ESCO FINANCING
An overview
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WHAT IS AN ESCO AND WHERE IS IT USED?

This note discusses the "ESCO" financing model of implementing energy efficiency projects.

The concept of an energy services company, or ESCO, is a very broad one. However, it is possible to set out some characteristics which are common to all these companies:

- ESCOs provide various services to their customers with a view to enhancing their energy efficiency. An ESCO's remuneration for these services is calculated by reference to the level of savings that it achieves;
- as a related point, an ESCO will provide a guarantee to its customers in respect of the service levels to be applied or the cost savings which the ESCO project will achieve; and
- a project structured using the ESCO model is capable of being financed by third party funders (as detailed below).

ESCOs therefore provide an efficient, flexible and bankable method for customers to leverage the technical and performance management skills of energy specialists in order to enhance their energy efficiency.

Examples of ESCO schemes might include:

- providing analysis and audits of a client's energy use and requirements and implementation of any associated recommendations;
- the design and implementation of energy infrastructure, for example a combined heat and power plant;
- efficient energy metering;
- property and facilities management.

The largest and most common ESCO projects tend to involve the commissioning and installation of equipment, for example biomass plants, combined heat and power plants or intelligent metering systems. ESCOs typically contract with a wide range of customers including local authorities, housing associations and commercial and industrial companies.
HOW ARE ESCOS STRUCTURED?

A number of corporate structures are available to implement an ESCO project. In the UK, the vast majority of ESCOs follow the "Energy Performance Contracting" model. Under this, the ESCO company guarantees the level of service to be provided or a specified level of energy savings.

To the extent that savings are made by the customer in excess of the agreed target level, then these are shared with the ESCO. The terms of this split are agreed at the outset of the project, having regard to a number of factors including the type of project, the relative bargaining position of each of the parties and financing arrangements.

Other models of ESCO are occasionally used. For example, a "chauffage" outsourcing contract which allows an ESCO to agree to supply a customer's energy at a set discount to its existing costs. Here, the ESCO then takes full control of, and responsibility for, the relevant energy services which it will then manage in such a way as to ensure that sufficient savings are made in order to allow it to make a profit. Although these other models exist, this note focuses only on the energy performance contracting model as this is the one we usually encounter.

There are typically two methods of structuring such an energy performance contracting ESCO project:

GUARANTEED SAVINGS CONTRACTS

Under this model, the ESCO gives a guarantee to its customer that an agreed target level of energy savings will be made, with any savings above this level being split on an agreed basis. The ESCO thereby assumes performance risk on the project. This enables the customer, assuming its funders are satisfied with its credit risk and that of the ESCO, to raise finance for the project directly. The level of saving to be guaranteed by the ESCO is then sized so as to be sufficient to meet the customer's costs in servicing its debt.

This model also lends itself to an asset finance solution, with the ESCO guarantee being sized so as to enable the customer to make equipment leasing payments.

SHARED SAVINGS CONTRACTS

Under this model, the ESCO company (often an SPV in these circumstances), rather than its customer, assumes responsibility for financing the costs of the ESCO project. Costs savings that are made from the project are, for an agreed period of time following project implementation, split in accordance with an agreed percentage between the customer and the ESCO. The share of costs
savings allocated to the ESCO tends to be higher than under a guaranteed savings contract in order to allow the ESCO to service its finance costs.

Bank funding here is usually on the following terms:

- the payment by the customer to the ESCO is split between (a) a fixed element and (b) a variable element.
- the fixed charge is sized so as to be sufficient to meet the ESCO's debt service costs together with adequate headroom. This can include an element of deductibles to take account of agreed service levels/key performance indicators;
- the variable element of the charge will usually include payments by the customer in respect of operating and maintenance costs as well as any fuel supply costs;
- as security, a funder will require that the ESCO company charges the assets used for the project in its favour and that the income stream from the fixed element of the charge is transferred to it. Funders may also require to enter into a "direct agreement" with the customer in terms of which the customer will not be entitled to terminate the ESCO arrangements (and with it the income stream available to repay bank debt) without first allowing the funder an ability to remedy;
- funders will also require to be satisfied with the terms of the underlying ESCO contract, having particular regard to the provisions regarding termination.

There are a number of advantages to the shared savings model. In particular, it allows finance to be raised in situations where the customer would be unable to finance the project itself. However, it should always be borne in mind that a funder will always ultimately be exposed to credit risk of the underlying customer. Also, there is a danger that ESCO companies, even if separate SPVs are used, could become over leveraged with the effect that bank funding becomes more difficult to obtain.
RELEVANT EXPERIENCE

• Advising CALA, the UK housebuilder on the implementation of ESCO district heating schemes on two of their major housing developments in the South East of England.

• Advising Galliford Try Renewables on their ESCO project at Graylingwells. This is a community heating scheme at the first net zero carbon housing development in the UK.

• Advising Foresight in relation to its bid to manage the Energy Efficiency Urban Development Fund. This involves co-investing proceeds from the London Green Fund as part of a European Regional Development Fund programme for energy efficiency retrofitting programmes (including through ESCO arrangements) in government and qualifying charitable/community estate in London.

• Advising an ESCO on its framework contract with the London Development Agency under the Building Energy Efficiency Programme.

• Advising Carillion Energy Services on the Community Energy Savings Programme, including two different funding models for energy measures in local authority estate.

CONTACTS

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