STATE AGENCY ENERGY EFFICIENCY CONTRACTS

LOUISIANA LEGISLATIVE AUDITOR

INFORMATION REPORT

PERFORMANCE AUDIT DIVISION

ISSUED DECEMBER 12, 2007

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LEGISLATIVE AUDITOR

December 12, 2007

The Honorable Donald E. Hines,
President of the Senate
The Honorable Joe R. Salter,
Speaker of the House of Representatives

Dear Senator Hines and Representative Salter:

This report provides the results of our review of current state agency performance-based energy efficiency contracts. The purpose of this report is to provide basic information regarding these contracts and to explain issues related to energy efficiency contracts. In preparing the report, we did not conduct an in-depth performance audit of any of the nine state contracts.

I hope this report will assist your understanding of energy efficiency contracts and thereby benefit you in your legislative decision-making process.

Sincerely,

Steve J. Theriot, CPA
Legislative Auditor

SJT/dl

EEC07

Office of Legislative Auditor

Steve J. Theriot, CPA, Legislative Auditor

Information Report

State Agency Energy Efficiency Contracts

December 2007

Audit Control # 07200689

Introduction

This report provides information concerning state agency performance-based energy efficiency contracts. We present this information to give an explanation of:

- What constitutes a performance-based energy efficiency contract
- How the process works
- Who is involved in the process
- The amount of money involved with each contract
- Guaranteed and stipulated savings

In preparing this report, we did not conduct an in-depth performance audit on any of the nine state contracts presently in effect. Instead, we performed the following procedures while compiling this information report:

- Reviewed relevant state law
- Reviewed each of the nine state contracts in effect
- Obtained total dollar amounts for each contract
- Obtained the amount that each agency has paid on its contract
- Compared state law with contract language to determine whether energy savings are fully guaranteed

Overview of State Energy Efficiency Contracts

What Is an Energy Efficiency Contract?

Louisiana Revised Statute (R.S.) 39:1496.1 provides that a state agency may enter into a performance-based energy efficiency contract for services and equipment. The contractor or energy service company (ESCO) provides equipment and services to the agency intended to reduce the agency's energy consumption. Such a contract is attractive because state law effectively requires that it results in no cost to the agency. According to R.S. 39:1484(A)(14), in a performance-based energy efficiency contract, the agency's payment obligation for each year is either:

(1) set as a percentage of the annual energy cost savings attributable to the service or equipment under the contract, or

(2) guaranteed by the contractor to be less than the annual energy cost savings attributable to the service or equipment under the contract.

The ESCO is to provide the agency a guarantee of energy savings, according to R.S. 39:1496.1(C)(1). This guarantee is designed to ensure that the equipment and/or services provided by the ESCO produce a total annual energy and operational/maintenance cost savings sufficient to at least fully fund the agency's payment obligations each year. This includes the costs of any financing arrangement entered into by the agency.

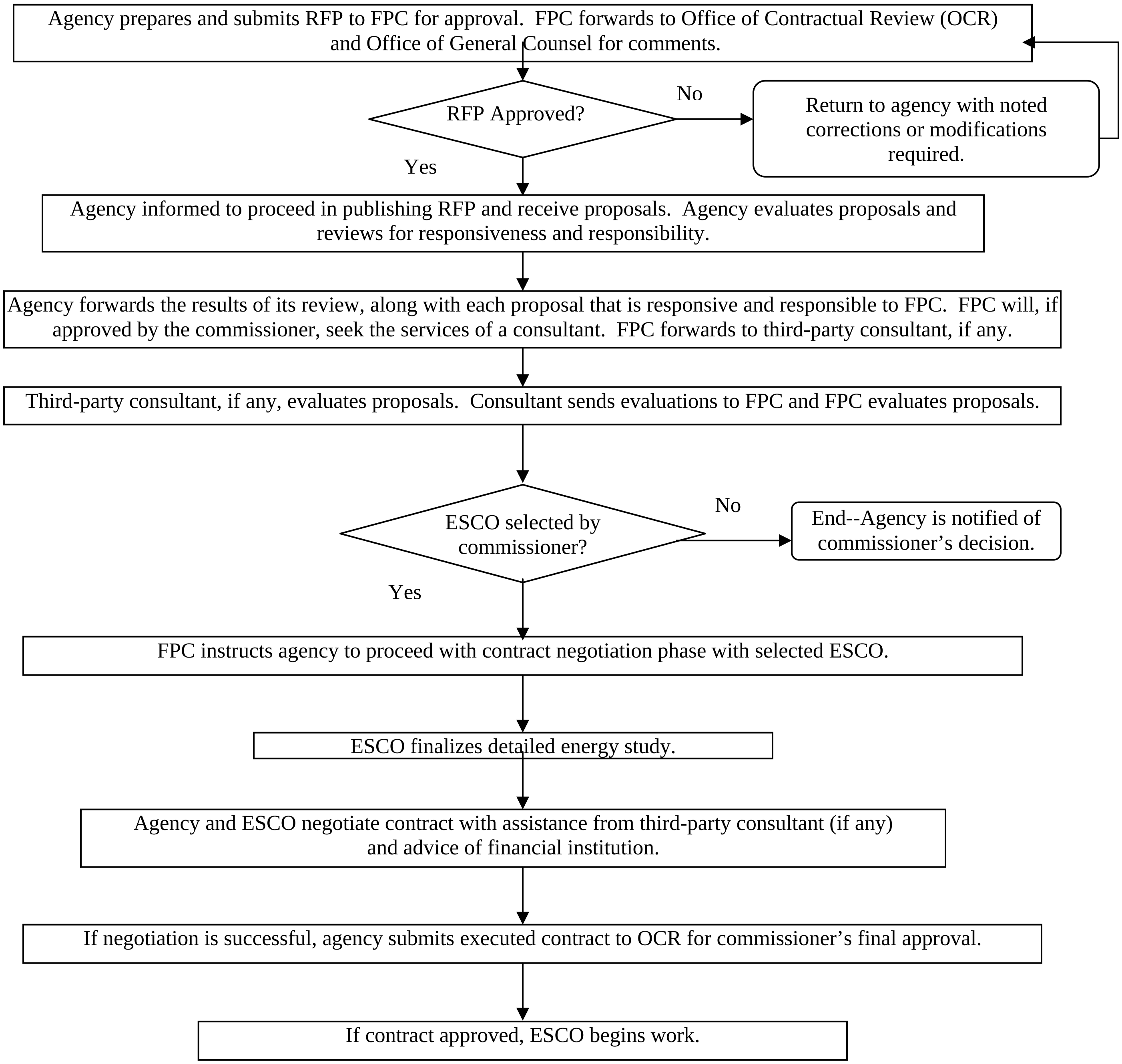
How Does the Contracting Process Work?

Energy efficiency contracts are not awarded through the public bid process. State law [R.S. 39:1496.1(B)] provides that any state agency desiring to enter into an energy efficiency contract must use a Request for Proposal (RFP) process. The agency will submit its RFP to Facility Planning and Control (FPC) within the Division of Administration (Division) for approval. Once approved, the agency publishes the RFP and receives proposals. After evaluating the proposals it receives, the agency submits to FPC the results of its evaluation and the responsive proposals it received.

FPC (and a third-party consultant, if selected by the Division) reviews and evaluates the proposals and forwards its recommendations to the commissioner of administration. If the commissioner selects an ESCO, FPC instructs the agency to proceed with negotiations.

The ESCO must first perform a detailed energy study of what improvements would benefit the agency. After the energy study is completed, the agency and ESCO negotiate a contract with assistance from the third-party consultant (if any) and the advice of a bank or other financial institution. The negotiated contract must be submitted to the Office of Contractual Review (OCR) (within the Division) for final approval by the commissioner of administration. If the contract is approved, the agency notifies the ESCO to begin work on installation of energy-saving equipment. Exhibit 1 contains a flowchart of the contracting process.

Exhibit 1
Energy Efficiency Contracting Process



Source: Prepared by legislative auditor's staff using information obtained from OCR. See www.doa.louisiana.gov/ocr/ESPCFlowchart.pdf.

What Is the Legislative Auditor's Role in Energy Efficiency Contracts for State Agencies?

The legislative auditor is to conduct performance audits of performance-based energy efficiency contracts entered into by state agencies, according to R.S. 39:1496.1(E)(2). The legislative auditor shall establish a schedule for executing such audits, which shall provide for periodic audits during the term, and upon completion of contracts. The Performance Audit Division of the legislative auditor will be responsible for carrying out these duties. Although we have not yet conducted a performance audit of a contract, we plan to begin such audits in the future.

The Division may use a third-party consultant to help select an ESCO. State law requires the legislative auditor to certify that the consultant has no direct conflict of interest with the agency, the proposals of the ESCO, or with any proposer. Although we have not yet had to certify the independence of a consultant, we have developed a questionnaire to use for this purpose.

In addition, the Financial Audit Division of the legislative auditor conducts audits of state governmental entities that may have energy efficiency contracts in effect.

Do State Agencies Have Contracts in Effect Now?

There are nine state agency contracts presently in effect. Exhibit 2 presents these agencies and also provides basic information concerning the contracts. Exhibit 3 shows the four state agency contracts that have terminated. We have not done an in-depth performance audit on these contracts to determine whether the contracts, in their entirety, are in compliance with state law regarding energy efficiency contracts.

According to an official at FPC, no state agencies are currently negotiating contracts. The Departments of State and Public Safety and Corrections, Corrections Services, are currently working toward issuing RFPs. Also, Northwestern State University is presently developing its RFP.

Exhibit 2
State Agency Energy Efficiency Contracts in Effect
Contract Information

	State Agency	Location	Vendor	Contract Date	Contract Term (Years)
1	Louisiana School for Deaf	Baton Rouge	Johnson Controls, Inc.	May-04	15
2	LSUHSC	Shreveport	Johnson Controls, Inc.	Jul-02	17
3	University Medical Center	Lafayette	Johnson Controls, Inc.	Oct-99	20
4	LSU Student Union	Baton Rouge	Johnson Controls, Inc.	Aug-02	15
5	UNO	New Orleans	Johnson Controls, Inc.	Oct-98	20
6	Lallie Kemp Medical Center	Independence	Johnson Controls, Inc.	Feb-03	17
7	LSU Cogeneration Plant	Baton Rouge	Bernhard Mechanical Contractors, Inc.	Jan-03	20
8	Southeastern University	Hammond	Sempra Energy Services	Dec-01	20
9	Louisiana Tech University	Ruston	Carrier Corporation	Jul-03	7

Source: Prepared by legislative auditor's staff using information obtained from FPC and OCR.

Exhibit 3
Terminated Energy Efficiency Contracts
Contract Information

State Agency	Vendor	Contract Date	Contract Term (Years)
Louisiana School for the Deaf	Johnson Controls, Inc.	Feb-93	10
University Medical Center	Johnson Controls, Inc.	May-89	10
Chabert Medical Center	Johnson Controls, Inc.	Nov-93	9
LSU Chiller Plant	CES/ WAY International	1992	2

Source: Prepared by legislative auditor's staff using information obtained from FPC.

For Each Contract in Effect, What Is the Contract Amount and How Much Has the State Agency Paid Its Vendor?

Exhibit 4 shows contract amounts and amounts paid as of September 2007 for the nine state agency contracts presently in effect. We present more detailed information on each contract on the following pages.

Exhibit 4
Energy Efficiency Contracts in Effect
Contract Amounts and Amounts Paid as of September 2007

	State Agency	Total Contract Amount	Amount Paid to Vendors
1	Louisiana School for Deaf[1]	$4,420,489	$848,424
2	LSUHSC-Shreveport	15,490,290	3,912,676
3	University Medical Center	4,746,367	1,768,944
4	LSU Student Union	3,452,118	1,742,348
5	UNO	30,508,091	12,679,128
6	Lallie Kemp Medical Center	3,462,797	813,335
7	LSU Cogeneration Plant	90,181,436[2]	32,281,083
8	Southeastern University	12,141,954	2,993,078
9	Louisiana Tech University[1]	1,985,245	1,181,694
	Total	**$166,388,787**	**$58,220,710**

[1] In these contracts, the state agency paid the ESCO in full for equipment by financing the purchase price with a bank.
[2] Not included in this amount is "Deferred Profit" in the amount of $7,300,888 that will be paid to the ESCO as energy savings are realized. This increases the contract amount to $97.48 million.

Source: Prepared by legislative auditor's staff using information obtained from FPC, OCR, and the state agencies under contract.

Louisiana School for the Deaf (LSD)

LSD entered into a contract for energy conservation equipment and consulting services in May 2004 with Johnson Controls, Inc., (JCI) for a term of 15 years. LSD desired to lower its energy costs and conserve energy through this contract with lighting retrofits and replacement, water conservation measures, chiller and tower replacement, and other improvements.

The purchase price of the equipment and work, including financing and other associated costs, was $3,320,544. LSD financed the purchase with a bank. In addition, there is a service agreement in which JCI agreed to provide 24 hour a day service on the equipment. The total price of this service is $1,099,945 thus, the total contract amount is $4,420,489. As of September 2007, LSD had paid a total of $848,424 to the bank and JCI.

Louisiana State University Health Sciences Center (LSUHSC)-Shreveport

LSUHSC-Shreveport entered into an agreement for performance-based energy equipment and services with JCI in July 2002 for a term of 17 years. Some of the equipment included a chiller and controls, two cooling towers, and two secondary chilled water pumps. The total amount to be paid over the term of the lease-purchase contract is $15,490,290. This amount is comprised of lease payments of $12,784,230 and maintenance of $2,706,060. As of September 2007, LSUHSC had paid $3,912,676 to JCI.

University Medical Center (UMC)

UMC, located in Lafayette, entered into an energy efficiency contract with JCI, effective October 1999, for a term of 20 years. Under this lease-purchase agreement, UMC is to acquire certain equipment installed by JCI. Originally, the total contract amount was $2,642,926, but the contract was later amended to include a maintenance agreement. The total cost of the maintenance plan is $2,103,441, resulting in a total contract amount of $4,746,367. As of September 2007, UMC had paid $1,768,944 to JCI.

Louisiana State University, Student Union (LSU)

LSU entered into an agreement for performance-based energy equipment and services with JCI in August 2002 for a term of 15 years. LSU wanted to make improvements to lighting and water systems. The total amount of lease payments under this lease-purchase agreement is $2,274,618. Under the terms of a service agreement, JCI is to provide maintenance services 24 hours a day, 7 days a week. The total cost for this service is $1,177,500 thus, the total amount of this contract is $3,452,118. As of September 2007, LSU had paid $1,742,348 to JCI.

University of New Orleans (UNO)

UNO entered into a contract with JCI in October 1998 for a term of 20 years. Under the lease-purchase contract, JCI installed certain equipment, such as hot water boilers, chillers, and a cooling tower. The total amount of lease payments is $23,548,091. In addition, there is an agreement which JCI is to provide service 24 hours a day, 7 days a week on all covered equipment. This agreement costs UNO $348,000 annually. With this added cost, the total contract amount for UNO is $30,508,091. As of September 2007, UNO had paid $12,679,128 under these agreements.

Lallie Kemp Medical Center (LKMC)

LKMC entered into a performance-based energy equipment and services contract with JCI, effective February 2003, for a term of 17 years. The total amount of the lease-purchase contract is $2,009,797. There is also a planned service agreement which JCI is to provide 24-hour maintenance, 7 days a week. The addition of the planned service agreement increases the total contract amount to $3,462,797. As of September 2007, LKMC had paid $813,335 to JCI.

Louisiana State University, Cogeneration Project

In January 2003, LSU entered into an agreement for consulting services and energy efficiency services and equipment with Bernhard Mechanical Contractors, Inc., (Bernhard) for a term of 20 years. The purpose of this contract is to design and install a new Gas Turbine Cogeneration System at the Baton Rouge campus. LSU entered this lease-purchase agreement to lower its overall energy costs. The total lease cost of the agreement is $65,250,771. This cost was to be paid in semiannual installments over the life of the contract.

There is also a maintenance agreement with a cost to LSU totaling $24,930,665 over the 20-year life of the contract. With the addition of the maintenance agreement, the total contract amount is $90,181,436. Not included in this amount is construction profit of $7,300,888 that Bernhard is deferring. This amount shall be recovered through savings if they are recognized. The two parties to this contract are currently in litigation, according to an LSU official. As of September 2007, LSU had paid $32,281,083 to Bernhard.

Southeastern Louisiana University (SLU)

SLU entered into a contract with Sempra Energy Services in December 2001 for a term of 20 years. The purpose of the contract is to design and install energy conservation measures and provide monitoring services to the campus. Under the terms of this lease-purchase agreement, the total amount of the contract is $11,751,142. In addition, there are measurement and verification costs of $390,812 thus, the total contract amount is $12,141,954. As of October 2007, SLU had paid $2,993,078 to Sempra Energy Services.

Louisiana Tech University

Louisiana Tech entered into a total retrofit solutions agreement with Carrier Corporation in July 2003 for a term of 7 years. The purpose of the contract is to improve and retrofit the lighting systems on campus thereby using less energy. The total contract amount for the retrofit solutions is $1,985,245, which includes interest and other associated costs. Louisiana Tech financed the purchased equipment. As of September 2007, Louisiana Tech had paid $1,181,694 to its creditor.

Do Any Contracts Have Savings That Are Not Guaranteed?

What Are Guaranteed Savings?

Performance-based energy efficiency contracts are attractive because state law effectively requires that they result in no cost to the state agency. State law requires that the ESCO provide a guarantee of energy savings to the agency. The guarantee of energy savings shall, at a minimum, ensure a total annual savings sufficient to fully fund any financing arrangement entered into to fund the contract. If the annual cost savings do not cover costs to the agency, the ESCO must annually make up any deficiency between the actual annual cost savings and the savings amount guaranteed in the contract.

State law requires that when total annual savings are calculated, maintenance savings must be included. "Maintenance savings" means operating expenses eliminated and future capital replacement expenditures avoided as a result of new equipment installed or services performed by the ESCO.

What Is the Problem With Stipulated Savings?

Contracts with stipulated savings are those where the parties agree that a certain amount of savings will be assumed to be achieved every year. The parties may further agree that these savings will not be monitored and measured.

The legality of unmeasured stipulated savings has been called into question. Attorney General (AG) Opinion No. 07-0002 involves a local governmental entity energy efficiency contract with stipulated operational savings.

The opinion concludes that the stipulated operational savings are not guaranteed because there is no measurement and verification of the savings. Without measurement and verification, the savings that were deemed to have been achieved may not actually have materialized. The opinion concludes the contract does not meet the statutory definition of a performance-based energy efficiency contract because operational savings are not guaranteed.

The parties involved in AG Opinion No. 07-0002 litigated their energy efficiency contract in the Eighteenth Judicial District Court (JDC). In <u>Siemens Building Technologies, Inc. v. Iberville Parish School Board</u>, the judge granted a Motion for Partial Summary Judgment filed by the Iberville Parish School Board on the basis that the contract between the parties was invalid for failure to comply with Louisiana law. In other words, the judgment of the Eighteenth JDC supports the reasoning of AG Opinion No. 07-0002. Siemens Building Technologies, Inc., has appealed this decision to the First Circuit Court of Appeal.

As a result of this litigation and other contracts appearing to not guarantee operational savings, some ESCOs have met with officials from FPC and our office to develop a possible solution to the problems with the current contracts and proposed contract language for future projects. Our office facilitated these meetings. Several ESCOs are working to devise methods to ensure that operational savings can be guaranteed in present and future contracts.

Do State Agency Contracts Have Stipulated Savings?

We reviewed the nine state contracts to determine whether their energy savings are fully guaranteed. We found that eight of these contracts contain stipulated savings that do not have to be measured or monitored annually. Thus, based on AG Opinion No. 07-0002 and the ruling of the Eighteenth JDC, these contracts may not be valid.

Recommendation: These agencies should seek advice as to whether these contracts could be considered invalid based on the Eighteenth JDC judgment and AG Opinion No. 07-0002.