

# TEN COMMANDMENTS FOR ENERGY HEDGE AGREEMENTS

LATELY, THE FINANCING OF A RENEWABLE ENERGY PROJECT HAS OFTEN RELIED ON AN UNDERLYING ELECTRICITY HEDGE AGREEMENT – WHICH CAN ALSO BE REFERRED TO AS CONTRACT FOR DIFFERENCES, VIRTUAL PPA, POWER HEDGE AGREEMENT, OR SWAP AGREEMENT. BY **DANIEL LYNCH**, PARTNER, AND **YAW T TEMENG**, COUNSEL, **AKIN GUMP**.

Regardless of the name, each of these agreements is intended to create a predictable revenue stream for the project company from a creditworthy offtaker. The purpose of this article is to provide a basic overview of the key considerations one should weigh in negotiating such a hedge agreement from both the perspective of the project company and the hedge provider.

## Term and termination

Relative to the typical 20 or more year terms for traditional power purchase agreements (PPAs), the shorter term of a renewable energy hedge agreement can be a concern for project lenders because of the ensuing period of unhedged merchant tail relative to the tenor of the term loan, which can impact the ability for the project to amortise its debt.

The length of a renewable energy hedge agreement is largely driven by the lenders and tax equity providers, and how comfortable such parties are, if at all, with exposure to the merchant tail – this assumes, which we have typically found to be true, that the project sponsors are willing to take on merchant risk. That being said, the term of hedge agreements are typically half of that of the typical PPA.

Termination rights are another key negotiating point in renewable energy hedge agreements. The hedge provider wishes to ensure a high confidence factor that the project company is able to fulfil its obligations under the hedge agreement both in terms of quantity and any financial obligations. Conversely, the project company sponsors wish to maximise profits from the project, and consequently may be willing to take more risks than a hedge provider may desire.

As a result, affirmative and negative covenants, and related termination rights for breach of such covenants, are important provisions to both parties. Project lenders and tax equity providers are also vested in the negotiation of such termination rights under the hedge, as the hedge typically is the primary source of income for the project company.

Further to that end, project lenders and tax equity providers often seek cure rights under the hedge documents, giving them an opportunity to cure defaults of the project owner/borrower and preserve the hedge value.

## Permitted additional transactions

As mentioned, hedge providers are incentivised to restrict the ability of project companies to enter into

other contractual obligations that may jeopardise the financial health of the project company.

In addition to maximising profit, project company sponsors also want to ensure that they are able to mitigate risk, such as transmission risk, and enter into other contractual arrangements that are ordinary for their projects, such as additional REC sales contracts or bidding into the day-ahead energy market. What additional transactions the project company is able to enter into is an active discussion point to ensure both parties feel adequately protected.

## Pricing real-time v day-ahead settlement

Power hedge agreements mitigate the price volatility incurred by the project company inherent in selling power in the merchant spot-market. Project sponsors trade the price risk, and potential upside, of merchant power sales for the assurance of a stable, fixed price. On the other hand, hedge providers take on such merchant risk and are often betting that energy prices will rise over the term of the hedge agreement and that the hedge agreement will remain in the money to their benefit.

Given the differing objectives, analysing and negotiating the appropriate strike price, that is, the agreed upon fixed hedge agreement price, is critical for the parties' achievement of their respective goals.

One item to note, beyond the strike price, is the price against which the strike price is compared when calculating the periodic payments to be made under the hedge agreement.

Typically, better pricing can be achieved through bidding into the day-ahead market; although, penalties will be assessed for any failure to meet delivery commitments. Hedge providers usually want the strike price to be based on the higher day-ahead market while project companies will want the strike price based on the lower real-time price, that is, not based on the day-ahead price.

At first it appears counter-intuitive that project sponsors typically want the hedge to be based on the, typically lower, real-time market price. However, this is because a strike price based on the real-time market price can be lower than an economically equivalent strike price based on the day-ahead market price.

Additionally, with a real-time strike price, the project company can then enter into the day-ahead market and capture the arbitrage between the day-ahead and real-time market. If the strike price is based on the day-ahead market,

the project company must ensure the quantity subject to the hedge agreement is actually sold into the day-ahead market to avoid being forced to shoulder the difference between the real-time and day-ahead market prices.

For many of the same reasons, hedge providers will want to use the day-ahead market price since they sit on the opposite side of the transaction. Fixing the floating price on the real-time, day-ahead or some combination of the two is a common source of discussion when negotiating a power hedge agreement.

#### **Basis risk**

The nodal price to hub price basis risk is a major negotiation point in nearly every transaction. While traditionally addressed through a tracking account, which can be thought of as an informal working capital credit facility provided by the hedge provider, recently hedge providers have been attempting to make modifications to the traditional model of using a tracking account in a way that shifts more of this risk away from the hedge provider and onto the project company.

Basis risk arises because the hedge agreement typically is settled at a liquid hub, compared with a location right next to the respective project, which is where the project company physically sells energy into the market. Even though the project company is typically bearing more basis risk, there are ways for the project company to mitigate this risk outside of the hedge agreement.

#### **Security/collateral requirements**

Required security, credit requirements, collateral, and even intercreditor terms are typically key points of negotiation in or surrounding a hedge arrangement. To mitigate the size of its credit exposure risk, the hedge provider often seeks lien rights on the project from the project sponsor, especially if the project sponsor is not willing to provide the more traditional security requirements of cash or a letter of credit.

The details surrounding a hedge provider lien are a significant negotiation point because the project sponsor is likely to have already pledged, or will need to pledge, its assets to its senior lenders, creating overlapping claims between the hedge provider and existing senior lenders, particularly its construction lenders.

As a result, an intercreditor agreement is often negotiated between the hedge provider, lenders and tax equity providers. Additionally, the hedge provider may try to ensure that the hedge settlement payments are paid out higher in the project waterfall of cash outflows than the senior debt payments. However, these points are subject to active negotiation.

#### **Construction milestones**

The swap provider wants to ensure that the project will be built on time. This is often because the swap provider has made commitments based on the expected commencement of the project and hedge agreement, such as entering into a back-to-back hedge agreement with a third party or relying on RECs that are also to be provided pursuant to the hedge agreement.

Often, exit ramps are inserted into power hedge agreements to require additional collateral, allow partial terminations (through a partial unwind) or allow a complete termination of the hedge agreement to occur if certain milestones are not met.

#### **Physical v financial settlement**

Whether the power will be physically delivered to the swap provider or if there will be only a financial settlement is often another point of discussion. In financial settlements, hedge providers will typically require the physical power subject to such financial swap to be sold solely in the spot market due to credit risk concerns if such power is sold to a third party.

The geographic scope of where a hedge agreement can be physically settled, and for that matter, financially settled, should also be investigated. In a financially-settled hedge, the strike price is compared against the market price and the resulting price difference will be paid by one of the parties, and whether such price difference is positive or negative determines who makes the payment to the other party.

In a physically-settled hedge, the hedge provider will pay the project company the strike price for the project company's physical delivery of the power at the settlement point.

#### **Availability requirements**

If the hedge agreement is based on a percentage of the facility's output, whether 100% or some lesser number, the swap provider will typically want a covenant that the facility is operating as expected.

This can be accomplished through mechanical availability, ie is the unit able to produce power, or through performance, ie how much power is the unit producing versus how much the manufacturer expects it to produce.

Negotiations around such a concept will involve, among other things, how to handle economic curtailment, for example, when the nodal price falls below US\$0, and renewable energy credit (REC) deficits.

#### **Change of law risk**

Which party bears the risk in a change of law, whether regulatory or otherwise, is always a topic of negotiation. This point is especially acute if (a) RECs are involved as neither party wants to bear the risk of increased costs involved with producing or delivering RECs and (b) future, currently non-existent products, such as capacity rights in ERCOT, are granted to the hedge provider as the project company does not know what costs will be required to enter into any future market for such products.

#### **Ownership of future capacity**

Recently, ownership of capacity or other ancillary benefits that may be created in the future, as mentioned immediately above, has been the topic of negotiation. If such future benefits are granted to the hedge provider, the project company will want to ensure that such ownership will not affect its ability to operate the project or to maximise its production of energy, in addition to ensuring that it will not be required to undergo major capital expenditures to enter into any such newly created market. ■