

SOLAR POWER PURCHASE AGREEMENTS

The Art (and Dark Arts) of PPA Structure and Implementation



RENEWABLE ENERGY SOLUTIONS

THE OBLIGATORY STATEMENTS

THIS PRESENTATION IS AN OVERVIEW OF APPLICABLE LEGAL AND TAX CONSIDERATIONS AND IS NOT DIRECTED TO ANY SPECIFIC TRANSACTION. TO ENSURE COMPLIANCE WITH INTERNAL REVENUE SERVICE CIRCULAR 230, PLEASE NOTE (A) ANY DISCUSSION OF FEDERAL TAX ISSUES IN THIS PRESENTATION IS NOT INTENDED OR WRITTEN BY US TO BE RELIED UPON, AND CANNOT BE RELIED UPON, BY ANY PERSON FOR THE PURPOSE OF AVOIDING PENALTIES THAT MAY BE IMPOSED ON SUCH PERSON UNDER THE U.S. INTERNAL REVENUE CODE; AND (B) AS TO ANY SPECIFIC TRANSACTION, PARTICIPANTS IN THE TRANSACTION SHOULD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT LEGAL OR TAX ADVISOR.

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POWER PURCHASE AGREEMENT (PPA) (A.K.A. SOLAR SERVICES AGREEMENT, ETC.)

Basics:

- Term – 10 -20 yrs.
 - Purchase Options; tax sensitivity term and option price
 - Product sold?
 - Parties?
 - Customer
 - Obligations
 - Conditions to Install
 - Default – Remedies
 - Tax - Title – Insurance
 - Lease v. Service Contract Issue
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WHO IS THE CUSTOMER?

- Credit of Customer credit is key
 - Credit enhancement or credit support for Customer is not typical
 - Investor typically reserves the right to approve the Customer on a case-by-case basis, although...
 - A portfolio approach can mitigate this risk by diversification of investment and transaction costs over a larger asset base, lessening the transaction cost per project.
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WHAT IS SOLD?

1. Electricity - All that the system produce or something less?
2. Environmental Attributes - Typically not sold to Customer - state this explicitly so as to avoid arguments

SYSTEM OWNER'S OBLIGATIONS

- System Owner is required to design, engineer, permit and install the System
 - Issues: Customer approval / supervision rights
- Approval rights of construction plans and schedule are common
 - Structural integrity and strength of the roof,
 - Damage to the roof as a result of construction activities –who takes the risk?
 - System Owners can try to pass this risk to the Customer – Customer knows more about its own building.
- Access / diligence was Developer given / allowed to conduct?

OBLIGATION TO OPERATE AND MAINTAIN THE SYSTEM

- System Owner's obligation is to deliver only what the System produces.
 - System Owner typically does not guarantee any specific production.
 - System Owner typically promises to operate and maintain the System reasonably and in good order.
 - Providing operation, repair and maintenance services to the Systems during the Term of this Agreement, should be a stand-alone agreement for subcontracting, sale and exit purposes.
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CONDITIONS PRECEDENT TO OBLIGATION TO BUILD:

- System Owner needs to be able to get out of the deal without penalties or other consequences if certain agreed pre-conditions are not met or do not come to pass
 - Technical or site conditions, such as there is a suitable electrical interconnection
 - Roof is sufficient; absence of unknown site conditions that would make the System uneconomic (materially increase costs or reduce revenues)
 - Availability of tax benefits, state solar rebates and incentives (“no (material) adverse change” in the tax or state rebate programs or other change in law that adversely impacts (or materially adversely impacts) the System Owner’s economics)
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CUSTOMER'S OBLIGATIONS

- Payments: The initial electricity price is typically made attractive to the Customer; it may be fixed, variable or based on a discount from the retail tariff price that would be charged by the local utility.
 - Price may escalates based on (1) escalation of utility prices, (2) inflation, or at a standard escalation (typically less than historical escalation)
 - Price re-openers that could lead to price reductions or links to indices or formulae that could lead to prices being reduced will be difficult for the Investor (especially if not subject to a floor).
 - Customer may request a mirror right in case costs decrease or additional (unanticipated) government benefits are made available.
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CUSTOMER'S OBLIGATIONS, CONT.

- Adjustment to price based on unanticipated cost increases/decreases as a result of changes in law/cost of otherwise available electricity; can be negotiated on a case-by-case basis.
 - Provide to System Owner access to the site and the system (typically contained in a separate site lease or license agreement)
 - Assist System Owner in obtaining permits
 - No liens on the system and remove any liens on the system that are attributable to Customer
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TITLE TO SYSTEMS

- Customer should specifically acknowledge that it has no interest in the system, that the system is owned by the System Owner (or, if System Owner uses a sale-leaseback financing arrangement, by its lessor).
- Secure sign-off from building Owner, Landlord and any lenders, if needed.

CESSATION OF CUSTOMER'S BUSINESS

- Typically Customer must provide an alternative site and pay relocation costs and expenses and agreement continues at the new site;
- System Owner should also ask to be paid lost revenue during the period when the system was not operating due to relocation down time). [Insurance coverage available]

LOSS OF BENEFITS:

- Must take care not to impair or reduce tax benefits or require recapture of tax benefits.
 - If the Customer's site/facility is sold, System Owner may want to keep the system at the site and ask that the new owner assume the PPA.
 - Termination of site and payment of Termination Value is a possibility after the tax recapture and depreciation period expires.
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PROPERTY AND SALES TAXES

- Allocation of Tax Responsibilities - PPA will have specific provisions allocating responsibility for taxes related to the system and the sale of electricity.
 - Sales taxes, if any, are for the account of the Customer.
 - Property taxes attributable to the system (if any) –but not those attributable to the site – are for the account of the System Owner.
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INSURANCE

- Casualty / property insurance – fire water flood tornado theft easily available
- Production Insurance – Tricky. Most products have some production guaranty (panels and inverters); however, system production loss not always attributable to a single components loss attributes, and system design can play a large role in production loss. General system degradation loss is harder to secure and for a claim to be made.

SYSTEM OWNER'S REMEDIES FOR CUSTOMER DEFAULT

- Remedies For Customer Default
 - System Owner can suspend performance / stop delivery of electricity
 - Escrow of three months' electricity and removal costs can be built into the lease
 - Terminate the PPA and remove the system (virtual net metering allows for a third-party to purchase the power, and may be able to negotiate direct access to utility (avoided cost price) and customer pays differential
- Demand payment of stipulated liquidated damages (often described as “termination value”)

CUSTOMER'S REMEDIES FOR SYSTEM OWNER'S DEFAULT

- Termination – Remove – Forfeit FMV
- Damages; remedies at law or in equity
- System Owner may want to specify the formula for computation of such damages, e.g., net present value (discounted at an agreed interest rate) of the additional price for electricity that Customer would have to pay to its local utility over the remainder of the term of the PPA, using the historical or estimated amount of delivered output.
- Customer can exercise its buy-out right in the event of a System Owner Default.

LENDER PROTECTION / ASSIGNMENT

- Assignment, etc.
 - Customer should not be able to assign the PPA without System Owner's consent.
 - System Owner should ask for flexibility in terms of assignment rights.
 - Having the right to assign to an affiliate is useful for structuring financing arrangements
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TAX ASPECTS OF PPAS

- Issue is whether the power purchase agreement (PPA) for the sale of electricity is to be treated as a **service contract or a lease**.
 - If PPA is a lease and power purchaser is tax exempt, then the property is exempt use property, no credit and depreciation over 12 years; if power purchaser is taxable, need to apply leasing rules to determine who is the true owner.
 - If PPA is a service contract, there is disagreement over whether the power seller is automatically the owner or whether ownership principles still apply. We believe the view is that the power seller is the owner, but may still be advisable to limit PPA to 80% of property life.

SERVICE CONTRACT OR LEASE GENERAL PRINCIPLES, CONT.

- The service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is non-performance under the contract.
 - The service provider does not use the property concurrently to provide significant services to parties unrelated to service recipient.
 - The total contract price does not substantially exceed the rental value of the property for the contract period.
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SERVICE CONTRACT OR LEASE GENERAL PRINCIPLES

- Code section 7701(e) lists vague factors distinguishing service contracts and leases—(fortunately because of a safe harbor these factors often unimportant):
 - the service recipient is in physical possession of the property
 - the service recipient controls the property
 - the service provider has a significant possessory or economic interest in the property service provider likely to use property for a substantial portion of its useful life
 - service recipient shares the risk that the property will decline in value
 - service recipient shares in appreciation in property value
 - service recipient shares in savings in property's operating costs
 - service recipient bears the risk of damage or loss to property

- A contract that purports to be a service contract will be treated as such, unless: the service recipient (or a related entity) operates such facility
 - the service recipient (or a related entity) bears any significant financial burden if there is nonperformance under the contract or other arrangement (other than for reasons beyond the control of the service provider)
 - the service provider (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract or arrangement
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- Creativity as to how to avoid the rules above is discouraged.
 - the service provider (or a related entity) receives any significant financial benefit if the operating costs of such facility are less than the standards of performance or operation under the contract or arrangement
 - allows certain expenses to be passed through as long as electricity is being provided.
 - the service recipient (or a related entity) has an option to purchase, or may be required to purchase, all or part of the facility at a fixed or determinable price (other than for fair market value)
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Mr. Polich has over 17 years of working experience in the photovoltaic (PV) industry covering all aspects of the solar industry, including research and development, manufacturing, legal, finance, training and consulting, product distribution, project development and installation, system management, market development and sales management.

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