

A Financial Model for Evaluating Projects with Performance Contracts

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Introduction

- The Financial Task Force was formed in Brazil in 2001
- Purpose of the FTF
- Organizations supporting the FTF
- The Financial Modeling Tool
 - Provided by Econergy (EIC)
 - For use by the Brazilian Financial Task Force (FTF) finance team
 - The purpose of the model is to aid the FTF in developing and evaluating financially viable energy efficiency projects in Brazil as part of its program administered by IBMEC.

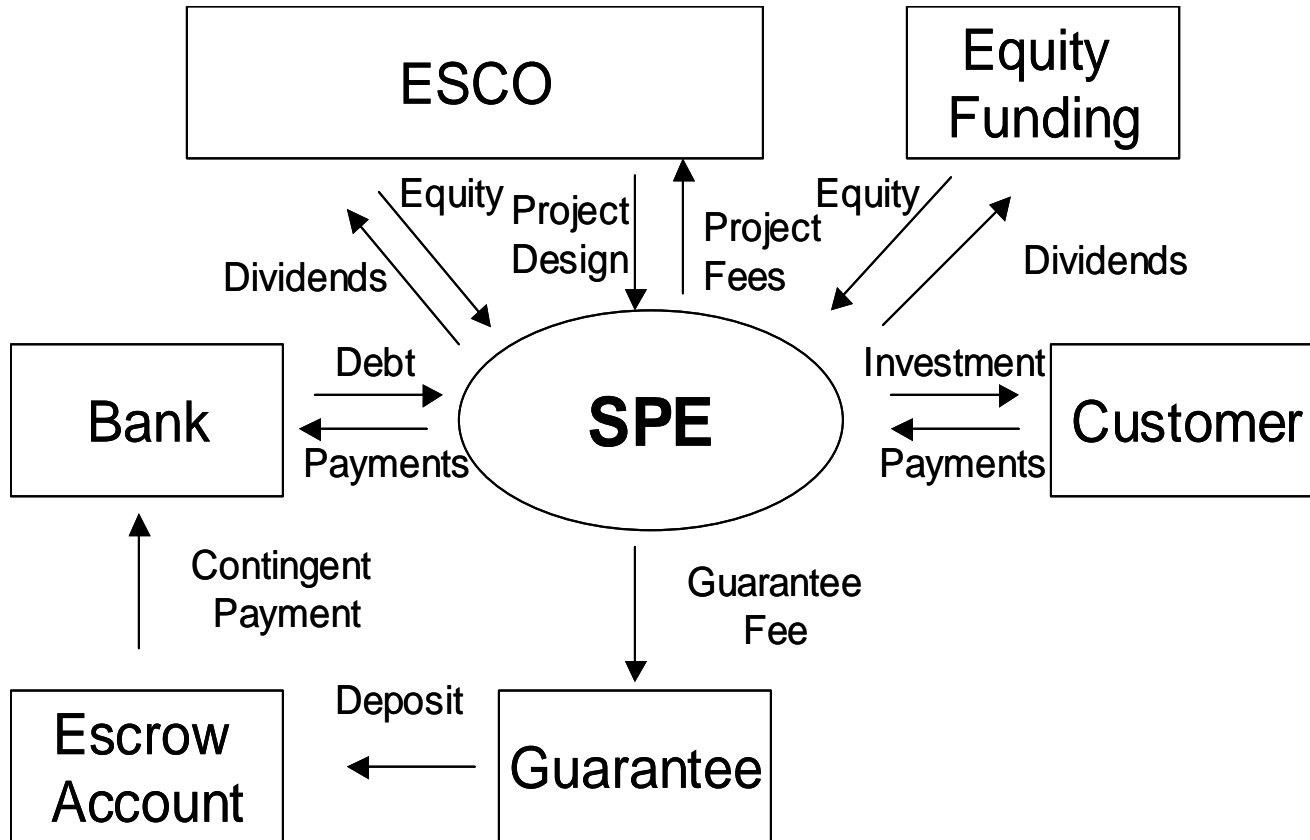
The Brazilian Context

- In 2003 Brazil possesses approximately two dozen firms that can fairly characterize themselves as ESCOs.
 - Some have experience in the application of performance contracting.
- Third party “financial guarantee” is necessary to make financing available for performance contracting.
- Most banks require adequate guarantees in excess of the loan amount.
 - A minimum of 150% of the loan amount would have to be guaranteed.

The Guarantee Issue

- The FTF has considered several possible financial structures.
 - Fundo de Aval exclusively for energy service companies
 - Equity fund exclusively for energy service companies
 - SuperESCO structure that provides a third party “leasing” approach to ESCO development.
- No single consensus
- In the April International Roundtable, the FTF finance team recommended the use of a SPE (Special Purpose Entity).

SPE



Advantages of an SPE

- ESCO as the third-party guarantor
- It allows any third party “equity fund” to invest with a clean investment structure.
- It reduces the risk for several of the other participants
 - It removes the project revenue stream from the ESCO balance sheet.
- The recommendation is to proceed with the SPE approach for the first few projects.
 - Transaction costs to set up an SPE will be minimal compared to the overall due diligence to make these first few projects finance worthy.

Review of the Financial Model

- Dynamic Excel spreadsheet which characterizes the full financial parameters of an energy service project.
- The model will provide: NPV, IRR, Income Statement, Balance Sheet and amortization table, which allows the user to see if the project is viable for all parties.
 - Key financial information on the customer
 - Key financial information on the ESCO as a guarantor of the project performance
 - It allows the user to plug in a cost for a third party guarantee
 - It allows for third party equity to be infused into the SPE and shows the equity investor a projected yield on its return

Possible Funding Sources

- There is little in the way of financial choices in Brazil
- Commercial banks are interested in new industries but are reluctant to participate.
- Some form of intermediation is required to prompt commercial lenders to participate.
- Equity funds have been seen as an alternative financing source.
 - Sumitomo
 - Clean Tech Fund
 - CAF
- Pension funds might be interested in performance contract financing.

Use of Financial Guarantees

- The structure proposed by the FTF provides three natural “guarantors”
 1. The customer
 2. The ESCO
 3. The third guarantor could be provided by a separate financial facility interested in supporting an ESCO activity such as FGPC and FAMPE.

Risks and Mitigation Strategies

- Country Risk
 - Short-term payback projects
 - Financial screening
- Inflation
 - Coordination between the sales and engineering teams
- Environmental Risks
- Performance and Persistence Risk
 - SPE needs to calculate how changes in operation can affect the facility's energy use prior to the retrofit.
- Contractual Liability
 - Insurance Provisions

Risks and Mitigation Strategies (cont)

- Currency, Inflation and Interest Rate risk.
- Sponsor Risk
- High transactions costs
- Long lead times
 - The SPE should have an adequate cash reserve to ensure project success.
- Savings guarantee

Brazilian Performance Contract Issues and Recommendations

- The “Guaranteed Financing” is the preferred structure in USA and Europe.
- The “Shared Savings” structure.
- The financing of the project as an operating lease.
 - ESCO is the lessor.
- Which style or structure should be used for an ESCO contract?

Conclusions

- The FTF financial team should to proceed with the application of the SPE model.
 - The SPE can receive guarantees from the customer, the ESCO or from third party sources.
 - Equity funds can be tapped to invest in a project to create greater comfort for a lender.
- Use the Financial Modeling Tool in the evaluation of the proposed projects for financing.
 - Provide the model to applicants to the FTF.
- The FTF should publish a series of performance contract models that interact with the Financial Modeling Tool.