Challenges for Setting Up ESCOs in Largely State-Run Economies such as the Newly Independent States of the Former Soviet Union

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ABSTRACT

It is well recognised that the expertise of creating and operating successful energy services companies (ESCOs) lies largely in the West – mainly in the US and Western Europe. There is now considerable interest in the ESCO concept from the countries of the former Soviet Union and the Eastern bloc, where the energy infrastructure has suffered from years of neglect due to lack of investment.

This experience in the west opens up huge opportunities for Western ESCOs and consultants to transfer their knowledge and experience to the East, where the economies are by and large state controlled.

State-run economies present particular challenges to the ESCO concept. In particular, the legal and fiscal systems are designed to ensure that the state continues to maintain its stronghold over financial and other enterprises.

This paper is based on work undertaken in 2004 on behalf of the World Bank, in which these issues were examined for one former Soviet country, Belarus. The author has previously been involved in ESCO studies in other Eastern European countries - Czech Republic, Poland, and Lithuania to name three, all of which have since become members of the EU.

In Belarus, there is currently little or no experience of ESCOs. Companies engaged in the energy field such as consultants and contractors are not sufficiently conversant with financing aspects of energy efficiency projects. There is therefore a strong need to introduce the ESCO concept. This could make immense contribution in overcoming the present difficulties in the energy sector which Belarus faces today.

In the opinion of the authors, there are five key pre requisites for ESCOs to flourish in a country, and this paper examines how a largely state-run economy such as Belarus meets them. The role of international finance is considered essential in getting the ESCO concept started. The authors outline key barriers and suggest that the involvement of the state can help to overcome most of the obstacles. Additionally, involvement of the state can give international financing institutions (IFIs) the necessary confidence and will therefore be vital in launching the ESCO concept in Belarus.

Finally, the paper defines organizational options involving the State and the IFIs through which an ESCO can be successfully launched in such an environment.

Introduction to Belarus - Energy Background

Belarus is one of the former Soviet Union states, where the ESCO concept could prove hugely beneficial but where the economy in general is still largely state controlled. This creates special circumstances and challenges for the introduction and promotion of the ESCO concept.

Belarus has no indigenous energy resources, and 85% of its energy demand is met by imported energy from other countries, mainly from Russia. Most recently Russia has threatened to increase the price of its gas for Belarus by some 300% to and bring the price inline with what
Russia charges the rest of Europe. This price hike, if implemented, will have a disastrous impact on Belarus.

To reduce its dependence on energy supplies from other countries, Belarus must explore new indigenous sources of energy, and as a matter of priority, introduce energy efficiency measures.

In 1992, Belarus approved an Energy Program for the period up to year 2012. It covers 4 elements:

1. Energy Conservation
2. Increased role of local fuels
3. Development of small scale hydro and CHP plants
4. Development of alternative sources of energy

Improving energy efficiency across all sectors of the Belarusian economy is at the top of these four elements, hence a priority.

Belarus planned a new nuclear plant, but in 1999 a 10 year moratorium was declared. Electricity use in Belarus has come down from 49 billion Kwh (1990) to 33.5 billion Kwh (2004). It is however, estimated to climb back to near 40 billion Kwh by 2010.

Energy use in the tertiary sector by the year 2010 is expected to reach 41 million GCal (Heat) and 8.3 billion KWh (Electricity). It is one of the most inefficient sectors (specially residential and domestic). Residential plus Commercial energy consumption accounted for approx. 37% of the final energy demand. It is estimated that the residential sector accounts for 75% of this aggregated demand thus leaving 25% in the Commercial or Service sector.

In the residential sector, all new houses are to meet stringent envelop criteria (insulation, double glazing etc), and all new construction are to have mandatory heat metering. The Industrial sector is a slightly larger consumer of energy. By the year 2010 Heat consumption is expected to reach 42 Million GCal & Electricity to 31.7 Billion Kwh.

On a per capita basis Belarus’ energy consumption in 2003 was almost twice the European average. On the basis of GDP ratios, the overall energy consumption is approximately three times that of Hungary or Czech Republic, two of the former soviet bloc countries which are closest in terms of population to Belarus, but are now of course members of the EU.

Belarus therefore offers considerable potential for economies through modernisation and implementation of energy efficiency measures. However to modernise and increase energy efficiency, a renewed dedication to energy efficiency is essential and a significant level of capital expenditure will be required.

A number of initiatives are therefore needed, both to kick start the Energy Efficiency industry and to introduce novel financial mechanisms to get the necessary finance injected into the Belarusian Energy Infrastructure. The introduction of the ESCO concept is recognised as one of the most effective means of bringing in the much needed capital into the Belarusian Energy Infrastructure.

**Conditions for Successful Operation of ESCOS**

At the time undertaking this study, ESCOs did not exist in Belarus. However, the Government of Belarus has shown interest in introducing and promoting this concept. A number
of government bodies and local banks have expressed a serious desire to create and or participate in ESCO type companies.

Before the ESCO concept can be introduced in Belarus, it is necessary to examine the suitability of the prevailing legal and fiscal conditions which are essential for the concept to succeed and flourish. It is also important to identify the key barriers and possible means of overcoming them, the motivations, the incentives and also disincentives to create and promote the ESCO concept.

In the author’s view, there are five basic prerequisites:

- Favourable Legislative Framework
- Favourable Financial and Fiscal Climate
- Motivation and Incentives
- Understanding of the ESCO Concept
- Removal of Restrictive Practices

Favourable Legislative Framework

Considerable improvements in the legislative situation in Belarus have taken place since the early nineteen nineties, when Belarus started to move toward market economy. The current legal environment in Belarus does recognise most international legal concepts and practices, and more importantly, they take precedence over national practices wherever they are in conflict.

Legal Status of ESCOs

Although the existing company law does not provide for ESCOs explicitly, the ESCO concept and contracts may implicitly, be considered permitted within the existing laws of Belarus. However, taking account of Belarus’ national culture and practices for running a business, it is almost certain that a dedicated law to enable ESCO operation would be required.

The Civil Code suggests a variety of ways for starting and running a company. The following are a few of the legally approved organisational formats for commercial entities:

- Shareholding companies
- Societies
- Production co-operatives
- One owner companies

All these types of companies can be government or privately owned.

In case of an ESCO in Belarus, a suitable organisational format could be one of the following:

- Closed end shareholding company (ZAO)
- Central government or local authority owned company (RUP and KUP)
- One owner companies when the sole owner is private (CUP)
- Limited or extended liability company (OOO or ODO)
The early stages of ESCO development certainly face serious barriers and beaurocratic obstacles in Belarus. Due to the barriers and the high risks involved it is difficult to expect a strong interest in ESCO participation from private companies and individuals.

If on the other hand, the state is involved in ESCO creation in one form or another, many of the barriers and difficulties will have a good chance of being overcome at least for the pilot activity. For possible pilot ESCO models shown later, it is therefore suggested that the State plays a key role in any future Belarusian ESCO.

With this in mind, the first Belarusian ESCO type to consider will probably be an RUP (a company with national government as a sole owner) or ZAO (closed end Shareholding Company).

According to the Investment Code of Belarus, the Government could provide the following types of financial incentives:

- Lower rates of taxation and import duties;
- Guarantees to IFIs, foreign investors, foreign and Belarusian banks financing investment projects; and
- Direct financing of investment projects from the national budget.

It can also be expected that if pilot ESCOs prove to be successful, the ESCO market will mature and the involvement of private capital will increase. When that happens, the most preferable legal status for ESCO could be a limited (OOO) or an extended liability company (ODO). The Civil code of Belarus allows for companies initially established as closed end shareholding companies and one owner companies to be transformed into limited/extended liability companies.

**ESCO Contracts**

Although at present, there is no specific ESCO contract provision in the Belarusian Contract law, a so called “mixed type” contract can cover most elements for the provision of standard services such as those encountered between:

- An ESCO (as a borrower) and investors, and
- An ESCO (as a contractor) and subcontractors like consultants, engineering/maintenance contractors and equipment suppliers.

However an ESCO’s contract with its clients makes it different from standard contracts where conventionally goods or services are provided by one party to another for a payment. Some of the specific differences are:

- An ESCO provides a basket of services to the customer, under a performance guarantee. Performance however, can be defined in a multitude of ways. The client may not actually pay for the services in the conventional manner.
- Instead, in some cases it is the ESCO who may actually make a net payment to its customer as a percentage of the savings it creates, whilst at the same time providing the customer its basket of services.
• ESCO services often include procurement/provision of funds, and provision of performance guarantees. In certain cases, an ESCO organises the finance from banks/financing institutions for its customer, whilst in other cases the ESCO itself operates as a financing institution.

• ESCO guarantees its clients (and the investors) that their investment will be fully paid back within the term of the contract.

Theoretically, the standard contract type suggested by Belarusian Civil Code may be devised to cover all aspects of ESCO operation but to achieve this in practice, it would become cumbersome and major amendments will be necessary.

A task for Belarusian lawmakers is therefore to develop a dedicated contract to cover the ESCO business, paying particular regard for setting up base lines against which to evaluate the ESCOs performance based service. Creating this type of contract will probably require a Ministerial Act. One of the government agencies in Belarus (Belinvestenergosberezhenie) is now understood to be in advanced stages of setting up an ESCO, and therefore it may be safe to speculate that a dedicated ESCO contract could be approved shortly.

Contract Law & Legal Enforceability of Contracts

Belarus has a well established contract law. Systems for legal enforcement of contracts were found to be operative and thus contracts entered into by organisations can be legally enforced. This is absolutely vital for the promotion and success of the ESCO sector.

Ownership of ESCO’s Assets on Public Estate

An ESCO (whether private, state owned or jointly owned) will invest in new infrastructure (boiler houses, power generation plants etc.) on client’s premises, of which in Belarus, a large proportion will be in the public sector. An asset belonging to an external company who may have a private shareholder, if installed on the public estate can create complexities of ownership rights, use of land, etc.

In the existing Civil Code of Belarus, these issues are well covered. Public sector organisations can own assets or run private (ESCO’s) assets on their land. After they are fully amortised, they can take over such assets without having to pay for them (other than perhaps a pepper corn residual value) at the point in time of handover.

However, in practice, public organisations are usually not keen to take on assets on their balance sheet for fear of being held responsible for the maintenance and operation of the asset and which could impose a cost liability in subsequent years.

Rights of Foreigners and Foreign Companies

Once the ESCO concept is established and proven, the real impetus in the growth of the ESCO sector, will inevitably involve the participation of foreign investors, foreign ESCOs, and foreign technology. This however can not happen unless the Ownership & Operational rights of foreigners and the repatriation of profits by foreign companies can be safeguarded.

Belarusian Government actively welcomes foreign investment and foreign technology, and the issues of safeguards are well spelt out in Belarusian legislation. A large number of successful foreign investment projects are now in progress. However, it has to be pointed out that
many projects with foreign participation have not been entirely successful. The reasons for this include inadequate assessment of the risks involved, changes in taxation, exchange rate fluctuations, rising labour costs etc. Therefore, a pilot ESCO with foreign participation will need to make a very careful assessment of the risks, and be properly safeguarded by a tight legal document.

**Favourable Financial & Fiscal Climate**

Belarus seeks to maintain what is termed as “socially oriented market economy” The market socialism model combines private initiative and competition, but the state maintains an active role in safeguarding social protection for the population. It is the author’s view that Belarus offers considerable advantages to foreign investors by virtue of its central location, a well educated work force and low crime rate.

**Inflation**

Inflation has been gradually coming down since 1999 (317 %), and whilst it has fallen considerably since 1999 it was still in double figures (29%) in 2003.

**Interest Rates**

Interest rates in Belarus vary from bank to bank. Whilst the average interest rates are exorbitant (circa 36 % or higher), the Belarusian cabinet regulation provides for low interest financing specifically for the purposes of energy saving activities. All legal entities in the energy efficiency field can be offered finance at an interest rate not exceeding 50% of the National Bank Rate. Today, finance for such activities carries on average an interest rate of approx.18%

**Availability of Long Term Finance**

Access to competitively priced long term finance is essential forESCOs. At this point in time, the maximum duration of lending by local banks as stipulated by the National Banking Code is limited to 6 years. However, most ESCO projects need loans over a longer term.

For this reason, setting up and running a pilot ESCO in Belarus has been difficult without the participation of an international financial institution. However, since the World Bank funded study was completed, the authors have learnt that an ESCO has been started by a government agency (Belinvestenergosberezhenie). Details about this ESCO were not available at the time of writing and therefore it is not entirely clear to what extent this ESCO is relying on funds from international financial institutions.

Some Belarusian banks are now actively negotiating long term credit lines from foreign banks so that they may make longer term loans available to their borrowers. Alternatively, some creative accounting concepts (e.g. back to back lending) will need to be explored which could extend the financing term for energy efficiency projects.
Acceptability of Leasing & Credit Sale Concepts

The legislation for both exists in Belarus. It is regulated by generally established legal standards. During recent years, credits sales of many type of goods and services have become wide spread.

Leasing is also allowed by law, but can be difficult to implement in practice. There are exceptions. Non commercial organizations such as schools, hospitals and municipalities may not enter into a lease contract as a Lessee. State run companies are however allowed to lease along side commercial companies.

Both Finance and Operating leases are available in Belarus. Banks provide Finance Leases while leasing firms can arrange for operating leases. The definitions of both types of leases are the same as in the west. On the whole, Belarusian Leasing legislation is considered to be liberal and opens up a wide range of opportunities.

Taxation Climate

The investment code of 2001 has brought about important changes in the investment climate of Belarus. According to this code, foreign investors are entitled to government guarantees, and are exempt from Corporation profit tax for three years for selling goods or services. All legal entities in the energy business may include the cost of energy savings into their profitability accounts within one year of the energy saved, and the sums may be accumulated for re - investment. Up to half of this accumulated sum may be offered as bonuses to their staff, and this mechanism thus may be interpreted as an indirect tax incentive.

Willingness of Financial Institutions to Consider Energy Projects

In principle, banks are prepared to consider energy projects, because competition for good borrowers is increasing. However, at the moment provision of loans to companies is based on overall assessment of their assets. Banks know almost nothing about international project financing1. The author and his Associates are trying to promote International Energy Efficiency Financing Protocol whereby banks can be trained to treat energy saving streams as an asset against which to lend.

Also, like any other sector in a state-controlled economy, the banking sector is also over-regulated by very prescriptive laws within the national banking code, and it does not allow for banks to act as an ESCO. However, the situation is not without a solution. Banks are allowed to open affiliate companies that can do a wider range of financial activities including the provision of ESCO type services. Considerable amount of training work within the banking sector of Belarus would of course be necessary.

1 The authors are working with the Efficiency Valuation Organization to introduce the concept of the International Energy Efficiency Financing Protocol. This is an APEC-funded initiative that is working to develop a set of guidelines for the evaluation and financing of energy-efficiency projects. The Protocol, once developed would streamline and facilitate the analysis of energy-efficiency and ESCO projects by banks and help stimulate lending and project finance for energy efficiency.”
Existence of Company Credit Register

At the moment a company credit register does not exist in Belarus, although one is now being planned. Therefore, an investor in Belarus needs to expend considerable time and effort to assess credit worthiness of potential clients. As in many other former Soviet countries, there are many large companies – former national giants who can boast huge assets but which in practice are worthless. They are almost bankrupt and have an uncertain future.

Risk Appraisal Skills

At the moments they are still rather poor both among local lenders and borrowers. Very often, there is also a strong pressure on lenders to invest into projects that the State considers good. These may include some very risky energy projects. Therefore, an ESCO with foreign participation should take particular care.

Stable Currency Exchange Rates

The exchange rate of local currency against the US$ has been reasonably stable since the year 2000. However, significant price increases in most goods and services in local markets have taken place during this period. This is explained by the fact that state subsidies on many commodities is disappearing rapidly on the one hand, and by the inefficiency of local industries and services on the other. Rising prices of goods and services have led to a proportional increase in wages and labour costs. It is expected that this trend will continue in the near future.

Motivation, Incentives & Disincentives

For the User

Ability to benefit from energy savings. In practice, the value of energy saved by an organisation is lost in the overall cash flow of the company under the current accounting rules in Belarus. It gets transferred into a central budget elsewhere. Therefore organisations do not see any benefit from the energy they save and thus the incentive for saving energy is lost. This today, is a major barrier and a big disincentive for energy efficiency in Belarus.

However, attempts are being made by Belarusian Committee for Energy Efficiency (CEE) to get this disincentive removed and allow companies to accumulate energy savings over a number of years on special accounts to be further used for energy efficiency initiatives. This system was in place but was abolished by the Ministry of Finance. There is now reason to believe that this barrier may be slowly coming down.

Nevertheless, to improve energy efficiency in Belarus, the following incentives are offered by the Belarusian Government:

- Provision of economic incentives to companies to save energy. Thus, investment into energy efficiency and interest payments are exempt from corporate profit tax.
- Special incentives are planned for public sector. Last year, several hospitals in Minsk were allowed to keep their energy savings (instead of returning them back to the
Government which is the common practice). The experiment worked well and this year it has been extended to a wider number of public sector organisations.

- For public and private companies, several national energy saving funds were set up and are now fully functional. The main ones are Belenergo Innovation Fund and National Energy Saving Fund.

Between the years 2000 & 2003, about 390 million US$ were invested in energy efficiency across Belarus. This includes Government grants, bank and special fund loans and own resources of the companies.

The major barrier to wider uptake of energy efficiency initiatives in Belarus is access to finance, at least in the public sector. In the climate of fast growing fuel prices organisations can barely pay their current energy bills, and very little is left to invest in energy saving measures.

**Legislation driven motivations.** Legislation driven motivations for companies to save energy are insufficient at present. However, the administrative pressure from the Government to save energy is considerable. It is applied in the form of numerous instructions and directives to reduce energy consumption by a certain percentage every year. In the first instance it is applied to Government owned companies followed by, but somewhat less rigidly to private organisations.

Belarus is almost ready to sign the Kyoto Protocol, and that in itself will bring about renewed motivation.

**For the ESCO**

**Existence of market demand.** Interest in energy efficiency projects in Belarus has always existed. Many Belarusian industrial and public sector companies employ qualified full time energy managers. However the number of companies in the private sector that are really able to justify and qualify for ESCO services is not very large, as ESCOs will only seek companies with a sound credit rating and good trading record, i.e. those that are able to satisfy the investors of their long term survivability.

On the whole, ESCO operation could be possible in the private sector, mainly with larger robust organisations. However, while the public sector organisations in general may present a lower credit risk to the ESCO, the number of restrictive practices in that sector can make the breakthrough very difficult for private ESCOs.

The real interest and potential demand for ESCO services is only just starting to come about, specially since the year 2000 when the Belarusian economy has begun to stabilise. However, multinational ESCOs, such as Dalkia who are active in neighbouring Lithuania, in the author’s view, believe that Belarus is not quite ready yet for their participation.

**Understanding of the ESCO Concept**

At the moment the level of awareness and understanding of the ESCO concept is poor among potential users and lenders. The perception remains that ESCOs have a big fat cheque book and they can sweep away all financial problems. Considerable amount of marketing, training and awareness campaigns are therefore needed in Belarus.
Restrictive Practices

Many restrictive practices still exist and it would be surprising for them not to be so in a state controlled economy. This greatly hinders ESCO development and in case of public sector these make it almost impossible. These practices are explained by the policy of extreme cost reduction in public sector. Most public sector organisations like schools and hospitals are owned by local authorities, but their finances, both for capital equipment and for revenue expenditure including energy bills are directly controlled by the central government through the National Treasury.

Public Procurement Rules and Competitive Tendering

Very strict tendering rules apply to procurement in public sector. All purchases over $10,000 must be put out to quantitative tender, and projects of a total value of more than $300,000 require setting up tendering commissions which include senior representatives of the national government. The concept of qualitative tendering is unheard of.

All goods and services have to be bought directly from producer (in case of locally made goods) or from the first importer into the country (in case of foreign imported goods). An unwritten law is that no mediators are allowed.

An ESCO, although a special organisation providing a full range of services will nevertheless be seen as a middle body and can face difficulty to win tenders in the public sector. A campaign is clearly required to explain that an ESCO is not in the business of selling, and if any thing, it is a means of bringing about cost reductions. Only education, training and awareness campaigns will enable ESCOs to be treated differently.

Bureaucratic Procedures, Delays and Slow Decision Making Process

Although considerable amount of work in Belarus is being done to overcome bureaucracy, and some progress has been achieved, the decision making process remains painfully slow. A typical energy efficiency project when fully or even partly financed by the government requires many stages of approval. Typically, pre-feasibility studies, feasibility studies, development of detailed design drawings and working documentation, all have to be approved by many government institutions.

Regulated Fuel Prices and Subsidies

In the past, considerable subsidies existed in Belarus for fuel for many categories of consumers including industries and the public sector. The Government can no longer support these subsidies, and gas, electricity and heat are distributed to consumers at cost, and certainly above the cost level to industries. Availability of cheap gas from Russia makes small scale production of electricity and heat very cost-effective. The days of cheap gas from Russia are however coming to an end, and the higher gas prices will certainly be a key driving force for greater implementation of energy efficiency measures. This in turn will help the ESCO industry to get established and mature in Belarus.
The First ESCO in Belarus

At the time of undertaking this work, there was a complete lack of ESCO experience in Belarus. For this reason, it will be very difficult to raise enough investment resources from within the internal resources of Belarus. One of the goals of the World Bank study was to assess options for establishing the first ESCO in Belarus. Foreign funds from IFIs will of necessity be required for the first Belarusian ESCO and to some extent they may be augmented by National resources.

As part of the World Bank project, senior Belarussian government officials were taken on a study tour of Ukraine, where amongst others, they had an opportunity to hold discussions with officials of the first ESCO in Ukraine which is called UkrESCO. A name BeESCO was therefore suggested by the authors in the World Bank report for a possible first ESCO in Belarus. This was suggested for nothing more than drawing comparisons with the operating practices of UkrESCO during discussions. There is no suggestion that this name has been formally adopted, and was used merely to avoid repeating the phrase, ‘the first ESCO in Belarus.’

Possible Financing Modes

Potential sources to finance the start up BeESCO can be:

- National funds of Belarus (at the moment the most significant is BELENERGO Fund).
- Grants from World Bank or other IFI.
- Targeted loans from the World Bank or other international financing institutions for development of ESCO against the State guarantees.

Loans could be provided from international financial institutions (IFIs) either directly (Option 1) to BeESCO or to the Ministry of Finance first and then passed on to BeESCO (Option 2)

Option 1. In this case BeESCO has to:

- Sign a loan agreement with the Ministry of.
- Open a foreign currency account with the bank appointed by the government.

Option 2. An alternative option could be that an IFI loan is provided to Belarussian Ministry of Finance. This option has a number of advantages over Option 1.

- During the period of agreement of the loan between the IFI and Ministry of Finance, BeESCO as a proper company could be registered.
- This option would make it easier to supervise This option would be considered as one with a lower risk by investors.

In addition to local banks, other Belarussian companies can participate in financing the ESCO operation. When it has accumulated sufficient reserves, this may be BeESCO itself, or one of its customers.

As an additional financing source for an ESCO start up, a Revolving Fund such as one now being set up under the GEF Biomass Project for Belarus may be considered.
Conclusions

This paper highlights the priority that the Belarussian government is placing on energy efficiency and the role that the ESCO concept can play in helping to bridge the technical and capital gap. The paper outlines five key pre-requisites for the ESCO concept to work successfully in Belarus. These are:
• Favourable Legislative Framework
• Favourable Financial and Fiscal climate
• Motivation and Incentives
• Understanding of the ESCO Concept
• Removal of Restrictive Practices

Some significant movement towards market economy and economic stabilization have taken place recently, and along with improvements in legal framework, they make ESCO operation almost possible. A number of incentives are in place. Contracts are enforceable and rights of foreigners are well catered for.

Economic indicators are moving in the right direction and inflation has fallen considerably although still high by western standards. Interest rates are coming down and there are tax incentives available for investment in energy efficiency. Banks are willing to consider loans for energy efficiency but the loan terms are short and they continue to lend only on an asset based philosophy.

However, much of the economy is still controlled by the state, there are still many restrictive practices in place and there is lack of coordination between different government bodies. There is heavy reliance on very prescriptive laws and detailed instructions and regulations in all areas of business. The inability of organisations to keep their savings remains biggest disincentive. There is however scope for optimism with regard to organisations being allowed to retain the benefit of the savings they achieve.

In these conditions, successful development of ESCO would require perseverance and tenacity and an intensive training and information campaign for end use and banking sectors, careful risk assessment techniques. For the first pilot ESCO in Belarus, foreign funds from IFIs will be essential. Active involvement and actual participation of the State in a pilot ESCO model will certainly facilitate the creation of the first ESCO and help in the overall growth of this sector.

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