

COMMERCIAL BANKING

# Energy Performance Contract Financing as a Strategy:

Transforming Healthcare Facilities Maintenance



## Landscape At-A-Glance

Both public and private hospitals have worked hard to control their operating costs in the face of thinning margins, an uncertain economy and a challenging regulatory environment. As a result, many have deferred or are deferring facilities maintenance projects based on budget constraints and perceived priorities – with quality patient care squarely at the top of the list. This inertia becomes somewhat problematic considering the issues confronting COOs, CFOs and facilities managers:

- Aging infrastructure and equipment that inefficiently consume energy.
- Lack of funds to invest in improvements, upgrades and maintenance.
- Impact of healthcare reform expected to reduce reimbursements and revenue.

However, as they become increasingly more aware of the cost and sustainability benefits of clean energy initiatives, hospitals hope to improve energy efficiency at their buildings, facilities and services by lowering energy consumption and cutting greenhouse gas emissions.

From this perspective, an Energy Performance Contract (EPC) engagement – a solution that might not have been part of the original discussion – makes economic sense. An EPC project can be the catalyst that frees up trapped capital to boost a hospital’s profit margin, purchase state-of-the-art equipment, or improve the overall patient experience. Funded by a range of financial vehicles, including Tax-Exempt Lease Purchase (TELP) agreements, EPC has become the preferred working capital solution.

## Energy Performance Contracting Snapshot

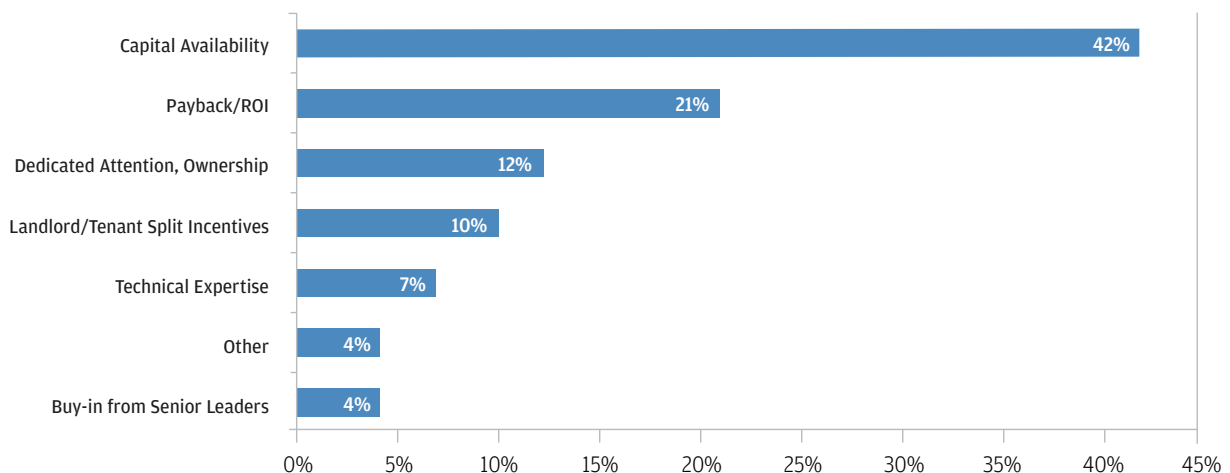
A typical EPC engagement provides healthcare organizations with a set of comprehensive energy efficiency measures. It represents an innovative form of contracting designed to overcome the major obstacles to deliver cost-effective energy efficiency and:

- Ensure savings generated will be sufficient to finance total project.
- Reduce utility bill costs.
- Improve air quality, indoor space comfort and productivity of building occupants.
- Comply with environmental regulations.

EPC is a viable alternative to traditional bidding and specifying where the burden of performance and guaranteed results is placed on highly specialized Energy Services Companies (ESCOs). With performance contracting a key deliverable, the ESCO provides all services required to design and implement an EPC engagement at a specific facility with long-term project financing usually provided by a third-party lending institution. In addition:

- Covering the initial energy audit through long-term monitoring and verification of project savings, the ESCO customizes a comprehensive set of measures to fit customer goals. These often include energy efficiency, distributed generation, water conservation, and sustainable materials and operations.

### WHAT IS THE TOP BARRIER TO CAPTURING POTENTIAL ENERGY SAVINGS FOR YOUR ORGANIZATION?



Source: Supple, Derek, Financing Models for Energy Efficiency and Renewable Energy in Existing Buildings, Institute for Building Efficiency, An Initiative of Johnson Controls, September 2010. Page 2.

- The ESCO “performance guarantee” is the distinguishing feature in this arrangement. It represents their commitment that a project will yield a specified reduction in energy and water use over a contracted term and guarantees the savings will be sufficient to cover the cost of financing for the life of the project.
- Energy cost reduction creates a favorable situation. At contract completion, the customer retains the full value of the savings. However, if the guaranteed reduction in energy use is not realized due to ESCO performance, the ESCO pays the customer the difference using pre-determined utility rate calculations.

There is one important distinction to be made. ESCOs do not guarantee reductions in utility bill charges since they cannot control utility rates. At the end of the contracted guarantee period, the client retains the full value of the energy savings.

## Financing Strategies

Clean energy projects depend on significant upfront investment and face a long payback period through energy bill savings. Fortunately, hospitals have access to an array of funding options offered through third-party financial institutions.

**TELP Agreement** financing strikes the simplest yet most important chord of an EPC engagement strategy by bringing the awareness of both the energy savings and the cost of the lease payments into alignment over the life of the contract. A well-structured TELP agreement – also known as a municipal or an abatement lease – enables the hospital to draw on dollars saved from their future utility bills to pay for new, energy-efficient equipment and upgrades today.

Due to the non-appropriation language typically included in TELP agreements, they may be considered operating rather than capital expenses. As a result, payments may not be considered “debt” in most states, and allow public healthcare organizations to avoid a voter referendum that might otherwise be required.

There may be cases when a TELP agreement is inadvisable, particularly where a state statute or charter may prohibit these financing alternatives from being implemented. In addition, the approval process may be too challenging to a point where the outcome would be compromised.

**Capital Leases** enable equipment acquisition through installment payments with little or no upfront capital required by treating the project as capital equipment owned by the financing organization and leased over a fixed term by the institution. Upon termination, ownership transfers to

the healthcare organization. While this represents a capital asset on the balance sheet requiring accountability for depreciation, it also provides tax advantages.

**Term and Tax-Exempt Loans** offered by commercial banks have been important sources of financing for healthcare organizations over time. Term loans are the most common solution and can be tailored to the size and scope an organization’s needs. Term loans may be secured or unsecured, and reflect an interest rate based on the lender’s cost of funds, the federal funds rate, the LIBOR (London Interbank Offered Rate), or the bank Prime Rate.

Rate and pricing fluctuations in the marketplace have made Tax-exempt loans attractive for financing large projects. While many banks continue to see low capital costs for these credit products, healthcare organizations should diligently evaluate them to ensure competitive pricing, convenient loan structure and the impact of the loan on their own credit rating.

**Power Purchase Agreements** improve energy efficiency from onsite renewable energy systems without investment upfront. The energy efficiency or renewable energy assets are legally owned by an entity separate and apart from the facility owner. In a common application, one might permit a qualified third party to install a solar photovoltaic system on your property and agree to buy the resulting energy at a set price for a specific term, usually 15-20 years. As a result, the hospital can capitalize on a number of tangible benefits including lower electricity cost.

## Measurement and Verification

As energy cost and consumption are too often invisible to all but a select few within an organization, a sound measurement and verification plan can help confirm actual energy costs savings through:

- **Comprehensive measurement** that uses industry best practices to measure savings created within an individual facility through an energy efficiency, water efficiency or renewable energy initiative. Since costs can be expensive based on project type and scope, matching the approved measurement strategy to the level of risk is vitally important. If risk is low, the effort applied to measure and verify may be limited in intensity. Adjustments, such as changes in square feet, effect energy savings measurement by enabling a realistic comparison of post-retrofit conditions to those of the base year. If these factors are left unaccounted for, any realized savings might be improperly calculated.

# CASE STUDY

## Case Study: University of Massachusetts Medical Center, Worcester, MA

Founded in the early 1970s, the University of Massachusetts Medical Center (UMass Medical), a two million square foot facility, faced mounting challenges from its aging and inefficient energy systems. Working with ESCO partner NORESKO, UMass Medical engaged in a 10-year EPC covering a range of infrastructure improvements for energy management systems and ventilation upgrades, process water improvements, lighting improvements, and more. The \$30 million project is expected to save \$36 million in utility and operating expenses over the next 10 years while improving power and system infrastructure reliability.

Source: NORESKO.com, Case Studies, NORESKO, LLC 2012.

- **Third party verification.** When the ESCO has more experience than the organization that has contracted with it, employing a qualified third party to audit the ESCO's reports becomes key to ensuring transparency, unbiased results, and compliance with the energy savings guarantee. This "trust but verify" arrangement ensures both parties agree the information determining payments is accurate.
- Taking steps to reduce **post-project risk** by including all deliverables and line item costs in the total economic snapshot to improve budgeting. Document all financial transactions to enable a thorough audit - critical where energy savings are central to performance-based payments and/or EPC guarantees.

## Best Practices

Consider the following steps to enhance the chances for success:

- Compare efforts required for handling energy efficiency initiatives internally vs. the holistic approach inherent in working with an investment-grade ESCO.
- Clearly define the scope of work, identify ESCO-related responsibilities and issue an RFP.
- Make the ESCO decision process inclusive across all stakeholder departments.
- Conduct a thorough energy audit of facility systems - lighting, heating, ventilation, air conditioning and water.
- Align goals with recognized energy conservation protocols.
- Engage unbiased third party to review/confirm results of measurement and verification reports/savings.
- Increase the chances of securing financing with the best terms possible. A realistic plan can boost investor confidence in your energy efficiency initiatives.

EPC financing provides an opportunity to optimize energy use, capture lost utility and operating costs, and re-purpose those funds to meet critical facility and clinical needs - often with minimal disruption to patients and medical staff. Project funding can be sourced through best-in-class, third party financial institutions with capital to lend. To optimize opportunities and minimize exposure to risk, choose a partner with a strong track record of success in healthcare EPC financing.

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