To: Rocky Mountain Institute

From: Zach Seder[1] & Lawyers for Good Government

Date: April 20, 2020

Re: Legal Considerations for Use of Virtual Power Purchase Agreements By Minnesota Municipalities

I. Executive Summary

Virtual power purchase agreements ("VPPAs") have proven to be an effective tool for private corporations to meet their renewable energy and sustainability objectives. This memo investigates whether VPPAs may also be used for such purpose by municipal entities in the State of Minnesota, and in particular by the City of Minneapolis. Due to the lack of direct precedent for municipal VPPA transactions, both in Minnesota and in other jurisdictions, this analysis requires an examination of various ways in which a VPPA may be characterized under current state and local law. While there do not appear to be any fundamental legal obstacles to use of a VPPA by a municipality, that conclusion will be strongest where the VPPA is treated as a potential expenditure of funds for a public purpose rather than as an investment opportunity intended to realize commercial gains. Implementation of specific authorizing legislation at the municipal level would also greatly enhance and clarify the legal foundation for a VPPA.

In addition to establishing the baseline legal viability of a municipal VPPA, it will also be important to take into account several practical limitations that may need to be overcome in order to effectively implement a VPPA. Specifically, the potential variability of payments under a VPPA will need to be reconciled with the city's budgeting and appropriations practices, either through legislative means or through the use of contractual provisions that mitigate variability. The accounting treatment of VPPAs should also be further investigated and managed where possible through use of appropriate contract terms.

Part II of this memo provides an overview of Minnesota constitutional and statutory concepts that may govern the ability of municipalities in Minnesota to enter into VPPAs. Part III of this memo addresses treatment of VPPAs under Minneapolis municipal law and measures that may be taken by the city at the local level to authorize and implement VPPAs. Part IV of this memo identifies compliance

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obligations to which the city may be subject in connection with federal regulation of swaps, as well as the need to evaluate potential derivative accounting treatment associated with VPPAs. Part V of this memo outlines a series of specific recommendations for consideration by the city.

II. Minnesota Constitutional and Statutory Requirements

In Minnesota, home rule charter cities such as Minneapolis have broad authority to regulate their own affairs provided the exercise of such authority does not conflict with the state constitution or state statute.[2] In evaluating what legal considerations may apply were a municipality[3] to enter into a virtual power purchase agreement ("VPPA"), it is therefore first necessary to determine whether such an action would be prohibited under the state constitution or present a conflict with any state statute.

a. Constitutional Considerations

i. Public Purpose Doctrine

The primary constitutional limitation of potential relevance in the context of a VPPA is the public purpose doctrine. The Minnesota Constitution includes several provisions requiring public funds to be used solely for public purposes. Specifically, the Constitution provides that taxes shall be levied and collected for public purposes,[4] prohibits legislation authorizing public taxation for a private purpose,[5] and limits the circumstances under which the credit of the state may be pledged for the benefit of any individual, association or corporation.[6] The courts have interpreted these provisions as broadly requiring that public funds be used solely for public purposes, and not used in furtherance of any private interest.[7]

The definition of a public purpose is generally construed to mean an activity that will serve as a benefit to the community as a body and which is directly related to the functions of the government.[8] Determinations of public purpose by legislative bodies and public officials are afforded significant deference by the courts, provided such determination is not manifestly arbitrary or capricious and the

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[2] ACE Equipment Company v. Erickson, 152 NW 2d 739, 741 (1967)
[3] Note that while this analysis is focused on home rule charter cities, additional considerations may apply in the case of a statutory city that has not elected to operate as a home rule city.
[4] Minn Const. Art X, § 1
[5] Minn Const. Art XII, § 1
[6] Minn Const. Art XI, § 2
[7] Minneapolis Gas Co. v Zimmerman, 253 Minn. 164, 176, 91 N.W.2d, 642, 651
[8] Visina v. Freeman 89 NW 2d 635 Minn Supreme Court 1958

purpose of such expenditure is not primarily to serve a private interest.[9] Additionally, the determination of the exact manner and degree to which a proposed expenditure may serve the public purpose is reserved to the discretion of the relevant governing body and is not subject to judicial review provided it is not unreasonable.[10] Absent proof of fraud, a municipal body is presumed to be acting in the public interest.[11]

The fact that a public expenditure provides an incidental benefit to a private interest does not in itself result in such expenditure being characterized as serving a private interest, provided the primary purpose is public.[12] In *RE Short Co v City of Minneapolis,* the Minnesota Supreme Court held that an expenditure of funds by the city for purposes of inducing construction of a hotel by a private developer did not violate the public purpose requirement because, while the developer was the direct beneficiary of the expenditure, the hotel itself served a public purpose by promoting economic development.[13]

ii. Application of Public Purpose Doctrine to VPPA

A VPPA providing for payments to a private developer of a renewable energy project may reasonably be viewed as a form of inducement for the construction of such project. Without such an agreement in place to ensure certainty of revenues for the project, it is unlikely the project would be able to attract financing or advance to an operational state. While a VPPA would certainly involve the potential expenditure of public funds to the benefit of a private interest, the primary purpose of such an agreement from the city's perspective would be to achieve its longstanding and well-documented[14] greenhouse gas reduction goals. As was the case in *RE Short Co v City of Minneapolis*, the developer would be the direct financial beneficiary of the contract, but the project induced by the contract would serve a broader public purpose.

Under the highly deferential standard of review applied by the courts, a determination of public purpose made by the city in connection with a VPPA should be definitive absent evidence of inappropriate intent. The private benefits of the VPPA to the developer may be considered incidental to the city's primary purpose of inducing construction of additional renewable energy capacity and consequent reduction in carbon dioxide emissions. This conclusion will be strongest where the project

[9] RE Short Co v. City of Minneapolis, 269 NW 2d 331 Minn Supreme Court 1978
[10] RE Short Co v City of Minneapolis *supra*, 341
[11] *Id.*
[12] Visina v. Freeman
[13] RE Short Co v. City of Minneapolis, *supra*
[14] *See, e.g.,* City of Minneapolis Resolution No. 2018R-121 dated April 27, 2018

serving as the basis for the VPPA does not already exist and will be constructed following entry by the city into the contract.

b. Minnesota Statutes

While there is no Minnesota statute expressly prohibiting or regulating the ability of municipalities to enter into VPPAs, the features of a VPPA are similar in some respects to other contracts or financial instruments which are regulated by state statute. This section evaluates whether a VPPA could be characterized as a form of debt obligation, investment, or procurement contract for purposes of state law, and the potential consequences of such a characterization in each case. This section also addresses whether VPPAs would be subject to the exclusive rights of utilities to provide retail electric service in Minnesota.

i. VPPA as Debt Obligation

Chapter 475 of the Minnesota Statutes governs the issuance of municipal obligations, and applies to all cities including those with home rule charters.[15] Chapter 475 prescribes a variety of limitations on the form, economic terms and overall amount of "obligations" that may be issued by municipalities. An "obligation" for purposes of the provisions of Chapter 475 is defined as follows:

"Obligation" means any promise to pay a stated amount of money at a future date or upon demand of the obligee, regardless of the source of funds to be used for its payment, made for the purpose of incurring debt, including the purchase of property through an installment purchase contract or any other deferred payment agreement, for which funds are not appropriated in the current year's budget.[16]

A VPPA could conceivably be construed as a promise to pay funds not appropriated in the current year's budget at a future date, since it would obligate the city to make settlement payments to the contract counterparty over an extended period depending on market conditions. A VPPA would not be entered into by the city for the purpose of incurring debt, though a precise definition of the meaning of "debt" in that context is not provided.

Given the lack of precedent for municipal VPPA transactions in Minnesota, there is currently no direct guidance for determining whether a VPPA would constitute an "obligation" of the municipality for purposes of Chapter 475. There are clear statements of legislative intent with respect to the treatment of similar contracts, however. Interest rate swaps operate in a similar fashion to VPPAs, since

[15] Minnesota Statutes § 475.753
[16] Minnesota Statutes § 475.51

they involve periodic settlement payments during the term of the contract based on the difference between market conditions and a fixed reference value. The liability of a municipality under an interest rate swap is expressly not considered an "obligation" for purposes of Chapter 475.[17] The exclusion of interest rate swaps from the definition of an "obligation," though not determinative, provides support for the conclusion that VPPAs would also not be subject to regulation under Chapter 475.

ii. VPPA as Investment

Chapter 118A.04 of the Minnesota Statutes regulates how municipalities may invest public funds. "Public funds" for purposes of the chapter is inclusive of all funds held or administered by a governmental entity, regardless of source or purpose.[18] The regulations in Chapter 118A apply to any public funds "not presently needed for other purposes or restricted for other purposes;"[19] or in other words, idle funds held in the city treasury and not currently needed to meet demands for cash or subject to limitations on use.[20] Investment of such idle funds is limited to United States securities, state and local securities satisfying certain credit requirements, high quality commercial paper, and insured deposits,[21] as well as certain repurchase agreements, investment trusts and guaranteed investment contracts.[22] A city with a population over 200,000 that has implemented a written set of detailed investment policies and an oversight process conforming to statutory requirements has additional flexibility, including the ability to enter into futures and options contracts for securities held by the city.[23]

A VPPA would not be likely to qualify as an acceptable investment of funds under Chapter 118A as it does not fit within any of the enumerated types of financial products eligible for investment. However, it does not seem accurate to characterize a VPPA as an investment of idle funds by the city that would be subject to regulation under Chapter 118A. While it is possible under favorable market conditions that the city may realize economic gains from its rights under a VPPA, that outcome is not

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[17] Minnesota Statutes § 475.54, subdivision 16 ("The agreement to pay the counterparty [under an interest rate swap] is not an obligation as defined in Section 475.51, subdivision 3"). *See also* Minnesota Statutes § 446A.14(d) ("The [interest rate swap] agreements authorized by this subdivision do not constitute debt of the [Minnesota Public Facilities Authority] for the purposes of the limits on bonds or notes of the authority…")

[18] Minnesota Statutes § 118A.01 ("'Public funds' means all general, special, permanent, trust, and other funds, regardless of source or purpose, held or administered by a governmental entity, unless otherwise restricted.")

[19] Minnesota Statutes § 118A.04, subdivision 1

[20] League of Minnesota Cities, Handbook for Minnesota Cities Chapter 19, Section XII (*available at* https://www.lmc.org/wp-content/uploads/documents/Sources-of-Revenue.pdf)

[21] Minnesota Statutes § 118A.04

[22] Minnesota Statutes § 118A.05

[23] Minnesota Statutes § 118A.07

guaranteed and the use of a VPPA by the city as an investment vehicle for idle funds would not be an appropriate purpose for such a contract. Rather, a VPPA would be more properly viewed from a legal perspective as a potential expenditure of funds made by the city for the public purpose of securing environmental benefits.

A VPPA would also not necessarily require at the time it becomes effective that any funds currently held in the city treasury be deposited or otherwise directed to an account associated with the VPPA. While there may be value commercially in providing dedicated cash collateral to secure the obligations of the city under the VPPA, a structure that avoids this requirement would be least likely to require review under Chapter 118A. This may therefore be a point worth taking into consideration in any request for proposals or commercial negotiations issued or conducted by the city in connection with a potential VPPA.

iii. VPPA as Procurement Contract

The provisions of Minnesota statutory law governing procurement contracts by municipalities are mostly procedural in nature. Minnesota Statutes Chapter 471.345 (the Uniform Municipal Contracting Law) applies to all agreements "entered into by a municipality for the sale or purchase of supplies, materials, equipment…or the construction, alteration, repair or maintenance of real or personal property."[24] Contracts having an expected value in excess of $175,000 are required to be awarded through a public solicitation process,[25] and contracts for energy conservation and efficiency projects are subject to additional requirements.[26]

A VPPA may be viewed as an agreement for the procurement of renewable energy credits or environmental attributes, as it generally involves a financial obligation being assumed by the buyer in exchange for assignment of such credits or attributes. It is not clear that renewable energy attributes should be considered as supplies, materials or equipment within the meaning of Chapter 471.345, but even if this chapter were to apply, the effect would simply be to prescribe certain methods of procurement.

[24] Minnesota Statutes § 471.345, subdivision 2
[25] Minnesota Statutes § 471.345, subdivision 3
[26] Minnesota Statutes § 471.345, subdivision 13.

iv. Utility Exclusivity

Minnesota has a regulated retail electricity market in which utilities have the exclusive right to provide electric service within their service territories. This concept is codified in Section 216B.37 of the Minnesota Statutes, which provides that "the state of Minnesota shall be divided into geographical service areas within which an electric utility shall provide electric service to customers on an exclusive basis."[27] "Electric service," in turn, is defined as "electric service furnished to a customer at retail for ultimate consumption," and is exclusive of wholesale electric energy transactions.[28]

A VPPA operates primarily as a financial instrument, and does not provide for physical delivery of electricity for consumption within the exclusive territory of a utility. Utility exclusivity does not therefore operate as a bar to the city entering into a VPPA. In fact, VPPAs with corporate offtakers are common in Minnesota and other regulated markets throughout the country as an alternative to conventional power purchase agreements involving physical delivery.

III. Minneapolis Municipal Law

As detailed in Section II above, there is no clear obstacle under Minnesota state constitutional or statutory law preventing Minneapolis from exercising the authority granted under its charter to enter into a VPPA. The analysis therefore turns to the charter itself, as well as the Minneapolis code of ordinances, to determine whether the authority to enter into a VPPA currently exists, and what other provisions may affect the city's ability to implement such an agreement.

a. Authority

Not surprisingly, there is currently no provision in the Minneapolis charter or code of ordinances providing for express authority to enter into a VPPA as this has not been a tool used previously by the city to advance its renewable energy objectives. While the city has broad authority under the grant of plenary power in its charter to exercise the powers generally available to a municipal entity as part of its common law police power,[29] the adoption of an ordinance providing a specific grant of authority for the city to enter into a VPPA would provide clarity and is recommended. Such an ordinance could potentially be modeled on the state statutes allowing for interest rate swaps, and

[27] Minnesota Statutes § 216B.37
[28] Minnesota Statutes § 216.B.38, subdivision 4a
[29] Minneapolis Charter § 1.4 ("The City, acting through the boards, commissions, committees, departments, and officers for which this charter or an ordinance provides, may exercise any power that a municipal corporation can lawfully exercise at common law")

could define acceptable parameters for counterparty credit, maximum liability, sources of funds available for payment, and other material concepts.

b. Appropriations

A practical limitation that may exist on the city's ability to perform under a VPPA is the requirement in Section 9.2 of the Minneapolis charter that all funds paid from the city treasury (other than those for debt service) must be included in a budgeted appropriation unless a separate resolution is passed by the city council authorizing payment from current funds.[30] Since payments due under a VPPA are variable in any given period based on the market price of wholesale electricity in the market to which the VPPA is indexed, it may prove difficult to budget and appropriate in advance the funds required to make payments due under the contract, if any. A counterparty to the VPPA may also seek assurance that amounts due under the contract during any settlement period can be paid without special action of the city council.

While not necessarily a limitation on the ability of the city to enter into a VPPA, the implications of city appropriation and budgeting rules on the ability of the city to meet its payment obligations under the VPPA will require more detailed consideration. This issue could potentially be mitigated through negotiation of contract provisions, such as longer settlement periods or a limitation on settlement amounts payable in any period, that allow for greater predictability of potential payment obligations.

IV. Dodd-Frank and Derivative Accounting

a. Dodd-Frank Requirements

Because they are not physically settled and involve payments determined with reference to the market price of electricity, VPPAs are generally considered to be fixed-for-floating swaps. As such, they are subject to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[31] Those requirements are primarily grouped into five categories: clearing, margin,

[30] Minneapolis Charter § 9.2 (a) ("No money may be paid out of the City's treasury except (1) pursuant to a budgeted appropriation, and approval of a contract or order for payment, by the City Council or other authorized board or commission, (2) in payment of principal or interest on a bond issued or other debt incurred under this charter or other law; or (3) pursuant to a resolution by the City Council, by three-fourths of its membership, authorizing payment out of current funds.")

[31] Steven Mickelsen, Dodd-Frank Compliance for Corporate VPPA Buyers, Futures & Derivatives Law Report, Thomson Reuters (Apr 2016), *available at* https://3degreesinc.com/wp-content/uploads/2016/05/GLFDLR4_Article-1.pdf.

recordkeeping, registration, and reporting.[32] Clearing, margin and registration requirements would generally not apply in the context of a VPPA, as VPPAs are not included within the list of swaps subject to clearing requirements,[33] fall within the end-user exception to margin requirements,[34] and are unlikely to involve a "major swap participant."[35] Reporting requirements, which require quarterly reporting of valuation data among other information, apply to all swap counterparties.[36] However, these responsibilities are customarily assumed by the seller under a VPPA, so the city would likely be able to avoid the administrative burdens associated with this requirement through appropriate allocation of responsibilities under the contract.

As the clearing, margin and registration requirements should not apply, and the reporting obligations can be allocated to the seller, the only Dodd-Frank requirement that the city would likely be subject to is therefore the recordkeeping requirement. These requirements obligate swap counterparties to keep "full, complete and systematic" records for the life of the swap and a period of at least five years after termination.[37] To the extent this conforms to existing practice, this should not represent a significant incremental burden to the city.

b. Derivatives Accounting

A common issue raised in connection with corporate VPPAs is the possibility that such agreements may impose the need for derivative accounting on the parties to the contracts. Determining whether such treatment will apply requires a detailed analysis of the specific provisions in each VPPA and the relevant accounting guidelines, and is beyond the scope of this memo. If derivative accounting were to apply, however, it would require among other things a periodic mark to market valuation of the contract.[38] It is recommended that the city seek the advice of an accountant familiar with the treatment of VPPAs to determine whether derivative accounting may apply, what

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[32] *Id*
[33] 17 C.F.R § 50.4
[34] 17 C.F.R § 23.150
[35] 7 U.S.C. 1a(33)(A)(i); *See also* U.S. Securities and Exchange Commission Fact Sheet, Defining Swaps-Related Terms, *available at* https://www.sec.gov/opa7 USC 1a(33)(A)(i)/Article/press-release-2012-67---related-materials.html (indicating the threshold used for determining "substantial position" is $1 billion of uncollateralized exposure)
[36] 17 C.F.R § 45.3
[37] 17 C.F.R § 45.2
[38] The Basics of Accounting for Derivatives and Hedge Accounting, prepared by KPMG *available at* https://www.cmegroup.com/education/files/fincad-hedge-accounting-kpmg-whitepaper.pdf.

impacts it may have, and how contracts may be structured in order to avoid triggering derivative accounting requirements.

V. Conclusion and Recommendations

There is no clear prohibition under Minnesota constitutional or statutory law that should prevent a home rule municipality from entering into a VPPA. From a legal perspective, a VPPA would be most soundly characterized as a potential expenditure made for a public purpose. To that end, it will be useful to expressly state the environmental objectives the city seeks to achieve by entering into the VPPA. The city should also ensure that any VPPA would support construction of a new project, rather than an existing project, so that the direct link between the VPPA and inducement of the desired environmental outcome can be established.

One area of potential uncertainty is whether a VPPA may be deemed an "obligation" subject to the debt limits and other requirements in Chapter 475 of the Minnesota Statutes. While the legislative precedent specifying that other forms of swaps are not "obligations" for purposes of Chapter 475 provides a reasonable basis for concluding that a VPPA would also not be considered as such, an opinion from the Minnesota attorney general could be one method for securing additional comfort on this issue.

At the municipal level, the lack of express authority for VPPA transactions in the Minneapolis charter and code of ordinances requires reliance on more tangential concepts of implied authority that put the city on less certain ground and may lead to concerns among contract counterparties. Adoption of an ordinance providing for such an express grant of authority would resolve such ambiguity, and could also be used as a means of defining acceptable commercial parameters for all VPPAs entered into by the city. Additionally, a method for aligning the variable nature of payment obligations under a VPPA with the budgeting and appropriation requirements in the charter will be needed so that contract obligations are credible and manageable. Contractual provisions that increase the predictability of payments within each budgetary period, for example by setting a price floor to limit exposure, carrying forward excess obligations to subsequent budgetary periods, or requiring seller to deliver annual forecasts, may be one way to address this risk.

Finally, in order to avoid prohibitive administrative burdens that may be associated with implementation of a VPPA, the city should require that Dodd-Frank reporting responsibilities are allocated to seller and confirm whether derivatives accounting will apply.