

# Chapman *Insights*

OPPORTUNITIES FOR OUR CLIENTS

November 21, 2013

## Financing Distributed Generation Through Third-Party Ownership

The majority of power generated in the United States historically has been, and continues to be, generated by large-scale, centrally located generation facilities. With recent advancements in, and the lower cost of, alternative generation technology, however, an increasing number of end-users (*e.g.*, businesses, manufacturers, governments, schools and non-profits) are moving away from the traditional model of power generation and are, instead, looking to meet or supplement their power needs through the use of smaller, on-site distributed generation facilities. By utilizing such facilities, these end-users are able to eliminate costs and inefficiencies associated with centrally located generation and significantly reduce their energy costs.

Not surprisingly, this new technology can be expensive and some end-users have struggled to find ways to finance the upfront investment needed to purchase and install these types of generation facilities. One form of financing that has increasingly been used over the past several years to finance this investment has been the “third-party ownership” model of financing (typically structured as a “power purchase agreement” or “lease” arrangement). The following reviews the basics of the power purchase agreement arrangement (referred to herein as the “PPA model”) and a few of the pitfalls parties should avoid in order to make their distributed generation projects more financeable.

### The PPA Model

The PPA model is a financial arrangement in which a third-party developer (often referred to as the “Facility Owner”) agrees to own, construct, operate and maintain a distributed generation facility (a “DG Facility”) located on real property owned or controlled by the end-user of the DG Facility’s output (often referred to as the “Host”). Under this arrangement, the Facility Owner agrees to sell to the Host, and the Host agrees to purchase from the Facility Owner, 100% of the energy output generated by the DG Facility for a predetermined period of time. At the end of this period, the Host may or may not have the right to purchase the DG Facility for its then-current value.

The benefit of this type of arrangement is that it allows the Host to enjoy the benefits of on-site energy generation (typically resulting in lower cost electricity) and, at the same time, shifts the entire responsibility for the facility’s upfront costs and on-going maintenance and operation to the Facility Owner. The Facility Owner, on the other hand, receives various financial benefits from owning the DG Facility, including the benefit of potential tax credits available to the owners of such facilities and access to a long-term stream of revenue generated by the sale of the facility’s output.



Like traditional project finance arrangements, the PPA model is documented by way of several principal project agreements. These include, but are not necessarily limited to, the following:

- **Power Purchase Agreement.** The Facility Owner’s obligation to sell, and the Host’s obligation to purchase, the electricity output from the DG Facility is set forth in a power purchase agreement (“PPA”). Typically, the PPA will remain in place for a period of time necessary for the Facility Owner to recoup its upfront investment, plus a reasonable margin. The PPA will also set forth the terms and conditions by which the facility’s energy will be delivered to the Host, including, but not limited to, the minimum amounts of energy that must be delivered, the date by which the

facility must begin producing energy, and the parties' rights and remedies in the event of a default. Depending on the structure of the project, the PPA may also transfer to the Host any RECs (defined below) attributed to the energy generated by the DG Facility.

- **Lease and/or Easement Agreement.** The Facility Owner's right to use the Host's property to own, construct, operate and maintain the DG Facility is typically set forth in one or more leases and/or easement agreements entered into by and between the Facility Owner and the Host. A non-exclusive right of access to the Host's premises may also be offered in lieu of a lease or easement. However, such a license is not as desirable because it may not run with the land (which could be problematic if the underlying real property is sold or transferred) and may potentially be terminable upon the insolvency of the Host. As with the PPA, these agreements will grant the Facility Owner the right to use and access the Host's property for a period of time necessary to recoup the Facility Owner's upfront investment, plus a reasonable margin.<sup>1</sup>
- **Interconnection Agreement.** To the extent the Host's facilities (e.g., manufacturing facility, office building, school, etc.) will remain connected to the local utility's electric grid, the local utility will require either the Host or the Facility Owner to enter into an interconnection agreement with the utility.<sup>2</sup> The interconnection agreement will typically stay in place for so long as the DG Facility is operational and/or connected to the utility's electric grid. Among other things, the interconnection agreement will set forth the rules for interconnecting the DG Facility, as well as the rules with which the DG Facility must comply in order to maintain the integrity of the grid. These rules include, for example, the right of the utility to curtail the DG Facility's energy production under specified emergency and/or maintenance situations.
- **Renewable Energy Credit Purchase Agreement.** In many cases, either the Facility Owner or the Host will enter into a renewable energy credit purchase agreement with a third-party purchaser (which may or may not be the local utility).<sup>3</sup> Pursuant to this agreement, the project will agree to sell, and the third-party purchaser will agree to purchase, some or all of the RECs attributed to the electricity generated by the DG Facility. Often times, the third-party purchaser will require that the project commit to deliver an annual minimum quantity of RECs in exchange for a long-

term fixed price commitment to purchase such RECs.

- **Engineering, Procurement and Construction Agreement/ Equipment Supply Agreements.** In most cases, the Facility Owner will enter into one or more construction and/or supply agreements with third-party vendors and contractors to purchase components and construct the DG Facility. These agreements will set forth, among other things, the third-party's obligations for designing, permitting and constructing the DG Facility. Such agreements will also set forth any obligations the third-party vendors and contractors may have to provide (or procure for the benefit of the Facility Owner) equipment warranties, performance warranties and/or production guarantees related to the DG Facility.
- **Operation and Maintenance Agreement.** Last but not least, the Facility Owner will typically enter into an operation and maintenance agreement with a third-party operation and maintenance provider for the on-going operation and maintenance of the DG Facility. The level of operation and maintenance required will depend largely on the type of generation technology being utilized, but is typically less intensive for solar facilities than it is for wind or other forms of renewable energy.

---

<sup>1</sup> For certain solar projects, the PPA and the real property rights may be combined into a single solar services agreement. Such an agreement will typically set forth most, if not all, of the rights and obligations of the Facility Owner and the Host as they relate to the DG Facility.

<sup>2</sup> In most cases, the local utility will require a DG Facility to proceed through the utility's interconnection process even if the DG Facility is not directly connected to the utility's electric grid because such a facility could nevertheless impact the performance and reliability of the grid.

<sup>3</sup> Renewable energy credits ("RECs") (also referred to as "renewable energy certificates" or "green tags") represent the environmental attributes of electricity generated from renewable energy projects (one REC is generated for every one MW of renewable energy produced). RECs are typically tracked and transferred through designated tracking systems and are typically sold separately from the underlying electricity (although RECs and the underlying electricity may be sold together as a bundled package). The party purchasing the RECs can then claim to have purchased renewable energy in order to satisfy any number of obligations or goals, such as satisfying a participating state's renewable portfolio standard requirement.

## Potential Pitfalls of the PPA Model

While the PPA model has proven to be an effective way to finance a distributed generation facility from the Host's perspective, the financing dilemma does not necessarily end there. In fact, many Facility Owners involved in DG Facilities will themselves find it necessary or desirable to finance some, if not all, of the costs of constructing, operating and maintaining these facilities.

When seeking such financing, Facility Owners will often seek to raise funds from both debt and equity sources through traditional forms of project finance. In many cases, the majority of the funds will come in the form of non-recourse debt, which will be repaid over time predominantly from the revenues generated from the sale of the facility's output (i.e., the revenues received under the PPA and the REC purchase agreement). As collateral for the debt, the project's lenders will look almost exclusively to the Facility Owner's assets. Because most Facility Owners will be structured as single purpose entities, those assets will typically be limited to the assets comprising the DG Facility itself (including its principal project agreements). In the event the Facility Owner defaults under the debt, its lenders' primary recourse will be to foreclose on the DG Facility and either re-sell it to another DG Facility operator or step into the project agreements, operate the DG Facility (directly or through a sub-contractor) and continue to sell power and RECs to the applicable counterparties under the PPA and REC purchase agreement.

Unfortunately, there is at least one significant aspect of the PPA model that can hinder a Facility Owner's efforts to obtain this type of financing -- namely, the existence of the Host. The following looks at a couple of these potential obstacles.

### The Host's Creditworthiness

One issue a Facility Owner should be cognizant of when structuring a PPA model project is how the Host's creditworthiness (or lack thereof) may impact the financability of the project. For example, in a traditional generation project, the party purchasing the facility's electricity output (i.e., its off-taker) will typically be a utility or some other creditworthy party. From a lender's perspective, this generally makes the underwriting process less complicated because there is a relatively low risk that the off-taker will default under the PPA and, thereby, cut off the flow of revenue to the project.

Under the PPA model, on the other hand, the primary off-taker will be the Host. The risk that the Host will default under the PPA could be much greater, particularly for smaller entities with few assets. In addition, if the Host is a governmental entity

or a school district, the Host's ability to fulfill its obligations under the PPA may be subject to other types of risks that are inherent to these types of entities, such as annual funding and/or appropriation risks. Such risks could make it significantly more difficult for prospective lenders to underwrite the debt.

### Lender Step-In Rights

Another issue a Facility Owner should be mindful of when structuring a PPA model project is how the Host's role in the project will impact a lender's right to protect its investment. Specifically, in a traditional generation project, the project owner will almost always be the primary (if not the only) party contracting on behalf of the project. Consequently, it is relatively simple for the lender to take a collateral assignment of the project's principal project agreements, which will allow the lender to step into all of the project agreements on behalf of the project should the project owner default under either the debt or the project agreements themselves. This right gives the lender the ability to make sure the facility continues to operate and, therefore, generate revenue to pay back the debt.

Under the PPA model, on the other hand, it may be the case that the Host will be the project's primary (if not the only) party to one or more principal project agreements. For example, for projects involved in net metering programs, certain utilities explicitly require that the Host (as the utility's retail customer) be the party that enters into the interconnection agreement, the REC purchase agreement, or both with the utility. While this is not necessarily a problem in and of itself, at least one utility has, in the past, refused to grant to a Facility Owner any rights whatsoever under these agreements -- not even as a third-party beneficiary. At the same time, the utility was reluctant to grant to the Facility Owner's lenders any meaningful lender protection rights under these agreements.

As a result of the utility's refusal to grant the Facility Owner and its lenders sufficient rights under these agreements, it was unclear whether the utility would continue to perform under these agreements in the event of a Host default. In fact, given the current state of the utility's net metering program, there was some indication that the utility would actually benefit from letting these types of agreement terminate so that the utility would no longer be obligated to purchase power from the facility under its net metering program. To the extent these agreements were terminated, it would have effectively cut off most, if not all, of the revenue to the project. Needless to say, this risk was extremely problematic from both the Facility Owner's and its lenders' perspective.

## Mitigating the Host

Because most lenders will not be willing to accept the types of risks described above, it is imperative that PPA model projects be structured in a manner that mitigates the potential adverse effects a Host can have on such projects. One way in which parties can do so is to ensure that the project's principal agreements (taken as a whole) grant the Facility Owner and its lenders the unimpeded ability to resell the facility's output (as well as the facility itself) to a third-party purchaser should the Host become insolvent. Another way parties can mitigate such risks is to build into each of the principal project agreements certain provisions that will ensure that the Facility Owner and its lenders have the ability to protect the project in the event of a default by the Host. Such provisions would include, at a minimum, each of the following:

- The right of the Facility Owner and its lenders to cure any and all Host defaults under the principal project agreements;
- A prohibition against the parties to the principal project agreements from entering into amendments to such agreements without the consent of the Facility Owner and its lenders;
- The right of the Facility Owner and its lenders to receive all notices issued under the principal project agreements;
- The right of the Facility Owner and its lenders to exercise direct recourse under the principal project agreements against the project's counterparty (e.g., the utility) in the event of non-performance by such party;

- The right of the Facility Owner to collaterally assign its rights under the principal project agreements to its lenders (including typical lender protection rights, such as notice and extended cure periods);
- To the extent the DG Facility is not sold to the Host at the end of the PPA, the right of the Facility Owner and its lenders to access the Host's premises beyond the term of the PPA (ideally for the life of the DG Facility) so that power can continue to be generated and sold -- even if not to the Host; and
- A notice to all parties with payment obligations benefiting the project that such payments are to be made to a lockbox or other account under the control of the Facility Owner's lenders, as well as an acknowledgment from such parties regarding such notice and the lenders' collateral rights generally.

By structuring PPA model projects in this fashion, parties can go a long way towards ensuring that these types of projects will be fully financeable from the perspective of both the Host and the Facility Owner.

---

*This document has been prepared by Chapman and Cutler LLP for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material. © Chapman and Cutler, 2013. All Rights Reserved.*



**Bruce Bedwell**  
Partner

Bruce Bedwell is a partner in Chapman and Cutler LLP's Corporate Finance Department where his practice focuses primarily on representing clients in the financing, development, acquisition and distribution of projects, with a focus on renewable energy projects.

Chicago Office  
T: 312.845.3755  
F: 312.516.3255  
bedwell@chapman.com



**Melanie Gnazzo**  
Partner

Melanie Gnazzo is a partner in Chapman and Cutler LLP's Asset Securitization, Lease Finance and Tax practice groups where she represents a wide range of finance companies and funding sources engaged in renewable energy projects, structured finance and securitization transactions, and portfolio acquisitions, dispositions, and restructurings.

San Francisco Office/New York Office  
T: 415.278.9020  
F: 415.541.0506  
mgnazzo@chapman.com