

December 19, 2014

Jessalyn Tillman
Procurement Officer, Departmental Purchasing
Florida Department of Management Services
4050 Esplanade Way, Suite 335B
Tallahassee, FL 32399-0950

Re: RFQ No: DMS-14/15-031

Dear Ms. Tillman,

The National Association of Energy Service Companies (NAESCO) appreciates the opportunity to submit questions about the Request for Qualifications (RFQ) for Shared Savings Financing for Energy Efficiency Upgrades, RFQ No: DMS-14/15-031.

Introduction to NAESCO

NAESCO is the leading national trade association of the energy services industry. NAESCO numbers among its members some of the world's leading energy services companies, including: ABM Energy, AECOM Energy, Ameresco, CM3 Building Solutions, Clark Energy Group, ClearEnergy Contracting, Climatec, ConEdisonSolutions, Constellation New Energy, Control Technologies and Solutions, CTI Energy Services, Energy Control Inc, Energy Solutions Professionals, Energy Systems Group, Entegry, Excel Energy, The Fulcrum Group, Indoor Environmental Services, NextEra Energy Solutions, Honeywell, Johnson Controls, Lockheed Martin, McClure Energy, Navitas, NORESKO, Onsite Energy, Opterra Energy Services, Pepco Energy Services, Performance Services, Schneider Electric, Siemens Industry, Southland Energy, Synergy Companies, Trane, UCONS, and Wendel Energy Services. Utility members include the New York Power Authority, Pacific Gas & Electric, and Southern California Edison.

During the last twenty years, NAESCO member companies have delivered hundreds of millions of dollars worth of energy efficiency, renewable energy, demand response, distributed generation and combined heat and power projects to institutional, commercial, residential, and industrial customers in Florida. Nationally, NAESCO member company projects have produced:

- \$50 billion in projects paid from savings
- \$55 billion in savings – guaranteed and verified
- 450,000 person-years of direct and indirect employment
- \$33 billion of infrastructure improvements in public facilities
- 450 million tons of CO2 savings at no additional cost

Context of NAESCO Questions

In order to make our questions more useful to DMS, NAESCO would like to put them into the context of the development of the US ESCO industry, which NAESCO has participated in for the past 35 years.

Shared Savings Was the Original Performance Contracting Model

Energy Service Companies (ESCOs) originated performance contracts in the early 1980s using the shared savings model, because customers were not willing to invest in what were thought to be novel energy efficiency (EE) technologies (e.g. energy management systems or electronic ballasts) and the federal tax code (prior to 1986 tax reform) offered some advantages. In a shared savings contract, the ESCO designed and implemented EE retrofits at its own cost and took both the risk that the retrofits would produce the expected savings (technology risk) and that the customer would pay for savings as they were delivered (credit risk). These early performance contracts were successful in demonstrating the efficacy of EE retrofits and were very profitable for ESCOs, often carrying implied interest rates of 20% or more.

Shared Savings Model Displaced by Guaranteed Savings Model

By the mid-1990s, the ESCO industry had effectively outgrown the shared savings model, for several reasons. First, the ability of EE technologies to produce substantial savings and the willingness of major manufacturers to warranty their EE products convinced customers that EE technologies were in fact not very risky. Second, the growth of the industry was limited by the borrowing capacity of ESCOs, because the full cost of every project was carried as a liability on their balance sheets. Third, the commercial banking industry saw that it could displace ESCOs as project financiers by offering innovative products that substantially lowered project financing costs.

The shared savings model of performance contract financing was quickly displaced by the guaranteed savings model, which separated the technology risk from the credit risk. As ESCOs demonstrated that the technology risk was minimal, they were able to reformulate their balance sheets going forward, so that their liabilities for projects were limited to their actual loss experience (e.g., their accumulated savings shortfalls, which were typically a few percent of their total guaranteed savings portfolio) rather than the entire cost of each project. Commercial banks were better able to assess each customer's credit and to access a full range of financing products, which enabled them to provide project financing at about a quarter of the interest cost of the shared savings model. ESCOs stopped providing project financing, because they could not compete with the banks, and the drop in financing costs enabled performance contracting customers to get significantly more building improvement retrofits and more energy savings for the same project expenditure.

Given this history, and the many benefits guaranteed savings model of project financing over the shared savings model, it is not clear to NAESCO why the Department of Management Services (DMS) wants to return to the shared savings model. Our questions below are designed to review some of the major issues of shared savings financing that are exemplified in the DMS RFQ documents, to ensure that DMS understands the issues and is comfortable that they will not cripple the program.

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| 1 | NAESCO | Contract | 17 | <p>Has DMS obtained a legal opinion or can DMS provide a citation to Florida law which explicitly allows for the ownership of critical building systems – lighting, heating and air conditioning, etc. – by a private third party? A related question is why the state requires the transfer of equipment warranties to the state while the ESCO holds title to the equipment?</p> |
| 2 | NAESCO | Contract | 17 | <p>Is DMS' intent with the shared savings agreement to ensure full off balance sheet treatment is received from auditors? Or is the intent to get "off credit" treatment where the credit agencies or oversight agencies, would not view the agreement as debt as the payments are contingent upon actual performance? If the intent is full "off balance sheet", then title cannot pass without a Fair Market Value (FMV) concept. Is DMS willing to include a FMV or return of equipment concept at the end of the shared savings term? Further, the term of agreement may be limited by useful life depending on the equipment. If "off credit", then title could pass upon acceptance and allow for the State to cover insurance requirements. Is DMS willing to consider these changes?</p> |
| 3 | NAESCO | | | <p>Has DMS researched the increased costs associated with replacing the guaranteed savings with the shared savings financing model? A useful comparison would be the Managed Energy Service Agreement (MESA) contracts offered by Metrus and other companies, which closely resemble the shared savings contracts from the early days of the ESCO business. MESAs carry significantly higher financing costs than guaranteed savings contracts, and so are targeted at private sector commercial customers, who lack the investment grade credit ratings and access to the tax exempt financing market that the state of Florida enjoys.</p> <p>As proposed, the Shared savings structure will limit the number of ECMS that can be included in the program because of the increased project costs associated with:</p> <ul style="list-style-type: none"> - higher interest rate, due to shared savings and due to any financing requiring the financing community to rely on shortfall payments from a taxable source; - insurance carrying costs; - longer interest carrying as payments in arrears |

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| | | | | and quarterly; and, - higher M&V costs due to quarterly M&V reconciliation and reporting requirements. Is DMS willing to consider options to reduce the costs that the ECMS have to cover, including the "off credit" approach noted above and possibly routing any shortfall payments via the State? |
| 4 | NAESCO | RFQ | 7-9 | Is DMS aware that the ability of an ESCO to provide shared savings financing is heavily dependent on the ESCO's balance sheet, since the balance sheet is the credit on which the lender bases its lending decisions? The RFQ does not ask for any contractor financial information and does not appear to recognize that an ESCO could be well qualified technically, but financially unable to provide shared savings financing. Historically, the reliance on shared savings financing severely restricted participation and competition in the ESCO business. The modern manifestation of this restriction is the federal performance contracting program, which uses a financing system in some ways analogous to shared savings, and thus restricts participation to 16 companies, only one of which is based in Florida. |
| 5 | NAESCO | Proposal Agreement | 9-10 | Has DMS obtained a legal opinion or can DMS provide a citation to Florida law that explicitly allows the Agency and/or DMS to take and use the work of the ESCO in producing an Investment Grade Audit (IGA) and project proposal with no compensation? The model shared savings agreement appears to allow the Agency to terminate the agreement if it decides that it no longer wants to pursue a shared savings contract and specifies that the Company must turn over all of its notes, reports and analyses. Thus, an Agency could terminate a project when the ESCO has completed 95% of the work required to complete an IGA and proposal, and be entitled to virtually the full value of the ESCO's work for nothing. NAESCO is not familiar with the details of Florida public construction law, but in other states the ESCO would be entitled to reasonable compensation (costs plus overhead and profit) in the event of such a termination. |
| 6 | NAESCO | Proposal Agreement | 5 | Can DMS provide further detail on what it means by "three distinct alternative schemes for potential EEMs." Does this mean alternative brands or models of equipment, or alternate technologies (e.g., one scheme that replaces a chiller with a |

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| | | | | <p>more efficient model vs. a second scheme that replaces the chiller with a hybrid electric/renewable system)? This requirement could be very expensive and unproductive if the ESCO is required to do full analyses, including building simulation model runs, for alternative schemes that it knows from experience won't pass the required life cycle analysis screening.</p> |
| 7 | NAESCO | <p>Proposal Agreement/ Contract</p> | <p>6 8</p> | <p>Is DMS aware of the history of performance contracting M&V protocols, in particular the experience in the mid-1990s New Jersey Standard Offer (NJSO) program that led to the development of IPMVP Option A for simple EEMs like lighting retrofits for which the savings calculations have only two factors: connected load and run hours. The NJSO program was established by the New Jersey Board of Public Utilities (BPU) to produce what the BPU called an "energy efficiency power plant" and the BPU specified an M&V protocol that is similar to the protocol specified by DMS. Each electric circuit on which an EEM was implemented was monitored in real time, with data fed back to a central database using 900-baud modems over dedicated phone lines. The project ESCO billed the local utility for kWh reductions, the price of which escalated each year for the 10 to 15-year contract term based on projected generation avoided costs and varied by seven seasonal and daily time-of-use bins.</p> <p>The protocol demonstrated conclusively that simple EEMs like lighting retrofits saved the energy and capacity (about 300 MW) guaranteed by the ESCOs. It also demonstrated that the specified M&V protocol was very expensive, typically consuming 10-15% of the total project cost, and did very little to lessen the risk to the customer, because the customer, not the ESCO, controlled the EEM run hours. So the panel of national M&V experts from US DOE, ASHRAE, NAESCO and other organizations that developed the IPMVP included an Option A, which they determined was both cost-effective and accurate for simple EEMs. NAESCO respectfully suggests that DMS, by prohibiting the use of Option A and requiring the use of revenue-quality meters (rather than monitoring devices that can provide the same data at a fraction of the cost), is increasing the cost of projects with little obvious benefit.</p> |

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| 8 | NAESCO | Contract | 14-21 | Is DMS aware that the shared savings contracts used in the early days of the ESCO industry and the federal performance project contracts used today include negotiated termination payment schedules, which specify the payments to be made by the customer in the event that the customer terminates the project early? These termination payment schedules provide the customer with significant flexibility in the event that it wants to terminate the project (e.g., if it can re-finance a successful project at a lower interest rate or decides to sell the building), and also avoids expensive litigation. The termination payment schedules recognize that most project EEMs have little or no salvage value and that, in the few cases where there is some salvage value, removing critical systems from public buildings is likely to constitute a public hazard and thus be forbidden. |
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Conclusion

NAESCO appreciates the opportunity to ask these questions about the shared savings RFQ documents, and is willing to provide further information about its questions or the experience of the ESCO industry that is referenced in the questions on request by the DMS.

Sincerely,



Donald Gilligan
President

(978) 498-4456
dgilligan@naesco.org