Virtual Power Purchase Agreement Legal Considerations

This memo addresses certain federal, state, and local legal considerations and best practices for a municipality entering into a virtual power purchase agreement (VPPA).

Disclaimer: this document should be used as a starting point for legal discussions but should not be construed as legal advice and does not address all issues that may arise with respect to entering into a VPPA in any particular jurisdiction.

What is a VPPA?

A typical virtual power purchase agreement (VPPA) is a *financial arrangement* between a renewable energy project developer and a buyer in which a buyer both (1) pays the developer the positive difference between a *fixed* price ($/MWh) for the generated renewable electricity and a *floating* market price ($/MWh) when the floating price is lower, and (2) receives from the developer the positive difference between the floating price and the fixed price when the floating price is higher. The buyer also receives ownership of the project's associated renewable energy certificates (RECs).

Unlike a physical power purchase agreement, the buyer does not take ownership of or receive the produced energy, and there is no direct impact on a buyer's physical operations or utility bills. Instead, the electricity generated by the project is sold into a wholesale electricity market, with the resulting revenues (which can fluctuate significantly over time, depending on market conditions) going to the project developer.

VPPAs are effective tools for stabilizing revenue streams for renewable power projects that sell their output on a merchant basis (that is, without traditional, long-term and fixed-price power purchase agreements). VPPAs can therefore enhance the availability of financing for such projects and increase the likelihood that they get built, a feature that makes VPPAs attractive for buyers looking to support new renewable energy development.

Utility regulation is not a barrier to entering into a VPPA.

- With a VPPA, even cities located in regulated energy markets may be able to support a renewable energy project because a VPPA is typically viewed as a financial instrument that does not involve the buyer in any of the activities typically subject to utility regulation.[1,2] The renewable project typically must be located in, or have access to, a wholesale market with transparent pricing for purposes of setting the floating price, or VPPA parties may use a transparent proxy pricing location.
- Similarly, a VPPA does not require FERC approval for the buyer or require a FERC-licensed power marketer to facilitate delivery because a VPPA does not involve any physical sale of electricity.[1,3]

To avoid potential legal challenges, municipalities should pass legislation which explicitly allows the city government to enter into a VPPA.

Our research and experience reveals that most states and cities do not have rules that directly mention VPPAs. As such, nothing explicitly authorizes municipalities to enter into a VPPA, nor does anything directly prevent them from doing so.
In the absence of explicit legal precedent or statutes, home rule cities arguably can enter into VPPAs, whereas Dillon Rule cities cannot.

- Under home rule, municipal governments have authority to expend public funds and therefore arguably can enter into a VPPA, unless expressly prohibited by state or local laws.[2,3,4]
- Under Dillon Rule, municipal governments may only enter into a VPPA where a statute permits it.[4]

However, as a best practice, a city should pass an ordinance or resolution that explicitly authorizes the municipality to enter into a VPPA.[2,3,4] This ordinance should ideally:

- Be passed before pursuing a VPPA contract.
- Categorize the type of contract a VPPA is (e.g. an expenditure of funds for public benefit) and is not (e.g., an investment or a debt obligation), and specify the process for pursuing one.
- Take positions that support the legal rationale for the VPPA, for example, that a VPPA is not an investment or a debt obligation.
- Define the acceptable terms of a VPPA.[1]
- Address how a VPPA supports a public purpose, including referencing existing local greenhouse gas reduction and renewable energy goals,[3] energy plans, environmental benefits, and other public purposes. These arguments can be strengthened by demonstrating that the project will be "additional" (i.e., the renewable energy resource would not be built without the municipality's financial commitment).[3]
- Define acceptable parameters for counterparty creditworthiness, maximum liability, source(s) of funds available for payment, and other material concepts.[3]

State and local regulations on similar financial arrangements, such as interest rate swaps and hedges, may apply to a VPPA or could be used to model VPPA ordinances. For example, Virginia state code §15.2-7219 allows Counties, Cities, and Towns to enter into interest rate swaps.[5] In 2020, Arlington County, Virginia entered a VPPA with its utility.[6]

Some cities may only need to pass a resolution to issue a request for proposals (RFP) and enter into a specific VPPA contract. A resolution should define the specific terms of the VPPA and demonstrate that the project being pursued meets the guidelines above.

VPPA contract design can mitigate budgeting challenges.

Budgeting for a VPPA may be difficult due to its variable nature. Continuous fluctuations in wholesale energy market prices can lead cities to pay, or receive, varying and unpredictable amounts at the end of each settlement period. This risk can be mitigated through contract provisions that increase the predictability of payments within each budgetary period, including:

- Establishing longer settlement periods,[3] such as one year compared to one month.
- Setting a price floor or other limitations on the settlement amount payable in any period.[3]
- Carrying forward excess obligations into subsequent budgetary periods.[3]
- Requiring the seller to deliver annual forecasts.[3]

- Working with a retail electric utility to incorporate VPPA credits or debits into electric rates.

For example, Arlington County, Virginia, used the following approach in cooperation with the retail electric utility, Dominion Energy Virginia, that serves the County[6]:

- The County structured its VPPA contract such that the counterparty, Dominion Energy, absorbs the financial fluctuations over the course of each year.
- At the end of the year, Dominion calculates an annual "true-up," or the cumulative differences between the VPPA price the county is paying and the revenues generated through the energy sales.
- The true-up amount is then incorporated into the County's retail electric rate for the next year and paid on each County accounts' monthly bill.
- When the county is owed a credit, the next year's retail electric rate is lower. If the County owes money, the next year's retail electric rate is higher.
- The benefit of this contract structure is the County does not need to pay or get paid monthly and does not owe (or receive) a lump sum at the end of the year.

A VPPA should be considered an expenditure, not an investment or a debt obligation.

A VPPA should be treated as an expenditure of funds for public benefit, such as securing environmental benefits through RECs.[2,3]

- Most states and municipalities follow a "Public Purpose Doctrine" and require expenditures and appropriations of public funds to be used for a public purpose.[2]
- Public purpose can easily be supported by referencing existing local greenhouse gas reduction and renewable energy goals, local energy plans, environmental benefits, and other public purposes associated with the VPPA.[3]

VPPAs should not be considered an investment.[2,3]

- State statutes often regulate how municipalities can invest public funds.
- A VPPA should not be considered an investment since the purpose is to achieve a city's environmental, energy, or other goals, not to make money.
- A structure that avoids dedicated cash collateral to secure the City's obligations under the VPPA would be least likely to be considered an investment.[3,4]

Cities should evaluate whether a VPPA may be considered a debt obligation and the impact of any such determination.

- As it creates future payment obligations, a VPPA may in some cases fall within the statutory definition of a municipal debt obligation.
- Some municipalities may have debt limits, special approval requirements, or other restrictions applicable to debt issuances that would make such treatment unfavorable for a VPPA.
- In some jurisdictions, interest rate swaps, which operate in a similar fashion to VPPAs, are expressly excluded from the statutory definition of a debt obligation. Where that is the case, cities may be able to look to such exclusions as support for not treating VPPAs as debt obligations.

A VPPA contract should follow all city and state laws for procurements and long-term contracts.[2]

- Contract terms and rules for procurements vary widely by state and city.

- In some cities, procurements which exceed a certain monetary value threshold need to go through a public solicitation process, which entails issuing an RFP.[2]
- Some states, such as Missouri, place restrictions on cities entering into multi-year contracts that will need to be addressed to enter a VPPA.[4]

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requirements are minimal.

VPPAs are structured as fixed-for-floating swaps where the buyer and seller settle the difference between the VPPA price and the market price periodically. Fixed-for-floating swaps are regulated by the Commodity Futures Trading Commission (CFTC) under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). However, Dodd-Frank requirements for a municipality entering into a VPPA are minimal, as detailed below.
Parties to a VPPA are generally exempt from clearing, margin, and registration requirements.[1,2,3]

- Clearing: VPPAs are not included in the type of swaps required to be cleared.[3,4]
- Margin: 2016 CFTC rules exempt non-financial entities "using swaps to hedge commercial risk" from requirements to post margin.[3] CTFC adopted rules that allows municipalities to avoid posting margin.[4]
- Registration: registration requirements are limited to swaps measured in the billions of dollars and likely exempt municipalities.[3,4]

Requirements for reporting and recordkeeping are minimal.

- Reporting: It is a common best practice for the VPPA contracts to require the seller to take responsibility for reporting requirements.[1,3,4] Additionally, all Dodd-Frank forms should be prepared prior to VPPA execution to ease the reporting process.[3]
- Recordkeeping: A municipality will need to comply with recordkeeping requirements under Dodd-Frank. All physical and electronic records associated with the VPPA transaction will need to be kept for five to fifteen years following the end of the swap arrangement (i.e., the end of the VPPA term) and be retrievable within five business days.[1,2,3,4]

References:

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6. Arlington County, Virginia. "County Board Agenda Item Meeting of January 25: Authorization to enter into a Power Purchase Agreement with Dominion Energy Virginia for the purchase of a portion of the output from a 120 MW_{peak} photovoltaic solar installation to be built in Pittsylvania County, Virginia," 2020. https://arlington.granicus.com/MetaViewer.php?view_id=2&event_id=1467&meta_id=191527.