Renewable Power Purchase Agreement Contracts

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Evaluating Energy Contracts

**STEP 1**
Determine if PPA is a variable interest and who should consolidate per FIN 46(R)?

**STEP 2**
Is the PPA a lease or contain a lease per EITF 01-8?

**STEP 3**
Is the PPA (or any elements thereof) a derivative per FAS 133?

**STEP 4**
Apply accrual accounting
FIN 46(R) Consolidation Model

- FIN46(R) is 1st step in consolidation analysis
- “Risk and rewards model” when voting control is not an effective method in identifying a controlling parent (Variable Interest Entities – VIEs)
- Variable Interest (VI) = those interests that absorb variability in an entity’s risks
- Focused on design of the entity and risks the entity was designed to create and pass along to variable interest holders [FSP FIN46(R)-6]
FIN 46(R) Consolidation Model

- FIN 46R uses terms **expected losses/expected residual returns**, derived from unique calculation of expected cash flows, to measure exposure to a VIE’s economic performance.

- Expected losses ≠ GAAP losses (even profitable entities will have expected losses).

- Variable interest holder who absorbs or receives a majority of VIE’s expected losses/residual returns is Primary Beneficiary (PB) and consolidates VIE.
Evaluating PPAs as VIs

Evaluation of PPAs as Variable Interests (VIs):

- Is it an lease? (EITF 01-8 evaluation)
  - operating lease at FV is not typically VI unless also contain a guarantee, option to purchase, or other terms that absorb variability

- Is it a derivative under FAS 133?
  - Special considerations exist when evaluating derivatives [FSP FIN46(R)-6]

- Does it absorb variability in risks the entity was designed to create and pass along?
  - Consider substance of PPA terms
FIN46(R) Example – Wind Farm

1st – determine risks the Project Entity was designed to create and pass along

Risks may include:
- Credit risk (Utility’s credit)
- Operating risk (including asset performance)
- Tax incentive risk
- Residual value risk
- Electricity price risk

2nd – determine if the PPA absorbs variability in these risks
FIN46(R) Example – Wind Farm

**If pricing is:**
- Cost Reimbursement → likely VI
- Fixed → likely not VI
- Market rate → likely not VI

**Is the PPA a VI?**

**100% PPA**
**Current model:**

PB is one who absorbs majority of expected losses

**Under ED:**

PB is one who can direct AND has potential for significant benefits/losses
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"Right to Use" PP&E defined as:

- Ability to operate while taking more than a minor amount of output, or
- Control physical access while taking more than a minor amount of output, or
- Taking substantially all output and price is neither:
  1. Fixed per unit of output, or
  2. Current market price per unit of output at time of delivery
Renewable PPA Lease Issues

• Unit pricing
• Multiple deliverables
• Multiple element accounting
• Assessment of MLPs
Lease Issues

**Unit Pricing:**

- Is pricing per unit of output 1) fixed or 2) market at date of delivery?
- Impact of escalators:
  - Considered fixed if determinable at contract inception
  - 2% per year is okay
- Other price changes:
  - On-peak and Off-peak
  - Seasonal shaping
  - Follow same rule-of-thumb (determinable at inception)
Lease Issues

Multiple deliverables:

• Many PPAs bundle multiple products with electricity
  – Regulatory Capacity (e.g. ICAP/UCAP)
  – RECs
• Impact on pricing assessments under EITF 01-8?
  – Which item(s) must be assessed?
  – Impact of bundled pricing
• Impact on “more than a minor amount of output” assessment?
  – Do outputs have to be physically produced?
Lease Issues

**Multiple element accounting:**

- Requirement under EITF 01-8 to identify and separately account for non-lease elements
- What non-lease elements exist in a traditional PPA?
  - Electricity purchase?
  - Acquisition of fuel and labor?
- Contract pricing may or may not be reflective of relative fair value
Lease Issues

Assessment of MLPs:

• Are all payments contingent?
  – Must-take arrangements where neither party dictates output (wind)
  – Other must-take arrangements (lessor controlled)

• If deemed non-contingent, how should MLPs be estimated?

• Other considerations:
  – Minimum production guarantees (vs. availability requirements)
  – Out-clauses (early termination)
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Renewable PPA Analysis – SFAS 133

**Derivative Criteria:**

- **Underlying and Notional Amount?**
  - Example: 20 MWH of electricity

- **Small Initial Net Investment?**
  - Generally, no payment upon contract execution (forward performance and settlement)

- **Net Settlement?**
  - Met if product to be delivered is fungible and highly liquid ("Readily Convertible to Cash")
Renewable PPA Analysis – SFAS 133

**Underlying:**

- Generally viewed as the price for the commodity output of the project (i.e. electricity)
- Impact of product bundling (electricity, ICAP/UCAP, RECs, etc.)
  - Still required to assess under SFAS 133
  - Consider predominant deliverable
  - May be a compound derivative
Renewable PPA Analysis – SFAS 133

Notional Amount:

- Minimum or fixed delivery amount defined in PPA
- Consider whether damage provisions in PPA establish a notional (is a minimum delivery quantity effectively guaranteed?)
- Minimum availability requirement may establish notional for electricity sales
  - Example, biomass unit dispatchable by buyer
  - If called and unavailable, penalty is replacement power
  - Similar to written option on power
Renewable PPA Analysis – SFAS 133

Notional Amount (cont.)

– Must-take arrangements
  • Buyer must purchase whatever seller is able to produce
  • Does seller control production levels?
    – Wind / Solar – Neither party can dictate output
    – Biomass – Seller controls output therefore notional may equal maximum (or plant capacity)
  – Consider whether DIG A6 is applicable
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