

B2B: Energy Performance Contracts & Energy Service Companies

By [Dominique Tissot](#)

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Dominique Tissot

Partner, Head of Energy Efficiency and Renewables Practice
CMS, Russia

Sustainable energy supply is one of the key challenges of the forthcoming decades in most countries around the world, especially Russia. Fortunately, Russian authorities and businesses have understood that reverting to energy efficient technologies can allow them to save money and reduce the impact on the environment.

Among the key barriers to the development of Russia's sustainable energy market are, of course, tariffs, which remain low as part of the government's immediate social policies. Still, most experts agree that a significant increase in tariffs is not only crucial to making energy efficiency projects financially viable, but an unavoidable step to ensure long-term energy sustainability and security.

A second barrier is the high cost and low availability of funding on the Russian financial market.

Finally, the lack of understanding of the energy efficiency business and its prospects, coupled with low public awareness on environmental and energy consumption issues, make it quite difficult today to attract private investments to this sector.

A first step toward encouraging the use of energy efficient technologies was achieved with the adoption of the federal law "On energy saving and the increase of energy efficiency" dated November 23, 2009 (hereinafter referred to as the "Law") and its application regulations.

In particular, the law introduced the concept of an "Energy Performance Contract" (further referred to as "EPC"). Among other things, such a contract may include a provision stating that the investor is remunerated out of the savings made from the customer's reduced energy consumption; the price in this case would therefore vary according to the achieved results or upon achieving the level of performance specified in the contract.

The law sets out the main conditions that must be provided in an EPC. As a matter of example, guaranteed energy savings and the term of validity (which may not be less than the time required for achieving the guaranteed energy savings) must be specified in the contract.

Apart from "pure" EPCs, the law also provides for the possibility of introducing energy service provisions in contracts of sale and purchase, supply or transfer of energy resources (except for natural gas).

In practice, however, because of the existing gaps in the current legislation on EPCs, as well as the regulatory constraints applicable to the use of energy resources in Russia (gas, other fossil fuels, electricity, etc.), most contracts on energy savings used in the private sector are usually based on general civil law principles and "classic" contractual schemes (i.e. service, sales or work agreements), rather than the "newly adopted" EPCs.

Generally speaking, and from the business perspective, two main EPC models can be envisaged:

The shared savings model — under this scheme, the ESCO finances the project by covering the project's costs (with its own debt and equity) and assumes both the performance and credit risks. The proceeds from energy savings are shared between the ESCO and the customer according to the EPC terms. Clearly this type of EPC model requires financially robust ESCOs capable of addressing their own financing needs or of attracting funding with appropriate security (pledge of assets, parent guarantees, etc.).

Most experts agree that a significant increase in tariffs is an unavoidable step to ensure long-term energy sustainability and security.

This model should be particularly attractive among potential customers and should help developing the ESCO market in Russia. In practice, however, only very few ESCOs are financially capable of implementing this type of EPC model. Moreover, the cost of funding, as well as the lack of financial products adapted to the specifics of the ESCO market, remain a hindrance to the development of ESCOs in Russia.

The guaranteed savings model — under this model the ESCO guarantees a given level of energy savings, taking upon itself the performance risk. The customer thus provides the financing, taking the credit risk. The ESCO is paid from the energy savings above the guaranteed levels, which may be split between the customer and the ESCO based on EPC terms. This model clearly requires a high degree of trust between the various project

participants (the ESCO, the customer and lenders). Thus, this model is more appropriate in mature markets; the lack of understanding of the energy efficiency business in Russia and the very few tested ESCO projects with sustainable financial models make this particular EPC model more difficult to implement for the time being.

Obviously, these EPC models are not exclusive and many other hybrid or alternative models may be used or seen.

EPC, as a new type of contract, should be particularly attractive to the public sector, as it allows public entities and state-owned companies to invest in energy efficient technologies and/or renewables at limited cost. Indeed, no or little upfront investment is usually required from the customer, as the investor takes upon itself some of the key project risks and gets paid from the energy savings made by the customer.

But the difficulty is that these types of public sector projects, mostly in the housing, public services and utilities sectors, usually require significant investments and have relatively long payback periods. As a result, potential investors will seek guarantees: financial guarantees (whether from financial institutions or directly from the federal, regional or municipal administrations), as well as tariff and operational guarantees (measurements and verification, proper operation and maintenance of installations, etc.).

Moreover, investing in the public sector is still considered riskier due to the political aspects of such projects and the various drawbacks of the Russian procurement, tariff and budgetary legislations, making it more difficult to secure payment and properly hedge or insure the corresponding risks.

This is the reason why it is contemplated that most projects and development opportunities in the nearest future will likely arise from the private sector and will be characterized by investments related to clearly defined technological processes / outputs.

Consequently, in order to facilitate the development of the Russian energy efficiency business, ESCOs will need to prioritize and aim for projects with a short to middle term payback period, which are more easily bankable, initiate the relationships with potential customers and get pilot projects that will set the basis for the industry practice.

That being said, it is noteworthy that EPCs pertain mostly to the planning, financing, implementation and monitoring of energy efficiency measures. In this respect, it may be relevant for ESCOs to think of broadening their services by offering all from energy savings services ("EPC model") to energy services ("Energy Services Contract Model"), thereby encompassing not only energy saving measures but also the delivery of energy resources, the operation and maintenance of facilities, as well as other energy-related services.

This would allow introducing hybrid remuneration structures (with fixed guaranteed and variable components), de facto mitigating financial risks and enhancing the projects' bankability and conversely increasing the attractiveness of the ESCO business on the Russian market.

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