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Power Purchase Agreements: Keys to Drafting, Negotiating & Allocating Risks

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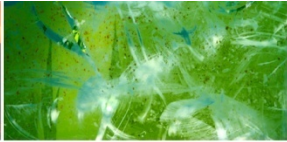
Topic Overview

- Project Construction
- Operation
 - Performance Guarantees
 - Curtailments
 - Maintenance
 - Pricing Issues
- Defaults and Termination
- Renewable Energy Credits (RECs)



Project Construction

- Tension Between Buyer and Seller: “Must Build” vs. “Put”
- Buyer wants:
 - Development and Construction Milestones
 - A Guaranteed Commercial Operation Date (“COD”)
 - Delay Damages for failure to meet Construction Milestones or Guaranteed COD
 - Liquidated Damages if the Project Achieves its Guaranteed COD With Less Capacity Than Promised



Project Construction

- Seller wants:
 - Force Majeure outs
 - Off ramps if specified conditions aren't met by a date certain
 - No damages if a milestone is missed but COD is still achieved before the Guaranteed COD
 - Caps on Delay Damages (the lower, the better)
- Buyer may agree to many of Seller's points, but may ask for "right of first refusal" or "right of first offer"



Conditions Precedent to Seller's Obligations

- Examples
 - Execution of required wind leases and rights of way
 - Execution of an Interconnection Agreement
 - Receipt of Permits (in a non-appealable form)
 - Receipt of Financing (Debt or Tax Equity)
 - Board approval



Conditions Precedent to Buyer's Obligations

- Examples
 - Public Utility Commission approval of the PPA, enabling Buyer to pass PPA costs through to its ratepayers
 - Board approval
- Public Entities
 - May be subject to contract procurement rules
 - Approval process governed by state law



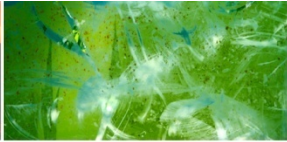
Building the Project: Milestones

- Will the PPA set out any Project development milestones?
- What happens if Seller misses a milestone?
 - Default?
 - Additional credit support?
 - Other cure?
- What if Seller misses a milestone but still achieves Guaranteed COD?



Building the Project: Commercial Operation Date (COD)

- COD often represents the transition between “test energy rate” and “contract rate”
- What is the Project’s expected COD? What is its guaranteed COD?
- What is required to achieve COD?
 - Buyer prefers subjective standards
 - Seller will press for objective standards and a dispute resolution process
- How “complete” must the Project be to achieve COD?
- Does Seller have a duty to complete the Project if COD is achieved at less than 100%?



Pricing Issue: Tax Credits

- In order to qualify for PTCs/ITCs/Cash In Lieu, renewable energy projects must be “placed in service” by dates specified for each resource.
- What happens if all or part of project isn’t “placed in service” in time or construction does not “start” before December 31, 2011?
- Options
 - Price adjustment (straight or partial pass through)
 - Developer’s right to terminate
 - Developer’s right to terminate, subject to offtaker option to buy at adjusted price



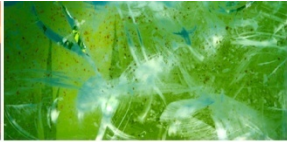
Delivering the Project's Output

- Will the energy be delivered “as available?”
- Will the energy be firmed and shaped?
 - Physical firming and shaping
 - Market-based firming and shaping
- What’s the “Delivery Point” for the energy?
 - Where title and risk of loss passes from Seller to Buyer
 - Seller usually prefers the point where the project interconnects to the transmission system (a “busbar” sale)
 - Buyer may prefer a point of delivery from which it has transmission
 - Take back an interest in assigned transmission!



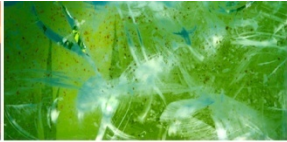
Curtailments

- Why do curtailments matter?
- If a wind energy project is curtailed because of insufficient transmission, it loses, on each MWh curtailed:
 - The Contract Price for the energy and RECs
 - The PTC (for a high capacity-factor project relying on the PTC)
- Under the AARA, some projects may rely on ITC or government grant, thus changing the curtailment calculus somewhat



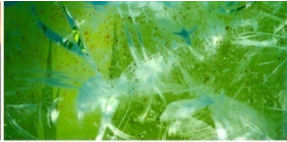
Curtailments (cont.)

- Seller wants to shift curtailment risk to Buyer by
 - Treating curtailed energy as if it were generated
 - Requiring Buyer to pay for the curtailed energy by paying the Contract Price plus the PTC (if applicable) on an after-tax basis
- Allocation of curtailment risk can be a contentious issue – possible compromises
 - Seller absorbs curtailment for an agreed upon number of hours or MWhs, after which Buyer pays as if the energy were actually generated
 - The parties share the cost of curtailment
 - Buyer doesn't pay for curtailment, but curtailed energy counts toward output guarantees



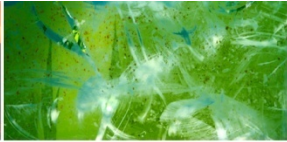
Curtailments (cont.)

- Curtailments are treated differently depending on cause of curtailment (system emergency, congestion)
- Curtailments are treated differently depending on quality of transmission (firm, non-firm, conditional firm)
- Regardless of how the risk is shared, the PPA needs to explain how to calculate the amount of energy that would have been generated without the curtailment
- See *FPL Energy Upton Wind I, L.P., v. City of Austin*, 240 SW3d 456 (2007), *reh'g denied* 2007 Tex App LEXIS 9306 (Tex App Amarillo 2007); *TXU v. FPL*, 2010 Tex. App. LEXIS 5905 (July 27, 2010).



Wind Integration Charges

- Wind PPAs Should Address How Price Will be Adjusted For Wind Integration and Other Post-Effect Date Charges
- What is a Wind Integration Rate (WI Rate)?
 - Bonneville Power Administration Rate Case: the WI Rate is what BPA charges for providing reserves to balance wind generation:
 - FY 2010-2011 BPA Rate Case set WI Rate at about \$1.29/kW/month
 - (\approx \$5.70/MWh)
 - BPA originally proposed a WI Rate more than double the final amount (\$2.72/kW/month (\approx \$12/MWh)), but reached an agreement with the wind community on the amount of reserves allocated to wind balancing



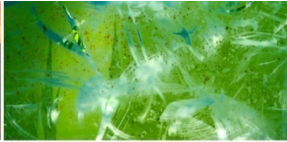
Other Potential Price Adjustments

- Taxes (e.g., sales or excise taxes) imposed after Effective Date
- O&M Costs
- Changes in law that increase operating or compliance costs



Performance Guarantees

- Seller prefers to deliver an “as available” product with no liquidated damages for shortfalls in performance; Buyer often insists on Performance Guarantee
- Mechanical Availability Guarantees
 - Availability is stated as a percentage
 - Seller assumes risk of equipment performance but does not assume wind risk
 - Force Majeure periods are usually excluded from the calculation
 - If Mechanical Availability falls below the guaranteed percentage, the parties calculate the shortfall in MWh and the Seller pays the Buyer liquidated damages



Performance Guarantees (cont.)

- Output Guarantee
 - Seller commits to a minimum “Guaranteed Output”
 - If there is a shortfall in output:
 - Seller liable for Buyer’s damages (usually replacement damages, but sometimes fixed amount per MWh)
 - Shortfall may even be deemed an Event of Default
- Increasingly common in US



Performance Guarantees (cont.)

- Features of Output Guarantee
 - The Output Guarantee will usually be stated as a percentage of the Project's Expected Output
 - If the Project is not built to full size, the Project's Expected Output needs to be adjusted downward
 - Seller will try to set Output Guarantee at a level it is very confident of achieving (P99).
 - Contract Price is often lower for Project output above 120-125% of Expected Output



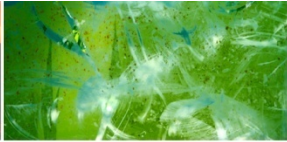
Performance Guarantees (cont.)

- Seller prefers to test the guarantee over two or three years
- Seller will want to count the following toward the achievement of an Output Guarantee:
 - Curtailed energy
 - Energy lost through force majeure
 - Energy that Seller can't deliver because of Buyer's breach
 - Cf. TXU v. FPL case.



Output Guarantee Issues

- Wind Risk(s)
 - The Seller cannot control the wind
 - Guarantees based on historic calculations of P50 or P95 conditions may be riskier than the Seller's models predict
 - “Global Weirding” might affect wind conditions at site over the life of a long-term PPA
- Mechanical Risk
 - Teething pains (e.g., serial defects)?
 - How will wind turbines perform in later years?



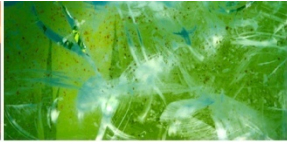
Default and Termination

- PPA will specify defaults and applicable cure periods
- What happens while a cure is pending?
 - Seller usually gets to mitigate its damages by selling to third parties
 - Non-defaulting party may suspend performance
- What happens if a shaping party defaults—is that Buyer's problem, or Seller's?



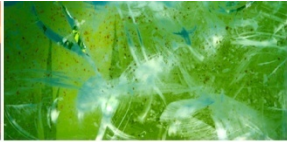
Defaults—Lenders and Tax Equity

- Lenders and Tax Equity
 - PPA should give Lenders and Tax Equity the right to step in to cure Seller's default
 - Lenders and Tax Equity will need additional time in which to cure a Seller default
 - Default under loan documents cannot be a default under PPA



Consequences of Event of Default

- Non-defaulting Party can terminate PPA and seek damages for the breach
- Damages are usually direct damages, typically measured by “cover”
- Aggregate damages are sometimes capped, but typically not for “willful” breach
- PPA may contain a detailed formula for calculating damages that a party is entitled to receive upon termination
- Beware the EEI “two-way termination” clause—there are scenarios in which it could cause the non-defaulting party to pay large sums of money to the defaulting party



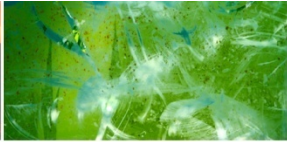
Limits on Damages

- PPA usually states that neither Party can recover punitive, consequential or incidental damages from the other
- However, the PPA should be clear that lost PTCs are direct damages and thus are not excluded by limit on consequential damages. Cf. TXU v. FPL
- The PPA should also be clear that damages that are a part of liquidated damages are also deemed direct damages
- Terminating party must mitigate its damages



Credit Support

- Seller is almost always required to provide credit support
- PPA almost never requires Buyer to provide, even in the face of a credit downgrade
- Credit Support
 - Guaranty
 - Letter of Credit
 - Cash
 - Second Lien on Project Assets
- Amount can vary from development to operation phase



Renewable Energy Credits (RECs)

- Aka “Green Tags,” “Environmental Attributes” or “Tradeable Renewable Certificates” (“TRCs”)
- RECs are often “Bundled” With Energy in PPA
- 1 MWh of energy = 1 MWh of RECs
- RECs can be separated from energy and sold “unbundled,” but unbundled RECs may not produce RPS compliance



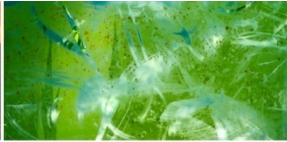
Sale of RECs

- The PPA will define RECs—the definition will be very broad, and the Buyer usually will not let Seller reduce that breadth.
- Who bears the risk of change of law with respect to RECs (or anything else for that matter)?
 - Seller prefers to take risk of laws in effect or at least known on date of PPA
 - Buyer (especially California utilities) often try to require Seller to comply with law even if it changes—in California, Seller's are only required to absorb “commercially reasonable” costs



Key Negotiating Issues re Restrictions on Assignments

- Collateral assignments to lenders and the ability of lenders to assign must be fully protected
- Clearly state that there is no restriction on upstream assignment of ownership interests
 - Do not assume that a restriction on assignment of assets will not apply to a transfer of ownership interests
- Beware of Purchaser's rights to assign the PPA to an affiliate, especially if Purchaser is thereby released
- When consent is required for an assignment, negotiate
 - “Not unreasonably denied, conditioned or delayed” language
 - Standards for approval



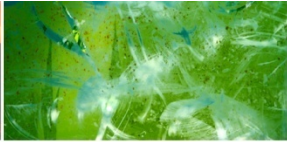
Dispute Avoidance 101

- Draft Clearly in Simple, Declarative Sentences—Subject, Verb, Object.
- Avoid “Teutonic Paragraphs”—Never Draft a Paragraph Bigger Than Your Head.
- It is desirable never, ever to write in the passive voice (consider this actual sentence from a wind lease: “Structures that interfere with the flow of wind are prohibited on the Premises.” Think about it.)



Dispute Avoidance 101 (cont.)

- Use Examples to Illustrate How Complex Provisions Will Work Under Certain Stated Assumptions (And Vary the Assumptions to Test the Provision).
- Decide What Things Are Valuable (Or Might be Valuable) and Clearly State Which Party is Entitled to Those Things (e.g., RECs, “white tags,” carbon offset credits).
- Avoid Inviting Two Dogs to Fight Over the Same Bone (e.g., Carbon Offset Credits for Methane Capture vs. RECs)



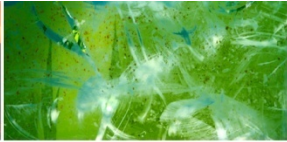
Dispute Resolution Provisions and Concepts

- Recourse to Courts for Dispute Resolution
 - Choice of Venue
 - Choice of Law
 - Waiver of Jury Trial To the Extent Permitted by Law



Dispute Resolution Provisions and Concepts

- Alternative Dispute Resolution Concepts
 - Step Negotiations Involving Senior Executives Before Submission to Mediation, Arbitration or Courts
 - Compulsory Mediation of Disputes Before Submission to Arbitration or Courts
 - Binding Agreement to Submit to Arbitration in Lieu of Court Proceedings



Hazards of An Elaborate Dispute Resolution Process

- Mandatory Negotiation, Senior Executive Negotiation and Mediation: “Results May Vary”
- What Happens if the Parties Are Clearly at Loggerheads Early in the Process?
 - Does the contract require the Parties to exhaust the steps specified in the contract before turning to binding arbitration or the courts?
 - If so, this can be both time consuming and futile if the parties are at an impasse (consider the effect of a clause that requires up to 40 days of initial discussions; another 30 days for Senior Executive negotiations; another 30-60 days for mandatory mediation; followed by submission to binding arbitration).



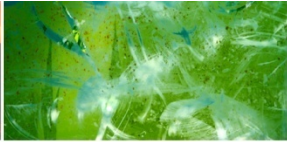
Potential Solutions

- The dispute resolution provision should preserve each Party's right to seek immediate injunctive relief to avoid irreparable harm or preserve the status quo.
- Consider drafting the dispute resolution clause to enable each Party to proceed promptly to the courts or arbitration if it is reasonably clear that negotiations or mediation are futile.
- Once the binding dispute resolution process begins, the Parties can still return to negotiation or mediation.



DISPUTES vs. Disputes

- Not every dispute is big enough to warrant the time and expense of step negotiations, mediation, arbitration or court proceedings.
- For the usual range of technical disputes that often arise in complex projects, set up a “technical dispute” procedure that will govern disagreements to be resolved by an Independent Engineer or other agreed-upon expert.
- “Technical Dispute” clauses are often used to resolve disagreements about, for example (1) whether a project has achieved mechanical completion, substantial completion, commercial operation, or final completion, and (2) routine billing issues.



DISPUTES vs. Disputes (cont.)

- Identify the “technical arbitrator” in the contract.
- If the Parties are not able to agree on the technical arbitrator at the time of contracting (probably not a good sign), clearly identify expedited mechanisms for selecting the technical arbitrator—these will be needed in any case if the Parties’ original choice is not available when the dispute occurs.
- Carefully define the “jurisdiction” of the technical arbitrator.
 - Describe the matters that are considered technical disputes.
 - Describe the matters that are not considered technical disputes and thus not subject to the technical arbitrator’s jurisdiction.



All Arbitration Services Are the Same, Right?

- American Arbitration Association
 - Rules on-line www.adr.org
 - Panel of Lawyer Arbitrators
 - Specific Rules for Large/Complex Matters
(Now Permits Depositions)
- Judicial Arbitration and Mediation Service
 - Rules on-line www.jamsadr.com
 - Full-time “Neutrals,” Most Retired Judges
 - Single Arbitrator Unless Parties Agree



All Arbitration Services Are the Same, Right? (cont.)

- CPR Institute for Dispute Resolution Rules for Non-Administered Arbitration
 - Rules and sample dispute resolution clause on-line www.cpradr.com
 - Panel of Arbitrators (or Self-Select)
 - Presumption of Three Arbitrators



Questions for the Arbitration Clause

- If a service is chosen, which of the service's rules will the Parties use?
- How many arbitrators? Some contracts provide for a single arbitrator to decide disputes below a specified dollar amount.
- Where will the arbitration take place?
- Should the Parties consider using "Baseball" or "Last Best Offer" arbitration?
- Should the arbitration clause say anything about discovery, briefing or other procedural matters?



Questions for the Arbitration Clause (cont.)

- Should the arbitration clause include mechanisms for expedited arbitration?
- Which court(s) can enforce the arbitrator(s)' decision?
- Is the arbitration decision final, or can it or some aspect of it be appealed? If so, to whom and what is the standard for review?
- Who bears the costs of arbitration?



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