

EXPECTATIONS AND REALITY OF ESCO BUSINESS IN RUSSIA



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In Russia, Philips Lighting started to investigate the energy service company (ESCO) business model in 2009 when the new law, №261-FZ, on Energy Saving was adopted. At the time, taking into account the state of lighting systems in the country and the lack of money and real interest in improving them, I thought usage of Energy Performance Contracts (EnPCs) could make a breakthrough in lighting projects because this business model supposes minimal or no customer involvement in financing the project or the selection of the technical solution.

Looking back and evaluating the actual results, I see that the ESCO business is developing more slowly than I expected at the end of 2009 when law 261-FZ was adopted. Why? What went slower than expected? What are the main difficulties of Russian ESCOs? Let's look at the biggest roadblocks that restrain the development of the ESCO business in Russia.

Legislation. *De jure*, EnPCs are not considered as investment contracts, and this creates difficulties for ESCOs when they are participating in municipal or government tenders (e.g. in street lighting projects). According to the law, in the majority of cases, participants are obliged to provide a security deposit of, on average, 10%. This requirement is absolutely valid for the standard cases with governmental financing. But *de facto* an ESCO is investing its own or borrowed money in the project. This

leads to extra costs that ESCOs finally add to the contract. Alignment of *de jure* and *de facto* issues, and changing the legal status of EnPCs to investment contracts would create proper conditions for the development of the ESCO business in Russia.

Quality of data. ESCOs bear huge risks in the projects. One of the biggest is the guarantee of achieving energy savings. To minimize this risk, it is vitally important to establish the baseline and precisely measure and verify results. If the second issue is under control of the company, the first one very much depends on customers' data. Due to historical conditions in design and exploitation of industrial or street lighting systems, finding precise data on current energy consumption and the working hours of installed equipment is difficult for the ESCO. Understanding these problems, an ESCO is forced to run the risks associated with data quality and unreliability, and the price of the contract reduces its attractiveness. Implementation of modern control systems, especially in street and industrial lighting, and splitting of the electrical networks for lighting and other purposes, would significantly increase transparency and the reliability of the data, and decrease the risks to ESCOs.

Project financing. By the nature of business and circumstances, Russian ESCOs are not very big companies, hav-



ing limited assets, which leads to limitations on banking financing. Even with their technical capacity and the customers' demand for service, in practice ESCOs cannot expand their business for the reasons mentioned above. Financial barriers are one of the main roadblocks inhibiting the expansion of the ESCO business. To eliminate this roadblock will need mechanisms for loan refinancing. At the moment, the European Bank of Reconstruction and Development (EBRD) is working on this subject. But still, there is no clear idea of when the process will be finished.

Total cost of ownership. The budget systems of our municipalities are deeply rooted in Soviet practice. Even now, investments in, and exploitation of, street lighting systems are financed from different categories in the budget. The ESCO business is built on the model called Total Cost of Ownership (TCO), but unfortunately its basic principles are unknown to municipal authorities (when we are talking about street lighting projects). This mismatch between the traditional and the new ways of thinking on financing projects creates stress on the decision-making side. Changing the point of view of the project's decision makers, explaining TCO principles to them, is one of the time-consuming aspects of the project. But these efforts are paying off, otherwise we would not be looking at a growing number of EnPCs.

Proposals and recommendations:

1. Creation of refinancing mechanisms for ESCO companies would boost attractiveness of the business and increase number of ESCO projects;
2. Remove contradictions between the *de jure* and *de facto* status of EnPCs and consider them as investment contracts.
3. Increase the knowledge level about TCO and basic ESCO business principles, especially among government decision makers. **BQ**