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Energy Savings Performance Contracts: Risks and Rewards for Local Governments

By David R. Cook, Jr.

Energy efficiency has received increased attention as the public begins to recognize the tremendous benefits it provides. Among other things, energy efficiency reduces utility consumption, which ultimately reduces utility costs.

Georgia governments, including counties, recently acquired new authority to enter into energy efficiency contracts, called “energy savings performance contracts” under the Guaranteed Energy Savings Performance Contracting Act (the Act). These contracts may provide a politically attractive way to replace old utility systems in county buildings or property (i.e., lighting systems, HVAC, etc.) or to install or replace energy efficient projects (i.e., installing new insulation, storm windows or weather stripping) funded by future utility

cost savings. Even so, before executing an energy savings performance contract, counties should review the risks involved.

What are energy savings performance contracts?

Energy savings performance contracts are agreements where energy service companies install or implement utility conservation measures and guarantee an agreed-upon level of utility cost savings. The amount of utility cost savings should cover the cost of installation and the company’s fee. After all costs have been recovered through savings, all future savings accrue to the benefit of the county.

These contracts are typically long-term agreements (ten, fifteen or twenty years) to provide ample time for the county to realize sufficient savings. While the installation and implementation phase may last only a few months, the guaranty phase (the period during which savings accrue) lasts much longer to ensure that all costs are recovered.

The projects usually involve physical construction, such as installing new insulation, storm windows or weather stripping, or upgrading or replacing HVAC systems and lighting fixtures. They also may involve services, such as utility rate analysis, labor studies or efficiency training programs. In addition to utility cost savings, they also may result in increased revenues, such as income from distributed generation (i.e., the production of energy at the county’s premises) or billing equipment upgrades.

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Benefits of energy savings performance contracts

Energy savings performance contracts provide two primary types of benefits to local governments: **cost savings** and **public goodwill**.

Utility Cost Savings: Utility cost savings are measurable reductions in utility costs resulting from utility conservation measures. To quantify utility cost savings, counties must compare their utility usage *after* installation with a baseline that accurately represents their utility usage *before* installation. By comparing pre- and post-installation utility usage, counties can determine the level of utility cost savings that is attributable to the energy savings performance contract project.

Energy saving performance contracts typically require companies to measure and verify savings by using generally accepted methodology and sound engineering techniques. For example, under “whole facility measurement,” companies collect data from a facility’s electric meter or sub-meter. Other techniques involve the measurement of

utility usage by specific equipment, or stipulated savings based on the owner’s normal operating hours or other valid assumptions.

In addition to reducing energy usage, these projects can result in energy generation. The Act authorizes counties to install renewable energy generation systems that use solar sources. On-site power generation obviously reduces the need to purchase power, thereby directly reducing utility cost. Furthermore, where onsite power generation exceeds demand, the excess may, in certain circumstances, be sold to the utility.

Public Goodwill: Another benefit of energy savings performance contracts is intangible in nature: public goodwill. While it is intangible, public goodwill is nevertheless a valuable asset derived from utility savings projects. Several attributes make these contracts very attractive to counties.

First, they result in net zero cost over the life of the contract. This attribute is especially attractive due to the need to cut costs. For instance, some facilities desperately need improvements that may be paid for, in whole or in part, by utility cost savings resulting from energy savings performance contracts. Some local governments can find creative

ways to acquire these necessary capital improvements at a net zero cost.

Second, these contracts promote sustainability. In a global survey conducted by *The Economist*, social responsibility was given as the second-most-important factor driving energy efficiency projects. In another survey by the U.S. Department of Energy, 65 percent of respondents cited public relations as a primary driver in energy efficiency efforts.

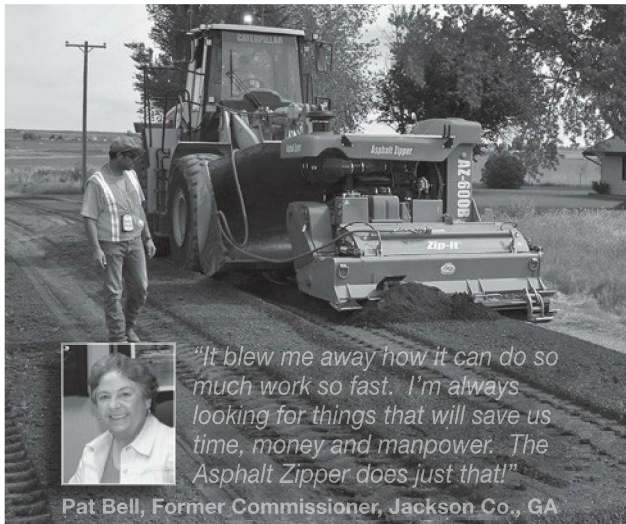
Third, energy savings performance contracts provide long-lasting benefits to the local government, extending years after the initial cost has been recovered. In other words, when the contract term ends, utility cost savings continue for the service life of the utility conservation measures.

Risks of energy savings performance contracts

Energy savings performance contracts clearly provide tremendous benefits to local governments. They do, however, come with significant risks that must be addressed and mitigated. These risks are significant because the contracts typically involve expensive capital improvements, complicated engineering and technical expertise, and long-term

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obligations. Moreover, they are usually performed in occupied facilities, adding a layer of complexity to the work.

Construction Risks: Because energy savings performance contracts normally require significant capital improvements and heavy construction, they give rise to many of the same risks as large construction projects. Construction risks include, for example, defective equipment or products and defective installation, which may or may not surface until long after installation.

Delay is also concern. The work is normally performed in occupied facilities, which may impact employees, administrators, and public events and services. Similarly, the contract may demand extra compensation for excessive delay caused by the owner, possibly resulting from interference from occupants and facility usage during installation.

Finally, construction projects are unpredictable. As a result, construction claims that include claims for additional work, changes in the work, or unexpected conditions uncovered at the facility, may occur.

Savings Deficiency Risk: Another risk is the failure to generate the required level

of savings. When the contract fails to produce the required savings, the owner does not receive its benefit of the bargain. The potential also exists that project costs will not be recovered through utility cost savings. To some extent, however, the savings guaranty (the company's promise to pay for any savings deficiency) mitigates against the risk of savings deficiency. Unless the company provides additional security, the guaranty is only as good as the company's creditworthiness.

Risk of Material Changes: After installation occurs, certain events can materially increase utility consumption – decreasing the amount of utility savings – at no fault of the company performing the work. For example, an owner may increase utility consumption by increasing the number of employees or hours of operation, setting the thermostat at an unreasonable or unanticipated level, or failing to properly service and maintain HVAC equipment. Such events may diminish the amount of savings the company would otherwise achieve. In these circumstances, most contracts provide for an adjustment to the baseline (the benchmark used

to measure savings) to account for the owner's impact on savings. Such events should be addressed by contract and with preventative measures.

Conclusion

Energy efficiency projects can provide the combined benefits of capital improvements along with long-lasting utility cost savings. Furthermore, with their political attractiveness, counties should certainly consider them. Despite their benefits, however, energy savings performance contracts need to be approached with caution to mitigate the associated risk.

For additional information on energy savings contracts, the Georgia Energy Savings Performance Contracting Act, and other public works resources for public owners, visit AHC's Construction Law Blog at: www.ahclaw.com/construction. ■

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