

Proxy Revenue Swaps Drafting and Negotiation

A Practical Guidance® Article by Bo Harvey, Stoel Rives LLP



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This article discusses the process of drafting and negotiating proxy revenue swaps, which are a specific variation of financially settled off-take agreements that may be used for renewable energy projects. While the agreements contain complex details and can be viewed as niche products, the general concept underlying the contract is straightforward: it is intended to create a relatively stable revenue stream that mirrors the anticipated revenue a wind or solar project is expected to receive over the life of the agreement, based on certain operational assumptions for the project.

For more information generally on project finance, see [Project Finance Resource Kit](#), [Power Purchase Agreements](#), and [Power Purchase Agreements in Renewable Energy Projects](#). For more information on establishing green targets for borrowers in the loan market sustainable, see [Market Trends 2019/20: Sustainability Linked Loan Principles](#).

Overview

With the recent rise of environmental, social, and governance (ESG) standards, interest in renewable energy infrastructure remains strong. Corporations across industries continue to pursue renewable energy goals, and certain investment managers have publicly committed to pursuing

sustainable investing strategies. Demand for renewable energy projects remains robust in light of the ongoing interest in sustainable, zero-emissions energy.

Similar to any project financing generally, an important component of any renewable energy project is establishing a predictable revenue stream with a creditworthy counterparty acting as an off-taker (see [Off-Take Contracts for Project Finance Investors, Developers, and Lenders](#)).

The alternative to entering into a contract that stabilizes a project's revenue stream is to take merchant risk by selling into spot markets, which is typically an unpalatable approach for lenders, investors, and developers in light of the unpredictability. Stable revenue flows assure stakeholders that a project will maintain economic viability over the life of their investment, which also increases financing options and, consequently, the potential for levered returns and attractive exit strategies.

Revenue contracts for renewable energy projects take many forms—including fixed-price power purchase agreements (PPAs), fixed-volume swaps, virtual PPAs, and proxy revenue swaps, among other forms. Each of these products essentially looks to de-risk the fluctuating prices a project would face if it were selling on a merchant basis, but each product uses different structures to achieve that aim. Moreover, each of these off-take arrangements mitigates a different set of risks to a project's revenue stream, whether those uncertainties relate to production, basis risk, or shape risk. This article focuses particularly on proxy revenue swaps, a relatively recent development in the renewable energy space. They tend to be associated with wind projects, although they can also be used for solar projects. For more information on solar financings, see [Solar Energy Financing](#) and [Solar Energy Project Development](#).

Features and Structure of Proxy Revenue Swaps

For the project finance lawyer, one way of understanding proxy revenue swaps is by distinguishing them from other forms of revenue contracts found in the energy industry. Unlike traditional PPAs with utilities, or certain hedges that might include the physical delivery of a fixed quantity of power to a commodities merchant, proxy revenue swaps are financially settled—similar to virtual PPAs—meaning power is not physically delivered as part of the transaction. Another distinguishing feature is that the counterparty to a proxy revenue swap is typically an insurance company comfortable hedging weather-related risks. Proxy revenue swaps also address risks to a project's revenue stream in a distinctive manner. To understand how this is the case, a brief summary of certain ways revenue stability can be jeopardized may be helpful.

In addition to being exposed to the standard risk of unpredictable pricing, a wind or solar resource has a variable production profile over the life of the project, creating volumetric, or production, risk. Put simply, some days the wind or solar conditions will be more favorable for energy production than other days. Certain off-take structures, such as fixed-volume energy hedges, attempt to alleviate production risk by tying project revenue to a fixed quantity.

A related uncertainty is shape risk, which reflects the correlation between supply and price for renewable resources. For example, wind resources in the same geographic location will generally all be producing simultaneously on windy days, driving down the market-clearing price of wind power on those days. By contrast, on days with lower wind speeds, production is lower, thus driving up the market-clearing price. Similar correlation exists for solar projects located in the same region. The risk to a renewable energy project is that the spot price will be lower at precisely the time when the project is producing more energy. Consequently, when a weighted average of the project's realized price across hourly intervals is calculated, the higher volume at low prices will drag down the average price received by the contract.

To address these uncertainties, a proxy revenue swap attempts to hedge anticipated revenue in contrast to a fixed quantity of power. Under the terms of the proxy revenue swap, the counterparty will pay a fixed premium payment periodically to the project. The fixed amount is typically paid monthly or quarterly, irrespective of the project's production output, or timing of such output. In return, the project will make a periodic floating payment

based on "proxy revenue." Proxy revenue is derived from the sum, over specified settlement intervals, of a project's expected generated volume (or "proxy generation") multiplied by a designated hub price. Although the floating amount paid by the project is not tied to actual production, to be sure, the calculation of proxy generation assumes certain operating characteristics of the project—particularly availability, performance, and electrical losses—and these fixed operational assumptions are key variables in the calculation of proxy generation. The result is that although the counterparty to the proxy revenue swap hedges the project's weather risk and volumetric risk, the project retains any operating risk that arises from the inability to perform in line with these fixed assumptions.

The amounts due between the parties are then settled on a net basis at the specified quarterly or monthly settlement periods. To the extent proxy revenue exceeds the fixed premium payment for the relevant period—for instance, when hub prices or wind speeds are high—then the project will pay the hedge provider. Conversely, when proxy revenue is less than the fixed premium payment for the relevant period, then the hedge provider will pay the project. Meanwhile, the physical power produced by the project can be sold into the market.

In addition to payment of the floating payment, the project typically makes an up-front payment and pays an annual fixed amount (much like an insurance contract) to the counterparty. Because the project will still sell physical power into the grid at the nodal price, the revenues received based on market sales can be used to offset the premium or floating payments made by the project to the proxy revenue swap counterparty. Note that this means that the project retains "basis" risk because proxy revenue under the terms of the swap is calculated using the more liquid hub price, while the market sales of physical power by the project are typically conducted at the prevailing nodal price. The result is the project's financial performance will be affected by significant differences between prices at the node and hub.

While other revenue contract structures may attempt to mitigate basis risk—in particular, fixed-volume swaps that include a tracking account mechanism—proxy revenue swaps do not target the mitigation of basis risk.

Documentation of Proxy Revenue Swaps

A swap is, at its core, an agreement by two parties to exchange streams of cash flows. Swaps are often documented under the documentation architecture

set forth by the International Swaps and Derivatives Association, Inc. (ISDA), and the proxy revenue swaps are no different in this respect. The ISDA suite of documentation includes a Master Agreement, Schedule, Credit Support Annex, and Confirmation. See [ISDA Master Agreement: A Practical Guide](#).

ISDA Master Agreement

The ISDA Master Agreement is a standard, industry-accepted agreement used to document swaps and other over-the-counter derivatives transactions. Over-the-counter derivative transactions refer to transactions that are privately negotiated directly between two parties and which do not occur through an exchange or trading platform. There are two versions of the ISDA Master Agreement: the 1992 and 2002 version. While the distinctions between these two versions are beyond the scope of this article, proxy revenue swaps are typically documented under the 2002 ISDA Master Agreement.

At its core, the Master Agreement governs the nature of payment and delivery obligations between the parties, specifies certain events of default and termination events, the termination process (including the calculation of a termination amount upon early termination), and dispute resolution mechanics. The Master Agreement is a standard form that does not change, but it can be negotiated further and customized by the parties via the Schedule, various annexes, and the Confirmation.

The Master Agreement is divided into the following broad sections:

- Section 1:
 - Defines the parties and provides that the Master Agreement, Schedule, and all Confirmations thereunder are a single agreement.
 - Provides for a documentation hierarchy in the event of any conflict (Confirmation > Schedule > Master Agreement).
 - Section 2:
 - Specifies the payment and delivery obligations, manner of payment, netting, gross-up for tax withholding, and conditions precedent. The absence of an Event of Default (EOD) and a Termination Event with respect to the other party is a condition precedent to a party's obligations. These terms are often modified further via the Schedule.
 - Section 3:
 - Contains standard representations and covenants, including those related to corporate power and authority, consents, absence of EODs and litigation, and accuracy of information provided. Any additional representations desired by the parties are added to the Schedule.
 - Section 4:
 - Obligates the parties to furnish specified information—which can be specified via the Schedule—and comply with applicable laws, and maintain certain authorizations and tax representations.
 - Section 5:
 - Specifies standard EODs and termination events, some of which are heavily modified via the Schedule.
 - EODs include, generally, the failure to pay or deliver, breach of agreement, certain credit support defaults, misrepresentation, a default under a specified transaction, cross-defaults that exceed a specified threshold amount (see below), bankruptcy, and a merger where the resulting entity fails to assume obligations.
 - Termination Events encompass situations in which a party cannot legally perform, a force majeure event occurs (which differs in certain significant respects from a PPA-style force majeure definition), and certain tax events.
 - Additional termination events (ATEs) are specified in the Schedule.
 - Section 6:
 - Prescribes, in detail, the close-out process when an EOD or Termination Event occurs
 - If an EOD occurs and is continuing, the non-defaulting party has the right to designate an Early Termination Date for all outstanding transactions. The non-defaulting party may designate such Early Termination Date by not more than 20 days' notice. Once designated, the Early Termination Date will occur whether the relevant EOD or Termination Date is continuing.
 - If a Termination Event other than a force majeure event occurs, the party affected by the Termination Event (the Affected Party) must notify the other party. In the case of Force Majeure Events, the Affected Party must use reasonable efforts to notify. Section 6 provides for significant additional detail with respect to which parties are the Affected Parties upon the occurrence of other termination events (such as those related to illegality of the transaction and tax events).
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- o The process for determining the applicable termination payment (the Close-out Amount) is quite granular, and subject to certain contractual setoff rights at the option of the non-defaulting or non-affected party. The close-out determination process was subject to significant litigation in the wake of the 2008 financial crisis, creating a line of case law that unpacks Section 6 of the ISDA Master Agreement in some detail.
- Section 7:
 - o This is an assignment provision, which provides the agreement cannot be transferred without the written consent of the other party except (1) pursuant to a merger/consolidation or sale of all or substantially all of its assets or (2) permitted transfers of an interest in an early termination amount. The Schedule often modifies Section 7.
- Sections 8–14:
 - o These sections contain various miscellaneous provisions, including, among other provisions, those relating to:
 - Notices
 - Governing law, jurisdiction, waiver of immunities, and designation of any process agent
 - Interest calculations
 - Offices and multibranch parties
 - Indemnities for enforcement costs
 - Standard provisions relating to amendments, survival of certain obligations, remedies, counterparts, and no waiver of rights –and–
 - Definitions

ISDA Schedule (the Schedule)

The ISDA Schedule supplements and is part of the Master Agreement. It contains the parties' specific modifications to, or elections under, the Master Agreement. For example, the Schedule is where the parties make any modifications to EODs, the close-out process, notices, and many other provisions. As a result, the Schedule is often highly negotiated. As an example, the standard ISDA Master Agreement has language that relates to cross-default triggers based on defaults that exceed the threshold amount. The threshold amount itself is specified in the Schedule; further, if the parties wish to change cross-default to cross-acceleration, this change is also made via the Schedule.

For proxy revenue swaps, examples of critical issues negotiated in the Schedule include the following:

- Disapplying or modifying EODs, such as specifying the relevant threshold amount that triggers cross-default (or cross-acceleration, if modified)
- Specifying the relevant specified indebtedness that triggers cross-default (if any)
- Changing the cure period with respect to the failure to pay default
- Whether to elect the “Credit Event Upon Merger” default, and, if so, unpacking the instances when a transferee entity is “materially less creditworthy”
- Adding ATEs such as for failure of the project to achieve commercial operation by a particular outside date, or the project's breach of certain fundamental covenants
- Inclusion of any full or partial termination events for casualty, condemnation, or force majeure events that impact the project, and specifying any relevant cure periods—in this respect, the parties often seek to add termination events that they more closely align with those found in traditional PPAs
- Negotiating the circumstances that will trigger a force majeure event
- Customizing the Close-out Amount so that it would look more like a standard PPA in certain cases (For instance, the project sponsor may look to cap the project's liability for paying any Close-out Amount in certain situations, such as force majeure or complete casualty events in which the project is destroyed or condemned.)
- Specifying the reports and operational certifications that must be delivered periodically by the project to the counterparty to the proxy revenue swap, or, in the case of the counterparty, requirements for the counterparty to deliver certain consents, estoppels, or other documents that may be required by the project's lenders or tax equity investors
- Specifying covenants of the project company related to taking on additional indebtedness, restrictions on asset sales, obtaining and maintaining certain insurance policies, and standards relating to the operation and maintenance of the project
- Providing for credit support providers and documentation (including any guarantees or, if the project is granting the hedge provider a lien on project assets as credit support, specifying the relevant security documents)

- Modifications to any setoff rights to apply across transactions or across affiliates –and–
- Additional representations made by the parties, including those related to Dodd-Frank regulations (including any required reporting under Commodity Futures Trading Commission regulations implemented under Dodd-Frank)

ISDA Credit Support Annex

The Credit Support Annex (CSA), like the Schedule, supplements the ISDA Master Agreement and governs any credit support being provided. The CSA will contain credit support provisions that apply to the project, in addition to those that apply to the counterparty to the proxy revenue swap. The CSA contains 13 “paragraphs” and are structured similarly to the ISDA Master Agreement: Paragraphs 1–12 of the CSA do not change, but in Paragraph 13, the parties are able to make certain elections and customize the CSA generally.

The CSA provides for a collateralization of each party’s exposure to the other party, on the basis of a mark-to-market valuation of the transaction. As the value of the swap fluctuates over time, the parties exchange variation margin payments in accordance with specific procedures and timing specified in the CSA. In addition, the CSA allows for the parties to specify up-front “Independent Amounts,” which are, essentially, additional collateral cushions that are intended to secure the potential future exposure that might result from closing out a defaulting counterparty’s position under certain market conditions over a certain period of time.

Eligible Credit Support

The CSA specifies the types of collateral that are acceptable as credit support. Credit support provided by a project company is typically in the form of a letter of credit or a lien on project assets (or some combination thereof). Project companies are not cash-rich, and project sponsors are often hesitant to provide guarantees, leaving letters of credit as a common fallback. The parties will also specify any credit requirements that are applicable to the issuers of letters of credit. For more information generally on letters of credit, see [Letter of Credit Resource Kit](#).

Alternatively, a project may provide credit support in the form of a lien on project assets, which can be efficient from a capital standpoint, but which may increase the complexity of obtaining construction or term financing from other lenders in light of the intercreditor arrangements that may need to be established between the hedge provider and other lenders or investors in the project.

In addition to specifying acceptable types of credit support, the CSA will assign the level of haircuts (Valuation Percentages) that apply to the collateral. Haircuts tend to be applicable in situations where marketable securities such as bonds or equities are being posted as collateral. Generally, this is not an issue for proxy revenue swaps where letters of credit or liens are being posted as credit support.

Collateralization Triggers

The requirement to provide collateral—typically in the form of cash, a letter of credit, or a guaranty from a more creditworthy parent entity—may also be subject to certain credit triggers, if negotiated by the parties. The parties can also tie the requirement to post collateral to certain exposure thresholds such that collateral is required only to the extent certain levels of exposure are exceeded, based on the valuation of the swap.

Dispute Rights, Use of Collateral, Distributions, and Substitution Rights

Other provisions in the CSA further address:

- Dispute resolution provisions in the event the parties disagree as to the valuation of the transaction (and hence the exposure levels and amount of collateral that must be posted)
- Conditions that apply to the secured party’s holding and using posted collateral
- Requirements that apply to custodians
- The treatment of interest, dividends, or other distributions –and–
- The right to substitute different forms of credit support

With the exception of dispute resolution procedures, these provisions tend to have narrow applicability where liens, guarantees, or letters of credit are the primary types of credit support.

Confirmation

The Confirmation will contain the specific commercial terms that relate to the proxy revenue swap. The Confirmation will, among other things, provide for the fixed and floating payments payable by the parties and the calculation of proxy revenue (including specifying the hub price revenue is indexed to). The Confirmation will also set forth in detail the relevant operational assumptions that apply to the project.

The parties will want to carefully consider the timing of the transaction as specified in the Confirmation. To the extent that the proxy revenue swap requires the exchange of payments prior to commercial operation of the project, the project will not have the benefit of offsetting merchant sales. On the other hand, if the effective date of the proxy revenue swap begins long after commercial operation, then the project will be exposed to merchant risk for a period of time until payments under the hedge begin to be exchanged by the parties.

The Confirmation will also address potential adjustments to the payments under the proxy revenue swap to account for circumstances where there are deviations between the as-built conditions of the project as of commercial operation and the conditions initially specified in the Confirmation, or casualty or condemnation events that result in a portion of the project not being rebuilt. These circumstances may also be designated as partial ATEs in the Schedule, therefore permitting a pro rata termination of the affected portion of the transaction. These adjustments allow the parties to modify the swap without carrying the burden of fully terminating the transaction or completely amending the terms of the swap.

Calculation Services Agreement

Finally, a proxy revenue swap will also include a Calculation Services Agreement pursuant to which an independent third-party acts as a calculation agent (for a fee) for the purposes of preparing settlement reports, assessing data quality, tracking operational losses, and proposing certain adjustments. The calculation agent will also carry out the calculation of the cash settlement amounts payable by the parties upon each settlement interval. The parties will negotiate a bespoke dispute resolution process that pertains to the calculations and determinations of the calculation agent.

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