



---

Portfolio Media, Inc. | 648 Broadway, Suite 200 | New York, NY 10012 | [www.law360.com](http://www.law360.com)  
Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | [customerservice@portfoliomedia.com](mailto:customerservice@portfoliomedia.com)

---

## Utilities And Renewable Energy: To Buy Or To Build?

*Law360, New York (July 29, 2009)* -- With more than 29 states and the District of Columbia having enacted mandatory renewable portfolio standards (RPS) and the prospect of a federal renewable electricity standard (RES) and a greenhouse gas emissions “cap and trade” program on the horizon, there can be little doubt that renewable energy production is poised to increase dramatically over the next decade.

Add to this the Obama administration’s unprecedented support for renewable energy resources and the public’s increasing demand for all things “green,” and it’s no surprise that electric utilities are increasingly looking to add renewable resources to their generation portfolios.

Renewable energy was once thought to be the exclusive province of independent power producers (IPPs). However, traditional electric utilities are poised to enter this market given the evolving legal mandates discussed above.

What is the optimal approach for utilities to add such renewable resources to their resource mix? Should utilities buy renewable power under contract with an IPP or should they build such projects themselves?

Electric utilities across the country are wrestling with this central question. Each option has its own set of risks and rewards. The future for utilities may lie somewhere in the middle of these two paths.

### Why Renewable Energy Now?

At least three factors are currently influencing electric utilities to add renewable resources to their generation portfolios: state RPS requirements; federal incentives and the prospect of a federal RES and greenhouse gas “cap and trade” program; and public demand.

With a majority of the states having implemented an RPS, many electric utilities are now required to supply a percentage of their load (often rising to 20 percent or more) from renewable resources.

Utilities failing to meet their applicable RPS may face penalties or fines under certain circumstances. Even states that have not yet passed an RPS are nevertheless encouraging the use of renewable resources through tax and other incentives.

Action at the federal level may prove to be an even greater motivator for utilities. Since President Obama took office, the new administration has called for a federal RES and a curb on greenhouse gas emissions, both of which are expected to spur increased development and investment in renewable resources.

On June 26, 2009, the U.S. House of Representatives narrowly passed the American Clean Energy and Security Act or “Waxman-Markey Bill,” named after the bill’s co-sponsors.

Under the Waxman-Markey Bill, the first-ever greenhouse gas “cap and trade” program would require greenhouse gas emissions to be reduced 3 percent below 2005 levels beginning in 2012 and reaching an 83 percent reduction by 2050.

In addition, the Waxman-Markey Bill would establish a federal mandate for the purchase of renewable energy, as well as a federal platform for the trading of renewable electricity credits.

Although the Waxman-Markey Bill faces an uncertain future in the Senate, and even if these new federal “sticks” fail to become law, the federal government has already established a number of “carrots” to support the development of renewable resources by utilities and others.

Principal among these are the production tax credit (PTC) and the investment tax credit (ITC), both of which have been recently extended and enhanced by the Energy Improvement and Extension Act of 2008 and the American Recovery and Reinvestment Act of 2009 (ARRA).

In particular, the ARRA permits owners of renewable generation facilities the option of receiving a 30 percent ITC in lieu of the PTC or in many cases a cash grant (equal to 30 percent of the cost of the renewable energy facility) from the federal government in lieu of available tax credits. These laws also allow public utility property to qualify now for the ITC.

Finally, many electric utilities are entering the “green” market because it is simply good business. Increasingly, customers are looking for green energy alternatives from their utility to mitigate the carbon impact of their energy usage.

In addition, some investors and lenders are starting to take into account a utilities' "greenness" in making their investment and lending decisions.

The use of renewable energy also makes for good public relations with these and environmentally conscious constituencies, and can deflect criticism of traditional fossil-fueled generation.

## **Outsourcing — The Power Purchase Agreement Option?**

Once an electric utility has made the decision to include renewable resources in its portfolio, the question becomes how best to obtain them. One option is to purchase renewable energy from a third-party IPP under a power purchase agreement (PPA).

This is the option traditionally pursued by utilities looking to add renewable resources to their generation mix, and was the industry standard for buying qualifying facility power under the Public Utility Regulatory Policies Act of 1978.

For many utilities, especially those new to renewable energy, the PPA option may be the "safe bet" because it generally offers fewer financial risks than the self-build option discussed below.

Among its advantages, the PPA option minimizes the capital demands on traditional utilities. Although most traditional utilities currently enjoy better access to debt and capital markets than most renewable IPP developers, many utilities are already committed to other capital expenditure programs and/or are looking to conserve capital funds in order to improve their balance sheets.

Thus, for some capital constrained utilities, a PPA may be the only viable option.

Buying renewable energy through a PPA also minimizes development and construction risk for the utility. This may be particularly appealing to those utilities that divested their generation fleet in response to restructuring mandates, many of whom lack direct experience with renewable energy development and consider this function to be outside of their core business of energy delivery.

Accordingly, pursuit of and diligence regarding renewable PPAs may provide valuable experience for traditional utilities in renewable development, particularly if utility personnel work closely with renewable energy developers in developing the PPA and operational/ dispatch protocols for the facility.

The PPA option also leaves technology risk with the renewable developer. Given the speed of technological change in the renewable sector, utilities and their state commissions may be reluctant to take on actual or perceived technology risk.

Acquiring renewable energy through a PPA may also reduce some of the regulatory risk for the utility. Utilities purchasing renewable energy may be able to recover their costs

through a fuel adjustment clause (FAC), particularly if regulators are willing to deem renewable resources as the “first unit” in a traditional utility’s generation stack.

In contrast, a utility that chooses to build a renewable energy project may be subject to heightened regulatory scrutiny through a state’s certificate of public necessity and related processes, which may put the utility at risk for under-recovery of its development and construction expenditures.

## **The Self-Build Option**

Although the PPA option may be less risky for some utilities, for other utilities developing a renewable energy project may offer potential rewards that outweigh or mitigate the recovery risk associated with the self-build option.

Some utilities may find that the PPA option does not provide them with sufficient control over or certainty with regard to the operation and management of renewable resources.

In the current economy, many renewable developers are having difficulty attracting the necessary capital to complete their projects — even with executed PPAs in hand.

Given the exigencies of renewable mandates, traditional utilities (and perhaps even state commissions) may be unwilling to shift development risk to a special purposes IPP project company with limited exposure.

Thus, if a utility needs the renewable resource to comply with a state RPS or federal RES, and does not want to risk the vagaries of the market, the self-build option may be preferable.

Utility cost recovery for the self-build option may be more challenging than the PPA option, as a state commission can scrutinize — and exclude — a wider array of costs.

If approved, however, the self-build option allows the utility to add the renewable asset to its rate base, which provides an opportunity to earn a return on the invested capital.

This should be considerably more attractive than a FAC pass through of renewable energy costs under a PPA which provides no financial return on the utility’s investment.

In addition, if the state commission allows it, a utility may also enjoy an incentive return on equity for investing in a renewable project, or other rate-based incentives such as the recovery of construction work in progress costs through rates.

If a utility can tolerate the regulatory risk associated with building a renewable resource, there are also distinct advantages to the utility once the facility is built.

For one thing, the utility maintains operational control of the renewable resource and can integrate the resource into its system in a manner that maximizes the value of the asset and is complimentary to the utility's other generation.

A utility will be much less likely to achieve these objective under the PPA option where the IPP has little to no incentive to operate the renewable resource in a manner that effectuates a reduction in the overall cost of purchased and self-generated power by the utility.

This may be particularly problematic for utilities that operate under state-imposed least-cost operations requirements that may be difficult or impossible to meet if third-party IPPs control a renewable resource.

Ownership and operation of a renewable resource also creates certain tax advantages for utilities. As described above, certain federal tax benefits are now more favorable to utility ownership than in previous years.

Last year, for the first time, the 30 percent ITC for solar property became available with respect to property that is owned in the regulated business of an electric utility.

This ITC is now available for facilities placed in service through 2016, providing for the first-time a long enough window of certainty to develop larger utility-scale solar facilities and be assured of credit qualification.

Even with respect to the PTC for facilities like wind, biomass, geothermal and hydroelectric projects, the extension of the time to place these facilities in service through 2012 or 2013 provides a longer planning window than had previously been available.

And, for facilities placed in service between 2009 and 2012 (in the case of wind facilities) or 2013 (in the case of most other types of qualifying facilities), a utility can elect to claim an ITC in lieu of the PTC, meaning that the credit will be available in the year the facility is placed in service (or even earlier with respect to certain facilities with longer construction periods).

In many instances, the availability of the federal grants in lieu of tax credits means that the benefits of the ITC can be realized even where a utility does not have sufficient taxable income to efficiently utilize the available tax credits.

## **The Best of Both Worlds**

An option that may bring the best of both worlds is a joint venture arrangement between the renewable developer and the electric utility. Such an arrangement allows the parties to share risk and to allocate risk and responsibility to the party best equipped to handle it.

For example, the utility may have the experience necessary to navigate the regulatory issues, while the developer may be better equipped to handle site selection and to source critical equipment.

Also, unlike many renewable developers, most utilities and/or their parent companies will have better access to capital and debt markets for financing purposes. This is in addition to the financial support that the utility can bring to the venture as offtaker of some or all of the energy of the renewable project.

In addition, many utilities can utilize the tax attributes associated with a renewable project, thereby eliminating or reducing the need for tax equity.

A joint venture arrangement can also allow utilities to participate in larger projects which can achieve economies of scale that might not be possible if the utility had to shoulder the entire burden.

Finally, the involvement of a utility in the venture may also help with interconnection and transmission expansion issues, even if the renewable project is located in another utility's service territory.

A few utilities have already entered into joint venture arrangements with renewable developers. Dominion, for example, entered into a joint venture arrangement with BP to jointly develop, own and operate wind farms in Virginia.

More joint venture arrangements are likely to follow as utilities expand their renewable resource portfolios.

--By Todd R. Coles and Anne K. Dailey, Troutman Sanders LLP

*Todd Coles is a partner with Troutman Sanders in the firm's Washington, D.C., office and co-head of the firm's project development and finance practice group and renewable and alternative energy team. Anne Daily is an associate with the firm in the Washington office.*

*The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.*