Financing Hospital Energy Services Projects

Capital allocation on mission critical investments is a challenge for many hospitals and health systems. Many hospitals have chosen to minimize or defer capital investments in non-core competency assets such as central utility plants and other facility infrastructure assets. Properly developed and financed energy services projects can help hospitals reduce and manage energy costs, while funding important facility infrastructure renewal.

By Shannon Clouse, Vice President, Bank of America Healthcare Finance and Jim Thoma, Senior Vice President, Bank of America Energy Service Finance

A recent Healthcare Financial Management Association publication entitled “How are Hospitals Financing the Future?” reported that half of the surveyed healthcare chief financial officers believe their infrastructure is deteriorating faster than they can make capital improvements. Statistics for average age of plant support these beliefs. HFMA concludes: “These findings suggest that deteriorating plants are likely to demand significant capital investment in the next five years.”

Deferring energy efficiency and facility improvements leads to unfunded or even unrecognized capital expenditures and higher operations and maintenance costs for utilities, labor and repairs. This results in a subtle but steady decline in facility performance, financial performance and environmental stewardship. Increasing energy costs compound these challenges for energy-intensive healthcare institutions with around-the-clock operations.

Energy services projects require significant design, engineering and development efforts to create projects that are technically and economically compelling for the hospital’s facilities and financial executives.

Getting Started

There are typically three parties involved in an energy-services project transaction:

- the hospital or health system (end use obligor)
- the energy services company (ESCo)
- the lender or investor representing the broader capital markets.

The first step in developing an energy services project is a thorough assessment of the existing energy and operational costs, supported by a detailed engineering analysis of infrastructure assets and systems. This process, commonly referred to as an investment grade audit, is normally conducted by an independent third party ESCo or engineering firm working in partnership with the hospital. The objective is to identify opportunities for greater efficiency and to suggest a mix of facility improvement investments, energy conservation measures and operational changes to produce savings.

In many cases, projects are developed to be self-funded, meaning the savings achieved are greater than the cost of the project, with the savings guaranteed by the ESCo contracted to do the work. Other times, projects are developed to satisfy acute technical needs, such as additional heating and cooling capacity for facility expansions or improved conditioning of existing space such as operating rooms or patient towers. Such projects might not be self-funding, but are usually developed to achieve maximum energy efficiency and lowest lifecycle cost with the ESCo assuming guaranteed performance obligations.

Healthcare executives are faced with varying financial objectives for facility renewal. The energy services market offers a wide range of technical and financial solutions.
Private Placement, Tax-Exempt Financing

The most common solution that results from an investment grade facility audit is an energy performance contract (EPC) project. EPC projects are developed to be self-funding, meaning the project costs, including financing and ongoing service, are less than or equal to the savings developed during the investment grade audit. The scope of work in an EPC project is dictated by the amount of savings identified. The larger the savings opportunity, the broader the mix of asset renewal, energy conservation and facility improvement measures that can be funded by the guaranteed savings.

Tax-exempt private placement debt is the most common financing solution for EPC projects. Tax-exempt debt is normally issued through the same financing conduit as the hospital’s bonds and is typically structured with amortizing terms of seven to ten years or longer. By documenting the transaction as a tax-exempt lease or loan, the hospital is able to access attractively priced tax-exempt capital with significantly lower cost and greater ease than a public bond financing. Because the issuance, underwriting and documentation of private placement financing is highly standardized, transactions can be completed in as little as two months from origination to closing. The overall efficiency of private placement financing enables borrowers to issue tax-exempt debt as small as $2 million or less and still achieve significant savings over commercial rate debt financing.

Off-Balance-Sheet Financing

For institutions concerned about adding leverage to their balance sheet, off-balance-sheet financing is available.

The most common approach to achieving off-balance-sheet accounting treatment is to structure the energy project financing as an operating lease. To do so, the lease must satisfy the lease classification criteria of Statement of Financial Accounting Standards No. 13 (FAS 13) which governs lease accounting. To ensure off balance sheet treatment, operating leases are usually structured with relatively short terms, ranging from three to seven years.

Off-Credit Financing

For many healthcare institutions, the key structural objective is actually off-credit financing of their energy services projects. This objective may be driven by internal capital policies, balance sheet impact, credit capacity concerns, external credit analyses and strategic interest in outsourcing non-core competencies such as facilities management and central plant operations. In this case, the structural solution is a highly customized transaction wherein the customer pays for energy services under some type of long-term contract, such as an Energy Services Agreement, Utility Services Agreement or Shared Savings Agreement. In order to gain off-credit treatment, these contracts must be truly executory, requiring ongoing performance by the parties and not containing a mandatory payment obligation based upon the passage of time. The customer’s payment obligation is based upon outcomes, such as actual energy savings or the provision of thermal power.
Structuring an off-credit energy services transaction requires close collaboration among the three key parties: the customer, the ESCo and the lender or investor. Although the parties share the objective of achieving an off-credit transaction for the customer, each party also has their own requirements and limitations to consider. Therefore, it is essential for the parties to work closely in good faith negotiation to achieve a successful result, the basic framework of which would include a contingent “pay-for-service” payment obligation for the customer, a clean sale of the project assets by the ESCo in conjunction with an ongoing services agreement and a bright line separation of performance and credit risk for the lender or investor.

Summary

By being aware of investor solutions and working collaboratively with a knowledgeable and experienced financing partner from the earliest stages of project development, hospitals and their ESCo partners can avoid delays and develop compelling financial solutions. The capital markets have an unlimited capacity to fund creditworthy, properly structured energy services transactions. Whether the concern is cost of capital, balance sheet impact or credit exposure, there are numerous solutions available with experienced capital providers.