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Commercial DG – Case for Financeable Contracts

DG lenders and developers should consider standardizing a model form of energy service agreement.

By Nicholas Giannasca

Distributed generation, DG, stands on the verge of significant growth. But to facilitate financing for DG projects, lenders and developers should consider standardizing a model form of energy service agreement, ESA,[1] that can be used as the basis for financing DG development.

Regulators and legislators are increasingly viewing DG as a cost-efficient alternative to the expenditure of significant ratepayer dollars to fortify and rebuild distribution systems. Some states envision that DG will play a central role in the development of a smart, interactive, resilient, and reliable distribution grid. Several regulatory, legislative, and contractual factors will impact the development of DG (e.g., regulatory uncertainty), and these factors will need to be thoroughly and carefully examined by stakeholders.

Once new market and rate designs are established, DG will need to be financed and constructed. But ESA forms that skew performance, breach, and liability obligations in favor of the DG developer and its lender will dissuade potential hosts from pursuing DG. If ESAs are not developed in a more "pro forma" style – a balanced model adopted by a sizeable contingent of the DG industry in a particular region – then DG deal flow will be hampered and market momentum for the wide-scale deployment of DG may not occur.

This article will review factors influencing the development of DG, with an emphasis on the need for financeable and deployable contracts on which DG can be financed, constructed and operated. Specifically, this article will provide a case study of the types of terms and conditions that have been used in the author's experience, in ESAs for a representative DG application (namely a combined heat and power installation). And how such terms and conditions should be negotiated to facilitate execution and performance of such contracts, hence the ability to be financed.

Until such an ESA is developed, hosts should consider the unbalanced allocation of risk and liability evident in the material terms and conditions addressed in this article and negotiate accordingly.

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New Regulatory Paradigm

DG is defined here as an electric generation asset that may be deployed either "behind the meter" at a retail customer's location or proximate to one or more retail load locations (e.g., as an anchor generation source for a micro-grid).[2] DG is being examined by regulatory agencies and Legislatures across the country as a generation source that can facilitate the creation of a smarter, more resilient and reliable electric grid.

Indeed, in certain jurisdictions, there is a manifest desire to stimulate the development and deployment of DG as part of an effort to re-design the paradigm under which electricity has been generated and distributed to customers. One jurisdiction in particular, New York State, is proposing a new market design premised on the interaction among Distributed Energy Resources (e.g., DG, energy efficiency, storage, and demand response), a transmission system operator, a distribution system manager (e.g., the traditional vertically-integrated utility), and consumers. It's to create and maintain a smarter and more secure electricity grid.[3] As a critical form of DER, DG is poised to play a pivotal role in this new paradigm.

Interestingly, this new paradigm is being developed in a manner fundamentally different from past statutory and regulatory efforts to stimulate generation development, prominent among which was the Public Utility Regulatory Policies Act of 1978. PURPA stimulated the development of utility-scale generation through a national statutory and regulatory platform featuring mandatory purchase and interconnection obligations.

Unlike the often antagonistic environment between generation developers and utility off-takers engendered by PURPA, state efforts like New York's will rely on market and regulatory incentives (but no mandatory purchase obligation imposed on utilities other than net metering). To encourage investment in smaller scale DG by creating a common development objective shared by the utility and the DG developer.

Regulators, legislators, utilities, and DG developers are working to facilitate the development of DG by establishing rate design and market rules that will recognize the value of DG and compensate DG appropriately. But if this effort does not also yield a readily deployable form of ESA, one that offers materially more balanced and simpler terms than many PURPA-based

Nicholas Giannasca is a partner in the Energy and Environmental Practice Group of Davis Wright Tremaine LLP. In his 28 years of practicing, he has represented developers and hosts of commercial distributed generation facilities.

ESAs, the market for DG is in danger of stalling and regulatory and market objectives may not be timely achieved.[4]

Regulatory Uncertainty

A primary impediment to DG development is regulatory uncertainty. In many jurisdictions, a potential host (i.e., an owner or operator of a commercial or industrial facility contemplating a DG installation) faces the prospect of regulation as a "public utility" or "electric utility," and the associated or perceived administrative burden of subjecting its business operations to agency scrutiny and review.

> "Hosts should consider the unbalanced allocation of risk and liability in the material terms and conditions and negotiate accordingly."
>
> *– Nicholas Giannasca*

Coupled with the very complexity of installing a combined heat and power facility, the prospect of agency regulation could be daunting. Regulators should endeavor, and lobby for legislative participation if needed, to present clear and definite rules that permit the ownership and operation of DG with minimal regulation of the host and the DG operations, with certain exceptions such as safety, environmental protection, and reliability.

Standby Charges

In addition to regulatory uncertainty, prospective developers and hosts of DG face an array of utility rules and tariffs that may render a proposed DG installation uneconomic. For example, several utilities maintain "standby" tariffs under which they provide supplemental power to hosts with DG during those times when the DG facility is producing less energy than the host requires or when the DG is on scheduled or unscheduled outage.

Some of these standby tariffs are structured so as to impose a demand charge (e.g., a charge not based on volumetric consumption but on demand placed on the system) on the host that is economically material. It may ratchet upward if the utility is called upon to provide supplemental power to the DG host during peak periods above a demand bench-mark determined often by the utility. When considered in the calculus of whether DG installation is economically viable for a host, these added charges may, and often do, tip the scale in favor of non-deployment.

Interconnection Studies

Electric interconnection rules mark another potential impediment to DG development. Some utilities maintain cumbersome and inefficient rules for the consideration of DG interconnections, and the actual, physical interconnection of the DG to the grid. These rules in some instances allocate unduly high costs of facilities to the DG developer.

Additionally, interconnection study periods are often protracted. Lenders, developers and hosts may abandon plans for DG deployment if the timeframe for interconnection study and construction becomes unduly long as development stakeholders can only expend limited resources before a project loses its economic viability.

Sales to the Grid

Once a DG facility achieves commercial operation (i.e., it has surmounted the hurdles described above), the host, and the developer and lender, need to consider the revenue impact related to the DG facility producing excess generation. In some jurisdictions, the host – as the titled owner of purchased excess electricity – may be able to inject the excess electricity into the grid in an arrangement known as net metering.

The host participating in such an arrangement typically receives a bill credit for each kWh injected at a value equal to the recipient utility's retail rate or a "wholesale" rate determined by reference to a real-time price determined in the market administered by an RTO/ISO. The potential for a net metering outlet to become unavailable (e.g., through regulatory or legislative action), places the host in a position of finding an avenue for disposing of such excess energy and deriving value.[5] The absence of that additional revenue, which may be used to offset mandatory payments to the developer (i.e., take-or-pay charges), could impose serious economic stress on the host.

Safety and Reliability

Regulators have valid safety and reliability reasons for imposing oversight on the construction and operation of generation connected at a distribution level. Utilities have a legitimate interest in recovering the cost of maintaining a distribution system though rates, including rates for standby service charges, and ensuring that generators are electrically interconnected safely and reliability. But the market for DG will only flourish if

regulatory and economic uncertainty can be allayed through moderate positions of regulatory and rate design compromise that address each party's valid interests.

Contract Terms

For commercial and industrial hosts considering the installation of a DG facility in a financing structure that does not require the host's outlay of capital, the basic contract structure will outline terms and conditions governing:

1. the DG developer's ownership of the DG facility
2. the lease by the DG developer of the host's property on which to install and operate the DG facility
3. the sale by the DG developer to the host of electric and thermal energy from the DG facility (a combined heat and power facility in the case of this article) over an extended duration.

Performance

It is absolutely essential for an ESA to define the performance that the DG developer is promising to undertake. The ESA must state with specificity how much thermal energy and electric energy will be delivered during each relevant performance period, where and how the amounts of each respective product will be measured, and where title to the two energy components will transfer to the host.

If the DG developer is guaranteeing a certain minimum level of delivery, or if the developer is promising "project benefits" associated with the delivery of thermal and electric energy (e.g., a certain level of energy cost savings), then the ESA must be clear as to how the host is compensated if the DG developer fails to perform. Some ESA forms used in the industry are unnecessarily complex in this regard, and place the host in the position of having to navigate through a bewildering array of terms and schedules to determine if the DG developer has performed and, if not, how the host is to be compensated.

Guarantees and Remedies

Hosts should note that ESAs often assign one form of relief to the host in the event that the DG developer has failed to deliver a minimum level of energy or "project benefits." Often, the host's only recourse is to demand a short-fall payment from the developer.

The payment will theoretically make the host whole for the DG developer's failure to perform. But this remedy does not permit the host to address what may be recurring and persistent instances of non-performance through a more drastic and effective remedy: a declaration of breach and termination of the ESA in the event that the non-performance is not timely cured by the DG developer or its lender.

Therefore, the host should negotiate for the inclusion of a general breach provision (i.e., holding the DG developer in breach for failing to perform a "material" term or condition of the ESA), giving the DG developer a reasonable opportunity to cure, which opportunity will be extended to the DG developer's lender. And conferring the right of termination on the host if the breach is not timely cured. Such a clause should permit the host to sue for direct contract damages (other damages are customarily excluded), with no dollar limit placed on the host's potential recovery.

Force Majeure

Closely related to the issues of performance, guarantees, and remedies is the concept of force majeure. ESAs typically contain a clause that excuses a party's non-performance if the failure to perform is due to an "Act of God", or other condition beyond the control of the non-performing party, that prevents the party's performance.

There are related conditions that the party claiming force majeure must satisfy (e.g., due diligence in rectifying the force majeure condition). Hosts should be wary of force majeure clauses in ESAs that confer a right to terminate on the DG developer if a force majeure impacting the host endures for a long period of time (e.g., six consecutive months).

A primary impediment to DG development is regulatory uncertainty.

Such termination clauses will often contain a related obligation on the part of the host to pay a termination payment to the DG developer, which payment can be substantial. Hosts should negotiate such termination clauses out of the ESA. In favor of a provision that requires the parties, after an event of force majeure of material duration, to re-negotiate the ESA to restore the economic status quo of the ESA for the benefit of both parties, which re-negotiation could include an extension of the term of the ESA to permit the parties to recapture lost economic value.

Termination Payments

The DG developer will have allocated significant capital to the construction, installation and operation of the combined heat and power facility. In the event that the DG developer exercises a right to terminate the ESA due to the host's breach, the DG developer will under many ESAs have the right to demand payment of a termination payment by the host.

The amount of such a "termination payment" is usually set forth in a schedule to the ESA and is often related to the year of the ESA term in which the DG developer terminates the ESA. The concept of a termination payment schedule as representing liquidated damages payable to the non-defaulting party (i.e., the DG developer) is reasonable as long as the termination schedule is fairly compensatory.

Hosts should be careful to review the assumptions underlying

the development of the termination schedule (e.g., using a third-party valuation consultant experienced in contracts like an ESA). For example, the host should inquire whether the calculation of the costs incurred, and the costs avoided, as reflected in the termination payment table is reasonable. Additionally, the host should confirm whether the schedule provides for the recovery of operation-related costs and expenses that the DG developer will now avoid as a result of the breach and termination of the ESA.

If it is determined that the termination payment is reasonable, then the host should insure that the DG developer is required to transfer to the host, upon the termination of the ESA, all of the DG developer's right, title and interest in the DG facility, including a release of any lender lien or security interest. So that the host can operate the DG facility after termination of the ESA. This transfer of title upon termination provision should also require the host to receive an "operable" facility and an assignment of all warranties, licenses, software, etc. related to the DG equipment.

While a termination payment by the host to the DG developer is reasonable if the ESA is terminated due to the host's breach of the ESA, the corollary is also fair. Namely, that the DG developer should be liable to the host if the developer breaches and the host terminates the ESA.

This reciprocal right to terminate is common in commercial agreements, and the amount of damages payable by the DG developer can also be reflected in a schedule. The more common practice however is to permit the host to sue for "direct contract damages," and not incidental, consequential, special or punitive damages if the DG developer breaches the ESA and does not timely cure the breach.

What is not common, and a host should negotiate forcefully to exclude such a clause, is a provision requiring the host (the non-breaching party) to make a scheduled payment to the DG developer if the DG developer breaches the ESA. This allocation of liability cannot be justified on sound principles of "compensatory" damages.

In this example, the host has been damaged by the DG developer's failure to perform and yet, the DG developer expects to be paid. Often, the justification for the termination payment is that the payment is calculated to be an amount lower than the amount payable in the case of the host's default because the DG developer excludes lost profit in the case where it was in default. ESAs reflecting a skewed damages provision will dissuade many hosts from pursing DG.

Expiration

Often given less attention in an ESA are the provisions pertaining to comparative obligations at the point that the ESA expires. Hosts should negotiate for a clause requiring the DG developer and host to appoint an independent party to determine the fair market value (FMV) of the DG facility and related equipment.

The clause should also confer on the host the option (but not the obligation) to purchase the DG facility at the determined FMV. If the host opts not to purchase the DG facility at the FMV, then the ESA should require the DG developer to remove the DG facility and related equipment and to restore the premises to the condition existing before the commencement of the ESA, with a consideration of normal wear and tear. It is incumbent on the host to specify in detail exactly what the DG developer must accomplish in order to restore the property properly.

Environmental Conditions

The installation of a combined heat and power unit on the host's premises has the potential to trigger a number of environmental events. First, the process of installation, construction and operation could disrupt and/or release hazardous substances onto the host premises.

Therefore, it is essential that the host have the premises subjected to a rigorous environmental analysis – particularly the area in which the facility will be located – to determine if hazardous substances exist and may be released during the installation and construction process. The cost of such an analysis can be allocated between the parties, and the analysis should be completed and a report issued and reviewed by the host and its advisors before the host executes the ESA.

It is absolutely essential to define the performance that the DG developer is promising to undertake.

In many cases, the developer will allocate responsibility for the existence or release of hazardous substances at or on the project site to the host. Nevertheless, a host should resist forcefully any attempt by the DG developer to limit the dollar value of its liability for remediating the premises due to the discharge or release of a hazardous substance under circumstances where the DG developer (or one of its agents) caused the discharge or release. Particularly in cases where the existence of the hazardous substance was known to the parties as a result of environmental due diligence.

The operation of the combined heat and power unit may cause emissions that need to be regulated, and the failure to abide by such emission standards will inure to the detriment of the DG developer and, after the ESA is terminated or expires, to the hosts. Therefore, it is important for both parties to understand the environmental permitting and regulatory standards to which the DG facility and its owner/operator will be subject, and to allocate the cost of achieving and maintaining compliance throughout the term of the ESA.

"It's certainly refreshing to meet someone with no energy policy."

Contract Re-Openers

Contract re-opener provisions represent one of the more disruptive provisions confronting a host in an ESA. Generally, such clauses are drafted to confer a right on the developer (but not the host) to modify the ESA unilaterally (and lower guaranteed project benefits) if a regulatory or legislative event increases the DG developer's cost to perform the ESA.

Such a clause places enormous risk on a host because an increase in the cost paid to the developer for electricity will result in reduced project benefits (i.e., savings). Hosts should resist broad re-opener language, which can be done in several ways.

First, the clause could be limited to certain anticipated regulatory or legislative events that both the DG developer and host can understand. Second, a provision should be added that requires the parties to negotiate an amendment to the ESA to restore the economic benefit of the original ESA if the change in regulation or law imposes a material adverse economic impact on the host, which adverse impact could be measured by a percentage change in the rate for payment under the ESA. PUF

Endnotes:

1. For purposes of this article, the reference to "ESA" includes both energy service agreements and power purchase agreements.
2. A "micro-grid" is defined as a group of interconnected loads and distributed energy resources with clearly defined electrical boundaries that acts as a single controllable entity with respect to the grid and can connect and disconnect from the grid to enable it to operate in both grid-connected or island mode.
3. See New York State Public Service Commission, Case 14-M-0101 – Proceeding on the Motion of the Commission in Regard to Reforming the Energy Vision.
4. Indeed, anecdotal evidence supports the conclusion that small scale combined heat and power development (e.g., 40 kW to 500 kW) may have already stalled in certain markets for third-party owned facilities due to a lack of a financeable ESA structure.
5. Net metering arrangements are being closely scrutinized in many jurisdictions. In certain jurisdictions, such programs have been modified to require the host to make a larger economic contribution (e.g., through a lower credit received from the utility) to the maintenance of the distribution system. See e.g., "Nevada's Solar Bait-and-Switch," (*New York Times*, February 1, 2016) reporting on the Nevada Public Utilities Commission's decision to increase contributions to be made by customers with solar installations and to reduce the amount of compensation solar owners receive through net metering for excess generation injected into the grid.