



Corporate Renewable Energy Procurement Industry Insights

Corporate Renewable Energy Procurement: Industry Insights

June 2016



AMERICAN COUNCIL ON RENEWABLE ENERGY

ACORE is a national non-profit organization dedicated to advancing the renewable energy sector through market development, policy changes, and financial innovation. With a savvy staff of experts, fifteen years of experience promoting renewable energy and hundreds of member companies, non-profits, and other organizations from across the spectrum of renewable energy technologies, consumers, and investors, ACORE is uniquely well-positioned to strategically promote the policies and financial structures essential to renewable energy growth. Additional information is available at: www.acore.org

CORPORATE PROCUREMENT WORKING GROUP

Leveraging ACORE's 15 years of leadership on renewable energy policy, finance, and market development, the Corporate Procurement Working Group taps the organization's extensive network of leading renewable financiers, developers, power generators, and corporate consumers of renewable energy to facilitate the procurement and integration of renewable energy into the power generation portfolios of leading American companies. Additional information is available at: www.acore.org/programs/member-initiatives/power-generation/corporate-procurement-working-group

© 2016 American Council On Renewable Energy (ACORE)

All Rights Reserved under U.S. and foreign law, treaties, and conventions. This work cannot be reproduced, downloaded, disseminated, published, or transferred in any form or by any means without the prior written permission of the copyright owner or pursuant to the License below:

Published by:

American Council On Renewable Energy
1600 K St. NW, Suite 650
Washington, DC 20006
202.393.0001

Questions or Comments: info@acore.org

THE RENEWABLE JUMBLE: BASIC LEGAL CONSIDERATIONS FOR CORPORATE END-USERS OF RENEWABLE ENERGY

Frank Shaw & Ethan Schultz

Skadden, Arps, Slate, Meagher & Flom LLP

In addition to helping meet corporate sustainability goals, renewable energy benefits from multiple direct and indirect subsidies, including tax credits, renewable energy credits, and other benefits that can make renewable energy an attractive financial proposition. As a result, many companies are considering buying renewable energy directly, through a standard power purchase agreement (PPA) where electrical output is physically delivered and the buyer takes title to the renewable energy. Others are procuring renewable energy through *virtual* or *synthetic* PPAs, which are essentially derivatives or swaps. However, corporate customers entering the market for off-site renewable energy face a jumble of legal, regulatory, tax, and accounting constraints, as well as potential benefits. Energy production and distribution is a highly regulated industry, at federal, state and local levels, and tax benefits entail complex rules and financing structures, which must be reconciled with accounting and financial reporting considerations.

Such considerations are likely to be unfamiliar to most corporate procurement officers, who may be accustomed to purchasing all their electrical needs from the local utility. Balancing all of the competing considerations can be a challenge. In evaluating a green energy procurement strategy, corporate end-users should first consider some basic legal and practical considerations, which are outlined below.

Does applicable state law allow direct retail access?

The most direct way to procure renewable energy would be through a standard PPA for physical delivery of energy from a renewable power project, either on-site, or off-site with transmission arranged by the seller. In many states, however, only traditional public utilities may sell directly to end-users, at regulated rates, within their service territory.

Other states, such as those in deregulated markets, may allow competitive sales by qualified retail service providers. In these states, a corporate customer seeking to procure renewable energy may be able to buy its electricity requirements from a state-qualified retail supplier of renewable energy, with the local utility continuing to provide transmission and distribution services scheduled by the seller.⁶³

Can the corporate customer establish its own renewable energy marketer?

Companies with large enough operations may even find it worthwhile to establish their own retail supply arms, which could procure renewable energy at wholesale, buying directly from large, utility-scale renewable energy projects, to capture the price savings from economies of scale. However, establishing and operating a captive retail supplier is also not simple. The retail supplier must qualify under state law, and likely will be subject to regulation at the state level. If the retail supplier becomes a power marketer, buying and selling in wholesale markets, it would be need to obtain market-based rate

⁶³ Virtual PPAs are typically financial instruments not implicated by state laws restricting retail sales to regulated utilities or approved retail service providers.

authority and have a rate on file with the Federal Energy Regulatory Commission (FERC). Such marketers are subject to reporting requirements and other regulation by FERC under the Federal Power Act.

How will procuring green power from a third party affect demand charges under the corporate customer's existing utility tariffs, including any exit fees?

Under traditional rate regulation, local utilities are permitted to recover capital and operating costs from their customers plus a regulated profit margin. The loss of customers can leave fewer ratepayers to pay the utility's fixed charges for building and maintaining its power plants and its transmission and distribution system. Thus, even states that permit retail customers to switch suppliers or self-generate may allow the local utility to charge an exit fee or a non-bypassable wires charge to compensate it for the loss of revenue. Utility tariffs also may include provisions for *demand charges*, which are set according to the customer's peak load, or for backup or maintenance power. A customer replacing much of its energy requirements with renewable energy thus may face higher-than-expected costs for obtaining the remaining power from the local utility. Corporate consumers seeking renewable energy alternatives should consider the costs the utility will charge to serve their remaining electrical needs.

Who owns the renewable energy credits, and who can claim them?

As an alternative to direct purchases of renewable energy, corporations may purchase unbundled renewable energy credits (RECs) from a renewable energy project or a broker. Such unbundled purchases are falling out of favor with some corporations seeking additionality in their investment in renewable energy, i.e., that seek to promote development of new renewable energy sources to displace non-renewable energy in the energy marketplace. Such corporations tend to favor purchases of renewable energy through PPAs or virtual PPAs.

In a standard PPA, the RECs can be bundled with the purchased power, or sold separately. Care should be taken not to double count, however. RECs are legally enforceable rights to claim the environmental attributes of renewable energy, and while they can be traded, they are tracked (though systems such as Green-e Energy) so the same REC is not claimed twice or by multiple parties. If the RECs are retained by the seller and sold separately, or if the purchaser of bundled renewable energy promptly resells the RECs, the renewable energy has lost its environmental attributes and become mere fungible electrons. Under the Federal Trade Commission's Green Guides, the right to claim environmental benefits of green energy belongs to the owner of the RECs.⁶⁴ Thus it would be potentially deceptive for a company to announce it were utilizing renewable energy purchased directly from a renewable energy project, unless the company also purchased (and retired) the RECs. The FTC's guidance is paralleled in the requirements for certification by Green-e Energy, which would similarly consider such an announcement as double counting, likely making the RECs ineligible for certification.

Some PPAs permit *REC arbitrage*, where cheaper, unbundled RECs purchased in other markets may be substituted for the RECs produced by the particular project under the PPA, which may be more valuable if sold separately in a local market. Again, however, corporations should consider carefully how such substitutions could affect marketing materials or other claims regarding use of renewable energy.

⁶⁴ 16 CFR §260.15.

Is the PPA subject to regulation as a swap under Dodd-Frank?

Some PPAs may be subject to regulation as a derivative or *swap* by the Commodity Futures Trading Commission (CFTC), whose regulatory authority was expanded under the Dodd-Frank reforms. A standard PPA in which the commercial entities intend the transaction to be settled through physical delivery of power most likely will be excluded from CFTC regulation as a *forward contract*. A virtual PPA that is settled financially rather than physically is likely to be subject to CFTC regulation as a swap, principally certain detailed reporting and recordkeeping requirements. Even a physical PPA, if it provides for “embedded volumetric optionality” (for example, one that allows the corporate purchaser to vary or curtail the quantity of electricity purchased) may be a “swap” unless it meets certain CFTC tests or qualifies as a *trade option*.

Corporate PPAs that are or may be regulated as swaps typically require the seller of electricity to handle these reporting and recordkeeping obligations, as a renewable energy provider is more likely to have the requisite experience (and staffing) to manage these obligations than a corporate off-taker new to the business.

What is the customer’s potential exposure to damages, and concomitant excuses or mitigants, under the PPA?

Most independent power projects, including renewable energy projects, are financed on a *project finance* basis, where the revenue from power sales from the project, rather than the corporate credit of the project’s sponsors, is the principal source of repayment of the debt or tax equity used to finance construction of the project. Project financiers generally require long-term PPAs for fixed quantities of power (or for some minimum portion of the project’s output), and clear damages and remedies provisions in the case of purchaser breach. While most PPAs contain customary excuses for failure to purchase required quantities, such as *force majeure* or transmission outages, such excuses may be limited or even overruled by *take-or-pay* provisions requiring minimum monthly or annual purchases. Corporations entering into long-term PPAs for renewable energy should review carefully their purchase obligations, including minimum quantities or take-or-pay provisions, provisions excusing performance, damages calculations, and limitations of liability. Damages are often determined by the difference between the contract price and forward price curves, for the required quantity of power, integrated over the remaining term of the agreement. Markets can be volatile, and under a long-term contract, potential damages in the event of a breach can grow very large.

Can the customer issue parent guarantees under its bond or debt covenants?

To secure this potential exposure under a PPA, a customer that does not have adequate corporate credit may be required to post financial security, typically in the form of letters of credit or corporate guaranties from a credit-worthy parent. Corporate customers should consider whether requirements to post such security are consistent with their bond or debt covenants. Of course, customers should confirm the creditworthiness of their counterparties as well. Renewable energy projects are typically special-purpose vehicles established solely to own a specific project, and renewable energy marketers may be thinly capitalized considering their potential liabilities.

How will the PPA be treated for tax and accounting purposes?

Under the tax code, a standard PPA may be recharacterized as a lease of the underlying property for tax purposes, depending on the particular facts.⁶⁵ There is a safe harbor for alternative energy facilities, unless the service recipient (i.e., the purchaser of power) or a related entity (i) operates the facility, (ii) bears any significant financial burden if there is nonperformance under the contract (not for reasons beyond the control of the service provider, i.e., the seller under the PPA), (iii) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract, or (iv) has an option or obligation to purchase all or part of the facility at a fixed and determinable price (other than at then-fair market value). Since classification as a lease can change the tax ownership of a project (if not respected as a true lease for tax purposes), upsetting the parties' expectations about allocation of depreciation and other tax benefits, a corporate PPA should be analyzed carefully to assess the risk of recharacterization. The tax treatment of a virtual PPA raises additional questions, depending on the specific characteristics of the PPA, and should be considered with the corporate purchaser's tax advisors.

Care also should be taken to structure the PPA to achieve the desired accounting treatment. In certain circumstances, a PPA may be treated as a lease for accounting purposes. If lease treatment is desired, the purchaser should further consider whether the lease is to be treated as a capital lease or an operating lease. Virtual PPAs, where no physical delivery of electric energy to the purchaser is contemplated, may be treated as derivatives for accounting purposes. Output guarantees, for example, may trigger mark-to-market accounting treatment, creating liabilities on the corporate purchaser's balance sheet, which many industrial or commercial customers may wish to avoid. Parties considering a corporate PPA should consult with their accounting and legal advisors to structure the PPA in a way that achieves the desired accounting treatment.

If direct ownership is desired, does the corporate customer have the *tax capacity* to utilize the ITCs, PTCs, or accelerated depreciation from the project efficiently, or the institutional capacity to master complex tax structuring vehicles?

Owners of renewable energy projects may claim various federal tax benefits, including a 30 percent investment tax credit (ITC) for solar or wind projects, a production tax credit (PTC) for wind and certain other renewable energy projects, and accelerated depreciation (MACRS).⁶⁶ Certain states, such as Hawaii and New Mexico (and until recently, North Carolina) may have state income tax credits as well. Corporate customers with the capacity to utilize such tax benefits could consider expanding their support of renewable energy to include a direct ownership investment in renewable energy projects.

Tax benefits together can constitute as much as 60% of the cost of constructing a renewable energy project in the United States, on a present value basis. Since most project developers do not have the federal tax base to efficiently absorb the tax benefits, they need to monetize the value of the tax benefits to finance the cost of constructing the project. In fact, renewable energy finance in the United

⁶⁵ Internal Revenue Code § 7701(e).

⁶⁶ The deadline for qualifying for such tax credits was recently extended by Congress under the Consolidated Appropriations Act, 2016. For example, solar projects can qualify for the full ITC if construction starts on or before December 31, 2019, and wind projects can qualify for the full PTC if construction starts on or before December 31, 2016. Each deadline ratchets down over periods of several years thereafter.

States is highly dependent on such tax equity investments, which is mostly provided by large banks and other financial institutions with large and relatively predictable tax appetites. If a corporate customer expects to have taxable income sufficient to utilize the ITC, PTC, and/or accelerated depreciation, it may be able to achieve an attractive after-tax return as a tax equity investor, while directly supporting construction of a renewable project. While the partnership or lease arrangements used to structure investments in such projects can be quite complex, more and more large corporations are becoming comfortable with such tax equity investments. In doing so, they can go beyond being a mere customer to being an active participant in renewable energy production.

Conclusion

A power purchase agreement for renewable energy can help corporate purchasers meet sustainability goals and, ideally, hedge against long-term price volatility in energy markets. Care should be taken to address basic legal questions first, however, and then to see that the PPA is properly structured in a way that meets tax, regulatory, and other legal objectives. Only by properly structuring the PPA can the corporate customer be comfortable that the transaction will be truly sustainable, not just for the environment, but for the corporate balance sheet too.

About the Authors

Frank Shaw is a counsel and Ethan Schultz is a partner in the Energy and Infrastructure Projects Group of Skadden, Arps, Slate, Meagher & Flom LLP. Ethan and Frank are based in Skadden's offices in Washington, DC.