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### Energy

## ***BNA Insights: Key Takeaways From Recent GAO Report Finding That Additional Actions are Needed to Improve Federal Management of ESPCs***



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In a time of increasing budget pressure, U.S. government agencies continue to look for ways to cut costs and operate more efficiently without sacrificing their mission. Energy savings performance contracts (“ESPCs”) offer a unique opportunity for agencies to achieve these goals. Authorized through 42 U.S.C. § 8287 et seq., an ESPC is a public-private partnership that allows an agency to secure energy savings over the long term and to improve its facilities *without* providing up-front capital costs (through appropriations) to fund these projects.

Although ESPCs generally present a win-win for the agency, the contractor, and the taxpayers, the U.S. Government Accountability Office (“GAO”) recently issued a 92-page report examining the effectiveness of these public-private partnerships and identified some definite

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areas for improvement.<sup>1</sup> The report, which focused largely on the government’s administration and evaluation of ESPCs, identified various issues, including a lack of agency oversight and the overstatement of cost and energy savings. The report also discussed how the Office of Management and the Budget (“OMB”) scoring rules are presenting a roadblock to certain ESPC projects.

While GAO did not necessarily cast a negative light on ESPC contractors, its report is likely to result in changes and other actions that could affect the contractor community. Accordingly, in this article, we highlight important aspects of GAO’s findings which could lead to changes down the road, and offer some thoughts on steps that contractors should consider taking now to prepare for the road ahead.

**ESPCs in a Nutshell.** In a typical ESPC, the contractor often identifies, designs and implements certain energy conservation measures – ranging from the installation of new LED lighting to solar photovoltaic power generation – for an agency’s facility. Because the contractor

<sup>1</sup> Report No. GAO-15-432 (“Energy Performance Savings Contracts: Additional Actions Needed to Improve Federal Oversight”), which was issued on June 17, 2015, can be found on GAO’s website at <http://www.gao.gov/assets/680/670851.pdf>.

generally funds the project through private third-party financing in lieu of relying on appropriated funds, the initial budget strain that an agency generally would encounter on projects of this magnitude is alleviated. In turn, the agency pays the contractor for its efforts over the life of the contract from the energy savings resulting from the improvements to the agency's facility (and specifically from funding that was appropriated or otherwise made available to the agency to pay for utilities and related operations and maintenance expenses). By statute, the term of an ESPC can be up to 25 years.

Under this arrangement, the contractor carries much of the risk because payments are contingent on it being able to verify that the estimated energy savings (as negotiated between the agency and the contractor, and defined in the contract) have been realized. In addition, payments to a contractor cannot exceed the amount that the agency otherwise would have paid for utilities without an ESPC during the pertinent contract years. After the contractor is compensated for its efforts, the agency continues to reap the benefits of the additional (and future) savings realized.

**GAO Report Critical of Agencies, Takes Aim at Reported Cost and Energy Savings.** While recognizing the benefits associated with ESPCs and their overall value to the government, GAO found in its June 17, 2015 report that several agencies – including the Department of Energy (“DOE”) and the Air Force, Army and Navy within Department of Defense (“DOD”) – “may have conducted limited oversight and evaluation of their ESPC projects,” and, as a result, more oversight is needed.

In the report, GAO determined that almost 75 percent of the ESPC projects it reviewed “overstated some cost and energy savings,” which means that the “reported savings . . . were not achieved.” GAO found that the “most common factor resulting in overstated savings for the ESPC projects we reviewed was an agency making changes to operating hours and temperature set points on programmable heating, ventilation, and air conditioning (HVAC) equipment.” Based on “available agency estimates, these changes generally resulted in lower energy and associated cost savings than expected, but contractors did not reflect these effects in reported savings amounts because they were due to agency actions.” In other instances, “components of energy conservation measures or entire measures were removed by the agency during the performance period, but contractors did not reduce reported savings because these changes were due to agency decisions.”

It is important to note that these overstatements were not a byproduct of improper contractor reporting. Rather they resulted from assumptions that contractors were permitted (and may in fact have been required) to make when calculating savings and which were beyond the contractor's control – like utility prices or the agency's use and maintenance of the energy-saving equipment. As GAO noted, “[i]f changes in such factors [beyond the contractors' control] reduce savings, contractors generally are not required to reduce the amount of savings they report or measure the effects of such changes.”

As a result, the energy savings reported do not necessarily reflect the *true* savings achieved. And without these data points, GAO is concerned that “agencies may be unable to determine what, if any, corrective actions should be taken.”

GAO also was critical of the agencies' administration of individual contracts and their ESPC programs generally. GAO found that “[t]he seven agencies in our review have conducted limited oversight and evaluation of their ESPC projects. Specifically, none of the agencies fully implemented FEMP [Federal Energy Management Program] guidance regarding observing contractors' measurement and verification activities or reviewing and certifying contractors' measurement and verification reports for individual ESPC projects. Moreover, most of the agencies in our review have not systematically evaluated their ESPC portfolios to determine the effects of changing circumstances—such as facility use, utility prices, or interest rates—on project performance because they do not have processes in place to do so.”

GAO concluded the report by offering several recommendations to ameliorate the issues it identified – ranging from devising a process to “determine the best way to obtain estimates of cost and energy savings that are not achieved because of agency actions in order to include these estimates in future measurement and verification reports for existing contracts” to evaluating “existing training and determin[ing] whether additional training is needed on observing contractors' measurement and verification activities and reviewing and certifying measurement and verification reports.” For the most part, the agencies that offered written feedback concurred in some fashion with GAO, and it appears that changes are on the way.

**GAO Report Examines How the Current OMB Scoring Rules May be Standing in the Way of Important ESPC Projects.** GAO also discussed how some significant ESPC projects (related to the consolidation of U.S. government data centers that consume substantial amounts of energy) have been delayed, and could even be shelved, due to concerns over how OMB will “score” these projects.

By way of background, if certain criteria are not met under the OMB scoring rules (generally found in OMB Circular A-11, Appendix B), an agency is required to obligate funding for the entire project/contract in its first year instead of annually over each year of the project/contract. Currently, OMB has specific guidance in place that outlines “the conditions under which the budget costs of ESPCs . . . - including their total capital costs - may be scored (and obligated) on an annual basis during the term of the contract.”<sup>2</sup> As one could imagine, scoring a large ESPC project up-front could wreak havoc on an agency's budget, resulting in the project not moving forward.<sup>3</sup>

In its report, GAO noted that DOE decided to delay awarding an ESPC to consolidate a data center in 2013

<sup>2</sup> See OMB Memorandum M-12-21, “Addendum to OMB Memorandum M-98-13 on Federal Use of Energy Savings Performance Contracts (ESPCs) and Utility Energy Service Contracts (UESCs)” (Sept. 28, 2012) available at <https://www.whitehouse.gov/sites/default/files/omb/memoranda/2012/m-12-21.pdf>.

<sup>3</sup> For additional discussion regarding the background of and issues arising from these budget scoring rules, see “The Crisis in the Federal Government's Infrastructure Federal Budgetary Scorekeeping: Impediments, Alternatives and Opportunities,” American Bar Association Public Contract Law Section, Privatization, Outsourcing and Financing Transactions Committee (Sept. 25, 2008) available at <http://apps.americanbar.org/webupload/commupload/PC800100/>

because “OMB staff raised concerns about the project,” including “(1) whether savings resulting from more efficient information technology equipment qualify as energy-related savings and (2) the project’s high proportion of cost savings resulting from the reduction in operations and maintenance costs, rather than energy cost savings.” According to GAO, this project was “expected to save DOE approximately \$76 million, and 97 percent of the overall cost savings would come from operations and maintenance such as maintaining computer hardware and software, or energy-related savings, and the remaining 3 percent from energy savings.”

Even though DOE is still considering this project, OMB has not provided any additional insights regarding its previous concerns that implicate the scoring of this project. GAO also reported that the Army is interested in consolidating data centers through ESPCs, but the Army is “hesitant” because OMB’s prior concerns related to the DOE’s proposed project. GAO concluded that, “[b]ecause OMB staff have expressed concerns about but have not clarified their position on what qualifies as energy-related savings and the allowable proportion of energy and energy-related cost savings, . . . agencies might be needlessly missing opportunities for potential energy and energy-related cost savings.”

**Key Takeaways for Contractors.** While the GAO’s critique is focused predominantly on the government’s administration of these public-private partnerships, the findings and the resulting changes could well impact contractors that participate in these partnerships. There likely will be an increased focus on ESPC contract terms and conditions, as well as contractor performance and compliance in the very near future.

We offer here a few observations on steps that ESPC contractors should take to ready themselves for these changes and a potential increase in scrutiny that may flow from the GAO report.

**1. Carefully review ESPC terms and conditions for changes to the norm, including changes to verification and measurement requirements and assumptions, and assess the impact of any changes.** Given GAO’s criticisms/recommendations and the agencies’ comments in response, contractors should expect to see some changes to ESPCs, including changes to verification and measurement requirements and assumptions. Contractors should not be complacent when reviewing/negotiating verification and measurement requirements and assumptions, or when receiving a notification from a contracting officer about a potential change mid-performance, because any tweaks to the status quo could significantly affect risk apportionment and compensation. To that end, contractors should cautiously assess whether *any* change will impact their performance and/or bottom line, and should strive to ensure that expectations are clearly stated in the contract to avoid disputes down the road. Clarity is key when any misunderstanding or ambiguity could lead to a significant loss of investment. At the same time, contractors also must be cognizant of the legality of any proposed

change because a change potentially contrary to law could very well be invalidated should a dispute arise.<sup>4</sup>

**2. Recognize the potential for disputes.** As agencies become more focused on determining their *true* energy savings (and determining whether their energy savings for contract reporting purposes are overstated)<sup>5</sup>, it is reasonable to assume that agencies may take a closer look at examining whether contractors are accurately calculating and reporting on energy savings. To avoid potential disputes downstream, contractors should be proactive with their reporting by carefully documenting assumptions and causes for savings, and should consider opening a dialogue with the agency when a discrepancy that may raise eyebrows is identified. Additionally, contract performance also may be more closely scrutinized. Contractors should be prepared to defend their performance at a moment’s notice.

**3. Be prepared for a potential decrease in ESPC projects going forward on a short term basis.** As agencies react to GAO’s criticisms and closely examine their ESPC portfolios, some agencies potentially may shy away from entering into ESPCs in the immediate future – especially those that may carry more risk with respect to projected savings – to avoid further scrutiny from GAO and others within the federal government. Other agencies may alter their ESPC portfolio and contracting strategy if changes to the verification and measurement requirements reveal lackluster savings when taking into consideration the cost and energy savings that were not achieved because of agency actions. Under either scenario, contractors should be prepared for less opportunities and more competitive procurements.<sup>6</sup>

**4. Ensure that all compliance policies and procedures are up to date, and all compliance programs are active.** Although GAO generally did not take aim at ESPC contractors, contractors may soon find themselves in the crosshairs. Increased scrutiny and oversight often leads to increased compliance and enforcement actions, and potentially whistleblower complaints. Contractors should not let their guard down, and should consider ramping-up compliance efforts.

Finally, we recommend that industry closely watch for any guidance provided by OMB that implicates how DOE’s proposed data center consolidation ESPC will be scored. Although ESPCs generally do not fall victim to the OMB scoring rules as often as other public-private partnerships, GAO has found that agencies are hesitant

<sup>4</sup> See Scott A. Freling and Kayleigh Scalzo, “ASBCA Disrupts Settled Expectations Concerning Green Energy Initiatives,” BNA Federal Contracts Report, 100 FCR 345 (Oct. 8, 2013) (analyzing an Armed Services Board of Contract Appeals decision invalidating certain compensation provisions related to the sale of Solar Renewable Energy Certificates, and noting that “even if all parties agree on the validity of a contract provision, that provision may be invalidated if a board or court deems it contrary to law or promulgated without actual authority”).

<sup>5</sup> In the report, GAO also framed this issue in terms of whether the “estimates of cost and energy savings . . . were not achieved because of agency actions.”

<sup>6</sup> Notwithstanding, GAO noted in its report that “Army officials said they plan to aggressively pursue using ESPCs, among other financing options, to improve energy efficiency.” Similarly “[Department of] Justice officials said they plan to extensively use ESPCs at all of their Bureau of Prisons sites to upgrade and repair many buildings that have aging infrastructure.”

about pursuing certain ESPC opportunities as a result of these rules. There could well be several significant

ESPC opportunities on the horizon if this budget scoring issue is resolved favorably.