



The Role of Lease-Financing within Energy Projects:

Module A: Energy-Efficient Office Equipment

Most energy-improvement initiatives are focused on reductions in electricity usage within applications found within the office environment due to the number and diversity of assets that are placed into service – many types of equipment and machinery with different intended service periods, and different cost-intensities with respect to the consumption of electricity.

The type of lease-financing product utilized within an energy-efficiency project is influenced by (1) an organization's procurement methodology – direct or indirect; (2) the purpose of the financial arrangement with respect to the ultimate disposition of the asset – ownership or use; (3) the useful life or intended service period of the asset; and (4) the organization's budgetary requirements.

Direct Procurement Methodology

Under a Direct Procurement methodology, the municipal organization is responsible for selecting the specific asset to be placed into service and ensuring that it meets the desired energy performance levels.

The equipment and the lease-finance product utilized to acquire it are procured under separate contracts with the ultimate intention being to own the asset outright, or to make eventual ownership of the asset economically feasible. This method of procuring goods and services requires disclosure of the components which contribute to the total purchase price of the asset, and the cost of the financing. The type of lease-finance product most commonly utilized within a direct procurement methodology is a capital lease which is a fixed rate payment obligation that remains constant throughout the term of a contract. The non-variable nature of periodic payments aide in project planning and budgeting and enables project expenses to be closely aligned with identified cost savings.

Acquisition Leases

The financing vehicle most often utilized under a direct procurement is the capital lease, which comes in two forms:

- (a) Lease-Purchase Agreement – which allows the purchase price of the asset to be amortized over the term of the contract, and equity to be gained in the asset with the payment of each periodic installment; or
- (b) Finance Lease – which finances the purchase of the asset over a period of time that covers most of its useful life, and includes three end of lease options: renew the lease for an additional period, usually one fiscal period at a time; return the asset to the party providing the lease-financing services (the Lessor – a bank, equipment leasing company, or finance division of an equipment supplier); or purchase the asset for a nominal amount, usually \$1.00.

Under either capital lease structure, title to the asset is typically transferred to the municipal organization upon funding of the lease, and outright ownership of the asset is conveyed to the organization either automatically upon the final payment under the lease contract or upon the payment of a small sum. The repayment schedule, ranging from 24 months to seven years, is arranged to mirror the useful life of the asset and the cash flow build up of the project.

Because of the nature of this financing arrangement, the Internal Revenue Service allows the interest component of the periodic lease payments to be shielded from taxation by the federal government. In turn, this tax benefit is passed on to the municipal organization in the form of payments computed at low tax-exempt rates.

Indirect Procurement Methodology

Under an Indirect Procurement methodology, the municipal organization specifies the energy performance criteria and operating parameters to be performed by assets procured under a single contract; usually with a single contractor. The contractor is responsible for selecting the equipment to be installed; achieving the energy-performance goals stated within the contract; and providing a number of ancillary services.

The contractor's compensation arrangement bundles together charges for the municipal organization's use of the asset on a monthly basis, plus periodic charges for all related services (service agreements, support, supplies, etc.), personal property taxes, and other periodic assessments which arise as a result of the equipment's use, such as in the case of contracts for computing or copier services. This method of procuring goods and services requires the cost components resulting from the use of the equipment and the charges for the ancillary services to be itemized within a consolidated billing statement. The process of paying for services received on a monthly basis aides in the determination of a project's cost-effectiveness because it aligns actual usage patterns with the actual costs incurred as a result of utilizing an asset.

The cost of the underlying financing is embedded within a payment factor that is fixed for the duration of the contract, and used to compute the minimum monthly payment required for the organization's use of the asset. The total required monthly payment, however, will fluctuate to the extent that operating expenses relative to the services provided exceed pre-determined levels.

Services Agreement Lease

Although obscured by the broader service features of the overall contract, the payment arrangement is an operating lease structured with operating rental payments that are based on less than 90% of the asset's value, and that are scheduled over an initial term that is less than 75% of the asset's economic life; typically 18 to 36 months.

While the contract may provide for the purchase of the asset at various points in the contract for its then fair market value, and contain options to extend the contract for additional periods at a fair rental value, the municipal organization never obtains title to the asset while the contract is in effect.

Due to the nature of this contractual arrangement, where periodic payments represent rental income to the contractor/lessor for a period of use that is shorter than the asset's useful life, the interest rate used to compute the rental payments is based on the contractor's cost of funds or some other non-tax-exempt rate. Nevertheless, because the operating rentals are based on less than the asset's total value at the inception of the contract, the lease component of the periodic payments is usually lower under this form of financing arrangement than any other.

Commentary within Modules is intended to communicate the basic concepts behind the use of an alternative form of capital to fund energy projects and the acquisition of energy-efficient equipment only. It is not intended to be a substitute for consultation with a professional.

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