

**PU-BENEFS**

**Country Specific report regarding**

**Specificity of public bodies**

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## Status and prerequisites for usage of energy services among Public Bodies

Country: United Kingdom

### 1 Overview

#### 1.1 The historical situation in the U.K.

At the earth summit, in Rio de Janeiro, Brazil, 1992, the UK Government, along with 153 countries, signed a declaration to limit the amount of greenhouse gas emissions on a global scale. Further concerns about climate change and the effects of global warming subsequently prompted changes to the UK policy framework for the use of fossil fuels. These policy changes include the use of economic instruments and setting up the Carbon Trust to manage the UK's climate change programme. The UK Government also accepted the view of the Royal Commission on Environmental Pollution, that it should adopt a strategy which puts the UK on a path to reducing CO<sub>2</sub> emissions by some 60% on 1997 levels, by 2050. The strategy pursued by successive UK Governments had been to encourage energy conservation, in particular through the adoption of an Energy Services strategy and the use of efficient technologies such as CHP. Of note is that a key issue deterring the use of energy efficient technologies in the Public Sector is the current low unit energy costs, notably for electricity and gas. This cost reduction became significant after the liberalisation of the energy markets in 1989, and became more marked within the electricity markets in 2001, after the adoption of the New Electricity Trading Arrangements. Government policies, designed to encourage the use of CHP, have inadvertently resulted in contracting the market by the combined effects of regulatory and fiscal measures. CHP policy analysts have subsequently called for a decision support framework for Energy Services businesses and have expressed "the need to develop a decision-making mechanism to be used as an internal tool for middle managers in Local Authorities. They can then be in a position to carry out an initial appraisal before a consultant is appointed to carry out a detailed study or design. The Energy Saving Trust (EST) - A Government Energy Agency - tasked to promote Energy Efficiency is of the view that a key solution to this anomaly is the development of a positive investment framework for Energy Services Companies (ESCO's). The underlying principle of an ESCO as defined by the EST is an organisation that has the ability to carry out all aspects of Energy Services.

#### 1.2 The general situation for public bodies

Currently, UK Local Authorities do not have express planning powers to stimulate commercial energy efficiency in use. Some authorities such as Woking Borough Council, have however adopted supplementary regulations to encourage the use of CHP, into their planning decision making process. Regional planning is therefore increasingly becoming an important factor in energy management for Local Authorities. In Addition whilst fiscal policies do indeed have a place in Local Authority management, however the hurdles for investment in Local Authorities are more related to bounded rationality (information deficit), principal agent problems (short term investment criteria) and moral hazard (lack of environmental awareness).

Local Mayors and Councillors are concerned with short term solutions and are frequently unwilling to seek tenders for selecting ESCOs to carry out traditional local Authority tasks, risking local jobs and diverting resources to third parties. The UK model is therefore moving in a direction of long term partnering agreements between Local Authorities and utility

companies or specially set Local Authority companies such as Thames Energy (formerly Waltham Forest Energy Services). Contacts with local financial institutions have shown the potential support of local banks in investing in energy saving projects, if guarantees about good design, quality execution of works, transparency in all process are provided. The EST recently invited bids from Local Authorities & private sector partners for funding towards the preparation of a feasibility study and a business plan for setting up ESCOs in their respective regions.

### 1.3 The general situation for the energy service providers

ESCO's are not a new concept in the U.K. ESCOs offer Independent consultancies on all aspects of energy supply and conservation offering research, consultancy and management of projects relating to energy use and energy efficiency in buildings, providing total energy asset management service, including CEM schemes. Other key actors such as local trade associations and local financial institutions are generally invited to participate in the consortia in order to foster partnerships dedicated to the implementation of performance contracts, according to specified guidelines and tender documents developed by the ESCO and approved by the Local Authorities.

There are currently 12 registered ESCO'S, operating within varying aspects of the energy industry. The EST was keen to stimulate niche energy services approaches, where local authorities, housing associations and not-for-profit organisations work in partnership with the private sector to provide energy services. The EST provided information, advice and initial support as well as financial grants for setting up and developing approved projects on the following approaches:

**(1) Affinity based approaches**, through partnerships agreements for energy supply and other energy efficiency services such as advice, loan finance and grant support. The customer will be offered energy supply along with other energy efficiency services.

**(2) Community- based Energy Services approaches**, through partnerships with the private sector to supply packages of locally generated supply – usually through CHP – and demand side measures.

The EST fostered the view that a successful energy services agreement will be a partnership between the private sector contractor and the public sector client. The contract should be open and co-operative, but with a clearly defined, approach to risk sharing, cost, staff issues. The public sector client must assign someone to be the project sponsor to ensure that the right contract is established from the outset. Although the contractor will relieve the client of much of the management burden associated with the contracted-out services, the contract must still be carefully managed throughout its duration and it is important that the client has a contract manager, to secure a partnership that works.

### 1.4 The need for an improved energy services market (main obstacles)

The need or opportunity for energy services may arise for a variety of reasons:

- the need for plant refurbishment or replacement
- excessive energy consumption and cost
- excessive operational costs
- the requirement to meet energy efficiency and environmental targets
- the poor quality of existing services
- changing operational requirements or organisational restraints
- the expiry of existing contracts

It is however becoming increasingly accepted in the UK that the energy services approach can help public sector bodies to realise energy, environmental and financial savings that are

otherwise unattainable. It offers access to the investment resources and specialist technical skills which are needed to provide energy services on a cost competitive basis. The client organisation is therefore able to focus better on its core activities and transfer much of the risk associated with providing the services to the contractor. Energy services companies are also able to take a long term and strategic approach to energy since this is their core business. The results of a properly formulated and well managed energy services agreement will be more cost effective and efficient services provision, with reduced environmental impact of the Local Authority's activities. Many obstacles however still exist and prevent the diffusion of energy efficiency services especially at local level amongst smaller municipalities. Traditionally in small and medium local authority areas the fuel for heating is purchased directly from municipal supply offices and the operation and maintenance is provided by local maintenance men in force to local call for tenders. Even all material for minor refurbishment is provided by local dealers. On the other side, the municipalities do not have enough financial resources for large investments in energy rehabilitation. The key barrier issues are:

1. Lack of a legal framework for Local Authority participation in ESCO's
2. Regional/ Local Authority structural differences hence responsibilities.
3. Secure and effective partnering arrangements
4. Individual pricing & charging structures
5. Different Investment financing criteria from funding agencies
6. Lack of agreed common performance benchmark

### **2 Current prerequisites for public bodies use of different types of energy services**

#### ***Specificity of public bodies***

The energy services approach can help public sector bodies to realise energy, environmental and financial savings that are otherwise unattainable. It provides access to the investment resources and specialist skills which are needed to provide energy services on a cost competitive basis. The client organisation is able to focus better on its core activities and transfer much of the risk associated with providing the services to the contractor. Energy services companies are able to take a long term and strategic approach to energy since this is their core business. The results of a properly formulated and well managed energy services agreement will be more cost effective and efficient services provision, with reduced environmental impact.

A successful energy services agreement would be a partnership between the private sector contractor and the public sector client. An open and co-operative, but clearly defined, approach to risk sharing, cost, staff issues and management will be at the heart of any well formulated agreement. The public sector client must assign someone to be the project sponsor to ensure that the right contract is established from the outset. Although the contractor will relieve the client of much of the management burden associated with the contracted-out services, the contract must still be carefully managed throughout its duration and it is important that the client has a contract manager, to secure a partnership that works. Both project sponsor and contract manager must have sufficient time and resources at their disposal, otherwise it is likely that the contract and its working will be deficient. Before embarking on the process of energy services contracting, public sector organisations are required to consider all aspects and deficiencies of the current provision and establish how changes may be of benefit to the organisation's long-term strategic objectives.

Particular considerations would revolve around:

- Limitations of available finance
- Long term ownership of buildings
- Transaction costs – Longer term cost implications
- Bounded Rationality- relevant staffing skills and experiences
- Organisational structure – Departmental responsibilities

### **2.1 EPC, Energy performance contracting**

#### **Public accountancy:**

As the energy sector is one of the most capital intensive of any major economic sector. UK Public sector procurement policies are therefore intended to influence both the supply and the use of energy; and should aim to reduce carbon intensity. Public sector procurement makes it essential to avoid unnecessary investment on either the supply or demand sides. Despite lower energy prices, evidence still suggests that many kWhs can be saved cost effectively; and some saved more cheaply than the delivered cost to customers' meters. This is despite the unavailability of investment allowances for energy efficiency investment by most small consumers, unlike for supply side energy investment. Further fiscal innovation (VAT, allowances, tax credits) might be required by the Government to level the playing field between the demand and the supply sides. Alternatively, suppliers are encouraged to use their investment allowances against company taxation to lease appliances and heating systems on the demand side. Specifically TPC contracts are allowed to claim Enhanced Capital Allowances.

#### **Public procurement:**

The public sector accounts directly for only 5% of UK carbon dioxide emissions and from that, three quarters is for space heating and lighting. But this sector – in particular the Government itself – has a vital role to play in leading by example. Government, along with other public sector organisations, is taking action to improve energy efficiency. The central Government estate has an interim target to reduce CO<sub>2</sub> emissions by 1% a year from 1999-2000, with new targets set in 2003 including on CHP. The review of government procurement has identified a number of areas where government purchasing could more strongly support sustainable development goals. The review has been considering how to build energy efficiency into government procurement and contract strategies, and identified some specific categories where products are already available which meet high energy efficiency standards. As a result, central arrangements were made, for departments to purchase goods with high energy efficiency standards and which provide value for money in areas such as IT equipment, boilers, lights and lighting systems, refrigeration equipment, televisions and washing machines. National Health Service (NHS) Trusts are already targeted to reduce the level of primary energy consumption by 15% or by 0.15 MtC equivalent, from March 2000 to March 2010. Since 2003 local authorities have been specifically required to benchmark their energy use in operational property and street lighting and set local improvement target in 2003/2004. Along with registered social landlords they are also required to bring their own housing stock up to decent standards by 2010. Detailed procurement targets have been developed alongside and complementary to the 2005 revision of UK Buildings Regulations and the methodologies for the implementation of the EU Buildings Directive, including building energy certification and labelling.

The targets have the following common principles:

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- They should be cost effective with a payback period less than the period of the procurement.
- They should be transparent, with easily understood methodology and calculations so that they can be used in the wider market.
- Performance against the targets should be monitored and publicly reported on annually.

### **Public organisation:**

Much research has been undertaken to examine the barriers to greater energy efficiency. These barriers are extensive and numerous. They include: the shortage, and high cost of finance; ignorance of cost effective opportunities and lack of information; a fragmented energy efficiency industry; managers' unwillingness for risk taking; the small proportion of energy costs in total costs and other more urgent priorities; exclusion of external environmental costs in final energy prices; and falling real energy prices (so that big savings are made in bills but by price rather than quantity factors). Lower prices also lengthen payback periods for energy investment.

### **Grouped procurement for energy and/or EPC contracts:**

Many public organisations in the UK are part of group buying consortia especially for energy services. Kent council is an example of a utility purchasing consortium for Local Authorities in the South East. The NHS, Police and Universities also have specific energy purchasing consortia. There are no grouped purchasing services for EPC as these are considered for individual cases. In any event the utility purchasing consortia are designed to reduce primary energy costs and have little incentive for further energy performance improvements within buildings. There are a number of trade associations such as ESTA - Energy services trade association - that provide a benchmark technical services to potential EPC clients. During the past 12 years of its existence, ESTA has however made little inroads into the public sector market as they only provide information on their paid up members which does not meet public sector competition rules. With the opening up of the government estates to EPC there is a suggestion that other trade associations such as the CHPA (Combined Heat & Power Association), IFBM (Institute of Facilities and Building Management) would become more actively involved with the regulation of the supply of Energy services to the public sector.

## **2.2 Profit sharing (Project and/or O&M incentives)**

### **Public accountability:**

These structures don't have any clear definitions for the UK public sector due to their broad approach and the implications for strict monitoring and accounting. Our general interpretation in this project is to focus on contractual approaches/structures enabling the contractor (ESCO or other) to benefit financially from cost cutting or efficiency increasing measures carried out within a contract with the beneficiary/client.

The main applications are project improvement and/or incentive based O&M and energy management.

- a) In terms of project perspectives, the contract could cover a performance based delivery of energy services, where the supplier could benefit from developing "own" alternative designs and concepts that fulfilling the clients' performance criteria at a lower cost.
- b) In terms of O&M, complete energy management services is the most common structure based on a contract where the contractor (ESCO or other) is responsible for the entire operational and maintenance of the clients' premises, and within this contract can benefit financially if he manages to cut energy and operational costs etc.

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These include 'active' energy services for larger buildings, such as surveys, audit and best practice bench marking; installing, commissioning and operating CHP or other energy-intensive facilities; 'build and operate' contracts; competitive energy purchasing (for individual customers or via purchasing consortia); and provision of finance.

### **Public procurement:**

#### **CEM – Heat with Rent**

A recent novel innovation for providing central heating to council tenants where Council are unable to fund such installations is the "Heat with Rent" concept. Basically capital funds are made available by the Gas (or Electricity) Authority to install individual gas (or electric) central heating. Capital repayments, on an individual basis, are made by the tenant over a fixed period (normally ten years) at a fixed, but slightly preferential, rate of interest. The Local Authority could assist with small capital contributions to reduce the cost and encourage tenants to participate. The Local Authority would underwrite the scheme although they would not be liable for individual tenant's debt. Such a scheme would not have an affect on their Capital Controls. Tenants would all have options on the system they wanted. This could be a very basic system incorporating two or three radiators and a control and a simple programmer, or an advanced system with electronic controls, thermostatic radiator valves etc.

#### **CEM – Shared Savings Contract**

The contractor, using his own financial resources or in association with an investor finances and undertakes energy saving feasibility studies and the design, and installation of new energy efficiency equipment in the customer's premises. The contractor owns the improvements either throughout their life or just for the duration of the contract, generally in the range of 5-10 years if a substantial investment is being made. The Contractor plays a direct role in the operation and maintenance of the new equipment either using his own staff or sub-contractors or training and overseeing the customer's staff. The contractor may also purchase and supply fuel and energy on behalf of the customer. At the end of his contract the new equipment may be transferred into the ownership of the customer for a consideration defined in the contract or without consideration or the contract may be re negotiated or the customer may enter into a hire agreement at nominal charge to cover the remaining life of the equipment. The customer may have the right under the contract to purchase the equipment before the full term of the contract.

### **Public organisation:**

See Public Accountancy.

## **2.3 Third Party Financing (Often partially included in EPC contracts)**

### **Public accountancy:**

There are a number of ways in which this can be achieved, including:

- maximise credit approval
- Rent increases in return for lower fuel charges. Recent changes to rules governing modular improvement scheme provide n opportunity to offset energy efficiency improvements by small increases in rent. Such schemes need to be agreed in consultation with tenants' groups. Tenants readily understand rent increases when associated with clearly demonstrated energy improvements that work to reduce fuel bills and provide better comfort.

- Contract Energy Management (discussed in more detail below)

### **CEM – Energy Service Contracts**

The services provided under this form of contract include the same range of possible services as shared contracts and often include the purchase and supply of fuel and energy. The newly installed equipment remains in the ownership of the contractor and the options at the end of the contract period are also similar to shared savings contracts. Only the method of payment is different. Under an energy service contractor customer pays directly for the continued provision at agreed standards of agreed energy consuming services such as space heating, domestic water heating, lighting, air-conditioning etc. The price is set as some figure lower than the cost of providing these services prior to the installation of the energy saving improvements e.g.: 3% lower initially rising to 13% lower over a period of 10 years. The contract defines methods of adjusting the price in an equitable manner to allow for changes in weather, the price of fuel, building occupancy etc.

#### **Public procurement:**

TPF is a procurement route that normally involves long-term contractual arrangements for the provision of a capital-intensive service to the public sector by a private sector organisation. In effective TPF procurement the public sector specifies the outputs it requires, and private sector consortia then compete to meet those output specifications in the most cost effective manner. The risks involved in the project are shared between the parties, with each party managing those risks they are best able. This approach to risk-sharing provides powerful incentives for the private sector to perform. Furthermore the integration of capital and life cycle costs provides an incentive to invest in more efficient technology up front to provide for lower life-cycle costs including lower carbon performance.

In order for these positive incentives in TPF to realise better energy efficiency and other sustainable development criteria, public sector clients need to be equipped to recognise and give appropriate weight to these criteria throughout procurement. Sustainable development criteria need emphasis in procurement documentation and end-customers (for example individual NHS trusts) need sufficient experience to recognise energy efficiency and evaluate bids on a whole-of-life value for money basis. Joint guidance by the ODPM, OGC, DfT and Defra and available on the HM Treasury website – Green Public Private Partnerships – provides advice about how to take account of environmental considerations within Public Private Partnerships and TPF project teams, including project owners and managers, and in-house and external advisors as well as contractors.

#### **Public organisation:**

The Government is committed to securing, over the long term, the most cost effective infrastructure for the public services. Where it is appropriately and properly used, Third Party Financing (TPF) can offer the best value for money from investment in public services through an optimal sharing of project risks between the public and private sector. Over 550 TPF projects have been signed to date, with a total capital value of £35.5bn, across the healthcare, education, transport, local authority and Government estate sectors. Around 10-15% of Total Investment in public services takes place through the TPF annually, with the remainder of public investment and central government procurement taking place through alternative routes such as leasing, design & build, or Prime type contracting.

### 2.4 Leasing

#### **Public accountancy:**

Public sector procurement rules in the UK are currently designed to minimise the use of leasing for equipment that has a life exceeding 15 years. In the 1980's, leasing had been a common tool used by Local Authorities for portable heating equipment such as storage heaters, photocopiers and other forms of office equipment. There were however a number of high profile cases involving some Local Authorities that were using leasing to circumvent the stringent public sector financial controls imposed by the then Conservative Government. A number of public sector organisations extended the leasing concept to a wide range of materials and services notably those with left wing Labour administrations. The Government consequently introduced very stringent regulations that effectively included lease value within the public sector borrowing requirements, thereby identifying the value of leases within the financial allocation of public sector authorities and reducing their Government allocations commensurately. Leasing does however form a significant part of procuring energy efficiency equipment.

#### **Public procurement:**

Types of leasing arrangements used in the UK:

**Financial leases** are generally instalment purchases of energy efficiency equipment. The lessee makes no capital outlay to purchase the equipment and receives all the savings from the project.

**Operating leases** are an arrangement in which the lessor owns the equipment, which is leased or rented to the lessee for a monthly fee.

**Municipal leases** are available only to tax-exempt entities like cities, counties, public school districts and special districts.

**Master lease** agreements are 'umbrella' contracts with general terms and conditions. This type of lease allows public bodies to fund many projects over a time frame.

**Certificates of Participation (COPs)** are lease purchase agreements that are divided and sold to multiple investors, similar to stocks.

#### **Public organisation:**

Where some public sector authorities do wish to enter into leasing arrangements such as for energy efficiency equipment, this can be through a lease-purchase agreement between the public body, as the lessee, and the company providing the leased equipment and/or financing, the lessor.

In a typical lease-purchase agreement, the public body agrees to pay a certain amount (lease payment) over a specified period at a particular interest rate. At the end of the term, the public body has the option to purchase the equipment at "peppercorn" price. The basic questions that need to be considered before entering into a lease are:

- How much experience does the lessor have in providing tax-exempt lease purchasing and financing for energy projects/
- How flexible is the lessor in structuring the financing needs?
- Is the lessor known in the municipal finance industry?
- Will the lessor be in business during the financing term?
- Will the term of lease be within the useful life of the project?
- The cost /benefit of the project.

In a typical lease arrangement, the lessor would require that the interest amount be 'capitalised'. This amount is borrowed through the lease and set-aside to make the interest payment during the construction period.

### **3 Current EPC or third party financing initiatives for public bodies**

#### **3.1 Public initiatives**

A distinguishing feature between Local Authorities in the UK and those in other European Countries (except France) is the lack of responsibility for local energy planning and management. In the London context, the Greater London Authority Act (1999) requires the Mayor to prepare a state of the Environment report by 2003, to "include information on energy consumption and on emissions that contribute to Climate Change". The Government has earlier showed considerable reluctance to move this level of Governance from a central to a regional level. The adoption of a Supplementary Planning Guidance document for energy efficiency and renewable energy use in new developments by Leicester City Council is also noted as some evidence of a changing role for Local Authorities in the area of sustainability planning. Whilst the Government is ostensibly not letting go of the central planning and control remit, it is perhaps unwittingly doing so through its devolvement of the sustainable development targets and the renewable obligations for regions. The main reason for the decline in energy services potential in the UK has generally been attributed to the introduction of New Electricity Trading Arrangements (NETA) in March 2001. By 2002 wholesale electricity purchase prices had been reduced by about 40% of 1990 levels. The introduction of NETA as part of the Climate Change package of measures was heralded by the Government as an encouragement for the use of energy services. The policy instruments relating to climate change were the Climate Change Levy (CCL), the Enhanced Capital Allowance and the Business Rates Reduction. Consequent concerns about a potential shortfall in meeting the Kyoto objectives, prompted the Government to set up a series of additional policy instruments, such a relaxation of the criteria for claiming CCL for CHP schemes to encourage the installation of CHP. The Community Energy Programme and the Energy Demonstration Programme in the UK, continue to offer financial incentives for energy services in the domestic sector. There is however no grant programmes specifically promoting the use of energy services by Public Sector Organisations (PSO's). The Finance Act, (2002), which allows the use of Enhanced Capital Allowances for third party contract investment, goes some way towards encouraging the use of third party financiers.

#### **3.2 Examples of Local Authority ESCO Initiatives:**

##### ***(1) Powys County Council - GreenHeat***

GreenHeat is a support package for renewable energy in rural Wales and specifically for small and community scaled/owned schemes. Its overall technical and funding advice and information service and feasibility fund covers rural Wales. The capital fund is available to projects in Powys Local Authority. It is co-ordinated by Powys Energy Agency through two full time employees, support of the Executive Director; and working with Ecodyfi and the Centre for Alternative Technology. The package is available to anyone interested in developing a RE project and in regard to any RE technology. Innovative wood based systems are particularly encouraged. On going promotion of GreenHeat has been essential, it took 6 - 9 months for the concept of the support available to become widely known and appreciated. Since then there has been an increasing number of enquiries, request for consultancy and for capital support. It is clear that there are many projects that people would like to see to fruition in the domestic, public and community sectors. The availability of hand-

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holding support, advice and funding is required to do this. As the first of its kind, GreenHeat and Powys Energy Agency was able to work with some projects which had been just ideas for many years.

### Results

- Advice line has received 380 recorded enquiries, of which 280 were from householders.
- Supported 38 feasibility studies. These range from a morning consultancy to involvement in £ 45,000 feasibility study;
- Enabled the completion of 17 renewable energy installations in Powys. This equates to the generation of 579 kW from innovative wood systems (for heating), 11.4 kW from heat-pumps, 76.30 kW from photovoltaics and 5.7 kW from wind making a total of 672 kW installed capacity;
- Worked with public, business and community sectors on various projects.

### **(2) Anglesey County Council – Arbed Ynni Mon –Energy Savers**

Arbed Ynni Mon Energy Savers was set up by Anglesey County Council to develop sustainable community projects in Anglesey. The key driver *for* creating AYM is to encourage the wider community to engage in Sustainable Development practices and to act as a focal point *for* exchange of information relating to Energy Efficiency and sustainable development in the rural community. Its objectives are to:

- Assist the authority in pursuing its sustainable development objectives
- Promote and protect a sustainable and safe environment
- Promote the social welfare of the Island's Communities
- Strengthen and develop local anti-poverty work in the Island
- Promote and develop the use of renewable energy technologies
- Address the problem of fuel poverty in Anglesey households
- Achieve affordable warmth for all households

AYM also envisages its longer term development opportunities in the following:

- Public sector contract energy management
- Solar Energy for street lighting
- Converting domestic refuse waste and Biomass to energy
- Combined Heat and Power projects for outlying farms, using biomass
- Gas supply to 'non-gas' towns and villages
- Solar and wind energy projects
- Tidal energy projects
- Encouraging the use of Renewable energy sources for public sector Transport fleets