

ARE RENEWABLE ENERGY POWER PURCHASE AGREEMENTS SWAPS?

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Introduction

There are various types of renewable energy power purchase agreements, and whether each type falls within the category of a “swap” is a key issue for those who participate in the renewable energy market and must comply with the swap regulation. There recently has been some confusion regarding what is a Virtual Power Purchase Agreement (VPPA), what is a Renewable Energy Certificate Purchase Agreement (RPA), and whether either is a swap. It is not the name but the specific components of the transaction that matter in determining whether a transaction is a swap. Here, we will first define a VPPA and RPA to avoid confusion over nomenclature and then show why a VPPA is a swap, but an RPA is not.

What is a REC?

A renewable energy certificate (REC) is a market-based instrument that represents the environmentally beneficial attributes of renewable electricity generation.¹ RECs are issued when one megawatt-hour (MWh) of electricity is produced from a renewable energy resource and delivered to the electricity grid.² Since RECs can be a flexible tool in aiding individuals and corporations to meet

their renewable energy goals, the REC market is growing rapidly. RECs can be purchased separately from electricity and independently matched with electricity consumption, even when such electricity is purchased from a non-renewable resource. Electricity, even when produced from a renewable energy resource, that is not paired with a REC cannot be claimed or marketed as renewable energy,³ as only the owner of the REC has rights to the environmentally beneficial attributes.⁴

What is a Swap?

7 U.S.C.A. § 1a(47)(A)(iii) defines a swap as follows (emphasis added):

Any agreement, contract, or transaction that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred.

If the agreement, contract, or transaction is a swap, participants are required to adhere to certain obligations such as documentation, reporting, and recordkeeping.

What is RPA?

RPA is a type of renewable energy power

purchase agreement between a renewable energy developer (Seller) and buyer, typically a corporate buyer (Buyer). Similar to a VPPA, Seller delivers RECs generated by a specific project to Buyer. A notable difference with a VPPA is the pricing formula. In a basic RPA, price is based upon the quantity of RECs exchanged—“\$[x] per REC.”

What is a VPPA?

VPPA is a type of renewable energy power purchase agreement between Seller and Buyer. Seller delivers RECs generated by a specific project to Buyer, whereas physical electrons (measured in MWhs) generated by the project are not delivered to Buyer. Instead, those electrons are delivered to the wholesale market, such as the ISO.

In a basic VPPA, Seller and Buyer financially settle using the formula: Fixed Price minus Floating Price. Fixed Price is a set “\$[x]/MWh” price, as agreed between Seller and Buyer. Floating Price is typically equal to the real time or day-ahead wholesale market price (locational marginal price (LMP)) at a specific Hub or Node. If the Floating Price is greater than the Fixed Price, Seller will owe the difference to Buyer. If the Floating Price is less than the Fixed Price, Buyer will owe the difference to Seller. As the price of a REC is incorporated into the Fixed Price, there is no individual pricing for each REC. What affects the settlement price, after the static Fixed Price is contractually set, is only the wholesale electricity market price.

Why is VPPA a Swap?

In a VPPA, RECs and the wholesale market price volatility of the electricity are traded. An easy way to view the transaction is that Buyer takes on the risk of price volatility in the wholesale electricity market and, in exchange for taking on such risk, receives a REC calculated on a per MWh of such risk assumed. Through this contract for differences arrangement, it is not Seller but Buyer that carries the risk of whole-

sale electricity market price volatility. Therefore, there is a “transfer of financial risk associated with a future change in any such value or level.”

On the other hand, the physical electrons themselves, which are associated with the wholesale market price volatility, are not physically transferred to Buyer. Therefore, there is no conveyance of “ownership interest in an asset or liability that incorporates the financial risk so transferred.” Accordingly, a VPPA meets the definition in 7 U.S.C.A. § 1a(47)(A)(iii), and therefore, should be classified as a swap.

What Do Dissenters Say?

Some have argued that since RECs are also transferred in a VPPA from Seller to Buyer, along with the financial risk, the transaction does not meet the definition in 7 U.S.C.A. § 1a(47)(A)(iii) because the transaction conveys an ownership interest in RECs, and therefore, it is not a swap. However, the exclusion under 7 U.S.C.A. § 1a(47)(A)(iii) requires that the asset must incorporate “the financial risk so transferred,” which does not occur under a VPPA (as described above). If wholesale market prices and REC market prices move together, Buyer would be receiving a physical asset (here, RECs) that incorporates the wholesale electricity price volatility risk. However, since the wholesale market and the REC market have completely different structures, it is a misconception that the physical price of a REC incorporates wholesale electricity price risk. For instance, wholesale market prices are set at the Node and often traded in five-minute periods, whereas REC market prices are set at the tracking system level and traded in longer periods. Fundamentally, REC market price volatility does not correlate with the financial risk associated with the Floating Price because REC pricing is largely based on demand from corporations’ sustainability goals.

Alternatively, were a contract, unlike a VPPA, to

transfer physical electrons, such contract would convey ownership in an asset that incorporates the financial risk transferred by the Fixed Price minus Floating Price payment formula. Accordingly, such a transaction would not be a swap. By contrast, since there is no correlation between the wholesale market prices and the REC market prices, a transfer of RECs does not mean there is a conveyance of ownership in an asset that incorporates the financial risk transferred by the above payment formula. Therefore, the transaction should be considered a swap. The focus needs to be on whether there is a transfer of an asset that incorporates the financial risk also being transferred. In other words, a focus on whether the physical electrons are transferred, instead of RECs, is needed to determine whether a VPPA qualifies as a swap.

Does the Forward Contract Exclusion Apply to VPPA?

7 U.S.C.A. § 1a(47)(B)(ii) provides that:

The term “swap” does not include any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.

This provision is called the forward contract exclusion. The CFTC notes that “The primary purpose of a forward contract is to transfer ownership of the commodity and not to transfer solely its price risk.⁵” In determining whether the forward contract exclusion applies to the transaction, the CFTC assesses the transaction as a whole, including the parties’ underlying purpose.⁶

As we mentioned above, a VPPA involves the trading of both RECs and the wholesale electricity market price volatility. The price risk transferred in a VPPA is the wholesale electricity price which is accompanied with the transfer of RECs. Both components are an essential purpose of the parties’ contract. The fact that the parties do not intend to physically deliver electrons is dispositive in both the analysis of whether the exclusion in subpart (A)(iii) (discussed

above) applies as well as whether the forward contract exclusion applies. While some may argue that a VPPA is used to facilitate the transfer of RECs, that is predominately the Buyer’s perspective. Seller primarily enters into the transaction intending to shift the financial risk, and to obtain price certainty, with respect to the price of electricity in order to obtain financing. Therefore, a VPPA likely does not meet the underlying purpose test.

Indeed, the CFTC identifies an environmental commodity, such as an emission allowance, as a nonfinancial commodity,⁷ and it concludes that “an agreement, contract or transaction in an environmental commodity may qualify for the forward exclusion from the swap definition if the transaction is intended to be physically settled⁸” because the delivery of ownership is necessary by the nature of the contract. This explains why an RPA qualifies for the forward contract exclusion—but not a VPPA. Just because RECs are traded in a VPPA does not mean the forward contract exclusion applies to the entire transaction. If it did, parties could physically exchange unrelated commodities to avoid classification of their transactions as a swap—such as delivering 10 paperclips in a transaction otherwise involving oil futures. For a forward contract exclusion to apply, there must be a transfer of ownership of the commodity that is associated with the price risk (as noted by the CFTC in the citation referenced above). Whereas in a VPPA, the wholesale electricity market price volatility risk is transferred, but the physical electrons themselves are not. For these reasons, the forward contract exclusion does not apply to VPPA.

Why is RPA Not a Swap?

In an RPA, since the parties do not base the settlement price (or purchase price) on a floating index price, it is not a contract for differences arrangement. The pricing mechanism in an RPA does not serve as a hedge against the risk of wholesale energy market price volatility for Seller. This means that there is no

transfer of financial risk. Therefore, an RPA does not meet the definition in 7 U.S.C.A. § 1a(47)(A)(iii).

Conclusion

As discussed above, it is important to recognize the essential components within a transaction and whether those components constitute a swap, regardless of whether it is labelled an RPA or VPPA. Although some parties name a VPPA as an RPA, if the agreement, contract, or transaction satisfies the swap definition, the title of the agreement alone does not negate the fact that the VPPA (as we have defined it, above) is a swap.⁹ The key is whether the financial risk associated with a future change in value of a commodity (here, electricity) is conveyed without also conveying physical ownership interest in an asset that also incorporates the risk or liability so transferred. The simultaneous transfer of a REC in a VPPA does not satisfy this requirement.

Statutes

- 7 U.S.C.A. § 1a(47)(A)(iii)

Except as provided in subparagraph (B), the term “swap” means any agreement, contract, or transaction that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred.

- 7 U.S.C.A. § 1a(47)(B)(ii)

The term “swap” does not include any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.

- 7 U.S.C.A. § 1a(41)

The term “security” means a security as defined in section 2(a)(1) of the Securities Act of 1933 (15 U.S.C.A. § 77b(a)(1)) or section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78c(a)(10)).

- 15 U.S.C.A. § 77b(a)(1)

The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness,

- 15 U.S.C.A. § 77b(a)(17)

The terms “swap” and “security-based swap” have the same meanings as in section 1a of title 7.

- 7 U.S.C.A. § 1a(42)

The term “security-based swap” has the meaning given the term in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78c(a)).

- 15 U.S.C.A. § 78c(a)(68)

(A) In general.—Except as provided in subparagraph (B), the term “security-based swap” means any agreement, contract, or transaction that—

- (i) is a swap, as that term is defined under section 1a of the Commodity Exchange Act [7 U.S.C.A. § 1a] (without regard to paragraph (47)(B)(x) of such section); and
- (ii) is based on—
 - (I) an index that is a narrow-based security index, including any interest therein or on the value thereof;

- (II) a single security or loan, including any interest therein or on the value thereof; or
- (III) the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial condition, or financial obligations of the issuer.

● 15 U.S.C.A. § 78c(a)(55)

(B)The term “narrow-based security index” means an index—

- (i) that has 9 or fewer component securities;
- (ii) in which a component security comprises more than 30% of the index’s weighting;
- (iii) in which the five highest weighted component securities in the aggregate comprise more than 60% of the index’s weighting; or
- (iv) in which the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting have an aggregate dollar value of average daily trading volume of less than \$50,000,000 (or in the case of an index with 15 or more component securities, \$30,000,000), except that

if there are two or more securities with equal weighting that could be included in the calculation of the lowest weighted component securities comprising, in the aggregate, 25% of the index’s weighting, such securities shall be ranked from lowest to highest dollar value of average daily trading volume and shall be included in the calculation based on their ranking starting with the lowest ranked security.

ENDNOTES:

¹U.S. Environmental Protection Agency, “Renewable Energy Certificates (RECs),” <https://www.epa.gov/green-power-markets/renewable-energy-certificates-recs>

²*Id.*

³FTC, “Guides for the Use of Environmental Marketing Claims,” 77 Fed. Reg. 62,131 (Oct. 11, 2012)

⁴U.S. Environmental Protection Agency, “Offsets and RECs: What’s the Difference?,” P.4 https://www.epa.gov/sites/default/files/2018-03/documents/gpp_guide_recs_offsets.pdf

⁵CFTC and SEC, “Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement;” Mixed Swaps; Security-Based Swap Agreement Recordkeeping,” 77 Fed. Reg. 48,228 (Aug. 13, 2012)

⁶*Id.* at 48,228 & nn.214, 215

⁷*Id.* at 48,233

⁸*Id.* at 48,234

⁹*Id.* at 48,260

