

Note from Larry Byers, member of CPARB representing sureties:

At this point, I do not have any surety language which could ameliorate the surety issues to the point where these contracts would be bondable, as there are numerous underwriting and legal challenges this program would create for contractors, subcontractors and sureties. Since sureties guarantee the contractor's obligations under the terms of the contract, the concerns that I expressed at the meeting are inseparable between sureties and the contractors they bond.

Design-build contracts can be challenging to underwrite to begin with but contracts with built-in guarantees for energy savings and carbon footprint reduction are substantially more hazardous. The proposed DBOM contracts then add long-term guarantees. Some of the key concerns include:

1. Guarantees of unproven technologies and savings that may or may not be realized, even if the project meets the certification requirements.
2. Guarantees of cash flows which can turn a standard performance bond into a credit enhancement mechanism.
3. Lawsuits that inevitably arise when purported energy savings do not occur (especially between the manufacturers of energy systems who blame the contractor who installed the equipment and the contractor who insists the equipment was installed in accordance with the manufacturers' specifications).
4. A much higher design standard (negligence standard vs. breach of contract).
5. Flow down risk to subcontractors.
6. The risk of performance standards embedded into the contract even if the OM is excluded, and
7. Tail liability incurred by the contractor which would be factored into the surety's underwriting.

In addition to these issues are a separate set of certification-related issues. For instance, according to the proposal, points would be awarded to the contractor based on "a demonstrated ability to obtain Energy Star certification." Since certification is awarded on a project-by-project basis, what if points are awarded to the contractor for his demonstrated ability, the contractor is ultimately awarded the job, but he is unable to obtain certification for the project? What are the damages to the owner, especially if the owner takes occupancy of the building in spite of the absence of certification? When is the project considered substantially complete and how long can the owner hold retention should there be a delay in certification?

Another issue that has not been addressed is how to resolve a situation where a certified project has simply failed to meet projected energy savings for whatever reason. What happens if all energy saving devices and systems were installed properly, the project was built to agreed upon specifications and the OM portion of the contract has now been completed but energy savings has not occurred. How does the owner and contractor resolve these issues? Can this affect the surety that bonded the construction of the project, perhaps several years earlier?

Another consideration that seems to have been overlooked is a requirement for an objective cost-benefit analysis for these projects. For instance, the proposal notes that "an Energy Star certified K-12 school costs forty cents per square foot less to operate than an average K-12 facility" but it does not specify the additional cost to build one of these schools and fails to indicate whether there is an overall net savings. The added risks to the contractor would certainly raise the construction costs even further (assuming that a few contractors might be able to work around the bonding issues) not to mention that there would be

so few contractors that could bid on projects like this that the lack of competition would allow for much greater margin.

As you can see, there are numerous, substantial issues that would need to be addressed from a bonding perspective before this proposal could move forward. I do not know if there is a task force meeting scheduled between now and the 8th. If not, I could arrange to meet with you in person or discuss this over the phone at your convenience. Please let me know what works best for you. You can reach me by e-mail or phone.

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NOTE:

The above e-mail was in response to an earlier version of the CPARB proposal where the contractor and surety would have been liable for longer and broader guarantees. The earlier proposal would have created serious underwriting and legal challenges that would have made it difficult for sureties to bond these projects and it also would have reduced competition among contractors bidding on this work.