**HB 1310**

# Department of Legislative Services

Maryland General Assembly
2011 Session

## FISCAL AND POLICY NOTE

House Bill 1310 (Delegate Conway)
Appropriations Budget and Taxation

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### Tax Supported Debt - Energy Performance Contracts

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This bill exempts capital leases used to finance energy performance contracts (EPCs) from the Capital Debt Affordability Committee's (CDAC) determination of tax-supported debt if the energy savings guaranteed by the contractor equal or exceed annual capital lease payments and are monitored in accordance with reporting requirements adopted by CDAC. It further authorizes the State Treasurer to enter into capital lease arrangements to finance EPCs and specifies that the capital lease payments may not exceed the actual energy savings realized under the contract.

The bill takes effect June 1, 2011.

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## Fiscal Summary

**State Effect:** Exempting capital leases used to finance EPCs from the calculation of tax-supported debt has no direct effect on State expenditures for debt service or capital lease payments. However, it does create excess debt capacity based on CDAC criteria. To the extent that the State uses the excess debt capacity to finance other debt-supported activities, special fund expenditures for debt service from the Annuity Bond Fund increase. To the extent that State property tax revenues are insufficient to cover the increased cost, general fund spending may increase to fill the gap. Exempting capital leases used to fund EPCs from the calculation of tax-supported debt also facilitates their continued use to reduce State expenditures on energy for State facilities, which reduces general and special fund operating expenditures.

**Local Effect:** None.

**Small Business Effect:** None.

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# Analysis

## Current Law:

*Energy Performance Contracts*

Subject to prior consultation with the Maryland Energy Administration (MEA), a primary procurement unit in the State is authorized to enter into an EPC that lasts up to 15 years. The payments and total contract amount of an EPC may not exceed the actual energy savings realized. Prior to approving an EPC, the Board of Public Works (BPW) may authorize the use of incentive contracts, including contracts that guarantee energy savings performance, and require prospective contractors to furnish appropriate guarantees of the level of energy savings. The guarantee may include a requirement that the contractor furnish a bond or other assurance in an appropriate amount to guarantee projected performance.

MEA is responsible for monitoring the status of active EPCs and reporting that status to BPW annually.

*Capital Leases*

A capital lease is defined as any lease, conditional sale, installment sale, or similar agreement in accordance with generally accepted accounting principles that is used to finance:

- the acquisition or construction of improvements to real property; or
- the acquisition of capital equipment.

A capital lease includes a master lease.

The State Treasurer, with the approval of BPW, may enter into a capital lease on behalf of one or more units of State government. Prior to submitting the capital lease to BPW, the Treasurer must submit the financing request and any supporting information to the Legislative Policy Committee (LPC). LPC has 45 days to review and provide written comments on the financing.

The Treasurer must, at a reasonable market rate, capitalize the annual lease payments for each fiscal year the lease is in effect. The greater of the annual capitalized payments or the amount of any purchase value at the termination of a capital lease must be included as tax-supported debt considered by CDAC in its annual estimate for that fiscal year.

*Capital Debt Affordability*

Chapter 43 of 1978 created CDAC, which is required to recommend a level of State debt to the General Assembly and the Governor. The Governor and the General Assembly are not bound by the committee's recommendations. To recommend an affordable level of debt, CDAC has developed two criteria. Total State debt outstanding should be limited to 4.00% of State personal income, and total State debt service should be limited to 8.00% of State revenues supporting debt service. **Exhibit 1** shows that current projections of tax-supported debt conform to those criteria, but the debt service-to-revenue ratio comes close to the 8.00% limit by fiscal 2016.

**Exhibit 1**
**State Tax-supported Debt and Debt Service Compared to CDAC Criteria**
**Fiscal 2011-2016**

| Fiscal Year | Debt Outstanding/ Personal Income | Debt Service/ Revenues |
|---|---|---|
| | (Criteria = 4.00%) | (Criteria = 8.00%) |
| 2011 | 3.40 | 6.87 |
| 2012 | 3.48 | 7.18 |
| 2013 | 3.50 | 7.24 |
| 2014 | 3.43 | 7.52 |
| 2015 | 3.33 | 7.64 |
| 2016 | 3.22 | 7.89 |

Source: Capital Debt Affordability Committee

**Background:** EPCs are a procurement strategy to upgrade energy infrastructure in a way that limits up-front expenditures for the upgrades. The mechanism involves the State procuring an Energy Service Company (ESCo) to conduct an energy audit that establishes a baseline level of energy consumption, which is reviewed by MEA. The ESCo then agrees to install or build infrastructure upgrades that reduce energy consumption. The upgrades are installed at no cost to the State, which in turn recognizes operational savings through reduced energy consumption. In exchange, the State makes regular payments to the ESCo that, by law, cannot exceed the level of total energy savings. The promised level of savings are often guaranteed in the form of surety bonds purchased by the ESCo that the State can make claims against if the level of energy savings falls short of projected levels.

EPCs have become a favored procurement strategy in the last few years. The Treasurer's Office advises that, as of June 30, 2011, the Treasurer will have financed 22 energy leases totaling $164.6 million. Of that, $86.3 million worth of EPCs were procured in just the last three fiscal years, more than the previous six years combined. Seventeen of the leases have surety bonds that exceed annual lease payments, with a total value of $155.6 million. Under the bill, these 17 leases would be exempt from the calculation of tax-supported debt.

**State Fiscal Effect:** Exempting capital leases used to finance EPCs from the calculation of tax-supported debt has no direct effect on State debt service or capital lease payments. However, it either reduces the debt affordability ratios calculated by CDAC or allows about $155.6 million in additional debt capacity to be issued by the State. To the extent that the State uses the excess capacity for other debt-supported activities, most notably capital construction projects, debt service payments increase. *For illustrative purposes only*, if the full $155.6 million in excess debt capacity was issued this year with a true interest cost of 5.0%, it would result in debt service payments increasing by $7.8 million for the first two years (interest-only payments) and $16.6 million for the following 13 years (interest and principal). State debt service payments are paid out of the Annuity Bond Fund, which is capitalized with proceeds from the State property tax and, when necessary, general funds.

The exemption for capital leases used to finance EPCs also facilitates their continued use to reduce State energy consumption costs, which reduces general and special fund expenditures on energy costs for State facilities.

## Additional Information

**Prior Introductions:** None.

**Cross File:** None.

**Information Source(s):** Maryland State Treasurer's Office, Maryland Energy Administration, Department of General Services, Department of Legislative Services

**Fiscal Note History:** First Reader - March 13, 2011
mc/rhh

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