



BUYER BEWARE:

ENERGY PERFORMANCE CONTRACTS DON'T ALWAYS DELIVER ON PROMISED SAVINGS

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Budget cuts and revenue shortfalls have plagued cities around the country for quite some time, and 2020 only increased those financial pressures. Many towns and cities are also currently facing the need to upgrade aging infrastructure and, in some cases, meet energy efficiency goals. To address these challenges, some cash-strapped government entities have turned to so-called “energy performance” or “energy savings” contracts to finance those costly updates.

These agreements promise to finance the capital costs of infrastructure projects with “guaranteed” savings from improved energy efficiency and reduced operating expenses. Whether they can deliver on those promises, however, is up for debate. Such contracts are supposed to be budget neutral, with the government entity’s capital costs recouped from savings generated by the project over a period of years. In practice, however, energy performance contracts may be based on illusory guarantees that deliver little to no cost savings, leaving governments paying off expensive capital projects for years into the future. When local governments also issue bonds to fund projects in anticipation of recouping the costs, the financial repercussions can be disastrous when the contracts fail to deliver the promised savings.

This has been a tough lesson to learn for some local governments. While litigation might recover some losses, government entities should be aware of the pitfalls before turning to energy savings contracts to finance an expensive infrastructure project.

Beware of Scope Creep

Energy performance contracts have a habit of expanding the scope of infrastructure projects. What starts out as a defined undertaking can quickly broaden.

The idea for using an energy performance contract often comes from contractors and service companies vying for infrastructure work. A contractor may tell city officials that they are losing thousands of dollars each month in energy costs as they operate aging facilities. The solution, according to the contractor’s sales pitch, is an energy performance contract that will result in enough “savings” to pay for the cost of the project. Since the project will supposedly pay for itself, the contractor may propose adding items to the scope of work. What began as a narrowly focused project to address certain facilities may soon grow into a proposal to overhaul HVAC systems, lighting, plumbing, and water systems throughout the city. Expanded project scopes will

result in an even larger financial burden if the promised savings fail to materialize.

Despite the contractor's pitch of a risk-free project, local governments should avoid the temptation to use energy performance contracts as a way to finance sweeping infrastructure upgrades. This approach rarely pays off and poses significant financial and operational risk, especially when the project delays other critical infrastructure work.

Scrutinize What Is Actually Guaranteed

As with any contract, details matter. When it comes to energy savings contracts, however, the details can be lost in a convoluted structure that often obscures the true nature of the guarantees. In fact, the contract may not truly guarantee the city's recoupment of any specified dollar amounts.

For example, certain savings might be "stipulated" in the contract, such as the cost of existing service contracts that can be terminated following the project or future capital costs avoided by the updates. In some cases, however, such avoided expenses are simply replaced by a similar

expense, thereby eliminating the supposed savings. And if the "stipulated" savings fail to materialize following the project, the city government bears the burden, not the contractor. In that situation, stipulated savings essentially guarantee nothing. The contract merely assumes that the savings will occur, without any guarantee that they will.

The benchmarks used to measure energy savings also may be manipulated to favor the contractor. For example, a baseline calculation might assume unrealistic operating conditions as part of the savings formula, such as assuming that a thermostat is kept at a certain temperature when evaluating a building's energy usage after installing a new HVAC system. Based on manipulated benchmarks, it might appear on paper as if the contractor satisfied the savings guarantee, while in reality the city did not achieve any savings.

For large infrastructure projects with multiple components for calculating guaranteed savings, even a few unrealistic assumptions and benchmarks can destroy the financial viability of the project. As a result, it's extremely important to closely review each aspect of an energy performance contract to ensure what's promised is actually possible.

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Avoid Front-Loaded Payment Schedules

For an infrastructure project financed by an energy performance contract, it is important to understand that, at best, a government entity will recoup its costs over an extended time period that can take multiple years or even decades. Despite the city's reliance on such future savings, contractors will often push for construction payment schedules where the majority of milestone payments are due near the front end of the project. This minimizes the contractor's financing costs and allows the contractor to shift risk to the government entity by receiving payment at the front end of the project without any regard for the back end guaranteed savings. The city, on the other hand, ends up paying for most of the project without having the time to judge whether the promised savings will actually materialize.

To avoid this risk-shifting, the majority of the city's payment deadlines should come near substantial completion of the project. If possible, the city should hold back a percentage of the total project cost until after verification of initial cost savings from the project improvements (for example, after measuring construction period savings and the first annual savings period).

Some Projects, Such As Water Meter Systems, Are Riskier Than Others

When it comes to financing an infrastructure upgrade with an energy performance contract, some projects are more problematic than others. Projects involving the installation of automated water meters and billing systems, for example, are particularly risky. The contract may promise "guaranteed" savings in the form of increased revenue and lower operating costs from supposedly more accurate automated systems, as opposed to old systems requiring manual meter readings. However, these projects often fail to guarantee any actual savings or revenue and can be plagued by technical challenges associated with complex new systems.

For example, an energy performance contract may promise that a sampling of individual meters will accurately measure water consumption based on their performance in a lab. Such a guarantee, however, may not lead to increased revenue in real world applications. Collecting revenue from water usage requires not only accurate meter readings in the field, but also reliable transmission of those readings

over the wireless network to the automated billing system. When a contract promises the accuracy of individual meters but fails to guarantee performance of the integrated meter and billing system as a whole, there is no real guarantee of revenue or savings of any kind. Assuring that a few lab-tested meters accurately measure water use is far different from guaranteeing the city's actual collection of increased revenue to fund the project.

On top of the flimsy guarantees of individual meter measurements, the guaranteed savings calculation for water meter projects often contains "stipulated" savings that depart from reality in the field. The contract simply assumes that the government entity will realize certain operational and maintenance savings from the new water meter system, regardless of whether those savings occur. When the new water meter system ends up being more complicated and expensive to operate than contemplated by the assumed savings, the government entity is burdened with those costs into the future. This defeats the very purpose of the water meter upgrades.

Engage Outside Help to Evaluate and Verify

Local governments may not have the right experience to evaluate an energy performance contract, particularly savings calculations that can be unnecessarily complex. If feasible, government entities should engage outside consultants to evaluate the agreements, including the ongoing assessment of whether savings benchmarks are being satisfied after completion of the project. Rather than allowing a contractor to measure its own performance over the guarantee period, government entities should consider requiring the contractor to pay for independent testing of the project improvements to ensure savings are being realized. Otherwise, the contractor's self-serving annual reports may go unchecked.

In short, government entities should be wary of sales pitches promising "risk-free" energy performance contracts for infrastructure upgrades. Otherwise, a city could end up with financial repercussions that last decades.

Brian C. Boyle is a partner with Lightfoot, Franklin & White LLC in Houston, Texas. He represents businesses and government entities in high-stakes litigation across the country, including disputes arising from energy performance contracts and infrastructure projects. ★