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Pioneering An ISDA Off-Take Agreement

Law360, New York (April 5, 2011) -- On Dec. 15, the Illinois Commerce Commission announced the winners of the Illinois Power Agency's (IPA) 2010 long-term renewable resources request for proposals. The IPA conducted the RFP on behalf of both Commonwealth Edison Co. (ComEd, the primary electric utility for Chicago and northern Illinois) and Ameren Illinois Utilities Corp. (the primary electric utility for southern Illinois).

Illinois law requires ComEd and Ameren to procure 25 percent of their electricity from various qualifying renewable resources by 2025. The law includes specific requirements for subcategories (including wind and solar photovoltaic) and various phase-in dates. The IPA conducted its fall 2010 procurement, in part, so that ComEd and Ameren could satisfy these requirements.

In the confines of Illinois's bare-knuckled political environment, the IPA did an admirable job of following its mandated priorities and conducting an open procurement process. Since the requisite analysis implicates, to some extent, future energy prices and renewable energy credits (RECs), only time will tell whether the economics of the procurement will benefit ratepayers in the ComEd and Ameren service areas. Those questions are interesting, but far beyond the scope of this article.

One thing is fairly certain at this point, however. The IPA broke new ground using an International Swaps and Derivatives Association form as the off-take agreement for the fall 2010 long-term renewables procurement. Typically in the U.S., utilities have used power purchase agreements for physical delivery of energy and (more recently) RECs.

The allocation of risk in these agreements varies from place to place and time to time. Under normal procurement conditions, therefore, the bankability of the off-take agreement would have been subject to some debate. (So would the bankability of the off-taker.) Still, the basic structure and allocation of risk in the IPA's ISDA form is of a different kind altogether. Its bankability is highly uncertain.

Like most swap arrangements, the IPA's ISDA off-take agreement positions one party (the utility) as a fixed price payer and the other party (the project company, with credit enhancement) as a floating price payer. Economically, this may not be much different from a traditional power purchase agreement.

There, as with the IPA's ISDA form, the utility would have agreed to pay a fixed price and the seller would have taken the risk of price rises in the market. Here, however, the seller will be selling power into the grid on a merchant basis and will therefore assume the attendant risks of scheduling and execution.

Additionally, termination rights, conflicting collateral interests of the utility and the project's financier, timing and size of cash flows, potential margin requirements under the newly-enacted Dodd-Frank regime, and other issues will all need to be sorted. The type of financier more accustomed to this arrangement would be a trader at Lehman Brothers, not a banker at RBS.

The effects of this are manifold. From the project finance perspective, the IPA's decision to use a financially settled swap agreement rather than a traditional power purchase agreement will make it more difficult for the winning projects to be financed on a nonrecourse project basis. Clearly, the IPA was not driven by the traditional notion of building up a project company and linking together the valuable pieces of a puzzle to arrive at a creditworthy special-purpose company based largely on its off-take agreement.

That is understandable — the law governing the IPA dictates otherwise. It will be interesting to see whether under the IPA's procurement regime, the underlying purpose of Illinois' renewable portfolio standards — which by implication is the replacement of traditional energy sources with new, renewable sources — will be met and by whom.

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