Energy Performance Contracting and its Applications

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Investing in clean energy „has been a noble way to lose money“ – Joseph A. Dear, Calpers Clean Energy & Technology Fund (USD460 million) - 2013

“Private investors will need to take a new approach to benefit from green investment opportunities” – The Green Investment Report (2013): Green Growth Action Alliance
GLOBAL OVERVIEW OF EE DEVELOPMENT AND FINANCING
GLOBAL EE DEVELOPMENT AND FINANCING

- Practical barriers to the growth of the EE Industry
  - Weak government push, lack of harmonization of legislation and contradiction on a government level
  - Information a EE Products offered is heavily skewed towards the EE industry.
  - EE products offered are ahead of the learning curve of the market
  - Supply of financing does not match EE project peculiarities
  - Innovation may not be the best way forward.
    - Innovative projects are particularly vulnerable to developments in the external environment that are different from what was expected at design phase.
    - There are risks that some innovations will fail
GLOBAL EE DEVELOPMENT AND FINANCING

• Lesson learned about the EE industry
  • The EE industry is for the most part technical, fragmented and lacks a coordinated push.
  • Stakeholders on the technical side are the best (and sometimes the only) deal generators in developing markets.
  • The product can be more sophisticated than the client, but the packaging definitely cannot.
  • Products offered should aim to ride on the back of a stronger investment driver.
Lesson learned about the financing industry:

- Banks are demand driven enterprises. They like scale and standardization.
- Asset based lending (collateral) is the core of banking.
  - It is there for a reason: to reduce loan loss in case of default; to address moral hazard of the borrower;
  - Desired properties: ability to be ring-fenced and isolated from the borrower; sufficient liquidation value.
- EE transactions have to be structured to resemble standard lending, not the other way around.
- The finance sector cannot be transformed to accommodate EE financing (in its current form) without relevant provisions of the banking regulations.
BASIC EPC AND ESCO MODELS
DEFINITIONS

Energy Performance Contracting

EPC is a **contractual arrangement** between a beneficiary and the provider of an **EE project** where investments in that project are **paid in part or in full based** on a contractually agreed level of **EE improvements** and its potential impacts.

- Why do we want to promote ESCOs?
- Application – what is desirable vs what is possible - Target Market, Contractors, Economic development
- Timing of the intervention – when to begin fostering the ESCO concept and when to penetrate the market.
Energy Service Company
An ESCO is a natural or legal person that delivers energy services and/or other EE improvement measures to a user’s facility or premises, and accepts some degree of financial risk in doing so. The payment for the services delivered is based (either in full or in part) on the achievement of EE improvements and on meeting the other agreed-upon performance criteria.
ESCO ACTIVITIES

Basic concepts of the ESCO business model:

- Repayments from savings allow clients to offset ESCO’s costs
- Savings are guaranteed to offset all implementation costs within a fixed period.
- Savings will be generated on a long-term basis to benefit the client.
ESCO ACTIVITIES

Services provided by an ESCO:
› Development
› Identification of energy conservation measures (ECMs)
› Engineering design
› Financing structure*
› Procurement
› Construction and on-site supervision
› Commissioning
› Capacity building
› Performance guarantees
› Operations and maintenance*
› M&V of savings

*Services not necessarily provided by an ESCO
ESCO ACTIVITIES

ESCOs are generally classified as:

› Independent ESCOs—concentrate on few geographic markets and/or target specific client market segments;
› Building equipment manufacturers—have an extensive network of branch offices;
› Utility companies—regulated or state-owned electric or gas utilities, concentrate on regional markets or focus on the service territories of their parent utilities;
› Other energy/engineering companies—owned by international oil/gas companies, non-regulated energy suppliers or large engineering firms.
ESCO ACTIVITIES

ESCOs can be differentiated on the basis of their marketing approach:

› Technology (boilers, controls, lighting, etc.)
› Sales approach
› Vertical market (schools, hospitals, steel plants, etc.)
› Utility suppliers (electricity, heating/cooling or compressed air, etc.)
ESCO MODELS

Shared-savings EPC

Energy services, equipment, installation, M&V of savings
Payment with savings until loan payoff

ESCO

Client

Debt Payment

Loan

Financial Institution
ESCO MODELS

Guaranteed-savings EPC

- Realized energy savings
- Client retains 100% of savings
- Client pays the ESCO during the implementation
- ESCO reimburses for underperformance of the project
- Client reimburses the loan directly to the bank.
- Bank loan to client who provides guarantees.

Financial Institution

Bank
ESCO MODELS

Chauffage

ESCO supplies energy from facility

Customer pays ESCO for energy

ESCO implements project and owns the energy facility. Typically pays 10-30% equity share.

Bank lends 70-90% of project costs to ESCO. ESCO is the borrower.

ESCO assigns receivables from Customer directly to bank (sometimes pays via bank). Loan is usually secured with energy assets.
ESCO MODELS

Comparison of the various models

<table>
<thead>
<tr>
<th>Contract Type</th>
<th>Who’s Balance Sheet?</th>
<th>Who Bears the Performance Risk?</th>
<th>Project-Specific Financing?</th>
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<tbody>
<tr>
<td>Shared Savings</td>
<td>ESCO</td>
<td>ESCO</td>
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</tr>
<tr>
<td>Guaranteed Savings</td>
<td>Customer</td>
<td>ESCO</td>
<td>Yes</td>
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<tr>
<td>Chauffage</td>
<td>ESCO</td>
<td>ESCO</td>
<td>No</td>
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</tbody>
</table>

Other types of models:
› Leases
› Other non-recourse financing vehicles
LESONS LEARNT

• ESCO model is too sophisticated for most developing markets.
• The ESCO industry can only be fostered through transactions, not through trainings.
• To have any market impact, ESCOs need:
  • a market with sufficient size for ESCOs to get experience specialize and grow;
  • Time for ESCOs to evolve from technology and solutions providers to real performance contractors (more than just technical risks).
  • a great degree of sophistication of the clients
  • a great degree of sophistication of the financial services market
  • an effective and transparent judicial system
• ESCOs are good in sectors with high replication potential (buildings, industry - technology specific projects)
• ESCOs cannot grow without public support.
• The key to marketing ESCOs is not innovation, but simplification.
EXAMPLES
THE ESCO MARKET IN BULGARIA

- ESCOs operate mainly in public sector (buildings and street lighting)
- EPC is a minor line of business of the contractors acting as ESCOs
- EPC is sometimes implemented via SPVs
- Scarce few projects in residential buildings have been implemented via EPC.
- Financiers – EERSF, EBRD, Commercial Banks, EU Structural Funds

<table>
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<tr>
<th>Year</th>
<th>Reported ESCOs</th>
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<tbody>
<tr>
<td>2005</td>
<td>18</td>
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<tr>
<td>2010</td>
<td>39</td>
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<td>2015</td>
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</table>
ENERGY EFFICIENCY AND RENEWABLE SOURCES FUND (EERSF)

Idea

Technical assistance

EERSF

Project

Energy Efficiency and Renewable Sources Fund

EERSF ESCO Loan
- Cheaper
- High risk tolerance
- Smaller projects
- Technical assistance
- Fast processing
- Pre-financing

ESCO Project PCGs
- Up to 80% cover
- High risk tolerance
- 0.5% to 2% per annum
- Technical assistance
- Fast processing

ESCO Portfolio Guarantees
- Target – ESCOs
- Up to 5% cover on a portfolio basis
- Very high risk tolerance
- Low guarantee fees

ESCO Receivables Purchase Facility
- Target – ESCOs
- Up to 100% of the receivables
- Attractive discount rate
EERSF – ESCO CESSION CONTRACT

Provides about 75% of the payments due under an ESCO contract for reimbursement of the loan to EERSF.

CEDANT ESCO

Cession contract

Payment in installments

CESSIONARY EERSF

Installments for reimbursement of the loan contract

DEBTOR UNDER ASSIGNED RECEIVABLE - MUNICIPALITY
EERSF – PORTFOLIO GUARANTEE

BANK →ESCO
Loan repayment
Project financing

ESCO → EERSF
ESCO service
ESCO receivables

EERSF → CLIENT 1
EERSF approves the project
EERSF guarantees the first 5% defaults

CLIENT 1
CLIENT 2
CLIENT 3
ESCOS – LESSONS LEARNT

• Piloting is almost always successful, but scaling up almost never happens
• For scaling-up we need standardization on both sides – operations and sourcing of funding.
• Sustainability – can only be achieved if financing is among the last barriers to be addressed
**ATTEMPT AT STANDARDIZATION**

- Colombian Energy Efficiency Trust – currently being set up
  - Tiered private + IFI equity investors + IFI debt.
  - Main target: financing of Colombian ESCOs on commercial basis
  - $24 million seed capital, scalable as necessary.
Thank You!

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