



Legal aspects of ESCOs, implementation of energy efficiency projects (ESCO model), and development of EPC conclusion practice

Saving energy and improving energy efficiency has become more important given energy price increases. Today energy savings and efficiency are priorities for Ukraine's state energy policy. These principles are set forth in a number of Laws of Ukraine: "On Energy Saving," "On Electricity," "On Heat Supply," "On Housing and Utility Services," "On Combined Heat and Power (Cogeneration) and Waste Energy Potential," and "On Alternative Fuels." They are also set forth in subordinate legislation.

In accordance with Article 3 of the Law of Ukraine "On Energy Saving," dated 1 July 1994, the main principles of state energy savings policy are energy efficiency in the implementation of economic, management, or other activities related to the extraction, processing, transportation, storage, production, and usage of energy resources; a combination of economic incentives and financial responsibility for the efficient use and economical consumption of fuel and energy resources; solving energy savings problem and implementing energy programs of Ukraine on the basis of broad international cooperation; and efficiently using energy resources with the help of combined heat and power production (cogeneration). There are others as well.

The world's most common energy savings mechanism is implementing efficiency projects through energy service companies.

As a rule, an energy service company (an "ESCO") is a specialized project company that provides services related to fundraising, engineering, and management of financial and technical risks related to energy savings project implementation. An ESCO provides certain guarantees on recoupment of investments and has the necessary experience and tools to attract project funding from private investors. In its classic form, an ESCO does more than just ensure the implementation of energy efficiency. It also provides proper operation and maintenance of project results during the period of cooperation with the client, and certainly during the project's payback period. The main source of an ESCO's income is the money a client saves as the result of cooperating with the ESCO.

The first ESCOs were established a century ago in France. The main activity of an ESCO was in the municipal field, to increase the efficiency of the heat supply in private and office buildings. The main source of an ESCO's income was its work supplying heat at a competitive price. The practice subsequently spread throughout Europe and North America. The global energy crisis has affected the activities and development of ESCOs. Many of them went bankrupt due to the rapid increase in fuel prices. At the same time, however, the crisis has led to the expansion of the range of ESCO types and services. The

crisis has also led to the development and implementation of new projects and new income acquisition mechanisms.

With the development of a competitive market came the formation and standardization of procedures and mechanisms for implementing efficiency projects, including draft agreements and standard terms and conditions.

Relationships between ESCOs and clients are regulated by contracts. Typically, contracts are long-term (for more than three years). This is connected with the length of payback periods. The most common type of contract between an ESCO and a client is an energy performance contract, i.e. an energy efficiency contract (EPC).

In practice, there is no one example of an EPC. The conditions for an EPC may differ greatly depending on the types of services an ESCO provides or the requirements that a client stipulates. The aim of the contract (energy savings) and the manner in which the ESCO makes its income (from fostering energy savings) remain unaffected.

There are several types of EPC based on the method of providing savings and effecting distribution:

- **Shared savings contract:** this provides income distribution from savings that is effected via from modernization, renovation, or the technical re-equipment of an enterprise, of a separate business unit, or of a bloc of individual customer equipment, beginning from the achievement of the economic effect,
- **First out contract:** this provides an ESCO with income at 100% of the savings during the term of project recoupment; income distribution begins only after investment recoupment. Usually the results of the project remain with the ESCO for the entire term of the EPC, but in any case they remain so until the full project recoupment and until the receipt of

the income agreed on by the client and the ESCO when the contract is signed.

The EPC is a contract (or a set of contracts) that provides income for both the ESCO and the client as the result of the client's lower energy costs. These lower costs in turn result from the technical re-equipment (modernization) of existing equipment or the installation of new energy-saving equipment.

The main characteristics of EPC projects are:

- full self-repayment and investment recoupment via energy savings,
- a high level of project development and the shifting of technical risks to ESCOs,
- an immediate effect after implementation,
- there is no need for the client to increase its staff,
- professional project management.

An EPC by its legal nature is a mixed contract in the sense of part 2 of Article 628 of the Civil Code of Ukraine. An EPC may combine components of different contracts, including a contractor's contract, a services contract (engineering, agency, consulting), a purchase and sale contract (including trade credit), a delivery contract, a financial contract, an operating lease contract, etc.

There are no legal definitions of ESCOs and EPCs in Ukraine and the market is developing most likely in spite of, not because of, government policy. Lack of regulation causes problems in those areas that are most interested in ESCO services, such as the public and municipal sectors.

Basic principles of Ukraine's state energy policy are also set forth in the country's subordinate legislation. For instance, the Decree of the President of Ukraine № 679/2008 of July 28, 2008 brought into effect the decision of the National Security and Defense Council "On Implementation

of the State Policy on the Efficient Use of Fuel and Energy Resources.” That decision encourages the efficient use of fuel and energy resources.

According to this document, the priority areas of state energy policy should be the following: to support ESCOs, to establish practice for drafting energy efficiency contracts, and to regulate ESCO activity related to projects in the public and utility sectors.

Today the legal uncertainty that surrounds, on the one hand, the ESCO as a specialized project company and, on the other hand, the EPC as a type of separate eco-

nomic and legal contract, does not allow for the use of effective state mechanisms to implement energy savings projects with EPCs or to establish a real ESCO market in Ukraine. This “uncertainty” is a significant barrier to establishing a real ESCO market. Companies that consider themselves ESCOs should “reinvent the wheel” and implement projects on the basis of contractor, supply, leasing, and joint ventures contracts, among other things. They should also add conditions that allow for identifying such contracts as EPCs, as is necessary if projects are to be financed by specialized funds and other organizations.