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Community Choice Aggregators in California: Key Considerations for Financing CCA PPAs

Financing energy projects that have entered into PPAs with CCAs presents unique challenges for lenders and investors.

Key Points:

- In recent years, CCAs have begun supplying energy to a growing number of consumers in California.
- CCAs are entering into long-term PPAs with project developers to procure electricity.
- Lenders and other financial backers of energy projects with CCA PPAs will need to understand and address certain risks relating to CCA offtakers.

The growing number of community choice aggregators (CCAs) in California and the increasing proportion of the retail electricity sector served by these CCAs have given rise to discussions in the project developer and project finance communities regarding whether CCAs may be a new, and possibly significant, source of financeable power purchase agreements (PPAs) in California.

CCAs in California are governmental entities or programs formed by cities or counties that combine (*i.e.*, aggregate) the electricity demand of electricity users within their communities and procure electricity to serve that demand. Since California launched its first CCA in 2010,[1] the number of CCAs and the load served by CCAs has continued to grow. According to a CCA industry association and other industry sources, as of February 1, 2018, California had 11 operational CCAs.[2] A number of other California cities and counties are in various stages of exploring or implementing CCAs.[3]

This *Client Alert* provides an overview of CCAs and their role in California's retail energy market, and examines key considerations faced by lenders and other financial backers of energy generation projects that have entered into PPAs with CCAs. There is an ongoing policy debate regarding the costs and benefits of the establishment and growth of CCAs in California; however, discussion of this policy debate is beyond the scope of this *Client Alert*.

What Are CCAs?

CCAs in California

Historically, investor-owned utilities (IOUs) and publicly owned utilities (POUs) have been the primary suppliers of electricity to retail consumers in California. Assembly Bill No. 117 (AB 117), signed into law in

2002, authorized the creation of CCAs as alternative suppliers of electricity to retail consumers in areas served by an IOU. Under AB 117, governmental entities in these areas may form a CCA to combine the electric loads of residents, businesses, and municipal facilities in their jurisdiction and to procure electricity on a communitywide basis.[4]

A CCA is responsible for procuring electricity for retail customers by either generating electricity itself or by purchasing electricity in the wholesale markets. The incumbent IOU remains responsible for delivering electricity to the CCA's customers over the IOU's transmission and distribution systems, as well as for providing metering, billing, collection, and customer service services to the CCA's customers.[5] A CCA customer receives an electricity bill from the IOU that includes two categories of charges — electricity generation procurement charges owing to the CCA, and charges for electricity delivery and other items owing to the IOU.

A CCA may be formed as a program or enterprise of a single city or county. Alternatively, a group of cities or counties may jointly establish a CCA by forming a joint powers agency (JPA), which is a separate legal entity from the governments that form it.[6]

When a CCA is established, all constituents of the government(s) forming the CCA automatically are enrolled in the CCA program; however, each customer may opt out of the program at any time and continue receiving "bundled" electricity service (*i.e.*, retail electricity supply and delivery services from a single source) from the incumbent IOU.[7] Upon being enrolled in a CCA, customers may opt out of the CCA within 60 days or two billing cycles of the date of enrollment without being charged a fee.[8] Thereafter, a customer that opts out of the CCA will be charged a reentry fee, but that fee must be approved by the California Public Utilities Commission (CPUC) and reflect only the cost of reentry to IOU bundled service.[9]

Power Procurement by CCAs

In order to supply its customers with electricity, a CCA may generate electricity through generation projects owned by the CCA or may procure electricity from third-party wholesale suppliers. CCAs may enter into several different types of arrangements to purchase electricity at wholesale from third parties. One option, which may be particularly attractive to early-stage CCAs, is to enter into a full requirements supply contract, under which a single wholesale supplier agrees to provide all of the electricity required to serve the CCA's retail load. CCAs may also enter into PPAs or other supply arrangements of various durations with independent power projects or other wholesale suppliers of electricity. CCAs may also purchase energy in the wholesale spot markets. In addition, certain CCA customers may generate electricity through rooftop solar or other technologies, and they may enter into net-metering arrangements with the CCA.

As they become more mature, CCAs may seek to obtain a larger proportion of their electricity through long-term PPAs in order to ensure their ability to meet renewable energy procurement targets and satisfy regulatory requirements at stable costs over longer periods of time.[10] Several CCAs are seeking or are expected to seek long-term PPAs through competitive solicitations or bilateral negotiations with potential wholesale suppliers.[11]

Current Status of CCAs in California

As mentioned previously in this *Client Alert,* the number of CCAs and the load served by those CCAs in California has continued to grow since MCE Clean Energy — the state's first CCA — launched in 2010.[12] According to a CCA industry association and other industry sources, the 11 CCAs that were operational in California as of February 1, 2018 included Apple Valley Choice Energy, Clean Power Alliance of

Southern California, CleanPowerSF, Lancaster Choice Energy, MCE Clean Energy, Peninsula Clean Energy, Pico Rivera Innovative Municipal Energy, Pioneer Community Energy, Silicon Valley Clean Energy, Redwood Coast Energy Authority, and Sonoma Clean Power.[13] A number of other cities and counties are in various stages of exploring or implementing CCAs.[14]

In addition to new CCAs coming online, existing CCAs have grown by allowing more communities to join their programs or by enrolling customers in other areas within their territory. For example, MCE Clean Energy recently approved membership of nine additional communities and projected that this would result in an increase from 255,000 customers to 483,000 customers.[15] CleanPowerSF is in the process of expanding its enrollment to include customers in all of San Francisco and estimates that this will increase its customer base from 75,000 customers to 350,000 customers.[16]

According to an industry association, the nine CCAs that were operational in 2017 served a total of 1,261,000 customer accounts with an annual load of 15,139 GWh in 2017.[17] A 2017 report estimated that CCAs comprised 5% of the total electricity delivery market in California in 2017.[18]

While it is impossible to predict the future growth of CCAs with certainty, CCAs have predicted substantial growth in the next decade. For example, MCE Clean Energy projects that its annual load will increase from 5,052 GWh in 2018 to 6,288 GWh in 2027.[19] A 2017 CPUC staff white paper estimated that as much as 25% of the retail electric load in areas served by IOUs would be served by CCAs and other non-IOU sources in 2018, and the paper observed that this percentage is positioned to grow quickly in the following decade.[20]

What Are the Key Considerations for Financing Projects With CCA PPAs?

A lender or other provider of financing to a project that has entered into a PPA with a CCA will need to consider certain issues that arise when a CCA is a project's offtaker. Given the relatively recent emergence of CCAs as a source of PPAs in California, the market is still in the early stages of exploring and developing approaches to address these issues and to mitigate the risks they present.

Creditworthiness of CCAs

Perhaps the most significant issue faced by lenders and other providers of financing to a project with a CCA offtaker is that CCAs typically lack a credit rating and may be unable to provide credit support for their obligations under the PPA. This is because most CCAs were formed relatively recently and are still becoming established from a financial perspective. They also generally do not have access to lines of credit that would allow them to provide material credit support for their obligations under PPAs.

CCAs that are formed as JPAs are separate legal entities from the governments that form them. As a result, the forming governments are not responsible for obligations of the CCA. CCAs that are formed as agencies or enterprises of a single government typically are structured such that the government is not responsible for the payment obligations of the CCA.[21] Therefore, in either case, the obligations of a CCA offtaker under a PPA typically are not backed by the credit of the cities or counties that formed the CCA.

As time passes and CCAs mature, the creditworthiness of certain CCAs may increase. For instance, MCE Clean Energy, the oldest of the California CCAs, has stated that it is currently working to obtain a credit rating, and has obtained credit facilities from a commercial bank that could be used as credit support for MCE Clean Energy's forward purchases of energy.[22]

CCAs and lenders have begun to develop the following approaches to mitigate the risks presented by CCAs' lack of creditworthiness:

- **Credit support provided by establishing government.** A government that forms a CCA may be willing to provide credit support for the CCA's obligations under the CCA's PPAs, particularly during the initial period of the CCA's development. One method for doing this is for the government to arrange for a letter of credit to be issued under a credit facility entered into by a more creditworthy entity within the government and delivered as credit support for the CCA's obligations under a PPA.[23] The CCA may agree to reimburse the other governmental entity for the costs associated with the issuance of the letter of credit and any liabilities relating to drawings on the letter of credit. In this manner, the government that formed the CCA, rather than the project supplying power under the PPA, bears the credit risk of the CCA.

- **Lockbox structures.** CCAs, particularly those in the earlier stages of development, may implement lockbox structures under which revenues from their retail customers are deposited directly into a blocked account and are distributed periodically pursuant to a "waterfall" (*i.e.*, a pre-defined set of priorities).[24] Projects supplying power to the CCA under PPAs may be entitled to priority payment at the top of this waterfall. This ensures the projects that they will receive amounts owed under their PPAs before the CCA's revenues are applied to other uses.

- **Internal ratings and ratings triggers.** If a CCA lacks a credit rating, a provider of financing may develop an internal rating of the CCA. The financing documents for a project with a CCA offtaker may include protective provisions that are tied to the CCA offtaker's internal rating (or actual rating, if available). For instance, a drop in the rating below a specified level may trigger a prohibition under the financing documents on the project making distributions to the equity owners (in order to increase the amount of cash that the project holds). Such a drop may also trigger a mandatory prepayment or cash sweep (under which excess cash flow is applied to pay down the debt) under the financing documents to "right-size" the outstanding amount of the debt to reflect the decreased creditworthiness of the CCA offtaker. A failure to maintain an agreed rating could also trigger an event of default, allowing the lenders to exercise remedies against the project.

  The thresholds for triggering these different consequences could be set at different levels, such that an initial decrease in the rating would trigger a prohibition on distributions and a further decrease would trigger a cash sweep, with an event of default only being triggered by yet another decrease. This type of arrangement could provide the project with time to address the credit issues with the CCA (for instance, by requiring credit support to be provided under the PPA) or to seek alternative offtake arrangements before a default is triggered under the project's financing arrangements.

- **Diversification of offtakers.** Another strategy to help mitigate risks relating to the credit of a CCA offtaker may be to finance a project with a CCA offtaker as part of a portfolio of projects, including other projects with more creditworthy offtakers. Through such an approach, the revenues under the PPA with the CCA would represent a smaller proportion of the overall revenue stream being financed and, in the event that payments under the PPA with the CCA were interrupted, revenues from the other projects' PPAs could ensure that there were still sufficient revenues to service the debt. A similar approach could also be implemented for a single project by entering into a PPA with a CCA for a portion of the project's capacity, and then entering into a PPA with a more creditworthy offtaker for the remainder of the project's capacity.

Opt-out Risk

As discussed above, customers that have been enrolled in a CCA program may opt out of the CCA and return to receiving bundled service from their IOU. If they do so more than 60 days or two billing cycles

after their date of enrollment, they will be charged a reentry fee; however, that fee must be approved by the CPUC and reflect only the cost of reentry.[25]

While the data remains limited, CCAs have reported that their customer participation rates (*i.e.*, the percentage of eligible CCA customers who do not opt out) have been high thus far. For example, recent participation rates for a few CCAs are as follows: more than 80% for MCE Clean Energy,[26] approximately 98% for Peninsula Clean Energy,[27] approximately 98% for Silicon Valley Clean Energy,[28] and approximately 97% for CleanPowerSF.[29] MCE Clean Energy has reported that the majority of customer opt-outs occur within a 120-day period commencing 60 days prior to the scheduled enrollment and continuing for 60 days thereafter, and that the customer base stabilizes after the initial enrollment period.[30]

The track record of CCAs in California remains limited, however, and has occurred in an environment in which power procurement costs (particularly for renewable energy) have generally been declining.[31] As the CCAs have procured all of their power relatively recently and may rely on a greater proportion of short-term power procurement arrangements, this trend of declining costs may have helped the CCAs keep their electricity prices below or close to those of the IOUs.

If CCA delivered electricity prices become materially higher than those of the IOUs, large numbers of CCA customers may decide to opt out and return to IOU bundled service. Given the limits on the reentry fee that may be charged to opting-out customers, the reentry fee is unlikely to act as a significant barrier to customers returning to the IOUs in such a scenario.

Other events also could impact CCA opt-out rates. For example, if one of the CCAs failed to meet its obligations and was dissolved, customers might lose confidence in other CCAs — causing opt-out rates to increase. The same domino effect could also occur if CCAs in California were to misrepresent important information to customers, such as the benefits that they provide or the likely cost of their delivered energy compared to incumbent utilities. (Other states with retail electricity competition have experienced this issue with certain competitive retail energy service providers.)

The ability of CCA customers to opt out at any time and return to receiving bundled electricity service from their local IOU presents a risk to projects with CCA offtakers. If the opt-out rate increases, then the CCA will be forced to spread its procurement and other costs (including start-up costs and working capital, as well as longer-term financial liabilities arising out of investments in power generation facilities, long-term PPAs, and financing) across a smaller customer base, and may need to increase its retail electricity rates. This increase in rates could lead to further departures of customers and the need for further rate increases. Eventually, the CCA may be unable to collect sufficient revenues to satisfy its payment obligations, including under PPAs.

The financing documents for a project with a CCA PPA may include certain lender protections that are triggered if the CCA customer participation rate falls below a pre-agreed level (similar to the protections tied to credit ratings described above). For example, the financing documents may include a prohibition on distributions or a mandatory prepayment or cash sweep that is triggered by a decrease in the customer participation rate. A failure to maintain an agreed customer participation rate could also trigger an event of default under the financing documents. As described above, the thresholds for these different consequents could be set at different levels to provide the project with time to seek to address the issue with the CCA or the lenders.

Power Charge Indifference Adjustment

What Is a PCIA?

A significant issue that has arisen in connection with the establishment of CCAs is how to address long-term electricity procurement costs that have been or will be incurred by IOUs under long-term supply arrangements entered into by the IOUs on behalf of customers who subsequently depart to CCAs.[32] AB 117 and related laws require CCA customers to pay for procurement costs that were incurred by IOUs on their behalf in order to ensure that remaining bundled service customers of the IOUs do not experience any procurement cost increases due to the formation of CCAs and the departure of customers to CCAs.[33] In other words, California law attempts to ensure that IOU customers who remain with the IOUs are "indifferent" to the formation and growth of CCAs. The primary mechanism for implementing this is the power charge indifference adjustment (PCIA), which is a non-bypassable charge assessed on CCA customers. The PCIA aims to compensate IOUs for a proportional share of the power procurement costs that the IOUs are subject to under long-term contracts at prices that exceed current market prices, based on load projections that included retail customers who have switched to CCA service.[34]

PCIAs are set annually for each IOU through a CPUC proceeding and are determined based on the difference between calculations of the cost of the IOU's power procurement portfolio and the market value of that portfolio.[35] The amount varies every year based on changes in market prices of power and gas, as well as other factors such as refunds received by IOUs under power procurement contracts.[36] The PCIA paid by a particular CCA customer also depends on the year in which the customer switched to CCA service (because a customer is only required to pay the PCIA with respect to power procured prior to the customer switching away from IOU bundled service).[37]

PCIAs have been the subject of much debate, with various interested parties disagreeing on whether the current method of calculating the PCIA accurately reflects costs incurred by the IOUs on behalf of CCA customers.[38] The IOUs have expressed concern that under the PCIA approach, customers who depart for CCA service are not being required to pay their full share of long-term procurement costs incurred to meet their electricity needs, resulting in costs being shifted to customers who continue to receive bundled service from the IOUs.[39] The variability of the amount of the PCIA and the inability to predict future PCIA levels over time have been of concern to the CCAs.[40] In June 2017, the CPUC commenced a rulemaking proceeding to review, revise, and consider alternatives to the PCIA, which remains ongoing.[41]

PCIAs and Opt-out Risk

Changes over time to the PCIA may exacerbate the opt-out risk faced by CCAs. As discussed above, PCIA amounts are reset each year. PCIAs have fluctuated significantly in certain years. For example, Pacific Gas & Electric Company's PCIA for consumers who departed to CCAs in 2012 decreased from 2012 to 2013, then increased by 86.7% for 2014, 7.1% for 2015, 94.6% for 2016, and 27.4% for 2017.[42]

The PCIA may represent a significant portion of a CCA customer's electricity bill. One report estimated that the PCIA represented approximately 5% of MCE Clean Energy's customers' total electricity bills in 2015 and up to 10% of their total bills in 2016.[43] If the PCIA increases to a level in which it causes total electricity bills of CCA customers to exceed those of bundled utility customers by a meaningful amount, then a greater number of customers might opt out of CCA service, leading to the issues discussed above under "Opt-out Risk."

One strategy that CCAs may pursue to address this risk is establishing rate stabilization reserves.[44] CCAs could build these reserves over time by diverting a portion of customer revenues to them. In the event of a significant increase in the PCIA, the reserve could be deployed to reduce the CCA's electricity rate and thereby maintain the customers' overall bill at a level that was not expected to lead to an increase in the opt-out rate, at least for some period of time.

Lenders and others considering extending financing to projects with CCA PPAs should closely follow the ongoing CPUC proceeding that is examining the PCIA. If that proceeding results in changes to the method of calculating the PCIA that increase the amounts charged to CCA customers, the resulting increases in the total electricity bills of CCA customers could also increase opt-out rates.

Other Financeability Issues in PPAs

Due to the number of CCAs and their relatively limited history, the legal terms in PPA forms utilized by CCAs may vary greatly. In addition, these PPAs may have a limited track record of being financed on a non-recourse basis. As such, project developers that intend to seek non-recourse financing and their lenders should carefully review the terms of a PPA being entered into with a CCA for items that may cause issues for financing. For instance, a CCA's form of PPA may include a purchase option that allows the CCA to acquire the project from the developer for fair market value after a period of time has passed. Such a term typically would not be financeable on a non-recourse basis unless it included a floor on the purchase price to ensure the availability of sufficient proceeds from an exercise of the purchase option to repay the financing.

Conclusion

If CCAs continue to grow and become a significant source of power procurement in California, lenders and other providers of financing to energy projects with CCA PPAs will need to proceed with caution. In particular, these entities will need to understand and continue to develop strategies to mitigate the risks that arise when CCAs serve as offtakers.

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Endnotes

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