

## **The Salix Methodology for ensuring its processes for Carbon reporting meet requirements**

### **PERFORMANCE ASSESSMENT**

The activities of Salix Finance are designed to have a material and incremental impact in terms of CO2 emission reductions across the public sector. The Company maintains and regularly reviews a set of measures, which are designed to assess both the performance of the funds provided to our clients and also the Company's own cost effectiveness.

The Company operates a policy of continuous improvement which is primarily designed to ensure:

- (a) the maximum efficiency in the deployment of funds to energy saving projects, and
- (b) the reliability and realism of the estimates of Carbon savings generated by clients for the projects which they undertake.

The Performance Assessment Methodology does not directly confirm that the reported CO2 savings will actually be achieved - it is a framework in order to try to ensure that everything possible is done to complete the projects and realise the associated savings. The Methodology includes procedures for detecting those projects with unusual costs or forecast savings so that the Company can confirm that the approach taken by the client PSBs is appropriate for estimating the likely savings. The Company has engaged KPMG LLP (UK) to provide assurance over the application of the procedures and processes which the Company operates in order to fulfil the second of these objectives.

### **MEASUREMENT**

The Company uses the following key measures in order to assess the performance of the seven funds which it currently manages:

1. Estimated annual CO2 savings from the projects committed by clients, using Government supplied energy conversion factors.
2. Estimated lifetime CO2 savings based on applying a set of agreed persistence factors (PFs) to the annual savings. Separate PFs are used depending on the technology type into which the projects fall.
3. Estimated annual and lifetime financial savings from the projects committed to by clients.
4. The lifetime cost effectiveness of the current Salix programmes, representing the Company's internal operating costs plus the opportunity cost of the funds being deployed to clients during the payback period in relation to the lifetime CO2 savings to be achieved.
5. The Company uses a series of other internal measures which are mainly directed towards assessing the efficiency of clients in their application of Salix Funds to energy saving projects.

### **PROCESSES AND PROCEDURES**

During 2009-10, the Company completed an extensive review of all of its operating procedures, with a view to enhancing its operational management of the funds entrusted to it. These new, more comprehensive processes and procedures have been documented and were phased in over the latter part of 2009-10 and have been further refined and improved in 2010-11. They are described in summary below.

The Company now operates the following key processes and procedures in order to monitor the reliability of the estimated carbon savings which are reported at the time when projects are committed:

1. Clients are required to process all projects through a standard Project Compliance Tool in order to ensure that projects meet the Company's investment criteria.
2. The maintenance of a central database for each of the Salix funds, which enables regular reporting and review of progress by clients at each stage of the fund management process.
3. All projects are passed through a Project Evaluation Tool (PET) in order to compare projected savings against a standard set of parameters, including the projected performance of previous projects of the same technology type.
4. The project evaluation process is overseen by a dedicated technical team within the Company. They are supported by the expertise of external technical contractors, particularly at the time when new clients join one of the Salix programmes.
5. For larger Recycling Fund and SEELS 2 projects, with a value in excess of £100,000, the client must submit formal business cases which are evaluated by both the Salix technical team and its external technical contractors.
6. If at any stage of the review process, a project fails to meet the Company's expected standards, it is excluded from the reported results until such time as the project data has been agreed and accepted as being realistic. Therefore, in the case of all of Salix's main funding programmes, those projects which have been excluded will, in the majority of cases, be reported in the following financial year at their revised and approved CO2 savings levels. As a result, the committed CO2 as reported only includes those projects committed by clients in a given financial year and which have also been validated by the Company's internal testing procedures up to the following 30<sup>th</sup> April.
7. In addition to the specific exclusion of projects as described in 6 above, it is the Company's policy to make general provision against the carbon savings reported by clients, based on past experience of the stage of development of each scheme and, wherever possible, on empirical evidence of the level of amendments likely to be made by clients to their original projections of savings, as they progress towards completion of their projects. This policy is kept under regular review and, as at 31 March 2011, the general provisioning level against reported carbon savings for funds which are currently accepting new project commitments has been set as follows: 9% for the Recycling Fund, 3.5% for SEELS 2 and 5% for SEELS Wales 2.

It is also Salix policy to make specific provision against the likely cancellation of client project commitments which could arise as a result of Salix making the decision before the end of a financial year to seek to terminate a client's fund by mutual agreement, as a result of low fund utilisation by the client.

8. The Company also operates an internal audit team, whose primary focus is to check that our clients are compliant with Salix scheme rules and have adequate systems, processes and documentation to support the evaluation and delivery of projects funded by the Salix programmes.

9. As part of the process of evaluating proposed client projects, when the Salix technical and internal audit teams note a high incidence of projects within a specific technology type where the financial feasibility is at or just below the maximum payback periods specified within the Salix scheme rules, additional in-house checks are performed to ensure that (a) clients are not making the forecast project payback more conservative and thereby protecting the risk against achieving the savings, or (b) clients are not making their forecast payback more aggressive in order to achieve compliance for only marginal projects.

## **DISCLAIMER**

In reporting committed CO2 savings, Salix does not warrant that the projected financed projects will eventually be undertaken by clients or that the CO2 savings will be achieved. However, the operating model adopted by the Company is based on the premise that the funding provided for the individual projects has to be repaid to Salix by clients from the actual energy savings achieved and that the rules of each Salix scheme specify the latest date for completion of projects.

It is standard Company practice for all clients with committed projects at or close to the latest permitted completion date to be contacted in order to resolve any issues causing the delay. Committed projects which still exceed the latest permitted completion date will only continue to be included in the Company's reported results if the clients provide written evidence to Salix that they have a credible project completion plan. In the case of SEELS loans programmes, if projects were initially scoped and committed and then later cancelled or amended, it is Company practice to retain a small residual pipeline of applicants in order to replace any reduction in these projects, thereby making the full deployment of the SEELS 100% loans funding more effective and manageable.

It is therefore considered that there is sufficient incentive for clients to ensure that all committed projects are completed and that the predicted savings are achieved.

## **THE CLIENT JOURNEY**

### **The Salix Recycling Fund clients**

Although Salix is not currently seeking new clients for the Recycling Fund, this section documents the processes in place for both the integration of a new client into the fund and then the subsequent processes which Salix asks clients to follow as part of the ongoing management of their fund.

New client applications are made up of an application form and supporting documentation.

A Client Relationship Manager (CRM) carries out an assessment of the application to ensure that it meets certain pre set criteria and then passes the completed assessment to our third party technical contractor to undertake a "reality check" which focuses on the projects and the in-house skills of the applicant to manage the fund without a hands-on role from Salix. The aim of this part of the process is to ensure that we recruit Public Sector Bodies (PSBs) able to manage the fund and identify a series of suitable projects effectively.

Subject to the application being positively assessed by both the CRM and the contractor, a conditional grant offer letter (CGOL) is issued to the PSB. This includes a schedule of payments and

dates which the applicant agrees to, and determines the speed of activity for that client. Upon signature of the CGOL and submission of a grant claim form, the first tranche of funding is paid.

Future funding tranches are dependent on the client committing projects on the Salix management information system (SERS). Commitment of 80% of the prior funding amounts paid by Salix triggers payment of the next tranche of funding. The CRM monitors progress of project commitment via SERS to ensure that the next tranche can be claimed on the due date.

Every month our Technical Services Team will review all projects added to the SERS system by all Recycling Fund clients in order to ensure they meet our compliancy criteria and fall within a number of pre-set project ranges. Each technology has its own set of parameters to ensure that all committed projects can be signed off as sensible and reasonable.

The range of tests include a visual review of projects to ensure that the input data is consistent within itself – review technology and energy type, project description compared to technology type and energy price against expectations. In addition to this, based on past projects each new project is assessed to ensure it falls within set boundaries. Those projects falling outside these boundaries are referred and reviewed separately in more detail. Only if that review is positive then the CO2 may be counted. At every stage questions can be raised with the client if a project has been identified as falling outside the expected criteria.

Any project identified in this process as failing the test is individually reviewed and its CO2 is only counted if it is considered a sensible project by our Technical Services team. Advice is sought from the Company's technical contractor when insufficient data is available in-house. Whilst this process is undertaken the CO2 is not counted.

For any project with a value over £100,000 a specific business case is required and this is reviewed by the external technical contractor. Once the technical contractor has completed its assessment, it awards a score and rating to the business case. If the business case is given a positive rating (within the defined scoring parameters) by the technical contractor, then the client is advised that the project can move forward. Checks are undertaken after the project has been committed by the client in the SERS system in order to ensure that the figures reviewed in the business case are the same as, or within tolerance of, the ones included in the SERS system and the CO2 is therefore checked back to the approved business case review.

In addition to this, we check clients to ensure that we have confidence in their ability to sensibly assess projects and put together logical project plans. As well as our internal reviews of every project entered into the SERS system, we also have an internal audit programme. This assesses a range of issues at the client, but for the CO2 reporting, it ensures that the explanations which they provided to Salix at the start of their journey (as to project identification and assessment) are the ones which they continue to use when calculating the energy savings from projects. The audit also reviews the client's compliance with the terms of their CGOL and ensures that clients prepare and retain adequate documentation to support the energy savings which they are reporting for each project. If the auditor concludes that there is no sensible process used by the client for calculating the energy savings from projects, they will recommend that the entire CO2 savings reported in the financial year are "parked" and not reported until such time as they have each been reviewed by the technical team. Moving forward, that client will also be required to submit project business cases for every project which they intend to undertake for the following six months in order to ensure that

they introduce a sensible methodology for assessing projects. Only when Salix is confident of their ongoing ability, will they be allowed to enter projects into SERS without hands-on review from Salix.

### **The Salix Energy Efficiency Loans Schemes (SEELS England 1 & 2, SEELS Wales 1 & 2 and SEELS Scotland)**

The original SEELS 1 programme was launched following the 2009 Budget announcement of specific funding for individual projects for any PSB in England. A similar programme was launched later in the year for Welsh PSBs (SEELS Wales 1). In 2010-11, two further tranches of 100% loan funding have been successfully launched (SEELS 2 and SEELS Wales 2). The £1m SEELS Scotland loans programme has been running successfully for three years and is now re-investing the repayments being made back into the fund by clients into new energy saving projects.

Any PSB can submit a Project Compliance Tool together with a signed application for project funding subject to a minimum application value of £5,000 and a minimum project cost of £500. Therefore a number of projects at the lower value have to be added together in order to meet the minimum application value.

Applicants have nine months to complete a project. Once completed, the applicant submits a completion certificate which confirms the actual cost of the project. This is checked back to the original application in order to ensure that it remains compliant. Subject to that test the actual cost of the project is funded by way of a 4 year loan for projects in England and Scotland, and 6 years for projects in Wales. In the case of Central Government departments participating in the SEELS 1 programme, the funding is by way of conditional grant which is repaid to Treasury or DECC.

During 2010/11 a number of the projects previously agreed under SEELS 1 were either replaced or amended as clients started to make progress towards project completion. All those projects which came through this process, either from the existing client or from a new client, were subject to the assessment review for SEELS 1 projects. This was undertaken to ensure that the data being supplied matched our criteria and that clients were capable of meeting the timescales for completion of the projects.

For SEELS 2 England and Wales & SEELS Scotland from January 2011 onwards, every project from the client's Project Compliance Tool is reviewed by our Technical Service Team in a manner that is similar to that of the Recycling Fund.

The range of tests again include a visual review of projects to ensure that the data is consistent within itself – review technology and energy type, project title/description compared to technology type and energy price against expectations. In addition to this, based on past projects, each new project is assessed to ensure that it falls within set boundaries. Those projects falling outside these boundaries are referred and reviewed separately in more detail. Only if that review is positive then the CO2 may be counted. At every stage questions can be raised with the client if a project has been identified as falling outside the expected criteria.

In addition business cases are also submitted by clients for SEELS 2 England and SEELS 2 Wales projects over £100K in value and these are assessed by our external technical contractors in order to ensure that they meet the criteria required for each loans programme. For projects over £20K but under £100K, additional checks are also made directly with the client by our Technical Service Team to gain confidence in the client being 'project ready'. For this a number of clear checks are covered

such as: has the client got firm offers or close budgets; have they decided on the supplier which they wish to use; what is the client's experience of the technology; are saving calculations available; and who identified the project, etc. Responses to these types of questions help to improve confidence in the projects being in turn finalised by the client and successfully delivered.

Only after the projects have passed the Technical Service Team tests then the application is confirmed by Salix and the funding can then be committed.

The Salix internal audit team will review projects funded by all SEELS 100% loans programmes. In those instances where the project has been completed at the time of the audit, the audit team will visit the site and check that it exists. The main purpose of the audit is again to ensure that the applicant followed a logical process when calculating the energy savings and has adequate documentation to record the process which has been applied.

**Salix Finance Limited**

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