



Steven F. Greenwald



Jeffrey P. Gray

QF Contracts and 21st-Century Economics

By Steven F. Greenwald and Jeffrey P. Gray

Many power purchase agreements entered into between qualifying facilities (QF) and electric utilities during the 1980s and 1990s have several years remaining on their terms. These contracts typically require the generator to comply with the Federal Energy Regulatory Commission (FERC) regulations promulgated pursuant to the Public Utility Regulatory Policies Act (PURPA). The foremost FERC requirement is that the QF deliver sufficient amounts of “useful” thermal energy to a “steam host” and thus satisfy FERC’s operating and efficiency standards.

The Odds Favored a 30-Year Steam Host

For the generator to maintain QF status, the steam host must maintain operations throughout the term of the agreement at production levels requiring PURPA-qualifying quantities of steam. PURPA contracts typically offer the QF pricing benefits and operating advantages. In return, the agreements often provide that any failure to maintain QF status constitutes a contractual breach and commonly enable the utility purchaser to recover substantial damages. These contractual arrangements are unique—the QF’s satisfaction of its contractual obligations is dependent on the performance of a third party. Even if the QF operates its generating facility flawlessly, it will likely be in breach if its steam host reduces or ceases production.

QFs (and their financial supporters) decided that the risk of the steam host failing to take sufficient steam was negligible because the QF offered the steam host a more reliable steam supply, at a lower price. By outsourcing its steam procurement function, the steam host also could relieve itself from environmental compliance, other permitting risks, and capital expenditures associated with operating an in-house boiler. Importantly, steam hosts were in most instances Fortune 500-quality companies in the oil, wood products, chemical, or food processing industries that often had been operating for scores of years. Through the latter years of the 20th century, assuming that a steam host would remain viable for 30 years seemed like a safe bet.

The New Economics

More recent years, however, have demonstrated that even the surest economic bet becomes risky when subject to the crucible of a 30-year term—economic conditions and practices and the fundamentals of corporate organization change dramatically. Mergers, corporate restructurings, intensified and expanding environmental regulations, changes in consumer demand and technology, and just pure economics have caused industrial facilities to shut down and abandon communities in which they have been the major corporate citizen for generations. Thus, many QFs have been confronted with the loss of their steam host, which in turn could precipitate a loss of QF status, a breach of the power sales agreement, and liability for damages.

FERC has established a general policy of granting QFs that lose

steam hosts a waiver for up to two years to find a replacement steam host. However, given the depressed state of the economy, finding a third party to assume the steam take obligations, especially for multiple years, has become increasingly daunting and expensive.

New Economics Require New Solutions

Compounding the generator’s problem is that the purchasing utility all too frequently seizes the loss of the steam host as a means to void the power purchase agreement and seek damages. The utility asserts that it must pursue these actions because the “breach” by the QF has deprived the ratepayer of the critical benefit bargained for in the power purchase agreement: the fuel and environmental efficiencies of cogenerated power.

To ward off this litigation, QFs (often supported by the steam hosts) invest capital to install facilities requiring steam. Though substitute steam uses are consistent with PURPA’s policy objectives and satisfy the QF’s contractual objectives, they often do not result in the optimal deployment of capital nor provide the utility the maximum benefit.

Today’s economic exigencies and energy realities demand a more practical and nonretributive approach. First, the QF’s “breach” is not operational; rather, it reflects only its inability to accurately predict 30 years of future economics. Second, there are more economically efficient and beneficial remedies that can restore the contractual benefits to the utility’s ratepayers.

For instance, QF contracts typically have very limited rights of curtailment, often requiring the purchase of power when less-expensive sources are available or even if the utility has no need for the power. Excusing a “not-at-fault” QF for a loss of a steam host in return for providing the utility meaningful dispatch rights would likely provide ratepayers a greater benefit than obligating the QF to install a substitute steam host. Doing so likely would also impose a lower cost on the QF.

Similarly, certain QFs that lose their steam hosts often could provide greater value by operating only for limited periods as peakers. Restructuring payment provisions to pay these QFs predominantly for capacity should reduce costs for the utility but preserve the reliability of the supply and the economics of the QF’s investment.

The current paradigm—based on “fault” and designed to restore a 1980s concept of the balance of benefit—is a distracting vestige of the investor-owned utility-QFs wars. Today the best QFs recognize utilities as valued customers and the best utilities respect QFs as valued suppliers. The solution for a loss of a steam host should be designed to best benefit ratepayers and not to sanctify anachronistic grudges from a bygone era. ■

— **Steven F. Greenwald** (stevegreenwald@dwt.com) leads Davis Wright Tremaine’s Energy Practice Group. **Jeffrey P. Gray** (jeffgray@dwt.com) is a partner in the firm’s Energy Practice Group.