

Performance-Based Contracts for Energy Efficiency Projects

Liang Ding

Stephen M. Ross School of Business
University of Michigan
Ann Arbor, Michigan, USA

Sam Aflaki

HEC Paris - Operations Management and Information Technology
Paris, France

Roman Kapuscinski

Stephen M. Ross School of Business
University of Michigan
Ann Arbor, Michigan, USA

Abstract

Energy efficiency projects are often executed by specialized entities, namely energy service companies (ESCOs). A typical ESCO's core business is conducted using performance-based contracts, whereby payment terms depend on the energy savings achieved. Despite their success in public, commercial, and industrial sectors, ESCOs in the residential sector are involved in fewer projects and face several challenges. First, an energy efficiency project often leads to changed consumption behavior; hence it is more difficult to evaluate the energy savings that are due to the project itself. The second challenge is that residential clients are more risk averse and, thus, less willing to contract for projects whose outcomes are uncertain. Third, a lack of monitoring protocols leads to ESCO's moral hazard problems. This paper studies ESCO contract design issues, focusing primarily on the residential market for energy efficiency. As opposed to other sectors, coordinating contracts do not exist. We show, however, that simple piecewise linear contracts work reasonably well. To improve their profitability, ESCOs can reduce uncertainty about the technology employed and/or develop ways of verifying post-project energy efficiency. Since policy makers are understandably keen to promote energy efficiency, we show also how regulations and monetary incentives can reduce inefficiencies in ESCOs' relationships and thereby maximize environmental benefits.

Keywords

Sustainable Energy, Energy Efficiency, Performance-Based Contracts, Double Moral Hazard