

Negotiating prepaid electricity purchases

In 2003, the United States Treasury Department released new regulations implementing *Section 141(c)* of the *Internal Revenue Code of 1986* that enable consumer-owned utilities to enter into prepaid contracts for electricity financed through the issuance of tax-exempt bonds. Although pre-paid transactions for electricity have generated a lot of buzz, the reality is that there have only been a small handful of deals completed on that basis.

In theory, a prepaid power purchase agreement should result in reduced power prices, particularly for power from renewable generating resources. First, the prepayment of the purchase price should remove any credit risk that the seller would have for the life of the contract. If the money has already been paid, then the seller obviously has no risk of a non-payment default. Although it is typically not expressly quantified as such, the credit risk component of a power purchase agreement can account for as much as 10 percent of the total purchase price.

This arrangement also may be used as a means for consumer-owned utilities to access tax incentives for renewable generating projects. These incentives include such programs as the federal Production Tax Credit (PTC) and, in Oregon, the Business Energy Tax Credit (BETC). These tax incentives are only valuable, however, to the extent that entities have an income tax liability to which the credits may be applied. Consumer-owned utilities typically have no federal or state income tax liability. One advantage of the prepaid power purchase agreement, therefore, is that the transaction can be arranged such that a private developer can take advantage of the tax incentives to reduce the capital costs of a generating facility and then pass a portion of those savings on to consumer-owned utilities through the power purchase price.

Another potential advantage may be a reduction in the seller's effective cost of capital. Presuming that the seller is incurring a capital expense in order to take advantage of available tax incentives, then the seller would be either tying up its own capital or borrowing capital. The advantage of the pre-paid transaction is that the seller would receive a sizeable upfront payment and would therefore be able to eliminate some or all of its costs of capital. Thus, notwithstanding otherwise applicable private-usage restrictions, the source of capital to construct the facility would essentially be tax-exempt bonds. Again, the cost savings associated with this financing should be reflected in the power purchase price.

However, there are a couple of potential disadvantages associated with prepaid power purchase agreements — particularly when financed through tax-exempt bonds. For example, the use of tax-exempt bonds for this purpose also carries certain usage restrictions. As a general rule, at least 90 percent of the prepaid electricity must be put towards a “qualifying use.” A “qualifying use” is either (1) direct use of the electricity by the retail customers within the utility's service area, or (2) resale of the electricity to another utility for the direct use by retail customers within the purchasing utility's service area.

Another issue to watch for is carrying the amortization period of the bonds beyond the term of the power purchase agreement. While this might be an enticing way to reduce near-term power supply costs, the long-term result is inevitably a debt-service obligation with no corresponding power benefit.

Another legal issue that could be a potential disadvantage in this arrangement involves the allocation of risk in the case of generator outage or underperformance. By comparison, with a

typical unit-contingent forward power purchase agreement, the purchaser remains somewhat protected against the non-delivery of power because the purchaser retains the option of simply not paying for any power that has not been delivered. In such case, the purchaser's damages are, at most, the costs of covering the short-fall on the market. This issue is more complicated with a prepaid transaction, however, for the simple reason that the money has already changed hands. There are a variety of legal tools that may be used to address this issue, including, but not limited to, the following:

- ❖ Maintaining oversight over the operation and maintenance of the facility
- ❖ Enforcing regular audit and true-up provisions
- ❖ Demanding liquidated damages for underperformance
- ❖ Requiring financial security to be posted and maintained by the seller during the life of the agreement in case any damages must be collected

In summary, prepaid electricity purchase contracts represent an intriguing new way for consumer-owned utilities to access new renewable power generation on a cost-effective basis. Such transactions do carry with them, however, certain legal, financial, and operational risks that are unique among power purchase agreements. As is always the case, it is best to identify these risks at the outset in order to properly allocate them between the two parties. **NWPPA**

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