Scottish Futures Trust

Legal Guidance on establishing Energy Services Companies (ESCOs)

March 2015
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Introduction

This Guidance provides information, from a public sector perspective, on "Energy Services Companies", often known as ESCOs.

Those public bodies most likely to consider establishing ESCOs are local authorities, registered social landlords (housing associations), universities and, perhaps, colleges of further education. That is not to say that other public bodies would not do so, nor that this Guidance may not be useful for them. It has, however, been prepared with these particular public bodies in mind.

The Guidance is divided into four sections. Section 1 explains what an ESCO is and addresses various questions which are often raised when ESCOs are discussed.

Section 2 considers why a public sector ESCO might be established or used, and addresses a number of practical, business related and legal factors which may be relevant to a decision about whether to establish an ESCO.

Section 3 looks at the types of entity which a public body might use for an ESCO, such as limited companies, partnerships and various others. The available types of entity are discussed in some detail and their suitability for use as an ESCO is assessed against a variety of parameters.

Section 4 concerns governance issues when an ESCO is formed. These are considered both from the perspective of governance internal to the ESCO and governance as between the ESCO and the "parent" public body.

The Guidance cross-refers to other SFT Guidance on: the powers of Scottish public bodies to generate / procure / trade heat and electricity supplies\(^1\); on delivery structures for heat networks\(^2\); and on VAT considerations for district heating\(^3\).

This Guidance is intended to provide general information on its subject matter. 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. Specific legal advice should be taken, as appropriate, with reference to the individual circumstances of projects. Depending on the nature of the ESCO under consideration, other professional advice may also be required, including technical advice and financial advice (for example, in relation to the detailed tax treatment and the accounting and budgetary treatment of different types of entities that may be used as ESCOs).

This Guidance has been prepared by Brodies LLP on behalf of Scottish Futures Trust.

The law in this Guidance is stated as at 1 February 2015.

\(^1\) [http://www.districtheatingscotland.com/content/procurement](http://www.districtheatingscotland.com/content/procurement)

\(^2\) [http://www.districtheatingscotland.com/content/procurement](http://www.districtheatingscotland.com/content/procurement)

\(^3\) [http://www.districtheatingscotland.com/content/finance](http://www.districtheatingscotland.com/content/finance)
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What is an ESCO?

Introduction

1.1 The term ESCO is frequently used, but can refer to a wide range of structures established for a variety of reasons. As an acronym, it stands for “energy services company” (or, occasionally, “energy supply company”, but an ESCO need not be a company established under the Companies Act 2006; it can take a wide variety of legal forms. The different types are discussed further in section 3 of this Guidance.

1.2 Use of the term ESCO does not of itself carry any legal implications. It is not necessary that an ESCO be established in order for energy services to be provided. Many businesses provide energy services (in their widest sense) without referring to themselves as ESCOs: the major energy companies are an example.

Definition of ESCO

1.3 In relation to ESCOs, the concept of “energy services” needs to be given a somewhat narrower meaning. It tends to be characteristic of an ESCO that it is involved in the delivery of energy efficiency services, energy savings, renewable or sustainable energy, and/or carbon emissions reductions. The entity in question may be procuring these services, managing them or operating...
them (so far as they involve works, plant or machinery). An entity which is in some way engaged in these processes can legitimately be described as an ESCO. This Guidance uses the term ESCO in that sense, which is the closest there is to a definition.

1.4 There is a sub-set of ESCO activities known as “energy performance contracting”. These are services provided by a private sector entity, whether to the public or the private sector, and which involve a guarantee or underwriting of energy savings and/or emissions reductions to be achieved by those services. This can involve assessment of the energy characteristics of a building or multiple buildings, and the provision of services which are to produce a reduction in energy costs and/or emissions. The key feature of these arrangements is the guarantee of savings or reductions, secured for single premises (whether industrial, commercial or office) or across a wider estate. An example relevant to the public sector is the Mayor of London’s RE:FIT programme. This is a framework from which mini-competitions are run to appoint a framework contractor, who will provide guaranteed energy savings by implementing a variety of energy efficiency measures. Also, for public sector bodies in Scotland, a new Non-Domestic Energy Efficiency Framework is currently being procured.

Public or Private Sector

1.5 An ESCO could be a public sector organisation, a private sector organisation or a joint venture between two or more such organisations. A public body may establish an ESCO for a variety of reasons relating to the matters referred to in paragraph 1.3. The ESCO so established may, or may not, have private sector participation. An ESCO may be established solely to implement a particular project (for example, a district heating scheme) or may be established on a more strategic basis with a view to implementing a variety of projects. These could be taken forward using a variety of delivery structures, and with varying degrees of private sector participation. The delivery model for each project will depend on a range of factors, including: the public body’s objectives and risk appetite; its access to funding and finance; in-house capacity and capability; and the attractiveness of the project to the private sector.

1.6 An ESCO may be a private sector entity established to provide energy services, whether to the public sector or otherwise. In some cases, the ESCO may be a special purpose vehicle established to design, build, operate and manage an individual facility or scheme (e.g. a district heating network).

1.7 An ESCO may also be a hybrid entity with a public body and private sector partner working together in a corporate joint venture. It is probably true to say, however, that public/private sector energy services arrangements are more usually constituted by contractual arrangements than by corporate joint ventures.

1.8 Regardless of whether an ESCO is a public or private sector entity or a hybrid, there is no necessary connection between an ESCO and the public sector. ESCO services, particularly energy performance contracting, are and have for some time been provided by private sector entities to the private sector. District heating or combined heat and power schemes have also been established
in private sector new-build developments and managed by private sector ESCOs (see paragraphs 1.22 and 1.23 for examples) with no direct public sector role.

1.9 This Guidance concentrates on ESCOs from a public sector viewpoint, but it is important to be aware that ESCOs have a wider application. It is also important to appreciate that it is not necessary, when considering energy services, efficiencies or emissions reductions either to establish, or to contract with, an ESCO. Section 2 of this Guidance considers factors which may suggest the establishment of an ESCO. The starting point, however, should never be that an ESCO needs to be established or that a private sector entity badged as an ESCO needs to be contracted with. The starting point should always be consideration of the public body’s objectives with regard to energy services. The establishment of an ESCO by a public body does not, of itself, guarantee the better provision of energy services to (or by) that public body.

*Profit or Not for Profit*

1.10 The business of an ESCO does not require to be conducted in any particular way. This is as would be expected given the wide variety of legal entities which badge themselves as ESCOs. This point is mentioned because there is sometimes a debate about whether a public sector ESCO should be “for profit” or “not for profit”.

1.11 These terms have two separate meanings, which tend to be confused or lead to confusion. First, any entity established to carry on a business or a social enterprise may make a choice about how to conduct that business or enterprise. It may choose to maximise profit or at least to ensure that profit is made. Alternatively, it may choose to conduct its business on the principle that, while prudently allowing for ongoing expenditure, it will not seek to make a profit but instead, taking one year with another, will break even. Some social enterprises conduct their business in this way. There may be good reasons to do so where ensuring affordability of the particular service provided is more important than making profit to invest in future projects. It is not necessary for a public sector ESCO to run its business along these lines. It may choose to do so but that choice has nothing to do with being an ESCO.

1.12 The second, and perhaps more significant, meaning of “for profit”/“not for profit” is about whether or not profits made should be capable of being distributed to members of the ESCO (for example if the ESCO is a Companies Act company, to the shareholder(s) in that company). In this context, the issue is not whether the entity should make a profit or not, but whether that profit should be capable of distribution to members of the entity. One reason that a decision might be taken that such distributions should not be made is in order to allow the ESCO to put money aside for the development of future projects. Another reason might focus on public perception: an entity established by the public sector which provides energy services only to take profit out and not to recycle it into further energy services might (in some circumstances) be viewed less favourably in terms of public and other stakeholder perception than an entity which does not.

1.13 Again, it is not necessary that a public sector ESCO be “for profit” distribution to members or “not for profit” distribution to members. There can be good reasons for either approach.
1.14 The “for profit”/“not for profit” issue (in both of its senses) may have implications for the legal form of any ESCO that is established. An ESCO which is not intended to be run with a view to making a profit, or an ESCO which is not intended to distribute profits to its member(s), would likely be unsuitable for any type of partnership structure, since a partnership is legally defined as carrying on business with a view to a profit and with an expectation that profit be distributed to the partners. Conversely, a community benefit society or a community interest company would likely not be suitable vehicles if the intention were to distribute profit to members.

Examples of ESCOs on the Public/Private Spectrum

1.15 The remainder of this section illustrates the concept of ESCOs with some examples of where existing energy services provision may fall on a public sector/private sector spectrum⁴. There are four main groupings:

1.15.1 public sector driven and directly managed (i.e. in-house and not through the use of an ESCO at all), with limited private sector involvement;

1.15.2 public sector driven and managed through a separate public sector ESCO, with limited private sector involvement;

1.15.3 public sector driven, but designed, constructed and operated by the private sector (with or without energy savings/performance guarantees): transactions like this may be pursued through a purely contractual relationship or through a corporate joint venture vehicle (which will of course still involve contracts); and

1.15.4 private sector driven.

1.16 With the exception of private to private ESCOs, which have only limited relevance to this Guidance (though see paragraphs 1.22 and 1.23 for examples), the groupings referred to in the preceding paragraph reflect a spectrum with varying degrees of public sector control set against varying degrees of risk transfer to the private sector. Broadly, with greater public sector control comes greater responsibility and risk, but more flexibility and potential benefits (including social benefits). With less public sector control comes greater transfer of responsibility and risk, but (depending on the terms of the relationship with the private sector) reduced flexibility and potential benefits. Where a public body sits on this spectrum will depend on a number of factors, but its desire for control and attitude to risk will be key among them, and should be considered prior to any decision to establish an ESCO. This point is discussed further in paragraph 2.7.

1.17 It may be useful to provide some illustrations of the types of ESCO referred to in paragraph 1.15. There are a number of public sector energy services arrangements which do not operate through an ESCO vehicle and which make limited use of private sector input. These include Fife Council's

⁴ Note that in the context of district heating schemes, further information on commonly used business models is provided in SFT’s Guidance on Delivery Structures for Heat Networks, available from the Heat Network Partnership website: www.districtheatingscotland.com/content/procurement.
Dunfermline district heating scheme and Islington Borough Council's Bunhill district heating scheme. These are operated by the Councils as in-house arrangements, that is, no separate ESCO has been established. They illustrate that it is perfectly possible to provide energy services without the establishment of a separate entity to do so.

1.18 An example of ESCO services being provided with limited private sector input but through a separately established vehicle can be found in Aberdeen Heat & Power Company Limited (AHP). AHP was established by Aberdeen City Council in response to a need to address fuel poverty within Council-owned housing stock. The establishment of a separate ESCO was considered desirable in order to allow a focus on this issue: it enabled energy efficiency measures and district heating to be implemented more quickly than would otherwise have been the case. It should be noted, however, that the external borrowings of AHP required to be guaranteed by the Council. While there was therefore a transfer of responsibility for implementing the necessary measures, the Council remained at risk in the event of failure of AHP to repay the monies borrowed (in fact, these monies were repaid by AHP without any recourse to the Council). This is not unusual for arm’s length companies established by local authorities.

1.19 AHP illustrates the establishment of an ESCO by a public body with a particular purpose in mind. It also illustrates a public sector ESCO which carries out most relevant operations itself rather than by contracting these services to a private sector partner. AHP procures private sector services in the construction of its energy centres and heat networks, but carries out operations, maintenance, heat supply and billing itself. The Pimlico District Heating Undertaking provides another example of a heat network owned by a public body (Westminster City Council), but managed and operated by an arm’s length ESCO established by it (City West Homes). Blue Sky Peterborough is a further example of an ESCO established and owned by a public body (Peterborough City Council) to deliver decentralised energy solutions, including, in conjunction with its delivery partner Honeywell, energy performance contracting.

1.20 An example of what may be described as a "concession-type" ESCO arrangement (public sector driven, but designed, constructed and operated by a private sector partner, SSE) is the Cube Housing Association Limited district heating scheme at the Wyndford estate in Glasgow. This supplies heat to around 1,900 properties, mostly owned by Cube but with some owner occupiers. After consideration of control and risk issues, Cube chose to procure these services through a design, build, finance (in part), operate and maintain contract with a private sector partner. No public sector ESCO was therefore established. The principal reason for proceeding in this way was that Cube wished to continue to concentrate on its core activities of providing homes for its tenants, maintaining and upgrading their fabric as necessary, and charging and collecting rent in return. It did not consider that the provision of the utility service of heat was something which it had the capability to provide. Cube did, however, understand that the provision of warm homes with affordable heat was of significant importance to its tenants and also in achieving relevant housing

[^5]: http://www.local.gov.uk/documents/10180/5785771/Income+generation+Case+Study+-+Peterborough+City+Council.pdf/31a75d67-c0d9-4d21-ae0a-87ec523b699a
quality standards. The contractual arrangement with SSE included a capital contribution from Cube. This secured a lower overall cost of funding, which ultimately helped to impact on fuel poverty.

1.21 The energy centre, heat network, heat supplies, and metering and billing services are therefore provided by a private sector ESCO under a long-term contract with Cube which, among other things, provides for oversight of the price charged to tenants for heat and of the terms of the tenant heat supply agreements. While Cube therefore has some important (and necessary) contractual controls over the project, the primary concern was to ensure risk transfer to the private sector ESCO of not only design and build, but also supply, metering, billing (and collection), operation and maintenance.

1.22 It is also useful to provide a couple of examples of private sector ESCO arrangements. The King’s Cross development⁶ in London is one of Europe’s largest regeneration projects, involving the creation of up to 2,000 new homes, new and refurbished office buildings and retail space across a 67-acre scheme. The regeneration site had very little in the way of existing services, thus offering a ‘blank canvas’ for energy infrastructure. Local planning policy strongly favoured district energy solutions. The main developer (Argent LLP), selected a multi-utility services provider (Metropolitan, part of Brookfield Utilities), with whom it entered into a joint venture ESCO (Metropolitan King’s Cross). The ESCO is responsible for delivering an integrated energy and utility solution for the site, including the provision of low carbon heat, electricity, fibre, water and wastewater services. Metropolitan operates the utility and energy assets, and retains ownership of the networks. The joint venture ESCO operates the energy centre under a 25-year concession agreement and provides metering and billing services. The ESCO is required to ensure that prices are benchmarked and remain competitive with heating through other means.

1.23 Another example is the Cranbrook and Skypark development,⁷ near Exeter. The development involves the creation of up to 2,900 new homes at Cranbrook, and the 1.4 million square feet Skypark business park. As with the King’s Cross scheme, district energy solutions were strongly favoured by local planning policy (in this case, Devon County Council). The development involved the procurement by a private sector developer consortium (St. Modwen) of a long-term energy services provider (E.ON) for the construction and long-term operation of energy infrastructure for the site under an 80-year concession agreement.

1.24 While the King’s Cross and Cranbrook district energy schemes are private sector led ESCO initiatives, and the relevant local authorities are not involved in the implementation of the schemes, they did use their powers under planning legislation strongly to encourage district energy solutions. While purely private sector ESCO developments are outwith the scope of this Guidance, these developments illustrate how local authorities can (and arguably should) influence energy services outcomes – including in projects in which they are not directly involved - through the use of planning powers.

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⁶ For further information see SFT’s District Heating Delivery Structures Guidance, available from the Heat Network Partnership for Scotland’s website: www.districtheatingscotland.com/content/procurement.
⁷ For further information see https://www.eonenergy.com/for-your-business/community-energy/Community-energy-casestudies/cranbrook.
2 Why would a public sector ESCO be established/used?

2.1 Section 1 of this Guidance has explained what an ESCO is. It has also made clear that a public sector body must not assume that establishing an ESCO is the only way of enabling energy services as described in paragraph 1.3 to be provided. There are costs associated with establishing and operating a separate entity and the process also raises significant governance issues, which are explored further in section 4 of this Guidance. Establishing an ESCO is not an end in itself (to be justified after the event) but a means to an end. The rationale for deciding whether or not to establish an ESCO must be coherent and the anticipated benefits must justify the time, expense and governance which will be required. There should always be a sound business case for this.

2.2 Before any question even arises of whether to establish an ESCO, a public body must have an energy services requirement. This may be broad (energy services generally, or district heating projects or energy efficiency) or it may be narrow (a site or development-specific project). Whichever it is, the public body must first consider what the particular energy service requirements are and what its objectives are in relation to those energy services. This is likely to involve both a strategic overview/options appraisal and preparation of a business case for implementation of the agreed strategy. The process is summarised in the text box after paragraph 2.10.

2.3 In turn, both of these processes will require internal discussion and agreement and possibly external consultation, e.g. with social housing tenants who may be affected by the proposed initiative, with partner public bodies, or other external stakeholders. It is likely that project-specific technical and financial studies will also be required to inform the options appraisal for how a particular energy services requirement could be met.

2.4 There is what might be thought to be an exception to the principles set out in the previous two paragraphs, namely, what is sometimes referred to as a "strategic" ESCO. Such a vehicle would be established with a view to acting as a central forum or clearing house for a number of potential energy services initiatives being pursued by its parent public body. While it is true that a strategic ESCO will carry out business planning activities it still remains the case that before any such ESCO is established, the parent public body should have considered its energy services strategy both in terms of aims and objectives and also in terms of the types of project which could be anticipated to be required to implement that strategy. Simply to hand over the task of developing strategy to an ESCO without first having considered what the strategy should be will either create very significant governance issues (around the exercise of control over the ESCO) or will result in a potentially challengeable delegation of functions.

2.5 Only once the energy services strategy has been considered is it then appropriate to consider the means of delivery. There will usually be different ways of delivering the agreed strategy: establishing an ESCO is just one of these. A public body should therefore have a robust business case for establishing an ESCO.

2.6 Any public body which wishes to establish an ESCO must also consider whether it has the power to do so. That question is outwith the scope of this Guidance, but is covered in detail for Scottish public
The question of whether or not an ESCO should be established may not arise for some energy services projects. As part of the business planning for a particular project (take the installation of solar panels on buildings as an example) a public body should have considered how that project is best implemented. This will involve the question of control versus risk outlined in paragraph 1.16. For example, in risk terms, would the public body prefer that the solar panel project is not only designed and built, but also operated and maintained by a third party, most likely a private sector partner? There will still be benefits for the public body to be derived from that project (whether heat or electricity) and possibly also income, but operational risk would have been transferred. On the other hand, the public body may prefer to retain more control and thus more risk, but with potentially greater benefits, whether in terms of income or future flexibility.

If maximising risk transfer is important for a specific project, then the question of establishing a public sector ESCO will almost certainly not arise. Instead the public body will enter into a contract, or a series of contracts, with a private sector partner or partners to implement the project: the establishment of an ESCO purely for the purpose of buying in a service or services is very unlikely to make sense.

The issue of control versus risk can arise at two different levels. As discussed in the previous paragraph, it may well impact on whether an ESCO should be established at all. However, a “strategic” ESCO of the type referred to in paragraph 2.4, if established, will require to consider a variety of projects across a wide spectrum of energy services. In considering how these individual projects should be implemented, control versus risk will again become relevant. The outcome at this project implementation level may be that a number of subsidiary special purpose vehicles are created: these may be wholly owned by the parent public body, or joint ventures with other public sector bodies or with the private sector.

The analysis so far in this section suggests, therefore, that: (a) a strategic overview/analysis of energy services requirements must be carried out before any question of establishing an ESCO arises; and (b) part of the process will be to consider the question of control versus risk, the decision on which is very likely to impact whether a public sector ESCO is established at all (rather than entering into contractual arrangements with private sector partners, who may or may not be ESCOs).

\[8\] Available at [www.districtheatingscotland.com/content/procurement](http://www.districtheatingscotland.com/content/procurement).
2.11 Once these key preliminary stages have been completed, there are a number of factors to be considered in deciding whether or not a public sector or public/private joint venture ESCO should be established. In broad terms, there are two sets of these. The first can be described as practical or business-related and the second as deriving from legal considerations. The distinction is not hard and fast, but it assists in the following analysis. We consider first the practical or business-related factors which may be relevant to any decision to establish an ESCO.

**Practical / Business-related Factors**

2.12 Establishment of a public body ESCO can ensure that there is dedicated resource available, concentrating wholly on the relevant energy services tasks. It may be harder (though it is by no means impossible) to ensure that such dedicated resource both is and remains available in-house in the future. Whether this factor is relevant in a given situation will depend upon what the ESCO is established to do. If, for example, it is intended that it will be responsible for taking forward and then operating a particular project, the dedicated resource factor may carry greater weight than, for example, in a case where the ESCO has a wider remit of considering a variety of projects having regard to strategy implementation.

2.13 The establishment of an ESCO may be a means of allowing an energy "champion" to emerge. This is really a sub-set of the factor referred to in the previous paragraph. Again, the question should be asked whether this cannot happen, or is more difficult to make happen, within the public sector organisation itself. There may be reasons why this is so, but these should be articulated. It might be said that a career path which is very much focussed on energy services (as an ESCO certainly should be) may be more attractive than an in-house position, although again that need not necessarily be so.
2.14 An ESCO may be more capable (than an in-house team or department) of acting as a **clearing house** for a variety of energy services projects. The idea here would be that an ESCO can retain a more developed skill set, and therefore provide a greater focus on potential energy services initiatives. District heating may provide an example of this. A public body may have a variety of district heating opportunities to consider, perhaps coming from a variety of sources within that public body. Some projects may have a social dimension (the relief of fuel poverty) while others may be joint projects with other stakeholders, and yet others may be internal energy efficiency measures for the public body's own estate. These projects may all be, or have been, the subject of discussion within different parts of the public body. Bringing these into an ESCO may better enable the collective skills and experience to be brought to bear, and the required focus to decide which projects to implement, and in what order. A separate entity may more easily be able to take an objective view than those sponsoring each project as to the advantages and disadvantages of all projects. Again consideration needs to be given to whether the same result could be achieved in-house. It may be that it is more difficult to bring the necessary focus to a multiplicity of projects by in-house means, but some public bodies have done just that.

2.15 The next factor is a wider application of the factor set out in the previous paragraph. This is what has been referred to as a "**strategic**" ESCO (see paragraph 2.4). Such an ESCO would act as a clearing house for initiatives across a wide spectrum of energy services rather than, (as in the paragraph above) one particular area of energy services, and similar considerations apply.

2.16 It may be more straightforward through the use of an ESCO to involve third parties with relevant **skills and expertise in energy services**. For example, the Board of directors of an ESCO which is a Companies Act 2006 company will have a number of directors who represent the public body, but may also have directors or senior managers who have expertise in the subject matter of the ESCO's activities. This may make for better decision-making than could be achieved in-house. A panel of advisers could perhaps fulfil a similar function for an in-house decision-making process but it may be felt that that is not the same thing as having expertise available within, as opposed to outside, a management structure. However, it should not be assumed that individuals with relevant skills and expertise will necessarily be available or prepared to become involved in the ESCO. This needs to be explored before proceeding.

2.17 In similar vein, the establishment of an ESCO may make it easier to **collaborate with other stakeholders** in particular projects. For example, a project may require co-operation between public bodies. The establishment of an ESCO may make this more straightforward in terms of decision-making, although it must not be forgotten that each public sector body representative, whether a member of the ESCO or of its management, will (or should) be subject to governance arrangements with his or her parent public body, so decision-making will not necessarily be faster. It may, however, be easier to reach agreement using the mechanism of an ESCO than not. There may also be legal considerations suggesting the use of an ESCO for joint public sector body energy services projects: these are discussed in paragraphs 2.21 to 2.24.
2.18 Another consideration is the **transfer of risk**. If a decision is taken by a public body to implement a project and this includes operation and maintenance of that project or the supply of services (for example heat, electricity, metering or billing) by that body, it may be felt desirable to pursue the project through an ESCO. The theory is that this isolates the public body from related risks of operational failure, service failure, cost overrun and so on. The use of an ESCO can achieve this to some extent, but it should be recognised, in practical terms, that there is always a point at which the public body may have to re-assume risk unless it is prepared to see a project fail entirely, whether at the design and build stage, or once operational. For example, in a project involving heat supply to social housing, the public body would likely step-in in order to remedy a serious service failure.

2.19 **Investibility** may be a factor in establishing an ESCO. An ESCO will not necessarily be able to access funds at rates cheaper than its parent public body, but it may be able to attract, by virtue of being a stand-alone vehicle, project finance on a non-recourse basis, or, if it is a company, equity finance. This would not be available for in-house provision. The ESCO may also be able to access funds for projects from sources to which the parent public body may not have such access, or where it is otherwise constrained in expenditure terms. Aberdeen Heat & Power Company Limited (AHP) had external borrowings which enabled fabric improvement and district heating projects to proceed considerably more quickly than if Aberdeen City Council had implemented the projects itself. It should be noted, however, that conventional finance made available to a newly-formed ESCO will very likely require to be guaranteed by its parent public body, as was the case with AHP.

2.20 There are a number of other practical and business-related factors that may be relevant, including the willingness of the public body to enter into a joint venture with the private sector, and the **accounting / budgetary treatment** of different structures. Not all of the practical or business-related factors referred to above will be relevant in any given case. Some may carry more weight than others, e.g. when clearing house type ESCO arrangements are considered compared to single project implementation. In each case, however, it is important always to ask the question whether the same result can realistically be achieved via in-house provision. Answers to that question will vary between public bodies, as all are different in terms of their internal management structures.

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**Key Business Factors in Establishing an ESCO**

An ESCO may enable:

- resources to be fully dedicated to the energy services task;
- an individual energy champion to shine;
- coordination and focus across a class of energy services;
- strategic coordination and focus across several classes of energy services;
- involvement of individuals with energy services expertise;
- strategic co-ordination of public sector / other stakeholders;
- transfer of risk; and
- access to investment/funding.
Legal Factors

2.21 It has already been noted that some projects may involve collaboration with other public sector bodies and that, in the context of management of these projects, a separate ESCO may assist joint decision-making by enabling decisions to be made through a single entity (see paragraph 2.17). Issues of public procurement law compliance may also suggest the use of an ESCO in projects where there is collaboration among two or more public bodies. These issues are explained in detail in paragraphs 8.10 to 8.25 of the SFT Powers Guidance.

2.22 An example will illustrate the point. Public body A wishes to procure heat for its principal offices. Public body B wishes to design and build an energy centre to provide heat for its own premises. Both public bodies agree that the energy centre producing the heat should be sized so as to provide "excess" heat to public body A, which is prepared to pay for the additional capacity and also for the construction of the extended network to its own premises. Public body A is also prepared to pay for the heat to be supplied to it by public body B's energy centre. From the perspective of public body A, there is a requirement to procure a heat supply and the network through which to make that supply. Under general public procurement law principles, it cannot simply contract with public body B to fulfill that requirement without running a compliant procurement process. This could, in turn, impact public body B if the supply of heat to public body A was successfully challenged as a direct award of an uncompetited contract.

2.23 Under Article 12 of the Public Procurement Directive (2012/24/EU), which codifies existing case law (the “Teckal” judgement), if the two public bodies create a separate body in which they are represented both as members and at board of management level, then the activities which each proposes to carry out for the purposes of the project are treated as if they were in-house and therefore not subject to public procurement constraints. There are certain limitations and controls around this (such as how much business any such entity may carry on that is not public sector to public sector) and these are discussed in paragraph 8.20 of the SFT Powers Guidance.

2.24 Article 12 also applies to the public procurement issue which would otherwise arise where a single public body decides to implement an energy services requirement through an ESCO. If that ESCO is wholly owned and controlled by the public body then, as between the parent public body and the ESCO, there is no procurement requirement arising out of the use of the ESCO to provide energy services to or for the benefit of the parent public body (see paragraphs 8.12 to 8.17 of the SFT Powers Guidance). The ESCO itself will, however, be a contracting authority and therefore bound to follow the public procurement rules in relation to any contracts it procures itself.

2.25 In some cases establishment of an ESCO may be desirable in order to protect charitable status. This could be relevant for an energy services project being pursued by a registered social landlord, a University or a further education college (since almost all of these bodies are charities). If the project is about the provision of energy services for the body itself, then no issue should arise. However, there may be projects undertaken by charitable bodies which involve supplies being made to other bodies, whether public or private. These supplies may not be regarded as falling within the body's charitable purposes unless they are made to a body with similar charitable purposes (for
example, a housing association to another housing association or a University to a college or vice versa). Supplies to non-related entities and/or to private sector entities are not likely to be considered as being carried on for charitable purposes within the terms of the Charities and Trustee Investment (Scotland) Act 2005. Carrying on such activities may ultimately put charitable status at risk.

2.26 This issue is discussed in more detail in the SFT Powers Guidance at paragraphs 2.22 to 2.24 (Universities), 3.24 to 3.26 (Further Education Colleges) and 6.22 to 6.27 (Registered Social Landlords). The prudent solution is to establish a non-charitable trading subsidiary of the relevant public body to make third party supplies such as this. Although not within the scope of this Guidance, the power to establish such a subsidiary will require to be checked, and any consents required for its establishment will need to be obtained. Information on these matters is provided in the SFT Powers Guidance.

2.27 For local authorities, consideration of issues arising from the Local Authorities (Goods and Services) Act 1970 may also suggest the use of an ESCO in certain circumstances. The 1970 Act constrains the trading power of local authorities in that it limits “commercial services” income from “relevant trading operations” to 0%, although there is provision for prior consent of the Scottish Ministers to be given to raise this limit in any particular case.

2.28 The constraint does not apply to trading agreements with other local authorities, or other public bodies, or bodies carrying out functions of a public nature, but it does apply to trading arrangements entered into with private sector bodies. There are also provisions which restrict the payment of dividends or profits by a body corporate (which would include a local authority established ESCO) to the local authority, again without prior consent of the Scottish Ministers. More detail is provided on the provisions of the 1970 Act and the issues arising in paragraphs 1.30 to 1.38 of the SFT Powers Guidance.

2.29 The point to draw from analysis of the 1970 Act is that care needs to be taken by a local authority in establishing an ESCO where the ESCO may be trading with the private sector and may also intend to remit dividends or profits to its parent authority: Scottish Ministers’ consent would be required to do this. However, as is mentioned in paragraph 1.38 of the SFT Powers Guidance, the articles of association or other governing document of the ESCO may include a provision that profit must be retained within the entity and used to further its purposes, or that profit 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 cases such as these, there will not be an issue under the 1970 Act even where the ESCO does contract with private sector bodies.

2.30 While detailed tax considerations are outwith the scope of this Guidance, there may be tax benefits in establishing an ESCO. For example, some parent public bodies may be unable to recover all the VAT incurred on construction and other project infrastructure costs. This irrecoverable VAT can be a considerable expense. The use of an independent (and separately VAT registered) ESCO entity to hold or lease the finished infrastructure, as well as supply energy services to its parent body can allow for full VAT recovery in these cases. For further information on VAT, see the SFT Report on
VAT Considerations for District Heating.\(^9\) Any public body taking forward provision of energy services should, of course, consider the potential tax consequences. We would recommend that great care is taken to consider and fully understand all the advantages and disadvantages of establishing any ESCO purely, or mainly, for tax-related purposes.

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**Key Legal Factors in Establishing an ESCO**

The formation of an ESCO may:

- be required to facilitate public procurement law compliance;
- be required to preserve the charitable status of the parent public body;
- address issues under the Local Authorities (Goods and Services) Act 1970 relating to trading powers of local authorities; and
- provide tax benefits (but should not be driven by them).

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\(^9\) Available at [http://www.districtheatingscotland.com/content/finance](http://www.districtheatingscotland.com/content/finance).
3 Options for legal form of ESCO

Preliminary Considerations

3.1 The previous two sections of this Guidance have considered what an ESCO is and why a public sector ESCO might be established.

3.2 This section considers the possible legal forms ESCOs may take. There are a number of attributes that different legal forms have, and which influence which type is chosen for an ESCO. These attributes are considered in the following paragraphs under the broad headings of flexibility, liability, tax treatment, suitability for “profit” or “not for profit”, and funding opportunities. The specific requirements of various legal forms are then considered, including how they are established, and their advantages and disadvantages. For the sake of completeness, most existing legal forms are discussed, even though some are unsuitable for use as an ESCO: understanding why a particular legal form is unsuitable can be instructive, and such forms may well have relevance to energy initiatives not involving ESCOs. There is also some reference in the discussion to charities. It is important to note that a charity is not a legal form, but a status. Many legal forms can, if they satisfy the relevant requirements, have charitable status. Only one, the Scottish Charitable Incorporated Organisation, is designed with that status specifically in mind.

Flexibility

3.3 Some legal forms (like companies limited by shares) are inherently flexible. They can be used for a variety of different purposes on a spectrum ranging from social enterprises to profit-making businesses. The constitution of these bodies can be tailored to the requirements of the parent public body and can be changed if any provisions become inappropriate for the ongoing activities of the ESCO. The shares in a company, or its assets, can be sold without significant legal restrictions. This may matter in terms of any exit strategy for a public body ESCO. Other legal forms, such as ordinary partnerships, have few reporting obligations or a limited regulatory framework. Yet others may allow conversion into different legal forms.

3.4 There are legal forms which are subject to greater limitations. They may be restricted to carrying out a particular type of activity, or required to act in pursuit of a defined aim or for the benefit of a certain group of persons. Some may need to have provisions in their constitutions which are not legally capable of being amended. There may be significant reporting obligations and/or significant regulation. Once some bodies are established, it is not possible for them to convert to another form.

3.5 The level of flexibility which is needed is dependent on the activities that the proposed ESCO will carry out. For an ESCO which is to be a clearing house for a broad range of energy services a greater level of flexibility is required to allow it to consider, and implement, a variety of projects and activities. For an ESCO which is established for a narrower purpose, such as alleviating fuel poverty in a certain area, limitations will be acceptable and may indeed be desirable. Lack of flexibility is,
therefore, not intended to be a criticism of a particular legal form: it is simply to acknowledge that the form exists for particular purposes.

**Liability**

3.6 An important attribute when choosing a legal form is whether that form provides its members with the benefit of limited liability. The essence of limited liability is that, if the entity becomes insolvent, its members do not have to pay more than a certain specified, often nominal, amount. The members do not have personal liability for the debts and obligations of the entity. Neither, generally, do its office holders (such as directors in a company).

3.7 Limited liability does not come without conditions, however. One of these is publication (in a register) of details about the entity, including (usually) its name, constitutive documents, office holders, annual accounts and so on. Another is enhanced regulation: this is not just a question of what an entity with limited liability must publish, but also of how it should or should not conduct its affairs. Finally, there are limits to limited liability. Fraud on the part of the members of a limited liability entity can result in limited liability being lost. The management (board of directors etc.) of an entity with limited liability can in some cases be made personally liable. Examples include trading while the entity is insolvent, or (as regards criminal matters) allowing offences to be committed by the entity either with consent, connivance or through neglect.

3.8 The scope and scale of the activities or projects which an ESCO may implement could carry significant levels of liability in the event of, for example, operational or service failure. As a result, limited liability will be a highly desirable, or necessary, attribute of an ESCO. If a significant factor influencing the decision to establish an ESCO is the transfer of risk, limited liability will be essential.

3.9 The concept of limited liability is linked with, although distinct from, the issue of whether the entity has a separate legal personality from its members or management. If the entity is a legal person, this means that, in law, it is an entity which is independent and separate from its members. This allows the entity to own property, enter into contracts, hire employees and so on.

3.10 An entity must have a separate legal personality in order to provide limited liability but just because it is a separate legal person does not always result in limited liability. This can be seen with ordinary partnerships formed under the Partnership Act 1890. In Scotland, these are separate legal persons but their members have joint and several liability for the debts and obligations of the partnership. Unlimited companies provide another example. Care should therefore be taken to ensure both legal personality and limited liability are present in the chosen legal form if (as is very likely) these are attributes which are relevant to the proposed ESCO.

**Tax Treatment**

3.11 Tax considerations may be relevant to the choice of legal form. It is not anticipated that there will be many situations where tax considerations are a key determinant of that choice. It is outwith the scope of this Guidance to consider tax implications in detail, principally because taxation regimes
vary significantly across different types of public bodies. Public bodies should always take specific advice on the tax consequences of establishing an ESCO.

3.12 By way of example, an ESCO which is a company will, if it makes a profit or gain, be liable to pay corporation tax. This will need to be paid before any distribution of profit is made to the parent public body or bodies. On the other hand, tax is generally only charged at the partner level of partnerships and limited liability partnerships, i.e. is only payable following distribution of profits to partners. This means that partnerships are regarded as "tax transparent" and the treatment of each partner is determined by their own tax status. In cases where the public body is itself not liable to pay income tax or corporation tax, use of a partnership can have advantages compared to use of a company in that profits and gains are not subject to prior tax. However, we should stress again that these considerations should generally not be the principal driver of the choice of legal form.

3.13 If the parent public body has charitable status, and an ESCO is established so as to ensure that the status is preserved, then if dividends or distributions are paid to the parent body, gift aid relief should be obtainable.

3.14 Mention of charitable status leads to a question sometimes asked about ESCOs as to whether they themselves could have charitable status. That status confers significant advantages, including exemption from certain taxes and relief from business rates. In practice, we think it unlikely that an ESCO could be charitable. For an entity to be charitable, it will require to fall within one of the charitable purposes as set out in section 7 of the Charities and Trustee Investment (Scotland) Act 2005 and the related charitable tests (on which the Office of the Scottish Charity Regulator has published extensive and useful guidance) and will require to be accepted as charitable for tax purposes by HMRC. One of the charitable purposes under the 2005 Act relates to the relief of poverty. It is therefore conceivable that an ESCO formed to provide energy services for that express purpose might be able to obtain charitable status. However, this point has not yet been tested.

3.15 Where an entity is a charity, those who manage its affairs are referred to as "charity trustees". The duties of charity trustees are set out in the 2005 Act and include various reporting requirements. Charities which are companies established under the Companies Act 2006 are subject to regulation both under companies legislation and charities legislation so their boards of directors will, in addition to the duties imposed on directors, also have the additional duties which are imposed on charity trustees.

**Profit or Not for Profit**

3.16 The distinction between entities operating with a view to making profit for members and those not seeking to make profit for members (i.e. which wish to reinvest any surpluses) has been discussed in paragraphs 1.10 to 1.14.

3.17 There are specific entities which are commonly used for not for profit activities. This is partly convention, as in the case of companies limited by guarantee. However, some legal forms may be, by definition, required to carry out their operations other than with a view to making a profit for
members. Such legal forms are usually required to have provisions in their constitutions specifically preventing the distribution of profits to members or distribution of assets to members in the event of dissolution. These provisions are known as an “asset lock” and will be considered where relevant to the particular entities discussed in this section.

3.18 If an ESCO is to be established on a “not for profit” basis, it should be borne in mind that some legal forms which have been designed solely with this in mind can be inflexible. Once created, some cannot be converted to other legal forms and their assets cannot be distributed to members. It is conceivable that the use of such a legal form could be suitable for part of an ESCO’s activities. For example, a community benefit society, considered at paragraphs 3.58 to 3.63, could be established by the ESCO itself to administer a community project as this may provide a useful forum for stakeholder/resident involvement. However, it would only be in limited circumstances that such an entity would be the principal legal form chosen for the ESCO itself. It could conceivably be appropriate where the ESCO solely concerns a community project, and where alleviating fuel poverty is the key driver.

**Financing Opportunities**

3.19 It may well be intended that an ESCO should seek finance from external sources in order to provide its services or implement its projects. There are, broadly, three types of finance available: debt, equity and project/asset finance. Debt finance involves the lender providing a sum of money in return for an obligation to repay that sum with interest. The borrower may be required to grant securities which, if the borrower cannot repay the debt, will allow the lender to realise assets of the borrower in order to satisfy the debt. Guarantees from other bodies, such as the parent public body, may be required to secure the repayment obligation.

3.20 Equity finance involves the lender investing by taking shares in the ESCO. This will then entitle the investor to participate in the distribution of profits through dividends. The share structure needs to allow this: it is possible to create different classes of shares, some of which may not carry an entitlement to dividends. An equity investor may be given a class of share with preferential rights to interest or dividend payment. An equity investor is also likely to enter into an agreement with the entity setting out the terms and conditions of the investment and conferring rights on the investor, for example to appoint directors, to approve the entity’s business plan, and so on.

3.21 Finally, there is project finance, where the income stream generated by a project is the primary source of repayment of the loan provided by a lender. Security will be taken over the contract which provides that income stream and also over the other assets of the borrowing entity. There is no recourse (for example to the parent public body) beyond the borrower’s assets. This is a relatively common form of financing for renewable energy projects. Asset finance operates on similar principles, but tends to be used for smaller-scale projects where a single asset (a biomass boiler supplying a school, for example) is key.

3.22 Certain legal forms are more suitable for financing than others. Those without shares cannot offer equity finance. Even if a body does have shares, provisions in its constitution may prevent the
distribution of profits thus preventing use of this source of finance. Most legal forms will be able to undertake an obligation to repay a debt, allowing debt finance. However, certain legal forms (such as companies and limited liability partnerships) can offer a greater range of security types to secure this obligation thereby making them more attractive to lenders. Whether project finance is available will be dependent on similar considerations, but also on the particular projects envisaged for the ESCO.

Legal Forms and Methods of Formation

3.23 The Table below sets out the various legal forms considered and summarises their suitability for use as ESCOs by reference to the various attributes considered in the discussion, namely, separate legal personality, limited liability, suitability for financing, ability to grant security, for profit/not for profit, flexibility (in terms of ease of exit) and tax transparency. The Table should be read only as a summary and not in substitution for the detailed discussion. In particular, some of its content has necessarily taken a generalised approach. For example, a partnership could be operated on a not for profit basis if the partners chose to do so, but in general terms a partnership is a for profit legal form. For completeness, most possible legal forms are considered in the following paragraphs. Some that are discussed would not be suitable for use as an ESCO, but they are mentioned because they may be familiar in other energy-related contexts or because they may come up in discussion about energy services requirements and community energy projects. The legal forms that are most likely to be suitable for use as ESCOs are:

3.23.1 companies limited by shares (paragraphs 3.84 to 3.93);

3.23.2 companies limited by guarantee (paragraphs 3.94 to 3.98); and

3.23.3 and limited liability partnerships (paragraphs 3.78 to 3.83).

Co-operative societies, community benefit societies and community interest companies could, in some limited circumstances, also be used.
<table>
<thead>
<tr>
<th>Type of Legal Form</th>
<th>Separate Legal Personality</th>
<th>Limited Liability</th>
<th>Suitability for Financing</th>
<th>Ability to Grant Security</th>
<th>Profit/Not for Profit</th>
<th>Flexibility (Ease of Exit)</th>
<th>Tax Transparent</th>
<th>Overall Suitability for use as an ESCO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unincorporated Association</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Not for Profit</td>
<td>Yes</td>
<td>No</td>
<td>Unsuitable</td>
</tr>
<tr>
<td>Trust</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Limited</td>
<td>Either</td>
<td>No</td>
<td>No</td>
<td>Unsuitable</td>
</tr>
<tr>
<td>Scottish Charitable Incorporated Association</td>
<td>Yes</td>
<td>Yes</td>
<td>Limited</td>
<td>Limited</td>
<td>Not for Profit</td>
<td>No</td>
<td>No</td>
<td>Unlikely to be suitable</td>
</tr>
<tr>
<td>Co-operative Society</td>
<td>Yes</td>
<td>Yes</td>
<td>Good</td>
<td>Full</td>
<td>For Profit</td>
<td>Yes</td>
<td>No</td>
<td>Potentially suitable for community schemes</td>
</tr>
<tr>
<td>Community Benefit Society</td>
<td>Yes</td>
<td>Yes</td>
<td>Limited</td>
<td>Full</td>
<td>Not for Profit</td>
<td>No</td>
<td>No</td>
<td>Potentially suitable for community schemes</td>
</tr>
<tr>
<td>Ordinary Partnership</td>
<td>Yes</td>
<td>No</td>
<td>Limited</td>
<td>Limited</td>
<td>For Profit</td>
<td>Yes</td>
<td>Yes</td>
<td>Unsuitable</td>
</tr>
<tr>
<td>Limited Partnership</td>
<td>Yes</td>
<td>Yes for limited partners; no for the general partner</td>
<td>Limited</td>
<td>Limited</td>
<td>For Profit</td>
<td>Yes</td>
<td>Yes</td>
<td>Unsuitable</td>
</tr>
<tr>
<td>Limited Liability Partnership</td>
<td>Yes</td>
<td>Yes</td>
<td>Full</td>
<td>Full</td>
<td>For Profit</td>
<td>Yes</td>
<td>Yes</td>
<td>Suitable</td>
</tr>
<tr>
<td>Company Limited by Shares</td>
<td>Yes</td>
<td>Yes</td>
<td>Full</td>
<td>Full</td>
<td>Either</td>
<td>Yes</td>
<td>No</td>
<td>Suitable</td>
</tr>
<tr>
<td>Company Limited by Guarantee</td>
<td>Yes</td>
<td>Yes</td>
<td>Good</td>
<td>Good</td>
<td>Not for Profit</td>
<td>No</td>
<td>No</td>
<td>Suitable</td>
</tr>
<tr>
<td>Unlimited Company</td>
<td>Yes</td>
<td>No</td>
<td>Limited</td>
<td>Full</td>
<td>Either</td>
<td>Yes</td>
<td>No</td>
<td>Unsuitable</td>
</tr>
<tr>
<td>Community Interest Company</td>
<td>Yes</td>
<td>Yes</td>
<td>Limited</td>
<td>Full</td>
<td>Not for Profit</td>
<td>No</td>
<td>No</td>
<td>Potentially Suitable</td>
</tr>
</tbody>
</table>
**Unincorporated Association**

3.24 The term “unincorporated association” is used to refer to a broad range of groups, clubs and organisations. Its key features are that two or more individuals are required for formation and that the common purposes which bring these individuals together are not commercial purposes.

3.25 To form an unincorporated association there is no more required than two or more persons and a set of rules. Its members are usually part of a particular community or group and they elect a management committee consisting of a president, treasurer and secretary. This is, however, not necessary as there are few regulations specific to this legal form.

3.26 An unincorporated association does not have separate legal personality and therefore is not a separate entity from the individuals which comprise it. This means that it cannot enter into contracts or hold property. Any contracts entered into will need to be in the name of all or some of its members who are therefore subject to personal liability.

3.27 The tax treatment of a trading unincorporated association is the direct opposite of its legal status. It is likely that an ESCO structured as an unincorporated association would be subject to corporation tax on any profits and gains arising at the association level. An unincorporated association may be able to claim tax reliefs and capital allowances as outlined in paragraph 3.90. A local authority association will not be subject to UK corporation tax. However, this will only be the case if the members of the association are local authorities (or their appointed representatives) and the association exists solely to further the interests of the local authorities themselves. It is unlikely that an ESCO would qualify for this treatment.

3.28 An unincorporated association cannot be carried on for a commercial purpose, so it cannot be used to make a profit for its members.

3.29 An unincorporated association would never be attractive to lenders. It does not permit equity finance, as it does not have any shares, or debt finance of any significance, because it does not have any separate existence beyond its members.

3.30 Given all of these issues, an unincorporated association is very unlikely to be suitable for use as an ESCO.

**Trust**

3.31 A trust is a relationship in which a person (or group of persons) is placed under a duty to hold property for defined purposes and for the benefit of another person or group of persons. A trust involves a tripartite relationship between the truster (the person who wishes to set up the trust), the trustee (the person(s) who will administer the property), and the beneficiary (the person(s) for whom the property is held). The truster can also be the trustee, in which case there are additional requirements for formation. To facilitate comparison with other legal forms, it could be said that the beneficiaries of the trust are equivalent to the members (e.g. of a company) and the trustees are...
equivalent to the management. The principal legislation regulating trusts is the Trusts (Scotland) Act 1921.

3.32 For a trust to be formed, there must be a declaration of trust. This document, which is usually in writing but need not be, sets out the trust purposes, the trustees and their powers, the beneficiaries and the trust property. The trust property must be transferred to the trustees for the trust to come into existence. In the case of a trust where the trustor is also the trustee, there is no requirement for a transfer of property. However, the declaration of trust, which in this instance does require to be in writing, must be communicated to the beneficiaries for the trust to be formed.

3.33 Trusts are widely used for a variety of purposes due to their flexibility. The purposes for which property is held are defined by the declaration of trust and can be tailored according to what is required by the trustor.

3.34 A trust is managed solely for the benefit of its beneficiaries in accordance with the particular purposes set out in the declaration of trust. However, its beneficiaries can be classified broadly, as in the case of a charitable trust. A trust is not really about profit or not for profit: it is about providing benefit to its beneficiaries. That benefit may be financial, but it could equally be in kind, such as the availability of facilities.

3.35 Despite the flexibility of the form, there are strict obligations imposed on trustees. Trustees must use the trust property for the purposes defined in the declaration of trust. They must administer the trust honestly and in good faith. They must always put the beneficiaries’ interests before their own when dealing with the trust. If breached, these duties can result in personal liability of the trustees, enforceable by the beneficiaries.

3.36 A trust does not have separate legal personality. Therefore, there is potential personal liability on the part of the trustees when dealing with third parties. However, the trustee holds the trust property in a separate “patrimony” (i.e. the trust property is deemed to be in a legally separate class to other property held by the trustee) and as a result the trust property cannot be claimed by the trustee’s personal creditors. Therefore, if a trustee is personally sequestrated (declared bankrupt), the trust property will not be included in the sequestration.

3.37 The taxation of trusts is a complex area of law and depends on the exact nature of the trustees’ powers and legal residence, the trust purposes, and the beneficiaries’ rights. Trusts can be liable to UK income tax, capital gains tax, stamp duty land tax or (replacing this in Scotland from 1 April 2015) land and buildings transaction tax, and corporation tax, depending on their nature. Specific tax advice should be sought when considering using a trust.

3.38 Generally, the trustees are liable to report any tax due at the trust level to HMRC and to meet it out of the trust funds. Trust beneficiaries may also be liable to income tax on an arising basis (i.e., when the income is received by the trust, rather than when it is distributed to them). Beneficiaries who receive a distribution from a trust may be able to claim a trust tax credit depending on the amount of tax paid by the trust and the beneficiaries’ own tax status.
As with unincorporated associations, a lender will need a more formalised structure than a trust. It cannot offer equity finance due to the lack of shares. If the trustees have the power to enter into loan agreements in the declaration of trust, they would be able to use debt financing and the obligation to repay the loan would only be binding on the trust assets.

The lack of limited liability, the obligations imposed on trustees and lack of financing opportunities mean that trusts are unlikely to be a recommended legal form for an ESCO. They are primarily used for personal or public/charitable purposes. They are sometimes used by communities for the management of funds or property for the benefit of that community. However, if the community wanted to take forward an energy services project (such as a wind turbine or district heating scheme), it should do this through a separate special purpose vehicle, not through a trust.

Scottish Charitable Incorporated Organisation

The Scottish Charitable Incorporated Organisation (SCIO) is a relatively new legal form. It is a special type of charitable status entity. SCIOs were created by the Charities and Trustee Investment (Scotland) Act 2005 and the Scottish Charitable Incorporated Organisations Regulations 2011. An SCIO must be a charity and like all charities, SCIOs are regulated by the Office of the Scottish Charity Regulator (OSCR).

In comparison to unincorporated associations and trusts, the formation procedure for SCIOs is more complex. An application for incorporation and the proposed SCIO constitution must be sent to OSCR. The constitution must contain a number of rules including the SCIO’s name and charitable purposes, membership rules, charity trustee rules, the organisational structure of the SCIO, procedures for meetings, and a statement as to how the SCIO will use any surplus assets at the time of its dissolution.

The application must be made by two or more natural persons (i.e. individuals) who will then become the first members of the SCIO. Later members can be corporate bodies. An SCIO must have at least two members and three charity trustees. The charity trustees can also be members and may be individuals or corporate bodies.

The charity trustees are the managers of the SCIO (like the board of directors in a company). They are subject to duties to act in the interests of the charity, to ensure that the charity operates in a manner consistent with its objects, to act with the care and diligence which is reasonable to expect of a person who is managing the affairs of another person and to ensure that the charity complies with legislation.

Some of the obligations placed on the charity trustees are also placed on the members of an SCIO. A member must act in the interests of the SCIO and ensure the SCIO acts in a manner consistent with its charitable purposes. Membership cannot be transferred.

It is possible for an existing body such as a trust or company to convert into an SCIO. However it is not then possible for an SCIO to convert into another legal form or amalgamate with another body. To be removed from the SCIO Register, the SCIO must be dissolved.
3.47 An SCIO has a separate legal personality and therefore can enter into contracts and hold property. Further, its members and its charity trustees benefit from limited liability. An SCIO is not appropriate to use as a vehicle to generate profit for members, because is a requirement of charitable status that profits are not distributed for non-charitable purposes.

3.48 As a charity, an SCIO will generally not pay tax on its income and gains, and should obtain relief from business rates.

3.49 Despite its separate legal personality an SCIO would not be an attractive form for lenders. It cannot grant a floating charge. This is a type of security that is available to some entities, such as companies, that provides security over the whole property and undertaking of the entity. An SCIO does not have shares and therefore equity finance will not be available.

3.50 Although the separate legal personality and limited liability of the SCIO are advantages, the degree of regulation of this form, together with the requirement of charitable status, and the requirement that only natural persons may apply for creation of an SCIO, mean that an SCIO is unlikely to be appropriate for use as a public body ESCO. On charitable status and ESCOs generally, see paragraph 3.14.

Co-operative Society

3.51 The Co-operative and Community Benefit Societies Act 2014 came into force on 1 August 2014 and replaced industrial and provident societies with two legal forms: the co-operative society (CS) and the community benefit society (CBS). Collectively they are referred to as “registered societies”.

3.52 To be registered as a CS, a body must carry on a business, industry or trade. It must have at least three members and must have rules for a number of matters including the objects of the society, membership, meetings and voting, and application of profits. The members will usually elect officers who will be involved in the management of the body.

3.53 To form a CS, an application for registration is sent to the Financial Conduct Authority. A CS must normally fulfil a number of conditions. There should be community of interest, namely a common economic, social or cultural need, or an interest shared by all the members of the society. The business should be run for the benefit of the members. The society should be controlled by its members and each member should have equal control. This means that the principle of ‘one member, one vote’ must apply, so that a member with 1,000 shares will have one vote, as will a member with only one. If profits are distributed, they should be paid to members in accordance with the extent to which they have participated in its business or used its services. If a registered society no longer meets these conditions, its registration can be cancelled by the Financial Conduct Authority.

3.54 A CS has a separate legal personality and its members also benefit from limited liability. It is a requirement that a CS is run for the benefit of its members and therefore it is likely to be a for profit organisation. A CBS is the “not for profit” option.
A CS is treated as a company for tax purposes and will be liable to corporation tax on any profits and gains. Depending on the trading activities of the organisation, exemptions, reliefs and allowances may apply (similar to a company limited by shares – see paragraph 3.90). Detailed advice should be taken on which of these are available.

The separate personality of a CS and level of formalisation of the body mean it can be appropriate for funding. A CS can offer both debt and equity financing, although the return which is permitted to be offered to equity investors is limited. A CS can also grant a floating charge which is a useful addition to the range of securities which can be offered to lenders.

A CS is a potential option for use as an ESCO, although not an obvious choice for a public body. It may be more suited to a community which seeks, for example, to provide energy services (such as electricity from wind turbines) to its members. It has the advantages of separate legal personality and limited liability. Its attributes make it a feasible structure for a variety of financing options. However, the requirement of three members is not suitable where a public body wishes to establish a wholly-owned ESCO. The one member, one vote requirement may also be inappropriate if different voting arrangements are required.

Community Benefit Societies

For an entity to be registered with the Financial Conduct Authority as a CBS, it must be run for the benefit of people who are not members of the society and in the interests of a community at large. It would be unusual for a CBS to issue more than nominal share capital. A CBS must also have a “statutory asset lock” in its rules. That is, the society’s rules must not permit the distribution of profits or assets to its members. They must also not permit assets to be distributed to members on winding-up or on dissolution. Instead any available assets must be transferred to a body with similar objects or to a body with similar charitable or philanthropic purposes.

Other requirements for registration of a CBS are the same as for a CS: the society must carry on a business, industry or trade, have at least three members and must provide rules for the matters listed in paragraph 3.52.

A company registered under the Companies Act 2006 may convert into a CBS and vice versa, which provides a measure of flexibility. However, it is not possible for a CBS to convert to a CS or vice versa. A CBS has a separate legal personality and also limited liability.

A CBS is treated as a company for tax purposes and will be liable to corporation tax on any profits and gains. Depending on the trading activities of the organisation, exemptions, reliefs and allowances may apply as outlined in paragraph 3.90. Detailed advice should be taken on which of these are available.

A CBS can accept debt financing and can also grant a floating charge to a lender seeking security. Although it has shares, the requirement that a CBS operates for the benefit of the community and the prohibition on distribution of profits to members make equity finance problematic.
3.63 As with a CS, a CBS is a potential option for use as an ESCO, although again it is not an obvious choice for a public body. As with a CS, it may be more suited to use by a community. While it has the advantage of separate legal personality and limited liability, its attributes make it less feasible for external funding and it is not a suitable entity where it is desired to distribute profit to members, given the asset lock requirement.

*Ordinary Partnership (1890 Act)*

3.64 The term "partnership working" is a popular term for collaboration between organisations which share a particular goal. However, this is an extended use of "partnership" and does not usually refer to the legal concept of partnership. In its legal sense, an ordinary partnership is defined as a business run by two or more persons in common with a view to profit. This type of partnership is governed by the Partnership Act 1890 and is a well understood legal form. The persons that form the partnership may be individuals or corporate bodies. A partnership under the 1890 Act must be distinguished from a limited partnership (discussed at paragraphs 3.74 to 3.77), and a limited liability partnership (discussed at paragraphs 3.78 to 3.83).

3.65 There are no formalities for the creation of an ordinary partnership and one can come into being without a written agreement. However, a partnership agreement should always be drafted to document the partnership. Its content is flexible and can be adapted to the requirements of the partners and the intended operations the partnership seeks to undertake. Management is also flexible. Usually the partners would also be the managers of the partnership but external appointees can be involved as well.

3.66 In comparison to other bodies such as SCIOs, community benefit societies and co-operative societies, there are few regulatory constraints on partnerships. There is no independent regulator, no registration body and no public reporting obligations.

3.67 An ordinary partnership is, under Scots law, a separate legal person and can, therefore, enter into contracts and hold property. However, despite being having legal personality, the partners of the partnership do not benefit from limited liability. Each partner has joint and several personal liability, along with the other partners, for the debts and obligations incurred in the ordinary course of the partnership.

3.68 A potential advantage of the partnership form is that it is "tax transparent" for the purpose of direct taxes (income tax, capital gains tax and corporation tax). This means that partners are taxed individually on the share of the partnership’s profits and gains on an arising basis and depending on their own tax status. As public bodies generally do not pay income tax, there could be a reduction in tax liability of the ESCO in comparison with companies, which are liable to pay corporation tax.

3.69 Any partners liable for tax on their share of the partnership profits would be able to benefit from capital allowances as outlined in paragraph 3.90.

3.70 Detailed stamp duty land tax and (replacing this in Scotland from 1 April 2015) land and buildings transaction tax rules apply to acquisitions of land by partnerships from their members.
Due to the requirement of at least two members, a partnership would require, in addition to the public body, another body which was entitled to participate in the profits of the business. This could be a company with a very small percentage share, such as 1%, in the profits. This structure might, however, depending on the circumstances, be seen as unnecessarily cumbersome by a public body seeking to establish a wholly-owned ESCO. It could of course work perfectly well if there are two real participants, for example two public bodies jointly pursuing an ESCO project.

A partnership is investible. It can offer debt financing but cannot, due to the lack of shares, offer equity financing. It cannot grant a floating charge and the lack of limited liability means that partners are liable for its debts along with the partnership.

The flexibility of partnership, its low level of regulation, legal personality and potential tax advantages are positive features of an ordinary partnership. However, the lack of limited liability of the partners is likely to rule out its use for the establishment of an ESCO.

Limited Partnership (1907 Act)

Limited partnerships (LPs) are governed by the Limited Partnerships Act 1907. They share many characteristics with ordinary partnerships. There must be two or more members who carry on a business with a view to a profit. LPs have a separate legal personality and are tax transparent.

However, in an LP, there are two classes of partner: limited and general. Both classes have to be present. The general partner is personally liable for the business debts of the partnership. On the other hand, the limited partner benefits from limited liability. This partially mitigates the main disadvantage of the ordinary partnership form. The general partner’s personal liability can also (i.e. at one remove) be circumvented by the general partner being a company limited by shares.

An LP could in theory be used as an ESCO. However, in order to ensure no personal liability, another legal body must be added to an already complex entity. In any event, the limited liability partnership form (discussed next) fully achieves limited liability.

LPs are taxed on the same basis as ordinary (1890 Act) partnerships (see paragraphs 3.68 to 3.70). However, there are specific anti-avoidance provisions regarding the allocation of profits within LPs, and advice should be taken on these as necessary.

Limited Liability Partnership

Limited liability partnerships (LLPs) are governed by the Limited Liability Partnerships Act 2000 and the Limited Liability Partnerships Regulations 2001. An LLP is similar in many ways to an ordinary partnership. Again, it is defined as two or more people carrying on a business with a view to profit. LLPs are regulated by a partnership agreement (referred to as a members’ agreement). The content of the agreement, and the internal management of an LLP, is entirely flexible. An LLP has separate legal personality and is tax transparent.
3.79 However, a notable difference is that LLPs fully benefit from limited liability. This means that the members of the LLP are not, in the ordinary course of events, subject to personal liability and instead the LLP itself is primarily liable for the debts and obligations of the business.

3.80 The price of an LLP having limited liability is that it has the same reporting obligations as a company so must submit an annual return and accounts every year to the Registrar of Companies. To form an LLP an application for incorporation must be sent to the Registrar of Companies.

3.81 The position as to investibility of an LLP is similar to that of a general partnership, but with the added possibility that an LLP can competently grant a floating charge, i.e. a security over all of its assets. In the case of an LLP, the individual partners will not be liable for its debts, although it should be noted that lenders are likely to seek personal guarantees when funding a newly-established entity.

3.82 The element of limited liability for all members of the LLP make this form a feasible option for use as an ESCO. The requirement of having at least two members may be cumbersome, although can be addressed through the use of some other subsidiary vehicle by a public body where the intention is to establish an LLP which is to be wholly-owned. Alternatively, if there are more than two public bodies involved, this ceases to be an issue. An LLP may be suitable for use where an ESCO is to be established with a view to making profit for distribution to its members. It is not particularly suitable if that is not the intention (i.e. in not-for-profit initiatives).

3.83 LLPs are taxed on the same basis as ordinary (1890 Act) partnerships (see paragraphs 3.68 to 3.70). However, there are specific anti-avoidance provisions regarding the allocation of profits within LLPs, and advice should be taken on these as necessary. In addition, if an LLP does not carry on a trade for six months then it loses its tax transparency and will instead be subject to corporation tax at the LLP level.

Company Limited by Shares

3.84 A company limited by shares is the most popular choice for those wishing to establish a business entity. It is a straightforward and well understood legal form. The law regarding companies is contained in the Companies Act 2006.

3.85 Forming a company takes little time and is low cost. A company is formed by submitting the required incorporation documents to the Registrar of Companies. There are various reporting obligations on a company, among which are that an annual return and accounts must be sent to the Registrar of Companies on a yearly basis.

3.86 A company is owned by its shareholders (or members), and managed by its directors. To set up a company, only one director and member is required and they can be the same person. The constitutional documents of the company are its articles of association and memorandum. The content of the articles of association, where the majority of the rules governing the company are found, is flexible and can be tailored to what is required by the public body. There are few restrictions on the operations that a company can be used to carry out.
3.87 Matters which are usually addressed in the articles of association include voting, distribution of profits, membership and objects (although objects are not necessary). Therefore, if desired, the articles could restrict the functions of the company to particular purposes, provide that profits are to be distributed only on certain conditions, or that certain members are to be allocated greater voting power than others. These provisions can be amended by members’ resolution if they are found to be no longer appropriate.

3.88 A company is a separate legal person. It can hold property and enter into contracts. The members benefit from limited liability. Members only have to contribute, in the event of insolvency of the company, to the unpaid amount (if any) on the shares which they hold. A company limited by shares will usually be for profit.

3.89 A UK resident company is liable to corporation tax on its profits and gains. Shareholders who are liable to income tax will pay further tax on any distributions from the company at specific dividend rates.

3.90 Although the use of a company structure may be seen as less tax efficient than a partnership model, companies (and other trading entities subject to tax) can benefit from various tax reliefs (depending on activities and expenditure) and significant capital allowances deductions against their taxable profits. This may be important for a public body. Until January 2016, a temporary annual investment allowance of £500,000 is available against expenditure on plant and machinery (from January 2016 it will reduce to £25,000 a year). In addition, enhanced first year allowances are available on many items of energy efficient plant and machinery (including, for example, energy efficient biofuel plants).

3.91 The form of a company is familiar and attractive to investors and financiers. They can be offered shares in return for investment, thereby giving the opportunity of equity finance in addition to debt finance. A company limited by shares can also grant floating charges.

3.92 Due to the flexibility of the content of its articles of association, a company can be adapted to a variety of different purposes. In comparison to bodies such as an SCIO or registered societies (CS or CBS) there are limited requirements as to the content of its constitutional documents. Although a company pays corporation tax and is not tax transparent like partnerships and LLPs, there is no requirement for at least two members and no requirement to run a company with a view to a profit for its members, although of course most companies are run for this purpose.

3.93 If it is anticipated that the ESCO may distribute profits to its member(s), then a company limited by shares is an appropriate form to use. This may be particularly so where the ESCO has been established to take forward a particular project or projects, with or without project finance being made available. The use of a company limited by shares will likely also be the preferred method of ESCO establishment for a public body which is a charity, and which wishes to carry on ESCO activities without risking loss of its charitable status (i.e. through the use of a trading subsidiary).
Company Limited by Guarantee

3.94 A company limited by guarantee has much in common with a company limited by shares. It is regulated by the Companies Act 2006. It is formed by application for registration to the Registrar of Companies and has annual reporting and accounting obligations. Its governing documents are its memorandum and articles of association. It is a separate legal person and its members benefit from limited liability.

3.95 The principal difference between a company limited by shares and one limited by guarantee is that the latter does not have any shares. Instead, the members’ liability on a winding-up is limited by the “guarantee” they have given. This is usually for a nominal amount such as £1. The absence of shares means that it cannot offer shares to investors and therefore equity financing opportunities are not available.

3.96 Companies limited by guarantee are often set up for social, non-commercial or charitable purposes. As a result, it is usual for restrictions to be placed on profit distribution to members (an asset lock) in the articles of the company. However, this is not a requirement of the legal form and a company limited by guarantee is not legally prohibited from distributing its profits in terms of the Companies Act 2006.

3.97 Where a public body is considering the establishment of an ESCO and where it is not intended that profits should be distributed to the parent public body as member, a company limited by guarantee may well be an appropriate form to adopt. It can be established with a view to benefiting, for example, the citizens of a particular area, as is the case with Aberdeen Heat & Power Company Limited, which was established for the benefit of the citizens of Aberdeen. While that is ostensibly a community benefit purpose, from the perspective of a public body, a company limited by guarantee offers greater flexibility than a CS or a CBS which have, as discussed, rather stricter requirements as to form.

3.98 Companies limited by guarantee are taxed on the same basis as companies limited by shares (see paragraphs 3.89 and 3.90). However they may not benefit from some tax reliefs available when group structures are used. This is because, as a company limited by guarantee does not have shares, it is not treated for tax purposes, as forming part of a group.

Unlimited Company

3.99 An unlimited company is also regulated by the Companies Act 2006 and is a separate legal person. It is also formed by application for registration to the Registrar of Companies.

3.100 However, its members have no limit to their personal liability. As a result of this, the reporting obligations are less onerous than for companies limited by shares. For example, annual accounts do not need to be filed with the Registrar of Companies.

3.101 Unlimited companies are taxed on the same basis as companies limited by shares or by guarantee (see paragraphs 3.89, 3.90 and 3.98).
3.102 Unlimited companies are rare in practice. They are primarily used where a corporate vehicle is wanted, where the lack of limited liability is not an issue, but where "privacy" is (that is, the lack of a requirement to file accounts). Because of its unlimited liability, this form would not be recommended for use as an ESCO.

Community Interest Company

3.103 There is a particular type of company called a community interest company (CIC). It was created to provide a legal form which can be used by, or for, non-charitable social enterprises. Like other companies, it is governed by the Companies Act 2006 but also by the Companies (Audit, Investigations and Community Enterprise) Act 2004 and the Community Interest Company Regulations 2005. CICs are regulated by the Office of the Regulator of Community Interest Companies.

3.104 To be accepted for registration as a CIC, the purpose of the company must be to use its assets, income and profits for the benefit of a community. A company will satisfy the community interest test if a reasonable person would consider its activities are carried on for the benefit of the community. Companies that are political parties or engaged in political activities cannot be CICs.

3.105 The articles of association of a CIC must contain an asset lock prohibiting it from transferring assets other than at full value unless the transfer is in a narrow range of permitted transfers, such as to another asset-locked body. If dividends are to be paid, they must generally be subject to a cap of 35% of profit available. On winding-up or dissolution, any surplus assets must be transferred to another asset-locked body.

3.106 A CIC can be formed by converting an existing company or by incorporating a new company. A community interest statement is sent to the Registrar of Companies which is then forwarded to the Regulator for registration as a CIC, provided the company meets the requirements set out in paragraph 3.104. Charitable status is not available for CICs.

3.107 CICs are taxed on the same basis as companies limited by shares (see paragraphs 3.89 and 3.90). A charity which becomes a CIC will lose its charitable status for tax purposes and will cease to qualify for any charity tax exemptions.

3.108 A CIC may be financed in the same way as a company limited by shares, but the restrictions on dividend payments make the form less attractive than a company limited by shares. In terms of appropriateness for use as an ESCO with public body participation, it does not offer any obvious benefits beyond those which can be obtained through the use of a company limited by guarantee. That said, the "badge" (i.e. the name CIC) and the limited ability to distribute profits might make the form suitable for community projects where there are both social benefits being provided but also income (installation of solar PV on tenanted properties might provide an example).
Joint Ventures

3.109 A joint venture is not a legal form as such. There can be two types. The first is a contractual joint venture, which is a term used where two or more parties agree that they will work together, each bringing different benefits and/or assets, to a common end. The terms of the venture are set out in an agreement between the parties. In the context of an ESCO, one party (for example a public sector body) might contribute land, or assist in making available property rights, while the other (often a private sector body) might agree to construct, say, an energy centre and heat network to serve various properties. These could include properties of the other party but could equally include third party properties. The agreement will contain provisions relating to liability for costs and, possibly, the sharing of profit. In establishing a contractual joint venture, care may need to be taken to avoid a partnership (in the legal sense of that word) coming into being.

3.110 The second type of joint venture is a corporate joint venture. This could also be used to implement a project such as that described in the previous paragraph. The difference is, however, that the parties to the joint venture choose to implement it through a corporate vehicle of some sort, that is, an entity with a separate legal personality and with limited liability. There will still need to be an agreement among the members of that vehicle but unlike a contractual joint venture, the vehicle established will likely hold the relevant assets and liabilities. The individual joint venturers’ participations in that vehicle (such as shareholdings) will be a matter for discussion and agreement.

3.111 Where a public body has concluded that it wants significant private sector involvement in an ESCO, but also that it wants to participate in a project itself, a joint venture ESCO arrangement (whether contractual or corporate) may represent a suitable way forward. Although it is now a wholly-owned subsidiary, Woking Borough Council originally established Thameswey Energy Limited as a joint venture entity with a Danish energy services provider.\(^\text{10}\)

\(^{10}\) See further at [http://www.thamesweygroup.co.uk/thameswey-group-companies/thameswey-energy-ltd/](http://www.thamesweygroup.co.uk/thameswey-group-companies/thameswey-energy-ltd/).
4 **Governance issues for an ESCO**

4.1 This section of the Guidance considers governance of a public body established ESCO. In its broadest sense, governance is about how a public sector body ensures that it is doing the right things, in the right way, for the right people, in a timely, inclusive, open, honest and accountable manner. It comprises the systems, processes, cultures and values by which the body is directed and controlled and through which it accounts to and engages with its stakeholders/customers. These words are (slightly) paraphrased from "Delivering Good Governance in Local Government" published by SOLACE/CIPFA in 2007\(^\text{11}\). Although the context is local government these principles have wider application.

4.2 A public body which establishes an ESCO must consider governance. A starting point will be the governance to which the public body itself is subject. It may be neither necessary nor appropriate to replicate all aspects of that within the ESCO, but equally there is no need to start from scratch.

4.3 It is beyond the scope of this Guidance to consider the governance of all public bodies which may establish ESCOs. However, there are some documents which it is worth mentioning. For local authorities which establish ESCOs, regard should be had to a Report published by Audit Scotland in June 2011: “Arm’s Length External Organisations (ALEOs): Are You Getting it Right?” This Report notes that there were, at the time of publication, around 130 major ALEOs in Scotland. It also points out that an options appraisal should always be carried out before any ALEO is established (on which, see paragraphs 2.2, 2.3 and 2.10). The Report notes, with approval, six principles in relation to ALEOs from a 1996 Code of Guidance published by the Accounts Commission and COSLA. Those principles are that a local authority should:

4.3.1 have a clear purpose in funding an ALEO;

4.3.2 set out a suitable financial regime;

4.3.3 monitor the ALEO’s financial and service performance;

4.3.4 carefully consider representation on its Board;

4.3.5 establish limits to involvement in the ALEO; and

4.3.6 maintain audit access to support accountability.

4.4 The Report makes clear that strong and effective governance is required from the outset, and that the business practices and standards which the ALEO is to observe should be specified. There should be an agreement between the ALEO and the local authority, which will set out what funding and other resources the local authority will provide to the ALEO and what it will expect from the ALEO in return.

\(^{11}\) Links to the sector-specific documents referred to in this section can be found at paragraph 4.58.
4.5 The Report contains useful analysis of governance issues to be considered and illustrates some of these with examples taken from existing practice.

4.6 With reference to the University sector, there is the Scottish Code of Good HE Governance, published in July 2013. This Code consists of main principles supported by guidelines and examples of good practice. While it is directed at the governing bodies of Universities, it contains some principles which are likely to be of relevance to any ESCO that may be established by a University. These include principles relating to conduct of members, frequency of meetings, preparation of a statement setting out or approving the body’s mission, strategic vision and long-term business planning, the requirement that governing body members include a balance of skills and experience, and annual reviews of effectiveness and of performance.

4.7 For the further education sector, there is a Code of Governance for Scotland’s Colleges, published in December 2014. Again, as with the University sector, some of the principles in this Code may be considered appropriate for use within an ESCO that may be established by a further education institution.

4.8 With reference to registered social landlords/housing associations, the Scottish Housing Regulator published its Framework “Regulation of Social Housing in Scotland” in February 2012. Section 5 of this addresses regulatory standards of governance and financial management. In addition, the Scottish Federation of Housing Associations issued a Code of Conduct for Governing Body Members in July 2014 (available to members of the Association).

4.9 The analysis of ESCO governance in this section of the Guidance should be read alongside the governance principles and documentation which apply to the type of public body which has established the ESCO in the first place. It should also be read alongside that public body’s own specific governance documentation. We are aware, for example, that a number of local authorities have governance documents and structures around ALEOs. These should generally apply to ESCOs as they would to any other ALEO. The analysis which follows is, necessarily, general: the specific circumstances of the ESCO, in the sense of what it has been established to do, must always be considered.

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**Key Aspects of ESCO Governance to be Considered**

- The “objects” of the ESCO - what it has been established to do;
- How the ESCO will implement those objects - the business planning process;
- How and by whom the ESCO will be managed;
- Policies and procedures for the management and monitoring of the ESCO;
- Other policies and procedures; and
- The relationship between the ESCO and its parent public body or bodies.
As discussed in paragraphs 4.2 to 4.8 an ESCO should not be established and then operate without considering the many and varied procedural and other safeguards which would apply to the parent public body or bodies if they were to pursue the ESCO activities themselves. While an ESCO may be established with a view to providing greater flexibility than is available to the parent public body (see, for example, paragraphs 2.16 and 2.17), this must not be confused with lack of governance or oversight. There have been cases where lack of ESCO governance has contributed to project failure.

There may be some cases, such as ESCOs established as a result of public procurement law considerations (see paragraphs 2.21 to 2.24), where it is necessary in legal terms to demonstrate that certain control requirements have been met.

Another “hard” legal issue may come into play in relation to the activities of an ESCO and their governance. All public bodies have functions and powers conferred upon them and while it is generally permissible for the implementation of these functions and powers to be delegated to some other entity (such as an ESCO) it may not be permissible (in the absence of a specific power to delegate) for strategic decisions as to how these functions are to be implemented to be delegated to a separate body, without oversight and parent public body approval processes being in place. If those are not in place, then the parent body may be challenged (by way of judicial review) on the basis that it has impermissibly delegated its powers or functions. Care needs to be taken to avoid this where, for example, an ESCO has been established to act as a clearing house for a number of initiatives, or as a “strategic” ESCO, and may therefore find itself making important policy decisions. The solution lies in ensuring that specified strategic decisions that the ESCO may take must be approved or otherwise ratified by the parent public body.

In the analysis which follows, we will assume, for convenience, that the ESCO is a Companies Act 2006 company. That could be either a company limited by shares (with a shareholder or shareholders, who own the company) or a company limited by guarantee (with a member or members, who own the company), and in each case a Board of directors (who manage the company), along with a set of Articles of Association, which will govern important procedural matters such as the rules applicable to directors’ and members’ meetings. This can be reasonably easily read across to other legal forms: in most cases the members of a body and its management will be different persons and even in cases where that may not be so (for example a partnership or limited liability partnership where the same persons may own and manage the business) there is still a legal and formal distinction between ownership and management.

Objects of the ESCO

In the vast majority of cases it is not necessary for a company to contain a statement of its objects in its Articles of Association. The same is broadly true of other legal forms although, as discussed in section 3 of this Guidance, there may be criteria which must be satisfied depending on legal form and these criteria may in turn require some statement of objects. For example, a community benefit society or community interest company needs to be able to demonstrate that it is for the benefit of a community or communities. Any entity which seeks charitable status will need to specify, as an object, one of the charitable purposes as set out in section 7 of the Charities and Trustee Investment
(Scotland) Act 2005. However, the point stands that there is normally no legal requirement to specify any particular objects in the governing document of an ESCO established by a public body.

4.15 It is, though, generally considered desirable to specify objects in the interests of good governance. Any statement of objects should be broad enough to encompass the measure of activities which the ESCO may undertake over time, but narrow enough to constrain those activities within appropriate and agreed bounds. It need not be lengthy. The benefit of specifying objects in the Articles or other governing document of the ESCO is that it operates at a high level of governance in a document which will be publicly available.

Example Articles of Association: Aberdeen Heat & Power Company Limited

3 “The Company is established for the benefit of citizens of The City of Aberdeen and, subject to that qualification, the objects for which the Company is established are:

3.1 To carry on in the United Kingdom and elsewhere the business of a general commercial company and in addition all or any one or more of the following businesses, either in combination or separately:

3.1.1 To carry on in any manner the Company thinks fit the business of generating and supplying electricity and space and water heating to consumers, selling surplus electricity commercially, purchasing and trading electricity and generally trading and dealing in the wholesale and retail markets in commodities, fuels and others of all kinds;

3.1.2 To design, engineer, manufacture, construct, extend, demolish, execute, carry out, equip, improve, work, purchase or otherwise acquire, lease, develop, administer, manage or control works and conveniences of all kinds wheresoever situated;

3.1.3 To provide consultancy and other services in relation to combined heat and power and other integrated energy schemes and to procure training programmes and dissemination of information relating to such integrated energy schemes.

3.2 To undertake and carry on any other business which may seem to the Company capable of being conveniently carried on in connection with any of the above specified objects…”

4.16 The above wording is offered only as an example. In deciding upon suitable objects, there are many issues to be considered. What is the expected scope of the ESCO activity? The AHP objects principally relate to heat and electricity. They may be too narrow for some ESCOs, or too broad for others. Should its activities be stated to be for the benefit of a particular category of person? Should the activities which it may carry on be geographically restricted? These and other issues require careful thought in each case.
Business Planning Process

4.17 An ESCO should develop a Business Plan. Aspects of this may already have emerged through the deliberations by the parent public body which resulted in the establishment of the ESCO in the first place. However, it will be for the ESCO itself, subject to any guidance from its parent, to consider and prepare its own Business Plan. This is a key process. For example, there is no point in establishing an ESCO of the clearing house or "strategic" type referred to in paragraphs 2.14 and 2.15 because it is considered difficult or impossible for progress to be made in-house, only for the ESCO itself then to proceed without having a properly developed Business Plan. If there are many potential projects and opportunities to be considered in relation to energy services, it is critical for the ESCO to give early consideration to how progress is to be made. The process is similar therefore, to that described in paragraph 2.10, but with this difference, that it should take account of any principles that may have been established by the parent public body when considering whether to establish the ESCO in the first place.

4.18 The Business Plan should be prepared by the ESCO's management and approved by its Board of directors (or equivalent). For governance purposes, it may also need the separate approval of the parent public body.

Management of the ESCO (high-level)

4.19 Management of the ESCO concerns how it is run on a day-to-day operational basis and on a more strategic level. In a company, operational management will be entrusted to a Chief Executive or similar and overview of that management and strategic matters will be entrusted to a Board of directors, of whom the Chief Executive will likely be one. A more fully developed company will also have a Finance Director.

4.20 However, it is not necessary for the ESCO to have either a Chief Executive or a Finance Director. Operations, especially at the early stage, may simply require that there is someone carrying out the role of principal officer. The point remains, however, that there will still need to be some person (possibly only one in the early days of an ESCO) responsible for day-to-day operational matters and there will need to be a Board of directors (or equivalent) for oversight of operations and for more strategic decision making. The directors, in other words, make the decisions which affect the course of the company.

4.21 Directors must act in the best interests of the company of which they are a director. In the case of public body ESCOs, it is likely that some (possibly even all) of the directors may themselves have been appointed by the parent public body in its capacity as a shareholder in, or member of, the company. For example, in the case of a local authority ESCO, they may be Councillors, or officers, or a combination. However, when acting as a director of the ESCO, they must not consider the business of the ESCO as if it were identical to that of the parent public body which appointed them. This will not be a problem, for as long as the interests of both are aligned (and good governance will assist in this), but great care needs to be taken around conflicts of interest, whether actual or potential.
4.22 Procedures must be put in place to manage such conflicts. One type may be referred to as “situational”. For example, a Councillor or officer of a local authority who is a director of an ESCO established by it will always have a situational conflict in respect of the fact that he or she is both a Councillor/officer and a director of the ESCO. It would clearly not be appropriate for that person to be unable to take part in the discussions at the Board of directors of the ESCO. Any such director, however, must carefully watch out for any matter which goes beyond this general level of potential conflict and becomes actual. For example, the Board of directors of the ESCO may be considering implementing a project which directly affects or benefits a particular director, whether personally, or in his or her representative capacity for a particular ward. In that case, the ESCO must have a process requiring that specific interest to be declared and also stating whether the relevant director may be present at the discussion at all (he or she would not normally be permitted to vote on the matter).

4.23 At the level of the parent public body, consideration also needs to be given to its approval requirements for significant projects which the ESCO may take forward. This may involve remitting these approvals to a Committee, in which case the question arises whether any members of that Committee who are also directors of the ESCO should be permitted to take part in the approval decision. It would not generally be appropriate for them to do so, although it would be appropriate for them to be present in order to assist in answering any questions about the decision which the ESCO reached, approval of which is now sought.

4.24 Consideration must be given to the composition of the Board of directors. To an extent, this will depend upon the purpose of the ESCO. An ESCO established to implement a single project and to operate and maintain it may have a fairly simple Board structure, perhaps two directors appointed by the parent body and one other, being the person responsible for the day-to-day operation of the ESCO’s business.

4.25 An ESCO established with a view to taking forward a larger number of projects or to act as a clearing house or a “strategic” delivery body will require a more robust Board of directors.

4.26 The key is to ensure that the Board has sufficient expertise and competence available to it to enable it to carry out its management, delivery and oversight functions effectively. This may mean that while the Board will have members who are appointees of the parent public body or bodies, it may also have “external” members who have been selected because of the skills and expertise they have in the anticipated activities of the ESCO. If there are “external” Board members, that may raise issues around the procedures for the carrying out of the business of the Board, including decision making and voting. These are discussed further in paragraph 4.38.

4.27 There may also be circumstances in which it would not be legally desirable to have those skills and expertise represented on the actual Board. An ESCO established as a result of consideration having been given to public procurement law requirements (see paragraphs 2.21 to 2.24) must satisfy a test of being under the control of its parent public body members to the same extent as if the activity had remained in-house: in our view that would preclude Board of director positions for external parties.
4.28 However, while it is desirable to have expertise available within the Board, it is possible to retain that expertise via use of an advisory panel or similar. The members of that panel would not be directors of the ESCO, but they would have a role in providing advice to the Board to assist it in making decisions. They will need to take care, however, to ensure that their role does indeed remain that of providing advice. If they actually take part in the decision-making process, then they may become "shadow" directors of the ESCO. If that happens, they are treated, for all legal purposes, as if they were in fact directors and therefore will have the duties and liabilities that directors have: they would be treated in all respects as if they were part of the management of the ESCO.

4.29 If there is a desire to have external expertise available to the ESCO or actually on its Board of directors, it will be necessary to identify individuals with relevant skills and expertise, and who would be prepared to take on a management or advisory role. It is prudent to consider this before establishing an ESCO which may significantly depend upon external input and assistance. While that input can always be provided on a "paid for" basis (and in some cases will need to be) it is still essential that there should be the right mix of skills either on the Board of directors or available to it via an advisory panel or similar.

4.30 It is likely to be useful to prepare a list of skills and attributes that external directors or advisory panel members should have so as to assist in any selection process.

Management of the ESCO (procedural aspects)

4.31 The following paragraphs consider a number of procedural aspects of management of an ESCO at Board level. They may seem to be points of detail, but they are very important in governance terms, for the same reasons that decision making processes and procedures are important in parent public bodies themselves. All of the points discussed should be considered at the time of the establishment of an ESCO and all of them should be addressed in its Articles of Association or other governing document.

4.32 There are a number of important procedural matters which need to be considered and resolved in relation to any ESCO established by a public body. If a public body is the sole member of the ESCO then, in terms of company law, it has the right to remove any director. It is always useful to make this explicit in the Articles of Association. The further question arises as to the extent to which the parent public body will wish to have the right to appoint directors. Clearly it will want that right in relation to its own members and/or officers. For example, a local authority with a wholly-owned ESCO will want the right to appoint and to remove (at least) one director of the ESCO. It is for consideration, within the relevant local authority, whether any appointed directors should be Councillors or whether there should be a mix of Councillors and officers.

4.33 A decision needs to be taken about how many directors the parent public body or bodies together may appoint. In some straightforward cases these appointees may be the only Board members. In others, they may be in a minority (for example, in a corporate joint venture ESCO with a private sector partner). Parent public bodies, particularly local authorities, should consider their own
procedures in relation to the establishment of arm's length external organisations (ALEOs). Where these exist and are appropriate to an ESCO they should follow them.

4.34 The parent public body may, or may not, wish to have the right to approve appointment of any “external” directors, i.e. directors appointed otherwise than by it or other public bodies participating in the ESCO. The alternative is for the appointment of additional directors to be left to the Board itself. It may be considered appropriate for the parent public body to leave the selection process for any external directors to the Board but for there also to be a requirement that the parent public body approves the appointments.

4.35 The number of directors should be specified in terms of a maximum and a minimum. This will depend on the nature and scale of the activities anticipated to be carried on by the ESCO. Hard and fast guidance cannot be provided, but figures could range from no more than between two and five for a more straightforward ESCO operation to between five and ten for a larger-scale ESCO.

4.36 The term of office of directors needs to be considered. It is poor governance for directors to remain in office without limit, so consideration must be given to an appropriate term. An example would be a three year term, renewable once with (possibly) any extension beyond that only with the approval of the entire Board and (possibly) the parent public body.

4.37 A quorum will need to be decided on for Board meetings. This may be a proportion of the Board as a whole. There could in addition be a requirement that a minimum number of parent public body directors be present for there to be a quorum. This will vary with circumstances, but should be considered.

4.38 Directors’ voting requires consideration. It may be that there are more “external” directors than there are parent public body appointed directors. Under normal principles, those external directors could outvote the parent public body appointed directors. Should there be a provision that a resolution cannot be passed unless a majority of the public body appointed directors are in favour of it? This goes against the grain of democratic decision making within the ESCO. On the other hand, the decisions that are made at the ESCO Board may be significant and important for its parent public body, although it should be remembered (see paragraph 4.56) that parent public body approval may be required in respect of the implementation of certain decisions in any event. Provided that additional layer of governance is in place, it may not matter that parent public body appointed directors may be outvoted. If it is felt that the issue does matter, then it may require reconsideration of whether the ESCO should be established on the basis that there will be “external” directors at all. Instead an advisory panel could be used.

4.39 There should be a requirement for the Board to meet on (at least) a specified number of occasions each year. It may be thought obvious that the Board will meet, but it is better to ensure that this is put beyond doubt. In most cases meetings should be quarterly or every two months.

4.40 Directors’ remuneration needs to be considered. It is likely that this will fit with the relevant public body’s own policies and procedures. Therefore, directors would generally not be entitled to be
remunerated but travel and other expenses of attending meetings and conducting ESCO business would be paid upon being properly vouched. However it may need to be considered whether some limited remuneration (such as an attendance payment) should be permitted for "external" directors.

4.41 It is possible, as part of the governance contained in a company’s Articles of Association, to add "entrenched" provisions for the benefit of the principal shareholder(s) (or member(s)) in the company, i.e. the parent public body or bodies. These are provisions which state that specified activities on the part of the ESCO are subject to a requirement of prior parent body consent. These could include:

4.41.1 establishing companies, partnerships or joint ventures;
4.41.2 borrowing or lending money (beyond an agreed limit);
4.41.3 granting or taking security over property;
4.41.4 purchasing, selling or leasing property; and
4.41.5 expenditure beyond specified limits, e.g. on consultancy or other services such as IT.

4.42 Whether or not to include provisions like this in the Articles of Association (which, it should be noted, is a publically available document) is a question of how strong the parent public body wishes control mechanisms to be. It is perfectly possible, and certainly more flexible, to make provision for the matters listed in the previous paragraph in the Agreement between the parent public body and the ESCO (see paragraphs 4.51 to 4.56). Such provision would have binding contractual effect in that Agreement and in practice it is easier to amend an Agreement than it is a set of Articles of Association.

4.43 There are other management matters which may require parent public body approval. These can include deciding to proceed with the procurement of a significant project (or perhaps any project) and subsequent key stage approvals beyond that decision as the procurement proceeds (post-PQQ, down-selection of bidders, preferred bidder appointment and contract signature). These approval requirements are better included in the Agreement between the ESCO and the parent public body than in the Articles.
ESCO Policies and Procedures

4.44 Consideration must be given to the extent to which the ESCO should adopt policies and procedures corresponding to those of its parent public body. For example, if the ESCO needs to procure works or services, then should the ESCO be required to follow the parent public body’s procurement procedures? This is not the same point as compliance generally with public procurement law: that will be required by the ESCO (assuming, as is very likely, that it will fall within the categories of authority which are caught by the public procurement rules). The question is whether the parent public body’s detailed procedures should apply. There is certainly a case for this – to align processes and promote consistency - but they may be more complex than is required for the ESCO.

4.45 The application of the public procurement rules to ESCOs established by public bodies or with their participation is tested by reference to a provision contained in Regulation 3 of the Public Contracts (Scotland) Regulations 2012. This provision applies the regulations to a corporation established, or a group of individuals appointed to act together, for the specific purpose of meeting needs in the general interest, not having an industrial or commercial character, and: (i) financed wholly or mainly by another contracting authority; (ii) subject to management supervision by another contracting authority; or (iii) more than half of the board of directors or members of which, or, in the case of a group of individuals, more than half of those individuals, being appointed by another contracting authority.

### Key Issues for ESCO’s Articles of Association

Key issues for Articles of Association (or equivalent governing document) to address include:

- appointment and removal of directors;
- the identity and number of parent public body appointed directors;
- maximum and minimum number of directors;
- whether external directors should be subject to special rules for appointment and removal;
- term of office of directors;
- quorum for Board meetings;
- voting rights of directors;
- number of Board meetings per year;
- directors’ remuneration;
- activities of the ESCO requiring prior parent public body consent; and
- conflict of interest.
This test is broad. Most ESCOs will be meeting needs in the general interest, and most will not have an industrial or commercial character. An ESCO which is wholly owned by a local authority will fall within the provision because the local authority is the only member. An ESCO which has a board of directors, fewer than half of which are appointed by a public body, but some of whose decisions are subject to approval by that public body, will also be caught by the provision. In most circumstances, therefore, an ESCO established by a public body will be subject to compliance with public procurement rules. This may not, however, be so in the case of a public/private sector joint venture ESCO, so long as the financing, supervision and control tests are not satisfied.

State aid

Most ESCOs will also need to ensure that they comply with the law on state aid. Consideration of this topic is outwith the scope of this Guidance, but some analysis can be found in section 9 of the SFT Powers Guidance (see paragraph 2.6 for a link to this).

Other areas

There are many other policies and procedures which could apply to the ESCO. They should all be considered in terms of their appropriateness to the ESCO’s activities. Examples include:

4.48.1 compliance with equalities legislation;
4.48.2 recruitment and employment practices, terms and conditions and pension arrangements;
4.48.3 data protection and handling;
4.48.4 freedom of information and environmental information;
4.48.5 standards and behaviour (of personnel generally and the ESCO’s Board of directors);
4.48.6 health and safety, and environmental, compliance;
4.48.7 accounting and audit procedures; and
4.48.8 anti-bribery policy.

The ESCO will likely need to have appropriate policies and procedures on these matters. As with procurement policy, the question is whether these should be those of the parent public body or whether there should be discretion on the part of the ESCO to formulate its own policies and procedures so long as they comply with applicable law and guidance.

Matters are more complicated if two or more public bodies are members of the ESCO. If it is desired that particular policies should be adopted by the ESCO (rather than that it may formulate its own) then a decision will need to be made as to which public body’s policies should be used. It may be
better in these circumstances to set the parameters for the ESCO to formulate its own policies rather than to pick and choose different policies from different public bodies.

Documenting the relationship between the ESCO and its parent public body or bodies

4.51 The preceding paragraphs have discussed many aspects of the relationship between the ESCO and its parent public body or bodies. However, in addition to these, there should always be a written agreement between the parent public body or public bodies and the ESCO. This should set out what the ESCO is to seek to achieve and what assistance the parent public body will provide. That may, or may not, include a commitment to funding. It may, and likely will need to in the early days of the ESCO operations, cover services that the ESCO needs. These services could include staff secondment or access to staff time, use of office space, access to IT and other systems and so on.

4.52 The Agreement should also provide for monitoring of ESCO performance against its objectives and Business Plan through the use of agreed and measurable key performance indicators (KPIs). Reporting periods for performance should also be specified. In addition, it would be expected that the ESCO will provide progress reports on its activities to its parent public body or bodies, again at agreed specified intervals. Accounting and auditing requirements should also be included.

4.53 The Agreement, like any other legal document, will need to address failure to comply, other breaches and, consequently, rights to terminate and/or withhold funding (where funding is agreed to be provided in the first place). The Agreement should also be for a specified term, but should make appropriate provision for extension and/or variation. It should have a dispute escalation and resolution process.

4.54 The Agreement should also address the policies and procedures discussed in paragraphs 4.44 to 4.50. It will either provide that particular policies are to apply to the ESCO or that the ESCO is to develop its own policies in accordance with applicable legislation and good practice, and with or without a right of approval of those policies, once developed, by the parent public body.

4.55 The Agreement may also make provision for activities which the ESCO should not carry out without parent public body consent. This could include matters such as the granting of security, purchase of property or borrowing of money in excess of a specified amount. An alternative would simply be to require consent for activities which are not in the agreed ESCO Business Plan.

4.56 There may also need to be provisions relating to decisions of the Board of directors of the ESCO where parent public body approval/ratification is also required. This could include, for example, strategic decisions or decisions to commence a procurement exercise for a large project, such as the provision of district heating within the parent public body's estate. Some of these “gateway” approval requirements may be contained in a separate, more detailed, procedures document, but it would be expected that they will be referenced in the Agreement itself.

4.57 Finally, it should be noted that in addition to governance considerations, a public body wishing to establish an ESCO should consider the applicable regulatory regimes, for example the specific licensing requirements relating to electricity supplies.
Further information on governance can be found at the following links:


4.58.5 Regulation of Social Housing in Scotland, the Scottish Housing Regulator, February 2012: [http://wwwscottishhousingregulatorgovuk/sites/default/files/publications/Our%20Regulatory%20Frameworkpdf](http://wwwscottishhousingregulatorgovuk/sites/default/files/publications/Our%20Regulatory%20Frameworkpdf)