THE ESCO PERFORMANCE GUARANTY: MARKET DRIVERS AND THE EFFECT OF LIMITING ITS SCOPE

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The Energy Savings Performance Contract ("**ESPC**") Model

- Performance based
- Energy savings support Customer payments of principal and interest ("**P&I**") for Energy Conservation Measure ("**ECM**") acquisition, as well as measurement and verification costs ("**M&V**") and ESCO service charges ("**Service Charges**") for maintaining ECMs for the life of the contract.
- Savings are guaranteed by ESCOs in amounts sufficient to pay for all costs associated with the ESPC so that the Customer does not have to come out-of-pocket.

ESPC Financing

- To reimburse their project costs, ESCOs typically sell the P&I portion of the payment stream to a third party Investor at an agreed upon interest rate.

Protections for the Investor

- Investors rely on ESCO performance guaranties if ECMs do not generate the anticipated savings.
  - Investors are paid their P&I despite any performance related dispute/withholding/non-payment.
  - ESCO retained M&V and Service Charges are subordinated to the P&I payment.

THIS IS A MARKET-DRIVEN CREATION NEEDED TO CREATE CERTAINTY FOR ESPC INVESTORS.

How are Interest Rates Determined?

Primary determinants of interest rates:

- Risk
- Liquidity
- Complexity
- Market Dynamics

Risk

A. Payment Risk
   - Relevant Components
     - Obligor Creditworthiness
       i. Obligor Profile
          - Business/Industry
          - Management Expertise
          - Reputation
       ii. Financial Analysis
       iii. Third Party Credit Ratings and Reports

B. Project Risk
   - Adequate Documentation
   - Reliable Supporting Assets/Equipment

Liquidity

How easy is it to transfer the investment to a third party?

- Bonds
  - Government
  - Private/Corporate
- Notes- Unconditional promise to pay
- Accounts Receivables
  - Type
  - Quality

Complexity

The character of the underlying investment:

- Bonds and Notes: Typically an unconditional payment obligation
- Accounts receivable are subject to the terms of the underlying transaction

Market Dynamics

Current Market Environment

- Are rates rising/falling? General economic conditions.
- Competitive alternatives
- Funds availability

Government Bond Interest Rates

- ESPC interest rates are typically based on a spread over U.S. Treasury Bonds.
- It's helpful to consider the similarities and differences between a Treasury Bond and an ESPC in order to understand how the market for ESPC pricing has developed and the transaction structure that exists today.

Attributes of Government Bonds

Three principle elements :

- Risk
- Liquidity
- Complexity

Attributes of Government Bonds

- **Risk:**
  - Government bonds are paid promptly on respective payment dates.
  - Not subject to contract related performance.
  - U.S. Government bonds enjoy the highest credit ratings.

Attributes of Government Bonds

- **Liquidity:**
  - Government bonds are highly liquid and marketable.
- **Complexity:**
  - **Government Bonds are simple.**
    - Pricing is market driven at a set coupon over the life of the instrument
    - The payment is made by the U.S. Treasury Department via automated electronic transfer

ESPC Attributes

ESPCs do not perfectly align with bonds.

- Risk:
  - ESPCs are performance contracts.
    - Payments may be reliant on ESCO guarantees.
    - The government has the right to withhold payments to the Investor based on insufficient savings.
  - The government only makes the required payments.

ESPC Attributes

- Liquidity:
  - ESPCs are not readily marketable. They can be re-sold, but it’s a process requiring negotiation, due diligence, legal review, and other costs, which can take months.
    - Some lenders argue that a substantial portion of the spread over Treasury Bonds in ESPC transactions is to compensate for liquidity risk.

ESPC Attributes

- Complexity:
  - ESPCs are complex compared to bonds.
    - Transactions are contract based.
      - Indefinite Delivery, Indefinite Quantity, Contracts
      - Task Orders
      - Master Purchase Agreements
      - Assignment Agreements, etc., etc.
  - Payments must be invoiced.
  - Frequent delinquencies
  - Federal regulations affecting government contracting.
  - Investor receives the debt portion of the contract. Contractor retains “Service” portion. Performance obligations remain.

ESPC Attributes

- ESPC financing premiums are relatively small compared to other loan transactions.
- Yet, ESPC risks are significantly higher than government bond risk.
- How did this low-rate environment for ESPCs develop?

3 Primary Market-driven Elements to Mitigate Payment Risk And Complexity

1. ESCO performance guaranties to the Customer.
2. ESCO payment guaranties to the Investor covering payment continuity.
3. Subordination of the service payments due to the ESCO to the Investor.

Performance Guaranty to Customer

- ESCO guaranties of performance provide certainty that the ECMs will function as planned for the life of the contract.
- Continued equipment functionality lessens the possibility of disputes and creates more certainty in the payment stream.
- Investors need certainty to provide lower rates.

Payment Guaranty: ESCO to Investor

- To make the transactions more “Bond-Like,” ESCOs provide:
  - Acceptance Guaranties
    - Timely acceptance
    - Failure to Accept
    - Termination prior to acceptance
  - Non-payment Guaranties associated with withholding, or otherwise resulting from the ESCOs default of the ESPC, including non-performance of the ECMs.
  - Guaranties associated with termination of Task Order due to default of ESCO.

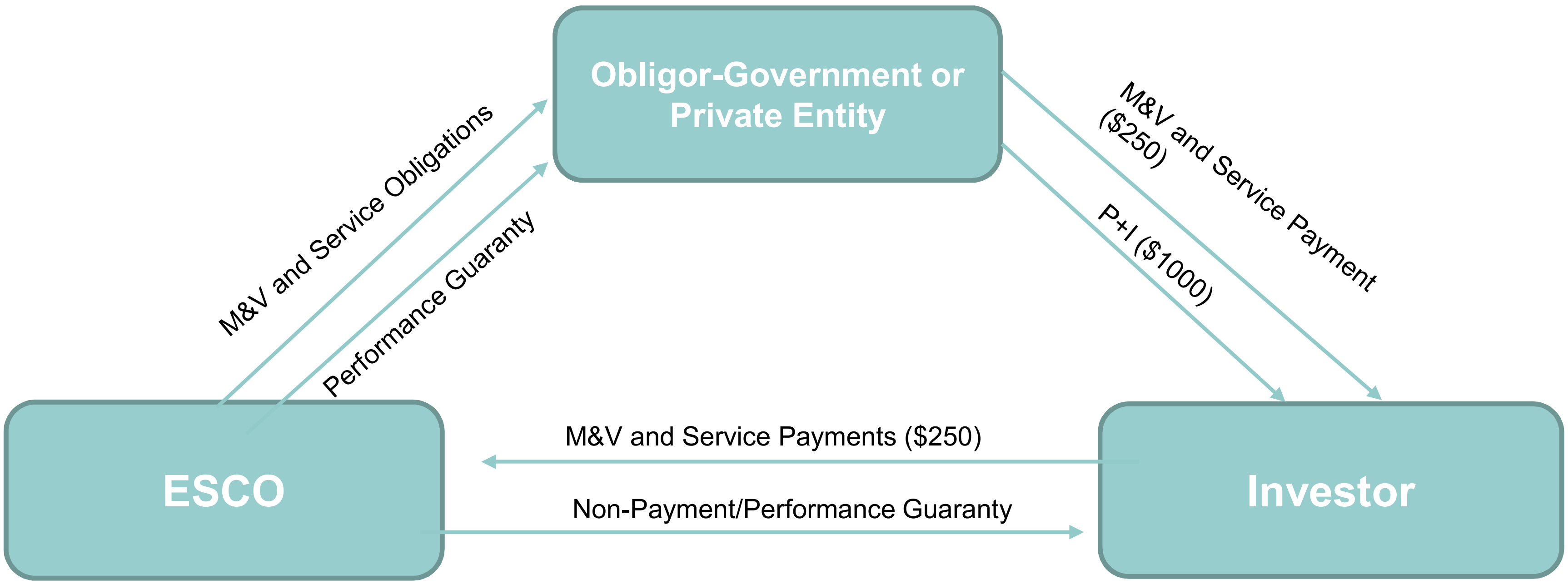
Subordination of M&V and Service Contract Payments Due ESCO

- M&V and Service Payments to the ESCO can be substantial (30% or more of the P&I payments).
- Investors are entitled to utilize ESCOs Service Payments for withholding or other claims.
- Creates payment certainty.

Subordination of M&V and Service Contract Payments Due ESCO

- Service payments due to the ESCO are deposited in an account controlled by the Investor.
- All payments due on the ESPC, the P&I **plus** M&V and Service payments, are made to the Investor controlled account.
- The M&V and Service Payments are remitted to the ESCO, provided that no withholding or other default has occurred.

ESPC Transaction with Performance Guarantees and Subordination Of Service Payments



Effect of Performance Guaranty/Subordination of Service Payments

- Mitigate payment risk based upon non-performance of the ECMs.
- Reduce the complexity of the transaction from the perspective of the Investor.
- Provide for a “buffer” in the event of a payment withholding.
- Make the ESPC considerably more “bond-like.”
- Tighter credit spread over treasury bonds, and therefore a lower interest rate.

Benefits to the ESCO:

- Lowest possible rate.
- Lower rates give the Customer a lower P&I payment and therefore give the ESCO a greater opportunity to add ECMs or create long-term service revenue.

CAN ESCOS LIMIT OR ELIMINATE THE PERFORMANCE GUARANTY?

ESCO Arguments as to Why Limiting the Performance Guaranty is Appropriate

- Occurrence of a default or issue in connection with the ECMs is very unlikely:
  - Engineering analysis
  - Proven, accepted, energy saving technologies.

- On quasi-government or private/corporate ESPC transactions, the ESCO can legally limit or eliminate the performance guaranty to the customer.

Investor's Perspective

- Without a full performance guaranty to the Customer and subordination of M&V/Service for the benefit of the Investor, such a transaction is substantially less "Bond-Like."
- With the possibility of disputes, there is a need to significantly increase their spread to compensate for the increased payment risk and complexity.
- Many Investors will not even <u>consider</u> a financing transaction without this cohesive structure.

Can the Performance Guaranty To The Customer Be Limited Or Eliminated?

Federal Transactions

- Limiting or eliminating the performance guaranty is contrary to the federal ESPC enabling legislation.
- Any attempt to do so would be unenforceable.
- The lack of provisions regarding a performance guaranty is not dispositive.
  - Christian Doctrine. G.L. Christian & Associates v. United States, 312 F.2d 418 (Ct. Cl 1963)
    - A mandatory clause that conveys a deeply ingrained strand of public procurement policy is considered to be included even if it is not actually in the agreement.

Can the Performance Guaranty To The Customer Be Limited Or Eliminated?

State or Municipal Transactions

- Comprehensive Statutes/Ordinances
  - Many states and municipalities have statutes or ordinances that mirror the federal ESPC enabling legislation.
  - Energy savings in these transactions must be guaranteed by the ESCO.

Can the Performance Guaranty To The Customer Be Limited Or Eliminated?

State or Municipal Transactions

- Those with Little or No Legislation:
  - If the enabling legislation is incomplete and ECMs are represented as an energy savings device which pays the amortization for the ECM costs, the possibility for payment disputes regarding non-performance exists.
  - Legal theories are available to the Customer if transaction was represented as being based upon energy savings.
    - Fraud in the inducement
    - Be aware of David vs. Goliath element
      - Applies not only to size of entity, but its sophistication
  - Investors are risk averse
    - The possibility of payment disputes = risk to the Investor
    - Risk = higher rates and/or little or no Investor participation

Can the Performance Guaranty To The Customer Be Limited Or Eliminated?

Legislative development “curve balls” can substantially change the landscape.

- ESPCs are long-term transactions.
- As the market matures, future, more comprehensive, legislation, or case law, may supersede inadequate legislation, causing transactions which were arguably compliant due to lack of legislation to become non-compliant.
  - Don’t rely on being “grandfathered” in.

Can the Performance Guaranty to the Customer be Eliminated in Private/Corporate ESPCs?

- Yes, theoretically.
  - If there are representations as to energy savings; however, there is inconsistency between those representations and the lack of a remedy if the energy savings are not realized.
  - Legal theories are potentially available to the customer in the event that energy savings are substantially less than what is represented, even if no guaranty.
    - Fraud in the inducement
  - The better transaction/legal structure is a pure equipment lease disclaiming any specific performance parameters.

Can the Performance Guaranty to the Customer be Shortened in a State/Municipal Transaction with Little to No Legislation or in a Private/Corporate Transaction?

Performance Period "Sunset" Transaction

- 3 to 5 year performance period.
- If performance parameters are met during that period, all performance obligations to the Customer cease.

Risks Associated with the Transaction

- Legislative changes on State/Municipal transactions.
  - ESCO may not be grandfathered in.
- Documentation
  - No recourse whatsoever to the ESCO, which INCLUDES THE ASSIGNMENT OF RECEIVABLES, after the performance period.
- The possibility of payment disputes remains.

The Investor's Perspective when the Performance Guaranty is Shortened

- Investors like certainty.
- The possibility for disputes after the performance period ends still exists.
  - David vs. Goliath
- Likelihood of much higher rates/non-participation from some Investors.

A Better Alternative to a Shortened Performance Guaranty Period

- Structure the transaction with a performance guaranty
- Add long-term service and maintenance costs
- Lengthen the payment term

Benefits to the ESCO:

- Attracts more Investors at lower rates
- Create more revenue to the ESCO
- Reduces the possibility of disputes

Concluding Comments

- Most Investors desire certainty.
  - Certainty achieves the lowest rates.
  - Low rates enhance the ability of the ESCO to market their transactions.
- Eliminating the performance guaranty reduces certainty to the Investor.