

Performance Contracting Legal and Regulatory Update¹

August 23, 2013

Recent History

In 2008 the State Auditor's Office (SAO) conducted a thorough review of the Performance Contracting process as permitted under state statutes (and Section 51.927 for Higher Education Institutions; 2166.406 of the General Government Code for State Agencies).² It found that of 15 contracts entered into by 9 agencies or universities, 13 did not fully meet the requirements of the law.

Some projects, for example, may have been paying for themselves out of savings, but the actual *guaranteed* savings were not greater in every year than the annual payment obligation. (The law requires that the guaranteed savings in any one year be greater than the total cost of the project divided by the term of the contract.) Some projects varied from others as to what costs were included. At least one contract allowed the performance contractor to pay for years in which there was a shortage of savings but recoup excess savings in another year. Some projects mixed energy savings projects with other projects under the same contract, so that the total contract did not meet the payback requirements of statute. In some cases, after years of savings results the SAO noted it may be unnecessary to maintain the monitoring and verification associated with the savings guarantee, which would allow additional cost savings.

No malfeasance was indicated, and no criminal intention was found. Agencies were generally pleased with the results of the work performed by their selected performance contractors. Nevertheless, the State Auditor's Office recommended that the State Energy Conservation Office (SECO), The Higher Education Coordinating Board (THECB), Bond Review Board (BRB), and the Texas Public Finance Authority (TPFA) coordinate with each other more closely, and scrutinize proposed projects and the underlying contracts more closely, both to provide additional guidance and assistance to agencies, and assure each contract did indeed comply with the letter of the law.

In 2012 the State Government Organization Committee of the Texas Senate, which had overseen the evolution of performance contract law, undertook an investigation of the current status of performance contracting and related state policy. The Committee's [interim report](#) found that the oversight agencies involved had made the process improvements recommended by the State Auditor, and the SAO confirmed that its concerns had been addressed satisfactorily. By the end of 2009, in fact, SECO had

¹ This history and status update on performance contracting for state agencies and universities was prepared by Robert J. King, President of [Good Company Associates](#), on behalf of [SPEER](#), the South-central Partnership for Energy Efficiency as a Resource, for the State Agency Energy Advisory Group, 8.22.13 following a verbal presentation and discussion with SAEAG members on 8.21.13, and does not necessarily represent the position of SPEER or its board of directors.

² The State Auditor did not review projects initiated by local school districts or local governments although the laws governing these jurisdictions (Section 44.901 of the Education Code for Public Schools and, Chapter 302 of the Local Government Code for Cities and Counties), mirror those for state entities.

added a number of guidance documents to its [website](#), including example contracts, and check lists for agency management and third-party reviewers to use to comply with state law, and receive approval.

Perhaps more importantly, however, the Senate committee reported that, “Since the 2008 SAO audit, state agencies have not made use of ESPCs, perhaps because they are unaware that they can and that they are encouraged to use this tool.” The report made three recommendations:

- SECO should work in an on-going way with state agencies and ESCOs to continually upgrade “...standards of accountability, performance and transparency to increase confidence of public sector energy managers in Energy Savings Performance Contracts (ESPCs).”
- “SECO and THECB should highlight ESPC success stories”
- “By way of encouraging state agencies to make use of the ESPC mechanism for funding, the Legislature should require SECO or THECB to review the Measurement and Verification of Savings report provided by the contractor and provide an analysis to state agencies, institutions of higher education and the Legislative Budget Board for a period adequate to determine performance and then discontinue the review.”

Legislative Update

In the 82nd regular session of the legislature, in 2011, the Chairman of the Energy Committee of the House, Representative Keffer, sponsored and the legislature passed a bill affecting performance contracting. HB 1728³ clarified that performance contracting could be applied to either new or existing buildings, recognizing the importance of design as well as new construction practice and new higher efficiency equipment. It further declares that an agency or institution can include other projects within the scope of work of a performance contract that do not meet the requirements for energy or water savings measures. So long as the funding for those measures is not borrowed from the state, the cost will not be counted against the savings guarantee. This measure was adopted in response to one of the issues raised by the SAO review earlier. Now, if an agency has confidence in a performance contractor, and wants that contractor to perform an ancillary function (such as roof replacement for example), it can be included within the scope of work without being included in the costs that must be paid for out of savings, so long as the money comes from a source other than state debt.

During the 83rd regular session of the Legislature a second piece of legislation was sponsored by the Chair of the Government Organization Committee. SB 535, by Senator Zaffirini, explicitly addressed the third recommendation of the Government Organization interim report, based on the desire for more in-depth evaluation by the oversight agencies (SECO and THECB), to assure savings indeed pay for the investments made. This bill requires that SECO and the THECB review energy and water savings reports prepared by or for the agencies engaged in performance contracting, and:

“provide an analysis, on a periodic basis, of the cost savings under the energy savings performance contract to the state agency [or governing board of the institution of higher

³ The legislation addresses performance contract law for cities, counties and school districts equally, allowing performance contracts to be applied to both new construction and existing buildings, and allowing inclusion of non-energy and water savings measures within a performance contract not to count against the savings guarantee, so long as funds to cover the cost of such additional measures is not borrowed from the state.

education] and the legislative Budget Board until the state agency [or governing board of the institution of higher education] determines that the analysis is no longer required to accurately measure cost savings.”

Not unrelated to this, the findings of the SAO included the concern that performance monitoring and verification reporting was adding substantial costs to some performance contracts, sometimes unnecessarily. SAO also noted that most of the existing performance contracts with state entities included a provision that tied M&V and ongoing maintenance support to the guarantee of savings. It is not unreasonable for a conscientious ESCO to want to have an ongoing maintenance contract to assure guaranteed savings do materialize as promised. The SAO findings suggest that agencies or universities should try to separate ongoing monitoring and verification of savings, however, from the performance contract and the savings guarantee language if possible, both to economize and eliminate potential conflicts of interest. This new language also suggests, however, that a state entity might release a performance contractor from its guarantee at some point during the term of a contract, although that might be interpreted to be in conflict with the requirement for a guarantee of savings.

We assume that no language the legislature adds to the law is meant to be without impact, and new words should be read in the context from which they arise. My reading of the resulting body of law is that, while approval of a performance contract requires the contractor to *offer* a guarantee that meets the requirements of the law, it may be within the authority of the agency or institution of higher education to terminate the guarantee, if:

- the state entity determines that the guarantee is no longer necessary; and
- if the analysis of SECO or the THECB (as appropriate) confirms such determination to the entity and the Legislative Budget Board; and
- it is in the financial interest of that entity.

Certainly, there is room for interpretation here, however, and I cannot offer legal advice, which each agency or institution will have to seek for themselves. Nevertheless, because this was a concern expressed by at least one state agency I would note the following elements of the law that might support this interpretation.

The law defines a performance contract separately from the requirement for the guarantee of savings, for example, in the very first paragraph:

“Sec. 2166.406. ENERGY SAVINGS PERFORMANCE CONTRACTS. (a) In this section, "energy savings performance contract" means a contract for energy or water conservation measures to reduce energy or water consumption or operating costs of new or existing governmental facilities in which the estimated savings in utility costs resulting from the measures is guaranteed to offset the cost of the measures over a specified period.”

In addition paragraph (f) of this same section states:

“The state agency may enter into an energy savings performance contract for a period of more than one year only if the state agency finds that the amount the state agency would spend on the energy or water conservation measures will not exceed the amount to be saved in energy, water, wastewater, and operating costs over 20 years from the date of installation.”

The language addressing the guarantee is found in only in paragraph (h):

“An energy savings performance contract shall contain provisions *requiring the provider* of the energy or water conservation measures to guarantee the amount of the savings to be realized by the state agency under the contract.”

Clearly the ESCO provider is required to provide the guarantee of savings (the italics highlight is my own), but it is not clear that a state entity is required to maintain the provisions beyond the point at which it no longer makes economic sense. Some measures installed (such as more efficient lighting or a more efficient chiller) can quickly be determined to be operating as hoped and expected, and likely carry manufacturer’s guarantees in addition. Some agencies, particularly smaller ones that do not have their own in-house capacity to maintain and monitor new equipment, could be wise to rely on the continuing guarantee and related upkeep services of the performance contractor. Where a state entity becomes satisfied that allowing the performance contractor to maintain a guarantee is expensive and no longer necessary, however, and either SECO or THECB as appropriate, after analysis, agrees, we would suggest the state entity might cancel the ongoing M&V and even release the guarantee where the contract permits. Perhaps it is worth seeking an Attorney General’s Opinion to verify this one way or the other, or clarify the need for legislation to allow such action if it would encourage additional energy upgrades.

Conclusion

The news is very positive: The State Legislature considers performance contracting a viable and attractive means to finance energy and water savings and reduce the cost burden on taxpayers, and continues to make modifications to the law to enable it. The Senate Committee on Government Operations’ interim report encourages state agencies to use the vehicle of performance contracting, and the State Auditor states that process improvements have been adopted to assure its viability and success. The [SECO Website](#) provides ample guidance and support for state and local agencies interested in reducing their bills through performance contracting.

Two bills were adopted in the regular session of the Legislature in 2013: one to provide additional assurance of savings in the early years of projects, until the state entity determines such analysis is no longer required; the other to allow flexibility to use performance contracts for new as well as existing buildings, and to include ancillary measures paid for by other funds under the same contract.

As an organization, SPEER supports the use of performance contracting in public and private application, and stands ready to support the evolution and continuous improvement of practices and standards used by the industry in order to insure its future success. Additional information and links to resources on performance contracting can be found on the SPEER [Energy Upgrade](#) webpage for commercial buildings.