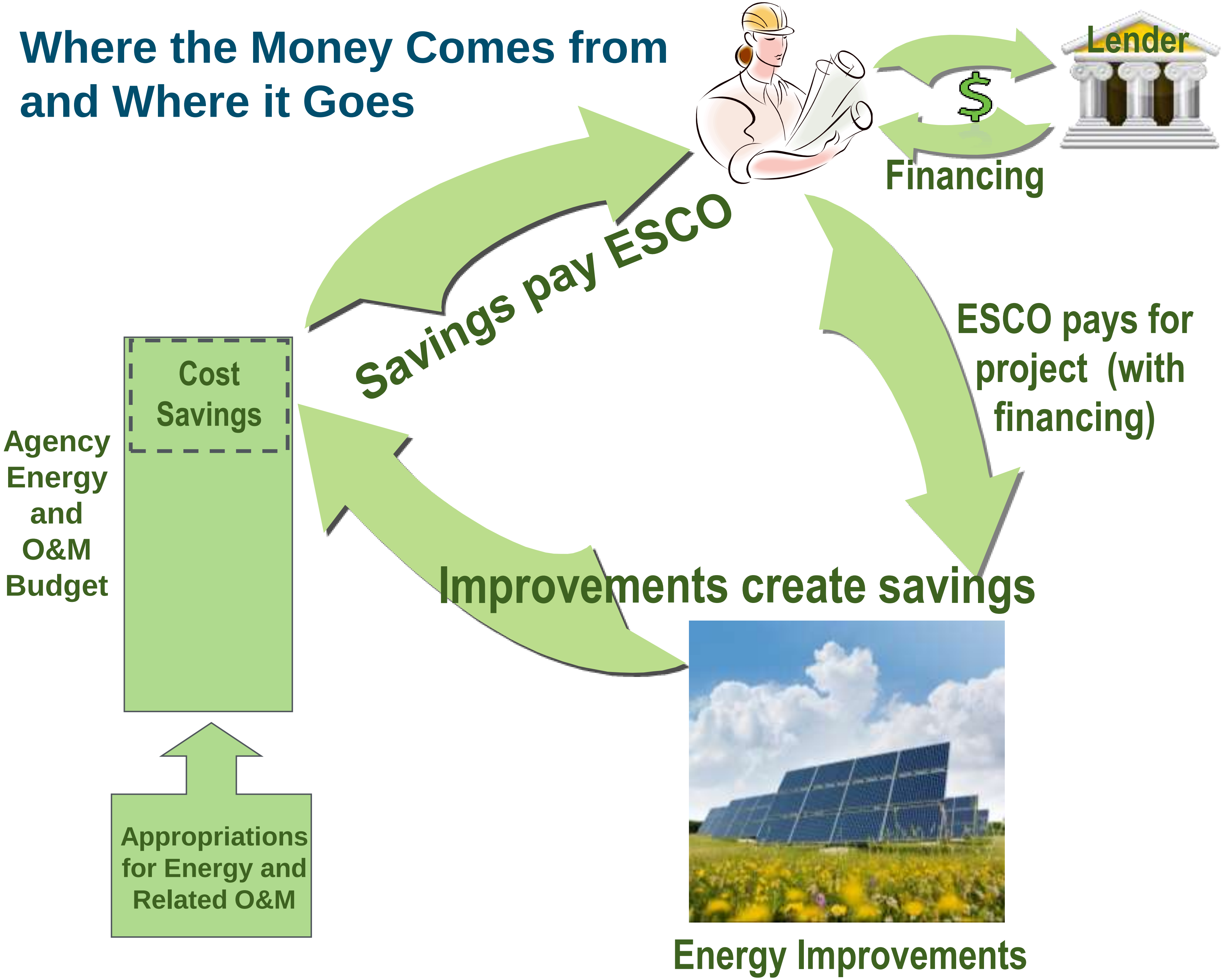
Proposal Review – Financing

U.S. DEPARTMENT OF ENERGY | Energy Efficiency & Renewable Energy

FEMP
Federal Energy Management Program

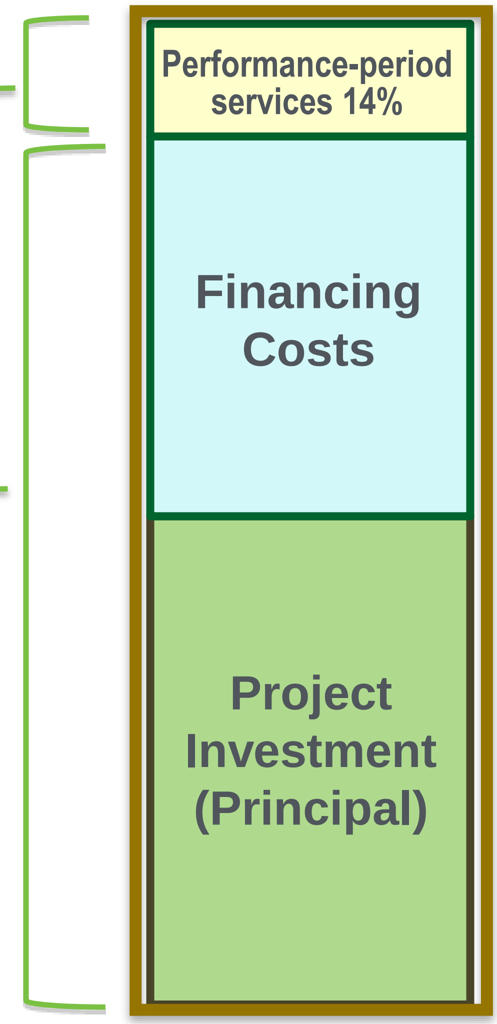
Where the Money Comes from and Where it Goes



What's in the payments?

- Performance-period services
  - M&V, O&M, R&R
  - NOT financed
- Debt service
  - Financing costs (Interest)
  - Project Investment (Principal)

Total Payments



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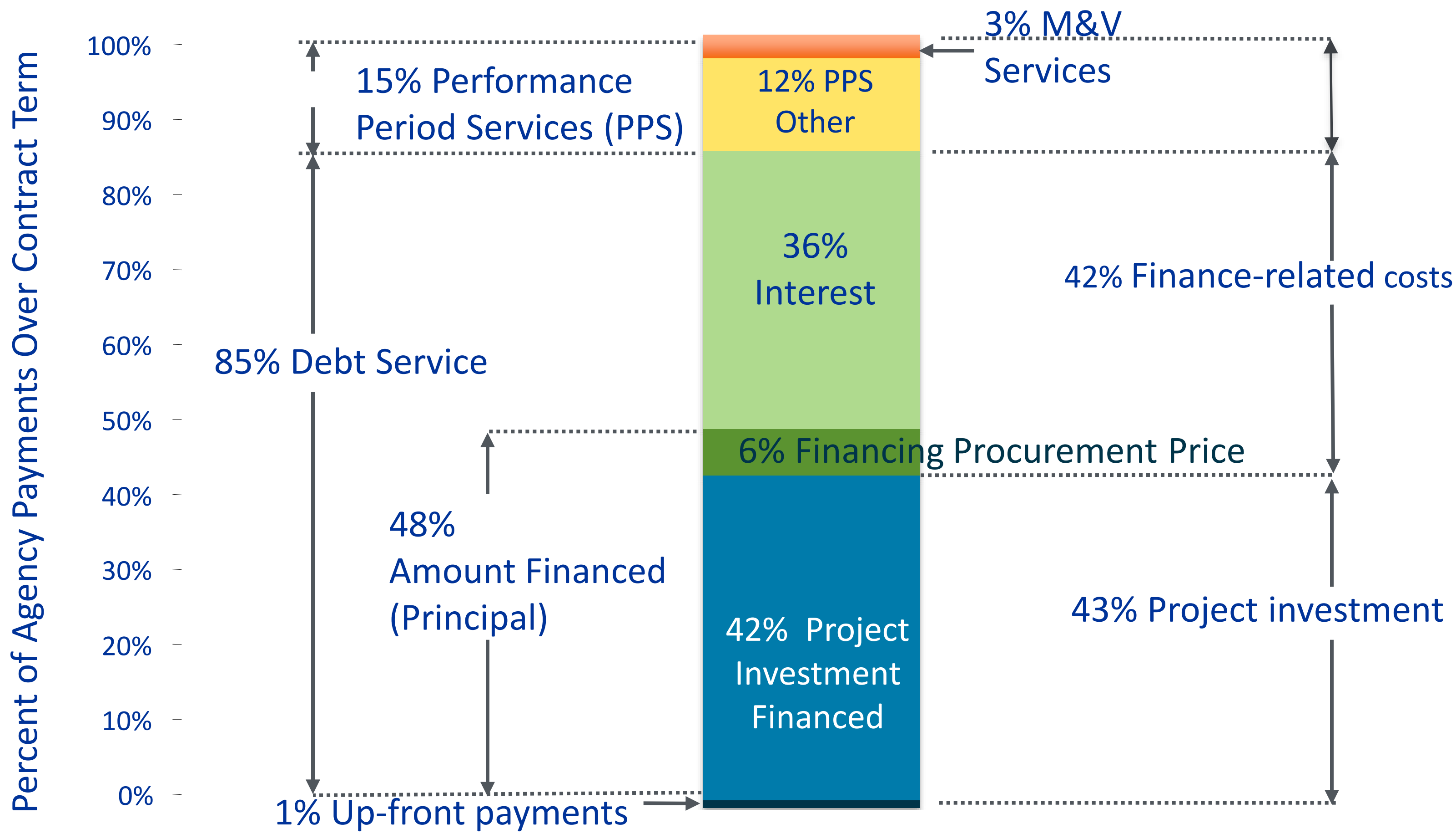
How the payments break down — The DOE-FEMP ESPC "Cost Stack"



*Data from DOE-FEMP ESPC projects awarded in FY09-11, average project interest rate = ~6.8%. ARRA-supplemented projects excluded. Figures may not add to exactly 100% due to rounding.

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Amount Financed =

+ ECM project development expense
+ indirects and profit

+ ECM design/construction expense
+ indirects and profit

+ Financing procurement price (FPP)

– *Minus* any one-time payments (usually before project acceptance)

Financing Procurement Price (FPP)

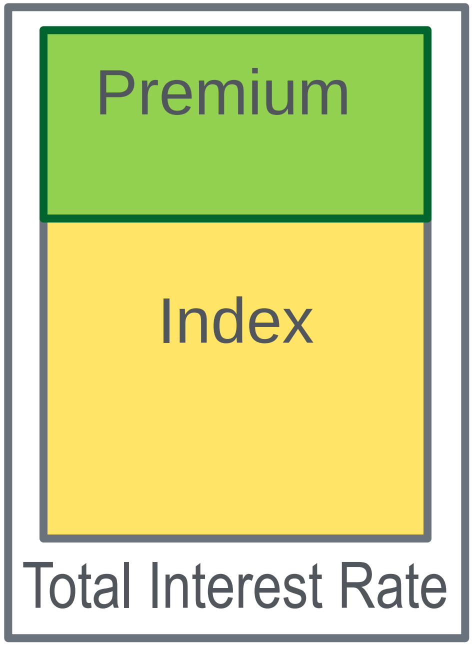
- Pass-through fee charged by financier
  - No profit for the ESCO
- Includes costs for:
  - Effort to arrange financing
  - Payment and performance bonds
  - Hedges to lock rates in advance of financial closing (hedges are not recommended)
- Biggest part of FPP is *capitalized construction-period interest*

What is capitalized construction-period interest?

- The total financed amount is deposited into a escrow account at beginning of construction
  - Generally administered by trustee
  - ESCO takes draw-downs
  - Account yields interest
  - ESCO pays interest on entire financed amount to the financier
- The difference between the interest earned and interest paid is the *capitalized construction-period interest*

Components of the Interest Rate

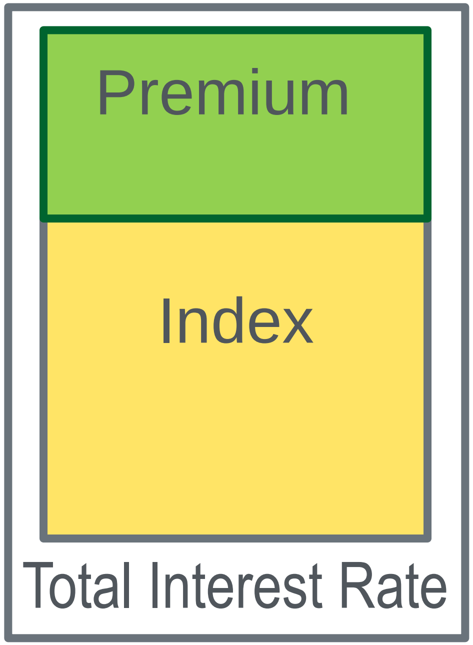
- Index interest rate — usually largest component
  - Represents the prevailing cost of money in the financial markets
  - Changes day to day
  - Any standard index can be used (e.g., like-term U.S. Treasury Securities)



- Web sources for rates
  - www.bloomberg.com
  - www.federalreserve.gov/releases/h15/current

The Premium

- Premium — Basis points added to index rate (1% = 100 basis points)
- Premium covers
  - Lender's costs (legal fees, administration, etc.)
  - Lender's perception of risk



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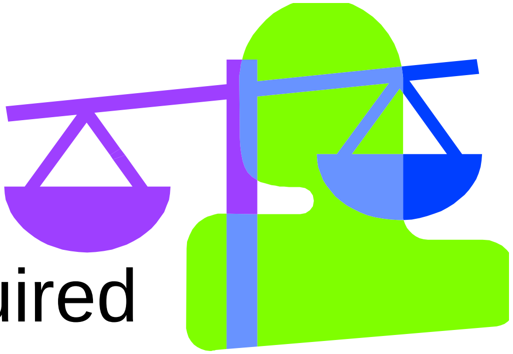
Competition in ESPC Financing

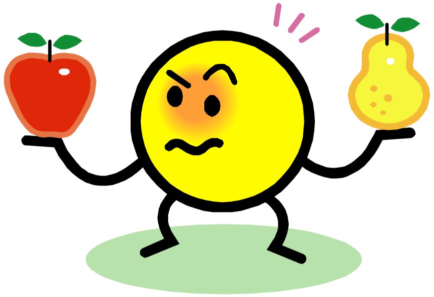


- FEMP-DOE ESPC ESCOs are required to solicit competitive financing offers
- Process and templates are defined in the contract
- Financing costs declined significantly with competition
- Selection of financing is still the ESCO's responsibility

Competitive Financing Process

- ESCO prepares Investor’s Deal Summary (IDS) and sends it to financiers to solicit offers
  - IDS establishes a common basis for solicitations
- Required content
  - All financial info
  - Risk, Responsibility, and Performance Matrix
  - Key target dates
  - M&V info
    - Financiers sometimes consider non-Option-A ECMs to represent risk

IDS and SFO Ensure that Offers are Directly Comparable



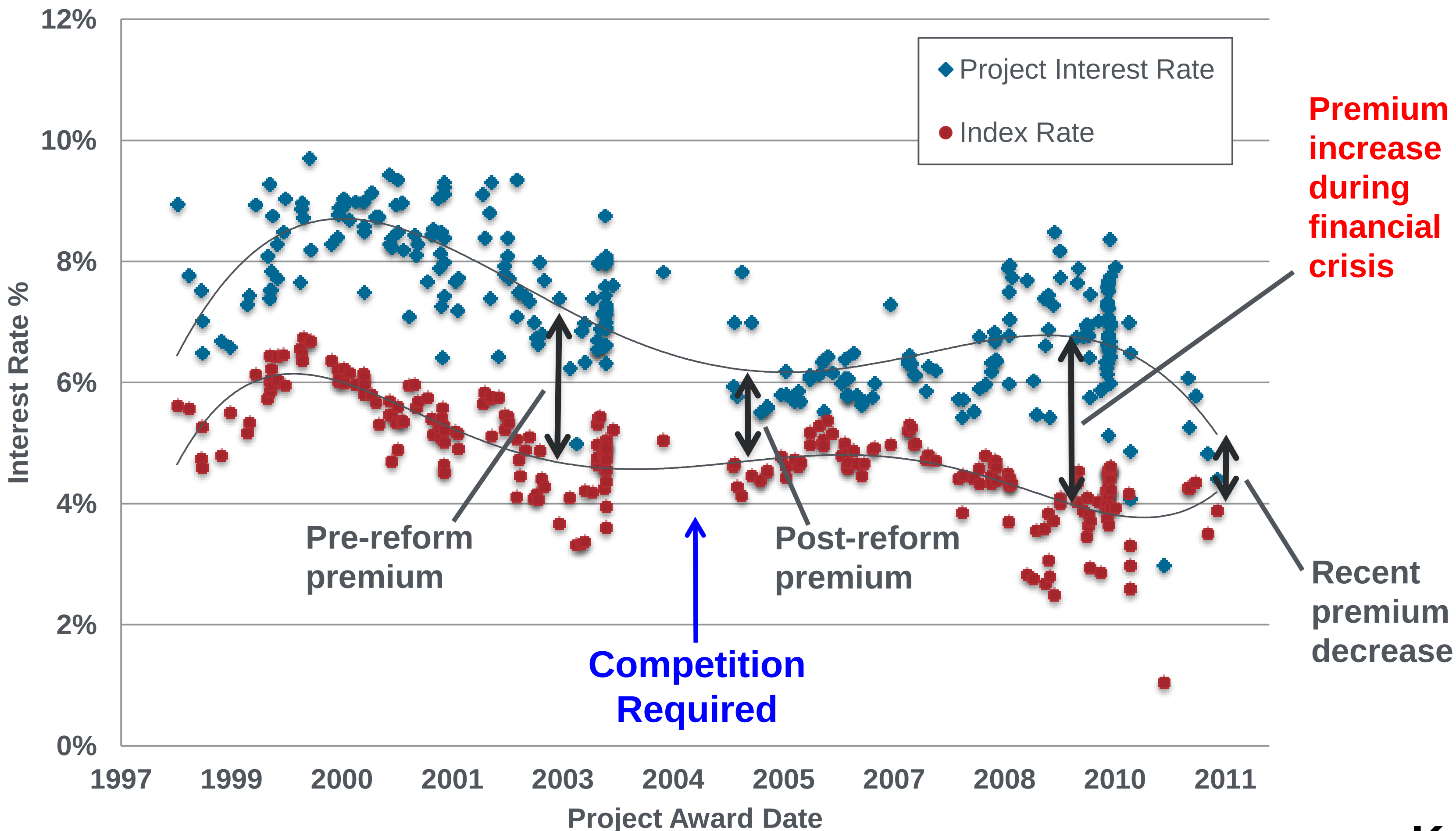
- Financiers make offers using Standard Financing Offer (SFO)
- Required contents:
  - Narrative description of financing package
  - Itemization of total amount financed
  - Period of time that offer will be honored
  - Other terms

Selection and Certification

- ESCO selects financing based on best value to the government
- ESPC provides a certified selection memo documenting process and rationale for selection
- Final proposal (and final TO schedules) are based on selected offer
- ESCO sends IDS and SFO for selected offer along with Certified Selection Memo to agency CO

With Financing, Competition Works

Competition cut interest rate premiums in half



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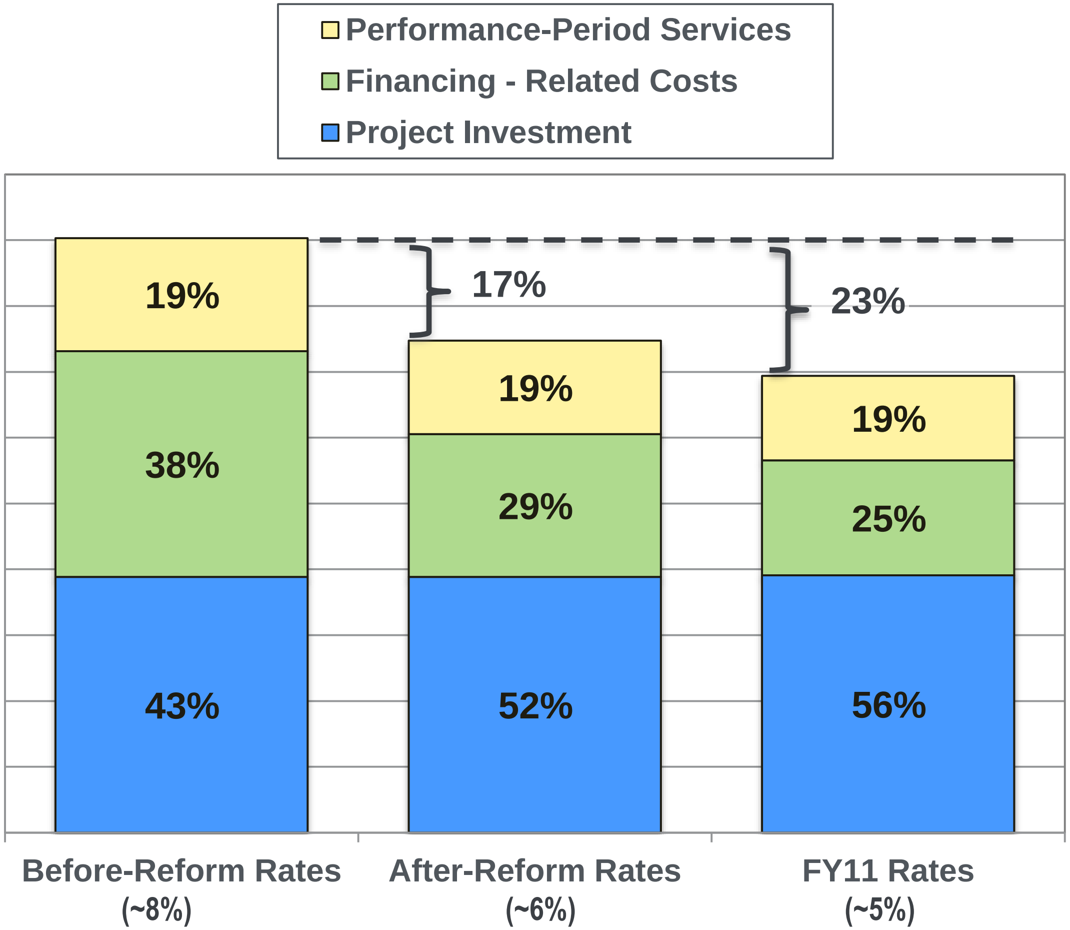
Same Projects for 23% Less

Using post-reform financing rates, the sum of payments for the *average project is 23% lower than with pre-reform rates.



*Average project is calculated from all DOE IDIQ ESPC awards, excluding ARRA-funded projects.

Lender's Perception of Risk

- Consider: The financing deal is between the financier and the ESCO
- Lender's perception of risk is influenced by:
  - ESCO's credit rating
  - Agencies' payment history (late payments, prepayments)
  - ESCO's track record (past performance)
  - Technical risk of the project
    - Level of M&V, complexity, etc.

How can you minimize financing costs?

Borrow less and pay it off sooner.

- Incentives and Rebates – Public benefit program EE and RE incentives; utility rebates
  - Agencies are “authorized and encouraged to participate” in these programs (EPACT-92 and other)
  - ESCOs are required by IDIQ contract to pursue all available incentives

FEMP’s Energy Incentive Program has info on incentives available to agencies in each state:
FEMP → Project Funding → Energy Incentive Programs

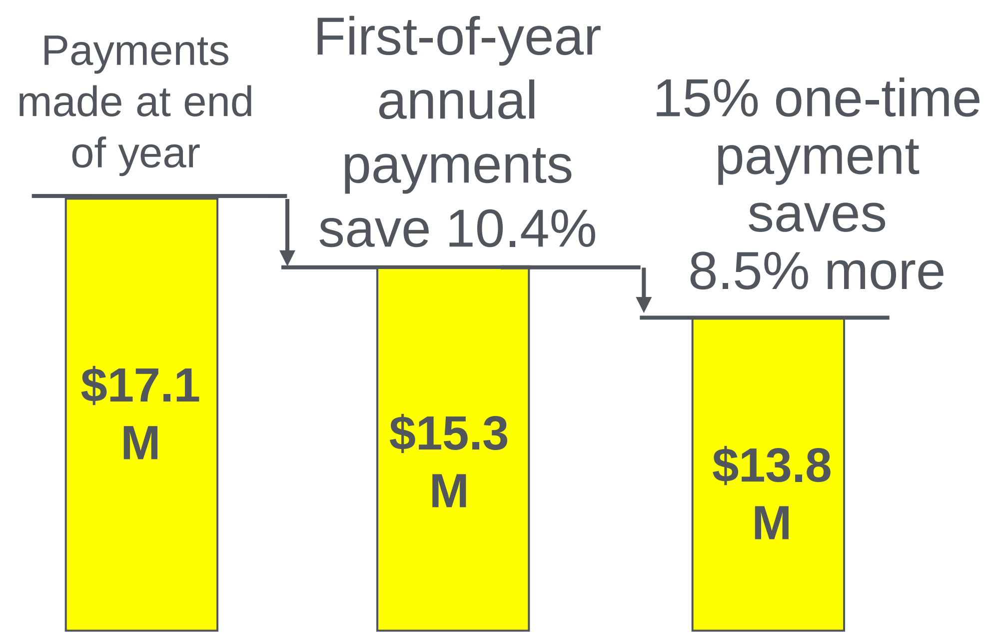
Borrow Less: One-Time Payments
– Reduce the Financed Amount
– Reduce Financing Costs

- One-time savings from avoided expenditures
- Construction-period savings

Pay Off Sooner: Make Annual Payments at Beginning of Contract Year

- This is permitted because it satisfies the condition that savings must be greater than payments on an *annual* basis

How Payment Strategies Can Total Project Payments Over Term By Reducing Interest Costs



Total government payments over contract term
(average ESPC project with 5% project interest rate)

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FEMP Advice on Financing Review

- Competition is a good thing. Make sure your ESCO is soliciting multiple offers.
- Wade through the details of the financial schedules (especially TO-3) and SFO and understand the components of the offer.
- Require justification for any differences between financier's offer to ESCO and ESCO's offer to government.
- Check the calculation of construction-period interest

Take advantage of FEMP's services and experience

- The FEMP ESPC team will review financing
  - Access to comparisons with other ESPC awards
  - Capability to analyze the financial schedules
    - Double-check the math
    - See that appropriate costs are entered where they should be

Review

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Q1: Are the costs for performance-period services financed, and must they be covered by savings?

A: No and yes

Q2: What are the two components of the total interest rate?

A: Index and premium

Q3: Who are the parties to the financing deal?

A: ESCO and lender

Q4: What (in general terms) can agencies do to minimize financing costs?

A: Borrow less and pay it off sooner

Next: Module L
Proposal Review – Pricing ►