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RECs In Secured Transactions Under Calif. Law

Law360, New York (April 01, 2009) -- A majority of states have established renewable energy credit (REC) markets as a practical means to track and achieve compliance with renewable portfolio standard (RPS) policies.

Each state sets its own parameters for the use of RECs, but the principle is generally the same: utilities may purchase RECs — certificates or other instruments representing the “attributes” of an amount of renewable energy generated from a qualifying source — from generators and apply them toward the minimum renewable energy requirement mandated in the applicable state RPS.

Although RECs may be “bundled” and transferred together with energy, they are more frequently considered tradable certificates or instruments representing the renewable (or “green”) attributes which have been “unbundled” or severed from the corresponding electricity.

In other words, while a specific quantity of electricity from a renewable source is sold to one party, the REC representing all of the environmental and other attributes associated with such electricity may be sold to another party.

For example, a utility unable to purchase actual, renewable energy due to geographic location or transmission constraints might achieve compliance with its state’s RPS through the purchase of unbundled and tradable RECs.

RECs may also be used by utilities or other regulated entities to supplement purchases of renewable energy or offset the acquisition of electricity from conventional sources.

Given that tradable REC sales have the potential to create a valuable revenue stream for a generator, a lender providing debt financing to a renewable project might naturally expect that it has secured rights in any RECs produced by that project.

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However, the method for granting and perfecting a security interest in a REC is somewhat unclear, as no existing statute or case law in any jurisdiction has squarely addressed the type of asset or collateral represented by a REC.

The classification of RECs for purposes of secured transactions appears to be an issue of first impression in all jurisdictions presently allowing their use, and it is likely that the treatment of RECs under California law will also become a valid consideration in the near future.

Following the example of many states with RPS directives, California is in the process of working toward the implementation of a REC market.

On March 26, 2009, an administrative law judge of the California Public Utilities Commission (CPUC) issued a revised proposed decision that, if adopted, will allow a market for unbundled and tradable RECs as a method to achieve compliance with the state's RPS requiring 20 percent of electricity from renewable generation by 2010.[1]

In an earlier August 2008 decision, the CPUC officially defined RECs for compliance with the California RPS as "a certificate of proof, issued through the Western Renewable Generation Information System, that one megawatt-hour of electricity was generated by an RPS-eligible renewable energy resource and delivered for consumption by California end-use retail customers."[2]

The question then arises as to what, if anything, this makes a REC in the context of a lender's collateral package.

While the answer remains unclear since RECs are yet to be labeled as any particular kind of property in California or any other jurisdiction, the most compelling arguments suggest that RECs fall within one of two Uniform Commercial Code (UCC) personal property categories: "goods" or "general intangibles."

If California determines that RECs should be included in either of these categories under the California Commercial Code (the UCC as adopted in the State of California),[3] a lender's security interest will be protected through a customary security agreement and UCC financing statement.[4]

In looking first at whether RECs are "goods," a review of case law governing the classification of electricity provides a helpful starting point since RECs correlate with and would not exist without the production of physical, renewable energy.

Although jurisdictions are split on the issue, California clearly recognizes electricity as a movable thing and a "good" under the UCC.[5] In fact, for over a century, California courts have generally considered electricity to be a thing which may be owned, bought and sold.[6]

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Given that RECs are so closely tied to a clear-cut good under California law, consistency would suggest that they would also be considered a “good.”[7]

For instance, it would seem logical that RECs linked to electricity from a renewable source are also goods when bundled and sold with that electricity.

The character of a REC remains the same whether bundled or unbundled; thus, under this line of reasoning, separately tradable RECs would likely be deemed goods as well.

REC certificates are also physical, movable and identifiable instruments which can be bought and sold.[8] These key traits would seem to plainly satisfy the definition of a “good” under the California Commercial Code.[9]

As discussed previously, a number of jurisdictions disagree with the view in California that electricity is a “good” under the UCC.

Under New York law, for example, electricity is viewed as a service because it is something that the utility moves, distributes and provides for consumer use rather than a manufactured product.[10]

Maryland, Ohio and Indiana courts hold that electricity is not a good under the UCC until it is actually metered and delivered to individual consumers because, while in a utility’s distribution system, electricity is not “marketable” or capable of purchase.[11]

The analysis of these courts would be difficult to apply to RECs. Unlike electricity under the New York view, RECs are an individual product produced by a renewable generator which may be subsequently bought and sold. Purchasers do not pay for the use of RECs — instead, they buy and own them.

Attempting to apply the Maryland, Ohio and Indiana reasoning to RECs is also somewhat illogical, because REC certificates exist in a marketable state as soon as they are created.

Under the CPUC draft decision, once generated, REC certificates are tracked in the Western Renewable Generation Information System (WREGIS)[12] and are ready for purchase and sale.[13]

The ultimate metering of electricity for consumer use does not change that the REC was a purchasable asset from the time of its generation. No subsequent event need occur for a REC to become more “tradable.”

Accordingly, unbundled RECs may be considered “goods” even in jurisdictions that would not recognize the related electricity as a good.

Although there are strong arguments for classifying RECs as “goods,” the characteristics of a REC also provide significant support for including these credits

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within the realm of "general intangible" personal property under the UCC, which, for example, includes various types of intellectual property, such as software.[14]

In its August 2008 decision, the CPUC further described RECs as including:

"all renewable and environmental attributes associated with the production of electricity from the eligible renewable energy resource, including any avoided emission pollutants to the air, soil or water, any avoided emissions of ... greenhouse gases that have been determined ... to contribute to the actual or potential threat of global climate change, and the reporting rights to these avoided emissions ..."[15]

Given that RECs are commodities representing the nonphysical attributes of renewable energy,[16] such as avoided emissions, they could very well be considered intangible property.

In fact, California may be more inclined to view RECs as a collection of intangible rights associated with electricity (or true "credits" lacking any concrete aspects) rather than tangible goods.[17]

If California were to consider RECs to be a "general intangible," then, like an ordinary good, a lender's security interest would be perfected by the filing of a UCC financing statement.[18]

California courts have not analyzed any assets under the intangible property category that are relevant enough to be likened to (or contrasted from) RECs, but other jurisdictions have.

Income tax credits, which are analogous to RECs in that they have intangible characteristics and provide an offset benefit to the owner, have been examined in Illinois and Tennessee.

The Illinois court declared that income tax credits are not intangible personal property subject to a security interest under Article 9 of the Illinois Commercial Code[19] because the credits have "no independent value in and of themselves" and are "incidental benefits" that cannot be separately transferred or sold.[20]

In reaching this conclusion, the court relied on a United States Supreme Court decision holding that tax credits or benefits were not a distinct asset or property because they were not "freely transferable from one person to another if wholly separated from the property to which they relate."[21]

Similar to Illinois, Tennessee does not consider tax credits to be an intangible property right because they are "irrevocably attached to" and "not severable from" the property that gives rise to the credits due to the conditions governing use of such property.[22]

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Unlike tax credits, unbundled and tradable RECs are undoubtedly severable from renewable energy and freely transferable from and after the point of their creation.

As such, any ongoing conditions affecting electricity would have no impact on corresponding RECs. The draft CPUC decision aims to promote a self-sufficient, liquid market for RECs which may exist separate from actual, renewable energy.[23]

RECs also represent the non-power characteristics of renewable energy[24] and may be purchased at a price determined independent of electricity sales.

If detachability and separateness are determining factors, RECs would likely qualify as credits within the arena of general intangible personal property under the UCC.

The limited case law addressing REC ownership issues also indicates that RECs are purchasable, personal property. The United States Court of Appeals for the Second Circuit has referred to RECs as “inventions of state property law.”[25]

A New Jersey court has also described RECs as something that “may be bought and sold in a public market.”[26] These descriptions — and the very fact that courts consider RECs capable of ownership — suggest that RECs would be personal property under the UCC.

The categorization of RECs as personal property lends further support to the arguments that RECs would be “general intangibles” or “goods” under the UCC.

If the CPUC authorizes a market for unbundled and tradable RECs, California courts may be forced to review issues regarding the key features of or secured rights in these credits.

Until these issues are addressed in detail in any jurisdiction, it is reasonable for lenders to expect that RECs would be treated as an ordinary “good” or a “general intangible” under the California Commercial Code.[27]

Again, under either classification, a lender will be protected through a proper security agreement and financing statement meeting the applicable UCC requirements.

RECs will likely receive more and more attention as many states move closer to their deadlines for RPS compliance.

As RECs gain even greater relevance, lenders providing financing to renewable energy sector projects may encounter issues causing them to inquire exactly how these credits are built into their collateral.

Now that a majority of states with RPS policies permit unbundled REC trading, the threshold question of just what these credits are within the framework of a secured transaction is ripe for examination.

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[1] Proposed Decision Authorizing Use of Renewable Energy Credits for Compliance with the California Renewables Portfolio Standard, Rulemaking 06-02-012 (Cal. P.U.C. mailed March 26, 2009), at docs.cpuc.ca.gov/efile/PD/99016.pdf [hereinafter Proposed REC Decision]. Under the revised proposed decision, California's three largest investor-owned utilities (Pacific Gas and Electric Company, San Diego Gas & Electric Company and Southern California Edison) may use tradable RECs for no more than 5 percent of their RPS annual procurement targets for a period of at least two years. Id. At 71.

[2] Decision on Definition and Attributes of Renewable Energy Credits for Compliance with the California Renewables Portfolio Standard, Decision 08-08-028, Rulemaking 06-02-012, 2008 WL 3925879, at *16 (Cal. P.U.C. Aug. 21, 2008), available at docs.cpuc.ca.gov/PUBLISHED/FINAL_DECISION/86954.htm [hereinafter REC Definition Decision].

For purposes of California RPS compliance, the "delivery" requirement is satisfied if a REC either (i) directly corresponds with electricity delivered into California or (ii) is "matched" with other electricity delivered into California. See id. at *16-17 ("The electricity underlying a REC must be delivered for consumption by California end-use retail customers, in accordance with the definition of delivery implemented by the California Energy Commission (CEC)"); see also Proposed REC Decision, supra note 1, at 71 (noting that the CEC allows a RPS-obligated Load Serving Entity to buy RECs and energy from an out-of-state RPS-eligible generation facility, sell the energy back to such generation facility, and then "match" the RECs with energy delivered into California under a pre-existing power purchase agreement or at prices indexed to energy or fuel prices.).

[3] Division 9 of the California Commercial Code (the state's enacted version of UCC Article 9) defines "goods" as "all things that are movable when a security interest attaches." Cal. Com. Code § 9102(a)(44) (West 2007).

[4] See Cal. Com. Code §§ 9203(b), 9310(a) (West 2007).

[5] See, e.g., Puget Sound Energy Inc. v. Pac. Gas & Elec. Co., 271 B.R. 626, 640 (N.D. Cal. 2002).

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[6] See Terrace Water Co. v. San Antonio Light & Power Co., 82 P. 562, 563 (Cal. Dist. Ct. App. 1905) ("[W]hen one gathers from the elements an energy or force which he may store, transmit, and utilize, he thereby appropriates to his own use that thing, whatever it may be, and it is a subject of ownership, of barter and sale, so long as it is in possession."); see also Baldwin-Lima-Hamilton Corp. v. Super. Ct., 25 Cal. Rptr. 798, 809 (Dist. Ct. App. 1962) ("Electricity is a commodity which, like other goods, can be manufactured, transported and sold").

[7] Other researchers have recommended that the sale of RECs be considered a sale of goods under Article 2 of the UCC to maintain consistency with the treatment of electricity under California law. See Bruce Elder, Renewable Energy Credits (RECs) in California 23 (2007), available at www.sandiego.edu/epic/publications/documents/070625_RECs_SB107_FINAL_000.pdf.

[8] It is important to note that, although RECs may be bought and sold, they are no longer tradable once retired (or counted) for California RPS compliance. See Proposed REC Decision, supra note 1, at 54, Appendix A, Appendix B; see also Cal. Pub. Util. Code §§ 399.16(a)(1) — (2). Accordingly, in order to avoid any double-counting, a utility would only be able to re-sell a surplus REC so long as it had not yet been retired.

[9] Similar to the definition of "goods" in Division 9, Division 2 of the California Commercial Code (the state's enacted version of UCC Article 2) defines "goods" as "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale." Cal. Com. Code § 2105(1) (West 2007). The cases cited herein which have analyzed whether electricity is a "good" did so under UCC Article 2.

[10] See Bowen v. Niagra Mohawk Power Corp., 590 N.Y.S.2d 628, 631-32 (App. Div. 1992).

[11] See Singer Co., Link Simulation Sys. Div. v. Balt. Gas & Elec. Co., 558 A.2d 419, 424 (Md. Ct. Spec. App.) ("[R]aw high voltage electricity contained in a utility company's distribution system, because it has not yet been converted into a useable state of lower voltage by passing through a meter ... is not the refined product that the customer intends to buy."); see also Cincinnati Gas & Elec. Co. v. Goebel, 28 Ohio Misc. 2d 4, 5 (Hamilton County Mun. Ct. 1986) (holding that electricity is a good under the UCC when no longer in "its raw state" and in "metered amounts passing through utility-owned conduits and into the homes of consumers.").

Although Indiana considers electricity to be a "good" under the UCC, a distinction is made between electricity in a utility's transmission wire and electricity having passed through a meter. See Helvey v. Wabash County REMC, 278 N.E.2d 608, 610 (Ind. Ct. App. 1972) (holding that electricity is a good under the UCC); see also Hedges v. Pub. Serv. Co. of Indiana, 396 N.E.2d 933, 936 (clarifying that electricity in a transmission wire is not a "good" because it is not yet intended to be bought and sold).

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[12] Visit www.wregis.org for more information about this renewable energy tracking system.

[13] See Proposed REC Decision, supra note 1, at 19, 45, 66, 69.

[14] The California Commercial Code defines a “general intangible” as “any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction.” Cal. Com. Code § 9102(a)(42) (West 2007).

[15] REC Definition Decision, supra note 2, at *16.

[16] See Wheelabrator Lisbon Inc., 531 F.3d at 186.

[17] In addition, under the UCC “predominant purpose” test, bundled RECs may be considered goods when joined to and transferred with physical electrons, whereas unbundled RECs may fail to possess any tangible characteristics when sold separate from electricity.

[18] Cal. Com. Code § 9310(a) (West 2007).

[19] Illinois’ enacted version of the UCC.

[20] See Chi. v. Mich. Beach Hous. Coop., 609 N.E.2d 877, 886 (Ill. App. Ct. 1993).

[21] Randall v. Loftsgaarden, 478 U.S. 647, 656-57 (1986).

[22] See Spring Hill, L.P. v. Tenn. State Bd. of Equalization, 2003 WL 23099679, at *15 (Tenn. Ct. App. 2003) (holding that tax credits were not intangible property right because they were attached to and couldn’t exist without real property subject to long-term conditions).

[23] Proposed REC Decision, supra note 1, at 2, 65.

[24] The Environmental Protection Agency describes RECs as “the property rights to the environmental, social, and other nonpower qualities of renewable electricity generation. A REC, and its associated attributes and benefits, can be sold separately from the underlying physical electricity associated with a renewable-based generation source.” See www.epa.gov/greenpower/gpmarket/rec.htm.

[25] Wheelabrator Lisbon Inc. v. Conn. Dept. of Pub. Util. Control, 531 F.3d 183, 186 (2d Cir. 2008).

[26] In re the Ownership of Renewable Energy Certificates (“RECs”) Under the Elec. Disc. & Energy Competition Act, 913 A.2d 825, 827 (N.J. Super. Ct. App. Div. 2007).

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[27] While there is some reason to think that RECs could be included in other categories of UCC collateral, the associations with these categories are strained. Since a REC is a "certificate of proof" representing ownership of the credit, one could argue that RECs are "documents of title" under the UCC, which includes "any ... document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold, and dispose of the document and the goods it covers." Cal. Com. Code § 1201(b)(16) (West 2007).

However, a document of title must be "issued by or addressed to a bailee and purport to cover goods in the bailee's possession," and WREGIS, as a tracking system, would not likely satisfy this requirement. See id. The California Commercial Code "instrument" definition also does not appear to apply to RECs because they do not represent a right to payment. See id. at § 9102(a)(47).

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