

Increased demand for renewable energy PPAs expected to create seller-friendly market

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Takeaways

- The widespread adoption of sustainability goals by major corporations has created significant demand for renewable power.
- That, in turn, is strengthening the hand of producers in negotiations over power purchase agreements.
- Energy producers are seeking to bind buyers for substantially longer terms and are shifting more risks to buyers.

In the U.S., approximately 20% of the total energy supply comes from renewable sources, but green energy capacity is not expanding nearly rapidly enough to meet corporate sustainability goals.

Over the past decade, hundreds of companies have publicly committed to various sustainability goals. Many are seeking to obtain all or most of their power from renewable sources. But bringing new renewable power projects online takes years. As a result, companies seeking to offset their greenhouse gas emissions (GHG) will face increasing competition for supplies of green power, and producers will have more leverage in negotiating power purchase agreements (PPAs). This shift in negotiation dynamics is already resulting in more seller-friendly terms.

Demand rises for green energy

RE100, a global corporate renewable energy initiative, has over 340 member companies that have pledged to source 100% of their electricity from renewable energy by 2050, and at least 20% of these companies have committed to an earlier deadline of 2030. Additionally, in 2021, more than 180 companies signed on to The Climate Pledge, agreeing to decarbonize (*i.e.*, use energy sources that do not produce GHGs) and reach net zero emissions (*i.e.*, offset GHGs with activities that remove those emissions) by 2040.

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expanding nearly rapidly enough to meet corporate sustainability goals. Because new projects can take up to four to six years to be developed, financed and constructed, companies with near-term and midterm sustainability pledges will face increasing competition for supplies of green power.

Corporate PPAs promote sustainability and provide steady revenues for project financing

A key component of most companies' sustainability strategies has been the procurement of renewable energy or renewable energy credits (RECs), certificates representing a certain amount of clean power delivered by a producer to the grid. Companies historically bought RECs to meet their mitigation targets for GHGs. But the sale of RECs typically did not yield enough revenue to finance a project. Investors and lenders now generally insist that a producer have a buyer contractually bound to purchase its energy output for many years in the form of a PPA.

Under a typical PPA, a company agrees to buy power at a specified price determined in the agreement for many years, ensuring the long-term, predictable revenue essential for obtaining project financing and investment. Corporate PPAs typically run from 12 to 15 years but may be up to 20 or 25 years.

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In many cases, however, corporate buyers do not actually take delivery of a project's energy output. The power, for example, may be generated too far from the user to be delivered economically. In these situations, the parties can enter a "synthetic PPA," which does not involve physical delivery of the energy to a buyer.

Synthetic PPAs effectively function as hedge arrangements, offering project owners guaranteed income and buyers price predictability and potential savings on the energy generated by the project. These contracts are frequently structured as fixed-price purchase and sale agreements for RECs with an embedded "contract for differences" for the energy. The project owner sells the energy into a wholesale

electricity market and is paid the prevailing market price. At the end of a specified settlement period, usually a month, the owner calculates the “floating price payment” based on the amount sold (or a hypothetical energy profile) and the weighted average of the price received.

If the floating price payment exceeds what the producer would have received at the fixed price in the PPA, the excess is paid to the corporate buyer. If it is less, the corporate buyer pays the difference to the project owner.

The settlement process under the synthetic PPA, together with the transfer of RECs to the buyer, acts as a GHG offset for that portion of the buyer’s energy use corresponding to the output of the project used in the settlement process.

Shifting negotiation dynamics are likely to result in more seller-friendly terms

Corporations purchased 23.7 gigawatts of green energy in 2020, 18% more than in 2019, and 74% more than in 2018. The total is forecast to grow by at least 30% per year in order for companies to meet their 2030 commitments.

Recently, some producers have been taking advantage of the leverage this demand has given them and have pressed for more favorable terms:

- Synthetic PPAs have typically run from 12 to 15 years. Increasingly, producers are negotiating terms of up to 20 or 25 years.
- Producers are bearing less “basis risk.” Synthetic PPAs are imperfect hedges, which create basis risk for the power generator when the floating prices used in the settlement process under the PPA differ from what the producer receives for its energy. This difference can be significant if the floating price is determined at a trading hub instead of the pricing node at which the project sells its energy output, or if the settlement

process is based on a hypothetical energy profile instead of actual sales.

- Generally, synthetic PPAs also have not provided producers with relief if actual energy sales differ from the hypothetical profile due to force majeure events, such as the January 2021 storm that led to a crisis for Texas’ grid. Increasingly, producers are requiring corporate buyers to cover all or some portion of the floating price difference and seeking force majeure relief for such production issues.
- Up to now, corporate buyers have generally been successful in negotiating reduced pricing for excess energy to avoid having to pay for power produced beyond their needs and what was expected to be hedged by the synthetic PPA. Increasingly, such pricing terms are being resisted by producers.
- Synthetic PPAs have generally included many terms to mitigate the risk of the producer’s nonperformance. For example, (1) a letter of credit to secure a seller’s payment obligations, (2) a production guarantee to compensate a buyer if the quantity of power generated by a project is less than expected and (3) construction milestones and preconditions to commercial operation to allow a buyer to terminate the contract if construction issues prevent a project from being completed.
- Increasingly, producers are not offering credit support to secure their payment obligations, and instead have pushed buyers to rely on project revenues. Likewise, they have been less willing to agree to construction milestones and have provided very limited recourse for failure to meet production guarantees or a target date for commercial operation (e.g., termination without liability after an extended period).

In conclusion, synthetic PPAs are effective ways for companies to advance their sustainability commitments, but they need to prepare to negotiate in a more seller-friendly market.

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