



Strategies to Execute a Power Purchase Agreement Amid the Uncertainties of the COGATI Reforms

Summary

To correct an energy pricing scheme that does not take into account key incentives, the Australian government announced that it would introduce material regulatory changes to its energy pricing, known as the Coordination of Generation and Transmission Investment (“COGATI”) reforms. However, the government scheduled those changes years in the future and did not finalize the specifics prior to the announcement, which has created uncertainty in the Australian energy market that is undermining renewable energy investment in Australia. This discussion addresses the regulatory shift as well as strategies that parties negotiating a power purchase agreement (“PPA”) should consider during this mercurial moment in Australian energy regulation, including utilizing a change in law provision, benefit sharing, downside mitigation, and expert assistance.

The Reforms as Initially Proposed Created Instability

The current electric energy regulatory pricing regime in Australia, in the view of the Australian Energy Market Commission (“AEMC”), does not sufficiently incentivize electric energy generators to minimize the cost of power for consumers because the current price of energy does not adequately account for factors that impact the value of electricity, such as accounting for real-time localized transmission loss and congestion. Under the current regime, generators are paid a regional reference price (“RRP”) multiplied by a marginal loss factor (“MLF”) – typically having a value between zero and one (meaning the generation is expected to increase transmission losses) but occasionally having a value more than one (meaning the generation is expected to decrease transmission losses). The MLF for a generator’s location is assigned annually by regulators to account for transmission losses within a generator’s region. From the perspective of a generator, the existing regime is relatively stable in that it is only updated annually but, from AEMC’s perspective, it is inaccurate, since a once-a-year adjustment cannot account for real-time transmission and congestion factors. To address the issue, the AEMC proposed a new regime where generators will be paid a locational marginal price (“LMP”) that reflects real-time, localized pricing factors. Replacing a stable and predictable region-wide price (i.e. the RRP) and a relatively predictable, annually-determined demand and transmission price adjustment (i.e. the MLF) with more volatile dynamic real-time pricing (i.e. the LMP) faced near unanimous resistance from the renewable energy industry. In response, the AEMC also proposed fixed transmission rights (“FTRs”), a financial instrument that would pay generators the positive difference, if any, between the RRP and the LMP, thereby providing generators with the



option to purchase an instrument that would provide price stability. In the face of substantial opposition, the AEMC delayed promulgating reforms, meaning that generators are left with knowing that significant reforms are probably imminent but are left without knowing what exactly those reforms will entail.

With very limited exceptions, a PPA or multiple PPAs are an essential component of every renewable energy project because they provide future financial security that helps energy facility developers (“Developers”) secure financing. For a buyer of renewable energy (“Buyer”), one difficulty of executing a PPA is the difficulty in committing to purchase power for ten or more years, especially when regulatory changes affect a critical component of a PPA, like the wholesale price of power (“Spot Price”). Unfortunately for Developers and Buyers in Australia, the COGATI reforms proposed by the AEMC would materially affect the Spot Price, creating pricing uncertainty and therefore making investment less attractive.

COGATI May Deter Market Participants, but that Need Not be the Case

When faced with significant regulatory changes, the Developer and Buyer involved in a PPA negotiation can promote stability by taking proactive steps to prevent the COGATI reforms from materially changing the economic and risk position of the pre-COGATI deal. Accordingly, parties must evaluate how to preserve the economic and risk baseline when the RRP and the MLF, two critical components of the Spot Price and thus two of the most critical components of any current Australian PPA, will be replaced with a to-be-determined replacement regime.

Change in Law

The parties could rely on a standard change of law section of a PPA that would require the parties to amend the PPA to preserve to the greatest extent possible the operation of the PPA sections impacted by the change in law. In a typical PPA, “Change in Law” will be broadly defined, and the PPA will set forth that a change in law that materially impacts the transaction will be subject to good faith efforts to mitigate the effects, possibly with some guardrails defined to pre-allocate financial risk. However, external forces, such as a potential financing party, may require a change as significant as COGATI to be addressed specifically to eliminate any negotiating uncertainty that could arise from requiring renegotiations following a change in law like COGATI.

If COGATI must be specifically addressed, parties must first decide what would trigger a COGATI provision. The parties could consider identifying triggers that change the risk allocation of the parties’ original deal, so that the provision is only invoked if COGATI redistributes risk, rather than using simply the enactment of COGATI as a trigger. To promote forward-looking stability, Parties must also identify parameters for the substance



of a PPA amendment that will be in response to a reform that the parties know is forthcoming but have little knowledge of its actual forthcoming substance, including caps and collars for benefit-sharing and downside mitigation with respect to the Spot Price, a well-defined transmission and congestion risk allocation baseline that must be maintained, and caps and collars with respect to additional costs that may arise following COGATI.

Benefit-Sharing and Downside Mitigation

By replacing the RRP and the MLF with the LMP, Spot Prices could increase or decrease. Parties negotiating a PPA could consider sharing in the potential upside from COGATI and to discuss how to mitigate any potential downside that may result. Since parties will always have different risk appetites, parties must consider such upside and downside on a case-by-case basis to align with each party's risk preferences to maximally preserve pre-COGATI risk and proactively allocate any potential post-COGATI upside and downside. Regarding the Spot Price downside possibility, parties should evaluate requiring purchasing FTRs to stabilize pricing and should determine who will be required to pay for FTRs and should carefully consider how to define the Spot Price. There are a range of options for parties to consider, including defining the Spot Price as the best approximation of the RRP that exists following COGATI, the price obtained by purchasing FTRs, or even the price that, in an expert's judgment, best approximates the RRP obtained prior to COGATI. By defining Spot Price precisely, parties can ensure that the spread between the Spot Price and the PPA fixed price that they negotiated for at the outset will be preserved after COGATI is implemented.

Expert Assistance

Lastly, parties should consider deferring to an expert to determine how the PPA will be amended in response to COGATI. Deferring to an expert acknowledges that parties can only be so prescriptive in the face of known unknowns and should be drafted with strict parameters regarding risk allocation and economic position that must be utilized by the expert. Parties could also consider including a risk and economic position baseline in the PPA to ensure that the baseline is maintained by the expert's proposed amendments. Such a baseline should include establishing who bears each of transmission risk and congestion risk, identifying what pricing the parties intend to preserve (i.e. the Developer's expected profit, the Buyer's expected payment obligations, the expected spread between the Spot Price and the fixed price, etc.) and establishing if and how many FTRs must be purchased and which party must pay for the FTRs.