisition of electricity by a local authority, but section 69 can be relied upon for this. This could be described as a "business as usual" scenario, and is not considered further in this Guidance.
- 1.13 As mentioned in paragraph 1.3, section 170A of the Local Government (Scotland) Act 1973 does not authorise a local authority either to buy electricity or to sell any electricity that is bought. It is clear that the section 69 power may be relied upon for the purchase of electricity by a local authority. We do not think that it can be relied upon for the onward sale by a local authority of electricity which it may itself have purchased using that power. This is because local authorities are not expected to be sellers/suppliers of electricity other than in the permitted circumstances set out in paragraph 1.4. We do consider that the section 69 power can, however, be relied upon (where a local authority does sell/supply electricity in those permitted circumstances) to permit provision by the authority of any necessary electricity-related infrastructure, such as a private wire network, where such provision would facilitate, or would be conducive or incidental to, the discharge of any of its functions (see paragraph 1.10).
- 1.14 The well-being power contained in section 20 of the Local Government in Scotland Act 2003 is not relevant to the production of heat and electricity by a local authority. The well-being power (despite being called a power) is intended to permit a local authority to act where otherwise that might not be clear. In light of that, it does not require to be exercised only in conjunction with some other identified function. However, if there is an existing function or power, then section 20 cannot be used to substitute for it or to add to it. By way of example, section 170A(1), read with section 170A(3) and the Sale of Electricity by Local Authorities (Scotland) Regulations 2010, permits the sale of electricity generated from renewable sources as well as the sale of electricity produced from waste or in association with heat. It does not permit the sale of electricity produced from non-renewable sources, unless from waste or in association with heat. Section 20 may not be used to supply that lack of power.

Constraints on the generation or procurement of heat and electricity supplies

- 1.15 As discussed, section 170A of the Local Government (Scotland) Act 1973 is the primary function conferring power on a local authority in relation to the provision of supplies of heat and electricity, or the acquisition of heat, via specially constructed plant such as a district heating scheme, while section 69 of the Local Government (Scotland) Act 1973 is relevant for "business as usual" supplies of energy to the authority.

- 1.16 Again as discussed, while section 170A is broad in scope, it is not unlimited: it does not permit a local authority to sell electricity from non-renewable sources, unless that electricity is produced either from waste or in association with heat. And also as discussed, the well-being power in section 20 of the Local Government in Scotland Act 2003 cannot be used to supply the want of that power, and nor can section 69 of the Local Government (Scotland) Act 1973.
- 1.17 In considering how to implement a decision to procure heat and/or electricity supplies, a local authority will have a number of choices. It may choose to do this in the wider market, which is the business as usual option. This is not further considered in this Guidance. Alternatively, it may choose (a) to put these supplies in place itself or (b) to fulfil its needs through the acquisition of, for example, heat and/or electricity from a district heating scheme already established by a third party. As regards the former, this falls squarely within section 170A. As regards the latter, section 170A permits the purchase of heat by a local authority, while section 69 permits the purchase of electricity by a local authority.
- 1.18 Where a local authority decides to pursue its own scheme for production and supply of heat and/or electricity, it may choose to do this entirely within the authority or it may choose to do it through an arm's length external organisation ("ALEO") or through participation in some other vehicle involving other relevant stakeholders.
- 1.19 A local authority may competently establish an ALEO or participate in some other vehicle, relying on the section 69 ancillary power to do so. However, care must be taken in reliance on that power. First, a function of the authority needs to be identified in relation to which the ancillary power is being relied upon. That function could be section 170A itself. It could equally relate to the implementation of a local authority's Climate Change (Scotland) Act 2009 duty set out in section 44, or to the provision of housing or education or a combination of these (see paragraph 1.10 for further examples).
- 1.20 Secondly, section 69 may not be relied upon as a means of providing a power to do something where none exists or to extend an existing but limited power.
- 1.21 Thirdly, a local authority must not, in the establishment of or participation in a ALEO or other vehicle, impermissibly delegate its functions: that is, a local authority cannot hand over functions to be discharged by a third party entity without retaining an element of oversight and control. This is a constraint around governance, and can be managed provided appropriate protocols are put in place.
- 1.22 Generally, however, the establishment of a ALEO or participation in some other venture for taking forward an energy scheme should be within the power of a local authority, provided due consideration is given to the functions which are being relied upon in respect of exercise of the section 69 ancillary power and to ensuring appropriate governance.
- 1.23 If a local authority decides to take forward an energy scheme, it will need to consider how that is to be financed. It is beyond the scope of this Guidance to consider all the various means by which this can be done. At one end of the spectrum the authority could procure a long-term design, build,

finance, operate and maintain ("DBFOM") contract, which may not require capital expenditure on the part of the authority, although it would, over the contractual term, involve significant revenue expenditure. At the other end of the spectrum, the authority may wish to fund the energy scheme entirely itself.

- 1.24 In that scenario, it may be necessary for the authority to borrow the required capital. A local authority's powers to borrow are set out in Schedule 3 to the Local Government (Scotland) Act 1975. These powers are not unconstrained. Section 35 of the Local Government in Scotland Act 2003 requires a local authority to determine and keep under review the maximum amount which it can afford to allocate to capital expenditure.
- 1.25 This is achieved through "prudential borrowing" and in particular through adherence to the CIPFA Prudential Code for Capital Finance in Local Authorities. Borrowing is permitted provided that it is prudent. The Scottish Government monitors local authority capital plans, outturn expenditure and borrowing levels and has the right to impose capital expenditure limits under section 36 of the Local Government in Scotland Act 2003.
- 1.26 Under section 1(1) of the Local Government in Scotland Act 2003 local authorities are also subject to a duty to make arrangements which secure best value. Best value is defined in section 1(2) as "continuous improvement in the performance of the authority's functions". In terms of section 1(3), in securing best value the local authority must maintain an appropriate balance among quality of performance, cost of performance and cost to persons of services provided by the local authority. In implementing the best value duty a local authority must also have regard to Guidance produced on Best Value by the Scottish Ministers. In deciding how to satisfy a requirement for heat and/or electricity supply, a local authority will need to consider the best value duty and reach a conclusion (if appropriate) that satisfying that requirement through generation or procurement of heat and/or power supply via an energy scheme (whether operated by itself or by a third party) achieves best value.

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

- 1.27 Section 170A of the 1973 Act permits local authorities to sell heat or (subject to the restrictions set out in paragraph 1.4) electricity and does not limit the categories of person to whom such heat or electricity may be sold: therefore supplies to both public and private sector entities are permitted. This applies where heat has been produced, or acquired, by the local authority or where electricity has been produced by it (subject to the restrictions set out in paragraph 1.4).
- 1.28 Section 170A does not authorise either the purchase or acquisition, or the sale of electricity which has been purchased or acquired (as opposed to produced) by the local authority. The ancillary power contained in section 69 of the 1973 Act can be used to authorise purchase of electricity by a local authority but we do not consider that it authorises the sale of any such electricity as is so purchased. So, as regards supply of electricity to third parties, a local authority may only supply electricity which has been produced by it where it has been so produced from waste, or in association

with heat, or produced separately from renewable sources specified in regulation 2 of the Sale of Electricity by Local Authorities (Scotland) Regulations 2010 (on which see paragraph 1.4).

- 1.29 Section 170A is itself a function, but there may be other functions (or duties) which a local authority is discharging through selling heat or electricity to third parties. These could include acting in implement of the duty under section 44 of the Climate Change (Scotland) Act 2009, (duty to act in the way best calculated to contribute to the climate change targets set out in Part I of the 2009 Act) or the well-being power contained in section 20 of the Local Government in Scotland Act 2003 (see paragraph 1.14), perhaps particularly in connection with any economic or other benefit to be secured within the local authority's area (although note in this connection that the section 20 power may not be used where the sole motivation is a money-making venture for the authority).

Constraints on the Supply of Heat and Electricity to Third Parties (Public and/or Private Sector)

- 1.30 Section 1(1) of the Local Authorities (Goods and Services) Act 1970 permits a local authority and any person, "in relation to any relevant trading operation carried on by the authority", to enter into an agreement for all or any of the following purposes:

- "(a) the supply by the authority to the person of any goods or materials;
- (b) the provision by the authority for the person of any services;
- (c) the use by the person of any property belonging to or facilities under the control of the authority and, without prejudice to paragraph (b) above, the placing at the disposal of the person of the services of any person employed in connection with the property or facility in question;
- (d) the carrying out by the authority of works or maintenance in connection with land or buildings for the maintenance of which the person is responsible."

- 1.31 Section 1(1) applies in relation to any "relevant trading operation" carried on by a local authority. In terms of Section 1(1O) a "trading operation" is one for which, in accordance with proper accounting practices under section 12 of the Local Government in Scotland Act 2003, the authority keeps trading accounts. There is guidance issued by CIPFA/the Local Authority (Scotland) Accounts Advisory Committee on trading accounts and when there is a requirement to maintain and publish them. A "relevant trading operation" is defined in Section 1(1P) as a "trading operation" which is carried on for the purpose of enabling a local authority to raise money, by borrowing or otherwise. In essence, the supply of heat or electricity to a third party is likely to constitute a relevant trading operation in that (a) the recipient of the service could go elsewhere for the service (as in most cases involving electricity) or could provide it itself (as in most cases involving heat), and (b) the service is (very likely) being provided on a basis other than a recharge of cost. However, if the supply is not a "relevant trading operation" it will still be permitted by virtue of section 170A of the 1973 Act (but see paragraphs 1.4 and 1.27).

- 1.32 In terms of section 1(1) the supply of heat and/or electricity would likely be the provision of a service through a network, though at the point of actual supply it is probably goods: our analysis is not altered depending on which it is, however. Exercise of this power is constrained (by section 1(1A)) in respect of agreements with private sector parties entered into by an authority under section 1(1) if the likely result of entering into the agreement would be that the "commercial services" income accruing to the authority in any financial year under that agreement and other agreements entered into would exceed the "statutory limit" as may be set by the Scottish Ministers under section 1(D)(b). As no limit has been set, it might be thought that there is no constraint. However, section 1(1H) provides that "if no statutory limit" has been set, the prohibition in section 1(1A) (trading not to exceed the statutory limit) applies, and "the condition of its application set out in" section 1(1A) is ignored. While this wording is somewhat unclear, it is clear enough from Government evidence given in June 2002 to the Lead Committee which considered the Bill which became the Local Government in Scotland Act 2003, and which inserted these provisions into the 1970 Act, that the intention was that the limit would be 0%. However, although the limit therefore appears to be 0%, provision is made in section 1(1I) for the Scottish Ministers to give prior consent to a local authority entering into an agreement which would otherwise be prohibited by section 1(1A).
- 1.33 This constraint does not apply to an agreement entered into by the local authority with (a) another local authority, (b) a public authority or body or (c) a person who, not being a public body, has functions of a public nature or engages in activities of that nature and the purpose or effect of the agreement is to facilitate discharge by that person of those functions or that person's engagement in those activities.
- 1.34 The effect of these provisions is that a local authority is free without constraint to enter into "relevant trading operation" (see paragraph 1.31) agreements with other local authorities, with public bodies or with bodies carrying out functions of a public nature. A local authority is constrained in terms of entering into agreements with private sector bodies in respect of a "relevant trading operation" unless prior consent is given by the Scottish Ministers under section 1(1I) of the 1970 Act. We have considered whether section 170A of the 1973 Act, which authorises the sale of heat by local authorities and, in more limited circumstances, the sale of electricity, could be considered to be stand-alone and not affected by section 1 of the 1970 Act. The concept of sale of heat or electricity does not preclude, or impose any limitation on, doing so so as to raise money. However, we are not convinced that this argument will work. Section 1 of the 1970 Act is broadly drafted with reference to "relevant trading operations" and if the sale of heat and/or electricity by a local authority is, as we believe, likely to constitute a relevant trading operation (see paragraph 1.31) then the section 1(1A) prohibition will apply notwithstanding the terms of section 170A of the 1973 Act.
- 1.35 Separately, in terms of section 1(1M), before entering into any section 1(1) agreement, a local authority must have regard to whether doing so will be likely to promote or improve the well-being of (a) their area and persons within that area; and (b) either of those: "well-being" is to be construed in the same way as it is construed for the purposes of section 20 of the Local Government in Scotland Act 2003. This applies to all agreements for the provision of goods and services, whether with the public or the private sector.

- 1.36 The provisions of the 1970 Act apply to a local authority directly itself entering into agreements for the provision of goods or services. An energy scheme may be structured in such a way that it is run through a ALEO established by the local authority or run through some other entity in which the local authority has a degree of participation (whether at member or director level or both).
- 1.37 While such entities (for example, if they are established under the Companies Act 2006) will have more or less unconstrained powers, a local authority either owning or participating in such a vehicle will require to remain mindful of the 1970 Act insofar as "commercial services" income flows to the authority from any such entity for the provision of services by it to a private sector entity. This follows from section 1(1D) of the 1970 Act which defines "commercial services" income as not only including income derived from agreements directly entered into by the local authority but also income from "relevant dividends" or "relevant profit sharing agreements" which are in turn defined in section 1(1E) as being dividends paid by a body corporate and profits remitted by a body corporate to the authority. The effect of this is that a local authority may not receive "commercial services" income via such dividends or profits where they are derived from the provision of services by the body corporate to a private sector entity unless prior consent has been given by the Scottish Ministers under section 1(1I) (see paragraphs 1.32 and 1.34).
- 1.38 It may not necessarily be the case that dividends are paid or profits remitted to a local authority from a body corporate or ALEO which is established to operate an energy scheme. There are many ways in which such entities can be structured. These may include provision that any profit must be retained within the entity and used to further its purposes or that profits should not be made in the first place, but instead the operations carried on with a view to breaking even taking one year with another. In these cases, there will not be an issue under section 1(1A) of the 1970 Act even where the body corporate or ALEO has contracted with private sector bodies.
- 1.39 On the "best value" duty, see paragraph 1.26 for a general description of the duty. In terms of making supplies of heat and electricity to third parties, a local authority will need to satisfy the tests set out in paragraph 1.26. If the authority has excess capacity whether of heat or electricity, it would seem intrinsically desirable that the capacity is not wasted. To sell that excess capacity to other heat or electricity users would seem to satisfy the requirement to secure best value.
- 1.40 Other than the constraints set out above, local authorities are not constrained as to the terms on which they may contract whether with other public bodies or with the private sector. They are therefore generally free to contract, but, like any other public body, must carefully consider the reasons for doing so and the benefits or otherwise that may accrue from doing so.
- 1.41 There is a further issue which is worth mentioning at this stage which has general application to heat or electricity schemes, and is not therefore applicable only to local authorities. Particularly in relation to a heat scheme, there may be a desire to "oversize" the energy centre, and possibly also to install additional pipe network, or pipe network of an increased diameter, in order to future-proof the scheme, that is, to allow further connections to be made without the need to incur greater subsequent cost in constructing and commissioning a new energy centre or pipe network.

- 1.42 Whether to oversize or not does not, for any Scottish public body, require searching for an additional power. If there is power to generate or procure heat and electricity, then there is a power to oversize and, similarly, where there is power to supply heat or electricity to third parties, there is also power to oversize. Instead, any decision to oversize plant or a network needs to be considered in terms of achieving best value (or value for money) and affordability. There is also a related issue of risk.
- 1.43 In our view, if a public body considers that it is reasonably likely that further connections will be made in the future, then oversizing can satisfy the requirements of best value (or of value for money), taking a longer term view.
- 1.44 Affordability is an obvious point. If the cost of oversizing cannot be afforded, it may of course still make sense to proceed with the original scheme. It is worth considering, however, in relation to any scheme, how many public bodies may be involved as stakeholders on the basis that if more than one will benefit from the scheme (now or in the future) and is able to make a financial contribution to the additional cost, then the affordability issue may be overcome.
- 1.45 Finally, risk should also be considered, although this is a wider consideration in all schemes, and not just relevant to oversizing. It is one thing for a local authority to oversize a scheme which it envisages will make further supplies to its own estate in the future. It is perhaps another thing to oversize a scheme where it is intended that supplies will be made both to the authority and to other public bodies and possibly also private sector customers. In these circumstances, it may be sensible in terms of sharing risk for all the public bodies involved in the project to come together and participate in a special purpose vehicle (assuming that they have power to do so) rather than to have a single public body being responsible for the supply to all of the offtakers.

2 Universities

Background

- 2.1 The 15 Scottish Universities can be divided into three categories: the "ancient" Universities, the Royal Charter Universities and the post-1992 Universities.
- 2.2 The ancient Universities (St Andrews, Glasgow, Aberdeen and Edinburgh) are regulated by the Universities (Scotland) Acts 1858, 1889, 1922, 1932 and 1966. In the case of these Universities, the governing body is the University Court, which is constituted as a body corporate. The Court may make Ordinances which, once they have gone through the relevant internal approval process, must also be approved by the Privy Council. Ordinances may be used, for example, to amend the powers of the governing body.
- 2.3 A number of Universities are incorporated by Royal Charter. The relevant Charter will provide for the University's powers and any constraints on the exercise of those powers. Universities in this category are Dundee, Strathclyde, Heriot-Watt and Stirling.
- 2.4 There are seven post-1992 Universities. The provisions relevant to them are contained in the Further and Higher Education (Scotland) Act 1992 (the "1992 Act") and the Further and Higher Education (Scotland) Act 2005 (the "2005 Act"). These Universities take various forms: some are bodies corporate, some are companies, but almost all are regulated by Privy Council Orders under section 45 of the 1992 Act, together in many cases, with the relevant articles of association. As with the Universities (Scotland) Acts and Royal Charters, these Orders (and related articles of association) will make provision with regard to the governing body of the University, and prescribe its powers and functions and any constraints on the exercise of those powers.
- 2.5 There are also three other higher education institutions in Scotland which are not Universities. These are SRUC, The Glasgow School of Art and The Royal Conservatoire of Scotland. These are all companies limited by guarantee and their powers and those of their governing bodies will be derived from the relevant articles of association. Finally, it should also be noted that the Open University (which is a University) operates in Scotland. Its powers derive from its Royal Charter, but it is not a Scottish public body.
- 2.6 Notwithstanding the different structures, there is a reasonable degree of commonality in the approach which is taken in terms of powers. Executive authority will vest in a governing body, which is usually called the "Court" or the "Board of Governors" (in some cases it may be a body corporate and in other cases not). This body will be responsible for the executive management of the University, its finances and investments, and management of its estate and buildings. There will also be a "Senate" or "Academic Council" which has responsibility for all academic matters.

Power to generate or procure heat and electricity supplies

- 2.7 For any specific University, the powers of the governing body should be considered so as to determine whether that University has the power to generate or procure heat and electricity and if

so, by what means. In any given case, this will require reference to the Universities (Scotland) Acts/any relevant Ordinances, the relevant Royal Charter or the relevant Privy Council Order/articles of association.

- 2.8 Given that all Universities own and manage premises, there can be little doubt that they have the power to procure or generate heat and electricity to supply those premises, whether by conventional means or otherwise.
- 2.9 In that context, the governing bodies of Universities generally have powers to make contracts or arrangements on behalf of the University, to enter into loans and mortgage agreements and to borrow money, and to acquire, hold or dispose of property, legal entities or businesses. These powers will generally also permit the establishment of subsidiaries or joint ventures. In any given case, however, the detail should be checked.

Constraints on the generation or procurement of heat and electricity supplies

- 2.10 The relevant constitutive provisions may specify limitations on the powers of the governing bodies of Universities. The governing bodies will therefore be legally obliged to adhere to any such limitations. It is however very unlikely that there would be any constraints preventing the generation of heat or electricity.
- 2.11 Where the University is a company as is the case, for example, with the University of the Highlands and Islands, the articles of association will contain provisions relevant to the University's powers. It is, of course, possible to amend the Articles if necessary, though the consent of the Office of the Scottish Charity Regulator ("OSCR") will be required to any amendments, given that the Universities are all charities.
- 2.12 The majority of funding received by the Universities (this is a generalisation: some Universities derive significant funding from other sources) is provided by the Scottish Further and Higher Education Funding Council ("SFC"). The SFC was established under the 2005 Act.
- 2.13 Section 9 of the 2005 Act gives the Scottish Ministers the power to make grants to the SFC. It also gives the Scottish Ministers the power to attach such terms and conditions as the Scottish Ministers consider it appropriate to impose on those grants.
- 2.14 Section 12 of the 2005 Act provides that the SFC may make grants, loans and other payments to "fundable bodies". "Fundable bodies" are those set out in Schedule 2 of the 2005 Act (and the Scottish Ministers can, by order, add or remove any entry relating to a body, or vary any such entry but only if the SFC has proposed, or has approved, the making of the modification).
- 2.15 The Universities, which are all fundable bodies, operate under a Financial Memorandum with the SFC. Among other things, Universities are expected to develop and maintain an estates strategy. This will address operation, maintenance and, as necessary, upgrade of the University estate in order to ensure that the University continues to be able to provide suitable education. The SFC has a duty under section 3 of the 2005 Act to ensure a high quality of further and higher education.

Accordingly, if Universities wish to generate or procure heat and electricity (other than via the conventional means of using existing suppliers and networks), they should include those proposals in their estates strategy. If SFC funding is needed to implement such proposals, they will need to satisfy the SFC that generating or procuring heat and electricity (other than via conventional means) is consistent with the objects of the University and that SFC funding will assist in ensuring high quality higher education.

- 2.16 In seeking to satisfy the SFC that the generation or procurement of heat and electricity is consistent with the SFC's duty to ensure high quality further and higher education, it is worth noting that in the exercise of its functions, the SFC is obliged to have regard to the desirability of achieving sustainable development and to encourage fundable bodies to contribute to this aim (sections 20(2)(a) and (b) of the 2005 Act).

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

- 2.17 The relevant constitutive provisions will need to be consulted to determine if a University has the power to supply heat and electricity to third parties.
- 2.18 We consider that the majority of these provisions will give the governing body of the University broad powers to carry out its functions. For instance, The Glasgow Caledonian University Order of Council 2010 (the University's Privy Council Order) provides that the University Court (Glasgow Caledonian University's governing body) has all the rights, powers and privileges necessary or expedient to conduct the University, to carry out or promote its objects (which are to advance learning and knowledge through teaching and research and to enable students to obtain the advantages of higher education) and to ensure its well-being.
- 2.19 In that context, the University Court has the following express powers:
- 2.19.1 To form relationships, associations or affiliations with other educational institutions, and such other public and private bodies;
 - 2.19.2 To initiate, establish, maintain, acquire or dispose of any companies, or any other legal entities, whether charitable or commercial, alone or in association with any other persons or entities;
 - 2.19.3 To undertake, acquire or dispose of any trade or business whatsoever;
 - 2.19.4 To enter into contracts;
 - 2.19.5 To acquire, hold and dispose of any undertakings, rights, assets or liabilities; and
 - 2.19.6 To invest University monies and assets as it considers appropriate.
- 2.20 Taking all of those powers into account, our view is that the University Court of Glasgow Caledonian University has the power to supply heat and electricity to third parties whether public or private. In particular, the University Court has the power to undertake any trade or business whatsoever. In

our view supplying heat and electricity would be a trade which, it could be argued, ensures the well-being of the University because it generates funds which could be used by the University in furtherance of its charitable objects.

- 2.21 Looking at the ancient Universities, section 6(1) of the Universities (Scotland) Act 1858 confers power on the University Court to:

"administer and manage the whole revenue and property of the University, and the college or colleges thereof existing at the passing of this Act, and also including funds mortified for bursaries and other purposes, and to appoint factors or collectors, to grant leases, to draw rents, and generally to have all the powers necessary for the management and administration of the said revenue and property."

We consider that this provision not only allows an ancient University to procure or generate heat and electricity for its own premises, but also allows it to supply third parties, in that such supplies can be seen to be part of the management and administration of the revenue and property of the University.

Constraints on the Supply of Heat and Electricity to Third Parties (Public and/or Private Sector)

- 2.22 Universities are registered charities and as such are subject to the charity law test, as set out in the Charities and Trustee Investment (Scotland) Act 2005 (specifically sections 7 and 8). This means that a University is legally obliged to act in a way which (a) is consistent with its charitable purposes; and (b) provides public benefit in Scotland and elsewhere. That requires the weighing up of the public benefit provided with any public disbenefit provided. OSCR regulates Scottish charities and will investigate those charities which it suspects may not meet the charity test.
- 2.23 The charitable purpose of a University will be the advancement of education. Supplies of heat or electricity to third parties may not be regarded as charitable. However, it could be argued that the supply of heat or electricity by a University to another University or to an FE college or other educational institution is within the scope of the University's charitable purposes as it can be seen to be related to the advancement of education. On the other hand, a supply of heat or electricity to a private sector third party will very likely not satisfy that requirement. It could also be argued that the provision of heat or electricity (provided that it is low carbon or renewable) falls within the charitable purpose of the advancement of environmental protection or improvement. However, even if heat or electricity generated from a particular source were to be regarded as satisfying that charitable purpose, a University would be unlikely to wish to extend its charitable purposes beyond those of the advancement of education. The key concern is that carrying on an activity which is not charitable for the purposes of the Charities and Trustee Investment (Scotland) Act 2005 risks investigation by OSCR which ultimately can put charitable status at risk.
- 2.24 Given the issues raised in the previous paragraph, the University may consider it prudent to establish a non-charitable trading subsidiary to make such third party supplies. The power to do that will likely be contained in the relevant constitutive provisions, though this will need to be checked.

- 2.25 As mentioned in paragraphs 2.15 and 2.16, engagement with SFC will be required in relation to any heat or electricity scheme which involve supplies of heat or electricity to third parties, just as it will be for any scheme which is purely to supply the needs of the University. SFC will want to understand the business case for making such third party supplies and will likely want reassurance that this does not come with significant financial or other risk to the University.

3 Colleges of Further Education

Background

- 3.1 The powers of, and constraints on, the 25 Scottish FE colleges are contained in the Further and Higher Education (Scotland) Act 1992 (“the 1992 Act”), the Further and Higher Education (Scotland) Act 2005 (“the 2005 Act”) and the Post-16 Education (Scotland) Act 2013 (“the 2013 Act”).
- 3.2 Prior to 1 April 1993, each college was part of a Local Authority Education Department and was funded from the funds of that local authority.
- 3.1 Under section 16(1) of the 1992 Act, with effect from 1 April 1993, property, rights, liabilities and obligations were transferred from the Local Authority Education Departments to, and vested in, the board of management of each college. Land and moveable property owned by the local authority before 1 April 1993 also transferred to, and vested in, the board of management.

Power to generate or procure heat and electricity supplies

- 3.2 Under section 11 of the 1992 Act most FE colleges were established as incorporated boards of management.
- 3.3 Boards of management are responsible for the “managing and conducting of their college” (section 12(1) of the 1992 Act).
- 3.4 That power includes the power to:
- “provide facilities of any description appearing to the board to be necessary or expedient for the purpose of or in connection with the carrying on of any of the activities mentioned in this subsection or in subsection (1) above (including boarding accommodation and recreational facilities for students and staff and facilities to meet the needs of students who have learning difficulties and disabled staff).” (section 12(2)(e) of the 1992 Act).
- 3.5 As a board of management can provide facilities (including accommodation and recreational facilities for students and staff), we consider that boards of management can, in carrying out their function of managing the FE college, generate or procure heat and electricity for those facilities.
- 3.6 That this is so is also clear because boards of management have the power to “do all such other things as are calculated to facilitate or are incidental or conducive to the carrying on of any of the activities which the board have power to carry on” (section 12(2)(m) of the 1992 Act).
- 3.7 Boards of management could procure or generate heat or electricity themselves, or they could form or promote, or join with any other person in forming or promoting, a company under the Companies Act 2006 (as they have power to do under section 12(2)(i) of the 1992 Act). This means they could connect into existing heat or electricity networks or could build district heating schemes for an entire campus.

- 3.8 Boards of management can, subject to sections 12(7)(a) and 18 of the 1992 Act, borrow such sums as the board think fit for the purpose of carrying on any of the activities they have power to carry on (section 12(2)(j) of the 1992 Act).
- 3.9 Section 12(7)(a) of the 1992 Act provides that a board will not, without the prior consent, given in writing, of the Scottish Ministers borrow money from any source, give any guarantee or indemnity or create any trust or security over or in respect of any of their property. Section 18 of the 1992 Act provides that the board of management will not, without the prior consent, given in writing, of the Scottish Ministers, dispose of certain property. We understand that the Scottish Ministers' consent functions are in fact discharged by the Scottish Further and Higher Education Funding Council ("SFC") by virtue of the Financial Memorandum between the SFC and the Scottish Ministers.
- 3.10 Subject also to sections 12(7)(a) and 18 of the 1992 Act, boards of management can raise funds, accept gifts of money, land or other property and apply these for, or hold or administer them in trust for the purpose of carrying on any of the activities which they have power to carry on (section 12(2)(l) of the 1992 Act).
- 3.11 They also have the power to acquire, hold and dispose of land and other property, again subject to sections 12(7)(a) and 18 of the 1992 Act (section 12(2)(g) of the 1992 Act).

Constraints on the generation or procurement of heat and electricity supplies

- 3.12 Section 12(7)(a) of the 1992 Act as outlined at paragraph 3.9 sets out constraints on (a) borrowing money from any source; (b) giving any guarantee or indemnity; or (c) creating any trust or security over or in respect of property. The prior written consent of the Scottish Ministers (discharged via the SFC) is required to take those steps, some or all of which may be required for generating or procuring heat supplies.
- 3.13 In addition the SFC provides the majority of funding to FE colleges. The SFC was established under the 2005 Act to replace separate funding bodies for FE colleges and for universities.
- 3.14 Section 9 of the 2005 Act gives Scottish Ministers the power to make grants to the SFC. It also gives the Scottish Ministers the power to attach such terms and conditions as the Scottish Ministers consider it appropriate to impose on those grants.
- 3.15 Section 12 of the 2005 provides that the SFC may make grants, loans and other payments to "fundable bodies". "Fundable bodies" are those set out in Schedule 2 of the 2005 Act (and the Scottish Ministers can, by order, add or remove any entry relating to a body, or vary any such entry but only if the SFC has proposed, or has approved, the making of the modification).
- 3.16 FE colleges which are fundable bodies operate under a Financial Memorandum with the SFC. Among other things, FE colleges are expected to develop and maintain an estates strategy. This will address operation, maintenance and, as necessary, upgrade of the college estate in order to ensure that the college continues to be able to provide suitable education. The SFC has a duty under section 3 of the 2005 Act to ensure a high quality of further and higher education. Accordingly, if

colleges wish to generate or procure heat and electricity (other than via the conventional means of using existing suppliers and networks), they should include those proposals in their estates strategy. They will need to satisfy the SFC that generating or procuring heat and electricity (other than via conventional means) is consistent with properly managing and conducting the college and that SFC funding for it will assist in ensuring high quality further education.

- 3.17 In attempting to satisfy the SFC that the generation or procurement of heat and electricity is consistent with the SFC's duty to ensure high quality further and higher education, it is worth noting that in the exercise of its functions, the SFC is obliged to have regard to the desirability of achieving sustainable development and to encourage fundable bodies to contribute to this aim (sections 20(2)(a) and (b) of the 2005 Act).
- 3.18 The 2013 Act will impact the way in which funding is provided by the SFC to colleges which are fundable bodies. Under the 2013 Act (not all of which is in force yet), in "single-college regions" there will be college boards that deal directly with the SFC, applying for and receiving funding as at present.
- 3.19 In multi-college regions, individual colleges will retain their own boards. However, regional strategic bodies will be created to negotiate with the SFC on funding. It will then be for the regional strategic bodies to allocate funding to the individual (referred to as "assigned") colleges in their area, while also agreeing their contributions to regional outcomes. The practical impact of this is that a college will have to make a business case for the generation or procurement of heat and electricity to the relevant regional strategic body. The regional strategic body will then approach the SFC to discuss funding, and any funding provided by the SFC will go to the regional strategic body to be distributed to the colleges in their region.
- 3.20 The diagram at Annex 1 has been produced by the Scottish Parliament to show how the funding of the colleges will work when the relevant provisions of the 2013 Act (sections 5–10) come into force, which is expected to be during 2014.

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

- 3.21 Boards of management of colleges have the power to "supply goods and services" (section 12(2)(f) of the 1992 Act). This means they can, in principle, supply heat and electricity to third parties in the public and/or private sector.

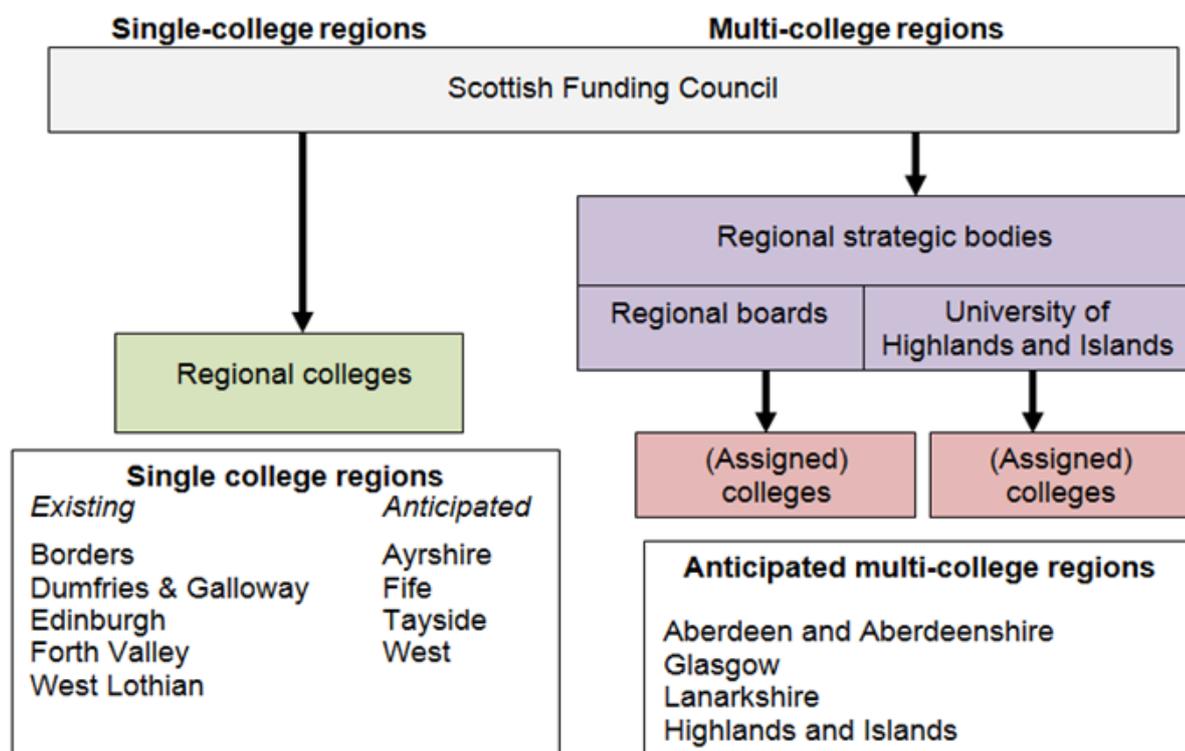
Constraints on the Supply of Heat and Electricity to Third Parties (Public and/or Private Sector)

- 3.22 As noted at paragraph 3.9, boards of management require the prior written consent of the Scottish Ministers (discharged via the SFC) to give any guarantee or indemnity. Accordingly, boards of management should be mindful, when entering contracts for the supply of heat and electricity to third parties, that any guarantee or indemnity given in those contracts will require the consent of the SFC.

- 3.23 FE colleges are registered charities, although the legal requirement that charities must not be subject to Ministerial direction does not apply. The Charity Test (Specified Bodies) Scotland Order 2008 disapplied section 7(4)(b) of the Charities and Trustee Investment (Scotland) Act 2005 in relation to Scottish colleges listed in Schedule 1 of the Order. Section 7(4)(b) of that Act provides that a body does not meet the charity test if its constitution expressly permits the Scottish Ministers or a Minister of the Crown to direct or otherwise control its activities. This means that FE colleges do not fail to meet the charity test by reason of the Scottish Ministers having the power (as they do) to issue directions to them. FE colleges are obliged to comply with directions issued by the Scottish Ministers (Schedule 5, paragraph 4 of the 1992 Act).
- 3.24 However, FE colleges remain otherwise subject to the charity law test. That test requires the weighing up of the public benefit provided with any public disbenefit provided. The Office of the Scottish Charity Regulator ("OSCR") regulates Scottish charities and will investigate those charities which it suspects may not meet the charity test as set out in the Charities and Trustee Investment (Scotland) Act 2005 (specifically sections 7 and 8). This means that an FE college is legally obliged to act in a way which is (a) consistent with its charitable purposes; and (b) provides public benefit in Scotland and elsewhere.
- 3.25 The charitable purpose of an FE college will be the advancement of education. Supplies of heat or electricity to third parties may not be regarded as charitable. However, it could be argued that the supply of heat or electricity by an FE college to another FE college or to a University or other educational institution is within the scope of the FE college's charitable purposes as it can be seen to be related to the advancement of education. On the other hand, a supply of heat or electricity to a private sector third party will very likely not satisfy that requirement. It could also be argued that the provision of heat or electricity (provided that it is low carbon or renewable) falls within the charitable purpose of the advancement of environmental protection or improvement. However, even if heat or electricity generated from a particular source were to be regarded as satisfying that charitable purpose, an FE college would be unlikely to wish to extend its charitable purposes beyond those of the advancement of education. The key concern is that carrying on an activity which is not charitable for the purposes of the Charities and Trustee Investment (Scotland) Act 2005 risks investigation by OSCR which ultimately can put charitable status at risk.
- 3.26 Given the issues raised in the previous paragraph, the board of management may consider it prudent to establish a non-charitable trading subsidiary to make such third party supplies. The power to do that comes from the power of boards of management to form companies (section 12(2)(i) of the 1992 Act) and the power to "do all such other things as are calculated to facilitate or are incidental or conducive to the carrying on of any of the activities which the board have power to carry on" (section 12(2)(m) of the 1992 Act).
- 3.27 As mentioned in paragraphs 3.16 and 3.17, engagement with SFC will be required in relation to any heat or electricity scheme which involve supplies of heat or electricity to third parties, just as it will be for any scheme which is purely to supply the needs of the FE college. SFC will want to understand

the business case for making such third party supplies and will likely want reassurance that this does not come with significant financial or other risk to the FE college.

Annex 1



4 NHS Boards

- 4.1 The powers of, and constraints on, NHS Boards are set out in the National Health Service (Scotland) Act 1978 (“the 1978 Act”).
- 4.2 Health Boards are bodies corporate (Schedule 1, paragraph 1 of the 1978 Act) which exercise functions on behalf of the Scottish Ministers (section 2(1)(a) of the 1978 Act).

Power to generate or procure heat and electricity supplies

- 4.3 Scotland’s health service (NHS Scotland) is made up of regional NHS Boards which are responsible for the protection and the improvement of their population’s health and for the delivery of frontline healthcare services. There are also a number of Special NHS Boards (and one public health body) who support the regional NHS Boards by providing a range of specialist and national services.
- 4.4 Section 2A(1) of the 1978 Act sets out that it is the duty of every Health Board and Special Health Board to “promote the improvement of the physical and mental health of the people of Scotland.”
- 4.5 A Health Board or Special Health Board “may do anything which they consider is likely to assist in discharging that duty including, in particular (a) giving financial assistance to any person, (b) entering into arrangements or agreements with any person, (c) co-operating with, or facilitating or co-ordinating the activities of any person (section 2A(2) of the 1978 Act).
- 4.6 In that respect, our view is that an NHS Board has the power to generate or procure heat and electricity, whether themselves or via another source. This is because heating and providing electricity in the property which vests in it is consistent with the duty to promote the improvement of the physical and mental health of the people of Scotland.
- 4.7 It is clear from section 2A(2) of the 1978 Act that NHS Boards have power to enter into arrangements or agreements (and therefore contracts) with any person in order to procure heat and electricity. Although this is not so clear, we believe this can also include participating in a special purpose vehicle established to provide supplies of heat and electricity. It is less clear whether NHS Boards themselves have the power to establish companies. It could be argued that establishing a company to provide heat and electricity to NHS premises falls within the category of anything considered “likely to assist in discharging” the principal duty under section 2A(1) of the 1978 Act.
- 4.8 The Scottish Ministers could enter into joint ventures or form companies to generate or procure heat and electricity for NHS Boards. The Scottish Ministers can also provide loans and guarantees in this respect. Section 84B of the 1978 Act provides that:

“(1) The Scottish Ministers may do any (or all) of the following (a) form or participate in forming companies to provide facilities or services for persons or groups of persons exercising functions, or otherwise providing services, under this Act; (b) participate in companies providing facilities or services for persons or groups of persons falling within paragraph (a); (c) with a view to securing or facilitating the provision by companies of

facilities or services for persons or groups of persons falling within paragraph (a)– (i) invest in the companies (whether by acquiring assets, securities or rights or otherwise); (ii) provide loans and guarantees and make other kinds of financial provision to or in respect of them.”

- 4.9 Health Boards are permitted to undertake to secure the provision of services jointly with other Health Boards and Special Health Boards (section 12J of the 1978 Act). Accordingly, it would be possible for Health Boards and/Special Health Boards to procure heat and electricity jointly.

Constraints on the generation or procurement of heat and electricity supplies

- 4.10 Section 2A(4) of the 1978 Act provides that anything done by a Health Board or Special Health Board in pursuance of sections 2A(1) and (2) of the 1978 Act is to be regarded as done in exercise of functions of the Scottish Ministers (as conferred on the Health Board or the Special Health Board).
- 4.11 The Scottish Ministers are responsible for providing funding to the Health Boards (section 85AA of the 1978 Act). There is a limit on the amount of funding provided to Health Boards by the Scottish Ministers each financial year – each Health Board will receive only the amount allotted to it for a financial year by the Scottish Ministers towards the performance by the Board of its functions (but not including certain expenses and certain remuneration).
- 4.12 Health Boards do have limited money raising powers (aside from the funding provided by the Scottish Ministers), but these only cover raising money by public appeals, competitions, entertainments, bazaars, sales of produce and the like, and are also subject to direction by the Scottish Ministers (section 84A of the 1978 Act).
- 4.13 Health Boards are required to submit to the Scottish Ministers a scheme for the exercise of their functions. The Scottish Ministers can approve any such scheme (with or without modifications), or can make such a scheme in the event of a Health Board failing to do so (section 2(6) of the 1978 Act). If a Health Board wished to generate or procure heat and electricity (other than by conventional means) it may need to submit details of that proposal in its scheme to the Scottish Ministers and the Scottish Ministers would have to approve that scheme before any steps could be taken.

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

- 4.14 Having considered the powers of Health Boards and Special Health Boards, we do not consider that supplying heat and electricity to any third party would generally be consistent with the function of promoting the improvement of the physical and mental health of the people of Scotland.
- 4.15 There may, however, be situations where the supply of heat and electricity to third parties would be consistent with that function. For instance, it could be argued that Health Boards have the power to supply heat and electricity to premises owned by third parties, in which the physical and mental health of the people of Scotland is cared for. This could include social housing, possibly generally and probably particularly where the housing caters for special needs such as those arising from illness or disability.

- 4.16 In this respect, Health Boards, local authorities and education authorities are obliged to co-operate with one another in order to secure and advance the health of people in Scotland (section 13 of the 1978 Act). In practice, therefore, Health Boards, local authorities and education authorities could consult on the possibility of supplying heat and electricity jointly to certain third parties involved in securing and advancing health.
- 4.17 Further, the 1978 Act, as amended by the National Health Service Reform (Scotland) Act 2004, makes provision for Community health partnerships to be established by Health Boards, as committees of those Health Boards, with the function of co-ordinating, planning, developing and providing the services which it is the function of the Health Board to provide (sections 4A and 4B of the 1978 Act). Health Boards are required to submit a scheme for the establishment of Community health partnerships, and are obliged to encourage the involvement of the local authority in the relevant area and any other person the Health Board thinks fit in preparing the scheme. We think a supply of heat and electricity could competently be set up via a Community health partnership.
- 4.18 The legislation on Community health partnerships is to be repealed and replaced by the provisions of the Public Bodies (Joint Working) (Scotland) Act 2014. This Act will require NHS Boards and local authorities to integrate their health and social care services. Under section 1, integration schemes are to be prepared and specified functions, whether of the relevant local authority or of the NHS Board, delegated either from one body to the other or to both bodies or to a body corporate to be known as an "integration joint board". Just as with Community health partnerships, we consider that a supply of heat and electricity could competently be set up via any integration joint board which may be established. Under section 12 of the 2014 Act, the Scottish Ministers may make provision by order about general powers of integration joint boards (including powers to contract, acquire or dispose of property, to borrow money or to incur liabilities). It is anticipated that the 2014 Act provisions will come fully into force by 1 April 2016.
- 4.19 There is one other scenario where heat and electricity might be supplied to third parties and which we think would be within the power of NHS Boards. It is possible that they may have excess heat or electricity available from their premises, whether on a constant basis or at particular times. We consider that the sale or disposal of that excess heat or electricity to third parties is permitted. The result otherwise would be an absurdity in that resources would be going to waste and no revenue would be being derived from the excess capacity.

Constraints on the Supply of Heat and Electricity to Third Parties (Public and/or Private Sector)

- 4.20 Any supply of heat and electricity by a NHS Board to third parties would only be within its power where it was consistent with the function of promoting the improvement of the physical and mental health of the people of Scotland. It would generally not be within an NHS Board's powers to supply heat and electricity to premises unrelated to the physical and mental health of the people of Scotland.

5 Central Government and its Agencies (and the Scottish Court Service)

- 5.1 In this section of the Guidance, we set out the powers of (a) central government, operating through the Scottish Ministers; (b) the Executive agencies of central government (including the Scottish Prison Service); and (c) the Scottish Court Service (which is an incorporated office, separate from central government).

Scottish Ministers

Power to generate or procure heat and electricity supplies

- 5.2 Scottish Ministers have powers set out in statute, such as the powers to make legislation within the legislative competence of the Scottish Parliament as set out in the Scotland Act 1998 (“the 1998 Act”). Scottish Ministers also have prerogative and common law powers. For instance, they can enter into a contract (this is a prerogative power).
- 5.3 In terms of the Scotland Act 1998, the Scottish Parliament has full legislative competence except in relation to reserved matters as set out in Schedule 5 to the Act. The effect of that Schedule in relation to the subject matter of this Guidance is that the generation, transmission, distribution and supply of electricity is not within the legislative competence of the Scottish Parliament, while the regulation of heat is and so also is environmental protection and regulation.
- 5.4 Section 53(1) of the 1998 Act provides that the functions previously exercised by Ministers of the Crown (such as Ministers of the UK Government and the Secretary of State for Scotland) are transferable to be exercised instead by the Scottish Ministers (so far as they are within devolved competence).
- 5.5 Ministers of the Crown (and therefore, by virtue of section 53(1) of the 1998 Act, the Scottish Ministers) enjoy broad powers to do things which are lawful. This includes the power to establish companies, partnerships or joint ventures and generally to enter into contracts.
- 5.6 By virtue of section 59(1) of the 1998 Act the Scottish Ministers can also hold property (in the name of the Scottish Ministers).
- 5.7 Accordingly, the Scottish Ministers have the power to generate or procure heat and electricity by whatever means they consider appropriate.

Constraints on the generation or procurement of heat and electricity supplies

- 5.8 There are no particular constraints on the process of Scottish Ministers in connection with heat or electricity. It should be noted, however, that the borrowing powers of the Scottish Ministers are currently limited. Section 66 of the 1998 Act provides that the Scottish Ministers may borrow from the Secretary of State any sums required by them for the purpose of (a) meeting a temporary excess of sums paid out of the Scottish Consolidated Fund over sums paid into that Fund, or (b) providing a working balance in the Scottish Consolidated Fund.

- 5.9 The Scottish Consolidated Fund is a Fund into which the Secretary of State shall from time to time make payments, out of money provided by the UK Parliament, of such amounts as he may determine. Payment can be made out of the Fund but only if it is required to (a) meet expenditure of the Scottish Administration; or (b) meet expenditure payable out of the Fund under any enactment.
- 5.10 Aside from those limited circumstances, the Scottish Ministers cannot currently borrow money. This could in theory (though in practice this is unlikely to be the case) limit their ability to generate or procure heat and power supplies. However, one example where there would be a limitation is if there was a desire to finance by public borrowing a capital investment programme for generation/transmission assets. It should be noted that the Scotland Act 2012 amends sections 66 and 67 of the Scotland Act 1998 so that, with effect from 1 April 2015, the Scottish Ministers will have the power to borrow for capital expenditure (subject to Treasury approval). There will be an overall cap of £2.2 billion on the principal outstanding at any time by way of such borrowing, and an annual cap on borrowing set at 10% of that year's capital expenditure budget, technically referred to as the Scottish Government's capital Departmental Expenditure Limit.

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

- 5.11 As noted at paragraphs 5.2 and 5.4, the Scottish Ministers enjoy a broad range of powers (by virtue particularly of section 53(1) of the 1998 Act). By virtue of that power, our view is that the Scottish Ministers can supply heat and electricity to any third parties.

Constraints on the Supply of Heat and Electricity to Third Parties (Public and/or Private Sector)

- 5.12 The Scottish Ministers are bound to adhere to the Scottish Ministerial Code. The Code sets out the responsibilities of the Scottish Ministers. We do not think that the supply of heat and electricity to third parties would mean that the Scottish Ministers had failed to comply with the Code.
- 5.13 As noted in paragraph 5.8, the borrowing powers of the Scottish Ministers are currently limited. Aside from borrowing from the Scottish Consolidated Fund in certain circumstances (outlined in paragraph 5.8), the Scottish Ministers cannot borrow money. This could in theory limit their ability to supply heat and power to third parties (both public and private sector). Even with the new borrowing powers referred to in paragraph 5.10, there are still limits.

Executive agencies

- 5.14 Executive agencies are part of Scottish Government and operate in discrete areas on behalf of Scottish Ministers. Examples include the Scottish Prison Service, Transport Scotland, Disclosure Scotland, the Scottish Public Pensions Agency and Education Scotland. Ministers are accountable to the Scottish Parliament for the work of the agencies.
- 5.15 Executive agencies have no powers beyond those of the Ministers responsible for them since they are acting on their behalf. They operate in accordance with a Framework Document as approved from time to time by the Scottish Ministers.

5.16 Accordingly, the powers and constraints set out for the Scottish Ministers above apply to the Executive agencies, but are administratively limited by the relevant Framework Documents.

5.17 By way of example, we set out below the powers and constraints that apply to the Scottish Prison Service.

Power to generate or procure heat and electricity supplies

5.18 The Scottish Prison Service Framework Document states that the aims of the Scottish Prison Service include:

5.18.1 maintaining good order in each prison; and

5.18.2 caring for prisoners with humanity.

5.19 The generation or procurement of heat and electricity by the Scottish Prison Service is required to achieve the aims of the Scottish Prison Service as set out above – maintaining good order in prisons and caring for prisons with humanity means that prisons must be provided with heat and supplied with electricity.

Constraints on the generation or procurement of heat and electricity supplies

5.20 The Scottish Ministers determine public expenditure provision for the Scottish Prison Service. They also set targets for and monitor the performance of the Scottish Prison Service. The Scottish Prison Service is required to submit to the Scottish Ministers a Scottish Prison Service Business Plan for approval. The Scottish Prison Service is also required to comply with any directions made by the Scottish Ministers from time to time.

5.21 If the Scottish Prison Service wished to generate or procure heat and electricity (other than by conventional means), it should include provision for that in its Business Plan and seek the approval of that Plan from the Scottish Ministers.

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

5.22 Given that the Scottish Ministers can supply heat and electricity to third parties, we also consider that the Scottish Prison Service can supply heat and electricity to third parties.

Constraints on the Supply of Heat and Electricity to Third Parties (Public and/or Private Sector)

5.23 As noted at paragraph 5.20, the Scottish Prison Service is required to submit to the Scottish Ministers a Business Plan for approval. If the Scottish Prison Service wished to supply heat and electricity to third parties, it should include provision and justification for that in its Business Plan and seek the approval of that Plan from the Scottish Ministers.

- 5.24 It is not immediately obvious that making supplies of heat or electricity to third parties would fit with the aims of the Scottish Prison Service as set out in its Framework Document.

Scottish Court Service

Power to generate or procure heat and electricity supplies

- 5.25 The functions of the Scottish Court Service (“the SCS”) are provided for in the Judiciary and Courts (Scotland) Act 2008 (“the 2008 Act”).
- 5.26 Section 61(1) of the 2008 Act provides that the “SCS has the function of providing, or ensuring the provision of, the property, services, officers and other staff required for the purposes of (a) the Scottish courts, and (b) the judiciary of those courts.”
- 5.27 Our view is that given the SCS has the function of providing property, it also has the power to generate and procure heat and electricity. This is because the property it provides will require to be heated and will require electricity.

Constraints on the generation or procurement of heat and electricity supplies

- 5.28 It should also be noted that there is no express power for the SCS to borrow money. As set out at paragraph 5.8, that is consistent with the current limitations on the powers of the Scottish Ministers and the Executive agencies. That may limit the power of the SCS to generate or procure heat and electricity supplies (other than by conventional means).
- 5.29 Section 66 of the 2008 Act provides that, every three years, the SCS is required to prepare and submit to the Scottish Ministers for approval, a corporate plan describing how the SCS proposes to carry out its functions during the period. The Scottish Ministers may approve the plan subject to such modifications as may be agreed between them and the SCS.
- 5.30 The SCS must, as soon as possible after the approval of a corporate plan, lay before the Scottish Parliament a copy of the plan as approved, and publish the plan in such manner as it thinks fit. In carrying out its functions in any three year period, the SCS must have regard to the corporate plan for the period.
- 5.31 If SCS wished to generate or supply heat and electricity (other than by conventional means), it should set that out in its corporate plan and seek approval of that plan from the Scottish Ministers.

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

- 5.32 There is no express power on the SCS to supply good and services (like heat and electricity) to third parties.
- 5.33 Schedule 3, paragraph 15 of the 2008 Act provides that the SCS has the following ancillary power:

“The SCS may do anything which it considers necessary or expedient for the purposes of or in connection with its functions.

In particular, the SCS may (a) acquire and dispose of land and other property, (b) enter into contracts, and (c) provide information and advice.”

- 5.34 Taking into account the functions of the SCS set out in section 61(1) of the 2008 Act, we do not consider that the SCS can supply heat and electricity to third parties (other than the Scottish courts and the judiciary of those courts).
- 5.35 Our reasoning for that view is that we cannot see how the supply of heat and electricity to third parties could be considered to be necessary or expedient for the purposes of or in connection with the functions provided for in section 61(1). This differs from the analysis of the Scottish Prison Service because the Scottish Court Service is given a specific set of functions by statute and is not an Executive agency.

6 Registered Social Landlords

Power to generate or procure heat and electricity supplies

- 6.1 Registered social landlords ("RSLs") will, in almost all cases, either be companies established under the Companies Acts or industrial and provident societies established under the Industrial and Provident Societies Act 1965: most fall into the latter category. The majority of RSLs are also charities in terms of the Charities and Trustee Investment (Scotland) Act 2005. RSLs are therefore bodies corporate with the powers specified in their rules (where an industrial and provident society) or in their articles of association (where a company).
- 6.2 A large number of RSLs have adopted model rules as issued by the Scottish Federation of Housing Associations. The model rules (which may be adopted with or without amendment) provide along the following lines in terms of the objects and powers of an RSL:
- (a) the relief of those in need by reason of age, ill-health, disability, financial hardship or other disadvantage through the provision, construction, improvement and management of land and accommodation and the provision of care;
 - (b) to undertake any activity allowed under section 24 of the Housing (Scotland) Act 2010 which is charitable both for the purposes of section 7 of the Charities and Trustee Investment (Scotland) Act 2005 and also in relation to the application of the Taxes Acts;
 - (c) power (though this is not always adopted) to carry on any activity necessary or expedient to achieve the objects;
 - (d) the RSL shall not trade for profit;
 - (e) express power to borrow, but almost always with an appropriate cap on total borrowings, and usually with a provision allowing the RSL to lend money to a subsidiary of the RSL.
- 6.3 Section 24 of the Housing (Scotland) Act 2010 sets out legislative criteria which a social landlord must meet in order to become an RSL. To become an RSL, a social landlord must be registered with the Scottish Housing Regulator, which is an Executive agency of the Scottish Ministers and which was established under the Housing (Scotland) Act 2010. Section 24(1) provides as follows:
- "(1) The "legislative registration criteria" are—
- (a) that a body does not trade for profit,
 - (b) that a body is established for the purpose of, or has among its objects and powers, the provision, construction, improvement or management of—
 - (i) houses to be kept available for letting,
 - (ii) houses for occupation by members of that body, where the rules of that body restrict membership to persons entitled or prospectively entitled (as

- tenants or otherwise) to occupy a house provided or managed by that body, or
- (iii) hostels,
 - (c) that a body carries out, or intends to carry out, those purposes, objects or powers in Scotland, and
 - (d) that any additional purposes or objects of a body must be from among the following—
 - (i) providing land, amenities or services, or providing, constructing, repairing or improving buildings, for its residents (or for its residents and other persons together),
 - (ii) acquiring, or repairing and improving, or creating by the conversion of houses or other property, houses to be disposed of on sale, on lease, on shared ownership terms or on shared equity terms,
 - (iii) constructing houses to be disposed of on shared ownership terms or on shared equity terms,
 - (iv) managing—
 - (A) houses which are held on leases or other lettings (not being houses falling within subsection (1)(b)(i) or (1)(b)(ii)), or
 - (B) blocks of flats (a block of flats meaning a building containing two or more flats which are held on leases or other lettings and which are occupied or intended to be occupied wholly or mainly for residential purposes),
 - (v) providing services of any description for owners or occupiers of houses in—
 - (A) arranging or carrying out works of maintenance, repair or improvement, or encouraging or facilitating the carrying out of such works,
 - (B) arranging property insurance,
 - (vi) encouraging and giving advice on the formation of registered social landlords,
 - (vii) providing services for, and giving advice on the running of—
 - (A) registered social landlords, and
 - (B) other organisations whose activities are not carried on for profit which are concerned with housing or matters connected with housing,
 - (viii) promoting or improving the economic, social or environmental wellbeing of—
 - (A) its residents (or its residents and other persons together), or
 - (B) the area in which the houses or hostels it provides are situated,
 - (ix) giving financial assistance (by way of grant or loan or otherwise) to persons in order to help them to acquire houses on shared equity terms."

6.4 There were similar provisions to section 24 of the Housing (Scotland) Act 2010 in section 58 of the Housing (Scotland) Act 2001.

6.5 It is clear that RSLs have power to generate or procure heat and electricity supplies. Their main object is the relief of those in need through the provision of accommodation. Strictly, an RSL's ability to generate or procure heat or electricity follows from the RSL's powers (see paragraph 6.2(b) and (c) in particular) to further its main object, which is the relief of those in need through the provision

of accommodation. This includes the provision of heat and electricity in and to that accommodation. We think that is the case even where the rules or articles of the RSL do not contain explicit provision that they may carry on any activity which is necessary or expedient for the discharge of their main object.

- 6.6 As to the means by which an RSL may choose to generate or procure heat and electricity supplies, this can be done directly, or through a subsidiary entity, or through participation in a special purpose vehicle. However, in any given case, the rules or articles of association of the RSL will need to be reviewed to ensure that there is power to establish subsidiaries or to participate in special purpose vehicles. In the case of establishing subsidiaries, RSLs which have adopted the model rules of the Scottish Federation of Housing Associations will have, within the borrowing powers section, provision to the effect that the RSL may lend to a subsidiary. This would suggest that there is power to establish subsidiary entities.
- 6.7 If there is any doubt, then it is open to the RSL to amend its rules or articles of association, although on that point, the constraints set out in paragraph 6.11 should be noted.

Constraints on the generation or procurement of heat and electricity supplies

- 6.8 As discussed in paragraph 6.5, RSLs have power to generate or procure heat and electricity supplies. We do not consider there is any barrier to an RSL doing this directly. As to whether it can do so via a subsidiary or participation in a special purpose vehicle, the rules or articles of association of the RSL will require to be considered and, if required, amended to permit this.
- 6.9 In general terms, both industrial and provident societies and Companies Act companies are, as regards third parties dealing with them, free of restriction in terms of their rules or articles of association: in other words, they can competently carry on any business, trade or activity. For this, see section 39 of the Companies Act 2006 and section 7A of the Industrial and Provident Societies Act 1965 (which will be replaced with effect from 1 August 2014 by section 43 of the Co-operative and Community Benefit Societies Act 2014, which consolidates and updates the legislation applicable to co-operative and community benefit societies).
- 6.10 However, in the case of an RSL which has charitable status (as most do) the provisions referred to in paragraph 6.9 do not apply and the RSL is subject to the restrictions or limitations set out in its rules or articles of association.
- 6.11 In addition, any amendment to the rules or articles of association requires (in all cases, whether the RSL is a charity or not) the consent of the Scottish Housing Regulator and (in cases where the RSL is a charity), the consent of the Office of the Scottish Charity Regulator ("OSCR"). The former is provided for by section 93 of the Housing (Scotland) Act 2010 and the latter by section 16 of the Charities and Trustee Investment (Scotland) Act 2005. We would not expect consent to be refused by either regulator for any change to rules or articles of association expressly designed to permit the establishment of a subsidiary or participation in a special purpose vehicle for the purposes of making

available supplies of heat or electricity to tenants of the RSL (or indeed directly to the RSL itself for its own offices etc.).

- 6.12 While RSLs do have borrowing powers, those that have adopted the Scottish Federation of Housing Association's model rules, will have a financial limit on borrowings (these are set by RSLs at varying levels). RSLs do borrow in the open market but, in so borrowing, will need to have regard to the effect of those borrowings on their financial position. Further, the Scottish Housing Regulator assesses and keeps under review the financial situation of RSLs as well as their arrangements for governance and financial management. However, the specific consent of the Scottish Housing Regulator to any particular borrowing is not required.
- 6.13 It should be noted that if an RSL chooses to procure a district heating network through a long-term design, build, operate and maintain contract with a private sector provider, that provider will likely expect a lease of the land on which the energy centre is to be constructed, together with servitudes/wayleaves for the heat pipes running across land to the properties to be served. An RSL proposing to contract in this way must obtain the consent of the Scottish Housing Regulator to the grant of the relevant lease and wayleaves/servitudes.

Power to supply heat and electricity to third parties (public and/or private sector)

- 6.14 In considering the power of an RSL to supply heat and electricity to third parties, there are various possible scenarios. One may involve the provision of heat and electricity to another RSL or to a local authority in that local authority's capacity as a provider of housing. We consider that this can be done by RSLs having regard to section 24 of the Housing (Scotland) Act 2010 and in particular to sections 24(1)(d)(i) or (v) or (viii). The first of these covers provision of services for residents, or for residents and other persons together. The second covers the provision of services for owners or occupiers of houses being, among other things, works of improvement, and the third covers promoting or improving the economic, social or environmental wellbeing of either residents (or residents and other persons together) or the area in which the houses provided by the RSL are situated.
- 6.15 However, these particular provisions will only apply in the case of any given RSL if it has chosen to adopt them in its rules or articles of association. This is because, in terms of section 24(1)(d), these are "additional purposes or objects" rather than required purposes or objects. The rules or articles will therefore require to be reviewed and, if necessary, amended.
- 6.16 A second scenario is the provision of heat and electricity to owner occupiers. Quite often, there will be a number of these within the blocks of housing owned by an RSL, as a result of tenants having exercised the right to buy their homes. We consider that this too is authorised by the same provisions as referred to in paragraph 6.14, but again subject to review of the RSL's rules or articles of association as whether such powers have in fact been adopted.
- 6.17 A third scenario is the supply of heat or electricity to other public sector third parties. The position here is less clear. It could be argued that the provision of heat and electricity, for example to a local

authority leisure facility, is authorised under section 24(1)(d)(viii) – promoting or improving the economic, social or environmental wellbeing of the area which the RSL's houses are situated. The same argument might be made in respect of a supply of heat or electricity to a hospital, college or university in that area.

- 6.18 Additionally, there is an issue around the scope of any such supplies. If an RSL has sized a heat network so as to enable a significant number of third party supplies, there is a question mark around whether that is in fact the carrying on of a trade or business which, given that most RSLs are charities, could risk loss of charitable status. In a scenario like this, we would recommend that the RSL participate in a special purpose vehicle involving those various offtakers as members or other participants rather than itself being the supplier to all offtakers.
- 6.19 A fourth scenario is the provision of heat or electricity to private sector third parties. We do not consider that this is authorised in terms of the additional purposes or objects under section 24 of the Housing (Scotland) Act 2010. It is probably too tangential to suggest that this would fall within section 24(1)(d)(viii): promoting the economic, social or environmental wellbeing of the area in which the RSL's houses are situated.
- 6.20 Equally, for the majority of RSLs which are charities, private sector supplies would likely be regarded as the carrying on of a trade or business and this could put charitable status at risk. They could also risk breaching the legislative registration criterion in section 24(1)(a) of the Housing (Scotland) Act 2010 that the RSL must not "trade for profit". If such supplies were to be made, and to avoid these risks, we consider that the RSL would need to establish a trading subsidiary and make the supplies through that entity.

Constraints on the supply of heat and electricity to third parties (public and/or private sector)

- 6.21 As discussed in paragraphs 6.14 to 6.20, while in certain scenarios an RSL may make supplies of heat and electricity to third parties, its rules or articles of association will need to be reviewed to ascertain whether such supplies are permitted. If they are not, then the rules will need to be amended in which case consent of the Scottish Housing Regulator will be required (for all RSLs) and consent of OSCR required (for RSLs that are also charities).
- 6.22 It is also necessary, for RSLs that are charities, to consider the potential impact on charitable status of making supplies to third parties in any of the scenarios considered in paragraphs 6.14 to 6.20. The fact that a particular activity may fall within section 24(1) of the Housing (Scotland) Act 2010 does not of itself mean that the activity is a charitable one. This is why, for example, the model rules issued by the Scottish Federation of Housing Associations (see paragraph 6.2) make reference to an RSL undertaking any activity allowed under section 24 of the Housing (Scotland) Act 2010 but then qualify this with the additional words "which is charitable both for the purposes of section 7 of the Charities and Trustee Investment (Scotland) Act 2005 and also in relation to the application of the Taxes Acts."

- 6.23 We are in no doubt that the supply of heat and electricity to an RSL's own tenants is part of its charitable activities. We think that the supply of heat or electricity to tenants of another RSL is likely also to be charitable. Where the position is less clear is in respect of supplies to owner occupiers and to other public bodies. As the principal charitable purpose of RSLs that are charitable will be the relief of those in need because of age, ill-health, disability, financial hardship or other disadvantage, the question needs to be asked in respect of supplies to owner occupiers and to other public bodies whether such supplies are, in fact, in furtherance of that charitable purpose. In the case of owner occupiers, that will very much depend upon the levels of income which they enjoy compared, for example, to those who are not owner-occupiers. In the case of the provision of heat and electricity to other public sector third parties, the link to charitable status may be difficult to establish, depending on the type of premises to be supplied.
- 6.24 For RSLs that are charities, there will be an issue with retaining charitable status if a trade or business is carried on. It might be possible, although the rules or articles of association of the RSL would likely require to be amended, to add the further charitable purpose (taken from section 7(2) of the Charities and Trustee Investment (Scotland) Act 2005) of "the advancement of citizenship or community development (rural or urban regeneration)". This could be used to permit the making of supplies to other public sector premises if such supplies can clearly be categorised as falling within that purpose.
- 6.25 These various considerations will need to be looked at by RSLs on a case-by-case basis, but it may well be that the safest course of action will be to implement third party supplies through the establishment of a subsidiary entity, on which see paragraph 6.27.
- 6.26 In relation to supplies to the private sector, we do not consider that these are authorised by section 24 of the Housing (Scotland) Act 2010. As that section contains the requirements which must be satisfied for a social landlord to become a RSL, the rules or articles of association of that RSL should not contain any contrary provision. Private sector supplies are also unlikely to fall within the charitable purposes of an RSL.
- 6.27 In this situation, therefore, the RSL would need to establish a subsidiary entity to make such supplies. If an RSL does propose to establish a subsidiary for this purpose then the subsidiary will neither be a charity nor an RSL. Any plan to establish such a subsidiary must be notified to the Scottish Housing Regulator in terms of its Notifiable Events Guidance of April 2012. The Scottish Housing Regulator will wish to understand the rationale for the establishment of the subsidiary and to be assured that this will not impact or affect the carrying on by the RSL of its principal objects.

7 Scottish Water

- 7.1 The powers of, and constraints on, Scottish Water are contained in the Water Industry (Scotland) Act 2002 (“the 2002 Act”) and the Water Resources (Scotland) Act 2013 (“the 2013 Act”).

Power to generate or procure heat and electricity supplies

- 7.2 Section 70(2) of the 2002 Act provides that the "core functions" of Scottish Water under the 2002 Act are its functions under or by virtue of (a) the Sewerage (Scotland) Act 1968 and the Water (Scotland) Act 1980; and (b) any other enactment (including the 2002 Act) so far as relating to the provision of water or sewerage services in Scotland.
- 7.3 The Sewerage (Scotland) Act 1968 (as amended) states that it is the duty of Scottish Water to provide such public sewers as may be necessary for effectually draining its area of domestic sewerage, surface water and trade effluent. The Sewerage (Scotland) Act 1968 gives Scottish Water the power to construct public sewers in certain circumstances. There are a number of other powers granted to Scottish Water under the Sewerage (Scotland) Act 1968, but we do not consider any of those to be relevant to the power to generate or procure heat and/or electricity.
- 7.4 The Water (Scotland) Act 1980 sets out the duties of Scottish Water to supply water to premises for both domestic and non-domestic purposes. We do not consider any of the powers provided for in that Act to be relevant to the power to generate or procure heat and electricity.
- 7.5 Section 25(1) of the 2002 Act provides that Scottish Water has the power to:
- 7.5.1 “engage in any activity (whether in Scotland or elsewhere) which it considers is not inconsistent with the economic, efficient and effective exercise of its core functions (within the meaning of section 70(2)).”
- 7.6 Section 25(1A) of the 2002 Act provides that the power of Scottish Water in section 25(1) of the 2002 Act extends to allowing Scottish Water to “engage in any activity that it considers will assist in the development of the value of Scotland’s water resources (as construed in accordance with section 1 of the Water Resources (Scotland) Act 2013).”
- 7.7 Section 1(1) of the 2013 Act provides that:
- 7.7.1 “The Scottish Ministers must—
- (a) take such reasonable steps as they consider appropriate for the purpose of ensuring the development of the value of Scotland's water resources,
- (b) do so in ways designed to promote the sustainable use of the resources.”

- 7.8 Section 1(3) of the 2013 Act provides that the value of water resources:
- 7.8.1 “(a) means the value of the resources on any basis (including their monetary or non-monetary worth),
- (b) extends to the economic, social, environmental or other benefit deriving from the use of the resources (or any activities in relation to them).”
- 7.9 Section 1(4) of the 2013 Act provides that “water resources” means wetland, inland water and transitional water as defined by section 3 of the Water Environment and Water Services (Scotland) Act 2003.
- 7.10 Section 25(2) of the 2002 Act provides that:
- 7.10.1 “Scottish Water may do anything (whether in Scotland or elsewhere) which it considers is necessary or expedient for the purpose of or in connection with its functions (including any activity in which it engages by virtue of subsection (1)).”
- 7.11 Taking those various powers into account, we consider that Scottish Water has the power to generate or procure electricity. The powers in section 25(1) and 25(1A) of the 2002 Act mean, for example, that Scottish Water can set up hydro schemes to generate electricity. This is because, in our view, that is something which would assist in the development of Scotland’s water resources, and, in particular, would develop the economic, social or environmental benefit deriving from the use of the resources. Section 25(1), on its own, would also permit electricity to be generated by other means, such as through anaerobic digestion plants, as indeed would section 25(2).
- 7.12 Again, sections 25(1) and 25(2) of the 2002 Act give Scottish Water the power to generate or procure heat. Scottish Water owns premises and accordingly, it is within its power to generate or procure heat to heat those premises.
- 7.13 Section 50 of the 2002 Act provides that Scottish Water must in exercising its functions, seek to ensure that its resources are used economically, efficiently and effectively. Further, in terms of section 50A of the 2002 Act, so far as is not inconsistent with the economic, efficient and effective exercise of its functions, Scottish Water must take reasonable steps to develop the commercial value of its assets, and in terms of Section 51A of the 2002 Act, again so far as not inconsistent with the economic, efficient and effective exercise of its functions, Scottish Water must take reasonable steps to promote the use of its assets for the generation of renewable energy (“assets” in both cases means property, rights and other assets (whether tangible or intangible)).
- 7.14 It is also worth noting that Scottish Water is under a duty to act in a way best calculated to contribute to the achievement of sustainable development, and must have regard to any guidance issued by the Scottish Ministers on that issue (section 51 of the 2002 Act).
- 7.15 Sections 50, 50A, 51 and 51A of the 2002 Act can be viewed as positive encouragement to Scottish Water to, for example, generate or procure heat and electricity, as those steps may: (a) ensure its

resources are used economically, efficiently and effectively; (b) develop the commercial value of its assets; (c) promote the use of its assets for the generation of renewable energy; and (d) contribute to the achievement of sustainable development. Accordingly they reaffirm our view that Scottish Water can generate or procure heat and electricity.

- 7.16 Scottish Water may generate or procure heat and electricity on its own or it may engage with another body to do that. This is because Scottish Water has the power to form or promote (whether alone or with others) companies under the Companies Act 2006 (section 25(3)(a) of the 2002 Act). It also has the power to form partnerships, enter into arrangements or agreements and co-operate in any way with any person (section 25(3)(d) of the 2002 Act).

Constraints on the generation or procurement of heat and electricity supplies

- 7.17 The generation or procurement of heat and electricity must not be inconsistent with the economic, efficient and effective exercise of Scottish Water's core functions (section 25(1) of the 2002 Act).
- 7.18 Scottish Water may do anything (whether in Scotland or elsewhere) but only if it considers that to be necessary or expedient for the purpose of or in connection with its functions (section 25(2) of the 2002 Act).
- 7.19 These provisions mean that Scottish Water, in so far as it invests its money, must be careful to ensure it is not hindered or prevented from carrying out its core functions economically, efficiently or effectively. So, for instance, Scottish Water should not invest in a risky venture which may result in it, for example, losing money so that it has insufficient funds to carry out its core functions.
- 7.20 Scottish Water cannot raise money (whether by borrowing or otherwise) in a manner which is not authorised apart from section 25 of the 2002 Act (section 25(6) of the 2002 Act). Section 25(3) of the 2002 Act provides that Scottish Water may, with the consent of the Scottish Ministers, borrow from them sums of such amounts as they may determine, and with the consent of the Scottish Ministers borrow money, whether in sterling or otherwise, from any person or body whether in the United Kingdom or elsewhere. This means that Scottish Water cannot borrow from any person or body whether in the United Kingdom or elsewhere unless it has the consent of the Scottish Ministers.
- 7.21 Scottish Water is obliged to comply with any directions issued by the Scottish Ministers as to the exercise of Scottish Water's functions and otherwise as to how its affairs are to be managed and conducted (section 56 of the 2002 Act).
- 7.22 Under paragraph 4 of section 1 of the Scottish Water Governance Directions 2009, Scottish Water is required to produce a Business Plan and to update it annually. Under paragraph 5 of section 1, Scottish Water may carry out any activity or incur expenditure where necessary provided that it is consistent with the approved Business Plan or its approved annual update. This applies both to the core functions of Scottish Water and to its non-core functions. As there is further provision in paragraph 5 of section 1 which permits, subject to a financial exposure limit of £0.5m, the carrying on of activities which are not contained in the approved Business Plan, this suggests that activities (such as procuring heat or electricity) should be referenced in the Business Plan in order to be

permitted in administrative terms. Additionally, paragraph 15 (first bullet) of the Schedule to the Scottish Water (Objectives for 1 April 2010 to 31 March 2015) Directions 2009 specifically requires Scottish Water, in support of the requirements of the Climate Change (Scotland) Act 2009, to take steps to mitigate its carbon emissions by seeking opportunities to reduce energy demand, by investing in energy efficiency and by increasing, where it is cost effective to do so, its renewable generation capacity. We understand that the Scottish Water Business Plan does in fact make reference to increasing renewable energy generation and investigating the feasibility of combined heat and power.

Power to Supply Heat and Electricity to Third Parties (Public and/or Private Sector)

- 7.23 We consider that the powers provided for in sections 25(1), 25(1A), 25(2) and 25(3) give Scottish Water the power to supply heat and electricity to third parties, both in the public and private sector.
- 7.24 In particular, section 25(3)(e) of the 2002 Act provides that Scottish Water has the power to “enter into a contract with any person for the provision of or making available of assets or services, or both (whether or not together with goods) whether by Scottish Water or by that person”. “Assets” means “assets of any description (whether tangible or intangible), including (in particular) land, buildings, roads, works, plant, machinery, vehicles, vessels, apparatus, equipment and computer software.” (section 25(5) of the 2002 Act). Accordingly, Scottish Water could enter into a contract to supply heat and power to third parties
- 7.25 As noted in paragraph 7.16, Scottish Water can form or promote (whether alone or with others) companies under the Companies Act 2006, and can form partnerships, enter into arrangements or agreements and co-operate in any way with any person.

Constraints on the Supply of Heat and Electricity to Third Parties (Public and/or Private Sector)

- 7.26 As with generating or procuring heat and electricity, the supply of heat and electricity to third parties must not be inconsistent with the economic, efficient and effective exercise of Scottish Water’s core functions.
- 7.27 Scottish Water may do anything (whether in Scotland or elsewhere) but only if it considers that to be necessary or expedient for the purpose of or in connection with its functions
- 7.28 Scottish Water must, therefore, ensure that in supplying heat and electricity to third parties, it will not be hindered or prevented from carrying out its core functions, economically, efficiently or effectively. Scottish Water should not invest in a risky venture which may result in it, for example, losing money so that it has insufficient funds to carry out its core functions.
- 7.29 As noted in paragraphs 7.21 and 7.22, Scottish Water is obliged to comply with any directions issued by the Scottish Ministers as to the exercise of Scottish Water’s functions and otherwise as to how its affairs are to be managed and conducted (section 56 of the 2002 Act).

8 Public procurement

Introduction

- 8.1 Public procurement law requires, in summary, contracting authorities (in broad terms, public bodies) to advertise their requirements for goods, supplies and works, and to run fair and transparent tender processes prior to contract award.
- 8.2 The energy requirements of a public body are within the scope of public procurement law. In particular, energy from a district heating ("DH") source is within that scope. In procurement law that energy would be categorised as a supply.
- 8.3 For most of their activities, the core of procurement law applying to public bodies in Scotland is contained in the Public Contracts (Scotland) Regulations 2012. However, if a public body is engaged in the provision or operation of a fixed network which provides or will provide a service to the public in connection with the production, transport or distribution of heat, then in relation to those activities the relevant core of procurement law is contained in the Utilities Contracts (Scotland) Regulations 2012. The principles referred to above (to advertise and to run fair and transparent tender processes) apply equally under both regimes. However, as this Guidance is targeted at contracts for the purchase of heat (rather than the contracts supporting operation and provision of the network such as the infrastructure works or the purchase of heat generation equipment) this section of the Guidance concentrates on the public sector regime.
- 8.4 Public procurement law can operate as a constraint on the success of a DH project because, as a general rule, a public body cannot purchase from a preferred supplier for its energy requirements (in this case the operator of the DH scheme) without conducting a compliant procurement process.
- 8.5 Critically, there is no general "public to public" exemption from procurement law, i.e. a public sector purchaser is not free to contract with the operator of the DH scheme, just because that operator is also in the public sector.
- 8.6 Although a public to public exemption does not exist, there are strategies which can be deployed for overcoming this constraint – these are the focus of the remainder of this section of the Guidance. We identify 7 possibilities. In each case we identify whether the strategy is applicable to a purchaser looking to buy heat from a public sector scheme, a private sector scheme, or is applicable to both.
- 8.7 Before moving on, however, it must be noted that there are other public procurement impacts in relation to the delivery of a DH project. For example, if a public body is purchasing heat generation or distribution equipment or works, or the energy inputs for a DH scheme, then these will need to be properly procured. However, this is no different from any of the other purchasing activities of a public body, and so although a constraint, is not a material one. These issues are not dealt with further in this Guidance.

Method 1 – Self-generation

- 8.8 Method 1 is only suitable for public sector schemes involving a single public body.
- 8.9 From a public procurement law perspective a public body is free to meet its requirements from its own resources, or by contracting with third parties.
- 8.10 As such, if a local authority (for example) elected to develop a DH scheme to meet its own needs, there would be no public procurement law constraint.
- 8.11 An example might be to purchase generation and network equipment to provide heat to local authority housing stock, leisure facilities and school accommodation, all of which were in the same neighbourhood. Procurement law is not a constraint on the decision to do that, but of course the equipment, infrastructure and works would need to be properly procured.

Method 2 – Single authority “Teckal”

- 8.12 Method 2 is only suitable for public sector schemes involving a single public body.
- 8.13 Public procurement law recognises an exemption from the normal rules where a public body is purchasing from an arm’s length body it has established, provided certain conditions are met.
- 8.14 The exemption (and the conditions) was established by a case decided by the European Court of Justice referred to as “Teckal” (*Teckal Srl v Commune di Viano*, Case C-107/98, [1999] ECR I-8121), which is the name by which the exemption has become known.
- 8.15 However, the new Procurement Directives (the Public Procurement Directive 2014/24/EU - see Article 12, and the Utilities Directive 2014/25/EU – see Article 28), which are likely to be implemented in Scotland by mid-2015, codify the case, and put the exemption on a legislative footing. There are three tests:
- 8.15.1 The first is that the public body exercises control over the arm’s length body which is similar to that which it exercises over its own departments. In case law that has been expanded on to refer to concepts such as the need for the public body to have a decisive influence over the strategic objectives and significant decisions of the arm’s length body.
- 8.15.2 The second is that there must be no private sector participation in the equity of the arm’s length body.
- 8.15.3 The third is that the activities of the arm’s length body must in the main relate to its relationship with its public body controlling “sponsor”.
- 8.15.3.1 In terms of current case law this is expressed as a requirement that the arm’s length body must carry out the “essential part” of its activities with its sponsor, and that activities with others must be of “marginal significance”.

- 8.15.3.2 This operates as a constraint because it means the degree to which the arm's length body can sell heat to purchasers other than its sponsor (whether those purchasers are public or private sector) is restricted. We have seen thresholds of, say, 90% by value of all sales to the sponsor being used as a rule of thumb.
- 8.15.3.3 In the codification of the rule in the new Directive, the threshold is described as a requirement that 80% of the activities of the arm's length body must be carried out in the performance of the tasks entrusted to it by its sponsor.
- 8.15.3.4 There is discretion as to how that 80% is measured. The new Directive allows a public body to use an average total turnover measure, or an appropriate alternative activity-based measure such as costs incurred.
- 8.15.3.5 In our view when the codification is implemented in domestic law it may open up a new argument which relaxes the constraint. It will be noted that the threshold is not applied to the extent to which the activities of the arm's length body are "with" the sponsor but rather the extent to which the activities are carried out in the performance of the tasks entrusted to the arm's length body.
- 8.15.3.6 In context, if a local authority (for example) established an arm's length body and entrusted it with the task of operating a DH scheme for the benefit of all in the area, there would be an argument that all its heat sales (whether to the local authority or third parties) were carried out in the performance of that task, and the proportion of local authority to third party sales would not matter.
- 8.15.3.7 Prior to implementation in domestic regulation we think a full analysis of this option is premature, but on implementation we consider this to be an avenue which is worth exploring in further detail.
- 8.15.3.8 For the time being we consider that using the text of the new Directive as a way of applying a new interpretation to existing case law would be a high-risk strategy.
- 8.15.3.9 Having said this, if a DH scheme involving an arm's length body is viable with 80 – 90% of its sales being made to its sponsor public body, then the Teckal model is not a constraint on this point. Limited third party sales can be made within a Teckal structure.
- 8.15.3.10 We think the safest measure of the 80-90% range is by turnover.

8.16 If the 80—90% rule on sales was breached, contracts between the arm's length body and its sponsors would cease to benefit from the Teckal exemption and so would be challengeable as direct awards.

8.17 The Teckal model does not prevent the arm's length body from making a margin or return on its sales (whether to its sponsor or from the limited permissible third party sales).

Method 3 – Multiple authority Teckal

8.18 Method 3 is only suitable for public sector schemes, but can involve multiple public bodies.

8.19 Cases decided by the European Court of Justice including *Asemfo (Asociacion Nacional de Empresas Forestales (Asemfo) v Transformacion Agravia SA (Tragsa)*, Case C-295/05, [2007] 2 CMLR 45), and the codification in the new procurement Directive, recognise that the Teckal relationship can exist between an arm's length body and a number of other public bodies in the sponsor position. From the perspective of a local authority (for example), this would allow the establishment of a joint venture arm's length body with other local authorities, or other public bodies such as, for example, NHS Boards or FE colleges or universities.

8.20 Where an arm's length body has multiple sponsors:

8.20.1 the "control" limb of the Teckal test is assessed by looking at the collective control which the sponsors have, and the board of the arm's length body must be composed of representatives from all sponsors;

8.20.2 the control limb will only be satisfied provided that the arm's length body does not pursue any interests which are contrary to those of the sponsors;

8.20.3 there must be no private sector participation in the equity of the arm's length body; and

8.20.4 the "essential part of activities" limb of the Teckal test is assessed by looking at the activities of the arm's length body with the sponsors taken together.

8.21 The Teckal model does not prevent the arm's length body from making a margin or return on its sales (whether to its sponsors or the marginal third party sales).

8.22 This opens up an effective model for public bodies looking to work with other public bodies in the delivery of a DH scheme.

8.23 To take an example, if a local authority has a DH scheme from which an NHS Board wishes to take energy, procurement law will operate as a constraint on the NHS Board's ability to make that purchasing decision.

8.24 However, if the local authority established an arm's length body to operate that DH scheme, and the NHS Board agreed to take a stake in that body and be involved in its governance then both the local

authority and the NHS Board could purchase heat from that arm's length body without procurement law operating as a constraint.

- 8.25 The stakes taken by each participant need not be equal. The "control" limb of the Teckal test is assessed by looking at the collective control which the sponsors have. Providing this collective control is there, and the board of the arm's length body is composed of representatives from all sponsors, the percentage of the shareholding (or equivalent) of each participant is not determinative.
- 8.26 The legal power (vires) of various public bodies to participate in this way is considered elsewhere in this Guidance.
- 8.27 As between local authorities, it would be possible under local government legislation (see sections 62A and B of the Local Government (Scotland) Act 1973) for a joint board to be established by the Scottish Ministers, by Order. A joint board is a legal entity in its own right, and so could be used as an alternative type of arm's length body. We cannot see any advantages to this model (from the procurement law perspective) in comparison to the flexibility offered by other types of body such as companies and partnerships.
- 8.28 A joint committee is another option under local government legislation (see section 57 of the Local Government (Scotland) Act 1973). However, a joint committee is not a legal entity in its own right, and so does not create a structure which can be made to work using the Teckal model.

Method 4 – Joint delivery

- 8.29 Method 4 is only suitable for public sector schemes, involving multiple public bodies.
- 8.30 A further exemption from procurement law, which is similar to Teckal, results from a recent European case concerning shared waste disposal services in and around Hamburg (*Commission v Germany*, Case C-480/06, [2010] 1 CMLR 32). It has therefore become known as the "Hamburg Waste" rule, and allows public bodies to contract with each other without procurement law being engaged, if certain conditions are met.
- 8.31 As stated in the introductory section to this part of the Guidance, it must be noted that there is no general "public to public" exemption from procurement law.
- 8.32 As with Teckal, the Hamburg Waste rule is codified in Article 12 of the new procurement Directive.
- 8.33 Contracts between public bodies benefit from this exemption if:
- 8.33.1 the contract establishes or implements a cooperation between the participating public bodies, with the aim of ensuring that public services they have to perform are provided with a view to achieving objectives they have in common;
 - 8.33.2 the implementation of that cooperation is governed solely by considerations relating to the public interest; and

- 8.33.3 the participating public bodies perform on the open market less than 20% of the activities concerned by the cooperation.
- 8.34 As with the Teckal rules, there is discretion as to how the 20% is measured. The new Directive allows a public body to use an average total turnover measure, or an appropriate alternative activity-based measure such as costs incurred.
- 8.35 The first potential obstacle to the use of this method is that the output of a DH scheme (i.e. the energy) has to be framed as part of each public body's public services.
- 8.35.1 The terminology used is those services the bodies "have to provide" which suggests there should be a legal duty, rather than something done on an optional, discretionary basis.
- 8.35.2 So, for example, a local authority has a duty to provide primary and secondary education, and could not fulfil that duty without providing facilities, and facilities which are heated. So, at one step removed, we think a local authority could argue that providing for a DH network which supplies heat to a school is part of the public services it provides.
- 8.35.3 If it can collaborate with, for example, an NHS Board (which has a duty to provide physical and mental healthcare), then we think it could be argued that there are two public services, and common objectives can be found. That argument stretches the underlying Hamburg argument (which was about front-line waste management services rather than things supporting service delivery) but not, we think, to breaking point.
- 8.36 The tests described above use the language of the new Directive. Having said this, the Hamburg waste case from which the rule is derived adds some additional background to what these tests may involve (and what the test is likely to be prior to implementation). From the case it can be surmised that:
- 8.36.1 the "cooperation" must involve mutual rights and obligations. At this stage it is not clear whether the mutuality is satisfied simply by payment. A greater degree of cooperation in terms of joint delivery would make the procurement and operation of a DH scheme on this legal basis more secure.
- 8.36.2 the "sole public interest" requirement may mean that the arrangement must not involve financial transfers between the participating public bodies, other than the reimbursement of actual costs. The lack of a profit element was clear from the Hamburg waste case, but is not expressly set out in the new Directive. As such, whether that condition is indeed part of the public interest test, or will no longer apply after implementation of the new Directive, remains for now a matter of some doubt.

Method 5 – Specification

- 8.37 Method 5 is suitable for public or private sector schemes.
- 8.38 This method addresses the following question: if a public body has energy demands which could be met from an existing DH scheme, can it go out to tender with a specification that its requirement is DH energy? That would, in most cases, limit the pool of potential providers to one.
- 8.39 The obstacle to this is that procurement law requires a public body to ensure that its specifications “afford equal access to economic operators and do not have the effect of creating unjustified obstacles to the opening up of public procurement to competition”.
- 8.40 That would be the argument a competitor energy supplier would no doubt run, and at present there is no case law of which we are aware which provides strong guidance on how such a dispute would be resolved.
- 8.41 Some guidance can be drawn from a Scottish case in 2011 (*Elekta Ltd v Common Services Agency*, 2011 SLT 815) involving the procurement by the NHS of medical equipment with a specification which limited the pool of suppliers to one. The court noted as follows:
- 8.41.1 First, the contracting authority must be entitled to decide what it wants, what is the subject matter of the procurement which it seeks to obtain, the subject matter of the contract, or to put it another way it must be entitled to decide upon the functional requirements it wishes to satisfy.
- 8.41.2 Secondly, the fact that the criteria included in the tender notice can only be met by one tenderer, or a limited range of tenderers, does not of itself contravene the principle of equality.
- 8.41.3 Thirdly, that the inclusion of these criteria can only be considered discriminatory if they cannot be justified objectively having regard to the characteristics of the contract and the needs of the contracting authority.
- 8.42 It would be the third limb of this analysis which, in our view, would come under greatest scrutiny. In the NHS case the objective justification was compatibility with other equipment, and that justification was not disputed in the arguments.
- 8.43 For a public body wishing to specify DH energy the justification would not relate to the functionality or characteristics of the energy, but rather its means of production. This is quite different from the NHS example, and so increases the risk substantially.
- 8.44 Regulation 9(16) of the Public Contracts (Scotland) Regulations 2012 requires a procuring authority, other than in exceptional circumstances, not to “lay down technical specifications in the contract documents which refer to materials or goods of a specific make or source or to a particular process”

or to “origin or means of production” which have the effect of favouring or eliminating particular economic operators.

- 8.45 So, while a public body could point to policies and considerations relating to energy efficiency and carbon etc. in an attempt to create the objective justification for specifying a DH source of energy, we think this would be a high risk procurement strategy to employ, which should therefore only be employed with the risk mitigation measures mentioned below.

Method 6 – Competition

- 8.46 Method 6 is suitable for public or private sector schemes.
- 8.47 This method would be applicable if a public body has energy demands which could be met from an existing DH scheme.
- 8.48 With the right specification and evaluation criteria we think it is perfectly possible for a procurement process to be launched which would allow the DH scheme operator and other energy providers to bid on the same basis. The offerings from conventional sources and from the DH scheme could be compared on factors such as price, resilience and environmental factors.
- 8.49 Care would have to be taken to ensure that the criteria were not unfairly skewed in favour of a DH outcome, but the fact that one potential supplier has existing infrastructure which is capable of giving it an advantage in the tendering process is not a fundamental obstacle to designing and running a compliant procurement process.

Method 7 – Risk management

- 8.50 Procurement law risk can be actively managed, with transparency and with the passage of time. A claim brought under the procurement Regulations, for example, must be brought within one month of an alleged breach. There is a significant body of case law about when that period starts, which is beyond the scope of this Guidance, but the general point stands.
- 8.51 What this means is that a public body can get to a position of relative procurement law safety by publishing notices in the OJEU relating to its contracting intentions (in advance) or actions (after contract award), with suspensive conditions or consequence-free termination rights applying in respect of any contract entered into, during that one-month risk period.
- 8.52 This is a strategy which could be adopted in its own right (e.g. a contract directly awarded by a public body for good reasons but with no procurement law justification) or in combination with the other methods identified above where, as always with procurement law, there are grey areas.
- 8.53 To take one example, method 5 involves specification of DH energy. This could be made very clear in the original OJEU contract notice. The one month period would start on publication, which would mean that any competitor energy supplier’s right of challenge would become time barred broadly around the time that PQOs are returned.

- 8.54 Another basis of challenge would be judicial review. Judicial review does not have such definite time bar periods, but in other areas of law (for example planning) 3 months is viewed as the period within which a challenge would have to be brought to have a reasonable chance of success. If a decision of a public body is perceived as vulnerable to judicial review then that period could be used in substitution for the one month period prescribed by procurement law. It should be noted that while the fact that a challenge might have competently been brought within that one month period but was not would no doubt be argued by the public body, this would not of itself be a bar to a judicial review challenge.

9 State aid

- 9.1 There is no single state aid analysis which can be applied to the investment in and operation by a public body of a district heating ("DH") or combined heat and power scheme. However, the following themes can be identified which can then be tailored to individual projects and proposals.
- 9.2 State aid is concerned, in essence, with the transfer of resource from the state to undertakings (broadly entities engaged in economic activities). In a DH scheme context that transfer of resource could take the form of the cost to an undertaking to develop the heat network, the cost to an undertaking to connect to the network, or the price at which energy is sold.
- 9.3 If a scheme is for the benefit of householders then the state aid risk is low. State aid law is concerned about state resourced benefits being given to businesses (undertakings) not individuals. This analysis would apply, for example, if an authority invested in a DH scheme to serve its housing stock.
- 9.4 If the investment in a scheme is done on a commercial basis (i.e. the authority expects a return in the long term on that investment at a level which would support private sector investment) then the state aid risk is low. This is referred to as "MEIP" – or the market economy investor principle.
- 9.5 If the financial benefit to any undertaking of a DH scheme is marginal only, then the de minimis exemption (Regulation 2013/1407/EU) may be applied. There are sector specific exemptions, but in general terms the exemption allows a benefit of 200,000 Euros over 3 years to be given to any undertaking without contravening state aid law. That threshold applies to aid from all sources, and is not assessed on a measure by measure basis.
- 9.6 If none of the principles described above can be applied, then there will be a state aid issue to be addressed.
- 9.7 The 2008 EU Commission Guidelines on State Aid for Environmental Protection (OJ C082, 01/04/08 P.0001-0033) recognise that state aid deployed in investment in DH may be compatible with the EU Treaty (i.e. not unlawful state aid) because of the environmental benefits.
- 9.7.1 The Guidelines allow state aid to be given to district heating generation installations if such generation is more costly than individual heating, provided it is also less polluting and more energy efficient in generation and distribution.
- 9.7.2 As with many state aid exemptions there are restrictions on the aid intensity levels i.e. the percentage of state aid which can be applied in relation to the overall costs. Depending on the economic size of the beneficiary, the intensity range is between 50% and 70% of eligible investment costs (that is, the extra cost over and above a conventional solution). If a competitive bidding process for the installation is carried out, the aid intensity may be increased to 100%. In addition there are rules around the efficiency of the installation.

- 9.8 The 2008 Commission Guidelines do not cover district heating distribution networks. State aid in support of network investment would therefore require a specific notification and request for clearance from the EU Commission. There are examples where such aid has been declared compatible.
- 9.9 New Commission Guidelines which replace the 2008 Guidelines, and will take effect from 1 July 2014.
- 9.10 In addition to the state aid exemptions referred to in paragraphs 9.3 to 9.5 and the 2008 Commission Guidelines, it may also be appropriate for a public body to consider, on a case by case basis, whether any of the provisions (such as those on aid for environmental protection) of the General block exemption Regulation (Regulation 2008/800/EU) would allow aid to be given to any particular beneficiary. Like the 2008 Commission Guidelines, this Regulation will be replaced by a new General block exemption Regulation which will take effect from 1 July 2014. Article 42 of that new Regulation, for example, makes specific reference to investment aid for "efficient district heating and cooling systems."

10 Competition law

- 10.1 The EU Treaty and the Competition Act 1998 both prohibit the abuse by an undertaking of a dominant position. In theory, this could be an issue in relation to supplies of heat. It is very much less likely to be so in relation to supplies of electricity because, with very limited exceptions, customers have the right to switch suppliers and suppliers the right to supply customers (even over a "private wire" network).
- 10.2 If a public body was the operator of a district heating ("DH") Scheme, and engaged in economic activity by selling energy to third parties as a result, it would be an undertaking for the purposes of competition law.
- 10.3 However, in our view it would be unlikely in most cases for the operator of a DH Scheme to be considered to have a position of dominance. This is because the relevant market, in which the degree of dominance would be tested, would be the wider energy market where traditional suppliers of gas, electricity and other energy sources would provide demand-side substitution. In that market, it can be seen that the operator of a DH Scheme would be one of many suppliers, and highly unlikely to hold a position of dominance.
- 10.4 An exception to this may be if a local authority were, as planning authority, to mandate connection to a DH Scheme as a condition of any new development. Leaving aside the legality of that from a planning perspective, such a policy may result in the relevant market being a narrower one for DH energy alone, not energy more broadly.
- 10.5 The holding of a dominant position is not a competition law problem. It is only the abuse of that position which is.
- 10.6 A full exposition of the law on the abuse of a dominant position is beyond the scope of this Guidance, but examples of abuse would include:
- 10.6.1 charging unfair prices;
 - 10.6.2 imposing unfair trading conditions;
 - 10.6.3 limiting output to the prejudice of consumers; and
 - 10.6.4 applying dissimilar conditions to equivalent transactions with customers.
- 10.7 These examples coalesce around the concept of fairness, and so provided the public body remained fair with its customers, its conduct as a dominant provider should not ordinarily amount to an abuse.
- 10.8 Competition law as it applies to mergers is not considered in this Guidance because the heat market is not at a stage of evolution where there is merger activity, and because the scope of electricity supplies likely to be undertaken by Scottish public bodies is not expected to be at such a scale as to engage merger provisions.